

KEY LEGAL ASPECTS OF PRODUCTION ENHANCEMENT CONTRACTS

After the successful launch of the pilot Production Enhancement Contract (PEC) project in April 2020, Ukrgasvydobuvannya (UGV), Ukraine's largest exploration and production company, is excited to announce the second round of engaging PEC investors with respect to four oil&gas clusters. Given that the concept of PECs is relatively new for Ukraine, below is the guidance on key legal considerations.

01

PEC v. JOA

The nature of the PEC is to engage the contractor to enhance the production from the PEC area. However, given that only one PEC has been signed in Ukraine to date, the PEC is to be carefully drafted, particularly regarding provisions clarifying the nature of the relationship between UGV and the contractor, in order to distinguish the PEC from a Joint Operating Agreement (JOA), which is subject to specific legal and tax rules. Emphasizing that UGV keeps the ownership rights to all produced hydrocarbons and the contractor receives a service fee as the consideration for its work and services distinguishes the PEC from a JOA.

02

Party to the PEC

Though foreign entities are allowed to participate in tenders, it is intended that the PEC will be with the Ukrainian subsidiaries of the winners. Certain provisions of the PEC require the contractor to be a Ukrainian entity (including those relating to obtaining of environmental and labor permits, which cannot be obtained by a non-Ukrainian entity, as well as transfer of employees). Alternatively, the PEC can be concluded between UGV and a foreign entity provided that the foreign entity will further assign some or all of its rights and obligations to its Ukrainian subsidiary.

03

ProZorro tenders

The selection of the contractors will be carried out through open and transparent tenders organized on the ProZorro system (which is frequently used by governmental entities and state-owned companies as per the requirements of the Ukrainian Public Procurement Act of 2015). The bidders will be required to meet certain pre-qualification criteria (such as experience in operating depleted oil&gas fields, good financial standing, etc.). The winners will be determined based on their commercial proposals, which will include "price" criteria (for example, lowest incremental tariff) and may include "non-price" criteria (for example, anticipated volume of incremental production or others); proposals will be evaluated automatically based on a formula, which will be developed and made public before the tenders.

04

Investor protections

It is anticipated that all key industry-standard protections attributable to PEC projects will be available to investors. These include, for example, international arbitration as the venue for dispute resolution (provided that the contractor is an entity with at least 10% of foreign equity investments) and limitation of liability. In addition to international arbitration, certain disputes may be referred to an independent expert pursuant to and with binding effect as specified in the PEC.

The PEC will be signed for a 15-year term, subject to a possible 10-year extension.

05 Liability

The parties' liability and will be specified directly in the PEC and can be subject to negotiation. Normally, the parties' liability under the PEC is divided into liability for any claims which took place or existed prior to the takeover date, which the principal (UGV) normally bears (the so-called pre-takeover liability); and liability for the claims after the takeover date, including claims related to the environmental and clean-up liability, and liability relating to fixed assets and personnel if due to the contractor's fault, which generally the contractor bears (the so-called post-takeover liability).

The contractor will need to arrange for insurance policies, which are usually required or desirable to operate depleted oil&gas fields in Ukraine. The parties may agree the list of such insurance policies directly in the PEC.

06 Guarantee

Before the takeover date, the contractor will be required to provide an irrevocable bank guarantee in favor of UGV, and UGV will be entitled to draw under this guarantee in case of breach by the contractor of certain obligations. The guarantee will automatically terminate after the contractor's performance of its minimum investment obligations, which is to be confirmed by an auditor.

07 Coordination of operations

Considering that the work will be performed by the contractor, while the licenses remain with UGV which bears responsibility as a license holder, the parties usually consider the establishment of a mechanism for coordination and approval of the operations under the PEC (for instance, by establishment of the coordination committee). Under this mechanism, UGV will need to have the right to approve, or, in certain cases, veto proposed work programs, budgets and field development plans, as well as other matters to be agreed in the PEC.

UGV will not interfere with the contractor's procurement operations under the PEC.

08 Transfer of employees

The PEC generally provides for the transfer of employees from UGV to the contractor. The parties are expected to use their best efforts and cooperate in raising the employees' awareness of the expediency, terms and conditions of the transfer and encouraging them to consent to the transfer, all in accordance with Ukrainian labor law provisions.

09 Title to and use of assets

UGV will retain the exclusive ownership rights to its fixed assets, which the contractor will use for performance of the PEC. The contractor is to be granted the right to use the land owned, leased or otherwise used by UGV, as well as the ownership rights to all facilities, properties, equipment and other assets purchased or otherwise procured by the contractor in the course of performing the PEC.

Upon termination of the PEC, the contractor will transfer all assets which it procured and created (for example, newly drilled wells, etc.) for performance of the PEC to UGV in exchange for the so-called transfer value agreed by the parties.

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Baseline and incremental production

As the consideration for its work and services, the contractor is to receive a baseline fee (i.e., the fee for the standard amount of hydrocarbons produced within the PEC area), and an incremental fee (i.e., a fee for the hydrocarbons produced as a result of enhancement, which is normally higher than the baseline fee to incentivize the contractor). The baseline and incremental production, as well as the baseline and incremental fees will be determined in the PEC based on the commercial proposal submitted as part of the ProZorro tender process. The PEC can also provide for a production guarantee – i.e., a cumulative amount of production which the contractor is obliged to deliver within the agreed period.

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HSE requirements

As part of the PEC process, UGV and the contractor will jointly develop and approve the Health, Safety, and Environment rules, which the contractor will need to obey during the project. It is expected that UGV will have the exclusive right to suspend operations in the field if, in its view, there is a serious imminent danger to environment or health.

12

Transportation

UGV will hold the exclusive property rights to any hydrocarbons delivered by the contractor from the PEC area. The contractor usually has the right to use the hydrocarbons produced within the PEC area for technological needs (for example, for fuel, compression, gas lift, power generation, reinjection, repressuring, recycling, etc.). There will be minimum requirements as to the quality of production, which will be based on the requirements of the Gas Transportation System Code, and UGV will have the right to refuse to accept production that does not meet the quality standards.

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Expenditures under the PEC

All chargeable expenditures (for example, personnel cost, transport, taxes, well expenditures, etc.) are expected to be recovered by the contractor only through the service fee (i.e., the baseline fee and the incremental fee). These chargeable expenditures will further include the cost of the assets created or purchased by the contractor for performance of the PEC (for example, newly drilled wells) except for the moveable and leased assets.

This publication does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

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About UGV. UGV is the largest gas production company in Central and Eastern Europe. In Ukraine, it is a major player producing more than 70% of natural gas and specializing in gas condensate production. In April 2020, UGV signed the first Production Enhancement Contract in Ukraine, which is expected to contribute to an increase of 300 million cubic meters of natural gas within the first five years. The successful completion of the PEC project will add more than UAH4 billion (approximately USD145 million) to Ukraine's GDP and bolster the economy of Lviv region.

Please email UGV's PEC team (pec@ugv.com.ua) for inquiries.

About Redcliffe Partners. Redcliffe Partners is a premier Ukrainian law firm with First-Tier banking, corporate and energy lawyers on board (according to The Legal 500 EMEA 2021). The firm is particularly renowned for its representation of large foreign oil&gas investors, including 'Oil Majors' such as Chevron, Eni and Shell.

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