The Need for and Future of Production Sharing Legislation in Ukraine

by Irina Paliashvili, Vadim Dmitriev, and Ethan Burger
Russian - Ukrainian Legal Group, P.A."}

To date, investment in Ukraine’s oil and gas sector has been fairly limited. This situation can only partially be explained by the existence of more attractive energy resources to develop elsewhere in the region (such as in Azerbaijan, Kazakhstan, and Russia). Certain Ukrainian legislators and government officials have recognized that the absence of a stable legal and tax regime has discouraged investment in the country’s energy sector.

In late 1997, the Ukrainian Cabinet of Ministers introduced a draft Law of Ukraine on Production Sharing Agreements (hereinafter the “PSA Law”) to the Supreme Rada (the Ukrainian Parliament). After the Spring 1998 elections, this draft PSA Law was reintroduced with certain amendments. In the view of many observers, whether it will be enacted will serve as an important litmus test as to the seriousness of Ukraine’s willingness to attract foreign investment to develop its energy resources. This article examines Ukraine’s need for the PSA Law and analyzes the provisions of the current draft.

I. Overview of the Ukrainian Economic Situation and its Energy Resources

Almost seven years ago, when Ukraine achieved independence, many observers were optimistic that the Soviet Union’s former “bread basket” would develop into an economically robust country. Blessed with an excellent climate and good soil, significant industrial resources, and an educated population, Ukraine’s potential...
seemed enormous. Unfortunately, Ukraine’s transition from a centrally-planned to a market economy has neither been smooth nor complete.

It remains to be seen whether 1998 will be the first year that the country will have positive GDP growth. Observers generally note several factors that have contributed to Ukraine’s disappointing economic performance, including: the unwillingness of the country’s leadership to reach a consensus on the need to achieve real economic reform and privatization, a constant stream of changing legislation (particularly in the tax area), and the absence of a well-developed rule of law, combined with widespread corruption.

At the present time, Ukraine imports the vast majority (approximately 80%) of its oil and natural gas, the bulk of which comes from Russia. According to the U.S. Energy Information Administration, Ukraine has proven oil reserves of 395 million barrels and natural gas reserves of 39.6 trillion cubic feet. In the last 20 years, Ukrainian oil production has declined by as much as 60%. Ukraine is eager to reduce its foreign dependence on oil and natural gas. To achieve this goal, it will need to increase foreign investment in the Ukrainian energy sector.

While it is unlikely that Ukraine will become a net exporter of energy, Ukrainian authorities hope that significant investment in Ukrainian energy resources will allow the country to increase its domestic oil production from 93,000 to 150,000 bbl/d by developing new reserves and expanding output from existing fields. Similarly, Ukraine hopes to increase its production of natural gas from 639 billion cubic feet to 1.6 trillion cubic feet per day so that a majority of natural gas consumed will be of domestic origin. If these goals are achieved, it will enhance Ukraine’s balance of payments situation and further strengthen its political independence. Some western experts consider such goals to be realistic if sufficient assets are directed at the relevant projects.

In our view, given the country’s current political and economic situation, such hopes will remain mere pipe dreams unless Ukraine adopts new production sharing legislation that will help to create an investment climate to give investors the necessary confidence to make significant long-term investments in the country’s natural resource sectors. In fact, according to U.S. Ambassador to Ukraine Steven Pifer, some investors have identified the absence of such legislation as the single largest impediment to their involvement in Ukraine.

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3 A brief but thorough analysis of Ukraine’s energy situation appears on the U.S. Energy Information Administration’s Web Site at www.eia.doe.gov/emeu/cabs/ukraine.html.
II. The Current Ukrainian Regime for Subsoil Use and the Characteristics and Rationale for Production Sharing Legislation

Before we discuss the potential benefits for Ukraine of adopting a production sharing regime, it is necessary to outline the features of Ukraine’s existing administrative-licensing regime for subsoil use.

(A) The Current Legal Framework for Subsoil Use in Ukraine

Generally, subsoil use in Ukraine operates under a licensing regime pursuant to which an investor purchases from the state the exclusive right to use a subsoil area by obtaining a license from the relevant state body. The state unilaterally (in theory – as negotiations do in fact take place) establishes the conditions under which the investor may undertake its activity in the subsoil area. Such licenses are generally not transferable, and under certain circumstances may be revoked by the state. In practice, the investor under such license becomes the owner of any extracted raw materials, though as noted below, the legal basis for the ownership of such extracted raw materials under Ukrainian legislation is not entirely clear. The investor bears all expenses and risks, makes payments to the state for the use of the subsoil and all other taxes and fees envisioned by applicable law.

Under the Ukrainian Constitution, bodies of state power and of local self-government exercise the right of ownership over subsoil resources in the name of the Ukrainian people. The 1994 Ukrainian Code “On the Subsoil” (hereinafter the “Subsoil Code”) establishes the current legal regime for subsoil use, the rights and duties of subsoil users and other issues related to mining, geology, production, technology, environmental protection and other special rules for subsoil use.

The Subsoil Code identifies various types of subsoil use, including (i) geological research, which can encompass the development of deposits of useful minerals having a national significance, (ii) extraction of useful minerals, (iii) construction and exploitation of subsoil structures for purposes such as storage of oil, gas, and other substances, and (iv) the establishment of geological territories and objects which have special scientific, cultural, recreational or health significance (Article 14).

Under the Subsoil Code, the state may grant the right to use the subsoil on either a permanent or temporary basis. The temporary use of the subsoil may be short-term (up to five years) or long-term (up to 20 years). In either case, the period of use may be extended (Article 15).

The Subsoil Code recognizes three acts that give rise to the right to use the subsoil:
- a special permit (license) for the use of the subsoil issued by the Ukrainian State Committee for Geology and the Use of the Subsoil (which is issued only with the consent of the Ministry for Ecological Security and Environmental Protection);

- an act on the issuance of a mining allocation within which subsoil use may be conducted.

- an act on the issuance of a land parcel in accordance with the rules established in the Ukrainian Land Code.

Under this scheme, the license is of the greatest importance. The right to use the subsoil is based on the existence of a license. The remaining acts are supplemental — they only formalize the right of subsoil use contained in a license.

The specific rules governing the issues of subsoil licenses are contained in the “Procedure for the Granting of Special Permits (Licenses) for the Use of the Subsoil”, approved by Ukrainian Cabinet of Ministers Decree No 709, dated August 31, 1995. Unfortunately, the relevant requirements are not well-defined which can lead to subjective decision-making by state bodies.

The state has the right in a unilateral procedure to adopt a decision on the termination and revocation of a subsoil license. Article 26 of the Subsoil Code lists seven grounds for the termination of the right to use the subsoil. Several of these grounds are sufficiently general so as to allow the authorities a great deal of discretion in adopting a decision to terminate the right of subsoil use.

Certain negative characteristics of the existing system of subsoil use are mitigated to an extent by provisions of Article 26 of the Subsoil Code. In some cases, the subsoil user is given the right to appeal a decision of the state authorities to terminate its right to use the subsoil in a judicial procedure.

The seven grounds identified are: (i) if the necessity for the subsoil use ends; (ii) in the event of the expiration of the period for the subsoil use; (iii) in the event of the termination of activity by the subsoil user to which was transferred the right of use; (iv) if the subsoil use is being conducted with the application of methods and means which negatively affect the condition of the subsoil and cause pollution of the environment or harmful consequences to the population; (v) in the event of the use of the subsoil not for that purpose for which the right to use the subsoil was granted, or the violation of other requirements envisioned by the permit (license) for the use of the subsoil area; (vi) if the user without justification does not begin to use the subsoil within a period of two years; and (vii) in the case of the withdrawal in the procedure established by legislation of the subsoil area granted for use.
One would expect that the Subsoil Code might follow world practice and state explicitly that the owner of a subsoil license would obtain the right of ownership over minerals it extracts. Unfortunately, the Subsoil Code does not directly state this. Instead, Point 2 of Article 24 of the Subsoil Code provides that the subsoil user has the right to dispose of extracted useful minerals. Under Ukrainian law, the right of disposal is just one of the elements of the right of ownership (possession, use and disposal).\(^5\)

The Subsoil Code provides that a subsoil user must pay for the right to use the subsoil in a procedure established by the Ukrainian Cabinet of Ministers. It does not create a special tax regime for the subsoil user which is subject to the array of taxes imposed generally by various Ukrainian laws, including special taxes imposed on enterprises conducting activity in the oil and gas sector (such as rent payments for oil and natural gas extraction and fees for geological exploration).\(^6\) Such taxes are constantly changing in terms of their type, amount and procedure for calculation and payment. This creates a situation which precludes long-range planning.

\(^5\) We note that the Subsoil Code states that in other legislative acts or in the license itself may be envisioned another procedure for the disposal of extracted useful minerals – other acts or licenses may address the ownership issue.

\(^6\) These taxes currently include: (i) Taxes Which are Included in the Sale Price Over the Cost of the Producer such as Value-added tax - at a 20% rate of the taxable base (the cost of goods (works, services); Excise tax – at rates for specific types of goods; Import duties - at rates set out in the Unified Customs Tariff; (ii) Taxes Which are Paid out of Profit, such as the Profit Tax on Enterprises - at a 30% rate of the sum of profit which is determined as the difference between gross income, gross expenditures and the sum of amortization payments; the Payment (Tax) for Land – as a percentage of the monetary value for each hectare of a land parcel (the rates depend on land type and location); the Rent payment for oil and natural gas which are extracted in Ukraine -for 1 ton of oil – US$ 19 and for 1000 cubic meters of gas – US$ 23; the Tax on owners of transportation means - at specific annual rates; (iii) Turnover Taxes, such as payments and fees for construction, reconstruction, repair and maintenance of automobile roads for public use - at the rate of 0.4 -1.2% of turnover volume; Fee to the State Innovation Fund - at the rate of 1% of turnover volume; (iv) Payroll Taxes, such as Fee to the Fund for the Liquidation of the Consequences of the Chernobyl Catastrophe and the Social Protection of the Population - at the rate of 5% of the wage fund (soon to be abolished); the Fee for mandatory social insurance - at the rate of 5.5% of the wage fund; and the Fee for mandatory pension insurance – at the rate of 32% of the wage fund; and (v) Other Taxes and Fees, such as the State Duty – at specific rates for actions for which the state duty is levied; Fees for the use of natural resources (payment for the special use of the subsoil during the extraction of useful minerals, payment for the special use of fresh water resources, payment for the special use of forest resources) – in accordance with norms established by legislation; the Payment for the pollution of the environment – in accordance with norms and limits on releases of polluting substances and the placement of wastes; Fees for geological exploration performed at the expense of the State budget - at specific rates in accordance with the type of useful mineral; Payment for the licensing of separate types of entrepreneurial activity – as a percentage of the minimum non-taxable income of citizens; the Communal tax – as a percentage of the of the minimum non-taxable income of citizens, but no more than 10% for each average paid worker; and Other local taxes and fees.
Furthermore, on the practical side, the process of obtaining the right of subsoil use is complicated due to the existence of a bureaucratic struggle among various state and local bodies involved in overseeing the use of the subsoil which seek to assert their power over proposed uses of the subsoil thus preventing such bodies from acting as effective counterweights to the Ministry of Finance or Tax Service in trying to lessen the tax burden on foreign investors contemplating investment activity to develop Ukraine’s energy resources.

(B) The Characteristics and Rationale for Production Sharing Arrangements

Production sharing was first used as a method for subsoil development in Bolivia in the 1950s. It was subsequently applied successfully with respect to the extraction of oil in Indonesia. It is currently widely applied as an alternative to licensing or concession arrangements and serves as the basis for the development of subsoil resources in over 40 countries including Angola, Vietnam, Libya, Egypt, Malaysia, Peru, Syria, and the Philippines. In 1995, Russia enacted the Federal Law “On Agreements for Production Sharing”, but while there are a number of projects underway pursuant to production sharing agreements, the law is not being widely applied because of the failure to enact certain enabling legislation.

Under a production sharing agreement (“PSA”), the state hires an investor to undertake certain specified work connected with the extraction of useful minerals. At the same time, the state undertakes the obligation to transfer to the investor for use the subsoil area specified in the agreement. In a majority of the world’s countries (including Ukraine), the subsoil belongs to the state. Thus the state has a monopoly over the use of the subsoil and the removal of natural resources from it.

While the state acts under a PSA as a party to a civil law agreement, it retains its state prerogatives. Thus it continues to have two roles: on the one hand it must fulfill its obligations under the PSA, and on the other hand, it preserves its regulatory functions. These roles may converge or come into conflict with one another. Therefore, it is important to delineate in a PSA the conditions that are governed by the terms of the agreement (in which case the parties shall be treated as equal parties) and those areas where the state has the right to exercise its authority on the basis of administrative law.

The state grants the investor exclusive rights during the term of a PSA’s validity, that is, the state may not undertake activity within a given subsoil parcel (unless so provided in the PSA) and must not permit such activity by third persons. The rights obtained by the investor are limited in the PSA to the conduct of certain identified

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7 The PSA Law’s use of the term “investor” rather than “contractor” is motivated in part to ensure that companies acting as contractors under PSAs enjoy special guaranties and other protections found in relevant foreign investment legislation and bilateral investment treaties.
activities, involving specified minerals or other subsoil resources for an established term. The investor does not obtain ownership or leasehold rights over a subsoil area. All raw materials extracted or processed by the investor from a subsoil area remain the property of the state, until the state pays the investor for its work with a portion of the produced production. This is the so-called production sharing.

Production sharing is the central part and the distinguishing characteristic of a PSA. In order to determine the volume of the extracted raw materials and to carry out production sharing, the concept of the “point of measurement” is used – an arbitrary point related to the movement of extracted raw materials specified by the parties in the PSA (the mouth of the shaft, delivery point, etc.). Up to the point of measurement, all the raw materials being extracted are the property of the state. Production sharing is also usually carried out at the same point using the following procedure:

- from the extracted production is separated that part which goes towards the compensation of the investor’s expenditures (cost-recovery production);
- that part of the extracted production which remains (profit production) is divided between the investor and the state in a proportion provided in the PSA.

From the time of production sharing at the point of measurement, the investor has the right of ownership to the cost recovery production and its part of the profit production. The conditions for production sharing between the state and the investor are determined in each specific PSA.

As a result of the production sharing, the state, without investing its own funds into the exploration and extraction of mineral resources and without bearing any commercial risks, receives a substantial part of the extracted production.

A special tax regime is used with respect to the investor undertaking activities pursuant to a PSA. During the PSA’s term of validity, the existing state taxes and other mandatory payments are replaced by a part of the profit production. They are taken into consideration when an agreement is drafted to determine the part of the production which remains in the ownership of the state. In this respect, no tax privileges are granted to investors, rather the existing tax system is replaced in whole or in part by production sharing.

What makes a PSA a more attractive basis for conducting activity than under a licensing regime is that parties to a PSA have the right to negotiate the terms of their arrangements. Of particular importance is that a PSA usually provides for a stable legal regime between the state and the investor for a long period of time. Such terms are essential if an investor is to be expected to make considerable expenditures with little to no expectation of an immediate return on its investment.
III. Status and Analysis of the Pending PSA Law

(A) Status of the PSA Law and the Need for Enabling Legislation

For the PSA Law to be enacted it must go through three readings by the Supreme Rada and be signed by the Ukrainian President (if it is vetoed by the Ukrainian President – an unlikely event, it could be nonetheless enacted by the Supreme Rada by a subsequent 2/3 vote (see Ukrainian Constitution, Article 94)).

Currently, the PSA Law has been reviewed by the sponsoring Rada Committees and it is tentatively scheduled for its first reading at the end of November 1998.

The Ukrainian legal system requires that any new law that changes existing legislation be followed by an enabling law that introduces relevant changes and amendments to existing legislation. The PSA Law introduces several fundamental changes to existing Ukrainian legislation, primarily in the area of taxation. Therefore, in order for the PSA Law to be enforceable, a Law “On the Introduction of Changes and Amendments to the Legislation of Ukraine on the Basis of the ‘Law on Production Sharing Agreements’”, (hereinafter the “Enabling Law”), must be adopted. The best scenario would be for the Enabling Law to be adopted together with the PSA Law. Then the PSA Law would be enforceable immediately. Delays in the adoption of the Enabling Law may result in a repeat of the situation in Russia where the PSA Law was adopted in December 1995, but it is not being enforced even now because the Russian Enabling Law is still pending in the State Duma.

(B) Analysis of Key Features of the PSA Law

The PSA Law is organized into six sections: (I) General Provisions, (II) Execution of Production Sharing Agreements, (III) Implementation of Production Sharing Agreements, (IV) Currency Regulation in the Course of the Implementation of Production Sharing Agreements, (V) Peculiarities of the Regulation of Employment Relations during the Implementation of a Production Sharing Agreement, and (vi) Miscellaneous. We will not cover all of these topics in this article, but will only discuss certain of the PSA Law’s key features.

The PSA Law provides that the “Authorized Body” shall hold a tender for the right to conclude a PSA. The winner of the tender shall then conclude with the Authorized Body a draft PSA consistent with the requirements established in the tender. One of the advantages that the PSA Law has over its Russian counterpart is

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8 We have provided our unofficial English language translation of the PSA Law at the time of publication of this article on our Web Site at www.ruig.com.
that lists of subsoil areas subject to PSAs in Ukraine are approved by the Cabinet of Ministers, rather than the Parliament.

We set out below a brief list of typical investor concerns with respect to PSA legislation in general and then note briefly how the PSA Law deals with these concerns.

- **Domestic Supply Requirements** – the PSA Law provides that unless otherwise provided by the PSA, the Investor may freely dispose of its portion of the produced production. The Investor is not subject to licensing or quotas restrictions when exporting nor similar restrictions on sales in Ukraine. A PSA may require the Investor to sell to the state or within Ukraine a portion of its production at world prices (Article 22).

- **Local Content Requirements** – PSA Law, Article 8 provides that the PSA should set forth the investor’s obligations to grant preference to products, works, and services of Ukrainian origin, but is silent as to what those obligations should be. The intent of Article 8 appears to be that such obligations would exist only with respect to Ukrainian works, products and services meeting “international standards”.

- **Local Employment and Training** - Similarly, Article 8 of the PSA Law envisions that a PSA set out the investor’s obligation to hire and train Ukrainian nationals, but the precise obligations seem to be left to the parties to negotiate. We note further that Article 35 provides that the Investor may hire foreign citizens “within the scope and for the positions (specialty) determined by the PSA without the need for obtaining a work permit.”

- **Assignment of Rights** – PSA Law Article 26 allows the possibility for the Investor to assign its rights and obligations under a PSA. However, the automatic re-registration of relevant licenses and permits to the assignee is not explicitly provided for. Such re-registration of licenses and permits should be added to both the PSA Law and the Enabling Law.

- **Unrestricted Carry-Forward of Losses** – although the Ukrainian Law “On the Taxation of the Profit of Enterprises” limits the carrying forward of losses to five years, the PSA Law provides specifically that an investor’s expenses may be attributed to subsequent tax periods for taxation purposes without any limitation (Article 25, Point 3).

- **Unrestricted Use by Investors of their Share of Production** – Article 22 of the PSA Law provides that unless otherwise agreed by the parties to a PSA, the Investor has the right to freely dispose of its portion of the extracted
production. It explicitly exempts the exporter from any regime of export licensing and quotas.

♦ Guarantees against Unfavorable Legislative Change – The PSA Law contains two provisions in this area, both of which contain certain limitations. The first provides that Ukrainian legislation in force on the date of execution of a PSA shall apply to the rights and duties of the parties, unless otherwise provided in the PSA, with the exception of changes in legislation in the areas of “national security, ensuring civil order, and the environment”. The second exempts investors from “normative and legal acts of executive and local authorities in the event that such acts limit the investor’s rights provided for in the PSA with the exception of directives of state control and supervisory bodies issued pursuant to Ukrainian legislation in order to establish conditions for the safe performance or works, protection of mineral resources, people’s health, as well as the guarantees of public and national security”. While the above language is not unusual in PSA legislation throughout the world, such guarantees are often difficult to implement in practice and there is of course the considerable risk that these exceptions will be broadly construed.

♦ Dispute Settlement and Waiver of Sovereign Immunity -- the PSA Law allows the parties to determine the method of dispute resolution themselves, thus providing an opportunity for the use of international arbitration. If the PSA does not address this issue, disputes will be resolved by Ukrainian courts. Also of importance, the PSA Law contains an explicit waiver by Ukraine of its sovereign immunity with respect to its obligations under a PSA, including with respect to the preliminary enforcement of a claim or enforcement of a court ruling.

♦ No need for Local Partners – The PSA Law does not require an investor to take on a local party. That being said, the Ukrainian Government and its local instrumentalities are likely to encourage it.

♦ Ease in obtaining various approvals, licenses, permits, quotas, etc. (hereinafter “official acts”) related to the performance of work under a PSA – the PSA Law provides for government guarantees with respect to the granting of such official acts in favor of the investors. PSA Law, Article 4, however, states that such official acts shall be issued in accordance with the requirements set forth in Ukrainian legislation. The PSA Law and the Enabling Law must provide for a streamlined procedure for the investor to obtain such official acts.

♦ Customs Treatment of Goods and Property Imported for the Purposes of Implementing a PSA – the PSA Law does not currently provide for a simplified procedure for the customs clearance of items imported in
connection with the implementation of a PSA. In addition, the PSA Law neither provides for an excise tax exemption for property imported into Ukraine nor does it allow for the temporary import of goods (equipment) for a period longer than one year.

The PSA Law’s tax provisions deserve a detailed examination that space constraints do not allow. Article 25 establishes a special tax regime for the investor. It provides that the investor is only subject to the following taxes and mandatory payments throughout the term of the PSA’s validity (up to fifty years):

- value added tax;
- tax on the profit of enterprises;\(^9\)
- fee for geological exploration works performed at the expense of the state budget;
- payroll taxes such as payment for mandatory social insurance and payment for mandatory state pension insurance;
- payments for the use of mineral resources specified in the production sharing agreement;
- payment (fee) for the issuance of special permits (licenses); and
- excise taxes (including during the importation of excisable goods, though this is not stated explicitly in the PSA Law).

Some of the major criticisms of Article 25 are that it does not adequately set out what expenses are deductible for profit tax calculations. In addition, foreign investors have complained that it does not exempt them from having to make VAT payments (which would be difficult to recover if the investor were to export the extracted production).

IV. Conclusion

Ukraine’s adoption of the PSA Law would be an important step towards making its subsoil resources more attractive to foreign investors. That being said, the text of the law itself, however, requires further refinement. In particular, the procedures dealing with the conclusion of PSAs, the relationship between the Authorized Body and relevant bodies of local self-government, applicable rules with respect to the issuance and assignment of licenses and permits when there is more than one investor need to be refined.

\(^9\) Article 25, Paragraph 3 establishes special rules for the calculation of the tax on the profit of enterprises.
Ultimately, whether foreign companies invest in the Ukrainian natural resource sector will depend on their assessment of the potential rewards and the political risk.

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