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This article describes Ukrainian laws on oil and gas exploration, development and production licensing. It also considers related laws that may affect the use of these licences.

Under current Ukrainian law, a licence is required from the State Committee on Geology and the Use of Mineral Resources ('SCG') for oil and gas exploration, development and production. The consent of other state entities is also required for such licences to be issued. These entities include (depending on whether the licence is for exploration or production) the State Committee on the Supervision of Labour Protection ('SLP') the Ministry of the Environment and the Regional Executive Committees. In addition, applicants must file studies and other information produced with the co-operation of bodies such as the Ukrainian State Geological Information Fund. Other state entities, such as the State Border Guards with respect to offshore areas, can also exercise authority over activities.

The process for obtaining a licence can be complex. Although theoretically under current law simultaneous exploration and production licences could be issued, as a practical matter unless current procedures are revised or special treatment is obtained, this generally will not occur. Even so, a foreign licence applicant should seek a simultaneous licence for all anticipated activities, encompassing all required permissions, at the outset.

Licence terminations, like licence issuances, are governed by a variety of laws, decrees and regulations which create broad and vague criteria. The currently proposed Ukrainian Concession Law will not resolve this problem. One solution is for applicants to seek changes in the Ukrainian law applicable to their licences, in particular through special decrees, in order to protect their rights. For significant projects, it is not unusual in Ukraine for special decrees to be issued.

Other laws affecting oil and gas exploration and development licences include Ukraine's relatively harsh environmental laws that provide, for example, for strict liability for certain drilling activities. Although these laws have not yet been stringently enforced against domestic companies, at least one foreign company has been heavily fined for an oil spill (see below).

Export restrictions must also be considered when undertaking an oil and gas project in the region. Under Ukrainian law, merely holding a licence to produce does not mean that resulting products may be freely exported. An exporter of oil products must have a special state authorisation, and for particular exports, an export licence must be obtained or an exemption must apply. Export duties may also be imposed, although oil and gas exports are currently duty-free.

Taxes and exchange controls should also be considered to determine how a licence may be most effectively used. Ukrainian tax and exchange control law has been undergoing considerable revision recently, so special protection in these areas is desirable. One way to obtain special customs, tax and other treatment for oil and gas activities might be for the area to be licensed to be included within one of the free economic zones when the existing framework legislation is implemented.

Given the risk of future changes in Ukrainian law, which can be influenced by state entities such as the SCG, a foreign applicant should seek to make all contractual obligations governing its oil and gas investments subject to foreign law and foreign arbitration. A sovereign immunity waiver should also be sought. By internationalising its contractual obligations, a foreign licensee may better protect its position. The SCG, however, currently requests that Ukrainian law govern all its contracts and that the contracts be subject to the exclusive jurisdiction of Ukrainian courts. This is an important issue for future licence applicants to negotiate.

Ukrainian Oil and Gas Law on Licensing of Exploration, Development and Production

The requirement for a licence

When Ukraine became independent in December 1991, Soviet laws were adopted as Ukrainian laws to the extent that they were not inconsistent with the Ukrainian constitution and subsequent Ukrainian legislation. The 7 February 1991 Soviet Law on Entrepreneurship was adopted on this basis and has since been amended by the Ukrainian Parliament nine times.

In its present wording, Article 4(2) of the Law on Entrepreneurship provides that 'prospecting' (exploration) and 'exploiting' (development and production) of mineral deposits is only possible (1) under a licence issued by the Cabinet of Ministers of Ukraine or (2) by a 'specially authorised entity'. It appears that this reference to specially authorised entities is limited to certain state enterprises.

The Ukrainian Cabinet of Ministers initially implemented the licensing requirement of the Law on Entrepreneurship by adopting Decree 18 of 13 January 1993. Decree 18 was an amendment to the Soviet Council of Ministers' Law 99 of 15 April 1991 establishing the basis for issuing oil and gas licences.

This Decree and the Soviet Law it amended were replaced by Decree 316 of 17 May 1994 of the Ukrainian Cabinet of Ministers, entitled "The Regulations on the Procedure for Issuing Special Permits (Licences) on

Carrying Out Some Types of Entrepreneurial Activity For Subjects of Business Activity' (the '17 May Decree'). The 17 May Decree repeats the requirement that 'exploration and production of natural resources' is only allowed pursuant to a special permission (licence).

Licensing authority

The 17 May Decree provides that: (1) licences for 'prospecting for (reconnoitring) mineral deposits', meaning exploration, may be issued by the SCG; and (2) licences for 'exploration', understood to mean both development and production, may be issued by the SCG with the agreement of the SLP. Interestingly, under the 17 May Decree, the SCG may delegate to regional or local authorities its power to grant licences.

The jurisdiction of other state ministries and agencies is also affected by such licensing decisions. For example, the state entities responsible for maritime sea lanes and defence, in particular the Border Guard Committee, exercise some control over offshore drilling areas. Under the 17 May Decree, co-ordination with other state bodies is supposed to be handled by the SCG before it issues a licence, so that in principle no other permissions will be necessary for operations to commence. However, the current procedure for production licences requires applicants to obtain approvals from other state entities.

Licensing procedure

Applications

The 17 May Decree provides that licences may be issued in response to applications by persons or entities. Individuals must certify their qualifications. By contrast, entities simply have to document their corporate existence, in principle with a certificate of incorporation and a certified copy of their Charter.

Types of licences

As observed, the 17 May Decree states that the SCG can issue licences for the following oil and gas activities:

(1) 'prospecting and reconnaissance' - understood to mean exploration;
(2) 'exploitation' - understood to mean development and production - and
(3) engineering research and planning activities.

The legal form for licences is regulated by the SCG's Order 86 of 21 October 1993 and the new Natural Resources Code discussed below. The SCG, following adoption of the new Natural Resources Code, began revising Order 86's provisions, but a new regulation probably will not be adopted before autumn 1995.

The 17 May Decree does not indicate that the different types of activities must be licensed separately. Theoretically, the SCG should be able simultaneously to license exploration, development and production. It is desirable, for various reasons including those noted in the discussion below on sovereign immunity, for all licences to be obtained at the outset, subject to relinquishment for non-use. Otherwise, a licensee will have to obtain a development and production licence after commercial deposits have been discovered, and the commercial terms for such a licence may then be different. As a practical matter, however, a special amendment to or interpretation of Order 86 appears necessary to permit the simultaneous issuance of exploration, development and production licences. This is because under Order 86 considerable information, including, apparently about exploration results, is supposed to be provided and related requirements involving government bodies satisfied before a production licence is issued.

Licensing process

According to paragraph 3.1 of Order 86, licences may be issued for defined objects within precisely defined borders taking into account the geological conditions, the availability of necessary technology and equipment and how prepared the licence applicant is for the proposed activity. The licensing process involves the following:

(1) submission (presentation) of an application with all necessary documentation attached;
(2) examination of the application and documentation by SCG experts;
(3) preparation and negotiation of the licence and licence agreement, including the actual licence as an addendum; and
(4) issuance of the licence.

The content of the licence applications depends on the activity being licensed. The application for an exploration licence should include the following:

(1) name of the applicant (stated to be the 'performer of the work);
(2) name of the customer for whom the work is to be done;
(3) information about the object (place name, location, goals, preliminary types and amount of geological exploration work to be done, and the date when the work will begin);
(4) final goals of the exploration; and
(5) information about the applicant.

A production licence application should include the following:

(1) name of the applicant;
(2) the equipment to be used and its availability;
(3) the availability of employees to perform the work;
(4) information about the object (name, location, who explored and evaluated the reserves, and the quantity of evaluated reserves);
(5) method of developing;
(6) (expected) final commodity products and annual production capacity;
(7) preliminary technical and economic evaluation of the field; and
(8) date for commencement of production.

Paragraph 3.5 of Order 86 requires that the following documents be attached to all licence applications:

(1) for corporate applicants, a copy of the Charter and the Foundation Agreement, if it exists. A Foundation Agreement is a document required to create a company under Ukrainian law by which the company founders agree on the terms for the company's creation. These documents are required to prove that the applicant is a legal entity having, as a corporate object and power, oil and gas exploration, development and production or related engineering research and planning;
(2) for corporate applicants, the certificate of incorporation evidencing state registration;
(3) agreement of the appropriate Regional State Administration and of the State geological enterprise of the SCG for the conduct of the specific exploration, production or engineering research and planning activities. For a production licence, the Ministry of the Environment's consent is also required;
(4) two copies of graphic materials (observation map, a contour map of the target area, and geological depth maps) that can give a complete plan of the geological structure of the target area; and
(5) a copy of an 'act of allocation' of the target area to the applying legal entity.

This latter requirement for an allocation or granting act, and the requirements to obtain this, are not further explained in Order 86. The SCG should in the near future provide further details of this and the other requirements, in particular for information on the amount of resources expected in the target area. A form for applications is contained in an addendum to Order 86.

Contrary to the apparent intent of Order 86, the consent for the applicant required from a Regional State Administration is usually obtained by the SCG rather than by the applicant. This consent usually takes the form of a brief statement that the Regional State Administration does not object to the applicant's conducting the activity in the specified area.

In addition, for the exploration licence application, the applicant must submit three copies of a list of geological mineral resource research studies (agreed with the local State geological enterprise) for registering the objectives with the Ukrainian State Geological Information Fund.

The SCG also requires, in its Classification 05-10/12 of 24 February 1994, that licence applicants must submit a 'technical-economic basis' report evaluating the advisability of the proposed activity. For an exploration licence, the applicant must submit detailed technical-economic calculations' of the results expected and a preliminary 'technical-economic' evaluation of expected resources to be found in the proposed target area. For a production licence for a defined field, the applicant must submit 'technical-economic calculations' on the advisability of the activity based on the 'technical-economic basis' figures for field development calculated by the State Commission on Natural Resources Reserves in Ukraine.

Order 86 states that, for a licence, the foregoing information provided with an application should prove the effectiveness of the proposed use of mineral resources, according to geological, mining, technological, technical, economic and other criteria, as follows:

(1) the extent of the geological exploration of the target area;
(2) the expected quantity and quality of the natural resource reserves;
(3) the extent to which the natural resources will be removed from the ground;
(4) the extent to which other natural resources will be used;
(5) preliminary data on the quantity and quality of the final products and their conformity to Ukrainian technical conditions and standards;
(6) the degree of depletion of natural resources during production;
(7) the extent of extraction of natural resources during the enrichment and processing (refining); and
(8) the capital reserves for shutting down operations.

These information requirements appear to expect exploration results. Order 86 expressly provides that a licence application should be refused if:

(1) the application and documents filed do not conform to the requirements of Order 86;
(2) the applicant intentionally provided in its application false information about itself;
(3) the person or entity to perform the work does not have the necessary equipment or qualified specialists for completion of the work;
(4) the applicant is not keeping up with the standards of its competitors; or
(5) the applicant has some legal impediment to undertaking the activity.

Following submission of an application, the 'technical-economic calculations' are examined by SCG experts and, as necessary and at the applicant's expense, by other interested organisations. After analysis and examination of the complete application, the SCG decides on the conditions and technical requirements that shall be required in the licence. These conditions and requirements may be stated either in the licence agreement with the SCG or in the licence itself (which is usually in the form of a one-page summary document annexed to the agreement).

The SCG is required, within 30 days from receipt of a complete application, to decide whether to issue or to refuse a licence. If a licence is to be issued, then the SCG is supposed to prepare the licence and the licence agreement. The licence must be signed by the head of the SCG and a second senior official and then be sealed and registered in the SCG record book of issued licences.

Other applicable laws affecting exploration, development and production licences

In addition to the 17 May Decree, Order 86 and the other laws and regulations cited above, oil and gas exploration, development and production is regulated by the 23 June 1991 Law on Nature Protection and the new Code on Natural Resources, adopted on 27 July 1994 (Law 132/94BP), The Natural Resources Code is dealt with in this section. The Law on Nature Protection is discussed more fully below.

The new Natural Resources Code, which replaces the 25 July 1976 Soviet Code, provides for detailed regulation by the Council of Ministers of exploration, development and production activities. The SCG, which is responsible for drafting the implementing rules, has so far prepared only *half* of an anticipated 18 detailed decrees. The nine draft decrees presented so far to the Council of Ministers are expected to be adopted by May 1995.

A licence applicant should review carefully the detailed provisions and implementing regulations of both the Natural Resources Code and the Law on Nature Protection. Where the applicant anticipates that operations may result in infringements of the applicable rules, modifications should be sought by special decrees.

In addition, under the rules of Addition 1 to the Temporary Instruction on the Procedure of Issuing Licences' of the SCG, consents from either the Odessan Regional Administration or the Crimean Council of Ministers are also necessary for any offshore drilling. The Presidential Decree of 30 April 1992 on 'Government in the Sphere of Using and Preserving Natural Resources' also applies. It states that the SCG, the SLP and the Ministry of the Environment share jurisdiction regarding the use of natural resources. This sharing of power with the SLP is reflected in the 17 May Decree and in the Natural Resources Code. The Role of the Ministry of the Environment is discussed further below.

After a licence is granted, the SLP retains considerable power to regulate the licensee's activities, although it appears that, having consented to a production licence, it cannot later revoke that consent. Instead, it should only be able to recommend to the SCG that the licence be terminated. The SLP could still cause operations to be temporarily suspended, for example if the labour conditions were found to be unsafe.

Likewise, section 1 of the Directive of 2 September 1993 and Article 62 (part 2) (item 2) of the Natural Resources Code give the State Inspection Committee of the State Committee for Oil and Gas power to control the basis and effectiveness of oil and gas exploration. There appear to be no guidelines, so far, as to how this power is to be exercised, and whether it may conflict with SCG supervision in order, effectively, to deny SCG licensed rights.

Regulations, including those on licence termination rights, are also provided in the Cabinet of Ministers' Order of 10 August 1992, see discussed below.

Simultaneous licences

As observed already, although theoretically exploration and production licences could be issued simultaneously, the documents to be submitted for a production licence contemplate submission of the results of exploration activities. In addition, consents from the Regional State Administration as well as the Ministry of the Environment and the SLP must be obtained for a production application. Presumably the other state bodies will not be bound by the SCG's promises in an exploration licence agreement for further licences. The Regional State Administration and the Ministry of the Environment will probably initially require exploration results, and therefore any request for a waiver of special consents for simultaneous exploration and production licences should involve these government bodies as well.

Access to licensed area

Having an exploration or production licence does not necessarily give a licensee access to move drilling rigs to the area for operations. However, under the 17 May Decree, the SCG is supposed to consult with all governmental bodies before issuing a licence so an SCG drilling licence should carry with it all other necessary permissions.

Nonetheless, other consents may be necessary as a practical matter. For example, for offshore areas the Ministry for Border Guards will exercise a continuing supervisory role. To prevent future problems, in any special decree for a project a provision might be sought to ensure that the relevant SCG licence shall carry a continuing permission from the Border Guards, the appropriate Regional State Administration, the Ministry of the Environment and all other state bodies exercising any jurisdiction over the licensed area.

Termination of licences

The licence is the basic legal document defining the rules for the licensee's activities and defining on what basis the licence may be terminated. Under the 17 May Decree, violation of the licence rules may result in its loss.

The licence agreement may be strictly construed against a licensee, so it is important carefully to negotiate its termination provisions. Under section 5 of the 17 May Decree, in the event of a breach of the rules and conditions of a licence, the authority that granted it can either permanently terminate the licence or give a warning and temporarily suspend the licence.

An initial warning would be likely for minor violations, but if they continued termination would probably follow. Immediate termination would probably apply for any serious breach of a licence agreement, in particular if the offence was irreparable or if, under the licence agreement, it expressly gave rise to immediate termination rights.

The 17 May Decree states that such a termination decision may be challenged in a court or by arbitral proceedings, as appropriate. While a decision is

pending, the termination apparently remains in effect unless stayed by a court.

Under Ukrainian law, there may be rights of termination in addition to those in the licence agreement's termination clause. To begin with, under Article 26 of the Natural Resources Code, utilisation rights may be completely or partially terminated in the following circumstances:

(1) when there is no further need for use of the natural resource or the resource is exhausted;
(2) when there is another more important State or social need for the resources in question;
(3) when the enterprise transforming (exploring or producing) the resources is liquidated;
(4) when there is a threat to public health;
(5) when the term for utilisation expires;
(6) when the exploration or other proposed activity does not start within two years after the licence has been granted and there is no reasonable excuse for this inactivity; or
(7) when there is any use of the natural resources that differs from the intended initial purpose, or the user's rights violate other natural resource exploration, use or production rules including those in the licence.

Of these, licence applicants should particularly seek clarification of how under item (2) any other State or social need might take priority, and whether such potential conflicts could be limited by a special decree for the proposed licence. In addition, item *(7)* on violation of other applicable rules, irrespective of materiality, is broad and vague, and for a particular licence it should be limited by special decree. There is in addition under Order 86 a general power to suspend a licence if the licence terms do not conform to the requirements of applicable Ukrainian law or international treaties.

Order 86 also allows a licensee to suspend its activities if circumstances concerning the use of the natural resources have changed, provided the suspension is conducted in a manner consistent with the conservation of the resources in question. The licensee must give the SCG written notice of any suspension for this reason. The conservation period that follows may be added to the total time for the licence, provided that the terms established by the SCG for such conservation are not violated. A suspension on this basis may not continue for more than one year.

Additional termination rights are created by the Order of 10 August 1992 of the Ukrainian Cabinet of Ministers. This Order was slightly modified by the 17 May Decree, but it continues to have force. Under Article 6 of the 10 August Order, the authority issuing a natural resources licence may terminate it in the following circumstances (most of which are covered by other legal provisions):

(1) violation by the user of the conditions of use (presumably those stated in the licence terms);
(2) deterioration of the environment because of the use of the natural resources;
(3) liquidation of the licensed entity;
(4) expiration of the term for mineral use;
(5) failure of the licensee to begin activities within three years (as observed, licence rights may be terminated under Article 26 of the Natural Resources Code if activities do not begin within two years);
(6) use of natural resources other than in accordance with their licensed purpose;
(7) violation of the legal norms or regulations for use of the natural resource; and
(8) if a request is made by the government bodies responsible for state sanitation supervision or other specially authorised bodies for state supervision.

In addition, a licence may terminate if the state body that granted it ceases to exist. As several Ukrainian state bodies have been replaced in reorganisations by new bodies, this potential problem should be addressed in a special decree.

Another more unusual basis for terminating a licence arises under the President's Order of 30 December 1993 entitled 'On Export of Open Geological Information on Mineral Resources'. The 30 December Order provides that the SCG has the right to sell geological information to foreign legal entities, and the State Customs Committee is responsible for ensuring that such information is only exported or imported with proper export and import documents.

The 30 December Order then states that 'Foreign legal entities that have received geological information not in accordance with the Order's procedures shall not be permitted to explore or utilise mineral resources on the territory of Ukraine'. Based on Order 86, cited earlier, this 30 December Order could provide a basis for termination of a licence agreement merely because geological information was obtained from unauthorised third parties, whether or not such information was generally available in the public domain.

This unusual prohibition on the possession or use of unauthorised geological information means that licensees must be careful not to hold or receive any such information in Ukraine. They should also be careful about disclosures made about information sources.

For example, consistent with the 30 December Order, the Western Geophysical description of terms for the next Ukrainian offshore licensing round (apparently undertaken pursuant to an agreement with the SCG) states that applicants will be able to obtain geological and seismic data exclusively through Odesmorgeologiya and Western Geophysical. Applicants will also be required to disclose the geological and geophysical information on which their application is based. Because of the 30 December Order, applicants should be careful not to refer to any information not obtained through SCG authorised sources, even if publicly available outside Ukraine.

One final issue of importance in dealing with licence terminations is the extent to which future Ukrainian laws can create termination rights undermining a previously granted licence. Under current law the position is not clear. This issue is considered in greater detail below under the heading 'Sovereign Immunity and Changes in Law'.

The Draft Ukrainian Concession Law

A Draft Law on Concessions was proposed in 1994 to govern all concessions for natural resources, including oil and gas. In its present form, the Draft Law would be an unsatisfactory revision of the current laws, and a number of groups, including the World Bank, are putting forward revisions or alternative proposals.

One particular problem arises in Article 10(3) of the Draft Law, which provides that a foreign concessionaire must have a State guarantee from its country for performance of its obligations. Under current international practice, it is entirely inappropriate to require foreign State guarantees of private companies, and ordinarily such guarantees will not be available.

It is interesting that in Article 10(2) of the Draft Law, there is a requirement that concessionaires from other states waive sovereign immunity. The SCG, however, has so far refused to waive sovereign immunity in its licence agreements, as discussed below.

As is the case under existing law, the Draft Law provides vague and broad termination rights, including for 'non-fulfilment' of agreements, violation of laws on concession activity, endangering the environment and events of *force majeure*. There are no criteria for materiality and no procedures for handling disputes over these termination rights.

One benefit of the Draft Law is that, in Article 14, it provides that if a concessionaire needs another licence under Ukrainian law, it is deemed to be included in the licence under the concession agreement. Although the wording of the proposed Ukrainian text is not satisfactory, the intention appears to be to protect SCG licensees from problems with other state entities.

Resource Use and Environmental Law Considerations

Liabilities for environmental damage

Laws

Ukraine has environmental laws written in tough terms, although they are not currently being fully enforced against Ukrainian companies. There have been indications, however, that they are being more strictly applied against foreign companies.

The principal environmental law is the 'Law on Nature Protection' of 25 June 1991. The new Ukrainian Natural Resources Code of 27 July 1994, discussed above, can also apply. Regulations under the new Code are currently under preparation. Once adopted, they will be the principal source of regulations governing oil and gas operations.

The Law on Nature Protection was adopted prior to the declaration of Ukrainian independence, but during a period when Ukraine was increasingly taking charge of its own affairs within the Soviet Union. The Law on Nature Protection generally provides a right to an ecologically safe and healthy environment and, to ensure this, requires ecological examinations of commercial operations by government experts. It states that there are three types of liability - civil, administrative and criminal - for violations of environmental laws:

Civil liability. The general rule for civil liberties under Article 69 of the Law on Nature Protection is that any damage to the environment, including to people and property, must be compensated in full if it was the result of illegal activity. The defendant is ordinarily not liable if it was not at fault. This defence does not apply, however, for extra-hazardous activity. Oil drilling, especially if offshore, would probably be considered extra-hazardous.

The rule for extra-hazardous activity is that the person or entity that owns or controls the source of the activity must compensate for any damage except if caused by *force majeure* (acts of God and so on) or by the intentional actions of the plaintiff. Liability arises even if a third party intentionally caused the damage.

Damages are calculated in accordance with instructions adopted during the Soviet era, and their current application is under modification. The instructions provide for awards based on Soviet roubles. For offshore oil, the SCG is acting as the relevant expert to measure harm, and civil damages for sea pollution are currently very low.

Administrative liability. The Administrative Code also provides for small penalties for environmental harm. They are typically only used for minor violations that do not cause much damage. For example, Articles 57 to 59 of this Code impose a 50 to 100 rouble fine on the manager of a company found guilty of a violation. The Ukrainian Parliament has since passed legislation increasing these administrative fines, beginning in 1992 with a ten-fold increase, and then, in 1993, with an indexation calculation linked to increases in the minimum permitted salary level. The formula for fines is calculated as follows: $X = Y + Z/L$, where X is the current fine, Y is the Code fine amount increased ten times, Z is the minimum salary at the time of the event being fined, and L is the minimum salary in 1993.

Criminal liability. Like many civil law countries, Ukraine imposes criminal liability on managers (directors) and others responsible for a company's environmental pollution as well as on individuals who pollute. This applies for negligent as well as intentional acts.

According to Article 228-1 of the Criminal Code, 'illegal' sea pollution, meaning pollution intentionally or negligently caused, is punishable by one year's imprisonment or a fine and, if the pollution causes serious harm to the environment or to people, by five years' imprisonment or a fine. The fines are stated as ranging from 10, 000 to 25, 000 Soviet roubles, and it is not clear how this would be converted into Ukrainian currency. For foreign companies, fines probably would be imposed in US dollars, as shown in the case described below.

Article 39 of the Law on Nature Protection provides that environmental control of resources of the continental shelf and the maritime exclusive economic zone and their exploration and exploitation are subject to the jurisdiction of the Ukrainian national

government rather than the regional governments. (The Crimean Parliament currently disputes this regarding offshore territory it claims.) For offshore environmental control, the SCG and the Ministry of the Environment co-operate, with the Ministry of the Environment turning to the SCG for measures of damages.

Another feature of Ukrainian environmental law is that companies which during operations cause general pollution, in particular air pollution, that harms no one in particular, are supposed to pay fees as determined by the Council of Ministers to permit their pollution. For domestic companies, the Council of Ministers' Decree 18 of 13 January 1993 entitled 'On the Procedure for Setting the Fee and the Terms of Payment for the Pollution of the Environment' provides that in view of the economic crisis, these fines will not need to be paid until 1 January 1996 if the pollution does not exceed specified limits. A pollution permit application could be made for oil and gas activities, but it seems currently unlikely to be granted unless there was an exceptional justification.

Assessment of damages. There has been one publicly reported case of significant penalties being imposed for oil pollution. This resulted from a fuel oil spill by a Maltese ship, the *Oakwell,* during loading in the port of Odessa. In that case, 12,419 kilograms of oil products were dumped into the sea, of which 12,369 kilograms were recovered and 50 kilograms were left on the sea's surface as oil film.

The State Inspectorate for the Protection of the Black Sea of the Ministry of the Environment imposed a penalty on the ship's captain of $1,000 and apparently required the insurer of the ship to provide a bond or guarantee for $95,474 in compensatory damages for the environmental damage. This seems to be an extremely high figure for 50 kilograms of damage (unless it includes the expense to clean up and recover the other 12,369 kilograms, which is unclear from the case report). Probably a high fine was imposed because Odessa is an environmentally sensitive location, with beaches and resorts nearby.

Generally, sea pollution has apparently been largely ignored so far or, where noticed, only minimal fines have been imposed. This would probably not be the case, however, for an important, well-publicised spill involving offshore drilling, especially if the spill reached the shore.

Consent of the Ministry of the Environment for production licences

As discussed earlier in connection with the oil and gas licensing procedure, a production licence application to the SCG requires, as one of the documents, a consent from the Ministry of the Environment. The Ministry could impose conditions for such consent.

Sovereign Immunity and Changes in Law

Under Ukrainian law, it is unclear whether the SCG could be sued for violation of its licence agreement obligations. In particular, it is not certain whether it could be sued for failing to issue a production licence when required to do so by the terms of an exploration licence agreement.

There is currently a conflict between a Soviet law permitting litigation against state entities and Ukrainian legislation expressly listing the limited instances in which such lawsuits may be brought. Since there is little Ukrainian law on sovereign immunity, it is unclear whether immunity, if it exists, may be waived. So far, the SCG has refused to waive sovereign immunity in its licence agreements. The only reference to sovereign immunity waivers occurs in the Draft Concession Law which, as already observed, would require foreign state licence applicants to waive sovereign immunity.

Order 53 of 18 August 1992 of the SCG entitled 'On the Procedure of Issuing Special Permissions (Licences) for Exploration, Development and Operation of Fields of Mineral Resources' appears generally to authorise **litigation against the SCG, stating in paragraph 32 that: 'All disputes connected with issuing and using licences** on exploration, development and operation of fields of mineral resources are to be decided by courts or arbitration courts.' As a practical matter, it is advisable that sovereign immunity waivers be included in contracts with Ukrainian state entities. If the contract is governed by a foreign law (such as English law or the law of any US state that has a developed sovereign immunity concept) and provides for international arbitration, then as a matter of contract law, this appears to be as much protection as is possible.

Another problem related to sovereign immunity is the effect of future changes in Ukrainian law, such as to relieve Ukrainian state parties from obligations. For example, if the SCG might revise its own Order 53 to provide for sovereign immunity and Parliament could ratify this measure.

Alternatively, new bases for licence terminations or changes could be created and then applied and justified by the relevant state entity as being acts of state or cases of *force majeure* (as was recently argued by a state shipping company when it tried to terminate a foreign management agreement. The best response for a foreign licensee is to 'internationalise' the obligations, as suggested above, with foreign law and arbitration and explicit contract clauses preserving rights. For example a contract could provide that rights may not be reduced by subsequent legislation and that indemnities shall apply in such cases.

Import VAT and Excise Taxes and Customs Duties

Materials imported into Ukraine for oil and gas activities, including, for example, drilling rigs, will be subject to 20 per cent import VAT (value added tax), excise tax (possibly up to 30 per cent) and customs duties (which usually range from 5 per cent to 25 per cent) on the value of the imports. The foreign investment decree discussed briefly below provides for a complete exemption from these taxes and duties for material imported as capital contributions to a Ukrainian company, provided certain formalities are complied with. Other methods for avoiding these taxes may also be available.

The best solution to these problems is to obtain a special Cabinet of Ministers' decree exempting all imports for proposed activities from import taxes and duties. Such a decree might be granted if deemed necessary to induce an important investment.

Exportation of Production

The SCG licence will not, by itself, provide for a right to export oil and gas products under current law. This appears also to be the case under the proposed Draft Concession Law, despite its attempt to make an SCG licence to explore and produce encompass all other necessary licences.

Oil and gas exports from Ukraine are tightly regulated. This is not surprising in view of the domestic oil and gas shortage. However, Ukraine has in principle 30 per cent of the oil and gas refining capacity of the former Soviet Union, which has recently been substantially underutilised. There are numerous proposals pending to facilitate imports of oil and exports of refined products which may apply for refining of domestic production as well as imports.

Currently, oil and gas exporters require a special authorisation from the Cabinet of Ministers, and very few authorisations have been issued. All contracts for oil and gas sales or purchases must also be registered with the Ministry of Foreign Economic Relations. The Cabinet of Ministers can be expected to grant such authorisations to facilitate important projects.

In addition, an export licence or exemption is necessary for an authorised exporter to export any product. Under Decree 55 of 20 May 1993, Ukrainian companies 30 per cent or more of whose shares are held as a qualifying foreign investment (based on financial criteria, discussed in the next section) do not need export licences for their own production. To prove that a proposed export is its own production, the exporter must obtain a certificate to this effect from the Ukrainian Chamber of Commerce, which should readily provide such certificates for crude oil and gas production. It does not appear, however, that this exemption from the licence requirement would apply for a foreign company acting in Ukraine directly or through a branch rather than a subsidiary, although this problem might be addressed by a special decree.

No export duty is currently imposed on oil and gas exports, but the prior system which imposed duty might be reinstated if there are future shortages. Previously, exports of oil products were subject to a 30 per cent duty (Decree 3 of 11 January 1993 entitled 'On the Export Duty in 1993', as amended by Decree 54 of 20 May 1993) unless: (1) an export quota had been obtained; or (2) the exports were made under international or State agreements in amounts approved by the Cabinet of Ministers; or (3) the Cabinet of Ministers exercised its power under Decree 36 of 23 April 1993 to exempt the company from such export duties.

An export quota is based on the Cabinet of Ministers' annual decision on the maximum exports of a product to be permitted. The total authorised amount for non-state entities is divided into smaller amounts called 'quotas', and the rights to export the quota are then auctioned, weekly in principle, by the Ministry of Foreign Economic Relations.

If a licensee wants to obtain an export licence, then an application would have to be made to the Ministry of Foreign Economic Relations on one of the following bases: (1) a quota was obtained by purchase at an auction; (2) payment was made of the normal export duty (unless specially exempted by the Cabinet of Ministers, which arguably should permit the licence); or (3) there is proof that the export would be pursuant to an international or a state agreement.

If a quota, special exemption or international or State agreement applies, then no export duty would be due. Typically, however, the export licence would be issued subject to a minimum export sales price. Licence prices currently are often close to or even above world prices, thereby effectively limiting exports. Thus, just because a licence is obtained, a licensee cannot be sure of being able to export as a practical matter. For this reason, a special decree should be sought on this and other export issues.

Taxation, Exchange Controls, and Other Considerations

Turning to a brief overview of tax aspects, an applicant should bear in mind that these legal areas have recently been modified and are subject to further change. Under present law, income of Ukrainian companies and resident branch operations is taxed at 30 per cent on profits, but expense deductions from revenues to calculate profits are more limited than in the West. (Until recently, there was a gross revenue tax with few deductions for expenses.) There is also a 15 per cent withholding tax on dividends, interest and certain other remittances abroad. Under most tax treaties, such as the recently negotiated Ukraine-US treaty, withholding is reduced. Under these tax treaties deductions are usually expressly permitted for wages and interest payments when calculating taxable profits.

Currently most foreign licensees should probably operate through a Ukrainian subsidiary to obtain lower withholding taxes, avoid import taxes and duties, and reduce profit allocation issues. Use of a branch may also be appropriate, however, to the extent this facilitates the use in a consolidated tax return abroad of losses, as these may not be carried forward under current Ukrainian tax law. Any investment should be highly leveraged to reduce the potential income and withholding tax.

Ukrainian exchange controls, including mandatory conversion into local currency of 50 per cent of all foreign currency proceeds and the requirement for transactions between Ukrainian residents to be conducted in local currency, must be carefully considered to avoid incurring currency losses. In particular, a hard currency licence should be sought for domestic sales, and exports should be made in accordance with exemptions on mandatory conversion of proceeds. Proposals have been made periodically to abolish hard currency licences, but even if this happens, it should still be possible to structure hard currency sales. It may also be possible to avoid some of the effects of exchange controls by receiving payments in kind, such as crude oil.

One possible legislative shortcut to or justification for eliminating export restrictions, as well as the taxes and exchange controls referred to above, might be to create a free economic or trade zone covering the area to be licensed. The concept of free economic zones, free of bureaucratic controls, taxes, labour and other laws, has considerable support in Ukraine, especially in the coastal areas of Crimea and Odessa for which proposals are pending. The image of creating lots of prosperous 'mini-Hong Kongs' has been cited favourably. The granting of special privileges in this context should be less likely to be controversial.

A framework law entitled 'On General Principles of the Creation and Functioning of Special (Free) Economic Zones', No. 2673-XII of 13 October 1992, provides general criteria for such zones. It states that one of the principal purposes for creating free economic zones shall be to encourage foreign investment, which is certainly necessary for Ukrainian oil and gas development. The framework law has, however, to be implemented by specific legislation for each zone, and so far no zones have been created.

Conclusion

Ukrainian oil and gas law is currently being developed. Potential licence applicants should attempt to obtain protection of their investments by special legislation and decrees, as well as through their licences and other agreements. Ukraine is reported to have considerable potential oil and gas reserves, and to reduce its reliance on oil and gas imports, the Government is committed to encouraging their development. In this context, it is expected that suitable protections may be negotiated to permit major oil and gas investments from the West.

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