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# Regulation of the Ukrainian Oil and Gas Transit Sector



by Taras V. DUMYCH

Ukraine is considered a world leader in the pipeline transportation of oil and natural gas through its territory. Presently the infrastructure of Ukraine's oil and gas pipelines system includes over 37,000 kilometres of trunk gas pipelines and over 4,000 kilometres of trunk oil pipelines. There is also a developed support system, including compressors, pumping stations and oil and gas storage facilities.

It should be noted that the history of the Ukrainian oil and gas transit sector goes back to 1924 when the first natural gas pipeline was constructed. Today, Ukraine has become a principal transit country for oil and natural gas from Russia, Kazakhstan and Turkmenistan to Central and Western Europe.

The operation of an oil and gas transportation system like the Ukrainian system also requires a developed statutory framework. In large part, Ukraine meets this requirement: national laws regulating the oil and gas transit sector are quite developed and relatively modern. Furthermore, Ukraine is a party to a number of bilateral and multilateral international treaties governing oil and gas transit. However, as discussed below, a number of controversial Ukrainian law provisions, in particular, governing ownership of oil and gas pipelines, require clarification and improvement in order to increase the investment

attractiveness of the Ukrainian oil and gas transit industry.

## Legal framework

The principal national laws regulating the oil and gas transit sector include *inter alia*:

- The *Pipeline Transport Act of 15 May 1996 (Pipeline Act)*;
- The *Oil and Gas Act of 12 July 2001 (Oil and Gas Act)*;
- The *Natural Monopolies Act of 20 April 2000 (Natural Monopolies Act)*;
- The *Act on Licensing of Certain Types of Business Activities of 1 June 2000 (Licensing Act)*; and,
- The *Concessions Act of 16 July 1999 (Concessions Act)*.

Further, a substantial number of regulations adopted by various state authorities are in effect concerning taxation, customs, tariffs, licensing, environmental and other issues related to oil and gas transportation.

Regarding international treaties impacting this area, they may be divided into (i) "general treaties", which establish the general principals and rules related to the transit of oil and gas, and (ii) "special treaties", which set out specific terms, including tariffs, quantities, customs, warranties or provide for the development of special projects in oil and gas transit.

Among the "general treaties", the following are important:

- *Energy Charter Treaty of 17 December 1994*; and,
- *Treaty on Conduction of Coordinated Policy in the Area of Transit of Oil and Oil Products by Trunk Pipelines of 12 April 1996*.

In the case of "special treaties", a large number of such treaties were signed with Russia as the main oil and gas export country and the principal "customer" of the Ukrainian oil and gas transit industry. Among the areas addressed in such Ukraine-Russia treaties, are establishing terms for strategic cooperation, providing guaranties and additional measures concerning the transit of gas, and establishing

special oil and gas transit projects. In addition, the multilateral treaty signed on the 16 December 2002 by the governments of Ukraine, Belarus, Russia, Slovakia, Hungary and Croatia deserves emphasis<sup>1</sup>. The aim of this treaty is cooperation between the signatories for the development of a project to integrate the Druzhba and Adria oil pipelines and transport of additional quantities of oil from Russia through the territories of other signatory countries to the treaty.

## Status of oil and gas pipelines and their operators/owners

Under the *Pipeline Act*, the system of Ukrainian pipeline transport consists of trunk pipelines and industrial pipelines<sup>2</sup>. The following features of an oil or gas trunk pipeline may be based on the *Pipeline Act* and the *Oil and Gas Act*: (i) it is a technological complex that functions as a unique system; (ii) it consists of a separate pipeline or several pipelines, with all the facilities and construction connected to it by the unique technological process; (iii) it is used for transit, interstate, and interregional supplies of oil and gas; and (iv) it was planned and constructed in accordance with state construction requirements for trunk pipelines.

The *Pipeline Act* establishes that trunk pipeline transport is owned by the state. Further, the *Pipeline Act* provides that privatization or change of ownership of state enterprises of the trunk pipeline is prohibited. As a result of these restrictions, the following questions arise: first, does the law mean that trunk pipelines can be owned only by the state of Ukraine, hence, no private ownership of trunk pipelines in Ukraine is permitted, and second, can a non-state owned company be an operator or owner of oil and gas trunk pipelines?

In principle, the problem concerning ownership of trunk pipelines has arisen due to the vagueness, or even lack of, a legal definition of trunk pipeline transport. Although a definition of a trunk pipeline

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exists (as discussed above), it is not entirely clear whether it is included in or similar to trunk pipeline transport as understood by law, resulting therefore, in the requirement of state ownership for trunk pipeline transport also applying to trunk pipelines.

It can be argued that Ukraine did not intend to introduce a requirement of state ownership for oil and gas trunk pipelines located in Ukraine, and moreover, such an ownership limitation would not be in Ukraine's interests. In this case the state ownership requirement would not only be considered a barrier to direct private investments into construction and operation of oil and gas trunk pipelines, but such a requirement would also be inconsistent with the *Ukrainian-Russian Treaty of 18 August 2004*<sup>3</sup> on establishing an international consortium in Ukraine in the form of a limited liability company (International Consortium) for developing and managing the Ukrainian gas transport system. According to this *Ukrainian-Russian Treaty*, the International Consortium shall have ownership rights to the new gas trunk pipeline that would be constructed in the future specifically for the International Consortium.

Regarding the question of private companies operating and owning oil and gas trunk pipelines, this issue was partly answered in the *Ukrainian-Russian Treaty* referred to above. However, in order to avoid any doubts on this issue, it would be useful if the *Pipeline Act* were supplemented with a provision expressly stating that in addition to state-owned companies, privately owned companies can also act as operators and owners of trunk pipelines in Ukraine.

Further, according to the *Concessions Act*, objects of state property which are used to transport natural gas can be provided by concession. Therefore, companies (including privately owned ones) interested in operating natural gas trunk pipelines owned by the state should also be able to carry out such activity on the basis of concession rights. It is interesting to note that the *Concession Act* does not provide for concessions of oil trunk pipelines.

At the present time, state-owned companies largely control the operation of oil and gas trunk pipelines located in Ukraine. Natural gas trunk pipelines have been transferred for operation to the National Joint Stock Company "Naftohaz

of Ukraine" (Naftohaz) which operates these pipelines through its subsidiary company Ukrtranzgaz. Oil trunk pipelines, on the other hand, have been transferred for operation to the Open Joint Stock Company "Ukrtransnafta" (Ukrtransnafta) 100 % of which is controlled by Naftohaz.

In the case of the trunk oil and gas pipelines transferred to Naftohaz and Ukrtransnafta, it is interesting to note that according to the relevant resolutions of the Cabinet of Ministers of Ukraine, the pipelines were transferred to these companies for the purpose of use. In this event it should be noted that, as a matter of law and the nature of the use by Naftohaz and Ukrtransnafta of these pipelines, it would probably be more correct to say that they own the pipelines under a right of full economic management, rather than a use right, as provided by current Ukrainian laws and, in particular, the *Commercial Code*. However, as the legal status of property held under a use right and under the right of full economic management is arguably quite different, both in terms of rights and obligations of the ultimate owner of the property and holder of the property, the status of the pipelines should be clarified by the Cabinet of Ministers of Ukraine and the companies involved.

### Legal regime of oil and gas transit

The transit of oil, gas and their processed products (hereinafter – OGP) by trunk pipelines, which is not only a feature of a trunk pipeline, but also its main purposes, is defined by the *Oil and Gas Act* as:

(a) transportation of OGP, according to agreements, by trunk pipelines through Ukraine between the boundary points of transfer and acceptance; or,

(b) transportation of OGP which originate from countries other than Ukraine and are designated to customers outside of Ukraine to the reloading facilities of OGP; or,

(c) transportation by trunk pipelines of OGP which is connected with provisions for temporary storage or processing services in Ukraine with further movement of such OGP outside Ukraine.

According to the *Licensing Act*, the transportation of oil and gas by trunk pipelines is a business activity, which is subject to licensing. The National

Commission for the Regulation of the Power Industry (Commission) is the state authority responsible for the issuance of relevant licences for such activities. For this purpose, the Commission has passed a number of regulations in the area of licensing the transport of oil and gas by trunk pipelines, in particular: the regulations governing the procedure for receiving licences and requirements for an applicant, licensing terms, procedures and instances for suspension and termination of licences, etc.

It should also be emphasized that approval of tariffs for transport of oil and gas by trunk pipelines that licensees charge to their customers for providing these transport services and the terms of the model agreements on transportation of oil and gas by trunk pipelines belong to the Commission's competence.

In addition to the tariff, a customer of oil and gas transit services would also be charged with the amount of rental payments for these services. According to the *2005 State Budget Act* the following sums of rental payments for 2005 have been established for transport of oil and gas by trunk pipelines: (i) UAH 1.67 per 1,000 cubic meters of natural gas for every 100 kilometres of transit transport distance, and (ii) USD 0.89 per ton of transported oil.

Finally, the importance and special status of oil and gas transportation by pipelines as an activity and an industry in Ukraine has been emphasised by the *Natural Monopolies Act*, in accordance with which transportation of oil and gas by pipelines falls within natural monopoly activities, with companies conducting such transportation considered the subject of a natural monopoly. As a consequence of such special status, various state authorities, including the Commission and the Antimonopoly Committee of Ukraine, are empowered by law to regulate and supervise these business activities in order to prevent abuse by the natural monopolies of their dominant status. ■

<sup>1</sup> *The Treaty on Cooperation for Realisation of the "Druzhba" and "Adria" Oil Pipelines Integration Project of 16 December 2002.*

<sup>2</sup> This article considers legal regulation exclusively of oil and gas trunk pipelines.

<sup>3</sup> *The Treaty between the Cabinet of Ministers of Ukraine and the Government of the Russian Federation on the Measures for Providing of Strategic Cooperation in the Gas Industry of 18 August 2004* (NB: The Treaty has not been yet ratified by the Parliament of Ukraine).