

# New Government Initiatives for the Attraction of Investments in the Oil-and-Gas Sector in Ukraine\*

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## Overview of Current Legislation

### 1.1. INTRODUCTION

The oil-and-gas sector is one of the most important factors affecting the viability of modern countries, and Ukraine is no exception. Nevertheless, despite its overwhelming importance, this sector remains one of the most complicated, problematic and inconsistent areas of the Ukrainian economy.

Under the new Government, Ukraine is hoping things will change for the better in the oil-and-gas sector. And indeed, substantial innovations have already taken place in this respect. It is not clear, however, how progressive these innovations are. One thing is clear – the Government's steps have caused a "storm" among the players on the Ukrainian oil-and-gas market and even "fights" between the Government and major Russian companies operating in the Ukrainian market. Today we will be reviewing the existing legal framework, recent reforms, and practical problems (both those inherited from the previous Government and new ones).

### 1.2. OIL-AND-GAS SECTOR LEGISLATION

It is impossible to cover all the relevant legislation here. But we should at least point out that Ukraine currently has numerous regulations at different levels covering various aspects of the oil-and-gas sector. The major regulations include the 1994 Subsoil Code, the 2001 Law "On Oil and Gas", the 1999 Law "On Production-Sharing Agreements", the Law "On Pipeline Transport" and several general laws regulating taxes in this sphere (including the Law "On VAT" and the Law "On Taxation of Profits of Enterprises"). Ukraine is also a signatory of international (bilateral and multi-

lateral) oil-and-gas agreements, including the Energy Charter, 1996 CIS Agreement for Agreed Policy in Transit of Oil and Oil Products Via Main Pipelines, the 1996 Agreement between the Government of Ukraine and the Government of the Republic of Kazakhstan Concerning the Principles of Cooperation in Oil-and-Gas Branches, the 1995 Agreement between the Government of Ukraine and the Government of the Russian Federation for Interaction During Operation of Main Oil Pipelines, the 1999 multilateral umbrella agreement on the institutional grounds for the creation of interstate systems of oil and gas transport, etc.

The oil-and-gas legislation has, unfortunately, been inefficient so far in carrying out its basic social role of establishing effective, transparent and consistent regulation of relations in this domain, including taxes. Let us consider some topical problems.

#### 1.2.1. Licensing Regime

Most economic activities in the oil-and-gas sector are subject to licensing (e.g. exploration for oil and gas, use and operation of oil-and-gas-bearing subsoil, construction and operation of underground oil and gas storage facilities, transport of oil and oil products via main pipelines, transportation of natural gas and oil via pipelines and its distribution, delivery of natural gas at regulated and non-regulated tariffs, storage of large amounts of natural gas, etc.).

The use of oil-and-gas-bearing subsoil is theoretically subject to triple licensing (based on the Subsoil Code, the Law "On Oil and Gas" and the general law "On Licensing Certain Types of Economic Activities"). However, some

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of these licensing procedures have been suspended for the year 2005. The procedure for granting licenses through public auctions remains effective today. Besides, Article 68 of the Subsoil Code has not been suspended; it stipulates a separate procedure for granting licenses to nonresidents through international tenders. One suspects that Ukrainian authorities, despite trying to block the main licensing channels, have simply overlooked Article 68. Besides, the regulations that were drafted to further develop the provisions of Article 68 and that prescribe a detailed licensing procedure have become outdated in many respects and require improvement. Therefore, this option is seldom used in practice, if at all.

### 1.2.2. Production-Sharing Agreements

We are glad to note, however, that Ukrainian legislation contains an attractive alternative to the aforementioned licensing, based on the Law "On Production-Sharing Agreements". The specifics and advantages of this regime are well-known, but I would like to note again that PSAs provide primarily for a contractual rather than administrative "dialogue" with authorities and provide significant guarantees to investors for longer periods of time (up to 50 years), which means this regime provides better stability than the licensing regime does.

The main positive feature of PSAs is, of course, the special tax treatment it offers, whereby the legislation replaces payment of most taxes with sharing a portion of profit production. Goods, works, services and other material valuables imported into Ukraine for the purposes of carrying out PSAs are VAT-exempt. The Law also establishes a strict list of internal taxes (e.g., local taxes, social fees) payable by the investor. No other taxes are levied.

However, the PSA regime does have some problems. Some provisions of the PSA legislation require improvement, but that is not the main barrier, because no sphere of law is perfect and each sphere has to be updated continually. In our opinion, the main problem of the PSA regime is that PSAs are not accepted by authorities. The authorities simply fail to understand PSA principles (in particular, their tax aspects).

It does not help that the investment regime in Ukraine is not attractive for major oil-and-gas multinationals. We remember that several years ago, while making a presentation on the develop-

ment of the Russian oil-and-gas legislation at a conference attended by many high-ranking Ukrainian officials, a respected Russian ambassador to Ukraine commented that he wished Ukraine had also adopted a PSA law. At the time, Ukraine's PSA Law had already been in effect for several years. Yet, not only did the Russian ambassador to Ukraine not know about the law – none of the Ukrainian representatives at the conference were aware of it either.

Unfortunately, PSAs have not become effective in practice yet, despite individual attempts by foreign companies to implement PSAs.

### 1.2.3. Lack of stability in taxes, prices, quotas and tariffs. General tax treatment in the oil-and-gas sector stipulates:

- ! a 25% profit tax and, for foreign companies, also a 15% repatriation tax, unless otherwise prescribed by international agreements for the avoidance of double taxation;
- ! that a 20% VAT remains mandatory for deliveries of oil products, including oil imports (we remind you that a zero VAT rate was effective before 1 March for oil imports into Ukraine);
- ! that customs duties are also levied during oil and gas imports into Ukraine;
- ! that oil-and-gas companies operating in Ukraine must also pay various social fees and charges to local budgets, etc.; and
- ! that oil-and-gas companies incur substantial costs in connection with rental fees payable for produced oil and gas (these fees are suspended for the year 2005, however), as well as for exploration fees, subsoil use fees, etc.

The number of novelties and changes to the tax and customs legislation concerning oil and gas matters, as well as in pricing policy, have increased drastically in recent months. We now address the most prominent changes which have occurred between March and June of 2005 in this area, including the amendments introduced by the Law "On the Budget for 2005":

- ! A 20% VAT is to be levied on imports of oil in Ukraine.
- ! Export of oil products has been restricted substantially. A zero quota has been established for export of gasoline and diesel fuel for the periods from April until May and from August until September.

! The Government attempted to impose price controls on light oil products (the price of A-95 was 2.99 UAH (approximately 17 rubles)). Russian companies initially accepted these conditions, but later “boycotted” gasoline deliveries and forced the Government to back off this plan. The price of A-95 soon increased to 3.25 UAH (approximately 18 rubles) and is still rising.

! Excise duties have been reduced and import duties have been cancelled in order to reduce the prices of light oil products and improve competition on the markets for these goods.

The question remains, however, whether these changes are positive. On the one hand, there is liberalization of market relations in the oil-and-gas sector, but on the other hand there is no effective control of, nor uniform policy by state bodies, in this strategic sector. The Government’s unpredictable steps as it makes drastic changes in the rules of the game do not improve Ukraine’s investment climate.

**1.2.4. Other issues.** Ukraine has numerous other problems in the oil-and-gas sector, which must also be resolved urgently, in particular:

Discussions on improving the effectiveness of use of the Odessa-Brody corridor are ongoing. Discussions focus on extending this pipeline to Plotsk (Poland). Ukraine is also working actively with Central Asian countries in order to use this channel; Turkey has also stated its interest in the pipeline.

Ukraine needs new oil refineries. The oil crisis has shown that foreign companies’ control over major Ukrainian oil refineries can substantially undermine Ukraine’s economic security. Therefore, the Government has repeatedly cited a need to create new, and increase the production capacity of, existing oil refineries.

Although Russian oil-and-gas companies do not acknowledge their monopoly status on the Ukrainian market, their substantial impact on the market is nevertheless obvious. Therefore, increasing competition in the market and use of alternative sources of oil and gas remains a serious problem (e.g. significant quantities of oil have been purchased from the Baltic states and Moldova; successful negotiations with several other ex-Soviet countries that have oil and gas resources are underway).

## Assessment of Possible Tax Reform in the Oil-and-Gas Sector

In our opinion, no deep and systematic tax reform or any other detailed transformations in said sector should be expected in the near future (before the Parliament elections in March 2006 and, probably, some months after the elections). This autumn, the country (and, in particular, all state bodies) will be involved in pre-election fights.

However, the burning problems in the sector remain and they need to be resolved today. The oil and gas sector can also be used as a trump in political pre-election games, so changes may occur even in this period. It is hard to predict today the specific changes that will take place, their intensity or benefits for the country and foreign investors. Therefore, this review will be limited to a brief assessment of the currently available reform proposals that are being discussed at this time and have a chance of being implemented:

NJSC “Naftogaz” intends to submit to the Cabinet of Ministers a proposal to lift oil export restrictions based on the fact that, in the opinion of NJSC “Naftogaz”, there is a surplus of light oil products in Ukraine today.

An increase in the tariffs charged for transport of Russian gas across Ukrainian territory is being discussed, in view of the expected increase in the price of Russian gas delivered to Ukraine.

A bill concerning the lowering of the excise duty levied on imported oil from 60 to 35 euros per ton for most gasoline groups and from 30 to 10 euros for diesel fuel has been registered. The drafters base their proposal on Russia’s intent to increase the duty on oil products delivered to Ukraine. Consequently, to prevent further increases in the prices of gasoline and diesel fuel, they propose reducing the Ukrainian duty.

Also, a law concerning exempting from VAT imports of gas under foreign- economic agreements made in observance of Ukraine’s international treaties has been submitted to the Parliament for consideration.

We assume that numerous similar proposals will arise later; however, like the aforementioned ones, they will probably be made ad hoc and in no organized manner. Some proposals will eventually become law. However, given Ukraine’s unpredictable political situation, it is not at this time possible to predict what changes will be made. □