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Natural Resources

Two Alternative Regimes for the Use of Subsoil in Ukraine

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Ukraine has two alternative regimes for the use of subsoil: (1) the Licensing Regime and (2) the production sharing agreements regime (PSA Regime). Below, we review the key features, advantages and disadvantages of both regimes, as well as their respective current statuses.

Licensing Regime

Ukraine's Licensing Regime is the more traditional and widely applied regime for the use of subsoil. It is regulated mainly by *Ukraine's 1994 Subsoil Code* and a number of special laws applicable to special types of subsoil, most notably the *2001 Oil and Gas Act of Ukraine*. This regime is further spelled out in various regulations. Unfortunately, there are several notable flaws in the legislative basis for this regime, as well as in its practical application. Moreover, in practice, as of 2005, the licensing of subsoil has essentially been frozen until new, more transparent and clear regulations are adopted. Despite these flaws, however, the Licensing Regime exists and has been used successfully by domestic and international companies in Ukraine in the past. At present, it remains under review by the Ukrainian Government with the aim of streamlining the system and improving and updating its legislative basis.

The Licensing Regime is regulatory rather than contractual because, under this regime, an investor applies to the state for a permit (licence) to use subsoil; once issued, such permit becomes the primary document authorizing subsoil use. Ukrainian legislation refers to the documents authorizing the use of subsoil sometimes as "licences", sometimes as "permits" or "special permits". In this article, we use the term "Subsoil Permit" to describe this type of document. Effective from October 2003, the issue of a Subsoil Permit must be accompanied by an agreement between the issuing authority and the subsoil user on the conditions for using subsoil (Licence Agreement), which is considered to be an integral part of the relevant Subsoil Permit. There is no model Licence Agreement and, in practice, the contents of a Licence Agreement vary depending on the particular Subsoil Permit to which it is attached (for example, the *Oil and Gas Act* has a list of key terms and conditions for a Licence Agreement) and other factors. Transfer or reformulation of Subsoil Permits is severely restricted and is usually only allowed in cases of legal succession.

A Subsoil Permit is issued by a state body authorized to issue Subsoil Permits (Licensing Body). Over the years, the Licensing Body has changed several times; the latest change occurred on



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20 April 2005, when the Licensing Body's responsibilities were assigned to the Ministry for Protection of the Natural Environment.

Because projects in the area of subsoil use usually require substantial and long-term investment, the ability of the state to change the rules, including the taxation rules, at any time and at will, has historically worried investors about engaging in projects under the Licensing Regime. And indeed, the major problem with the Licensing Regime, in addition to various problems described below, is its lack of stability, transparency and certainty.

Another problem is that the laws regulating the Licensing Regime are not well integrated. This has resulted in the creation of several separate and uncoordinated procedures for licensing the use of subsoil (multilayer licensing). The main problem is that the various Subsoil Permits are not mutually exclusive; they are simultaneously required by different, overlapping and sometimes contradictory laws.

Moreover, standard licensing procedures have been suspended for 2004 and 2005 by the respective annually adopted *State Budget Acts*. Because all regular licensing procedures were thus suppressed, special licensing (auction) procedures for obtaining Subsoil Permits were established by the Cabinet of Ministers first in May 2004, and then in August 2005. This was an emergency measure based on just a few lines in the *Budget Act*, which has no basis in subsoil legislation, and as such, it can only be regarded as temporary until Ukraine returns to the standard licensing procedures stipulated by subsoil legislation. It should be noted that the *2006 Budget Act* continued the suspension of standard licensing procedures and, therefore, special licensing (auction) procedures were extended for yet another year.

In conclusion, we believe that the regular licensing procedures based on subsoil legislation must be reinstated and that

subsoil legislation, especially the outdated *1994 Subsoil Code*, must be modernized and streamlined.

PSA Regime

The PSA Regime was established in Ukraine with the adoption of the *Production of Sharing Agreements Act of Ukraine in 1999 (PSA Act)* and the subsequent adoption of the *2000 Enabling Act* and a number of regulations. The interagency PSA Commission, which is the "one-stop" agency for initiating, tendering, negotiating and implementing PSAs on behalf of the Ukrainian Government, was set up in and has been functioning since 2000.

In contrast to the regulatory Licensing Regime, the PSA Regime is a more progressive and investor-friendly contractual regime, under which relations between an investor and the state are governed by a contract (a PSA). Although a Subsoil Permit must be also issued, its issue is almost automatic and it is of secondary importance compared with the PSA. The most attractive feature of the PSA Regime is its stability for the duration of the contract, because the state cannot change the terms and conditions of a PSA without the investor's consent. And the investor always has the option of disputing the actions of the state in a civil law court (arbitration).

Despite the PSA Regime's obvious advantages over the Licensing Regime for large and long-term investment projects, the PSA Regime has not yet been applied in practice. Several PSA projects are currently pending. The main reason for the slow development has been the political reluctance of previous Ukrainian governments to allow a more liberal regime in the area of subsoil use. However, considering the strong signals that the new Cabinet is sending about its willingness to open up the subsoil sector to international investors, we hope that the PSA Regime will soon be actively applied in practice.

Review of the Key Objectives Targeted in PSA Regime

- Establishing a strict regulatory framework and, at the same time, leaving the PSA negotiating parties with as much flexibility as possible with regard to the terms and conditions of individual PSAs.
- Establishing the priority of the *PSA Act* over other legislation.
- Limiting the opportunities for Government interference in the implementation of PSAs.
- Making licences and other approvals subordinate to the PSA.
- Providing long-term stability.

Finally, there are a number of standard issues by which the PSA Regime is judged by the international subsoil industry. Here is how Ukraine's PSA Regime addresses some of these issues:

- **List of Subsoil Areas Eligible for PSAs:** the lists of subsoil areas subject to PSAs are approved by the Cabinet of Ministers, rather than by Parliament.
- **Domestic Supply Requirement:** the *PSA Act* stipulates that, unless otherwise provided for in the PSA itself, the investor may freely dispose of his portion of the project's output.
- **Local Content Requirement:** the *PSA Act* stipulates that the PSA should state the investor's obligation to grant preference to products, works and services of Ukrainian origin, but only insofar as they meet "international standards" and are competitive in terms of quality and price.
- **Local Employment and Training:** the *PSA Act* envisions that a PSA should set out an investor's obligation to hire and train Ukrainian nationals, but the precise obligations are left to the parties to negotiate.

- **Assignment of Rights:** the *PSA Act* allows assignment of rights subject to the consent of the state, which cannot be unreasonably withheld.
- **Unrestricted Carry-Forward of Losses:** the *PSA Act* specifically provides that an investor's expenses may be attributed to subsequent tax periods for taxation purposes without any limitation.
- **Limits on Cost Recovery Production:** The amount of cost-recovery production is limited to 70%.
- **Dispute Settlement and Waiver of Sovereign Immunity:** the *PSA Act* allows the parties to determine the method of dispute resolution themselves, thus providing an opportunity for the use of international arbitration.
- **No Need for Local Partners:** the PSA Law does not require an investor to take on a local partner.
- **Unrestricted and Tariff-free Movement of Equipment and Other Items Needed for PSA Implementation:** the *PSA Act* provides for the unrestricted, duty-free and VAT-free (but not excise-free) import and re-export of such equipment and other items, including by subcontractors.
- **Special Tax Regime:** the *PSA Act* establishes a PSA tax scheme, which requires that an investor pay profits tax (which may be paid in kind), VAT (with the exemption of imported goods and property and exported production) and excise taxes, and few lesser mandatory payments, the amount of which can be negotiated in individual PSAs.



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