

## 5 ENERGY

# THE PECULIARITIES OF LEGAL REGULATION OF PRODUCTION SHARING AGREEMENTS

One of the few areas in Ukrainian economic life that's seen remarkable developments in terms of foreign investor activity is subsoil use, in particular production of hydrocarbons in Ukraine and on its sea shelf.

The year 2013 saw the signing of valuable agreements in this field. In January, in Davos, the State of Ukraine, Shell Exploration and Production Ukraine Investments (IV) BV, and Nadra Yuzivska LLC (governed by Nadra Ukrayny NJSC) signed a production sharing agreement (PSA) for recovery of hydrocarbons in the Yuzivska field (located in the Donetsk and Kharkiv regions). Later, in September, the joint operating agreement that compliments the PSA was signed during an official visit of Prime Minister of Ukraine Mykola Azarov to the Netherlands. And finally, on November 5, 2013, Ukraine and Chevron Ukraine B.V. signed a second PSA.

In general, Ukrainian legislation and established practice make possible three ways in which a foreign investor can conduct geological survey and mining operation activities in Ukraine.

In the first way, a foreign investor establishes an affiliate company in Ukraine. It obtains via tender a special permit for subsoil use and then performs the necessary work, either on its own or in concert with contractors.

In the second way, a foreign investor establishes a joint venture with a state-owned company. That company might already hold all the necessary permits for subsoil use. Even if it doesn't, joint ventures can enjoy a simplified permitting procedure, which is one of the advantages of public private partnerships.

In the third way, the investor concludes a production sharing agreement with the Ukrainian government. This form of public private partnership provides the most protection for

the foreign investor. In addition, production sharing agreements benefit from a number of exceptions in the tax and customs laws, as well as in other areas.

Production sharing agreements are thus potentially very attractive for foreign investors, especially when significant amounts of money are being invested.

The Ukrainian government's participation in negotiations with potential investors in 2012–2013, including globally known oil and gas companies, apparently stimulated it to improve its subsoil use laws. Ukrainian law provides favorable conditions for import of goods that will be used in PSAs. For example, the government provides investors with approvals; quotas; special subsoil use permits; licenses for prospecting (exploration) and exploitation of mineral deposits; documents certifying the right to use land; and other permits and licenses related to subsoil use, performance of works, and construction of the structures stipulated by the PSA. (Part 3 of Article 4 of the Law of Ukraine "On Production Sharing Agreements" is the relevant document in this respect.)

We'll thus analyze here basic features of Ukraine's legal regulation of production sharing agreements.

## Legislation that regulates production sharing agreements

The main legislative act that regulates the conclusion and execution of PSAs is, naturally enough, the Law of Ukraine "On Production Sharing Agreements" ("the Law").

The Code of Ukraine "On Mineral Resources," the Law of Ukraine "On Pipeline Transport," and certain other docu-

ments also touch on PSAs. Part of the Tax Code of Ukraine is devoted to regulating taxation in the context of a PSA.

Article 2 of the Law mandates that PSAs conform to it. It determines the basic legal requirements for PSAs and for legal relations that attend production sharing in the context of subsoil use. The rights and obligations of parties to PSAs are determined in accordance with the civil legislation

of Ukraine, taking into account the peculiarities of the Law “On Production Sharing Agreements.” Other Ukrainian legislation on PSAs shall, according to the Constitution of Ukraine, apply in compliance with the Law, which takes precedence over other legislative acts in this field.

## Concept and subject of the agreement

According to Article 4 of the Law, one party, Ukraine, assigns the other party, the investor, to prospect for, explore, and extract mineral resources in the designated subsoil area(s) and to perform work related to the agreement for a specified period of time. The investor, meanwhile, undertakes to perform the assigned works at its own cost and risk. The investor is compensated for its costs and is remunerated by a portion of the profit from production.

By “profitable products” the law means a portion of the production, shared between the investor and the state. It is defined as the difference between production that’s delivered to the measurement point and the portion of production that’s transferred to the investors towards recovering expenses and,

in certain cases, taking into account its indexation (cost-recovery production).

According to the Law, PSAs can be concluded for specific subsoil area(s) within which mineral deposits of national and local significance are located, including subsoil areas within the continental shelf and the exclusive (maritime) economic zone of Ukraine.

The Law makes possible changing the geographic coordinates of subsoil areas (mineral deposits) for which a PSA was concluded if the investor so wants.

## Parties to the agreement

According to the Part 2 of Article 4 of the Law, a PSA can include several investors, provided that they incur joint liability for the agreement’s obligations.

The parties to a PSA are the investor or investors and the state as represented by the Cabinet of Ministers of Ukraine (Article 5 of the Law).

Investors can be citizens of Ukraine, foreigners, stateless persons, legal entities of Ukraine or another state, associations of legal entities created in or outside Ukraine, or persons acting alone or jointly, if they have the appropriate financial, economic, and technical potential or relevant qualifications to use subsoil and have been identified as tender winners.

PSA relations between the state and the foreign investors are administered through the latter’s representative office in Ukraine.

If two or more investors participate in a PSA, one is designated the agreement operator and represents their interests in relations with the state.

In some cases, a tender may require that the PSA be concluded between the tender’s winner and a company indi-

cated in the tender. The state owns 100 percent of the charter capital in that company, or that company establishes another company the participation interest of which is determined in the PSA (Article 7 of the Law).

According to the Law, the investor has the right to assign all or a part of its rights and obligations to any legal entity or physical person on condition that the entity or person has sufficient financial and technical resources and experience to perform the works the agreement stipulates (Article 26). The state shall not refuse consent to this without a substantial reason.

Assignment of rights and obligations of this sort shall be formalized by a written contract. If a Ukrainian investor assigns its rights and obligations to a foreigner or a foreign legal entity, the PSA can be amended upon the foreign investor’s request.

## Basic requirements for an agreement

Article 6 of the Law stipulates that a PSA shall be concluded with the winner of the tender, taking into account the tender’s terms and the winner’s bid.

Article 8 establishes mandatory requirements for the PSA.

In particular, the PSA must include: a list of the investor's activities; a mandatory work program with specified deadlines; amounts and types of financing, technological equipment, and other items (these amounts cannot be lower than those that the investor proposed in a competitive bid); and other essential terms.

Among other essential PSA terms are:

- a description of the subsoil area (mineral deposits) for which the agreement is being concluded, including geographic coordinates and depth restrictions;
- the conditions governing provision of the land plot for needs associated with subsoil use, and of the subsoil area;
- type(s) of subsoil use;
- list, scope, and deadlines for performance of the work stipulated by the agreement;
- procedure by which the parties can negotiate annual budgets and works programs;
- conditions governing mineral resource use;
- the procedure for determining the value of extracted mineral resources, including the currency in which the value will be expressed in the agreement with the foreign investor;
- the procedure for making payments for subsoil use;
- the point of measurement;
- conditions for calculating the amounts of cost-recovery products;
- composition of costs to be recovered with cost-recovery products;
- the procedure and conditions by which the state and the investor will share profit;
- the procedure for conserving or liquidating mining facilities;

- the term of the agreement, the date and place of signing, and the procedure governing its entry into force;
- the liability of the parties to the agreement and their means of securing it;
- the procedure for settling disputes.

In accordance with Part 5 of Article 8 of the Law, a PSA shall list the investor's obligations. These include favoring products, works, and services of Ukrainian origin and employing mainly Ukrainian citizens on Ukrainian territory to achieve the goals that the agreement stipulates.

This list, however, isn't complete. The Law of Ukraine "On Production Sharing Agreements" is a complicated one, and investors should understand its terms in their entirety when they draft PSAs. Failing to account for a part of the law could mean invalidation of the PSA.

The PSA shall contain the enclosures that the parties to the agreement make reference to in the text of the agreement.

The draft of the PSA shall be prepared in Ukrainian (Part 2, Article 10 of the Law).

A PSA, then, is a complex document, and drafting one requires a wide range of specialists and close attention to the peculiarities of Ukrainian law. Since it's the investor that drafts the PSA, moreover, it's the investor who will have to do the majority of the work.