

Ten Key Legal Aspects of Production Enhancement Contracts

On April 10, 2019, Ukrigasvydobuvannya (UGV), Ukraine's largest exploration and production company, announced two tenders for Production Enhancement Contracts (PECs). Given that no risk service contract has been concluded in Ukraine to date, below is guidance on key legal considerations.

1 PEC v. JOA

The nature of the PEC is to engage the contractor for performance of works and provision of services to enhance the production from the PEC area. However, given that the concept of a risk service contract is new for Ukraine, the PEC is to be carefully drafted, particularly regarding provisions clarifying the nature of the relationship between the principal (i.e., UGV) and its contractor. Emphasizing that the principal keeps the ownership right for all produced hydrocarbons and the contractor receives a service fee as the consideration for its services and works distinguishes the PEC from a Joint Operating Agreement (JOA).

2 Party to the PEC

Though foreign entities are allowed to participate in the 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. Specifically, the contractor will need to obtain certain permits of an environmental and labor safety nature, which cannot be granted to a foreign entity. Also, the PEC provides for the transfer of employees from UGV to the contractor, which needs to be done under Ukrainian law. Alternatively, the PEC can be concluded between UGV and a foreign entity provided that the foreign entity will have the right to assign some or all of its rights and obligations to its Ukrainian subsidiary.

3 Liability

The parties' liability is subject to negotiation, and will be specified directly in the PEC. Normally, the liability under the PEC is divided into: (i) liability for any claims which took place or existed prior to the takeover date, which the principal normally bears (pre-takeover liability); and (ii) 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 shall bear (post-takeover liability). The contractor's liability is normally limited to the amount agreed by the parties.

4 Governing law, dispute resolution and expert determination

If the PEC is concluded with a Ukrainian entity as the contractor, the PEC is required to be governed by the laws of Ukraine. Disputes under the PEC can be settled either by Ukrainian courts or by international arbitration institutions (provided that the contractor is a legal entity with foreign investment – i.e., at least 10% of the contractor's charter capital should belong to a foreign entity). If any matter requires to be referred to a technical or professional expert, it can be settled by an independent expert pursuant to mechanisms and with binding effect as specified in the PEC.

5 Coordination of operations

Considering that the works and services within the PEC area will be performed and provided by the contractor, while the licenses remain with UGV which bears responsibility as a license holder, the parties normally consider the option of establishment of the mechanism for coordination and/or approval of the operations under the PEC (for instance, by establishment of the coordination committee), which is subject to negotiations.

6 Transfer of employees

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

7 Title to and use of assets

UGV will retain the exclusive right of ownership to its fixed assets, which the contractor will use for the performance of works and provision of services under the PEC. The contractor is normally granted (i) the right to use the land owned, leased or otherwise used by the principal, and (ii) the ownership right to all facilities, properties, equipment and other assets purchased or otherwise procured by the contractor in the course of performing its obligations under the PEC.

Upon termination of the PEC, the contractor shall transfer all assets which it procured for performance of its obligations under the PEC and the assets it created for enhancement of production (e.g., newly drilled wells, etc.) to UGV in exchange for the so-called "transfer value" agreed by the parties.

8 Baseline and incremental production

As the consideration for its works and services, the contractor is to receive a baseline fee (i.e., the fee for the baseline production – 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 negotiations between the parties. 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.

9 Transportation

UGV will hold the exclusive property right to any hydrocarbons delivered by the contractor from the PEC area. The contractor will be required to deliver, and UGV will be required to accept, the production at the relevant delivery points agreed by the parties.

The contractor normally has the right to use the hydrocarbons produced within the PEC area for technological needs (e.g., for fuel, compression, gas lift, power generation, reinjection, repressuring, recycling, etc.).

10 Expenditures under the PEC

All chargeable expenditures (e.g., personnel cost, transport, taxes, well expenditures, etc.) should normally only be recovered by the contractor through the service fee (i.e., the baseline fee and the incremental fee). The referenced chargeable expenditures are expected to include the cost of the assets created and/or purchased by the contractor for performance of works and provision of services under the PEC (e.g., 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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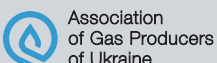
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