



U.S.-Ukraine Business Council (USUBC)

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FOR IMMEDIATE RELEASE:

UKRAINE: PRODUCTION SHARING AGREEMENT (PSA) LAW & RECENT AMENDMENTS SO IMPORTANT

PSA is the most modern, stable and attractive legal and fiscal instrument available to investors in the natural resources sector of Ukraine.

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WASHINGTON, D.C. --- What is so special about the Production Sharing Agreements (“PSA”)? Why the PSA Law and the recent Amendments to the PSA Law are so important? The answer is simple: PSA is 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 seem to evolve from declarations into real actions, this legal instrument is vital for attracting direct foreign investment (“FDI”).

Specifically, it will ensure the inflow of FDI into exploration and production of Unconventional Resources (Shale Gas, Tight Gas, Shale Oil, etc.), as well as Black Sea development. The natural resources sector will not develop without FDI, which are bringing not only funding, but also newest technology, know how, international best practices and environmental standards, as well as so much needed competitive environment.

Everybody understands that, other resources rich countries in the region – Kazakhstan, Azerbaijan, Poland, Turkey (but also Georgia, Latvia and Lithuania that do not even have significant resources) made a strategic decision long time ago to attract FDI as a guarantee of their energy independence.

FDI IN ENERGY SECTOR PUSHED ENTIRE ECONOMY FORWARD

In those countries FDI in the energy sector proved to be an engine pushing the entire economy forward, even during economic crisis, and carrying multiplier effect on infrastructure, development of various local service industries, jobs creation, training of local labor force, significant and steady budget revenues both on national and local levels, as well as support of social causes and assistance to local communities.

The Government of Ukraine (“GOU”) understood that too, but for 20 years failed to organize itself and exercise the political will needed for FDI to come and feel comfortable in our country. On the contrary, those courageous few, which took the risk and invested in the energy sector, went through major pain and suffering in the hands of GOU 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 US major came and left Ukraine twice in 20 years), saying collective and decisive “NO”. Ukraine paid a high price for this, with no major FDI coming it ended up with nothing but underdeveloped and undercapitalized industry, lost opportunities and fundamental energy dependence.

We often hear that the success of Shale Gas revolution in the US and Canada was based on three things: technology, capital and favorable legal/regulatory/fiscal framework. But for Ukraine there is one more crucial factor: the political will of GOU. If this factor is now present, the technology and capital will be brought by FDI. And the last factor - favorable legal/regulatory/fiscal framework - surprisingly has been in place for more than 10 years.

TRADITIONAL INSTRUMENTS DO NOT DO THE TRICK

To this end, the traditional legal instruments in the natural resources sector – Licensing Regime (Subsoil Licenses, Joint Activity Agreements, JVs) does not do the trick - it subjects investors to archaic, legalistic and conflicting legal system, and equally unacceptable implementation by GOU: inefficient, bureaucratic, non-transparent, irrational and selective.

Investors mostly boycotted Licensing Regime refusing to be left to the mercy of GOU and Ukrainian courts. The only viable option was to carve out from the existing legal system a stable, civilized and legally solid space, where investors will be comfortable bringing their funding and technology, and confident that their projects will in fact work if they turn out to be commercially viable.

Luckily Ukraine did create such an alternative legal and fiscal instrument – PSA, the solid foundation for which was laid back in the end of 90s when the original PSA legislation was adopted. However, 15 years is a long time in modern global economy, in Ukraine nobody even mentioned Unconventionals (in particular Shale Gas) then, and deep water Black Sea development seemed ages away. PSA legislation needed updating and adjustment to modern realities, and over the years investors have created a “Wish List” of requirements for this exercise.

Bits and pieces from this Wish List were incorporated into PSA legislation over the years, but the final push came just recently, with the newly adopted comprehensive Amendments to the PSA Law and other legislation incorporating most of the Wish List. PSAs are now available either through PSA Tenders or through conversion of existing Subsoil Licenses into PSAs (PSA Conversion).

NEWLY AMENDED PSA REGIME IS A STRONG MESSAGE TO INVESTORS

This newly amended PSA regime is a strong message to investors, with GOU 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 GOU wants in return?

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

In the PSA Conversion projects, where an existing Subsoil License is usually held by a local company (most often a State-owned one), the presence of the local partner is even more assured because this local partner holds the Subsoil License. So far investors are accepting this balance, and are actively participating in PSA Tenders and contemplating PSA Conversion projects.

With the updated PSA legal instrument in place, it is crucial that Ukraine does it right, that the opportunities are indeed offered to investors and implementation is up to international standards of compliance and transparency.

One more factor was pointed out by the ex-Governor of Pennsylvania, Edward Rendell, who presided over Shale Gas revolution in his State: asked at the IHS CERA Conference on Natural Gas and Ukraine's Energy Future back in January what was the secret of the Shale Gas success in the United States, he cited the win-win factor for all stakeholders: every single stakeholder – from land owners, to local communities, to investors, to the State of Pennsylvania – benefits from Shale Gas development. GOU must understand this too and must share the benefits of new projects with all stakeholders.

Availability of the PSA instrument, further enhanced by recent Amendments, in fact puts Ukraine ahead of neighboring countries with comparable Unconventional Resources that do not offer such attractive instruments, for example Poland.

Of course Poland has a much better traditional legal/regulatory framework than Ukraine and is also guided by EU regulations, but PSA is definitely a big advantage for Ukraine in competing for FDI, and may become an example for the neighboring countries to follow.

IS CINDERELLA INDEED ON HER WAY TO THE BALL?

The energy community often refers to Black Sea as the “sleeping beauty”, which started waking up with the big commercial discovery in offshore Romania. Using this fairytale references, I would call the energy sector of Ukraine a Cinderella for FDI, and if the GOU is finally getting serious about offering investors real opportunities and the only acceptable legal framework - PSA - to back them up, then our Cinderella is indeed on her way to the Ball.

FOOTNOTE: RULG- Ukrainian Legal Group’s detailed legal analysis of the new PSA Amendments is available at http://www.rulg.com/publications_resources.asp.

NOTE: RULG-Ukrainian Legal Group is a member of the U.S.-Ukraine Business Council (USBUC), www.usubc.org.

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Power Corrupts & Absolute Power Corrupts Absolutely.

Most governments absolutely have too much power, money and corruption

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