

The Peculiarities of Legal Regulation of Production Sharing Agreements



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One of the few industries in Ukraine where remarkable changes in the activity of foreign investors were observed in 2012 is subsoil use, particularly in the production of hydrocarbons in Ukraine and the sea shelf.

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

The first way is when a foreign investor establishes an affiliate company in Ukraine that takes part in a tender that provides special permit for subsoil use, and then receives this special permit and perform, independently or together with the contractors all the necessary works.

Also, a foreign investor may establish a joint venture with a certain state-owned company. Depending on the circumstances of the establishment of a joint venture such company may already have the necessary special permits for subsoil use from the very beginning, as well as such permits may be obtained later. In any case, current Ukrainian legislation makes it possible to simplify the procedure to obtain special permits for such joint ventures, which is an absolute advantage of such public-private partnership.

The third way is when the investor concludes a production sharing agreement with the

Ukrainian state. From the legal point of view, precisely this form of public-private partnerships provides the foreign investor with the maximum protection of investments. In addition, Ukrainian legislation provides a number of exceptions in legislative provisions that regulate tax, customs and other relationship for production sharing agreements.

Thus, concluding production sharing agreement is potentially very attractive for foreign investors, especially in case of significant investment sums.

Conducting tenders on concluding production sharing agreements for products that will be produced in Ukraine by the Ukrainian Government in 2012, and negotiations with potential



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investors, including worldwide known oil and gas companies, apparently provoked our government to adopt a number of legislative acts that amended the basic documents governing the subsoil sphere as well as more favorable conditions for investors' activity in taxation were confirmed, import of goods that will be used for the purposes of production sharing agreements, etc. For example, the State provides investors (including agreement operators), and representatives of foreign investors and facilitates the provision of their contractors, subcontractors and other organizations, as well as representative offices of foreign contractors, subcontractors and other organizations with approvals, quotas, special permits for subsoil use and licenses to carry out the activities

of prospecting (exploration) and operation of mineral deposits, documents certifying the right to use land and other permits and licenses related to the use of subsoil, performance of the works, construction of the structures according to the production sharing agreement (Part 3 of the Article 4 of the *On Production Sharing Agreements Act of Ukraine*).

Therefore, we suggest that you analyze the basic features of legal regulation of production sharing agreements in Ukraine.

The legislation that regulates the production sharing agreement

The main legislative act that regulates the conclusion and the execution of production sharing agreements is the *On Production Sharing Agreements Act of Ukraine*.

Some provisions related to production sharing agreements can also be found in the *On Mineral Resource Code of Ukraine*, in the *On Pipeline Transport Act of Ukraine* and in some others. A separate part of the *Tax Code of Ukraine* is devoted to regulating special features of taxation of taxpayers under the conditions of effect of a production sharing agreement.

It should be noted that the correspondence of production sharing agreements to Ukrainian law is a mandatory requirement of the *On Production Sharing Agreements Act of Ukraine*. In particular, Article 2 of the stated Act provides that this Act regulates relations arising in the process of concluding, executing and terminating production sharing agreements, determines the basic legal requirements for such agreements and legal relations on subsoil use in conditions of production sharing. The rights and obligations of the parties to production sharing agreements are determined in accordance with the civil law of Ukraine, taking into account the

features provided by the *On Production Sharing Agreements Act of Ukraine*. At the same time, other legislation of Ukraine on production sharing agreements shall, according to the *Constitution of Ukraine*, be applied in compliance with peculiarities stipulated by the *On Production Sharing Agreements Act of Ukraine*. If the legislative acts of Ukraine establish other regulations than those provided by the *On Production Sharing Agreements Act of Ukraine*, the regulations of this Act are applied.

Concept and subject of the agreement

According to Article 4 of the *On Production Sharing Agreements Act* 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 the works related to the agreement for a specified period of time, whereas the investor undertakes to perform the assigned works at its own cost and risk, with further compensation of the costs and receipt of payment (remuneration) in the form of a portion of the profit produced.

Thus, under the "profitable products" law means the portion of the produced production that is shared between the investor and the State, and is defined as the difference between produced production under a production sharing agreement and delivered to the measurement point (produced products) and a portion of the produced production that is transferred to the ownership of investors to recover expenses and, in cases stipulated by the Act, taking into account its indexation (cost-recovery production).

It should be noted that under the provisions of Article 19 of the *On Production Sharing Agreements Act of Ukraine* only investors expenses can be recovered by cost-recovery production that are connected with performance

UKRAINIAN LEGISLATION PROVIDES a number of EXCEPTIONS in LEGISLATIVE PROVISIONS that REGULATE TAX, CUSTOMS and other RELATIONSHIP for PRODUCTION SHARING AGREEMENTS



The On PRODUCTION SHARING AGREEMENTS ACT provides CHANGES to the GEOGRAPHIC COORDINATES of SUBSOIL AREAS (mineral deposits), RELATED to WHICH the PSA was CONCLUDED, that PERFORM at the REQUEST of the INVESTOR(S)

of works related to the agreement, other activities related to the agreement and performing other obligations by the investor related to the agreement occurred after official publication of the tender results on concluding production sharing agreement unless otherwise provided by the agreement. According to the *On Production Sharing Agreements Act of Ukraine* production sharing agreements may be concluded with respect to specific subsoil area(s) limited in space and coordinates, within which mineral deposits or parts thereof of national and local significance are located, including the subsoil areas within the continental shelf and the exclusive (maritime) economic zone of Ukraine.

It should be noted that the *On Production Sharing Agreements Act* provides changes to the geographic coordinates of subsoil areas (mineral deposits), related to which the production sharing agreement was concluded, that perform at the request of the investor(s), as stipulated by the production sharing agreement.

Parties to the agreement

According to Part 2 of Article 4 of the *On Production Sharing Agreements Act*, production sharing agreement may be bilateral or multilateral, i.e. several investors may be parties thereto, provided that they incur joint liability for the obligations stipulated by such agreement.

The parties to the production sharing agreement are the investor(s) and the State represented by the Cabinet of Ministers of Ukraine (Article 5 of the *On Production Sharing Agreements*).

Investors may be citizens of Ukraine, foreigners, stateless persons, legal entities of Ukraine or another state, association of legal entities created in or outside Ukraine, persons acting alone or jointly those who have the appropriate financial, economic and

technical potential or relevant qualifications to be able to use subsoil and identified as a tender winner(s).

The relations between the State and foreign investors regarding the production sharing agreement are implemented through its representative office in Ukraine.

If two or more investors participate in a production sharing agreement, they shall designate among themselves one investor — agreement operator to represent their interests in relations with the State.

The agreement operator or foreign investor's representative office in Ukraine shall have all powers established for the investor by the production sharing agreement.

In some cases, the tender terms may provide the requirements related to the production sharing agreement, concluding with the winner of the tender and a business company identified in accordance with the tender terms according to which the State owns 100% of the charter capital, or a business company created with its participation, stating the company's interest in the production sharing agreement (Article 7 of the *On Production Sharing Agreements Act*).

According to the *On Production Sharing Agreements Act*, the investor shall have the right to assign all or part of its rights and obligations stipulated in the production sharing agreement to any legal entity or physical person on condition that such entity or person has sufficient financial and technical resources as well as experience to organize operations necessary to perform works stipulated in the agreement (Article 26 of the *On Production Sharing Agreements Act*). The State shall not refuse such consent without substantial reason.

Such assignment of the rights and obligations under the agreement shall be formalized by a written contract with the

entity or person assuming such rights and obligations under the production sharing agreement. If a Ukrainian investor assigned its rights and obligations to a foreigner or a foreign legal entity in compliance with the procedure stipulated by this Article, the terms of the production sharing agreement can be amended upon the foreign investor's request, taking into account the peculiarities of foreign investments stipulated by the *On Production Sharing Agreement Act of Ukraine*.

Basic requirements for the agreement

Article 6 of the *On Production Sharing Agreements Act* stipulates that the production sharing agreement shall be concluded with the winner of the tender taking into account tender terms and the winner's bid.

Article 8 of the *On Production Sharing Agreements Act* establishes mandatory requirements that should be met by the production sharing agreement.

In particular, the production sharing agreement stipulates: a list of investor's activities and mandatory work program with specified deadlines, amounts and types of financing, technological equipment and other indicators that cannot be lower than proposed by the investor in a competitive bid and other essential terms.

Among other essential terms of production sharing agreements are:

- a description of the subsoil area (mineral deposits) with respect to which the agreement is concluded, including geographic coordinates of the operation area, and depth restrictions;

- the conditions for providing a land plot for the needs associated with subsoil use, and a subsoil area;

- type(s) of subsoil use;
- list, scope and deadlines for performance of the work stipulated by the agreement;

— procedure for the parties to negotiate annual budgets and programs of the works;

— conditions for using mineral resources;

— the procedure for determining the value of extracted mineral resources, including the currency in which such 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 for sharing the profit products between the State and the investor;

— the procedure for conserving or liquidating mining facilities;

— the term of the agreement, date and place of signing and the procedure for its coming into force;

— the liability of the parties to the agreement and their means to secure it;

— the procedure of dispute settlement.

It should be noted that in accordance with Part 5 of Article 8 of the *On Production Sharing Agreements Act of Ukraine* a production sharing agreement shall include the obligations of the investor. That is, to provide preferences to the products, works and services of Ukrainian origin and to employ (hire) mainly Ukrainian citizens in the territory of Ukraine for the needs stated in the agreement.

The stated list is not complete. The *On Production Sharing Agreements Act of Ukraine* stipulates a large number of terms that are essential in its understanding.

These terms should be taken into account by investors while drafting the production sharing agreement because their formal absence may cause the agreement to be considered invalid.

The production sharing agreement shall contain the enclosures that parties of the agreement refer to in the text of the agreement.

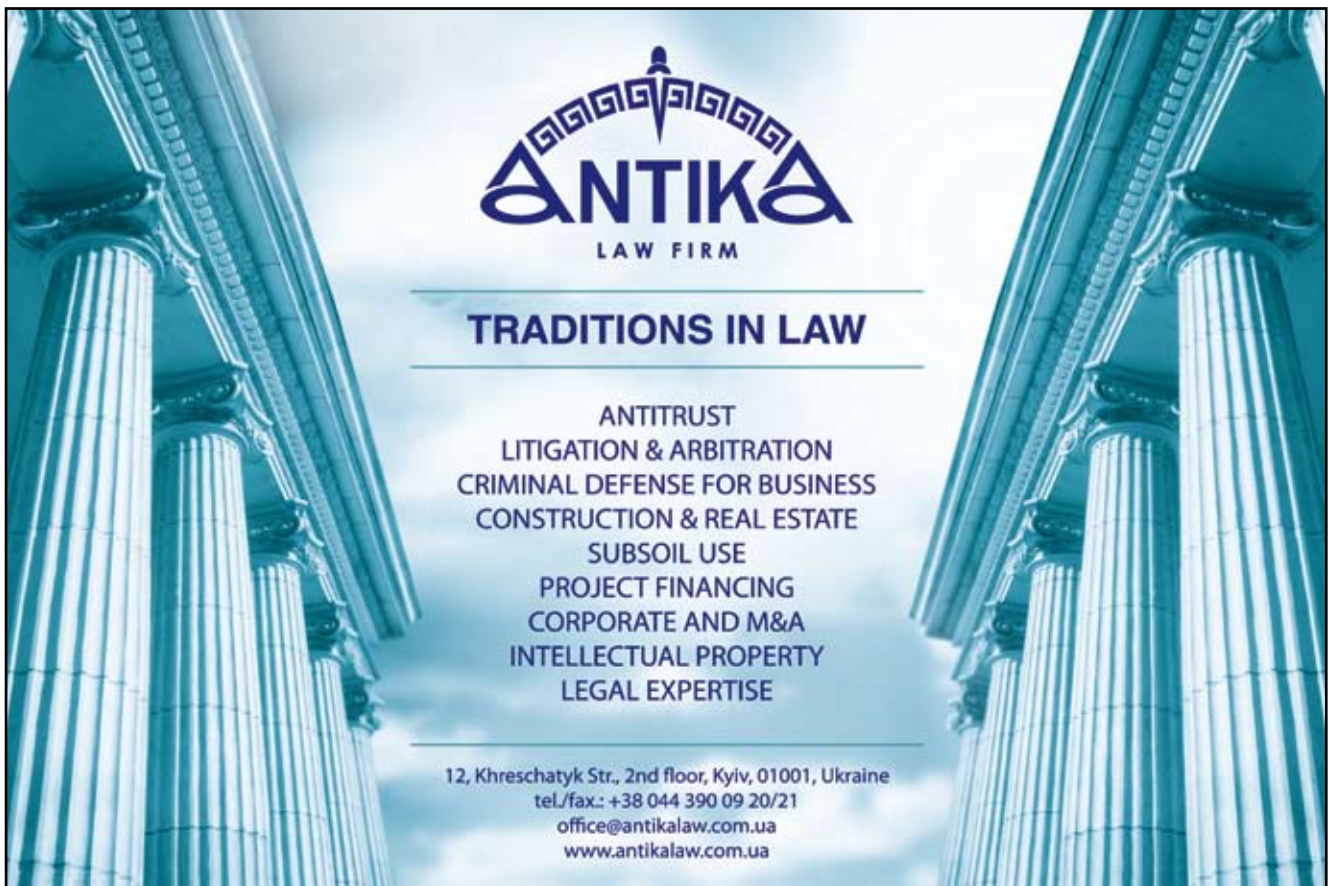
The Draft of Production Sharing Agreement shall be prepared in Ukrainian (Part 2, Article 10 of the *On Production Sharing Agreements Act*).

Thus, the production sharing agreement is a complicated document in terms of its content, the drafting of which requires the engagement of a wide range of specialists and attention to the peculiarities of legal regulation under Ukrainian law. Taking into account the fact that the investor drafts the production sharing agreement it is he who will have to do most of the work.

Taking into account the fact that the INVESTOR DRAFTS the PRODUCTION SHARING AGREEMENT it is HE who will have to DO MOST of the WORK

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