

## COUNTRY REPORT: UKRAINE

### **Economic and Legal Instruments for Reducing the Negative Environmental Impacts of Shale Gas Development in the Ukraine**

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For environmental law, 2013 was a year of theoretical and practical debate in Ukraine. Discussion focused on shale gas development and the distribution and use of mineral resources rights. The Ukrainian government signed two Production Sharing Agreements for shale gas projects. These Agreements exempt investors from state taxes and fail to provide local governments with sufficient resources to mitigate probable environmental issues and consequences.

On the one hand, shale gas development has the potential to attract investors and help Ukraine secure gas independence from Russia. On the other, there are a number of potential weaknesses in the current arrangements. This report addresses some of these beginning with the allocation of revenues raised from fracking activities versus the allocation of responsibility for environmental protection.

The legal basis for Ukrainian local government includes the *Constitution*, the *Budget Code* and *Law on Local Self-Government*. These laws task local governments with, among other things, responsibility for the local environment and regional development. Local governments are given a budget to help them fulfill these responsibilities and act with economic independence. The local budget allows the local self-government body to develop infrastructure and expand the economic potential of the region. Ultimately, the local budget allows the local government to fulfill its legal duties and in doing so, maintain the trust of the local people.

The *Tax Code* article 335.2 requires investors who are party to a production sharing agreement to pay value added tax, income tax and fees for the use of subsoil in mineral resource production.<sup>1</sup> The *Budget Code* requires all value added and income taxes to be

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transferred to the state budget. Up to 50 percent of subsoil fees can be transferred to the local budget. The state budget also receives:

- 50 percent of duties for the special use of water (except duties for the use of water bodies of local importance)
- 50 percent of fees for the use of subsoil in mineral resource production (but 100 percent of fees for the use of subsoil off the continental shelf or in the exclusive maritime economic zone)
- 100 percent of permit fees to use mineral resources, and 100 percent of funds from the sale of such permits

A *Law for the State Budget* is adopted each year.<sup>2</sup> This law specifies how taxes and duties will be distributed between state and local budgets in the following year. For example, the state budget law for 2011-2012 specified that 20 percent of all environment contamination taxes are to go to the Oblast councils and 50 percent to the city and village councils. These percentages are to be significantly reduced in later years. In 2013 Oblast councils are to receive 13.5 percent and city, settlement and village councils 33.5 percent. From 2014, Oblast, city, settlement and village councils must share 35 percent of contamination taxes (article 69 of the *Budget Code*). Percentages are not determined by need or by where contamination has occurred. Set percentages are dispersed equally between all local governments. This means that some local governments may not have the necessary funds to pay for social, economic, environmental and infrastructure issues arising as a result of shale gas development.

There are two ways to improve this situation. The first is to adopt a National Program of shale gas development in Western Ukraine. If adopted, it would make this issue high priority, and provide an avenue for state budget funding to be channeled to Local Councils. The second way is through the "targeted and voluntary contributions of enterprises, institutions, organizations and citizens in the local environmental funds". These contributions are envisaged by article 69 of the *Budget Code*. Investments in local communities could minimize the possibility of social protests. Contributions should be made directly into the local budget to ensure that local communities get the funds. If the money is paid to the state budget, there is high probability it will be used for other purposes. Contributors should also require a publicly-released accounting of how the money was spent.

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<sup>1</sup> Tax Code of Ukraine // Official Bulletin of Ukraine. - 10.12.2010. - № 92, Vol.1, p. 9, art. 3248

<sup>2</sup> Budget Code of Ukraine // Information of Verkhovna Rada of Ukraine. - 24.12.2010. - № 50, p. 1778, art. 572; The Law for the State Budget // Voice of Ukraine : Official publication. – 1012. – Vol.193.

As a conclusion, excessive centralization of budgetary resources, inadequate methods of distribution, insufficient local budgets and low efficiency in intergovernmental transfers substantially inhibit the ability of local governments to provide quality services and improve social and economic outcomes for the Ukrainian people. The main problems faced by local authorities in discharging their functions include:

- inadequate local government funding due to excessive centralization of revenue
- depletion of local funds due to the heavy financial costs of providing social services
- a lack of flexibility in how funds may be spent due to a complex and confusing reporting system

To address these problems, local budgets should be allowed to be more independent and self-financing. Increasing the local government share of fixed income will encourage local authorities to find sources to replenish the tax-base and in doing so, increase their own resources. It is necessary to strengthen the role of local taxes and fees in the formation of local budgets. This will require the development and implementation of regional tax policy. The policy must be based on a clear division of state, territory and local legislative powers, responsibilities and finances. In the process of extraction and use of natural resources, the affected local council should be able to ensure the environmental, social and financial interests of the local community.

Similarly, while Article 69 of the *Budget Code* provides for the division of fines for damage caused by violations of Environmental Protection law, the divisions do not match the harm caused. Instead 50 percent goes to local, settlement and city budgets, 20 percent goes to the Oblast budgets, and the remaining 30 per cent goes to the State budget. However, these amounts go to all local governments regardless of whether the violation occurred within their jurisdiction. Moreover, the fines are arbitrary and do not correspond to what is actually needed to mitigate the effects of shale gas development. A more rational approach would be to highlight some areas that need protection (for example, the territories with shale gas development) and then direct most of the money to those local budgets for the period of that activity. The legal basis for that reform could be grounded in the adoption of a National Program of shale gas development by the Cabinet of Ministers. This would mean that the territories affected by shale gas development are being observed by the state, and the state could offer financial help where necessary (for example, subsidies).

A second potential weakness relates to the obligations on producers to meet certain conditions contained in the *Law on Production Sharing Agreements*.<sup>3</sup> For example, the agreement must require the investor to return the subsoil areas, and any lands granted for purposes related to the use of subsoil, after the termination or completion of certain phases of work. The agreement must also require investors to work towards efficient and integrated use and protection of mineral resources and the environment. In accordance with Part 5 of Article 8, agreements must stipulate the duties of investors in prioritizing the national interest. For example, agreements must require investors to:

- show a preference for products, goods, works, services and other material of Ukrainian origin
- utilize a hiring preference for Ukraine citizens
- provide adequate training for all levels of management

These provisions can deliver protections and benefits for local populations. However, an issue arises when the Cabinet of Ministers is party to an agreement and all the basic functions of coordination and enforcement are assigned to central authorities. In these instances opportunities for local government participation in these agreements are minimal and so too then may be the opportunity to benefit from these provisions. This goes against the Ukrainian history of making so-called "social contracts" or "agreements on social partnership". Such agreements may be concluded between public or local authorities on the one hand, and legal entities or individual entrepreneurs on the other. Legal entities may undertake, for example, to ensure that local residents have priority in hiring or that sufficient funds are allocated for local social and economic development (for example for the construction of public roads or development of social infrastructure). Local government administrations should make more use of these agreements rather than leaving it to authorities from the central government, particularly as they, the local government authorities are in a better position to understand the needs of the area and local population than central government authorities.

A third potential weakness lies in addressing the significant adverse ecological effects associated with shale gas activities. Here the proper settlement of investor environmental obligations is important. In production sharing agreements, specific environmental commitments and clear sanctions for their failure ought to be prescribed. There is potential for this under the *Law on Oil and Gas* which states that an investor should conclude an

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<sup>3</sup> Law on Production Sharing Agreement // Official Bulletin of Ukraine/ - 22.10.1999. – Vol. 40. p. 2.

agreement about use conditions with the State Service of Geology and Mineral Resources.<sup>4</sup> This agreement becomes an inalienable part of the special permit for mineral resource use. The agreement should include all technical, technological, organizational, financial, economic, social and environmental obligations.<sup>5</sup> These agreements allow the state to specify the environmental commitments of the subject-subsoil users. However, a detailed analysis of some existing use condition agreements leads to the conclusion that they only include the general investor responsibilities already required in the *Code of Ukraine on Mineral Resources*. Use of condition agreements would benefit from the involvement of local government authorities. Local involvement in structuring these agreements would provide more detailed investor obligations to local communities, and mechanisms for implementation and oversight of environmental and social programs.

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<sup>4</sup> Article 10 of Resolution of the Cabinet of Ministers "Procedure for special permits for mineral resources use" 05/30/2011.

<sup>5</sup> The definition of the agreement about the use conditions is in Articles 1, 28 of the Law on Oil and Gas.