

## Overview of Licensing Regime for the Use of Subsoil in Ukraine in 2007

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Ukraine has two alternative regimes for the use of subsoil: the Licensing Regime and the production sharing agreements regime (PSA Regime). This article is devoted exclusively to the Licensing Regime, including its legislative and practical aspects in 2007 and the prospects for its development in 2008, with special emphasis on its applicability to foreign investors in the oil & gas sector.

There are serious and on-going flaws in the legislative basis for the Licensing Regime, as well as in its practical application. Despite these flaws, the Licensing Regime exists and has been used by domestic and international companies in Ukraine with varying degrees of success.

### I. Legal Basis for the Licensing Regime

The Licensing Regime is regulated by subsoil legislation, which includes: the 1994 *Subsoil Code (Subsoil Code)* and the 2001 *On Oil and Gas Act of Ukraine (Oil & Gas Act)* (we omit the laws regulating other types of subsoil resources) and is spelt out in various subsequent regulations. Therefore, a standard law-based legislative basis, albeit outdated and at times ambiguous and conflicting, does exist for the Licensing Regime (hereinafter — Standard Legislative Basis).

Since 2004, however, the Parliament of Ukraine (Rada) has suspended the Standard Legislative Basis through annually adopted laws on the *State Budget (Budget Acts)*, and stipulated an annual *ad hoc* system for the Licensing Regime based not on laws, but on regulations adopted annually by the Government (the Cabinet of Ministers) of Ukraine (GOU). Over the years, this temporary measure has in practice evolved into an entirely new system of its own. In sum, the Standard Legislative Basis for the Licensing Regime is being replaced annually by regulations (Regulation-Based System).

In practice, this replacement takes place through a two-step process: (1) the Standard Legislative Basis is suspended, usually at the end of the year, by the *Budget Act* for the next year; and then (2) in the first quarter of the next year, the GOU adopts licensing regulations for the particular year, which remain in effect only through to the end of the particular year. Of course, this *ad hoc* Regulation-Based System, creates a high degree of unpredictability and makes the oil & gas sector much more prone to political influence and dependant on the composition, orientation and discretion of the GOU at the moment.

Unfortunately, for 2008 we do not see the much-needed return to the Standard Legislative Basis as likely, because the *Budget Act for 2008* once again provides for the suspension of the Standard Legislative Basis and renews the flawed Regulation-Based System.

The Licensing Regime is regulatory rather than contractual because under it, an investor applies to the State for a permit (li-



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cense) to use subsoil (Subsoil Permit), which is the primary document authorizing subsoil use. A Subsoil Permit is issued by a state body authorized to issue Subsoil Permits (Licensing Body). Over the years, the Licensing Body has changed several times, and the current Licensing Body is Ukraine's Ministry for Protection of the Natural Environment (Environmental Protection Ministry). Issuance of the Subsoil Permit must be accompanied by an agreement between the Licensing Body and the subsoil user on the conditions for using subsoil (Licensing Agreement), which is considered to be an integral part of the relevant Subsoil Permit.

It should be noted that Subsoil Permits are issued separately for exploration (Exploration Subsoil Permit) and for production (Production Subsoil Permit).

Under the Regulation-Based System, Subsoil Permits are generally sold through auctions (Auction Procedure). In certain special cases determined by the GOU, Subsoil Permits are instead granted without an auction being held (Non-Auction Procedure).

It is important to note that in addition to a Subsoil Permit, which is obtained for the use of a specific subsoil area pursuant to subsoil legislation, a requirement also exists to obtain a license allowing to generally carry out a certain type of activity, such as exploration or production. The licensing of types of activity in various industries is regulated by the *On Licensing Certain Types of Economic Activity Act of Ukraine*.

### II. Key features of the Licensing Regime in 2007 and trends for 2008

We have identified the following notable trends in the Regulation-Based System for 2007 as compared to 2006, which we categorize as (1) positive; (2) general; or (3) negative.

#### (1) Positive Trends

- The respective GOU regulations established clearer (but still not sufficiently clear) provisions with regard to converting an Exploration Subsoil Permit into a Production Subsoil Permit: if certain conditions are met the holder of an Exploration Subsoil Permit has the right to obtain a Production Subsoil Permit without an auction.
- The possibility of obtaining a single Exploration-Production Subsoil Permit is more directly implied in the respective GOU regulations.
- The grounds for reformulating (transferring) a Subsoil Permit have been expanded and some new possibilities have appeared for investors, provided that certain conditions are met. These possibilities include reissuing a Subsoil Permit for the benefit of a new joint venture company (JV) or for the benefit of a subsidiary or parent company.

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## (2) General Trends

- The list of the cases when an existing Subsoil Permit can be suspended or cancelled has been significantly revised and expanded.
- Compared with 2006, the list of grounds for applying for a Subsoil Permit under a Non-Auction Procedure has increased from 10 to 13 and some grounds have been restated.
- The deposit payable at an auction for a Subsoil Permit increased from 5% to 20% of the starting bid for such Subsoil Permit.
- The auction participation fee in 2007 is no longer refundable to applicants (a 50% refund was stipulated in 2006).
- The deadline for filing an auction application has been reduced from 30 to 15 days, and the deadline for making the official auction announcement has been reduced from 45 to 30 days, with both deadlines counting from the date the auction is held.

## (3) Negative trends

Historically, issuance of Subsoil Permits under the Licensing Regime in Ukraine has been very politicized, and this has been especially true in the last few years, and specifically in 2007. In reality, only the least attractive and most expensive oil & gas areas were allowed to be auctioned. Subsoil Permits for remaining areas have been granted through “exceptions” to the Auction Procedure. Not surprisingly, even those few auctions that did take place in 2007 either did not attract any bidders, failed to sell any Subsoil Permits, or sold very few Exploration Subsoil Permits, and no Production Subsoil Permits were offered at all. The analysis of the Auction Procedure in 2007 shows that it is not sufficiently transparent and allows for baseless cancellation of an auction or withdrawal of some Subsoil Permits from an auction. In addition to the regulatory flaws, the practical implementation of the Auction Procedure in 2006-2007 was inconsistent, ambiguous, and deeply flawed. This resulted in highly publicized scandals, which caused the President of Ukraine to issue a Decree in the fall of 2007 suspending all future auctions.

Another negative trend was that in 2007 the GOU declared unlawful the traditional method by which foreign investors participate in the use of subsoil, to wit, through joint activity agreements with Ukrainian holders of Subsoil Permits (JAAs). In general, JAAs are possible under Ukrainian civil legislation, and, in particular, the *Oil & Gas Act* recognizes the tie between JAAs and oil & gas exploration and production by mentioning it in various contexts. At the outset, it should be noted that JAAs do not represent a sufficiently solid and risk-free legal basis for long-term investment in the oil & gas sector because of a number of general legal concerns and risks. In addition, JAAs do not allow foreign investors to acquire any rights to Subsoil Permits held by local partners.

In practice the Licensing Body had always recognized JAAs, and even encouraged foreign investors to invest in oil & gas projects specifically through JAAs. The GOU was well aware of this practice and accepted it by never raising any objections. However, in 2007, the GOU adopted an inconsistent and contradictory approach towards JAAs. Following instructions issued by the GOU, the State Tax Administration, Ministry of Economy, Ministry of Justice, Ministry of Finance and Ministry for Fuel and Energy came to the unanimous — but unexpected — conclusion that the GOU considers the use of JAAs to invest in oil and gas exploration and production to be unlawful. Obviously, the GOU's inconsistent, hostile and hypocritical position with regard to JAAs creates substantial risks for foreign investment in the oil & gas sector and raises doubts about the GOU's true intentions.

Finally, another major negative setback in 2007 has been the GOU's open interference in the gas market. The *Budget Act for 2007* and later GOU Resolution No. 31 dated 16 January 2007 introduced restrictions on the sale of natural gas extracted in Ukraine. Companies in which the State owns a majority stake are now required to sell their natural gas exclusively to NJSC Naftogaz Ukrainy at a price

approved by the National Commission for Regulation of the Electric Power Industry, i.e. at low prices set by the State. It is important to note that these restrictions apply not only to gas owned by companies in which the State owns a majority stake, but also to gas owned by their privately-owned JAA or JV partners. For example, if a foreign investor happened to have a JAA with such a state-controlled company, the share of extracted gas belonging to this foreign investor would also be subject to these restrictions, and the foreign investor would be forced to sell its share of gas to Naftogaz Ukrainy at an artificially low, regulated price.

As a result of the above restrictions, 2007 saw gas prices in Ukraine set not by the free market, but by the State. Predictably, these restrictions outraged the investment community and resulted in litigation — while the GOU openly ignored the protests and court decisions. Unfortunately, the *Budget Act for 2008* contains the same restrictions, so we expect that in 2008, this issue will again end up in the courts.

## III. GOU Plans for the Development of the Oil and Gas Sector

In 2007 GOU and President of Ukraine have made a number of declarations about developing the energy sector, improving its legal basis and attracting foreign investment in this sector. Unfortunately, to date these good intentions have not been implemented. In practice, in 2007 the GOU continued to carry out hostile policies against investors and cultivated an unpredictable, contradictory and arbitrary regime for investment in the energy sector. It remains to be seen whether the new-elected Rada and the new GOU introduce serious positive changes in the energy sector and the good intentions are implemented in practice.

### PRO file



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