

## WORLDWATCH: ENERGY &amp; UTILITIES SECTOR

UKRAINE**Legal regime of hydrocarbons subsoil use in Ukraine**

by Oleg Y. Alyoshin

Ukraine, as a net importer of energy, has a generous endowment of hydrocarbon resources both onshore and offshore in the Black Sea. Hydrocarbon resources of Ukraine are estimated at 7-8 billion tons of fuel equivalent. The hydrocarbon potential of the Ukrainian Black Sea shelf is substantial; however, it has been inefficiently and insufficiently explored up to date. It is a common view among oil and gas industry specialists that, in spite of a number challenges, the benefits both for investors and for the country from successful oil and gas exploration and production projects are potentially very high. And in this context, the clear, transparent and predictable rules relating to long-term use of subsoil bearing hydrocarbons reserves is of much importance for potential investors in the sector.

**Subsoil licensing regime**

Pursuant to the Law of Ukraine 'On Oil and Gas' (the 'Oil & Gas Law'), the special permits (licences) for use of subsoil bearing hydrocarbons must be granted on the basis of a *tender* according to the procedure as determined by the Cabinet of Ministers of Ukraine (CMU) in accordance with requirements of the Oil & Gas Law. However, since 2004 the tender procedure for granting the right to subsoil use has been, and in fact continues, to be replaced by the *ad hoc auction-based system*, which is grounded not on the laws, but rather on regulations annually adopted by the CMU. This system is pretty unstable and unpredictable for the investor, and, in fact, leaves the industry at the mercy of the annual CMU's Licensing Regulations. Another problem is that the CMU has been adopting the annual Licensing Regulations as late as possible in a year, leaving the industry paralysed for the first few months of each year.

In the middle of 2008, following the decision of the Constitutional Court, the tender procedure subsoil licensing was restored in the Oil & Gas Law. As a consequence, the market expected that in 2009 the CMU will finally implement a stable and transparent licensing regime based on tender procedures, as provided for in the Oil & Gas Law. However, these expectations have not materialised. The CMU continued to practice the auction-based procedure for issuing special permits for subsoil use, which is based on the CMU's annual licensing regulations. Pursuant to the recently adopted Law of Ukraine 'On the state budget of Ukraine for the year of 2010', the 2009 Licensing Regulations were extended to 2010, having retained all procedural deficiencies and lack of transparency. This year, as in the previous one, the CMU continued the practice of granting special permits for subsoil use to state-owned companies without holding an auction, creating preferential opportunities for the state-owned sector.

**Production – sharing agreements**

Production-sharing agreements establish a separate and independent ground for subsoil use in Ukraine. The Oil & Gas Law does not extend to the use of hydrocarbons subsoil on conditions of production sharing, as governed by the Law of Ukraine 'On Production-Sharing Agreements' (the 'PSA Law'), which has been effective since 1999. To be eligible for development on conditions of production sharing, a hydrocarbon subsoil block needs to be approved by the CMU. The right to use a subsoil block on conditions of production sharing is subject to competitive tender to be held by a so-called Interdepartmental Commission, a specialised agency consisting of representatives from various state bodies and local administrations.

The only international competitive tender for a production-sharing agreement since 1999 was the tender for the Prykerchenska offshore block in the Black Sea, held in 2006. The tender was won by independent

American oil company Vanco. In late 2007, the first Ukrainian hydrocarbons production-sharing agreement (PSA) was signed between Vanco and the Ukrainian government. However, in April 2008 Vanco's licence for subsoil use of Prykerchenska Block was revoked by the government of Yulia Timoshenko and in May 2008 the government tried to terminate the Prykerchenska PSA. All these circumstances gave rise to international arbitration between Vanco and the Ukrainian government, which is still pending.

The production-sharing agreements are seen by investors as a good instrument for investment into the sector, albeit subject to a significant increase in the transparency of tendering procedures, the level of protection offered to foreign investors against various risks, including political ones, and clarification of tax and regulatory issues in a manner consistent with international standards. At the moment, the new PSA Law is under discussion in Ukraine and investors hope that the amended law will bring the PSA regulations up to internationally accepted standards.

### Joint activity agreements

The joint activities agreements (JAA) between foreign investors and the state-owned companies holding relevant subsoil licences has been the main investment vehicle in the subsoil sector over the last few years. To be able to enter to the JAA, state-controlled (a stake in excess of 50 percent) companies must obtain prior approval from the CMU. In 2008 to 2009, JAAs became a less attractive investment instrument for investors due to reinstated Article 14 of the Oil & Gas Law, which restricts assignment of the rights under subsoil licences in case of joint activity. Public authorities interpreted these restrictions in a broad sense, 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. This interpretation was confirmed by the decision of the Supreme Court of Ukraine published in 2009, 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. A similar restrictive approach will be supported by the government in 2010.

### Conclusion

Despite numerous efforts, no major foreign investor has been able to achieve any significant success in Ukraine's upstream oil and gas sector. If developing the country's domestic hydrocarbon resources is a priority for Ukraine, especially those located on the Black Sea Shelf, and if foreign investment is essential to the country's ability to develop those resources in a timely manner, then it is vital for the new government and the President to make efforts to improve the investment climate of Ukraine in the upstream oil and gas sector.

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