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*In This Issue:*

**Officials Balance Oil  
Production and Tax  
Revenues**

**Update on the Licensing  
Regime for Subsoil Use in  
Ukraine**

**First Russian LNG Plant  
Headlines Shelf  
Developments**

**Licensing Prospects**

**Russia and China Reach Oil  
Export Agreement**

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## Table of Contents

### Government

#### 100 Update on the Licensing Regime for Subsoil Use in Ukraine

By Dr. Irina Paliashvili, President and Senior Counsel, Tamara Lukanina, Senior Counsel RULG - Ukrainian Legal Group, P.A. Kiev and Washington, D.C.

Developments in regulations governing Ukrainian subsoil use during 2008 indicate the improvement of the oil and gas sector will be slow in coming. Little progress ensued, with the oil and gas sector in 2009 again dependent upon the good will and competence of the Ukrainian cabinet.

### Projects

#### 13 Developments in the Main Russian Oil and Gas Regions

By Sergei Glazkov

The overall situation in Russian oil and gas production depends upon the dynamics in the main extraction regions - the Khanty-Mansi autonomous region (KMAR, accounting for 57 percent of all oil production) and the Yamal-Nenets autonomous region (YNAR, 87 percent of all gas production). In 2008, extraction of gas in YNAR rose 1 percent year-on-year, while KMAR oil production fell 0.3 percent. In 2009, expectations are for a more pronounced decline in both gas and oil production. Special concerns emerge for small production companies. However, a few of the majors are optimistic. Rosneft is planning not to lower but to raise extraction in 2009, while TNK-BP (Russia/UK) has officially opened the Urna and Ust-Tegus fields in the Uvat area of the Tyumen region.

#### 19 First Russian LNG Plant Headlines Shelf Developments

By Victoria Nezhina

In February, the first Russian liquefied natural gas (LNG) plant opened, located within the framework of the Sakhalin-2 project. Plant capacity is 9.6 million tons a year. KNOC wants to move on the West Kamchatka shelf project with

### Government

#### 5 Officials Balance Oil Production and Tax Revenues

By Inna Gaiduk

Oil and gas companies were optimistic in advance of a meeting at Kirishi at which government heads had promised to discuss the situation in the sector and state support. Despite pledging preferences to some companies, the government has emphasized that it is not going to eliminate taxes from oil sales, an essential revenue flow for the budget. Authorities have supported the idea of a temporary export duty decrease on oil extracted in Eastern Siberia, as well as the need for a special model of taxation for new deposits. Companies have received a 0 percent import customs rate on equipment necessary for deep oil refining complexes. However, in addition to considering a delay in transition to European gasoline standards both inappropriate and unreasonable, Prime Minister Vladimir Putin upheld the decision to achieve a 95 percent recycling of associated gas by 2012. Authorities are also less enthusiastic about setting up a strategic oil reserve.

Gazprom, while Rosneft and its partners are laying down Sakhalin-3 plans. However, Sakhalin-1 has suspended work following a disagreement with officials over investment plans and budget.

#### 24 Russian Companies Enter the Spanish Market

By Ilya Kedrov

Following Madrid meetings on March 2-3, Russian President Dmitry Medvedev and Spanish Prime Minister José Luis Rodríguez Zapatero signed a declaration on strategic partnership. The two countries have committed to developing relations similar to those Russia currently has with Germany, France and Italy. The Kremlin intends to strengthen the new Spanish union with contracts involving Gazprom. To date, these have resulted in only small gas deliveries within the framework of swap operations. However, starting in 2014, Gazprom will deliver to Spain gas from Shtokman. In exchange, Spain could participate in the second or third stage of the project. Vnesheconombank and Spanish export credit agency SESSE have signed a memorandum to assist in the reconstruction and modernization project at the Khabarovsk Refinery. In addition, Inter RAO and Iberdrola will cooperate on investment projects in Russia and other countries. All of this activity may well end in a Russian state

company purchasing a stake in Spanish oil major Repsol.

### Transactions

#### 29 Main Transactions at the Beginning of 2009

By Elena Kirillova

Mergers and acquisitions continue in Russia, despite the global financial crisis. Oleg Deripaska, the owner of mega-holding Basic Element (BasEl) moves forward with the purchase of RussNeft despite BasEl itself being on the verge of default. Artimorneftegazrazvedka hopes for state help to avoid bankruptcy, while state company Zarubezhneft has already declared interest in its privatization, thereby providing a direct access to shelf work. Gazprom, as expected, has received 100-percent control over the South-Tabeiskoye deposit.

#### 35 Licensing Prospects

By Svetlana Milyaeva

Out of 11 auctions on 54 blocks that should have taken place in February-March, the Federal Subsoil Use Agency (Rosnedra) has cancelled auctions on 38 blocks. The actions resulted from a total absence of applications. What is happening in the license sector? Small companies, earlier active auction participants, are not bidding for new blocks. They are also stopping activity and handing licenses

## Update on the Licensing Regime for Subsoil Use in Ukraine

By Dr. Irina Paliashvili, President and Senior Counsel, Tamara Lukanina, Senior Counsel RULG - Ukrainian Legal Group, P.A. Kiev and Washington, D.C.

*Developments in regulations governing Ukrainian subsoil use during 2008 indicate the improvement of the oil and gas sector will be slow in coming. Little progress ensued, with the oil and gas sector in 2009 again dependent upon the good will and competence of the Ukrainian cabinet.*

In 2008, all branches of the Government of Ukraine actively declared the need to reform and modernize the use of subsoil in the fuel and energy sector, as this process is vital to the energy security and energy independence of Ukraine. In particular, on January 16, 2008 the Cabinet of Ministers of Ukraine (CMU) adopted the program of activity entitled "Ukrainian Breakthrough: for People and not for Politicians" (CMU Program), which includes an action plan in the sphere of the fuel and energy complex (Clause 3.3). This action plan contains the following important aspects:

Ukraine's strategy during the next five to seven years will aim at achieving the goal of creating an attractive investment climate for the private sector in the exploration and production of oil and gas. According to the CMU Program, achieving this goal requires that the regulatory framework must be stable, the CMU's actions must be predictable, the energy policy must comply with the purposes of the Energy Charter Treaty and the regulatory

framework must be brought into compliance with European Union (EU) standards. The CMU declared the following tasks:

- step-by-step introduction of the market-based procedure for developing prices of natural gas and simultaneous introduction of target subsidies to low-income population for gas;
- establishing a transparent, tender-based procedure for granting subsoil licenses and strengthening oversight by the state of the observance of licensing conditions by license holders;
- increasing the financing of geological exploration;
- ensuring the achievement by state-owned companies of exploration drilling targets for oil and gas in accordance with the Power Sector Strategy of Ukraine until the year 2030;
- creation of favorable conditions for exploration in new territories, including the Black Sea and Azov Sea shelves.

The CMU undertook the obligations to amend the Law of Ukraine "On Rental Payments for Oil, Natural Gas and Condensed Gas" concerning the establishment of effective rates and payment procedures that would promote increased production; and to ensure stability of the legislative framework regarding the taxation of production and trade in oil and natural gas.

Following the adoption of the CMU Program, the President of Ukraine expressed his views on the development of the oil and gas sector

in his Decree "On Certain Measures Aimed at Improving the Regulation of Mining Relations" of February 28, 2008. He instructed the CMU to elaborate a number of laws and regulations, to adopt and implement certain programs, elaborate and implement effective mechanisms for attracting domestic and foreign investments into the development of mineral raw materials, and to monitor and enforce compliance with the legal requirements for granting subsoil licenses and the compliance by subsoil users with the terms and conditions thereof.

Looking back at 2008, it needs to be admitted that, from the point of view of both legal regime and practical implementation, very little progress was achieved in the oil and gas sector, and, indeed, it was one of the least attractive years for investment in this sector. Most of the goals and tasks declared by the CMU Program and the instructions to the CMU set in the presidential decree have not been implemented. In practice a number of existing projects with the participation of foreign investors were either frozen or cancelled, and no new oil and gas subsoil areas were offered at auction.

We have already described in detail the specifics of the licensing regime for the use of subsoil in Ukraine in "Overview of the Ukrainian Licensing Regime for Subsoil Use in 2007," *Russian Petroleum Investor*, February 2008. Therefore, in this article, we will only outline the main developments and trends of 2008.

The flawed ad hoc Regulation-Based

System, governing subsoil licensing, continued in 2008, but there was much uncertainty through the first half of the year with the two key regulations, the Licensing Procedure and the Auction Procedure. The Licensing Procedure was reported as adopted on February 27, but published only in early April and took effect on April 11. The Auction Procedure adoption took place as late as June 4 (taking effect June 17). The CMU did not take into account most of the comments and amendments to the drafts of these regulations, as suggested by the industry (through the European Business Association).

The CMU strongly favored the state sector, to the disadvantage of the private sector, in exploration and production. For example, in 2008 virtually no oil and gas subsoil areas were offered at subsoil auctions (only one area was offered and then withdrawn from the auction that took place on December 16), thereby depriving the private sector from any opportunity to invest in new E&P projects. At the same time, a large number of oil and gas subsoil areas were granted to the state-owned NJSC Naftogaz Ukrainy (for example by the CMU Ordinance of September 17, 2008) without an auction and without apparent legal grounds.

At the same time, further severe restrictions were introduced for cooperation of state-owned companies with the private sector. The main vehicle for such cooperation, a Joint Activity Agreement (JAA), an approach used for years, became virtually unavailable. In particular, the CMU Ordinance of May 7, 2008 required that an individual CMU permit be obtained for any JAA that involves a state-owned company (and "state-owned" means any company where the state's stake

exceeds 50 percent. No procedure for obtaining such a permit was adopted. Moreover, the same Ordinance called for early termination of previously concluded JAAs. Further, when a large number of subsoil areas were granted to Naftogaz Ukrainy by the CMU Ordinance of September 17, 2008, this Ordinance contained a direct prohibition to develop these areas on the JAA basis.

On October 30, 2008, CMU issued a Resolution requiring that granting of subsoil licenses for strategically important natural resources can be made by the Ministry of Environment Protection only upon prior permission of the CMU, without even specifying the criteria and procedure for such a permit.

We offer a very brief review of the 2008 Licensing Regulations – the Licensing Procedure (CMU Resolution No. 273) and the Auction Procedure (CMU Resolution No. 525). Without going into detail, the picture appears to be very mixed and non-transparent. Some of the positive trends of 2007 found their way into the 2008 Licensing Regulations, and some of them did not. On the other hand, some of the negative aspects of Licensing Regulations in 2007 were repeated and some new negative aspects appeared in the 2008 Licensing Regulations. The following are a few examples of negative aspects of the 2008 Licensing Regulations:

- The possibility of transfer (reformulation) of a license in favor of a joint venture or a subsidiary, or a parent company, which was present in Licensing Regulations in 2007, was removed, and moreover such transfer was directly banned.
- The very short deadlines for announcement of an auction (30 days) and submission of applications

(15 days), which were present in the Licensing Regulations in 2007 (in the 2007 Auction Procedure), and which directly contradict the relevant EU Directive, were preserved in the Auction Procedure in 2008.

- No possibility to challenge the decision of the Auction Committee was provided in the Auction Procedure in 2008. Moreover, the auction organizer was granted the right for withdrawal of selected areas from the announced auction, or even canceling the announced auction without any explanations.

Below are a few examples of positive aspects of the 2008 Licensing Regulations:

- A single (exploration and production) license is explicitly allowed by the Licensing Procedures for 2008.
- Foreign legal entities are directly mentioned a few times in the Auction Procedure for 2008. They are also mentioned in the Licensing Procedure for 2008, but only in a footnote. A conclusion can be made that in 2008 foreign legal entities could directly participate in auctions and, moreover, obtain licenses through a non-auction procedure (it should be noted that no such opportunity was given to them in practice).
- The Auction Procedure for 2008 removed a notorious provision, which was present in the 2007 Auction Procedure, allowing, in the event of failure to pay for the license purchased at the auction by the auction winner, the subsequent transfer of the right to purchase the license to the next bidder.
- A single unified format was introduced for the subsoil license.

For 2009, the new Budget law once again confirmed that subsoil licensing will be governed by the ad hoc Regulation-Based System, and,

# Government

therefore, this system will be again based on the Licensing Regulations (Licensing Procedure and the Auction Procedure) to be adopted by the CMU for 2009 only for the current year. In other words, the oil and gas sector will again depend on the good will and competence of the CMU. The Drafts of the Licensing Regulations became available for public discussion on the Ministry of Environment Protection's website on January 15, 2009 and, thus, it appears that in 2009 they again will be adopted with substantive delay.

At the same time, despite all the negative trends in 2008, the CMU will have no choice but to improve the licensing regime in 2009 and to make the oil and gas sector much more attractive for investment. It appears that the economic crisis, the exodus of investors from Ukraine, the gas dispute with Russia, various threats to energy independence and other dramatic events of 2008, have taught the CMU some powerful lessons on the vital need to create an attractive investment regime, particularly in the oil and gas sector.

*RULG-Ukrainian Legal Group is a full-service law firm based in Kiev and Washington, D.C. that provides comprehensive legal support to large- and medium-sized international corporate clients doing business in Ukraine and other CIS countries. One of the RULG's key practice areas is upstream oil and gas, both under licensing regime and under the PSA regime. RULG authored the production sharing legislation (two laws and a number of regulations) for Ukraine, which provided the legislative basis for the first Ukrainian PSA signed in October 2007. Detailed information about RULG practice is available at [www.rulg.com](http://www.rulg.com). Dr. Paliashvili can be contacted at [irinap@rulg.com](mailto:irinap@rulg.com)*



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