



Overview of Ukraine's Subsoil Licensing Regime in 2010 and Trends for 2011

We have been reporting in this magazine on the new developments in the subsoil licensing regime for several years, and 2010 was an especially significant year because of the changes in the Ukrainian Government (GOU) and the new direction it took at opening up the natural resources sector for investment. There have been a number of important developments, most notably the sharply increased interest in investment opportunities in Shale Gas and the Black Sea Shelf, the new taxation regime stipulated by the recently enacted *Tax Code* and the changes in the legal regime for production sharing agreements (PSA).

Although 2010 was a very active year for the natural resources sector, the GOU so far has failed to transform its good intentions into practice and has not demonstrated sufficient political will to offer real opportunities.

I. Subsoil Licensing Regime in 2010

As in previous years, the procedures for granting Subsoil Licenses (special permits) and holding subsoil auctions in practice continued to be regulated not by law but by temporary GOU resolutions (Licensing Regulations), which are adopted on an annual basis. However, it is interesting to note that the GOU adopted a decision, which took effect on 1 January 2011, abolishing the practice of temporary annual Licensing Regulations and requiring that starting from 2011 they must be adopted on a permanent basis. No such permanent Licensing Regulations have been adopted to date.

However, in contrast to previous years, 2010 was the first year when the Licensing Procedures were changed mid-year: in the first half of 2010 the Licensing Regulations in effect were the two Cabinet of Ministers Resolutions adopted on 17 June 2009 and



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extended for 2010; in the second half of 2010 the above Resolutions were replaced by Resolutions *On Approving the Procedure for Granting Special Permits to Use Subsoil in 2010 No.596 of 23 June 2010* and *On Approving the Procedure for Holding Auctions for Sale of Special Permits to Use Subsoil in 2010 No.662 of 21 July 2010*.

Analysis of the Licensing Regulations applicable in the second half of 2010 shows the following trends:

- The list of cases when Subsoil Licenses may be granted without an auction or tender (i.e. on a non-competitive and non-transparent basis) was expanded from five to fourteen.
- The possibility of granting Subsoil Licenses based solely on a GOU decision without stipulating any specific requirements or grounds (again on a non-compete and non transparent basis) was introduced.

— The procedure of negotiation and adoption of decisions by the Ministry of Ecology and Natural Resources (the Ministry of Ecology) on granting Subsoil Licenses without an auction or tender was made more complex.

— Although the Licensing Regulations provided for the possibility to grant Subsoil Licenses at tenders for use of strategic minerals (instead of auctions), no clear procedure was established for holding such tenders and, as a consequence, no such tenders were held at all.

— the Ministry of Ecology received the right to unilaterally amend Licensing Agreements made with a subsoil user, which are an integral part of the Subsoil Licenses (while the previous Licensing Regulations expressly prohibited such unilateral amending).

— The fees for extension of Subsoil Licenses were increased considerably.

— While the previous Licensing Regulations deprived the holders of Exploration Subsoil License from an opportunity to convert them into Pro-

duction Subsoil License, the current Licensing Regulations allow such a possibility (provided certain conditions are met).

— The list of cases when a Subsoil License may be reformulated (transferred) was expanded, but still remains extremely limited.

In practice in 2010, as in 2009, the GOU offered a negligible number of Subsoil Licenses for hydrocarbons at auctions and only four auctions were held. At the same time, the GOU continued to grant Subsoil Licenses on a preferential basis to State-controlled companies without an auction/tender and continued to adopt decisions to this effect. The lack of transparency became even more evident because some of these decisions were not even published.

II. Activity Licenses

In Ukraine a number of activities, related to exploration and production of mineral resources were subject to licensing, i.e. a company in order to engage in these activities first needed to obtain a relevant license (Activity Licenses). A separate Activity License was required for exploration and for production (extraction of minerals) activities. These Activity Licenses were issued by the State Geological Service. Effective from 17 October 2010 such types of economic activity as exploration and production of minerals are no longer subject to licensing.

III. Joint Activity Agreements (JAA) in 2010

In 2010, as in 2009, there were the same restrictions and risks in place for entering into joint activity agreements (JAA) with state-controlled (more than 50% stake) companies, which in order to enter into a JAA must obtain prior approval of the GOU. Yet, the procedure for obtaining such approval does not

exist (making this exercise at best non-transparent or entirely impossible).

In general the JAAs, which have been the main investment vehicle in the subsoil sector for years, remain under attack from the GOU. In particular, the tax authorities keep insisting on their long-standing position that the rights of ownership to the extracted minerals may belong only to the subsoil user that obtained the special permit to use subsoil, and such rights cannot be contributed (assigned) under the JAA.

Moreover, in December 2010 a new version of Article 14 of the *On the Oil and Gas Act of Ukraine* was adopted (taking effect on 1 January 2011) confirming that contributing the rights arising out of Subsoil Licenses into a JAA is prohibited. The confusing and inconsistent attitude of GOU towards JAAs remains a serious risk factor for using them as an investment mechanism in the oil & gas sector.

IV. Production Sharing Agreements (PSA) Regime

2010 saw many significant, mostly positive, developments in the PSA regime, which is an alternative to the Subsoil Licensing regime.

Over the years several attempts have been made to amend the existing investor-friendly *PSA Act*. Finally a new Act (*PSA Amendments Act*) was adopted. In a dramatic development the *PSA Amendments Act* was vetoed by the President and then re-adopted taking into account all the President's proposals.

In general the *PSA Amendments Act* will have a very positive effect with one important caveat: one of the Presidential veto's proposals cancelled the stability clause (guarantees against changes in the legislation for the duration of the PSA) contained in Article 27 in the original *PSA Act*, which investors consider essential for such long-term and high-cost investment. Although there are similar stability clauses in other Acts currently in effect (for example, in the *On Investment Activities Act*), which broadly cover the PSAs, the GOU was strongly criticized for this move because it altered the PSA regime to the extent that it may become unattractive and too risky to international investors. Many investors de-

clared both publicly and privately that no investments should be expected under the PSA regime unless the GOU restores the stability clause. The GOU swiftly made amends by introducing a strong stability clause with regards to the PSAs taxation regime in the recently adopted *Tax Code* and by supporting the re-introduction (through a parliamentary MP) of the general stability clause into the *PSA Act*, which is currently pending in Parliament.

V. Other Developments in the Natural Resources Sector

(1) The long-awaited *On the Fundamentals of the Natural Gas Market Functioning Act of Ukraine* considerably liberalized the natural gas market.

(2) Adoption of the *On the Fundamentals of the Natural Gas Market Functioning Act of Ukraine* facilitated Ukraine's accession to the Treaty establishing the Energy Community (Energy Community Treaty of 2005, Athens). In December 2010 the Ukrainian Parliament adopted the *Act On Ratification of the relevant Protocol on Ukraine's Accession to the Energy Community (EC)*. It is expected that in early 2011 Ukraine will become the 10th Party to the Energy Community.

(3) The *Tax Code* was adopted on 2 December 2010 and took effect on 1 January 2011, establishing important provisions for the natural resources sector.

(4) In October 2010, the Cabinet of Ministers approved the Draft memorandum of cooperation between the Cabinet of Ministers, Naftogaz Ukrayiny with the Russian Federation government and TNK-BP group of companies concerning exploration and production of gas in Donetsk Region, Ukraine.

(5) The GOU initiated an investment project titled *Supplies of Liquefied Natural Gas to Ukraine and Construction of the Regasification Terminal*.

(6) With the aim of attracting investments into development of hydrocarbon deposits in the Black and Azov Sea Shelf, the Ministry of Fuel and Energy and Naftogaz Ukrayiny developed in 2010 a *Concept of Development of Hydrocarbon Resources of the Ukrainian Economic Zone of the Black Sea and the Sea of Azov Until 2019*, which is currently being considered by the GOU.

Profile

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