

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 (the "PSA Regime"). Below, we review the key features, advantages and disadvantages of both regimes, as well as their respective current statuses.

(1) 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 Law "On Oil and Gas". 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 Government of Ukraine 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 (license) 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 "licenses", sometimes as "permits" or "special permits". In this article, we use the term "Subsoil Permit" to describe this type of document. Effective October 2003, issuance of a Subsoil Permit must be accompanied by an agreement between the issuing authority and the subsoil user on the conditions for using subsoil (a "License Agreement"), which is considered to be an integral part of the relevant Subsoil

Permit. There is no model License Agreement and, in practice, a License Agreement's contents vary depending on the particular Subsoil Permit to which it is attached (for example, the Oil & Gas Law has a list of key terms and conditions for a License 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 (the "Licensing Body"). Over the years, the Licensing Body has changed several times; the latest change occurred as recently as 20 April 2005, when Licensing Body 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 Laws on the State Budget. 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, then in August 2005. This has been an on-going emergency

measure based on just a few lines in the Budget Law, which has no basis in the subsoil legislation, and as such, it can only be regarded as temporary until Ukraine returns to the standard licensing procedures stipulated by the subsoil legislation. It should be noted that the 2006 Budget Law continued the suspension of the standard licensing procedures, and, therefore special licensing (auction) procedures were again re-adopted on 20 February 2006 for the year of 2006.

In conclusion, we believe that the regular licensing procedures based on the subsoil legislation must be reinstated and the subsoil legislation, especially the outdated 1994 Subsoil Code, must be modernized and streamlined.

(2) PSA Regime

The PSA Regime was established in Ukraine with the adoption of the Law “On Production Sharing Agreements” in 1999 (the “PSA Law”) and the subsequent adoption of the 2000 Enabling Law 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 issuance is almost automatic and it is of secondary importance compared to 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. Considering the strong signals that the new Cabinet is sending about its willingness to open up the subsoil sector to international investors, however, we hope that the PSA Regime will soon be actively applied in practice.

Below is a brief overview of the key objectives targeted in the 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. The regulatory framework established in the PSA Law may seem too detailed at first sight. This, in fact, was intentional, since, as was demonstrated many times in the past, the absence of strict, detailed and transparent rules opens the field to bureaucratic “creativity” and abuse. Establishing “rules of the game” in the PSA Law that cannot be changed as easily as lower-level normative acts should ensure long-term stability and legal protection for all parties to PSAs. For example, the PSA Law contains detailed rules on the tender process, which otherwise would be governed by the ever-changing regulations of the Government agencies responsible.

! Establishing the clear priority of the PSA Law over other legislation. This objective was generally met in the PSA Law, but with certain caveats. Although Article 2 may be interpreted as giving priority to the provisions of individual PSAs and the provisions of the PSA Law on issues covered by such provisions, Article 2 also says that those issues not regulated by the PSA Law are governed by other legislation. The question of whether a particular issue is covered by the PSA Law is often subject to interpretation.

! Limiting the opportunities for Government interference in the implementation of PSAs. The PSA Law contains several provisions aimed at meeting this objective. For example, the reasons for suspending a PSA are limited to the standard ones of direct threats to life, public health, or the environment, and suspension is only permitted pursuant to the procedure established by the PSA itself. Article 28.1 does provide for a Government audit of each PSA every five years and requires the Cabinet of Ministers to terminate a PSA in the event of finding substantial violations by the investor, but only through a dispute resolution forum named by the parties in their PSA.

! Making licenses and other approvals subordinate to the PSA. The PSA Law provides for government guarantees with respect to the granting in a timely manner of various licenses and approvals, which remain in effect for as long as does the respective PSA.

! Providing long-term stability. This objective is reflected in various provisions of the PSA Law, most notably by providing guarantees against unfavorable legislative changes. The PSA Law contains two provisions in this area, both of which have certain standard limitations. The first provides that Ukrainian legislation in force on the date of conclusion of a PSA shall apply to the rights and duties of the parties, unless otherwise provided for in the PSA, with the exception of changes in legislation in the areas of “defense, national security, ensuring civil order, and the environment.” The second provision 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 aimed at establishing conditions for the safe performance of works and for the protection of the subsoil, the environment and people’s health.

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 the Parliament, and a couple such lists have already been approved by the Cabinet.
- ! Domestic Supply Requirement:** the PSA Law stipulates that, unless otherwise provided for in the PSA itself, the investor may freely dispose of its portion of the project’s output. A PSA may require an investor to sell to the State or to sell within Ukraine a portion of its production at world prices, but only if such a requirement is set forth in the tender terms and conditions.
- ! Local Content Requirement:** the PSA Law 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 Law 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. In addition, Article 35 provides that an investor may hire foreign citizens within the scope and for the positions determined by the PSA without needing to obtain work permits for them.
- ! Assignment of Rights:** the PSA Law allows for the possibility of an investor’s assigning, selling or transferring its rights and obligations under a PSA to another entity, with relevant licenses and permits to be re-issued within 30 days.
- ! Unrestricted Carry-Forward of Losses:** although current Ukrainian tax legislation limits the carrying-forward of losses to five years, the PSA Law 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 Law allows the parties to determine the method of dispute resolution themselves, thus providing an opportunity for the use of international arbitration. (What makes international arbitration possible in practice is Ukraine’s explicit waiver of its sovereign immunity with respect to its obligations under a PSA, including with respect to the preliminary securing 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 partner. (The Ukrainian Government and its local agencies are, however, likely to encourage taking on a local partner.)
- ! Unrestricted and Tariff-free Movement of Equipment and Other Items Needed for PSA Implementation:** the PSA Law 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 Law establishes a typical PSA tax scheme, which requires that an investor pay profits tax (this may be paid in kind), VAT (with the exemption of imported goods and property and exported production) and excise taxes, as well as a few lesser mandatory payments, the amount of which can be negotiated in individual PSAs. □