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Introduction

Changes needed in oil & gas sector of Ukraine

Establishment of competitive, transparent and nondiscriminatory energy markets under EU rules and standards by providing of regulatory reforms is one of the main aspects of cooperation between Ukraine and the European Union envisaged in Art.338 of the Agreement on association.

Full implementation of the Third Energy Package, optimization of GTS work and creation of independent GTS Operator, development and increase of liquidity of energy markets and energy exchange under EU energy legislation, increase of transparency and clarity of granting of special permits for subsoil use, provision of nondiscriminatory access to geological information, implementation of EITI standards for extractive companies, reducing import dependence on oil products and LPG market, increase of renewable energy sources to 11%, etc. are among the main goals for future 2-3 years under the Energy Strategy of Ukraine till 2035 “Safety, energy efficiency and competitiveness”, approved by CMU Resolution #605-r dated August 18 2017.

Increase of national production of gas for reducing import dependence on energy sources, attraction of investments in energy sector and provision of Ukraine’s energy independence are also provided under the Concept on development of Ukraine’s gas production sector, approved by CMU Resolution #1079-r dated December 28, 2016.

Reforms on liberalization of energy sector of Ukraine are welcomed by the Energy Community Secretariat, European Commission Support Group for Energy & Environment in Ukraine, International Secretariat for Extractive Industries Transparency Initiative and other international institutions and organizations.

We would like to thank experts from Chamber Member companies for the support in preparing of this Paper and cooperation towards modernization of Ukrainian energy complex.

Leading international and Ukrainian companies support energy reforms in Ukraine and provide proposals on its efficient introduction based on international and national experience.

The American Chamber of Commerce (the Chamber) is among the most active and effective non-government, non-profit business organizations operating in today’s Ukraine.

The American Chamber of Commerce in Ukraine

American Chamber of Commerce in Ukraine

About the Chamber

The Chamber member-companies represent the largest strategic and institutional investors operating in Ukraine who have committed the majority of the foreign direct investment into this market.

The Chamber cooperates closely with the Ukrainian authorities to improve the business environment and attract domestic and foreign investment into the economy, advocate for predictable, transparent, equitable and stable rules of doing business, and promote Ukraine’s integration into the larger global community.

The Chamber Energy Committee has been successfully operating for many years within the Chamber with the main mission to represent and protect the interests of the leading energy companies as well as promote the further development and modernization of Ukraine’s energy sector by attracting investments in support of the vision of a more energy self-reliant Ukraine.

One of the principal activities of the Chamber is to represent the foreign investment community as well as to facilitate the entrance of potential new investors into this market.

The Chamber advocates on behalf of its member companies from more than 50 nations across the globe not only to the Ukrainian government, but also to other governments and economic partners of Ukraine, on matters of trade, commerce, and economic reforms.

The Chamber’s diverse Membership base unites companies from a variety of regions and countries, including North America, Europe, Asia and Ukraine.
American Chamber of Commerce in Ukraine

This Paper is the third edition issued by the American Chamber of Commerce regarding reforms of the oil & gas sector.

The main goal of this publication is to communicate the position of independent private companies and investors to governmental institutions and experts of how the business community sees the reform of the oil & gas sector.

List of Acronyms

AMCU: Antimonopoly Committee of Ukraine (Committee)
CCCTB: Common Consolidated Corporate Tax Base
CMU: Cabinet of Ministers of Ukraine (Government)
EEA: European Economic Area
EFET: European Federation of Energy Traders
EITI: Extractive Industries Transparency Initiative
EU: European Union
GTS: Gas Transmission System
IFRS: International Financial Reporting Standards
IMF: International Monetary Fund
JAA: Joint Investment Activity Agreements
LPG: Liquefied petroleum gas
NBU: National Bank of Ukraine
NBP: «National Balancing Point», gas hub based in Great Britain
NCG: «Net Connect Germany», gas hub based in Germany
NERC: National Commission for State Regulation of Energy and Utilities (Regulator)
OECD: Organisation for Economic Co-operation and Development
Parliament: Verkhovna Rada of Ukraine
PEG Nord: «Point d’Echange de Gaz Nord» (Peg North), gas hub based in the North of France
PSA: Production Sharing Agreements
PSV: «Punto di Scambio Virtuale», the Italian gas hub
PSO: Public service obligation
SAB: State Authorized Body
SEDES: Systems of early detection of emergency situations
SLSU: State Labor Service of Ukraine
TTF: «Title Transfer Facility», gas hub based in the Netherlands
TSO: Transmission System Operator
VFS: «Voluntary» fire squad
VTP: Virtual trading points
**Successfully transforming the Ukrainian gas market**

Significant achievements have been made successfully transforming the Ukrainian gas market, showing what can be done with a determined local champion (in this case PJSC “Naftogaz”) leading the process.

Change in the gas market has been revolutionary, with the result that today Ukraine is close to having a fully functional European style market. Unfortunately very little has been achieved in the other key areas required to modernise the upstream industry. Since the revolution in 2013 - 2014, several international oil and gas companies have withdrawn or are in the process of pulling out of Ukraine.

Our objective is to find common ground with the Government and to lay the foundations for a revival of the industry, eventually attracting new investors from around the world.

These investors, together with the existing industry, will need to be ready to accept the risks required to explore, appraise and develop as yet unproven sources of hydrocarbon resource.

Appropriate regulation is a vital component of improving the investment climate. Current oil and gas regulation draws heavily on Soviet era planned economy systems. It is burdensome, bureaucratic and a major barrier to progress.

The underlying philosophy, of trying to ensure detailed state control of the industry, is not appropriate. It leads to conflict and curtails investment. Investors need to have the freedom to spend their money as they see fit, and the state should focus on safety and the environment, and ensuring a fair and transparent system for all. The regulatory systems of advanced economies need to be studied and adapted to the Ukrainian system, with a view to cutting out all but essential regulation.

A first step in achieving this objective is to ensure the optimum alignment of the surviving entities still engaged in this business in Ukraine. This entails the Government taking leadership responsibility for the sector’s long term well being and examining international best practise in the fields of regulation, compliance monitoring and fiscal take, ensuring Ukraine is in a strong place with respect to international competitiveness.

A dialogue with industry is essential, but it is imperative that short term interests do not distort or detract from the longer term objectives.

**Fiscal Reform**

A similar radical approach is needed to modernise the fiscal system. What is needed is the adoption of a new system based on the principles of stability, fairness and international competitiveness.

The current system is based on arbitrary and sometimes illogical distinctions (for example well depth) which are often subject to change, and is heavily reliant on fixed tariff based rates (Rent Tax).

The resulting matrix of differing and changing Rent Taxes resembles random taxation and does not form a platform on which an investor can reliably base a long term plan. Without a stable fiscal platform based on the royalty on profits system, risk taking exploration which is the fundamental requirement for growth in the sector is not encouraged.

Successful oil and gas fiscal systems are mainly progressive, and relate tax payment to profit in various forms. Such systems seldom require change, providing investors with a predictable investment environment.

Ukraine is out of line with international practice. Ukraine has made impressive progress with gas market reform. Further reforms, using a similar model with determined leadership, focused on establishing an environment of best international practice, are required. Further reforms are needed to complete the transformation of the current stagnant state of the Ukrainian upstream oil and gas sector and to become an attractive proposal to international risk taking investors.

The investors, together with the existing industry, may re-invigorate and find the potential for Ukraine to achieve energy self sufficiency.

This requires a major change and a long term view, with very significant rewards for Ukraine.
Chapter 1
Reforms In Oil & Gas Sector of Ukraine

Upstream Sector

MAJOR GOALS

1. Introduce a Profit Based Taxation system for Oil and Gas Industry in Ukraine

The Government’s ambitious goal to produce 27-30 bcm of gas by 2020 is only possible if an economically reasonable and transparent fiscal load is introduced for the production of gas, oil, and condensate. Chamber experts have developed a new taxation model which provides for the royalty on production to be replaced by a uniform tax, the “royalty on profit” gained from a subsoil area, which would apply to all types of hydrocarbons produced on shore and off shore, and to all types of subsoil users.

The proposed royalty on profit, if implemented, would be levied on operating profit margin from each subsoil area which would, in turn, factor in all economic performance indicators of every project (cost of production, scope of production, sale price etc.).

Such a balanced approach would provide economic incentives for subsoil users to bear higher exploration risks and costs, and to develop reserves which are economically unappealing under the regime currently in place.

Obviously, the development and implementation of a new system would take time, and it is therefore advisable that the Government make a number of changes to taxation in the short run, in particular, remove the existing distortions, e.g. such as the unjustifiable difference between oil and condensate taxation.

Also, given the long periods of time it takes to carry out license area exploration projects followed by field development, it is critical that fiscal regime is stabilized for a long period of at least five years.

Position:

- In the medium term to set up a balanced taxation system based on taxation of profit;
- To guarantee stability of the tax regime.

Decision makers:

- Ministry of Finance of Ukraine
- State Fiscal Service of Ukraine
- Cabinet of Ministers of Ukraine
- Parliament

Profit Based Taxation

Background:

Over the last few years, the tax rates applicable to hydrocarbons production have been drastically changed without proper prior consultations.

Thus, in 2014 the Government increased taxes on gas production for private companies from 28% to 55% of gross revenue for gas produced from reservoirs shallower than 5,000 meters, and from 14% to 28% for gas produced below 5,000 meters. The tax increase, originally introduced by the Government as a temporary measure, was extended till January 1, 2015.

Starting from the beginning of 2016, the gas tax rates were decreased to 14% and 29% (depending on the production depth) for private production companies. Starting from the beginning of 2017, the oil tax rates have been decreased from 45% to 29% for reservoirs shallower than 5,000 meters, and from 21% to 14% for oil produced below 5,000 meters.

However, the tax rates for condensate (whose technical characteristics do not differ from oil) have remained unchanged. In doing this, the Government has allowed an already overcomplicated system to become more arbitrary and apparently irrational.

<table>
<thead>
<tr>
<th>Category</th>
<th>Up to 5 km</th>
<th>Deeper than 5 km</th>
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<td>State Companies</td>
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<td>Offshore</td>
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<tr>
<td>Production under Joint Activity agreements</td>
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<td>Hard to recover wells</td>
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<td>2</td>
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<tr>
<td>Production under Production sharing agreements</td>
<td>Based on contract agreement *</td>
<td></td>
</tr>
<tr>
<td>Condensate</td>
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<td>21</td>
</tr>
<tr>
<td>Oil</td>
<td>29</td>
<td>14</td>
</tr>
</tbody>
</table>

* is not effective yet
# Upstream Sector

## 2. Develop a new Subsoil Code

A completely new subsoil use concept should be developed.

### Background:

Reforming of oil and gas sector is carried out slowly and randomly by the way of introduction of numerous cosmetic amendments (The Procedure for Granting Special Permits for Subsoil Usage adopted by CMU Resolution № 615 as of 30.05.2011 is an example). The current Ukrainian legislation is fragmentary, outdated, often with conflicting provisions.

A new Draft Subsoil Code has been in development since 2012, the necessity of its adoption is supported by all state authorities (including the Ministry of Ecology and Natural Resources of Ukraine and the State Geology Service), business associations and international donors. Different state authorities started to develop the Code, however their work lacked systematic access and efficiency.

### The Introduction of Amendments to CMU Resolution №615

<table>
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<tr>
<th>Number</th>
<th>Date</th>
<th>Description</th>
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<tr>
<td>N°24</td>
<td>January 2013</td>
<td>Introduction of fee for granting special permits for subsoil use out of auction for the purpose of Project Sharing Agreements implementation.</td>
</tr>
<tr>
<td>N°42</td>
<td>January 2015</td>
<td>Cancellation of monitoring and scientific support of subsoil use.</td>
</tr>
<tr>
<td>N°76</td>
<td>February 2016</td>
<td>Substitution of authority performing mining inspectorate.</td>
</tr>
<tr>
<td>N°1173</td>
<td>December 2016</td>
<td>Amendments to the system for granting approvals while issuance of special permits (&quot;silent consent&quot; rule).</td>
</tr>
<tr>
<td>N°775</td>
<td>November 2017</td>
<td>Introduction of &quot;out of auction&quot; procedure of granting special permits for geological exploration of amber.</td>
</tr>
<tr>
<td>N°1063</td>
<td>November 2017</td>
<td>Renewal of grounds for granting special permits for subsoil use out of public auction in case of geological exploration if the applicant is the owner of the integral property complex.</td>
</tr>
<tr>
<td>N°519</td>
<td>November 2017</td>
<td>Enabling of State Geology Service to extend validity of special permits if an applicant is in debts for rent payment of subsoil use for production of minerals in certain cases.</td>
</tr>
<tr>
<td>N°518</td>
<td>November 2017</td>
<td>Cancellation of the right to refuse granting of special permits in case of a failure to fulfill a work program on certain subsoil areas; Cancellation of the requirement to certify subsoil users’ documents by seals etc.</td>
</tr>
</tbody>
</table>

### Position:

To develop a new Subsoil Code.

### Decision makers:

- Cabinet of Ministers of Ukraine
- Ministry of Ecology and Natural Resources of Ukraine
- Parliament
- State Geology Service

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Subsoil use legislation needs 1) systematization and codification 2) modernization; 3) reduction of excessive regulation. Such targets can be achieved only by development of a completely new concept of subsoil use.

First of all a new Subsoil Code should achieve the following goals:

- to unify, make transparent and formalized by law procedures for obtaining special permits for subsoil usage, introduction of amendments to them, termination and deprivation of rights for subsoil usage;
- to guarantee secured conversion of exploration phase special permits to production permits;
- to provide for a number of transparent legal instruments for partner relationships and investments in the subsoil use sphere (such as implementation of operatorship concept, creation of legal base for agreements on joint operation, service contracts, lease of drilling rigs etc.);
- to add more liquidity to the licensing regime allowing for transferring of licensing rights to interested investors (under control of the state);
- to guarantee equal rights for all market participants for the distribution of special permits (to eliminate preferences for state companies);
- to reduce overregulation and state pressure on subsoil user.
Upstream Sector

QUICK WINS

3. Improve fiscal regime in the short term

Poor increase in investments leads to decline in hydrocarbon production

Background:
The fiscal policy of Ukraine, which regulates taxation in the upstream sector, is seen as unattractive, complicated and unpredictable.

All these factors lead to poor increase in investments into the sector and as a result to decline in hydrocarbon production.

During 2014-2016, there were several radical changes of the fiscal regime: from an increase of royalty rates for oil and gas production in 2014, to return to previous rates for gas in 2016.

In December 2016, the Parliament of Ukraine voted to amend the Tax Code of Ukraine and decreased tax rates for oil from 45% to 29% for reservoirs shallower than 5,000 meters, and from 21% to 14% for oil produced below 5,000 meters.

At the same time, the tax rates for condensate (technical characteristics do not differ from oil) have remained unchanged.

In doing this, the Government was guided by the necessity to replenish the State treasury rather than economic expediency and market situation. The same unequal conditions were created with the introduction of the Tax Code by Article 252.21, which establishes a 2% royalty rate only for additional amount of hydrocarbons produced from the sites difficult to recover and depleted deposits.

However, 2% royalty rate is established only for the companies with a share of 25% and more in their capital owned by the state or another company owned by the state for 25% or more, their affiliates, subsidiaries, representatives, also for companies which are members of Joint Investment Activity Agreements (JAA).

Generally, the current fiscal regime for upstream is characterized by:

- unclear and complex system of royalty rates (some of which are too high for the current market situation), which differ according to the depth of reservoirs, types of hydrocarbons and type of production company (independent, state-owned or joint activity);
- different rate for gas condensate and oil (which is practically the same substance), in addition to plenty of other rates;
- introduction of non-transparent mechanisms, for example 2% royalty rate for production from ‘hard to recover reserves’.

Position:

It is expected that in the long-term, a profit based taxation system will be developed and adopted.

At the same time, in order to implement the Government Strategy on Increase of Gas Production by 2020, it is recommended to adopt the following decisions in the fiscal sphere:

- to eliminate distortions between gas condensate and oil by decreasing the rate for condensate to the same rate as oil;
- to introduce an economically reasonable tax rate for gas for all market participants in order to stimulate production caused by decrease in gas prices and general stagnation in the sector;
- to remove 2% royalty rate for reserves difficult to recover and depleted deposits.

Decision makers:

- Ministry of Finance of Ukraine
- State Fiscal Service of Ukraine
- Cabinet of Ministers of Ukraine
- Parliament
Upstream Sector

4. Improve legislation on Production Sharing Agreements (PSA)

Without new investments the sector will suffer stagnation

Background:

Successful implementation of effective and future PSA projects in Ukraine requires daily coordination of different central and regional government bodies of both executive (CMU, ministries, state agencies/services) and legislative branches (the Parliament, regional councils). The existing practice of appointing a single ministry (currently the Ministry of Energy and Coal Industry) as a State Authorized Body (hereinafter — SAB) for implementation of PSAs has already proven to be ineffective, as one ministry does not have enough powers and instruments to secure timely decisions by other government bodies necessary for such massive projects as PSAs.

Moreover, the current Regulation on the Ministry of Energy and Coal Industry, approved by CMU Resolution #208 dated March 29, 2017, does not provide for the duties or authorities of the Ministry of Energy and Coal Industry regarding implementation of PSAs.

As a result, often PSA investors are left one-on-one with problems with individual authorities which have practically no interest or experience in PSA projects. Therefore, investors are often forced to spend their time and resources on resolving government-related issues with their PSAs without proper support from the Government.

In order to solve this problem, the Government should initiate transformation of the Interagency Commission on Organization of Signing and Execution of PSAs into an interagency government body that would be able to facilitate execution of already signed PSAs during the entire period of project implementation.

Also, the Government should raise the status of the Commission and its decisions by transforming protocols/resolutions approved by the Commission into orders on the Government level, signed by the Prime Minister.

SAB should be a core state organ responsible individually for project implementation and effective law implementation by the government bodies, including the decisions and the effective work of Interagency Commission. To enact the aforementioned functions the respective changes should be introduced to CMU Resolution #644 dated August 1, 2013 “On creation of Interagency Commission on Organization of Signing and Execution of PSAs”.

An alternative solution of this problem could be authorisation of one ministry for SAB functions which would have a wider scope of powers, duties and functions clearly established in the relevant regulation on such ministry.

Attempts to execute PSAs in Ukraine revealed a number of provisions of the Law “On PSAs” that need to be improved. In particular, legislation does not regulate the legal status of expenditures, property, or geological information taken/acquired before entering a PSA. No option to act at own risk is provided, a number of inconsistent provisions regulate the obligatory annexes to PSA, availability of the project of land restoration, environment evaluation, performance of ecological expertise, etc.

Several draft laws aimed at elimination of the above disadvantages have not been supported by the Parliament.
Upstream Sector

5. Elimination of administrative barriers for PSA investors

PSA regime should be 100% protective for PSA participating foreign investor at all stages

Background:

The legal mechanism of Production Sharing Agreement (‘PSA’) governed in Ukraine by the Law of Ukraine “On Production Sharing Agreements” was designed and aimed at attracting and promoting foreign investments into exploration and production of natural resources, especially in the oil and gas sector, for the benefit of both the Ukrainian government and participating (foreign) investor(s).

PSA, when executed by the parties for certain licensed area and endorsed by the Government of Ukraine, becomes an integral part of this legal mechanism defining, inter alia, the details of parties’ cooperation in upstream project, material and procedural provisions of PSA legal environment which are not or insufficiently covered by local laws.

In order to increase foreign investor trust and willingness to join upstream opportunities in Ukraine, the PSA regime should be 100% protective for the PSA participating foreign investor at all stages: when starting natural resources exploration and production opportunity, all the way to realization and implementation of PSA and, of course, when leaving the project before its end because of proper reasoning according to PSA.

In case a participating foreign investor is appointed an Operator of PSA, according to Ukrainian laws it becomes in charge of paying PSA operations’ related taxes through its Representative Office registered in the Ukrainian Tax Office as Tax Operator for PSA. Having done so, the foreign investor’s RepOffice would be in charge of taxation and accounting reporting on PSA operations throughout the latter’s life cycle.

In reality, it may happen that the participating investor decides to early exit the PSA project for whatever reason captured in that PSA beforehand, for example: prolonged force majeure, material changes of circumstances etc. preventing realization of upstream project. Practically, the PSA investor which has exited PSA in line with PSA’s provisions then faces “administrative obstacles” in getting released from the role of PSA Tax Operatorship which, consequently, obstructs winding up its PSA related RepOffice in Ukraine.

Therefore, the foreign investor incurs extra cost for maintaining its office in Ukraine because of being unable to close it as due, remaining unreasonably associated with the upstream project in Ukraine it has already left.

Position:

The Tax Office’s ‘doors’ should be ‘open’ not only for registering investor’s Representative Office to be the PSA Tax Operator at the beginning of upstream project, but also ‘open’ for accepting and processing the filed documents when PSA withdrawing investor turns to Ukrainian Tax Office to get de-registered as PSA Tax Operator because it has left the respective upstream project. Procedure for registration of taxpayers should be adjusted to reflect PSA withdrawal specifics.

Ukrainian Authorities should ensure there is no obstacle to the PSA withdrawing foreign investor in taking steps to get tax de-registration as PSA Tax Operator and stop being associated with the earlier upstream opportunity.

This would add much to the transparency of internal (tax) procedures for foreign investors in the country.

Decision makers:

- State Fiscal Service
- Ministry of Energy and Coal Industry
- Ministry of Economic Development and Trade
Chapter 1

6. Improve the procedure of issuance and use of special permits

Background:

Legislative acts and processes associated with the issuance of special permits for subsoil use and their «life cycle», are traditionally characterized by non-transparency and overregulation. The Chamber regularly initiates improvements to these processes, but not all of the recommendations are implemented and the solutions are replaced by new problems. The following issues are currently essential:

1. The main CMU Resolutions which govern the procedure for issuance / termination / introduction of amendments to special permits, including the Procedure for Auctions for Sale of Special Permits for Subsoil Use, approved by CMU Resolution #594 of 30 May 2011, and Procedure for Granting Special Permits for Subsoil Use, as approved by CMU Resolution #615 of 30 May 2011, are constantly changing. This approach does not provide a sense of legislative stability.

2. The current paragraph 13 of the Procedure for Granting Special Permits for Subsoil Use obliges the subsoil users to pay for the geological information in case the mineral reserves / reserves base are increased. During 2016, the State Geological Service made numerous initiatives to introduce additional fees in such cases. The aforesaid provision and similar initiatives can hardly be said to stimulate investments in geological study, exploration and supplementary field appraisal.

3. Establishment of additional fees contradicts the currently applicable legislation, namely Articles 28 and 34 of the Subsoil Code of Ukraine, and exceeds the legally defined powers of the Cabinet of Ministers in the field of geological study, use and protection of natural resources.

4. According to Art. 25 of the Procedure for the State Examination and Evaluation of Mineral Resources approved by CMU Resolution # 865 on December 22, 1994, subsoil users are obliged to have the State examination and evaluation of mineral resources performed every five years of exploitation of respective subsoil plots and in case there are definite changes in qualitative and quantitative characteristics of the mineral resources and in technical, economic and financial indicators of business operations.

NECESSARY STEPS

- Cancellation of additional fees for subsoil use in case mineral reserves increase.
- Random amendments to legal acts on regulation of procedure for granting special permits for subsoil use (inter alia CMU Resolution #594 and #615 dated 30 May 2011).
- Weighty internal affairs authorities audits and financial monitoring while issuance of special permits, legally uncertain criteria of its specific aspects.

CURRENT SITUATION

- Unreasonable additional financial burden on production companies. To ensure legislation stability, proper and systematic elimination of legislative gaps, inter alia by adoption of a new Subsoil Code.
- Unreasonable performance of re-estimation of reserves of mineral resources every five years of exploitation of respective subsoil plots in terms of deposit geological structure, bureaucratic and financial burden on production companies.

Decision makers:

- State Geology Service
- Ministry of Ecology and Natural Resources of Ukraine
- Cabinet of Ministers of Ukraine

The requirement to have reserves re-evaluated every five years is inappropriate and discriminatory for the extractive industry, moreover it imposes additional bureaucratic and financial burdens on extractive companies.

Re-evaluation of hydrocarbon reserves in fields that are small or in the final stage of development is generally economically inefficient because the cost of reserves re-examination and re-evaluation in such cases is higher than the total value of all remaining hydrocarbon reserves which significantly influences the technical and economic indicators of such fields and increases the cost of production.

Re-evaluation of reserves and state re-examination should be conducted in the event of a significant change in qualitative or quantitative characteristics of hydrocarbons due to mining or further exploration. The need for a common approach in issuing special permits for subsoil use to all market players should be specially emphasized. It primarily relates to abolishment of any preferences for companies fully or partially owned by the state.

Such preferences appeared on multiple occasions in the Procedure for Granting Special Permits for Subsoil Use, having completely deprived private extractive companies of an opportunity to compete for subsoil areas with a high geological potential.
Chapter 1
Reforms In Oil&Gas Sector of Ukraine

7. Eliminate certain approvals of the Ministry of Energy and Coal Industry

Background:
As stated in articles 35, 36 of the Law of Ukraine «On Oil and Gas», and sub-items 9 and 12 of the item 4 of the Regulation on Ministry of Energy and Coal Industry of Ukraine approved by CMU Resolution #208 dated 29 March 2017, it is envisaged that the Ministry of Energy and Coal Industry:

- Takes decisions on the field or separate oil and gas reservoir to be set into pilot development planning or commercial development.
- Approves technological projects (schemes) of commercial development of the field (reservoir), integrated projects for its arrangement to be performed according to the legislation, investment projects (programmes) for pilot development planning or commercial development of oil and gas fields.

For this purpose, the Ministry of Energy and Coal Industry of Ukraine created a working group for the matters of oil and gas field development (Decree #437 dated 09 July 2015).

It should be mentioned that the requirements of technical project documentation are set thoroughly in the recently adopted Rules for Oil and Gas Fields Development approved by the Decree of the Ministry of Ecology and Natural Resources of Ukraine dated 15 March 2017 #118. Their development is performed by design institutions and after that, they pass expertise in expert and technological centers of the State Labor Service. Projects are fulfilled with the field development audit.

Moreover, the main document to allow subsoil use is a special permit. It already maintains certain types of subsoil use which may be fulfilled by the subsoil user: geological survey of oil and gas bearing resources, including pilot commercial field development; geological survey of oil and gas bearing resources, including pilot commercial fields development with further oil and gas production (commercial fields development) etc. The subsoil user who gets the special permit shall conclude a license agreement with the State Geological Service. The program of work is an appendix to the license agreement.

Position:
To remove articles 35 and 36 of the Law of Ukraine «On Oil and Gas», and sub-items 9 and 12 of the item 4 of the Regulation on Ministry of Energy and Coal Industry of Ukraine approved by CMU Resolution #208 dated 29 March 2017 and the Decree of Ministry of Energy and Coal Industry of Ukraine dated 09 July 2015 # 437.

Decision makers:
- Ministry of Energy and Coal Industry
- State Geology Service
- Ministry of Ecology and Natural Resources of Ukraine
- Cabinet of Ministers of Ukraine
- Parliament

In global practice, the field development project is approved by the subsoil user only.
8. Develop a state program of transfer to new gas quality standards

Background:

The Code of Gas Transmission System ("Code"), which came into effect in November 2015, provides certain requirements for the physical and chemical composition of natural gas which can be accepted to the Gas Transmission System.

However, the physical and chemical composition of natural gas produced in Ukraine does not meet these requirements of the Code.

Previously, Ukrainian gas quality had to comply with GOST 5542-87 which is valid until 01.01.2018. Thus, there is a certain conflict of legal acts as to what standards of physical and chemical composition of natural gas companies must comply with. In addition, the Ministry of Energy and Coal Industry is working out Technical Regulations that are supposed to replace GOST 5542-87 and be incorporated in the Code, implementing European standards of gas physical and chemical composition.

Under item 15 part 1 Chapter III of the Code, the Transmission System Operator is entitled to refuse acceptance of gas at GTS entry points if the physical and chemical composition of gas doesn’t comply with requirements prescribed by standard agreement for gas transmission, approved by the Regulator.

Until requirements to the physical and chemical composition of gas are finally defined by Technical Regulations and the Code, the TSO’s right to reject gas producers should have sufficient terms to comply with the new requirements.

There is a risk that the gas of some producers may be rejected or charged with additional payment (penalty); therefore, the Government changed the requirements for gas quality and introduced penalties without any transition period. Moreover, these requirements will be changed again. As a result:

a) it is not clear which requirements for gas quality will be finally established;

b) there is a risk that the gas of some producers may be rejected or charged with additional payment (penalty);

c) development of gas treatment systems to comply with the requirements shall take several years and require significant capital investments.

Therefore, it is suggested:

- To define reasonable gas quality requirements and set them out in the Technical Regulation and Code;
- To provide a transition period (several years) for gas producers to establish the necessary equipment for gas treatment;
- To provide a compensatory mechanism by the Government to cover the costs for establishment of equipment for gas treatment;
- To resolve all the issues with gas quality mentioned above in the State Program of transition to new standards.

Position:

The uncertainty over gas quality requirements may lead to refusal of TSO to accept gas into the gas pipeline network and to imposing of penalties by TSO for noncompliance of gas quality with the requirements of the Code.

The requirements to gas quality should be reasonable.

If any gas parameters are significantly changed, gas producers should have sufficient terms to comply with the new requirements.

Until requirements to the physical and chemical composition of gas are finally defined by Technical Regulations and the Code, the TSO’s right to reject gas should be canceled. The requirements to the physical and chemical composition of natural gas shall be reasonable and consider the interests and risks of GTS, consumers and gas producers and comply with European standards.

If gas quality requirements will be changed significantly, there should be no less than 10 years transition period for establishing the necessary equipment and the compensatory mechanism ensured by the Government to cover the costs for development of gas treatment systems.

In order to make the operation of the natural gas market efficient and the conditions of doing business predictable, there should be a relevant State Program of transition to new standards.

Decision makers:

- Ministry of Energy and Coal Industry
- Transmission System Operator
- Regulator
- Parliament

Source: GTS Code, approved by NERC Resolution #2493 dated September 30, 2015
Upstream Sector

9. Reform land legislation for the needs of oil and gas sector

Due to impossibility to formalize legal relations in respect of agricultural land, subsoil users usually have to choose less geologically promising land plots to perform works, and the investments in the production are unsecured.

Procedure for execution of land allotment agreements for the purposes of building, construction, exploitation and servicing of gas and oil wells should be simplified.

If no abolishment of moratorium is planned in the nearest future, than purchase/rent of agricultural land for the purposes of oil and gas industry should be an exception from it.


Background:

O&G companies constantly face problems with getting access to the land. There are several factors for such problems:

- the procedure for land allotment is too complicated and can continue for 1.5-2 years; such a long term for land allotment is the main reason for untimely performance of geological exploration and production activities;
- land plots, where the most hydrocarbon deposits are located, are mainly situated in the agricultural land which is in moratorium on disposal and conversion of land designation;
- inadequate regulation of easement agreements;
- agreements for exploration works as provided for in Art.97 of the Land Code have numerous legal drawbacks, including the lack of a procedure for registration of such agreements; such agreements are not applicable at the production stage and at the stage of conversion from geological exploration to the production stage, and that may result in blocking the whole project;
- nowadays the legislation does not offer a legally perfect mechanism for land allotment for subsoil usage purposes, which in turn provides ideal conditions for abuse and corruption.

Complex amendments to the Land Code are required

Position:

To put on vote and to adopt Draft Law Nº3096-d, to ensure an active support of the Draft Law by the Ministry for Energy and Coal Industry.

Decision makers:

- Agrarian and Land Committee and the Committee on Fuel and Energy Complex, Nuclear Policy and Safety of the VRL
- State Service of Ukraine for Geodesy, Cartography and Cadastre
- Ministry of Energy and Coal Industry

ADOPTION OF DRAFT LAW №3096-d WILL PROVIDE FOR

Compensation of damages and losses to owners and land users due to land exploitation for purposes of oil & gas sector

Simplification of procedure for use of geological information received by subsoil users at their own cost

Creation of conditions for implementation of internationally approved system of hydrocarbon reserves assessment

Voluntary state registration and account of works and researches related to geological exploration

Simplification of procedure for launch of exploratory and commercial development

Possibility to execute and use an easement (limited right for a land use under the law or an agreement for objects related to facilities infrastructure without change of a purpose assignment of such land parcel)

Cancellation of duplicating of permitting documents for topsoil removal at the land parcel where well drilling and construction is on-going

Simplification of a procedure for land use in case of transfer to commercial development of a deposit

Cancellation of a mining allotment in oil & gas production sectors due to duplicating in other permitting documents

Exclusion of objects of oil & gas sector from the list of city construction objects due to its distribution beyond localities

Source: Ukrgazvydobuvannya
Upstream Sector

10. Create conditions for compliance with the Extractive Industries Transparency Initiative (EITI)

**Background:**

EITI is an independent and voluntarily supported at the international level standard of transparency being implemented in nearly 50 countries.

EITI implementation is an important tool for building confidence of investors who require stability and a fair playing field; trading partners who expect reliable import and transit of hydrocarbons; and political partners who put high value on generally accepted standards of transparency and accountability, whereas:

- EITI enables to cover wider aspects of the value chain in the extractive industries – so as to be an even more powerful and useful tool to address the challenges of natural resources management;
- Greater transparency of the fiscal regime, energy data and market rules will speed up investments and increase competitiveness. Ukraine is able to demonstrate that it is a transparent and responsible country;
- EITI enables to improve the positive impact on Ukraine’s sovereign credit rating and eventually lead to the reduced cost of sovereign loans. By implementing EITI, the government can demonstrate compliance with the effective, open and responsible corporate governance;
- Establishing a social dialogue among the government, companies and civil society representatives through Multi-Stakeholder Group activity, which makes possible to consult on a wider basis for policy relevant issues.

In September 2009, Ukraine committed to implement EITI, having approved its intentions in agreements with the IMF and the EU, as well as in the framework of the Open Government Partnership.

On October 10, 2012, the Ministry of Energy and Coal Industry created the Multi-Stakeholder Group (MSG) in Ukraine by its Decree #785; however, MSG’s effective work requires not only the active participation of companies and the civil society, but also a number of legislative changes.

The necessary amendments have been partially implemented by adoption of the Parliament of Ukraine Law # 521-VIII “On Amendments of Some Legislative Acts of Ukraine Regarding Extractive Industries Transparency” as of June 16, 2015. However this law has only introduced general provisions, having left numerous gaps such as the absence of sanctions for non-submission or late submission of reports, existence of obstacles preventing access to information, etc., which resulted in essential problems during the process of information gathering for the preparation of the reports.

In order to eliminate the aforesaid gaps, the MSG, supported by business and civil society, has developed Draft Law #6229 “On Ensuring Transparency in Extractive Industries” which is pending consideration in the Parliament.

**WHY IT IS IMPORTANT TO ADOPT THE DRAFT LAW №6229 “ON ENSURING TRANSPARENCY IN EXTRACTIVE INDUSTRIES”**

**Advantages for Business:**
- New rules in Ukrainian legislation will attract foreign investors who have already conducted their business under similar rules in USA, Canada, Australia and EU.
- Transparent and clear legislative framework for business will ensure minimization of investment risks and Ukraine’s attractiveness for further business expansion.
- New rules will provide more responsibility for Ukrainian companies during development of mineral resources as well as control over implementation of investment programs and prevention of tax mitigation. A consolidated report will be submitted from parent companies, promoting transparency of holding groups.
- Moreover, provision of reports may facilitate building of a constructive dialogue with local communities and the Government.

**Advantages for Ukraine:**
- State authorities in charge of upstream development will be able to better evaluate the situation due to new scope of information. Basic financial information regarding tax payments will be generally available, without any necessity to apply for such information to fiscal authorities.
- Moreover, the following comprehensive information, important for understanding of business conditions, will be disclosed: fiscal regime, regulatory and licensing system, scope of production and beneficiary owners.
- The Government will be able to control companies which refuse to timely submit information or provide incomplete or erroneous data. Besides introduction of fees, the law, at the same time, will prevent illegitimate pressure on business companies.

**Advantages for citizens:**
- Local authorities will have access to information regarding social projects and compliance with ecological requirements, employment, payments to local and regional budgets.

**Specific aspects**

- More efficient functioning of upstream sector: companies which disclosed information can submit proposals on increase of efficiency of extractive industries during 2 months following publication of EITI reports.
- Public access to information: reports should be publicly available for 10 years. All information regarding payments should be also published on the website of the Ministry of Energy and Coal Industry. Besides, the companies must put on the Internet copies of agreements on subsoil use permission.
- More transparent accountability of companies and state authorities in receiving payments.
- Public access to unbiased information on payments from production companies.
- Creation of conditions for efficient use and management of natural resources.

**Why it is important to adopt the Draft Law N°6229 “On Ensuring Transparency in Extractive Industries”**

**Source:** DiXi Group

**Position:**

Bringing the national legislation framework into compliance with the EITI requirements, including adoption of Draft Law #6229.

**Decision makers:**

- Ministry of Energy and Coal Industry
- Parliament
Midstream Sector

Critical issues blocking the Ukrainian natural gas market development

Over the last 2 years the natural gas market of Ukraine has changed significantly

Progress can be seen in the establishment of a competitive environment for gas trading at the EU-UA border, mainly achieved by creating available entry capacities to Ukraine by the TSO and the fact that the old system of “monthly balances of gas volumes from shippers” which was steered by Naftogaz has been removed from the law.

The new Law of Ukraine “On natural gas market”, gas system codes, rules and regulations have been adopted, allowing the market to facilitate gas transactions on a bilateral basis.

At the same time, there is a lot which still has to be done. The introduced reforms have not provided for bi-directional free cross-border trading; licensing rules are still very restrictive as they require a company setup in Ukraine; no standardized contracts; customs and tax rules are prohibitive and not matching European standards; no transparency of market prices; an incumbent who is setting the floor price on a monthly basis; unclear and prohibitive rules for supplying end customers and much more.

To overcome all obstacles, Ukrainian gas market players should unite and by joint efforts work with the Regulator, TSO, the stakeholders and the law makers to develop a market which will attract new market players, create liquidity, giving the right incentives for the gas producers to extract their gas and to the gas consumers to invest into their infrastructure and develop the whole gas industry.

In this Chapter we will outline the most critical issues blocking Ukrainian natural gas market development. Certainly, further necessary steps are not limited to the problems indicated below and have to be supported and implemented by the state by committing to complex measures including the reform of courts, financial institutions and processes, systems of relationship in areas of ownership and reduction of bureaucratic red-tape in all spheres.
Midstream Sector

11. Introduce a reasonable financial guarantee requirement, prepayment for transportation capacities

**Background:**

According to current rules of the accession to the GTS capacities, the shipper has to provide TSO with financial guarantees of the balancing services of 20% of the monthly quantity to be transported and the financial guarantee covering 100% of the nominated quantity in the current and previous (or next) month.

Since the term of the financial guarantee is one month following the termination of a transmission period, the shipper has to freeze up to 240% of the gas amount to be transmitted. Prepayment mechanisms complicate the efficient and rapid interaction with TSO, aggravate nomination-renomination procedure, and require freezing of cash funds and correspondently additional costs.

At the same time, state owned monopolistic companies the National JSC “Naftogaz of Ukraine” and Public JSC “Ukrgazvydobuvannya” are free from obligation to provide any financial guarantee to TSO. Naftogaz is still a parent company of the TSO despite of the Government’s obligation to unbundle them. All of the abovementioned factors create unfair and non-competitive conditions for market participants and hamper market development.

**Position:**

To optimize the level of financial guarantees for balancing services.

To implement daily balancing in the shortest term.

To finish unbundling procedures and procure equal rights and obligations to all market players.

**Decision makers:**

- Regulator
- Transmission System Operator
- Parliament

The full integration of the Ukrainian gas sector into the European gas market area requires the necessary level of market development and free competition.

The Government has to fulfill the unbundling of Naftogas of Ukraine and TSO. All the privileges for state owned companies, including the privileges related to PSO, have to be cancelled. Daily balancing has to be implemented as soon as possible.

Midstream Sector

12. Free choice of supplier

**Consumers’ right to choose a supplier is limited**

**Background:**

Presently the Ukrainian laws and regulations (part 2 of the Article 14 of the Law of Ukraine "On Natural Gas Market" and para 18, subpara 11, Chapter 1, Section XI of the GTS Code) restrict the rights of customers to freely choose a supplier and allow to purchase natural gas only from one supplier within one settlement period (one month).

This restriction blocks development of gas trading and the entry of new gas market players to the Ukrainian gas market. Besides, such a rule causes underdevelopment of free competition on the Ukrainian market and hampers new investments to the Ukrainian economy. European gas legislation and Third Energy Package do not contain similar restrictions and allow purchasing gas from one, two or more suppliers within even the shortest period, both for industrial customers and for households. Especially large consumers will have an advantage if they can work with several suppliers who can show competitive pricing.

In relation to new gas market players who do not have enough flexibility yet to regulate their imbalances or additional needs in gas, the possibility to have several suppliers would give a chance to start activities, as without such a possibility, and supplying only baseload gas, they take risks that any interruption or imbalance will not be covered by another supplier.

Considering the fact that new market players starting their activity bear huge expenditures such as capital costs and high exit/entry tariffs on cross-border points, the probability of development of a proper gas market in such a situation is very low.

**Position:**

Such provisions should be removed from the Law of Ukraine “On Natural Gas Market” and secondary legislation.

**Decision makers:**

- Regulator
- Transmission System Operator
- Parliament

- Monopolized economy
  - Strict market regulation
  - Establishment of a tariff or single prices
  - Impossibility to choose alternative suppliers
  - Only one market player (disregarding affiliated companies)

- Free market economy*
  - Free competition
  - Establishment of prices based on market competition, volatility
  - Change of suppliers at any time
  - Multiple market players

* Free choice of supplier is an element of a free market economy
Midstream Sector

13. Provide a reasonable (re)calculation of Transportation tariffs on entry-exit points to the GTS

Background:

Since 1 April 2017, NERC established a new payment for booking capacity on the entry-exit points internally in the country for gas producers in amount of $10.91 for 1000 m³ in the form of prepayment (Tariff). It was made by NERC Decree #348 dated March 28, 2017.

Previously such Tariff was implemented by NERC on interstate points between Ukraine and EU for importers at $12.47 for 1000 m³ by Decree #3158 dated December 29, 2015. Implementation of the Tariff meets the requirements of the Third Energy Package; however, this Tariff is well above the average European tariffs for such points. The overestimation was caused by methods of the accelerated depreciation applied to Ukrainian GTS and used for tariff calculation by the Regulator.

Application of accelerated depreciation (4 years instead of 20) was caused by PJSC “Gazprom” management decisions stating that they will stop using Ukrainian GTS for transit activities commencing from 2019.

New tariff for GTS entry is three times higher than the average European one

However, when applying the principle of accelerated depreciation, state authorities should adhere to principles of Ukrainian legislation and, first of all, to the provisions of the Tax Code of Ukraine. Since Gazprom refused to pay transportation Tariff on entry-exit points, a dispute arose between Naftogaz of Ukraine and Gazprom, being under consideration of Stockholm Arbitration today.

The unreasonably high Tariff affects the process of the Ukrainian gas market integration into the European gas market, as it is higher than the average European level so does not sustain the competition in relation to the other international gas transit projects or projects of commercial gas storage with temporary inflow/outflow, which, as a rule, have another approach to pricing of GTS access in developed markets.

Moreover, exit points Bereg Daroc, Budince, Hermanowice cannot be used due to the absence of exit tariffs, which have not been established by the Regulator. All of these issues combined make it impossible to launch full-fledged cross-border natural gas trading and gas export from Ukraine, thus, the local Ukrainian gas market will develop at a slower pace.

Ukraine has one if the highest tariffs for GTS entry points among Europe

The exit-entry Tariff should be competitive and fixed on the average EU level. The Tariff on interstate points should be introduced in full and enable shippers to use different options of trade, thus developing competition. Only competition will help the Ukrainian market to reach the proper liquidity and make the gas price more reasonable and acceptable for end-users.

Additional financial burden for gas producing industry is $210 million per year

The Tariff should take into account profitability of TSO, market environment, competitiveness and viability of transmission services and should not take into account political reasons, court proceedings of separate enterprises, or other manipulations introduced to the market to help some companies to solve private problems. The conditions of the functioning and transportation Tariff should be equal for all market players.

TARIFFS ON NATURAL GAS FOR ENTRY/EXIT POINTS IN UKRAINE

The Tariff affects the gas producers’ margin and their ability to invest into gas production growth, increasing the gas price for end-users. Industrial customers (chemical, metallurgical industry, etc) have an additional burden in the form of a high gas price and add this price to the primary cost of products, which, in turn, makes their products non-competitive on world markets and correspondingly has a negative effect on the Ukrainian economy.

NATURAL GAS CROSS-BORDER ENTRY/EXIT TARIFF IN UKRAINE AND CERTAIN EU COUNTRIES

The conditions of the functioning and transportation Tariff should be equal for all market players.

For example, the points Beregove, Drozdovichi, Uzhgorod, where the tariffs for entry-exit points have been established, cannot be used for export of gas from Ukraine for the time being due to the restrictions arising out of the Naftogaz transit agreement with Gazprom.

Besides, gas export is not possible through some cross-border exit points that Ukraine has with EU countries. For example, the points Beregove, Drozdovichi, Uzhgorod, where the tariffs for entry-exit points have been established, cannot be used for export of gas from Ukraine for the time being due to the restrictions arising out of the Naftogaz transit agreement with Gazprom.
Midstream Sector

14. Allow an equal nomination and allocation of gas in cross-border trade

The every-day change of heating value in the Ukrainian system causes the every-day change in cubic meter’s quantity of gas, which, in turn, causes the imbalance between delivered and accepted volumes of gas on the border (see the infographics below).

Besides, the balancing rules on the Ukrainian market and their understanding do not coincide with the European market.

To avoid imbalances shippers must use complicated and sophisticated manipulations that require a lot of effort and time; a shipper does not have the option of cash-out mechanisms to solve the imbalance and should either use storage capacities for this or sell/purchase imbalance gas from other shippers.

To solve cross-border imbalances and to comply with EU rules, TSO promised to switch over to energy units from cubic meters from the 2nd quarter 2017, but still we see only the efforts to use both energy/volumetric units that will not allow the market to introduce civilized methods of cross-border trade.

It is necessary to avoid imbalancing in cross-border trade

Background:

In order to facilitate cross-border trade and prevent the creation of imbalances that can be solved between TSOs under their bilateral balancing agreement, the cross-border nomination always equals the cross-border allocation on the EU gas market.

This allows for the introduction of different mechanisms and options of cross-border trade and expediting, documenting and acceptance mechanisms for imported and transferred natural gas.

At present, cross-border trade has not introduced equality of nomination to allocation since nomination of natural gas from the EU’s TSO is made in energy units, but acceptance is made in cubic meters.

The imbalance between delivered and accepted volumes of gas on the border leads to

- Overbalance of actual volume of gas
  - In this case, additional expenses are needed for:
    - Formal registration of overbalance of gas volume
    - Sale of such gas overbalance
    - Storage of such gas overbalance

- Deficit of actual volume of gas
  - In this case, additional expenses are needed for purchase of gas to cover the deficit

Overbalance/deficit of gas volume occurs due to

- Different units for measuring gas at the time of import
- Volatility of gas heating value
- Absence of direct access to information on gas heating value

Position:

To allow equal nomination and allocation on the border and avoid imbalancing in cross-border trade, TSO should introduce only energy units for gas trade as well as establish trade on Virtual Trading Points.

This, among other things, will enable the launch of gas trade and introduction of up-to-date trading mechanisms and gas purchase contracts.

Decision makers:

- Regulator
- Transmission System Operator
Midstream Sector

15. Improve payment mechanism for sales of gas, close-out and volume netting, unified gas contract

The Ukrainian laws should not restrict Ukrainian enterprises in terms of payment for commodities

Background:

There is no possibility of close-out or volume netting in cross-border gas transactions at the Ukrainian local market due to unavailability of cash-out procedure and clearing houses in Ukraine.

The netting mechanisms could decrease paperwork under gas sale contracts and support further development of gas stock exchange or OTC trading in Ukraine.

In order to enable spot trading and establish a gas hub/stock exchange in Ukraine, it is necessary to create and introduce the unified universal gas purchase-sale contract like the EFET contract on the European market.

Presently, the different approaches and long procedure of contracting makes rapid trade impossible, thus full integration of the Ukrainian market to Europe is also not currently possible.

Position:

Ukrainian laws should not restrict Ukrainian enterprises in terms of payment for commodities and give the possibility of attraction of a larger number of suppliers for purchase of commodities.

Ukrainian financial institutions, first of all National Bank of Ukraine, should analyse and elaborate clearing house establishment rules and netting procedure to enable establishment of a civilized market and gas hub.

Decision makers:

- Ministry of Economic Development and Trade
- Ministry of Finance
- National Bank of Ukraine
- Cabinet of Ministers of Ukraine

ADVANTAGES OF DEVELOPMENT AND FUNCTIONING OF GAS HUB IN UKRAINE

- Increase of gas market efficiency
- Avoidance of political speculations
- Development of regional market and integration of Ukraine to the European Energy Community
- Ensuring of market transparency and strengthening of traders’ trust to market
- Ensuring of balance during peak-load period (gas sale in case of unexpected change of demand or gas supply shortage)
- More balanced market prices due to pricing based on demand and supply
- Ensuring of energy safety and sufficient gas volume for internal supply (storage of significant gas reserves, provided by various suppliers)
Midstream Sector

16. Develop a legislation on trading platforms

Background:
The establishment of an electronic trading platform is not a requirement of the Third Energy Package as such. The Regulator should establish market-based balancing mechanisms to maintain the market.

Establishment of electronic trading platform may be used for this purpose. On the one hand, Regulation (EC) 32/2014 establishing a Network Code on Gas Transmission of Transmission Networks determines transparency requirements, in particular, transparency of price formation for purposes of balancing the gas market.

TOTAL TRADED VOLUMES AT EUROPEAN GAS HUBS **

<table>
<thead>
<tr>
<th>HUB</th>
<th>TOTAL TRADED VOLUMES (TWh)</th>
<th>2008</th>
<th>2011</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
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<tbody>
<tr>
<td>TTF</td>
<td></td>
<td>560</td>
<td>6,295</td>
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<tr>
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<td>415</td>
<td>525</td>
<td>+37</td>
<td>+720</td>
<td>+23</td>
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</table>

Monitoring of correlation between a transparent, market-based wholesale price and a retail energy price, as well as mark-up between wholesale prices and retail energy prices is lacking due to the fact that market-based organized trading platforms or power exchanges do not exist yet.

The development of trading platforms and electronic technology for real-time balancing, day-ahead and intraday trading and settlement, as well as for electronic auctions for the allocation of cross-border capacity, is another challenge which depends on the adoption of the new legislation.

Dutch Experience

Bratlee' concludes that a successful gas hub could generate additional economic activities worth € 2.14 billion in the period up to 2020 and create 136,000 job-years. A job-year is one job for one person for one year.*

On the other hand, there are requirements on balancing stipulated by Regulation (EC) 715/2009 on conditions for access to the natural gas transmission networks, and they have been transposed by the Law on Gas Market of Ukraine. The balancing regime has been defined by the Transmission Code.


«BEST PRACTICE» MODEL OF A EUROPEAN GAS HUB ***

In its “Gas Hub Development Study” the EFET managed to develop a “best practice” model of a gas hub, based on analysis of European liquid hubs practices, respective regulatory developments, traders’ activities and expectations from the hub etc.

According to EFET, efficient and successful hubs exist in case of:

1. Established consultation mechanism.
2. Defined market structural issues (gas release programs, transport capacity release programs etc.).
3. Defined Role of Hub operator (what are its responsibilities in comparison with the TSO).
4. Established entry-exit system.
5. Ensured title transfer (gas can be traded without physical delivery, usually by transfer between balancing groups).
7. Gas trade is accessible to non-physical traders (for trade you do not require to flow gas physically from entry to exit).
8. Ensured non-punitive credit arrangements.
10. Use of standardized contract (e.g. EFET Master Contract).
11. Price Reporting Agencies active at the hub.
12. Market makers and Brokers.
13. Reliable index, used as benchmark.

Results of 2016 EFET Review of Gas Hubs Assessments show that the NBP and the TTF are the only hubs that can be considered as mature, deep, transparent and liquid. Besides, the TTF now is the largest traded and pre-eminent benchmark gas hub in Europe.

*** Source: 2016 EFET Review of Gas Hubs Assessments; P. Heather

Position:
The establishment of transparent price formation needs competitors on the market, consequently Ukraine needs to develop legislation on trading platforms and electronic technology for real-time balancing, consistent and understandable trading rules in terms that the EU imposed stricter ‘unbundling’ requirements. In general, it will create more competitive pricing and transparency. As wholesale trade develops, gas hubs with short-term contracts may represent a second source of gas provision in parallel with long-term contracts.

Decision makers:

Regulator

NATIONAL REGULATORY AUTHORITY
TRANSMISSION SYSTEM OPERATOR
CREATED BY MARKET CONDITIONS
MARKET PARTICIPANTS AT EUROPEAN GAS HUBS **

<table>
<thead>
<tr>
<th>HUB</th>
<th>MARKET PARTICIPANTS</th>
<th>ACTIVE</th>
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<td>n/a</td>
<td>112</td>
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</tbody>
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Chapter 2

Midstream Sector

17. Improve the regulatory regime for temporary storage of natural gas and cross-border transactions of Ukraine

In particular, according to the Order, customs clearance of gas transported to Ukraine by a non-resident for purposes of storage at gas storages shall be made in the regime of “customs warehouse”, which allows non-residents not to pay the 20% import VAT. Now European partners can order from PJSC «Ukrtransgaz» services for storage of natural gas for a period of up to three years. At the same time, non-residents can transfer title to the gas kept in gas storage facilities under the «customs warehouse» regime provided that the customs regime of such gas is changed to a regime which envisages payment of VAT.

Although the «customs warehouse» regime does not require payment of VAT by non-residents, non-residents still have to pay fees for using entry and exit points of the transmission system.

2. Cross-border trading

The Gas Transmission System Code expressly provides that gas may enter/exit the system at the interconnectors established between the Ukrainian gas transmission system and the gas networks of neighbouring countries. However, the Code does not provide for clear rules and regulations with respect to gas trading at such interconnectors.

For example, the Regulator is not entitled to establish virtual trading points (VTPs) at the interconnectors at its own discretion. The “replacement” of gas (i.e., withdrawal of gas at any exit points irrespective of the entry point where the natural gas was physically injected) is also not expressly allowed by national legislation. The above significantly limits gas trading options for foreign investors.

3. Export of natural gas from Ukraine

The Government’s decision represents a significant step towards liberalisation of the natural gas market and trading in Ukraine, which would allow natural gas to flow not only from EU countries Ukraine has interconnected with, but also from Ukraine to them.

At the same time, exporters of natural gas from Ukraine are now required to pay tariffs for using Ukraine’s gas system exit capacity at the interconnectors with its neighbouring EU countries. Such tariffs are calculated and approved by the Regulator for each particular exit point in USD per 1,000 m³.

However, not all cross-border exit points have a tariff yet and the Regulator has yet to announce fees for many points. Unfortunately, this creates an obstacle for exporting gas through such points.

Position:

With respect to the temporary storage of gas in Ukraine — despite positive developments related to the introduction of the «customs warehouse» regime for the purpose of gas storage, it is necessary to ensure that all secondary legislation is in place which would allow practical implementation of the «customs warehouse» regime.

With respect to cross-border trading — a number of amendments must be introduced to the secondary legal acts (in particular — changes to the GTS Code providing for a new definition and legal status of VTPs and interconnectors).

A set of clear and transparent rules for regulation and performance of cross-border transactions must be developed and adopted.

Decision makers:

With respect to temporary storage of gas in Ukraine:

- Ministry of Finance
- State Fiscal Service

With respect to cross-border trading and export of natural gas from Ukraine:

- Regulator
Downstream sector

Transparent and fair market conditions in downstream sector are critical today

Wherever the Ukrainian downstream fuel market has gaps today those need to be identified, being vocal on those gaps and closing them within the shortest term.

This year the Chamber is addressing three areas for consideration to regulators in the Fuel Retail segment:

- Recommendations to resolve problems of antimonopoly control in Ukrainian fuel retail market
- Elimination of illegal LPG units and illegal fuel sites in Ukraine
- Significant reduction of administrative burden and bureaucracy

Transparency and fair market conditions are critical to ensure market players can serve consumers sustainably, with good and reliable quality products and on a continuously improving service level.

Ukraine is going through market transition in the downstream sector. This is a very good change, but has to be carefully monitored and supported to ensure the transition will move the sector in the right direction, and that market conditions are getting significantly better and cleaner for transparent market players who are operating with great compliance and integrity according to the EU compatible market rules and regulations.

Through this change, consumers will also gain more trust in the sector. Competing for them fairly is the engine of every well-functioning market.
Downstream sector

18. Recommendations to improve antimonopoly control in Ukrainian fuel retail market

The Ukrainian fuel market is dynamic and highly competitive

Background:

The Ukrainian fuel retail market is dynamic with a high competitiveness. As mobility and fuel prices are critical areas of the economy, the Antimonopoly Committee of Ukraine (the AMCU) or ‘the Committee’) is also trying to exercise rather strong control over competition in this field. Market transition is far from completion as there are many regulatory and legislative gaps, which provide great opportunity to the “grey zone” and illegal players to stay or even grow rapidly in Ukraine.

Last year the AMCU demonstrated some degree of openness towards retail fuel marketers: it organized and participated in round tables, listened to concerns of operators, and informally recognized their voices as reasonable to a point. However, this didn’t find that much support in AMCU investigation outcomes and decision-making impacting the market.

Practically, one of the most ‘popular’ topics monitored by the AMCU is changes in retail fuel prices for light fuels, diesel and others which happen quite frequently because of the specifics in the oil fuels market.

Fuel price fluctuations trigger the Committee’s suspicion over ‘similar fuel pricing’ moves in competitors’ behavior, which, in turn, often launches the AMCU’s reactive ‘constraints’ on the market like recommendations and calls to keep prices down. In some cases, even anticompetitive investigations can be opened.

Remarkable is the AMCU ‘selective’ approach in detecting and investigating alleged ‘facts’ of anti-competitive behavior in actions of different retail fuel operators: while those doing fair and transparent retail business, paying taxes (among them members of the ACC) are scrutinized by the AMCU, the majority of other fuel marketers, whose behavior features suspicious ‘grey’ or ‘illegal’ practices, are completely out of the scope of the AMCU investigations for a long time period. It is as if they are ‘non-existing’ in the market from the competition control viewpoint.

1. Role of illegitimate privileges in competing with ‘white’ fuel retailers for those who sell off-books, counterfeited (diluted, ‘blended’) products, underpay taxes etc. is underestimated in the monitoring of the market. These are clearly non-market privileges for some fuel marketers (scoring in aggregate to quite a considerable volume all over the country – up to 20%) which can freely operate while causing obstructions to fair competition in Ukraine. By not pursuing these noxious practices, the AMCU actually tolerates them.

2. Huge volumes of fuel running through Ukrainian grey and black fuel markets cannot be counted in the AMCU investigative calculations because no information can be officially collected by the AMCU in this area. This means competition control measures are lagging behind the realities of oil fuel product markets. Objective and robust analysis by the Committee on the fuel market is hardly possible under such circumstances.

3. In its investigations the AMCU ‘overrides’ the normal and legally acceptable ‘parallel behavior’ of fuel retailers and converts this into so called ‘anticompetitive concerted actions’ for which it immediately penalizes by applying huge fines on companies. Findings of the anticompetitive investigations involving parallel fuel pricing are based much on the Committee’s assumptions and broad and biased interpretation of the anticompetitive rules failing at the same time to collect real proof that price collusion in any form between competitors did ever happen.

4. Methodology used by the AMCU in reviewing market behaviors and finding features of anticompetitive concerted actions is really out-of-date and should be modernized. We note the recent AMCU efforts within the recently launched ‘Twinning Project’ to help update Ukrainian antitrust laws and rules with use of modern European practices.

Recommendations to improve antimonopoly control in Ukrainian fuel retail market

- The AMCU’s mission should be support of businesses in all sectors.
- The AMCU should detect and strike upon unfair competition practices working together with relevant business associations.
- It’s essential to revise the most appropriate and feasible (for operators also) way to provide information upon the AMCU’s obligatory requests.
- A broader representation of fuel operators should be added into the system of electronic submission.
- The AMCU should collect information and form its opinion with regard to grey/black fuel A-brands.
- The AMCU should initiate setting up a working group of the Committee and market participants.
- The AMCU should continue updating methodologies used in evaluation of the marketing behavior of the operators.

Position:

1. The AMCU’s mission should be support of businesses in all sectors, as well as in the retail fuel market by developing and safeguarding the rules of fair competition. At the same time this has to be done so that those rules are very clear and consistently followed by all players of the market. This is essential to accelerate market transition and to ensure a level playing field for all participants of the fuel retail market, its competition control measures, including investigations being equally scrutinized, not only on fuel A-brands.

2. The AMCU should detect and strike unfair competition practices working together with relevant business associations, legislative regulators and authorities to ensure their scope is full and not selective, having a real impact on the fuel market clean up.

3. It’s essential to revise the most appropriate and feasible (for operators also) way to provide information upon the AMCU’s obligatory requests including better use of existing Hardware & Software System (‘System’) capabilities, decreasing time and resources for preparation of this information in operators’ offices, and its provision (making it available) for the Main Office of the AMCU and its territorial divisions.

4. In view of item 3 above, add a broader representation of fuel operators into the System of electronic submission of information necessary for the Committee to monitor over fuel retail market. The System can be modernized, scope and type of information included into it can be reviewed as necessary and coordinated with market players.

5. The AMCU should collect information and form its opinion with regard to grey/black fuel market in Ukraine, should accept and recognize the information available from relevant business associations and market experts.

6. The AMCU should think about setting up a working group of the Committee and market participants, relevant business associations, market experts for periodic exchange of legitimate information and market problems with recommendations of this group being valid for the AMCU in its competition control.

7. The AMCU should continue updating methodologies used in evaluation of the marketing behavior of the operators in a way to give retailers more ‘legitimate’ flexibility in pricing from the AMCU outlook and making rules closer to market realities and best antitrust practices collected from abroad by Ukraine.

Decision makers:

Antimonopoly Committee of Ukraine
Downstream sector

19. Eliminate illegal LPG units and illegal fuels sites in Ukraine

Competitiveness of a petrol retail market should be guaranteed in Ukraine

Since 2015 in Ukraine there has been a rapid spread of new small autogas and/or fuel stations along motorways. Quite noticeable and known by regulators and market players there are a plenty of new LPG (‘car gas’ or propane butane) units and diesel filling points, for example in the city of Kyiv, Kyiv Oblast and other regions. Many of these ‘re-filling units’ don’t really look like fuel sites, but sell car fuels, mostly LPG, cheaper than market rates. Many of these sites are factually out-of-law since they have no permitting documents and official clearance from Ukrainian authorities necessary for operating a fuel filling station. Most probably they do not keep ‘white’ accounting of the sold fuels, use cash machines for accepting money from their customers, nor pay the prescribed taxes on fuel sale operations.

OIL PRODUCT USE

The scale of such operations is impressive – for example, in 2016 non-taxed LPG trades in Kyiv reached 70% of market volumes. In the city of Kyiv alone over 300 illegal LPG units were noticed – significantly more than the number of legitimate gas re-filling units in the Ukrainian capital. There are cases where the earlier dismantled illegal LPG points re-appear on the same sites in a while. Mass emergence of such illegal re-filling units began in 2015 with introduction of retail excise tax on sales of motor fuels, which was much less for LPG than for other fuels. In 2016 the negative effect from this tax continued. Starting from 2017, the retail excise tax was abolished and base excise tax increased accordingly. Despite of this positive change the problem with the spread of illegal LPG in Ukraine remains. Economic instigator is the disproportion in excise tax rate on light fuels (motor fuel and diesel) versus that on LPG: for high octane motor fuels EUR 213.50/1000 l.; for diesel fuel EUR 139.50/1000 l. This fact and the increasing demand for car gas as a cheaper fuel stimulates illegal LPG units quite quickly with no compliance with the administrative requirements for formalizing a title to land plot, permits for operations, with no regard to LPG units exploitation being a hazardous activity. Their operators are getting illegal non-market privileges over the rest of the market, because of: (i) quick entry (maneuvering) in the market, and (ii) price dumping because of not paying taxes, which undermines fair competition, glutting the LPG market and provoking even more ‘black market’ and ‘easy money’ activities, corruption issues for the controlling authorities.

BALANCE OF OIL PRODUCTS

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LPG GREY MARKET SEGMENT IN 2016

Official market/grey market

Kyiv

Grey market

In 2017, 39 of illegal gas stations were dismantled and 198 selfdismantled in Kyiv. The problem of mantling of illegal gas stations in other regions is still significant. 74 illegal gas stations were dismantled in Dnepro city. Such a positive tendency is also observed in other cities, since local authorities supports the necessity to make LPG market more transparent.

Total loss of Kyiv and state budget due to illegal gas stations in Kyiv is 625,3 mln UAH, inter alia Kyiv budget loss is 316 mln UAH.

Source: Ukrainian Oil & Gas Association

In 2016 a good tendency of fighting illegal fuel operators, especially ‘LPG units – violators’, and cooperation with transparently working fuel retailers demonstrated Kyiv City Municipal Authorities and their Department on Municipal Improvement and Environmental Protection, in particular under the project “Liquidation of Illegal Fuel/LPG Sites in city of Kyiv by Eurovision 2017”. Good consolidation task examples in this area should be promoted and strengthened in 2017 and with participation of other relevant authorities.

UNPAID TAXES IN 2016 BY ILLEGAL FUEL STATIONS AND SITES, LOCATED IN KYIV

Position:

1. Fix clear and exhaustive procedures for setting-up and opening small LPG, diesel or other fuel units (so called retail “mono-units”), clarify their legal status (do not allow them to be seen as “temporary constructions”), define whose – state or local authority’s competence these issues are;

2. Coordinate the office and field work among regulators, tax office, police and other relevant authorities to consolidate/amend procedures (local legal normative acts like city level or so on) and enhance level of on-site control and for quick detection, identification and dismantling of every illegal LPG or other illegal retail motor fuel units. This is required – to ensure compliant operation, safety of people, eliminate tax avoidance and guarantee fair competition on the retail fuel market.

3. Considering market trends, to balance out disproportioned excise tax value between LPG and light fuels.

Decision makers:

Ministry of Energy and Coal Industry

State Fiscal Service

State Service on Emergency Situations

Local Municipal Authorities
Chapter 3

Reforms In Oil&Gas Sector of Ukraine

Downstream sector

20. Eliminate administrative burden and bureaucracy for retail fuel sites

Deregulation of petrol market is required

Background:

There are many procedures in place in the Ukrainian downstream Fuel Retail sector which are conflicting with rationality, creating uncertainty and additional administrative burden to market players, at the same time creating a huge playground for corruption. The Chamber is getting vocal on those issues helping regulators to eliminate unnecessary practices and support market transition.

1. "New construction rules applied to old fuel sites". Current regulations allow government agencies to check the sites constructed according to earlier applicable building rules (no longer effective) against construction requirements. The auditing authorities still can penalize companies or even stop operations of those fuel sites for deviations in updated construction requirements. Such approach was used against sites constructed and put into operations in the past. These procedures are needed from government to government transition. Such approach was used against sites constructed and put into operations which had in the past received regulatory ‘yes’ to operate from the same controlling authorities.

2. Systems of early detection of emergency situations ("SEDES"). In fact, SEDES was required to be installed at each fuel site, thus duplicating already in place and activated functional equipment, including on-site alert systems, technological and industrial automation, portable gas emissions control systems (gas analysers), technology equipment re-enhanced explosion security. Moreover, in many cases SEDES is not connected to local fire protection service so it is completely useless to alert the fire brigade.

3. Insurance for ‘voluntary’ fire squad (“VFS”). Under the law, so called VFS members assigned to hazardous objects must be insured with obligatory life/health insurance. Some fuel retailers, at their own discretion and apart from this rule, provide life/health insurance to their fuel site personnel. Such company’s insurance should be recognized for the purpose of the mentioned obligatory insurance for personnel making fuel retailers compliant with the regulation. Otherwise, double insurance would be very unreasonable and burdensome for the market.

4. "Duplicated ecology expertise". It is legally required for fuel sites to be registered with all prescribed state authorities as a “hazardous object” in the course of collecting permissions when constructing fuel sites, including ecological expertise. Commissioning of fuel sites into operation is subjected to this rule, and so each fuel site must be compliant in this sense before it starts operating. However, and on the top of this, another rule urges fuel retailers to run another ecological expertise after having collected all permission/approvals for each site. This service is again duplication and causes avoidable cost burden to operators. In fact, this is a repeated exercise for documents already checked with all relevant authorities. The measure, having no real role for evaluating impact on environment, should be de-regulated as redundant and corruption tempting.

5. "Fuel price stela status". By current rules, price stela installed by a fuel site under permitting rules is viewed as an “external advertising” object subjected to all respective requirements. Substantially, this approach is wrong – price stela is a legally required customer information tool displaying fuel prices. Price stelas are installed to inform customers upfront about retail fuel prices and giving them the right to choice before they drive in to that or another fuel site. In fact, price stela supports transparency of fuel retailers’ offer to customers and fair competition.

6. "Daily cash register report logbook". Each cash register on site provides electronically to tax authorities data on all sales and purchase operations. At the end of the day a daily report is printed out and sent electronically to the tax authority. On the top of that, report data must be entered in writing by the cashier into the log book (KORO) assigned to that cash register. This electronic + manual report is in fact a duplication and a redundant administrative burden for sites.

Moreover, manual data entry is a stone age process and can be easily incorrect simply because of the human factor. "Typos" in cash register log books are treated by tax authorities as ‘mistakes’ in reporting usually penalized with huge fines (five times of deviation cash amount), although the same data is sent electronically and typos in writing can be checked against it. The cash register log book should be deregulated: either repealed altogether as a duplicating document or, at least, companies should not be punished for ‘typos’ or other ‘mistakes’ in hand writing.

7. "Safety permits prolongation". According to legislation, every fuel station every 5 years should receive a permit allowing execution of gas hazardous work and a permit allowing operation of equipment for storage of hazardous substances. Receiving such permits for one fuel station is quite expensive (fee - UAH 20 000). Fuel retail companies are entitled to prolong these permits provided that no serious incidents has happened or nor safety rules have been broken on site during the said period of time. However, the State Labor Service of Ukraine (SLSU) interprets this rule so that if an incident or safety rules breach took place at one site then it can deny prolongation of permits for all other sites of that fuel retailer. Practically, SLSU bodies ignore the mentioned prolongation right of ‘no-incident’ companies working over 5 years, thus pushing them to incur extra fees to pass redundant procedures or tempt them to corruption. This practice should be eliminated within the system of SLSU.

Position:

1. More deregulation is expected on the side of controlling authorities in auditing compliance with construction and maintenance requirements of fuel retail sites built under past rules; relevant instructions are needed from government to government authorities.

2. Eliminate duplication of regulatory requirements for fuel sites; fuel sites should be treated as specific ‘smaller scale’ hazardous objects not equal by law to big objects like chemical plants or refineries.

3. Making amendments to the regulations to recognize the personnel life insurance provided by fuel retail companies equal to the obligatory fire protection-related insurance for compliance purposes.

4. Repeal the obligatory 2nd level ecology expertise for fuel retail sites having all operation-related permits in place.

5. Amend rules on external advertising to exclude fuel price stelas from their scope.

6. Eliminate cash register log books (KORO), until then amend law and regulations re-softening/excluding penalties on companies for typos in cash register log books (KORO).

7. Eliminate ‘negative’ practices of SLSU with ‘hazardous’ related permits; adjust/clarify the law and regulations so that it would not be possible to misinterpret permit prolongation entitlement of fuel retail companies.

Decision makers:

State Architecture and Construction Inspection

Ministry of Regional Development and Construction

State Service on Emergency Situations

Ministry of Ecology and Natural Resources

Cabinet of Ministers of Ukraine

State Labor Service of Ukraine

Local Municipal Authorities

State Fiscal Service

Parliament

Reforms In Oil&Gas Sector of Ukraine
Financial issues in Upstream, Midstream, Downstream

This section contains questions relating to the financial aspects of the oil and gas industry, including aspects of improving accounting issues which are relevant to upstream, midstream and downstream.
Financial issues in Upstream, Midstream, Downstream

21. Liberalize foreign currency exchange rules

The main purpose of foreign currency exchange control in Ukraine is to prevent illegal capital flow. Foreign currency transactions are regulated by the Decree of the Cabinet of Ministers “On the System of Currency Regulation and Currency Control”, Law of Ukraine #185/94 VR “On Procedure of Payments in Foreign Currency”, dated September 23, 1994 and a number of rules issued by the National Bank of Ukraine (“NBU”). Ukrainian banks act as agents of currency control for the Ukrainian government. They are required to enforce compliance of their clients’ foreign currency transactions with Ukrainian law. The restrictions introduced in 2014 to settle the situation on Ukrainian monetary and foreign exchange markets have been extended quarterly, although certain deregulation of transactions in foreign currency is taking place.

Currently NBU by its Resolution # 410 dated 13.12.2016 has extended monetary market and currency control restrictions in Ukraine initially introduced in 2014-2015. Thus, the following restrictions remain in effect: prohibition to early repayment of loans from non-resident lenders (with some exceptions); the limit for foreign currency purchase by individuals set at UAH 150,000 per day, etc.

The Resolution shall remain valid until other Resolution is adopted by NBU subject to absence of unstable financial performance of the banking system or circumstances that threaten the stability of the banking and/or financial system of Ukraine.

Decision makers:
- National Bank of Ukraine
- Parliament
- Reforms In Oil&Gas Sector of Ukraine

10 Key steps:

1. To cancel the restrictions on repatriation of the dividends accumulated in all periods. Note only repatriation of dividends to foreign investors accumulated in 2014-2016 is allowed (subject to the NBU restrictions on the amount and the procedure for transferring of such dividends abroad). In the future it is necessary to allow repatriation of the dividends accumulated in all periods.
2. To cancel mandatory sale of UAH for foreign currency income, provided that NBU preserves the right to introduce such restrictions in case of a financial crisis.
3. To ensure a free transfer of the proceeds from the sales of shares, investment certificates, corporate rights or other assets by cancellation of the restriction to purchase and transfer the foreign currency by a resident from non-residents, loan repayments to non-residents (including the repayment of credits, loans at NBU interest rates, agreements);
4. To cancel the restrictions on foreign currency by a resident from non-residents, loan repayments to non-residents (including the repayment of credits, loans at NBU interest rates, agreements);
5. To liberalize the procedures for obtaining of credits and loans in foreign currency by the residents from non-residents, and granting loans to non-residents by the residents:
   - To cancel the restriction for early repayment of loans;
   - To ensure the right to make payments in accordance to loan agreements;
   - To establish appropriate rules for sufficiency of capitalization aimed to combat over-indebtedness;
   - To ensure the right to register assignment agreements by a new creditor – non-resident (without participation of borrower and without NBU consent subject to the relevant provisions in loan agreements);
   - To abolish registration of credits, loans at NBU and to introduce a system of simple statistics notifications by the servicing banks.
6. To establish the national regime for business activity of permanent representative offices of foreign investors in Ukraine, including their ability to perform foreign economic activities from the territory of Ukraine. To ensure the right of the permanent representatives offices to receive foreign proceeds to the accounts, also by the way of the appropriate clarifications of NBU
7. To ensure the right to set-off under foreign contracts and ensure the right of the banks to discharge export obligations of the clients from control after the documents for set-off are provided. NBU should preserve the right to introduce similar restrictions in case of financial crisis.
8. To abolish limits for credit loan amounts to be allocated from non-residents. To establish a procedure for credit operations control by tax instruments.
9. To cancel individual licenses for export, transfer and transfer abroad of foreign currency and maintain licensing regime for certain transactions relating only to countries which are not members of EU, EEA or which have not signed agreements with Ukraine on mutual protection of investments (including the countries provided under CMU Decree “On the System of Currency Regulation and Currency Control” and a number of other outdated CMU Decree “On the System of Currency Regulation and Currency Control" and a number of other regulations which are an obstacle to free capital flow in Ukraine, and without waiting for a new law which will establish the general principles of currency regulation that would match the current situation and market needs. These changes involve taking specific actions which can be mostly realised by adoption of relevant NBU resolutions aimed to implement the Steps together with practicable deadlines for their implementation.

The Steps are designed for 1-1.5 years, but most of them can be implemented within 6-7 months.

Background:
The extremely high level of control is one of the factors that slows down cross-border payments and encourages investors to take the currency assets out of the country at the first opportunity.

However, as the practice of other countries shows, business needs a regime which would allow to perform all the operations, except those "suspicious" transactions that fall within the scope of currency regulation.

In all other cases the effective monitoring of cross-border transactions should be achieved through other instruments, including tax control mechanisms (restrictions to classify as tax deductibles and requirements for transfer pricing, etc.).

Decision makers:
- National Bank of Ukraine
- Parliament
- Reforms In Oil&Gas Sector of Ukraine
Furthermore, for the companies using P(s)BO, there is no interpretative guidance clarifying P(s)BO 33 and accounting treatment of upstream business activities, and there is no rule allowing use of international practices. There is also no special accounting standard or interpretative guidance regarding accounting treatment of expenses incurred during the hydrocarbon production stage.

Finally, special tax rules for oil and gas upstream were abolished in 2015 (special depreciation rules, the right to deduct exploration costs as incurred). The minimum tax depreciation for wells is 15 years (as compared to 11 years established by the Tax Code prior to 2015). This does not reflect the actual useful life of a well.

Deficiencies in financial accounting rules and the absence of special tax rules increase the tax burden and affect project performance thus obstructing the attraction of additional investment.

If mineral exploration costs are presented in accordance with the standards which ensure the regular methods for the implementation of planned and actual operations and projects, costs will be presented in full, subject to the risky nature of exploration and its economic essence.

Position:
- Amend and reformulate P(s)BO No. 33 Mineral Exploration Costs to align it with IFRS 6.
- Amend Section III of the Tax Code to reintroduce special depreciation rates for productive wells (11 years).
- Ministry of Finance should issue detailed guidance and clarifications on P(s)BO No. 33 regarding exploration, pilot production for the companies using P(s)BO No. 33, to reflect the best world practices and to establish common ground.

Decision makers:
- Ministry of Finance
- State Fiscal Service of Ukraine
- Parliament

Background:
The high-risk nature of extracting companies and their specific type of assets - mineral reserves - require special rules for the accounting of business investment and special reporting requirements. Much of the investment in extraction is made before the presence of minerals in the explored area is determined. As the extent of investment in future production is very significant on the scale of an extracting company’s operations, the procedure for their accounting significantly affects the project.

Starting from 2015, taxable profit is directly linked to financial profit before tax, determined either under P(s)BO or under IFRS. P(s)BO are not supposed to contradict IFRS.

However, the current version of P(s)BO No. 33 Mineral Exploration Costs is not in line with IFRS 6 “Exploration and evaluation of mineral assets”, and does not reflect all the aspects of hydrocarbons exploration.

For example:
- P(s)BO 33 limits the exploration stage to the period when pilot commercial development starts, while under IFRS 6 the stage could partly include pilot commercial development. There is no guidance on financial accounting of exploration expenses during pilot production stage in P(s)BO.
- P(s)BO 33 requires capitalizing all expenses incurred during exploration stage, while IFRS 6 allows to recognize relevant costs as expenses during its actual defrayment, subject to the company’s accounting policy.
Financial issues in Upstream, Midstream, Downstream

23. Abolish VAT obligations on unsuccessful wells

**Background:**

The Tax Code still does not regulate VAT issues relating to unsuccessful wells.

In particular, the current version of the Tax Code (Art. 189.9) provides for VAT assessment where fixed assets are written off by an independent decision of the taxpayer. The taxable base should be the regular price but not lower than the book value as at the write-off.

Given that, under the current version of the Tax Code, a well is not an individual accounting entity like it was until 1 January 2015 but rather is accounted for as a tangible asset being part of the fixed assets. Therefore there is a high risk that the write-off of unsuccessful wells will be treated by fiscal authorities like the write-off of fixed assets by independent decision whereafter VAT will be assessed on the residual value of such wells as at the write-off.

It is necessary to ensure proper performance of VAT obligations, VAT being essentially an indirect tax assessed on each stage from production to marketing, from the raw material to the end product based on the value added to each stage and paid by the end consumer.

**Position:**

Amend the Ukrainian Tax Code: the Tax Code should regulate issues relating to the write-off of well construction costs where wells turn out to be unsuccessful so that such operations should neither be treated as “write-offs based on an independent decision” nor fall under Article 189.9 of the Tax Code.

**Decision makers:**

- State Fiscal Service of Ukraine
- Cabinet of Ministers of Ukraine
- Parliament

24. Allow tax deductibility of lost assets in ATO zone

**Background:**

Whereas the non-current assets of some companies are located in the ATO area with access to such assets being limited or totally unavailable, companies with such intangible assets on their books must properly indicate the actual status of such assets on their records.

Where companies have totally lost control over such assets, impairment tests should be conducted with relevant costs to be specified in a reporting period. On the other hand, Tax Code provisions do not allow the inclusion of such impairment costs in deductions from the CPT taxable base.

If the Tax Code allows such deductions in the future, the write-off of such assets will in fact be impossible due to such assets not being in accounting records during the relevant period.

Therefore, due to the current circumstances preventing owners from exercising control over assets in the ATO area, taxpayers incur significant losses.

**Position:**

To amend the Ukrainian Tax Code: allow the deduction from the CPT taxable base of the costs arising from the impairment of assets which are located in the ATO area and cannot be controlled; at the same time to adopt of a resolution stating such assets are impaired according to accounting regulations.

**Decision makers:**

- State Fiscal Service of Ukraine
- Cabinet of Ministers of Ukraine
- Parliament
Reforms In Oil&Gas Sector of Ukraine

Chapter 4

Reforms In Oil&Gas Sector of Ukraine

Consolidation of taxes should be allowed between affiliates incorporated in Ukraine. This will significantly improve the investment climate in Ukraine as investors, especially those carrying out long-term investment in such activities as the oil and gas business, would be able to compensate for the costs and revenues incurred by their own Ukrainian companies on a consolidated basis separately for each individual company. As an additional benefit, it would also reduce the cost of compliance with tax legislation.

In 2013 the Ukrainian tax system was expanded with tax control over transfer pricing. According to common international practice, transfer pricing control is accompanied by the introduction of tax consolidation among certain groups of taxpayers. However, applicable Ukrainian legislation does not allow tax consolidation among Ukrainian-incorporated companies.

The arguments in favor of the position are:
- Successful experience of tax consolidation practice in the leading economies: USA, UK, Austria, Australia, France, the Netherlands, Denmark, Spain, Germany, Japan etc.;
- Currently the European Commission is working to implement the Common Consolidated Corporate Tax Base (CCCTB) which will expand the tax consolidation practice from a single country to the global level. The CCCTB administrative framework provides for a "one-stop-shop" approach which would allow groups with a taxable presence in more than one EU country to deal primarily with a single tax authority across the EU;
- Tax consolidation will minimize the opportunities for contractual pricing abuse aimed to reduce tax liabilities by groups of companies, the pricing will be more transparent and market-oriented;
- Exclusion of operations inside the consolidated group of taxpayers from tax control will simplify both profit tax administration and tax control procedures.

Position:
Amend the Ukrainian Tax Code to allow tax consolidation among Ukrainian companies.

Decision makers:
- State Fiscal Service of Ukraine
- Parliament
- Cabinet of Ministers of Ukraine

Background:
Financial issues in Upstream, Midstream, Downstream

25. Allow tax consolidation on a group basis

According to applicable Ukrainian legislation, the definition of engineering covers the provision of services/works with the preparation of technical specifications, proposals, research and feasibility surveys, engineering and exploration work on construction sites, development of technical documentation, engineering and design study of facilities and processes, consultation and designer’s supervision during installation and start-up, as well as consultation related to such services/works, i.e. a significant amount of work during exploration, pilot and commercial production fall under the definition of engineering.

If engineering services are provided by foreign providers including affiliates, a tax on such income at the rate of 15% is charged and paid when the payment for such services is made unless otherwise provided by international treaties between Ukraine and the countries of residence of persons to whom the payments are made. Unfortunately, most of these agreements do not provide for any taxation benefits for engineering services. Thus, the cost of services for Ukrainian customers increases by 15% to cover the cost of the tax.

Unfortunately, the hardware and methodologies available to domestic service providers does not always match modern international expertise, and sometimes such services are unavailable. Thus, subsoil users attract foreign service providers to reduce geological, technical and technological risks.

Engineering services cover a significant scope of work, especially at the exploration stage, when investors incur the highest geological risks by investing high-risk capital.

Many double taxation treaties do not provide for tax benefits for the taxation of the provision of engineering services by non-residents; the necessity to pay an additional 15% for services provided by non-resident providers increases the contract price and requires additional funds from the subsoil user, especially at the exploration stage.

Position:
To amend Tax Code of Ukraine with the changes of definition of engineering, in relation to centralized services: remove expenses associated with the implementation of licensing agreements and pilot and commercial production projects from the list of engineering services subject to taxation on such income at the rate of 15%.

Decision makers:
- Ministry of Finance
- Cabinet of Ministers of Ukraine
- Parliament
### Changes needed in oil and gas sector and responsible authorities

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<td>1. Introduce a Profit Based Taxation system for the Oil and Gas Industry in Ukraine</td>
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<td>2. Develop a new Subsoil Code</td>
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<td>3. Improve fiscal regime in the short term</td>
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<td>4. Improve legislation on Production Sharing Agreements (PSA)</td>
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<td>5. Eliminate administrative barriers for PSA investors</td>
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<td>6. Improve the procedure of issuance and use of special permits</td>
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<td>7. Eliminate certain approvals of the Ministry of Energy and Coal Industry</td>
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<td>8. Develop a state program of transfer to new gas quality standards</td>
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<td>9. Reform land legislation for the needs of oil and gas sector</td>
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<td>10. Create conditions for compliance with the Extractive Industries Transparency Initiative (EITI)</td>
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<td>11. Introduce a reasonable financial guarantee requirement, prepayment for transportation capacities</td>
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<td>12. Free choice of supplier</td>
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<td>13. Provide reasonable recalculation of Transportation tariffs on entry-exit points to the GTS</td>
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<td>14. Allow equal nomination and allocation of gas in cross-border trade</td>
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<td>15. Improve payment mechanism for sales of gas, close-out and volume-netting, unified gas contract</td>
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<td>16. Develop legislation on trading platforms</td>
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<td>17. Improve the regulatory regime for temporary storage of natural gas and cross-border transactions of Ukraine</td>
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<td>18. Recommendations to improve antimonopoly control in Ukrainian fuel retail market</td>
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<td>19. Eliminate illegal LPG units and illegal fuels sites in Ukraine</td>
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<td>20. Eliminate administrative burden and bureaucracy for retail fuel sites</td>
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<td>21. Liberalize foreign currency exchange rules</td>
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<td>22. Eliminate income tax uncertainty arising from accounting standard deficiencies</td>
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<td>23. Abolish VAT obligations on unsuccessful wells</td>
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<td>24. Allow tax deductibility of lost assets in ATO zone</td>
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<td>25. Allow tax consolidation on a group basis</td>
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<td>26. Ensure clear definition of the tax categorization of engineering services which will not cover exploration and development expenses</td>
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