

Overview of Subsoil Licensing Regime in 2009 and Trends for 2010

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We have been reporting in this magazine on new developments in the subsoil licensing regime for several years now. And it appears again in 2009 that most of the promises declared by the Ukrainian Government (GOU) to improve the investment climate in the fuel and energy sector have not been implemented. Various progressive policy guidelines, in particular, stated in the GOU's Action Program "Ukrainian Breakthrough: For the People, Not For Politicians" and in various decisions of Ukraine's National Security and Defense Council have largely been ignored.

1. Subsoil Licensing Regime in 2009

2009 was marked by the formal restoration of the tender-based licensing regime stipulated in the *Subsoil Code* and the *On Oil and Gas Act* ("Standard Legislative Basis"), which was suppressed every year since 2004 and replaced by the *ad hoc* auction-based system relying not on laws, but on regulations adopted annually by the GOU (the "Regulation-Based System"). The Regulation-Based System was quite unstable and unpredictable, leaving the industry at the mercy of the annual GOU Licensing Regulations. The GOU also undertook the practice of adopting the Licensing Regulations as late as possible in a year, leaving the industry paralyzed for the first few months of each year.

In the middle of 2008, following the decision of the Constitutional Court, the Act was adopted restoring the Standard Legislative Basis for subsoil licensing. Thus, 2009 was supposed to be the first full year since 2003 with a stable tender-based subsoil licensing regime stipulated in *Subsoil Code* and the *On Oil and Gas Act*. That did not materialize in practice because the GOU failed to follow the Standard Legislative Basis in its licensing activities.

Instead, GOU continued to rely on its 2009 Licensing Regulations: Licensing Procedure (Cabinet of Ministers Resolution No. 608) and Auction Procedure (Cabinet of Ministers Resolution No. 609), both adopted on 17 June 2009. It should be noted that for the first time the 2009 Licensing Regulations were extended to 2010, so at least there is no gap in subsoil licensing regulation in 2010.

As in previous few years, in 2009 GOU offered very few oil and gas deposits at auctions. At the same time GOU generously granted subsoil licenses to state-owned companies. For example, according to the Cabinet of Ministers Ordinance No. 1095-r of 26 August 2009, subsoil licenses were issued to Naftogaz Ukrayiny (100% state-owned company) without the holding of an auction with respect to twelve oil-and-gas deposits. Moreover, before granting these licenses the GOU, by its Ordinance No. 1094-r of 26 August 2009, first cancelled the licenses granted with regard to same deposits to other companies in 2007.

Therefore, in 2009 GOU again created preferential opportunities for state-owned companies, offering next to nothing to the private sector.

Below we offer a very brief review of negative and positive trends of Licensing Regulations for 2009, which continue to remain in effect in 2010.



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Negative Trends:

— Very short timeframe between the announcing of the auction and submission of an application deadline, which in practice would limit the opportunities of companies, especially international ones, to submit their applications in a timely manner. Thus, an auction announcement must be published not later than 30 days before the auction date and only in one Ukrainian central newspaper (*Uriadovy Courier*) and on the Environment Ministry's website.

— The auction process is burdened with numerous difficult-to-meet (especially for foreign investors) or entirely unfeasible conditions. With the auction to be announced 30 days before its date, the rules state that the prospective bidders must submit their applications with complete document sets within 15 calendar days after the date of the announcement, including to pay for and receive auction documents from the Environment Ministry, and to pay an advance fee.

— The auction committee is authorized to cancel an auction without stating its reasons or to withdraw specific licenses without prior notice (even on the day of the auction);

— In 2009 the holders of oil and gas exploration licenses are deprived of an opportunity to receive the production license without an auction, and now must, upon completion of exploration, bid for the production license at an auction.

— The Model Licensing Agreement contains many conflicting obligations to be assumed by the subsoil user, some of which are contrary to the laws of Ukraine (e.g. those dealing with land allocation), and some of them are not of a contractual nature since they are based on mandatory laws and not at the mutual agreement of the parties.

Positive Trends:

— The list of cases in which subsoil licenses can be granted without an auction has been reduced substantially from fifteen in 2008 to five in 2009.

— The procedure for issuing subsoil licenses without holding an auction is tightened: a GOU decision is needed in each case (with the exception of underground waters).

— In 2009 the Environment Ministry finally approved the Model Licensing Agreement for each type of subsoil (each license must be accompanied by a licensing agreement signed between the subsoil user and the state, which becomes an integral part of the license).

— A single form for the subsoil license was approved in 2009.

— The Environment Ministry cannot unilaterally amend a Licensing Agreement made with a subsoil user and enclosed to the subsoil license.

— A subsoil license can no longer be cancelled because its holder or the holder's contractor do not have, at the time of initiation of their works, an activity license with respect to such works (exploration or production of mineral resources, etc.).

— The Presidential Edict No. 912 of 10 November 2009 obliges the GOU to ensure equal conditions for receipt of subsoil licenses for national and foreign investors.

2. Joint Activity Agreements (JAA) in 2009

Although JAA is the main investment vehicle in the subsoil sector, in 2009 the GOU reconfirmed restrictions imposed earlier on state-controlled (more than a stake of 50%) companies, which in order to enter into a JAA must obtain prior approval from the GOU. The GOU continues to fail to establish a procedure for applying and receiving such an approval, making this exercise at best non-transparent or entirely impossible.

Also, given the reinstated Article 14 of the *On Oil and Gas Act*, that expressly stipulates prohibition of assignment of the rights stated in subsoil licenses *inter alia* in case of joint activity, the risks involved in JAA have become somewhat bigger in 2009. Public authorities interpreted these restrictions as broadly as possible, arguing that the rights to use the subsoil, including the rights to dispose of produced hydrocarbons, pay rent and other fees for oil and gas, are not assignable under JAA.

Such interpretation was confirmed by the decree of the Supreme Court of Ukraine published in 2009 (Yurydychny Visnyk Ukrayiny, No. 25, 2009.06, p. 15) by which the Court refused to protect the ownership rights of a non-state party to a JAA to the mineral resources extracted under this JAA arguing that its right to dispose of the extracted hydrocarbons (gas) was restricted by this Act.

Therefore, in 2009 the risks involved in exploring and producing natural resources under JAA have increased for private

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sector parties, while the confusing legal regime encourages state-owned parties to default on their obligations under JAA. As was reported in the *Ekonomicheskaya Gazeta* of 15 July 2009, "the majority of joint activity agreements are being challenged in courts".

It should also be noted that the GOU is not inclined to change its stance on JAA, and in 2009 it submitted to Parliament a bill that would enforce and broaden restrictions imposed on JAA.

3. New CBM Act Adopted

In a positive and long-awaited development, the *On Coal Deposits Gas (Methane) Act of Ukraine (CBM Act)* governing legal relations in the production and use of coal bed methane (CBM) was adopted in 2009. The *CBM Act* is a timely and important act that will help to promote CBM production and create an investment-friendly environment for this sector. It expressly stipulates investment options, including opportunities for making foreign investments in CBM exploration and production under JAA, as well as a simplified procedure for land allocation for CBM projects.

The GOU is making active efforts to implement the *CBM Act*. A program of priority steps has been developed, which includes *inter alia*:

— drafting other laws that will grant tax exemptions to those entities involved in CBM production;

— development of a legal framework that will enable a simplified procedure for auctioning subsoil licenses for CBM extraction from coal deposits.

It appears that the *CBM Act* opens up new and exciting opportunities in subsoil use, primarily for those investors who have relevant experience and implement modern technologies.