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*RULG-Ukrainian Legal Group is a full-service law firm based in Kiev and Washington, D.C. that provides comprehensive legal support to international corporate clients doing business in Ukraine and other CIS countries. One of the RULG's key practice areas is upstream oil & gas, under both the Licensing Regime and the PSA Regime. RULG co-authored the production sharing (PSA) legislation for Ukraine, and has been representing international oil companies in their investment projects in Ukraine for over 20 years. 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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## Overview of Ukraine's Legal Regime for Upstream Oil & Gas Sector in 2013-2014

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### **I. Introduction**

The extraordinary political events that occurred in Ukraine at the end of 2013 and beginning of 2014, and resulted in overthrow of ex-president Yanukovich regime and appointment of the new interim Government of Ukraine (“**GOU**”) and elections of the new President Petro Poroshenko, accompanied by an extreme geopolitical crisis, occupation and annexation of Crimea by the Russian Federation - threw the upstream sector in absolute disarray. This can be said to a various degree about all other sectors of Ukraine’s economy, but the upstream sector has been suffering most because it is so heavily dependent on the State regulation, and many of its key actors are State-controlled companies. Moreover, the loss of Crimea has had a watershed effect on this sector because a large portion of Ukraine’s reserves is located in offshore areas of the Black Sea adjacent to Crimea, and the State-controlled company operating in Black Sea offshore, Chornomornaftogaz, which is a 100% subsidiary of the State-owned NAC Naftogaz, is based on the occupied territory of Crimea. To this end the new authorities of Crimea announced “nationalization” of Chornomornaftogaz (presumably in favor of the Russian Federation) with the “aim of future “privatization (presumably by one of Russia’s State-controlled companies, such as Gazprom or Rosneft).

It is expected that the above developments will result in the avalanche of significant claims by Governments and companies against other Governments and companies filed in national courts, international arbitration institutions, international courts, including through the mechanisms established within international organizations, such as for example WTO.

The political and geopolitical situations are so volatile that at the time of this writing it is indeed impossible to predict how the legal regime for the upstream sector will develop, and what long-term strategy and priorities, for the energy sector in general and the upstream sector in particular, will be established by the new GOU.

Usually, despite of various changes in policy, our previous annual overviews showed consistent trends in the upstream sector, especially during the entire period of ex-president Yanukovich regime, which lasted almost four years. In this overview, however, because of the abrupt regime change, we need to analyze two different periods: the first one, under previous GOU, lasted until 21 February 2014, when ex-president Yanukovich and some of the most senior officials in his GOU (including the Minister for Fuel and Energy Eduard Stavvtsky) fled the country, and the second period starting 27 February until the present time, when the new interim GOU took over and Crimea was occupied and annexed by the Russian Federation.

It should be noted that many of the developments and tendencies of the first period may be no longer relevant because they were based on the policies and priorities of the previous GOU. At the same time, because the previous GOU was quite consistent in opening up the upstream industry to foreign investment (albeit on their own terms, which sometimes could be regarded as rather exotic), it may be expected that the current interim GOU, and future GOUs, will continue many of the same trends, but possibly in a different format.

During the first period, the previous GOU continued to attract big-scale international investment in exploration and production of domestic natural resources, most importantly Unconventional Resources (Shale Gas, Tight Gas, Shale Oil, etc.), as well as Black Sea development. These investments were attracted on the basis of the most modern, stable and attractive legal and fiscal instrument available to investors in the natural resources sector – production sharing agreements ("**PSA**").

Although as a rule a PSA are offered on the basis of a tender, which was the case with the two major PSA signed in 2013 with Shell (for the Yuzivsska subsoil area) and Chevron (for the Olesska subsoil area), the previous GOU developed the legislative basis for an exception from this rule, a new mechanism under which a PSA can be granted without a tender through converting the existing Subsoil License ("**PSA Conversion**").

The first PSA, based on PSA Conversion, was negotiated and signed at the end of November 2013 by the State of Ukraine with a group of Ukrainian (Chornomornaftogaz and Vody Ukrainy) and international (Eni Ukraine Shallow Waters B.V. and EDF Ukraine Shallow Waters) investors for the Subbotina, Abiha, Mayachna and Kavkazka offshore subsoil areas in the Black Sea (the "**Eni PSA**"). The Ukrainian parties, Chornomornaftogaz and Vody Ukrainy are subsidiaries of the State-owned companies NAC Naftogaz and NAC Nadra respectively, and are the holders of Subsoil Licenses (Chornomornaftogaz for Subbotina and LLC Vody Ukrainy for the other three), which were subject to conversion into the Eni PSA, while the international investors, Eni Ukraine Shallow Waters B.V. and EDF Ukraine Shallow Waters, provided financial and strategic resources.

Although the Eni PSA has a major significance for Ukraine's energy sector as the first precedent of the PSA Conversion, unfortunately one of the Ukrainian PSA parties - Chornomornaftogaz - and the location of all four subsoil areas in the Black Sea appear to be outside of Ukraine's control at present because of the annexation of Crimea by the Russian Federation. Therefore, the practical fate of the Eni PSA is unpredictable. At the same time, it remains a road map for the future PSA Conversion projects in Ukraine, should the current interim GOU or future GOUs wish to continue offering this mechanism to investors.

One more PSA project was close to signing in 2013, following the PSA Tender for the Skiphska Subsoil Area on the Black Sea Shelf, which was won in August 2012 by a group of investors led by ExxonMobil. This PSA, unfortunately, was entirely derailed by the annexation of Crimea.

Surprisingly, in contrast to 2012, in 2013 the previous GOU did not carry out a single PSA tender, although at least two tenders were publicly promised: the repeated tender for the Forosska subsoil area on the Black Sea Shelf (the first tender in 2012 did not attract any bidders) and a new tender for Slobozhanska onshore area in the Kharkiv region (Shale Gas and other hydrocarbons). One would expect that based on the success with other tenders followed by signing of the PSAs, the previous GOU would be eager to capitalize on this success and carry on. For some reason, perhaps the change of geopolitical course - when ex-President Yanukovich refused to sign the EU Association Agreement in November 2013, no PSA tenders were held in 2013.

As to the second, current period, it started with the appointment on 27 February 2014 of the new interim GOU, which remains in power at this time. This period so far was not marked by any significant initiatives in the upstream sector.

## II. Reform of the Regulatory Bodies

It is important to note the changes in the Regulatory Bodies of the interim GOU, which may signal a less consistent and coordinated approach than within the previous GOU. As we often noted in our previous annual overviews, there always has been a duality in the Regulatory Bodies for the upstream sector, which has been under control of two different Ministries (and other regulatory bodies and State-owned companies functioning under these Ministries): the Ministry of Ecology and Natural Resources ("**Ministry of Ecology**") and the Ministry of Energy and Coal Industry ("**Ministry of Energy**"). Various periods in the past were marked by a bitter rivalry between these two Ministries and their leadership, which was a serious obstacle to investment in the upstream sector in Ukraine. Under the ex-president Yanukovich regime, however, this rivalry was gradually eliminated, although not by the institutional alignment of the Regulatory Bodies, but rather by appointing the politically aligned leadership. Such

alignment will hardly last with the current interim GOU, in which the interim Minister of Energy, Mr. Prodan (he served in the same position in the coalition GOU under Prime Minister Timoshenko) at the moment seems to be entirely preoccupied by the gas wars with Russia, and the interim Minister of Ecology, Mr. Mokhnik, who appears not to possess deep expertise in the upstream sector, belongs to the right-wing “Svoboda” party, which in the past was vocally opposing the development of Unconventionals in Ukraine.

It is also not clear what would be the role of the current “central body of executive power in the sphere of geological study and rational use of subsoil”, which is the State Service for Geology and Subsoil of Ukraine (“**Derzhgeonadra**”). This long-suffering regulator has been at times independent, at times entirely absorbed by the Ministry of Ecology and at times given large degree of independence under some kind of vaguely defined supervision by the Ministry of Ecology. In practice, within the previous GOU the issue of aligning Derzhgeonadra primarily with the Ministry of Ecology, but also with the Ministry of Energy, was resolved by the same Byzantine method - not by the institutional alignment, but by appointing the vertically aligned leadership, with the ex-Minister of Energy Eduard Stavtysky being on top of this vertical, followed by ex-Minister of Ecology, Oleg Proskuryakov, while Derzhgeonadra was given a subordinate role.

Obviously, the renewed duality and, at best, the lack of coordination, but at worst an open rivalry, between the two key Ministries will have a negative effect on the upstream industry. In addition, the industry will have to deal with the unclear practical status of Derzhgeonadra, which may result in its conflict with the Ministry of Energy.

One can only express hope that this or future GOU will finally carry out a fundamental and sustainable institutional reform of the Regulatory Bodies, with the aim of removing unnecessary bureaucracy and creating streamlined, modern, transparent, uncorrupt, fair and investor-friendly regulatory environment, preferably using as much e-Government methods as possible.

### **III. Subsoil Licensing Regime**

The legal regime for upstream activities in Ukraine continues to be divided into more traditional **Licensing Regime**, with Subsoil Licenses (referred to in legislation as “special permits” to use Subsoil) generally offered at auctions, and the alternative **PSA Regime** under which the investor obtains the rights to use Subsoil under a PSA concluded with the State.

The main legal instruments for Licensing Regime available to investors are either directly obtaining the Subsoil License (accompanied by the Licensing Agreement with the State) or

concluding a Joint Activity Agreement (**JAA**) with the existing License Holder. Over the years, the Licensing Regime and its legal instruments have been consistently compromised by the GOU and Ukrainian courts, with the rights of investors threatened, and Subsoil Licenses and JAAs challenged or cancelled.

The first period we analyze in this article, which refers to ex-President Yanukovich regime, was not marked by any significant developments, with the previous GOU continuing to issue Subsoil Licenses on a non-competitive basis (i.e. without an auction) to various entities connected to the regime.

After the interim GOU took over on 27 February, a number of corruption schemes were uncovered and investigated in the upstream sector. According to the General Prosecutors Office, in March 2014 a number of Subsoil Licenses were cancelled, which were issued to an entity reportedly connected to the ex-Minister of Energy Stavytsky, because these Subsoil Licenses were issued without holding an auction and with many other violations. We should also note that at present a criminal case is being investigated against the ex-Minister of Energy Stavytsky, who is accused of large-scale embezzlement.

The shady practices of the previous GOU and also of its predecessors in terms of issuing Subsoil Licenses definitely must be punished and the issued Subsoil Licenses must be carefully reviewed and canceled if necessary, but for the future the GOU needs to establish a clear, unambiguous, transparent and competitive mechanism for issuing Subsoil Licenses, which would benefit the State and the legitimate applicants rather than various well-connected entities.

While in the past very few Subsoil Licenses for oil & gas areas were ever offered at public auctions, with the majority of Subsoil Licenses, as we now see, distributed privately among well-connected entities, the good news is that for 2014-2015 Derzhgeonadra plans to offer 45 (a large number compared to previous years) of oil & gas areas at auctions, the list of which was published on Derzhgeonadra website <http://geo.gov.ua/anonsi/468-derzhgeonadra-ukrayini-ogoloshuyut-perelk-dlyanok-naftogazonosnih-nadr-yak-planuyetsya-vistaviti-na-aukcon-u-2014-2015-rokah.html>. It is interesting to note that all Subsoil Licenses on the list will be single Exploration/Production Licenses (while on the past most of the Subsoil Licenses offered at auctions were for exploration only), and some of them are offered for Unconventionals.

We do not expect any serious legislative changes in the Licensing Regime until the new version of the Subsoil Code is adopted, which has been discussed in numerous versions for years, but is not currently pending at the Parliament. The latest news is that yet another draft of the Subsoil Code was promulgated by Ministry of Ecology.

#### IV. The Implications of the Crimea Annexation

Occupation and annexation of Crimea by the Russian Federation brings a substantial negative effect on Ukraine's upstream sector, and creates a legal limbo for all parties concerned, in particular the investors.

At present, Russia considers Crimea to be the integral part of the Russian Federation, while exercising its practical jurisdiction over Crimea, and Ukraine considers Crimea to be the integral part of Ukraine, although with the status of a "Temporarily Occupied Territory". Relevant Law "On Enforcement of Rights and Freedoms of Citizens of Ukraine on the Temporarily Occupied Territory" was recently adopted and took effect (the "**Crimea Law**").

According to Article 3 of the Crimea Law, the status of "Temporarily Occupied Territory" extends to (i) the land territory and internal waters; (ii) internal sea waters and territorial sea of Ukraine adjacent to the Crimean Peninsula, the exclusive (maritime) economic zone of Ukraine and the adjacent Continental Shelf of Ukraine; (iii) the airspace above the aforementioned territories.

Although initially the draft of the Crimea Law stipulated a ban on any types of business activity that are subject to any kind of licensing (i.e. we suppose including the upstream development), in the final text this ban was removed because the Parliament agreed with the proposal of the business community to regulate business activity in Crimea by a separate law to be adopted in the future.

It is not clear at all what will happen with the existing oil & gas projects in Crimea. The most notable project – a pending PSA for the Skiphska Subsoil Area on the Black Sea Shelf, led by ExxonMobil, will probably never result in signing of the actual PSA because foreign investors signaled their intention to withdraw from this project.

It will be interesting to see what happens to the existing PSA for the Prykerchenska area on the Black Sea Shelf (the "**Prykerchenska PSA**"), the implementation of which was delayed by a long-standing international arbitration dispute between the investor (Vanco Prykerchenska Ltd) and the GOU. The dispute was eventually settled, and the investor was looking to farm out all or part of its interest in the Prykerchenska PSA. Would the investor now look at farming out its interest to a Russian company?

Another important project to be developed off-shore Crimea is the Eni PSA, signed back in November 2013.

Ukrainian interim GOU has not announced its legal position with regards to oil & gas projects in Crimea, while the Russian Government officials have made several statements indicating that



they have not yet decided how to handle these projects. Both Russia and Ukraine allow PSA, but the legal regime for PSA in the two countries is quite different. In particular, the Russian PSA Law requires that a PSA concerning the subsoil areas located on the Continental Shelf or exclusive maritime zone of the Russian Federation must be approved by a separate federal law. This restriction probably derives from Article 9 of the Russian Law "On Subsoil", which provides that only Russian legal entities, which have at least 5 years of experience of developing resources on the Continental Shelf, and moreover which are controlled by the State (i.e. in which the Russian Federation owns or controls more than 50% stake) – are allowed to be subsoil users on the Continental Shelf or exclusive maritime zone of the Russian Federation.

Obviously, none of the current subsoil users in Crimea – not those, which obtained their Subsoil Licenses under the Licensing Regime, and not those, which obtained their subsoil rights through PSA, do not meet, even remotely, the above requirements of the Russian law.

Only one thing is clear with regards to oil & gas projects in Crimea: there will be extensive political and legal negotiations and disputes, irrespective of what solution Russia may offer to the current holders of subsoil rights.

## V. PSA Regime Update

PSA regime was considerably improved in 2013. Basically, the GOU implemented the investors' "Wish List" through adoption of the amendments to the Law of Ukraine "On Production Sharing Agreements" ("**PSA Law**") and other laws and regulations, as well as finally incorporated the interests of local communities into the PSA conclusion and implementation process allocating 10% of the State's share of production for local needs.

Below is a brief overview of the most important developments concerning the PSA Regime in 2013 and 2014 (we note that most of the developments occurred in 2013, while the current interim GOU has not so far come up with any substantial initiatives):

**(1)** The Law "On Amendments to the Law of Ukraine "On Production Sharing Agreements" concerning the State Regulation of the Conclusion and Performance of the Agreements" (the "**Law**") took effect on 21 July 2013. The main purpose of this Law was to reinstate the previously abolished PSA Interagency Commission (the "**PSA Commission**").

Following adoption of the Law, the Cabinet of Ministers adopted a Resolution, which formed the PSA Commission (including the representatives of the Ministry of Energy, the Ministry of Ecology, the Ministry of Economic Development and Trade, the Ministry of Finance, the Ministry of Incomes and Charges, the Ministry of Justice, Derzhgeonadra, the State Service of Mining Supervision and Industrial Safety), appointed the Ministry of Ecology the Working Body

of the PSA Commission and appointed the Minister of Energy the Head of the PSA Commission. It remains to be seen what position the interim GOU will take with regards to the PSA Commission.

The Law also introduces some other significant amendments to the PSA Law:

1. a new provision was added in Article 5 (part two) explicitly allowing the PSA parties to delegate the management and coordination of their PSA to the Management Committee or another body created by the parties.
2. amendments to Article 13 (part three) was made to prevent the parties from making the English version of their PSA the prevailing one if there is a conflict between the Ukrainian and English versions, establishing a mandatory rule that the Ukrainian version of the PSA prevails in case of a conflict with the English version.
3. amendments to Article 28 was made stipulating regular inspections of PSA implementation by the Cabinet of Ministers, which inspections must be carried out at least once in five years.

**(2)** In its Letter No. 29-216/6760/7303 dated 20 June 2013 the National Bank of Ukraine (“**NBU**”) implements a number of previously adopted legislative amendments exempting PSA-based business transactions of investors (including foreign investors' representative offices in Ukraine) from various burdensome currency and banking restrictions.

**(3)** The amendments to the Budget Code of Ukraine took effect on 1 January 2014 and are aimed at securing the interests of the local communities where PSA subsoil areas are located. According to the amendments, 10% of the State's share of production under a PSA must be allocated to the local budgets of the territories where PSA subsoil areas are located (previously the PSA Law allocates no share of production for any local needs). Establishing this incentive for local communities was an inevitable positive measure needed for the efficient and fair PSA conclusion and implementation process. However, the legislation was not yet updated to make sure this incentive can be implemented in practice.

**(4)** A new “Procedure and Rules Concerning the Investor's Mandatory Civil-Law Liability Insurance, Including Harm to the Environment and Human Health, Under Production-Sharing Agreements, Unless the Agreement Stipulates Otherwise” took effect on 5 February 2014 (the “**Procedure**”).

It is interesting to note that although the Procedure uses the word “mandatory”, the insurance requirement is not, in fact, mandatory, because under Article 30.2 of the PSA Law the PSA parties may agree otherwise in their PSA. In other words, the insurance requirement will become mandatory only if the PSA parties failed to agree otherwise in their PSA.

(5) The signing of the Eni PSA on 27 November 2013 was the first precedent implementing the PSA Conversion mechanism, while according to our information several similar projects were being negotiated by the previous GOU with holders of Subsoil Licenses and potential investors. The current interim GOU and future GOUs should make this mechanism available to international investors and should further develop it, which would allow a number of smaller projects to take advantage of the modern and stable PSA instrument.

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