

Production sharing agreements vital to energy sector



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What is so special about the production sharing agreement law recently enacted into law? The answer is simple: These agreements provide the most modern, stable and attractive legal and fiscal instrument available to investors in the natural resources sector of Ukraine.

Considering Ukraine's quest for energy independence and diversification, which after 20 years finally seems to be evolving from declarations into real actions, this legal instrument is vital for attracting direct foreign investment.

Specifically, the agreements will ensure the inflow of investment into exploration and production of unconventional resources, including shale gas, as well as development in the Black Sea.

The natural resources sector will not develop without major outside investment, which also brings the newest technology, know-how, international best practices and environmental standards, as well as much-needed competition.

In many other countries, investment

in the energy sector has proved to be an engine pushing the entire economy forward. The government of Ukraine understands that, too, but for more than 20 years failed to organize itself and exercise the political will needed.

On the contrary, those courageous few investors who took the risk and invested in the energy sector went through major pain and suffering at the hands of the government of Ukraine and Ukrainian courts. Their rights were threatened, subsoil licenses challenged, contracts cancelled.

As a result, most of the investment community voted with their feet (one U.S. major came and left Ukraine twice in 20 years), giving a collective and decisive "No!" Ukraine paid a high price for this. With no major foreign direct investment coming, the nation ended up with nothing but an underdeveloped and undercapitalized industry, lost opportunities and fundamental energy dependence.

We often hear that the success of the shale gas revolution in the U.S. and Canada was based on three things: technology, capital and a favorable legal/regulatory/fiscal framework. But for Ukraine there is one more crucial factor: the political will of the government. If this factor is now present, the technology and capital will arrive from investors.

The previous traditional legal instruments in the natural resources sector – licensings regimes (subsoil licenses,

joint activity agreements, joint ventures) did not do the trick. Those conditions subjected investors to an archaic, legalistic and conflicting legal system, and equally unacceptable implementation by an inefficient, bureaucratic, non-transparent, irrational and selective government. Investors mostly boycotted the licensing regime, refusing to be left to the mercy of the government and Ukrainian courts.

The only viable option was to carve out from the existing legal system a stable, civilized and legally solid space. Ukraine created such an alternative legal and fiscal instrument – a production sharing agreement, adopted in the 1990s, but it needed updating. The final push for these changes came just recently, with the newly adopted comprehensive amendments to the production sharing agreement law and other legislation. Production sharing agreements are now available either through PSA tenders or through conversion of existing subsoil licenses into PSAs (PSA conversion).

This newly amended law is a strong message to investors, with the government basically saying: "We will perform our regulatory functions during PSA tenders or PSA conversion, then we will negotiate a PSA with you as a business partner, and after the PSA is signed, the rules of the game will be clear and stable for you. We will monitor your PSA implementation as a

regulator, but will not interfere unless there is a violation on your part, and if we do, we will only do it respecting due process and invoking the dispute resolution mechanism provided in the PSA itself. Moreover, we also guarantee the stability of your PSA legal framework, and agree with several levels of international legal protection for you, waiving our sovereign immunity in case of a dispute."

Is this too good to be true?

And what does the government want in return?

In addition to classic expectations (development of energy sector, budget revenues, jobs, local content, etc.), the government also is asking investors in some projects, in particular in case of PSA tenders for onshore unconventional, to accept and carry a local partner with a certain government stake in it. To justify this, the government most often cites the example of Turkey, where the national oil & gas company, TPAO/Turkish Petroleum Corporation, has a stake in every project with investors. So far, investors are accepting this balance and are actively participating in PSA tenders and contemplating PSA conversion projects.

With the new law in place, it is crucial that Ukraine does it right, meeting international standards of compliance and transparency. One more factor was highlighted by the ex-governor of Pennsylvania, Edward Rendell, who

presided over a shale gas revolution in his state. He cited the win-win factor for all stakeholders – from land owners, to local communities, investors and the state. Ukraine's government must understand this too and must share the benefits of new projects with all stakeholders.

The recent legislation, in fact, puts Ukraine ahead of neighboring countries with comparable unconventional resources, such as Poland. Of course, Poland has a much better general legal/regulatory framework than Ukraine and is also guided by European Union regulations, but specifically in the energy sector, Ukraine has a definite advantage in having the production sharing agreements.

The energy community often refers to the Black Sea as the "sleeping beauty," which started waking up with the big commercial discovery in offshore Romania. Following this fairytale reference, I would call the energy sector of Ukraine a Cinderella for foreign direct investment. If the government is finally getting serious about offering investors real opportunities and the only acceptable legal framework – the PSA – to back them up, then our Cinderella is indeed on her way to the ball.

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