

TO: Clients and Friends of the Firm
FR: Frishberg & Partners
RE: Law “On Production Sharing Agreements”

I. Introduction

In the past, Ukrainian mineral resources were rich and plenty, but the primitive Soviet-era extraction methods and lack of investments led to poor quality and mind-boggling waste. Still, many opportunities for mineral extraction can be found in Ukraine today. Because of Ukraine’s desperate need for an infusion of cash, we are witnessing a renewed balancing act in attracting foreign investment as President Yushchenko continues the struggle to bring the mineral extraction business up to date while simultaneously attracting funds for the state budget.

Foreign investors have been interested in exploring Ukraine’s natural resources since Ukraine won its independence in 1991. Until recently, however, no clear and transparent mechanism existed that would allow foreign investors to assist Ukraine in extracting the raw product while gaining a profit. Often investors were not even allowed to freely export their share of extracted minerals for sale on the world market. Finally, on September 14, 1999, President Kuchma signed Law No. 1039-XIV “On Production Sharing Agreements” (the “Law”).

Below, we review the Law and analyze its applications for foreign investors.

II. Discussion

A. Overview

The Law governs relations between investors and the State connected with the exploration, extraction and/or production of mineral resources. Its main purpose is to create favorable conditions for foreign investors, while developing and modernizing mineral production on the territory of Ukraine, its continental shelf and its maritime economic zones. The scope of this Law is quite broad and still requires numerous supporting instructions, but it is a precedent which requires review.

Ukrainian production sharing agreements are very similar to the western understanding of concession agreements, whereby a government grants specific privileges to investors to effectuate the development of natural riches or other economic resources over which the government usually exercises a monopoly stranglehold. The Law grants privileges to investors to extract minerals and

export the final products for sale abroad and/or on the Ukrainian market. Investors can be Ukrainian and/or foreign citizens and legal entities. The only condition is that such investors have the appropriate qualifications, including the technical and financial capabilities necessary to extract and process the mineral resources. Potential investors must submit various documents, issued in the investors' country of registration, confirming these capabilities.

The Law called for the Cabinet of Ministers to create a so-called Interdepartmental Commission, empowered to supervise the organization, execution and implementation of production sharing agreements. The Interdepartmental Commission (the "Commission") is comprised of representatives of the state, bodies of local self-governance and local councils of people's deputies (where required). If necessary, the Commission may enlist production and scientific experts, as well as other experts and consultants.

The Law defines a production sharing agreement as a written agreement, entered into between the state and an investor (or several investors) for a specified term, to carry out prospecting, exploration and extraction of mineral resources in areas designated by the state as having mineral deposits ready for extraction. Under the Law, the foreign investor undertakes to extract, transport, treat, store, process, and perform any other obligations provided for in the agreement at its own risk and expense. In turn, the investor shall be compensated for its costs and expenses with a portion of the extracted materials, designated for sale at a profit.

The extracted raw materials are typically shared amongst the parties to a production sharing agreement and fall into one of the following three categories:

- 1) "extracted products", defined as the total volume of the products extracted pursuant to a production sharing agreement, which are delivered to a designated point of measurement where the extracted minerals are divided between the parties;
- 2) "compensation products", defined as part of the production which is transferred directly to the ownership of the investor as compensation for the costs and expenses for extracting the mineral resources; and
- 3) "profit products", which comprise the portion of the production which is shared between the State and the foreign investor and is determined as the difference between the produced and compensation products.

As an additional incentive for entering the Ukrainian market, the State guarantees to provide the foreign investor with (i) all of the necessary consents, quotas, permits and licenses to use the mineral resources, (ii) the relevant acts for mining allocation, (iii) documents evidencing the right to use land and (iv) other permits related to the activities contemplated by the production sharing

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