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Briefing note

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Investing in Upstream Oil and Gas Projects in Ukraine

The Ukrainian government has recently demonstrated its determination to increase the pace of development of Ukraine's reserves of unconventional hydrocarbons. As a result, over the last few years more and more investors have started to look at Ukraine's oil and gas potential. For those investors keen to enter the country, Ukrainian laws offer several ways to invest in the upstream sector of the oil and gas industry. This briefing provides a summary of these options.

Forms of Investing

In general, there are four options available for companies that want to invest in upstream oil and gas projects in Ukraine:

- *Licence-Based Option*: through obtaining oil and gas exploration and/or production rights directly from the State Service for Geology and Subsoil of Ukraine. Such rights are normally granted via auctions.
- *JAA Option*: through entering into a joint activity agreement ("**JAA**") with someone who already holds oil and gas exploration and/or production rights.
- *PSA Option*: through signing a production sharing agreement ("**PSA**") with the Ukrainian Government. PSAs may be signed with the winners of tenders held by the Ukrainian Government or as a result of the conversion of existing subsoil licences.
- *Equity Acquisition Option*: through acquisition (directly or indirectly) of shares in a company that already owns oil and gas exploration and/or production rights.

Licence Based Option

Under this option, the investor applies for the grant of a new licence directly from the Ukrainian Government. This option is normally only used by foreign investors that have established local partners. This is because the process of obtaining the licence usually involves, as a part of the auction process, navigation through numerous Ukrainian authorities to get the various state consents and approvals.

This option has the following major advantages for a non-resident investor:

- *Control of the Process from the Outset.* This option allows the investor to

Key issues

- Subsoil Licences
- Joint Activity Agreements
- Production Sharing Agreements
- Equity Acquisition

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control the process of obtaining the licence from the very beginning and therefore avoid risks associated with the Equity Acquisition Option and JAA Option.

- *No Antimonopoly Committee Approval*. Antimonopoly Committee approval is not required for a licence acquisition.

This option has the following major risks and disadvantages for a non-resident investor:

- *Dual Licence Risk*. Most licences issued cover either exploration or production. It is rather rare to obtain a licence that covers both. As the conversion of an exploration licence into a production licence is a rather complex process requiring significant interaction with state agencies, there is always a risk that the holder of an exploration licence may not be able to convert the licence into a production licence for the production phase.
- *Significant Interaction with State Authorities*. It requires significant interaction by the investor with state authorities.
- *Complications*. It requires any non-resident investor to go through lengthy and complicated procedures for obtaining oil and gas exploration and/or production licenses.
- *Time*. It is normally more time-consuming than the Equity Acquisition Option or JAA Option.

JAA Option

Under the JAA Option, a company, being the holder of an existing oil and gas exploration and/or production licence, agrees to jointly develop its natural gas reserves with an investor and then share any profits obtained as a result of the joint activity pursuant to an agreed proportion. The JAA Option is normally used by foreign investors doing business with state owned companies, in circumstances where the latter own exploration and/or production licenses but do not have the funds to carry out the works.

While the use of this option has a number of disadvantages and legal risks, it is often used by foreign investors due to the absence of legal alternatives to develop natural gas reserves owned by state owned companies. It is usually not possible for state owned companies to contribute their licenses into the share capital of a newly created legal entity or otherwise assign or sell them to a foreign investor.

State owned companies normally announce public tenders for the right to enter into joint activity agreements with them. Sometimes these tender announcements are published on the internet (e.g., tenders announced by NAK "Nadra Ukrayny" are published at: http://www.nadraukrayny.com.ua/tenders_ukr.htm).

This option has the following *major advantages* for a non-resident investor:

- *No Need to Obtain a Licence*. As with the Equity Acquisition Option, the licence does not normally have to be re-issued if its holder enters into a joint activity agreement.
- *Expediency of the Transaction Process*. As with the Equity Acquisition Option, the absence of the requirement to obtain a licence also means that the transaction can be undertaken quite quickly.

This option has the following *major disadvantages* and risks for a non-resident investor:

- *No Control over Validity of Licence*. The investor does not have any control over the licence. If the licence holding partner violates any Ukrainian laws then the licence may be revoked. Further, the licence holder can give up the oil and gas licence or dissolve voluntarily or as a result of a court proceeding. The sole remedy the foreign investor would then have would be damages under the JAA. In practice, it is very difficult to enforce contractual liability provisions against Ukrainian state owned companies.
- *Risk of Invalidation*. Ukrainian law does not clearly regulate what kind of relationships oil and gas JAAs are permitted to allow. In the past, Ukrainian state bodies have been inconsistent in their position as to legitimacy of JAAs in the area of exploration and production of oil and gas. One view of the law has been that such agreements are illegal if the operator's rights to carry out exploration or production are given to the partner that does not hold the licence. Given the lack of clarity in the law there is a risk that a JAA can be contested in court and invalidated.

- *Restricted Marketing*. Where a state owned company has an interest of 50% or more in a JAA then the natural gas produced must be sold to the state at prices fixed by the state. Likewise, crude oil, gas condensate and liquefied natural gas may not be disposed of freely by such joint ventures and must be sold at auctions.
- *Antimonopoly Committee Approval*. Antimonopoly Committee approval is required if the terms of the agreement contemplate concerted actions of the parties and where the transaction exceeds certain financial thresholds (which are relatively low).
- *Separate tax accounting.* For tax purposes, a JAA creates an entity that is considered as a separate taxpayer and requires separate tax reporting.

PSA Option

Under the PSA option, an investor enjoys a legal regime in which the subsoil right arises principally from a contract negotiated by it with the Ukrainian Government. PSAs are executed with the winner of a tender announced by the Ukrainian Government or as a result of the conversion of an existing licence.

To date four PSAs in relation to oil and gas reserves have been signed in Ukraine. One of them was signed by Vanco International Ltd. in 2007 in relation to an offshore oil and gas block. This PSA was later the subject of arbitration, which was only recently settled in favour of the investor. The other PSAs were signed with Shell, Chevron and Eni together with Electricite de France in 2013.[1]

This option has the following *major advantages* for a non-resident investor:

- *Duration*. PSAs may be executed for a term of up to 50 years.
- *State's Assistance in Obtaining Licences and Permits*. Although an investor under the PSA regime is not exempt from licences, permits and approvals, the State undertakes in the PSA Law that all of these regulatory authorisations will be provided to the investor. Therefore, under a PSA arrangement, an investor can expect reasonable assistance from the State in obtaining such licences, permits and other approvals, which may, in fact, be crucial for the successful implementation of a project.
- *Legal Stabilisation*. The PSA Law contains so-called "legal stabilisation" provisions designed to protect investors under production sharing agreements from adverse changes to the law. In particular, the PSA Law provides that the rights and obligations of the parties to a PSA will be governed by the laws effective as of the date of signing of such agreement, except for changes in Ukrainian laws in relation to "defence, national security, ensuring public order and environmental protection". The legal stabilisation provision does not restrict investors from taking advantage of any beneficial legislative changes.
- *Tax and Customs Benefits*. The Ukrainian tax law establishes favourable tax and customs treatment for an investor under a PSA.
- *No Antimonopoly Committee Approval*. In general, Antimonopoly Committee approval is not required for entering into a PSA.

This option has the following *major risks* for a non-resident investor:

- *Support from Government.* As with any long-lasting major investment project, in order to be effectively implemented continuous support by the Government is important.

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1 Vanco International Ltd., Eni and Electricite de France acquired rights to offshore blocks in the Black Sea near the Crimean peninsula, which is currently the subject of a dispute between Ukraine and the Russian Federation. Accordingly, the status of these PSAs remains unclear.

- *Only Suitable for High-Profile Projects*. Very high-level involvement is required in order to sign a PSA with the Ukrainian Government. Therefore, this option may be considered only for very significant projects, such as development of large territories or deepwater offshore areas.

Equity Acquisition Option

The acquisition of a Ukrainian company that owns an existing oil and gas exploration and/or production licence is the most common tool for making investments in upstream natural gas projects in Ukraine.

This option has the following *major advantages* for the investor:

- *No Need to Acquire Rights to Develop Resources*. Ukrainian oil and gas authorities do not usually include a "change of control" provision into oil and gas licences. Therefore, no consent or re-issuance of the licence would normally be required as a result of the acquisition of a shareholding in a company that owns an oil and gas licence. However, consent to such an acquisition would most likely be required in the event that the target was a party to a JAA or PSA.
- *Expediency of the Transaction Process*. As the target already holds the exploration and/or development rights, the transaction can be undertaken quite quickly.

This option has the following *major risks and disadvantages* for a non-resident investor:

- *Dual Licence Risk*. Most licences issued cover either exploration or production. It is rather rare to obtain a licence that covers both. As the conversion of an exploration licence into production licence is a rather complex process requiring significant interaction with state agencies, unless the company to be acquired already has production licences there is always a risk that the holder of an exploration licence may not be able to convert the licence into a production licence for the production phase.
- *Historic Liabilities*. The buyer takes on all of the target company's liabilities. In addition to tax liabilities, this also relates to any violations of subsoil, environmental or other laws which may lead to suspension/cancellation of the licence or significant cleanup costs. In our experience, many holders of oil and gas exploration and production rights are not in full compliance with these obligations. Even technical breaches can put a licence at risk of being suspended or cancelled. It is therefore important to carry out full due diligence into the target to evaluate the risks. Likewise, where the target is a party to a JAA or PSA any historical liabilities or violations may lead to the termination of such agreement.
- *Antimonopoly Committee Approval*. If 25% or more of a company is to be acquired then Antimonopoly Committee approval is required, assuming that the transaction exceeds certain financial thresholds (which are relatively low). Failure to obtain such approval can result in penalties or the unwinding of the transaction.