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Overview of Ukraine's Legal Regime for Upstream Oil & Gas Sector in 2012-2013

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RULG-Ukrainian Legal Group is a full-service law firm based in Kiev and Washington, D.C. that provides comprehensive legal support to international corporate clients doing business in Ukraine and other CIS countries. One of the RULG's key practice areas is upstream oil & gas, under both the Licensing Regime and the PSA Regime. RULG co-authored the production sharing legislation (two laws and a number of regulations) for Ukraine, which provided the legislative basis for the first ever Ukrainian PSA signed in October 2007 and for subsequent PSA Tenders. Detailed information about RULG practice is available at www.rulg.com. Dr. Paliashvili can be contacted at irinap@rulg.com

The period of 2012 - the beginning of 2013 has been marked by an avalanche of developments in the upstream sector, culminating on 24 January 2013 in signing the Production Sharing Agreement ("PSA") with Shell. The signing, which symbolically took place at the World Economic Forum in Davos, signifies a new era in Ukraine's energy sector ensuring exploration and production of domestic natural resources, most importantly Unconventional Resources (Shale Gas, Tight Gas, Shale Oil, etc.), as well as Black Sea development. A number of PSAs are expected to follow, both for onshore and offshore development.

As any cardinal reform, the opening up of Ukraine's upstream sector to major international investors carries numerous obstacles and risks, including geopolitical, political, environmental, legal, social, and other risks.

In particular, a strong PR campaign was initiated by certain opposition political forces against development of Unconventionals citing environmental grounds. A highlight of this campaign was introduction on 31 January 2013 by several opposition Members of the Parliament (Verkhovna Rada) of a Bill imposing a temporary Moratorium on exploration and production of Unconventionals. This Bill was later withdrawn, but replaced with Bill # 2318 proposing not only strict environmental protection measures, but also an irrelevant and burdensome requirement that each PSA must be approved by the Parliament. The fact that the battle against Unconventionals moved to the Parliament and is taking the shape of formal legislative initiatives signifies a new, more serious level.

On the positive side, Ukraine offers a legal instrument, which will help to meet the challenges and minimize risks: PSA is the most modern, stable and attractive legal and fiscal instrument available to investors in the natural resources sector.

The PSA legislation, most notably the PSA Law, was considerably amended in 2012, incorporating a long "Wish List" of various improvements proposed in the past few years by the investment and legal community, including by our firm, as well as amendments needed for the GOU to move forward on the PSAs already under negotiations and future PSAs. The amendments stopped short, however, of clarifying the legal specifics for implementing PSAs on the Continental Shelf, which in the absence of the law on Continental Shelf creates a substantial loophole in the legislation.

A new opportunity was defined for the investors to get the PSA. If before the only realistic way was through the competitive process of a PSA Tender, now the PSA Law offers an opportunity of getting a PSA through the conversion into PSA of existing Subsoil Licenses (held mostly by local State or private companies – License Holders). This opportunity ("**PSA Conversion**") was theoretically provided by the PSA Law before, but could not be implemented because of lack of critical details, which are now defined in the PSA Law. The PSA Conversion is the most intriguing new possibility for an investor to directly negotiate a PSA with the Government of Ukraine ("**GOU**") without holding a PSA Tender, provided that an agreement is reached with the local License Holder on jointly applying for the PSA Conversion.

No amount of legislative improvements, however, will make the real projects happen. Ukrainian legislation provides for various internationally-recognized investment vehicles, such as PPPs, JAAs, concessions, and indeed PSAs, but these vehicles are not always available or successful in practice. The key ingredient is the political will of GOU, and this will has been clearly demonstrated with regards to the PSAs within past two years.

The advantages provided by PSA come with the price. Clear tendencies emerged from several PSA Tenders carried out in 2012 by the GOU, focusing on Unconventionals and on the Black Sea Shelf: GOU established a practice of (i) imposing a "Local Partner", which needs to be carried in 50-50 proportion by the investor-winner of the PSA Tender *for onshore projects*; and (ii) no "Local Partner" or a "Local Partner" with a smaller interest than 50%, but a large signing bonus *for offshore projects*.

Below we offer a more detailed summary of the current legal regime for upstream sector, focusing on PSA Regime, which consists of the following sections:

- I. **Subsoil Licensing Regime**
- II. **Reform of the Regulatory Bodies**
- III. **Production Sharing Agreements (“PSA”) Regime**
 - (A) PSA Tenders
 - (B) PSA Conversion
 - (C) Prykerchenska PSA Settlement
 - (D) PSA Legislative Developments

I. Subsoil Licensing Regime

The legal regime for upstream activities in Ukraine continues to be divided into more traditional **Licensing Regime**, with Subsoil Licenses (referred to in legislation as “special permits” to use Subsoil) generally offered at auctions, and the alternative **PSA Regime** under which the investor obtains the rights to use Subsoil under a PSA concluded with the State.

The main legal instruments for Licensing Regime available to investors are either directly obtaining the Subsoil License (accompanied by the Licensing Agreement with the State) or concluding a Joint Activity Agreement (**JAA**) with the existing License Holder. Over the years, the Licensing Regime and its legal instruments have been consistently compromised by the GOU and Ukrainian courts, with the rights of investors threatened, Subsoil Licenses and JAAs challenged or cancelled.

It is not surprising that investors, who never had much trust in the Licensing Regime to begin with, are abandoning it in favor of the PSA Regime. There are close to none JAAs being signed, and no attractive Subsoil Areas are offered at auctions. The only still viable opportunity under the Licensing Regime is for investors to acquire companies holding Subsoil Licenses, but such acquisitions are complicated by the fact that many companies-License Holders are not for sale because they hold various other unrelated rights and assets. They would like, however, to transfer their Subsoil Licenses to a subsidiary and then sell the subsidiary, but the current Subsoil Code prohibits such a transfer. Therefore, only the company License Holder itself may be acquired in order to take possession of its Subsoil License.

We do not expect any serious changes in the Licensing Regime until the new version of the Subsoil Code is adopted, which may take place sometime in 2013.

Although in our annual overviews we usually described in detail both regimes, Licensing and PSA, but considering that not much has changed in the Licensing Regime compared to our previous overviews, we decided to concentrate in this article on PSA Regime, while referring those readers who are still interested in Licensing Regime to our previous articles http://www.rulg.com/publications_resources.asp

II. Reform of the Regulatory Bodies

Before going into detail on the latest developments in the PSA Regime, we should mention serious changes that occurred in the GOU bodies regulating the natural resources sector (“**Regulatory Bodies**”). In practice the issue of which Regulatory Body is in charge of the upstream sector has been evolving for some time, and has had strong political connotations.

At present “the central body of executive power in the sphere of geological study and rational use of subsoil” is the State Service for Geology and Subsoil of Ukraine (“**Derzhgeonadra**”).

In practice, however, it appears that at present the Ministry of Ecology and Natural Resources (“**Ministry of Ecology**”), and specifically Minister Oleg Proskuryakov, is in charge, with Derzhgeonadra playing a secondary role. In addition, with the recent transfer of former Minister of Ecology, Eduard Stavytsky, to head another Ministry - the Ministry of Energy and Coal Industry (“**Ministry of Energy**”), which was formerly headed by Minister Boyko, the Ministry of Energy may play a bigger role in regulating the upstream sector.

This game of musical chairs accompanied by constant silly (and costly) renaming of Regulatory Bodies, and with actual developments not always accurately reflected in the applicable legislation, has been extremely confusing for investors. The present outcome, however, may bring more clarity and better coordination among the Regulatory Bodies. In the past the Ministry of Ecology/Derzhgeonadra (overlooking NAC Nadra) on the one hand, and the Ministry of Energy (overlooking NAC Naftogaz) on the other hand, had not been known to coordinate their positions. This lack of coordination between two branches of GOU responsible for energy has long bothered investors and slowed down many projects.

At the beginning of 2013, when the new Cabinet of Ministers was appointed following the Parliamentary elections, this problem appears to be resolved if not in legislative sense, then in practice with the former Minister of Ecology, Eduard Stavytsky, transferred to head the Ministry of Energy, while his close ally, Oleg Proskuryakov, who previously headed Derzhgeonadra, becoming the Minister of Ecology, and an ally of Minister Oleg Proskuryakov, Valeriy Dudinov, appointed the Head of Derzhgeonadra.

One more important regulatory development of the past year was related to the PSA Inter-Agency Commission. This was the only institution, where all key Ministries were working together on the PSA issues. In a surprising development, the PSA Inter-Agency Commission was abolished altogether as of December 2012, replaced at various degrees with Derzhgeonadra and Ministry of Ecology (the role of the Ministry of Energy is still unclear, but in practice it will definitely be more influential than before). On 13 February 2013 a Bill #2291 was introduced to the Parliament proposing to restore the PSA Inter-Agency Commission, but it is not yet clear whether this Bill will be adopted.

At present, therefore, there is no internal GOU institution, apart from the Cabinet of Ministers itself, which would coordinate the PSA issues among various key Ministries. To this end Article 3 of the PSA Law stipulates that “the Cabinet of Ministers of Ukraine, within the scope of its powers, shall coordinate the activity of the bodies of executive power and local self-government during conclusion, implementation and termination of production-sharing agreements.” In the absence of the PSA Inter-Agency Commission, it is unlikely that the Cabinet of Ministers itself will take over the role of internal coordination, so we probably should expect a procedure to be adopted by the Cabinet of Ministers explaining how the Derzhgeonadra, Ministry of Ecology and

Ministry of Energy, will coordinate and ensure all internal approvals of various other Ministries, State Agencies and bodies of Local Self-Government.

III. Production Sharing Agreements (“PSA”) Regime

After several uneventful years (first PSA tender was held back in 2006 for the Prykerchenska area on the Black Sea Shelf), within past 18 months the PSA Regime underwent major positive legislative and regulatory changes, and also was marked by several important actual events, such as accomplishing three PSA Tenders and start of negotiations on several PSA Conversion projects, as well as by finalizing the peaceful settlement of the long-standing dispute on Prykerchenska PSA between GOU and Vanco Prykerchenska Ltd.

(A) PSA Tenders

PSA Tenders for Yuzivska and Olesska Subsoil areas (Shale Gas, Tight Gas and other hydrocarbons) were announced in February 2012 with the winners selected and announced on 16 May 2012: Yuzivska tender was won by Shell and Olesska – by Chevron. There were a few other international investors bidding in these PSA Tenders (Eni – for Olesska and ExxonMobil and TNK-BP for Yuzivska), with Russian investors, apart from TNK-BP, notably absent.

The Yuzivska and Olesska PSA Tenders were followed by two more PSA Tenders for the Subsoil Areas on the Black Sea Shelf: Skiphska, which was won in August 2012 by a group of investors led by ExxonMobil, and Forosska, which did not attract bidders. It is expected that GOU will put up Forosska again for a PSA Tender in 2013, making tender conditions more attractive to investors, and will also announce a PSA Tender for Slobozhanska onshore area (Shale Gas and other hydrocarbons).

As it was mentioned above, Shell and Chevron, which are investors respectively in onshore Yuzivska and Olesska PSA projects, were imposed by GOU a “Local Partner”, which needs to be carried in 50-50 proportion. This “Local Partner” was selected through a two-level tender process: first a tender determined the State company: NAC Nadra of Ukraine, and then another tender was held among private companies, which was won by a small geological company SPK Geoservice. Two joint ventures, Nadra Yuzivska and Nadra Olesska, were established between NAC Nadra of Ukraine and SPK Geoservice (in which NAC Nadra of Ukraine has a 90% stake) to act as the “Local Partner” in each respective PSA Project

Notably, although PSA Tenders for Olesska and Yuzivska took place at the same time, and the winners, Chevron and Shell, were announced at the same time, the Yuzivska PSA was negotiated in a record short time and signed on 24 January 2013, while the Olesska PSA is still being negotiated with no approximate signing date announced. This longer negotiation period on Olesska PSA is explained by the fierce resistance of local authorities, citing mostly environmental reasons, to the development of Shale Gas and other Unconventional reserves located across several regions in Western Ukraine.

In fact the GOU has pursued a very ambitious timeframe for signing both above PSAs. The PSA Law establishes an up to 18 months (up to 12 months in general and additional 6 months if requested by Investor) timeframe, while Yuzivska PSA was signed by Shell on 24 January 2013, i.e. after only 8 months since it won the PSA Tender on 10 May 2012.

The deadline for signing Olesska PSA is 09 May 2013 unless Chevron asks for the 6 months extension.

It should be noted that there was a persistent confusion in various reports between the timeframe for signing PSA and for signing JOA with the “Local Partner”. The timeframe of up to 18 months for signing a PSA is described above and is established in the PSA Law, while the timeframe of 120-days for signing the JOA with Local Partner for each Olesska and Yuzivska projects was established in Article 18 of the respective CMU Resolutions on carrying out PSA tenders dated 30 November 2011. CMU twice extended this original 120-days deadline for signing the JOA with the “Local Partner”, but because of delays with the Olesska PSA the GOU finally gave up and in December 2012 removed this deadline altogether for both Yuzivska and Olesska PSA projects.

(B) Conversion of the existing Subsoil License into a PSA

The long anticipated mechanism for the conversion of the existing Subsoil License into a PSA without a tender (“**PSA Conversion**”) opens up for investors a large number of existing projects, which are under control of local companies – License Holders.

According to the previous version of the PSA Law, PSA Conversion was possible, but there was no procedure provided, and the possibility for such a PSA Conversion was expressly allowed only for the License-Holders, which in most cases are Ukrainian State-owned or private companies. There was no mention of a possibility to bring an investor into the conversion and make the investor a party to the future PSA together with the License Holder.

The recent amendments to the PSA Law introduced the procedure and timeframe for the PSA Conversion, but still do not expressly allow bringing an investor, along with the License Holder, into the PSA Conversion. Because this issue is of critical importance for investors, which intend to participate with License Holders in the PSA Conversion, the absence of express provision in the legislation leaves a gap open to interpretation.

However, the PSA Law in its new version elaborates on the concept of a "multilateral" PSA, and it is possible to interpret the “multilateral” PSA, as the one in which another party-investor can enter into, along with the License Holder during the PSA Conversion. In practice GOU seems to support this interpretation. In this case the PSA will be concluded on the one side by the License Holder and another party-investor, and on the other side by the GOU. PSA Law further adds that in such a case, after “multilateral” PSA is concluded, a new Subsoil License will be issued in the name of all investor-parties to the PSA.

(C) Prykerchenska PSA Settlement

The long awaited settlement of the Prykerchenska PSA dispute brought by Vanco Prykerchenska Ltd. against the State of Ukraine under the Rules of Arbitration Institute of the Stockholm Chamber of Commerce has reached its completion. The settlement was approved by the Arbitration, and the Cabinet of Ministers of Ukraine (the “**CMU**”) at present carries out necessary legal procedures on cancelling its previous acts on termination of the Prykerchenska PSA. In particular, on 11 February the CMU adopted an Ordinance 58-p, cancelling its previous Ordinance 740-p of 28 May 2008 on termination of Prykerchenska PSA.

Considering that Prykerchenska area is located in deep waters on the Black Sea Continental Shelf, and any activities there would require very substantial costs, it remains to be seen when and how actively the investor, Vanco Prykerchenska Ltd., will implement the ambitious Work Program and its substantial investment commitments under the PSA. It would be also

interesting to observe whether Vanco Prykerchenska Ltd. would seek to farm out all or part of its interest in the Vanco Prykerchenska PSA to another investor.

(D) PSA Legislative Developments

The new Law "On Amendments to Selected Legislative Acts of Ukraine Concerning Execution of Production Sharing Agreements ("**PSA Amendments Law**") took effect on 7 November 2012, introducing a number of important amendments into the PSA Law and a few other laws.

Some of its most important highlights are the following (the new regime for PSA Conversion is described in a separate sub-section (B) above):

1. Waiver of Sovereign Immunity by the State

The PSA Amendments Law restored the provision on waiver of sovereign immunity by the State, which was stipulated in the original PSA Law, but later invalidated by the Constitutional Court. This time, the PSA Amendments Law made such a waiver a right, but not an obligation of the State. In any case this is a major improvement in terms of strengthening international protection mechanisms available to foreign investors, and obviously foreign investors should insist on inclusion of the waiver of sovereign immunity by the State into their PSAs.

2. Separating PSAs from the PPP Law

The Public Private Partnership ("**PPP**") Law was adopted much later than the PSA Law and listed PSAs as a type of PPP, which carried multiple risks for PSAs because of conflicting rules in the PPP Law and in the PSA Law. The PSA Amendments Law separated PSAs from the PPP Law, removing these risks.

3. Adding Unconventionals

The PSA Amendments Law added Unconventional Hydrocarbons to the list of natural resources eligible for PSAs. Furthermore, it distances PSAs made specifically for Unconventional Hydrocarbons from regular requirements, and makes sure that the parties can provide a special regime for Unconventionals in the PSA itself. Thus, PSA Amendments Law allows to establish in an individual PSA specific provisions applicable to Unconventionals, which may differ from the legislation applicable to Conventionals, and which will prevail in case of a conflict.

4. Strengthening Regulatory Obligations of the State to the Investor

The PSA Amendments Law reinforced the obligation of the State to issue a Subsoil License and various other regulatory approvals to the PSA investor(s) and expanded this obligation to subcontractors, suppliers and other counterparties of the PSA investor(s).

5. More Flexibility for the Investors in the Multilateral PSA

The right of the investors in the PSA to change the shape (geographical coordinates) of the Subsoil Area subject to the PSA was reinforced, and no changes to the PSA itself are needed in this case. In addition, The PSA Amendments Law granted more flexibility to investors in a multilateral PSA to re-arrange their relations (for example, change their stakes in the shared production).

6. Clarifying and Strengthening the Role of the Operator

The role of the Operator under the PSA was clarified and strengthened, allowing the Operator to make independent decisions with regards to day-to-day operations under the PSA.

7. Automatic Granting of a Subsoil License under the PSA

The obligation of the State to grant a Subsoil License to the investors on the basis of the PSA was reinforced and clarified, adding that no Licensing Agreement is needed in this case.

8. Clarifications as to Cost-Recovery

The PSA Amendments Law attempted to clarify investor's expenses subject to cost-recovery. In particular, it clearly stated that expenses incurred before the PSA is signed are not subject to cost-recovery, but then added "unless otherwise stipulated by the agreement". We assume therefore that this rule can be avoided and pre-PSA expenses can in fact be included into cost-recovery if so specified in an individual PSA.

9. GOU needs to Apply to Courts for Early Termination of a PSA

The PSA Amendments Law requires GOU to follow due process and to apply to courts (or other dispute resolution forum, meaning international arbitration) in case GOU discovers substantive violations by the investor and wishes to terminate the PSA.

10. PSAs are Exempt from Gas Export Restrictions

By introducing amendments to the Law "On Conditions for Functioning of the Natural Gas Market" the PSA Amendments Law exempted PSAs from the gas export restrictions and price controls.

11. PSAs Exempt from Various Currency Control Restrictions

By introducing amendments to currency regime legislation, the PSA Amendments Law exempted PSAs from various currency control restrictions.