CMS Cameron McKenna

Ukrainian Oil and Gas Sector in 2011

by Vitaliy Radchenko and Volodymyr Kolvakh, lawyers with CMS Cameron McKenna

2011 has served as a transition period for the Ukrainian oil and gas industry even if there are no particular accomplishments or dramatic changes to speak of. This transition period should pave the way for important and interesting developments in 2012.

1. Export of natural gas

On 1 January 2011 the Ukrainian oil and gas monopoly, National Joint-Stock Company "Naftogaz of Ukraine" ("**Naftogaz**"), halted deliveries of natural gas to Poland under a gas supply agreement with PGNiG. Officials of Naftogaz and the Ministry of Energy and Coal Industry explained that this interruption was the result of a "new" piece of legislation which, in 2010, had imposed a mandatory obligation on state-owned oil and gas companies to sell natural gas produced domestically to residential consumers as a matter of priority. At the same time gas coming from Russia could not to be re-exported due to restrictions set forth in contracts between Naftogaz and Gazprom.

Trying to resolve this conflict, on 17 June 2011 the Ukrainian Parliament managed to pass some amendments to the Law of Ukraine "On Principles of Natural Gas Market Functioning" No. 2467-IV, aimed at allowing Naftogaz and its subsidiaries to export natural gas produced in Ukraine. However, similar to the legislative framework that existed in previous years, such exports would have to be carried out in accordance with (i) the annual forecast of the natural gas intake and distribution in Ukraine, drawn up by Naftogaz and the Ministry of Energy and Coal Industry and (ii) a procedure established by the Ministry of Energy and Coal Industry. Due to a huge gap caused by a transfer of 12.1 billion cubic metres of natural gas from Naftogaz to RosUkrEnergo (the result of Naftogaz losing to RosUkrEnergo in an arbitration in Stockholm), the forecast for 2011 was not officially adopted, leaving no chances for natural gas exports from Ukraine in 2011 at all.

2. LNG terminal on the Black Sea coast

Last year's discussions about a 10 billion cubic metre LNG terminal on the Black Sea coast eventually resulted in a tender for a feasibility study, which was announced by the State Agency for National Projects in July 2011 and held in August 2011. The Spanish company Socoin was selected from a total of nine competitors to be the consultant for the feasibility study.

Despite the Agency's long-term plans, at the end of the year the LNG terminal coordination committee postponed the project due to a lack of interest from investors. Results of the feasibility study suggest that a better option would be to rent a floating regasification platform with a capacity of 3-4 billion cubic metres until the funding is secured. The Agency is considering this option and the future of the LNG project should become clearer in 2012.

3. Stability in subsoil licensing

In 2011 the Government deviated from its usual way of adopting resolutions in relation to subsoil use. Formerly, resolutions governing the auctioning and issuance of special permits (licences) were adopted annually and remained effective only for a year. The new Resolutions No. 594 and No. 615 will not be limited to the span of one year and will remain effective until they are amended.

The procedure set out in the new resolutions is more transparent than in previous years and has brought positive change. In particular: (i) where the State has a stake of at least 25% in an incorporated company special permits can be issued to that company without an auction; (ii) special permits can now be transferred to a joint venture where the original holder of the special permit is a participant in the joint venture and at the moment of transfer holds a stake of at least 50%; (iii) fewer consents are required from state authorities to nominate a subsoil area for an auction; and (iv) auction results can be challenged only in court.

As a result of an administrative reform, the State Service for Geology and Subsoil of Ukraine has taken over the responsibilities of the Ministry of Ecology with regard to administering subsoil auctions and issuing special permits.

In view of the positive changes to subsoil licensing it was disappointing to have only one auction of special permits in 2011 and for that auction to have been left to the very end of the year.

4. Unconventional gas perspectives

According to preliminary estimates carried out by the U.S. Geological Survey, Ukraine might hold about 1-2.5 trillion cubic meters of recoverable unconventional gas. A number of leading international oil and gas companies have also suggested there could be significant reserves of unconventional gas in Ukraine: TNK-BP plans to invest about USD 1.8 billion in development of unconventional gas in eastern Donetsk region, which has been reflected in a memorandum of understanding with the Ukrainian Government; Shell teamed up with Naftogaz's subsidiary, UkrGazVydobuvannia, to test out an exploration project for unconventional gas with a potential investment of up to USD 800 million; ExxonMobil signed an agreement with Naftogaz to analyse unconventional gas potential at certain mutually identified areas; and EBRD has expressed its willingness to assist Ukraine in the development of its gas resources.

5. Important changes to PSA Legislation

During 2011 Parliament made several modifications to the main legislative act governing production sharing agreements ("PSAs") - the Law of Ukraine "On Production Sharing Agreements" (the "PSA Law"). First of all, Parliament reinstated the stabilisation clause (protecting investors from unfavourable changes in the law), which had been removed in 2010. The next change eliminated the requirement to have a nominated area of investor's interest included by the Government into a special list of areas eligible for PSA tenders, before any such tender could actually be initiated. Finally, Members of Parliament introduced a new clause into the PSA Law, which may require the winner of the PSA tender to carry a state-owned company through the exploration phase of the PSA project.

6. Announcement of two PSA tenders

At the end of 2011 the Government officially announced its plans to hold two tenders for hydrocarbons sharing agreements in 2012. In this respect on 30 November 2011, the Cabinet of Ministers adopted Resolution No. 1297 and Resolution No. 1298, containing the main conditions on which the PSA tenders for the Oleska and Yuzivska areas will be held.

Successful bidders will be granted a 50-year "all-inclusive" special permit for the exploration and commercial production of natural gas, shale gas, tight gas, CBM, oil and oil condensate. The investors will have to develop subsoil areas jointly with, and carry through an exploration stage, a state-owned company, which will be entitled to 50% of the investors' rights and obligations including 50% of the investors' share in profit production. The minimum investment required at the exploration stage will be approximately USD 163 million for the Oleska area and USD 200 million for the Yuzivska area; at the commercial production stage (if any) the minimum investment required will be approximately USD 3.125 billion for the Oleska area and USD 3.75 billion for the Yuzivska area.

7. Painful gas negotiations with Gazprom

Naftogaz is still facing tough negotiations with Gazprom, desperately trying to agree a cheaper price for the natural gas imported through a Russian pipeline. Unlike some European countries which managed to arrange price discounts, or neighbouring Poland which after six months of unsuccessful negotiations decided to resolve the price dispute through arbitration in Stockholm, Naftogaz still hopes to achieve a miraculous win-win situation.

The key issues being negotiated relate to two joint ventures proposed for the management of Ukrainian gas transportation and distribution systems which are of great importance to Gazprom. In exchange for a price discount, Gazprom suggested transferring the Ukrainian gas transportation system and underground storage facilities to the first of the joint ventures between Gazprom, Naftogaz and, perhaps, EU-based partners. The second joint venture would take over Ukrainian gas distribution networks, currently leased and managed by regional gas distribution companies. New gas transportation joint ventures would be immune to changes in tax legislation, antitrust laws, and tariff changes and would have the authority to set tariffs for transportation and distribution of natural gas, as well as to fix gas prices for different categories of consumers.

Having failed to reach a common ground with Gazprom on the joint ventures and, as a consequence, on the ultimate gas price for Ukraine, Naftogaz suggested lowering the off-take volumes of Gazprom's gas for 2012 from 52 to 27 billion cubic metres, trying to avoid contractual penalties provided by the "take or pay" provisions. However, by the year-end Ukrainian-Russian negotiations were unable to shed light on either gas prices and contracted volumes or on the future of Ukrainian gas transportation and distribution systems. Negotiations between Gazprom and Naftogaz are ongoing.

8. Constantly rising gas prices

Similar to 2010, in 2011 we have seen a gradual increase of gas prices for industrial and commercial consumers and state and municipal budget-funded companies. The price cap of UAH 2282 (USD 285) per 1000 cubic metres set by the National Electricity Regulatory Commission at the end of 2010 reached UAH 3509 (USD 440) per 1000 cubic metres in late December, an increase of almost 54%. Except for domestic supply the end price of natural gas is driven primarily by the price of gas imported from Gazprom. This price has been set at USD 416 per 1000 cubic metres in the state budget for 2012.

9. Engaging in a joint activity with state companies

Changes have been made to the legal framework governing joint activities (non-incorporated and contract-based joint ventures) with state companies. First of all, companies that are included in a non-privatisation list are now prohibited from contributing their fixed assets into the joint activity.

The second change is a requirement for entities with more than 50 percent of the State's stake in their capital to hold at least 50% share in the joint property of the joint activity. This, however, does not extend to contributions or profits distribution of joint activity partners.

10. Unbundling of Naftogaz

By moving towards the liberalised gas market under the guidance of the European Energy Community, the Naftogaz monopoly would definitely face substantial changes in its structure in the following years, which it has opposed so vigorously in recent years. Ideally, as a result of unbundling of the production, transportation and distribution operations of Naftogaz, we would see a spin-off of a number of Naftogaz' subsidiaries into separate entities, although the extent of their independence would still be an issue. A number of experts suggest privatisation of Naftogaz subsidiaries as an alternative. Some officials have also expressed confidence in a Naftogaz IPO in 2013, but before that a number of significant legislative changes have yet to be made to allow Naftogaz to go public and be, at least partially, privately owned.

11. Transit pipelines

The European campaign for diversification of gas supply routes has made progress in 2011. In September Russia, Germany, France and the Netherlands put a USD 12.5 billion Nord Stream pipeline in operation and just before New Year Turkey gave Gazprom's South Stream pipeline the green light to cross its territorial waters. The launch of Nord Stream is not expected to increase gas exports from Russia to Europe, but on the other hand, the transit pipelines are likely to drive import prices up in Ukraine and result in greater political pressure.

12. Fuel quality

The switch to EURO 4/EURO 5 fuel quality standards, p by the Government for July 2011 and then January 2012, has been postponed once again. The switch has been delayed because several oil refineries have not completed their modernisation programmes, which may take another two years. Most of the fuel traders and producers were ready for the higher standards to come live in 2011.

13. Changes in taxation

At the end of 2011 Parliament passed amendments to the Tax Code. For the oil and gas sector these amendments will increase (i) excise duties on petrol and diesel fuel by about 10%; (ii) the charge on the use of subsoil for the extraction of natural gas by about 11%; and (iii) the environmental tax on the emissions of polluting substances by about 9% (which is included in the petrol price).

14. Outlook for 2012

Many of our predictions for the Ukrainian oil and gas sector in 2011 came true, and there has been gradual progress in the market.

The outlook for 2012 depends significantly on the outcome of negotiations with Gazprom over the price of gas imports. That said, key features of 2012 will include (i) the first stage of reforms in the gas market; (ii) significant oil and gas projects with major international oil and gas companies; and (iii) finding ways to diversify gas supply (for large industrial consumers as well as local consumers and utility companies) and reduce gas consumption in Ukraine.

* * *