

Overview of the Subsoil Licensing Regime in 2008 and the Tendencies for 2009

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In 2008 all branches of the Government of Ukraine actively declared the need to reform and modernise 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 16 January 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 fuel and energy complex (Clause 3.3). This action plan contains the following important aspects:

Ukraine's strategy during the next 5-7 years will be aimed at achieving the goal of creating an attractive investment climate for 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 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 *On Rental Payments for Oil, Natural Gas and Condensed Gas Act of Ukraine* as to 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 & gas sector in his Decree *On Certain Measures Aimed at Improving the Regulation of Mining Relations of 28 February 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 that very little progress was achieved in the oil & 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



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either frozen or cancelled, and no new oil & gas subsoil areas were offered at subsoil auctions.

We have already described in detail the specifics of the licensing regime for the use of subsoil in Ukraine in our article published a year ago in this "Ukrainian Law Firms 2008. A Handbook for Foreign Clients", and so 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: Licensing Procedure and the Auction Procedure. The Licensing Procedure was reported to be adopted on 27 February, but it was not published until early April and took effect on 11 April, and the Auction Procedure was adopted as late as 4 June (and took effect on 17 June). Most of the comments and amendments to the drafts of these regulations, suggested by the industry (through the European Business Association) to the CMU, were not taken into account.

The CMU strongly favored the state sector, to the disadvantage of the private sector, in exploration and production of oil & gas. For example, in 2008 virtually no oil & gas subsoil areas were offered at subsoil auctions (only one area was offered and then withdrawn from the auction that took place

on 16 December), thereby depriving the private sector from any opportunity to invest in new oil & gas exploration and production projects. At the same time, a large number of oil & gas subsoil areas were granted to the state-owned NJSC Naftogaz Ukrayiny (for example by the CMU Ordinance of 17 September 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 private sector. The main vehicle for such cooperation, a Joint Activity Agreement (JAA), which has been used for years, became virtually unavailable. In particular, the CMU Ordinance of 7 May 2008 required that an individual permit of the CMU be obtained for any JAA that involves a state-owned company (and "state-owned" means any company where the state's stake exceeds 50%). No procedure for obtaining such a permit was adopted. Moreover, same Ordinance called for early termination of previously concluded JAAs. Further, when a large number of oil & gas subsoil areas were granted to the state-owned NJSC Naftogaz Ukrayiny by CMU Ordinance of 17 September 2008, this Ordinance contained a direct prohibition to develop these areas on the JAA basis.

On 30 October 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 JV 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,

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 & 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 15 January 2009 and, thus, it appears that in 2009 they again will be adopted with substantive delay.

At the same time, despite of all negative trends in 2008, the CMU will have no choice but to improve the licensing regime in 2009 and to make the oil & 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.

PRO file

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