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Diagnostic Review of Legal and Regulatory Framework for PPPs



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INTRODUCTION

This diagnostic review report (the "**Diagnostic Review**" or the "**Report**") is prepared by Gide Loyrette Nouel using legal experts from its international and Kyiv offices (together the "**Legal Advisor**"), under a U.S. Agency for International Development contract with the Academy for Educational Development ("**AED**") in relation to the Public-Private Partnership Program ("**P3DP**") for Ukraine.

This Report constitutes the first stage of a comprehensive process undertaken by P3DP to contribute to establishment of a fair and competitive PPP framework in Ukraine which should encourage private investors to invest through Public-Private Partnership ("**PPP**") projects. In particular, this Report will be one of the tools to be taken into account in preparation of a PPP strategy for Ukraine.

In accordance with the Legal Advisor's contract for services signed on 5 July 2011 with AED (the "**Contract**"), the Report is designed as a "*high-level diagnostic review and assessment¹ of the existing legal and regulatory framework for PPPs in Ukraine*" to be conducted "*in the light of international best practice.*" The Report "*is intended to be a high-level (broad-brush) review; it is not meant to be a detailed analysis of all relevant provisions. The purpose is to highlight the areas where legal changes are needed or where improvements are recommended, to explain why they are needed or recommended, and to describe in broad terms the kinds of changes that should be made to remedy the deficiencies (or the different options that could be pursued to this end).*"

In order to provide high-level and practical recommendations, the Legal Adviser made use of his international experience gained in advising international investors, governments and international financial institutions on PPP projects in both developing and developed world. We also made use of our knowledge and expertise gained while reviewing and analysing the existing concession and PPP legislation of 27 EBRD countries of operation, including Ukraine.

The Kiev office of the Legal Adviser also contributed to the Diagnostic Review in terms of both specific knowledge of Ukrainian legal and regulatory framework and extensive experience in advising international investors on various investment projects in Ukraine.

Ukraine has demonstrated in the last few years its commitment to implement a favourable legislative framework for PPPs, notably through the Presidential Program of Economic Reforms for 2010-2014 which stressed the necessity to adopt a new PPP Law for Ukraine. After much discussion in Parliament, the law "*On State-Private Partnership*" was passed

¹ In that respect, the present Report may be considered as a complement to the detailed report prepared by Prudence Law Firm under the supervision of the International Finance Corporation (IFC).

before the Ukrainian Parliament on 1st July 2010 and came into force on 31st October 2010 (the "PPP Law")².

The PPP Law represents a part of the Ukrainian PPP framework which also includes a number of important earlier laws (e.g. the Concession Law³ or the Motorway Concession Law⁴), regulations and Ministerial resolutions (see **Schedule 4** for the list of Ukrainian PPP legislation reviewed under this Report). These texts have to be read in conjunction with the provisions of various Ukrainian Codes, such as the Commercial Code or the Civil Code, making the Ukrainian PPP framework relatively complex for international investors to understand. As discussed during the kick-off meeting in Kyiv organised by P3DP with Ukraine's PPP stakeholders from 11 to 13 July 2011 (See **Schedule 2**), many stakeholders believe that such complexity has contributed to the fact that no PPP projects have been implemented so far under the new PPP Law despite the strong appetite demonstrated by the private sector for the Ukrainian PPP market. Final issues were raised by stakeholders during the presentation of the initial findings of this Report in Kyiv on 4-5 October, 2011.

Before embarking on the diagnostic review of the Ukrainian PPP regulatory framework itself (**Section 3**), we will make a brief presentation of the concept of PPP as it is considered in the international practice (**Section 2**) and a more detailed description of the rules and guidelines generally considered as "international best practice" in the field will be attached as **Schedule 1**. **Section 1** will outline the summary of our recommendations in order of priority.

The final version of the Report will serve as a base for discussions during a workshop to be organized in Ukraine with key PPP stakeholders on 20 October 2011.

This Report is legal in nature and as such does not cover economic aspects of implementation of PPP projects in Ukraine. We understand the importance of such economic element but this work should be analysed separately.

Finally, while preparing this Report we did not address the issues relating to preparation of the public partner for implementation of PPP Projects nor protection and securing of interests of the public partner while entering into the PPP agreement. Such issues are outside our scope but also merit a separate report which should also analyse the social and institution aspects of implementing PPP.

² Law of Ukraine "On State-Private Partnership" dd. 01.07.2010 N° 2404-VI.

³ Law of Ukraine "On Concessions" dd. 16.07.1999 N° 997-XIV.

⁴ Law of Ukraine "On Concessions for Construction and Operation of Motor Roads" dd. 03.04.2003 N° 662-IV.

TABLE OF CONTENTS

1.	SUMMARY OF RECOMMENDATIONS	6
1.1	FIRST PRIORITY (NECESSARY FOR SUCCESSFUL IMPLEMENTATION OF PILOT PROJECTS)	6
1.2	SECOND PRIORITY (NECESSARY TO INCREASE ATTRACTIVENESS OF THE PPP FRAMEWORK)	7
1.3	THIRD PRIORITY (NECESSARY TO INCREASE LONG-TERM EFFICIENCY OF THE PPP FRAMEWORK)	8
2.	CONCEPT OF PPP	9
2.1	EUROPEAN COMMISSION DEFINITION OF "PPP"	9
2.2	UNCITRAL DEFINITION OF "PRIVATELY FINANCED INFRASTRUCTURE PROJECTS"	11
3.	COMMENTS AND RECOMMENDATIONS ON UKRAINIAN PPP FRAMEWORK	13
3.1	PRELIMINARY COMMENTS ON THE UKRAINIAN PPP FRAMEWORK	13
3.1.1	General PPP Legal Framework.....	15
3.1.2	Institutional Framework for PPP projects.....	15
3.1.3	Recommendations	17
3.2	DEFINITIONS AND SCOPE OF THE PPP LAW.....	18
3.2.1	Presentation.....	18
3.2.2	Eligible sectors	18
3.2.3	Scope of authority to award PPP agreements	18
3.2.4	Power of public authorities to delegate functions and responsibilities to the PPP company.....	20
3.2.5	Definition of the private partner	21
3.2.6	Recommendation.....	21
3.3	SELECTION OF THE PRIVATE PARTNER	21
3.3.1	General.....	21
3.3.2	Recommendations	23
3.4	PROJECT AGREEMENT.....	24
3.4.1	Presentation.....	24
3.4.2	Peculiarities of the certain types of the projects.....	24
3.4.3	Permits and approvals in connection with PPP projects	26
3.4.4	Restrictions on the provisions permitted in a PPP agreement	26
3.4.5	Model agreement and Essential Conditions	27
3.4.6	PPP company's freedom to contract with third parties	27
3.4.7	Ability of the public authority to override explicit terms of PPP agreement	28
3.4.8	Rights of the parties upon termination of the PPP agreement	28
3.4.9	Recommendations	30
3.5	SECURITY AND SUPPORT ISSUES.....	31
3.5.1	Possibility to take security interests over public assets in the PPP	31

3.5.2	Step-in rights.....	32
3.5.3	Support Issues.....	33
3.5.4	Recommendations.....	36
3.6	SETTLEMENT OF DISPUTES AND APPLICABLE LAWS.....	37
3.6.1	Settlement of Disputes	37
3.6.2	Applicable Laws.....	39
3.6.3	Recommendations.....	40
3.7	OTHER ISSUES	40
3.7.1	Use and ownership of site and assets for a PPP	40
3.7.1.1	Assets	40
3.7.1.2	Peculiarities of lease and concession of water supply, heating, and sewage infrastructure	41
3.7.1.3	Peculiarities of highway concession	41
3.7.1.4	Depreciation charges	41
3.7.1.5	Land.....	41
3.7.1.6	Ability to transfer rights over public assets to the PPP company.....	42
3.7.1.7	Recommendations:.....	43
3.7.2	Bankruptcy provisions.....	43
3.7.3	Labour Law Issues	44
3.7.3.1	Employment of Ukrainian Citizens.....	44
3.7.3.2	Work Permits for Foreign Citizens	45
3.7.3.3	Recommendations:.....	45
3.7.4	Tariffs	45
3.7.4.1	General.....	45
3.7.4.2	Peculiarities of road concessions.....	47
3.7.4.3	Peculiarities of the heating, water supply, and sewage sectors.....	47
3.7.4.4	Ability of the PPP company to impose sanctions against non-paying customers	49
3.7.4.5	Recommendations	50
3.7.5	Tax.....	51
3.7.5.1	General.....	51
3.7.5.2	Recommendations	Error! Bookmark not defined.

SCHEDULES

SCHEDULE 1. GENERAL PRINCIPLES GOVERNING INTERNATIONAL BEST PRACTICE IN PPP LEGISLATIVE FRAMEWORK	52
SCHEDULE 2. KICK-OFF MEETINGS AGENDA IN KYIV WITH UKRAINE'S PPP STAKEHOLDERS.....	64
SCHEDULE 3. ANALYSIS BASED ON EBRD METHODOLOGY OF RECENTLY IMPLEMENTED PPP LEGISLATIVE REFORMS	65
SCHEDULE 4. THE PPP LEGISLATION	67

1. SUMMARY OF RECOMMENDATIONS

The following recommendations are the result of a high-level review of the Ukrainian PPP framework, and are provided in order of priority.

1.1 First Priority (necessary for successful implementation of pilot projects)

- *Foresee the possibility of equitable compensation solutions upon early termination of the PPP agreement aimed at (i) reimbursement of the private partner's reasonable loss (depending on the grounds for termination) and at (ii) avoiding the situations of unjust enrichment of either party following such termination.*
- *Amend the Budget Code so that State or municipal support and privileges given to the private partner shall be paid to the private partner, notwithstanding whether it was budgeted.*
- *Amend the Budget Code so that authorities are obliged to include compensation of the difference between the approved tariffs and the full commercial price, without following a separate procedure of voting such amounts.*
- *Allow the public partner to grant subsidies to the private partner, if tariff increase is politically or socially problematic, and amend the Budget Code accordingly.*
- *Amend the Budget Code and related legislative acts to provide for the obligation to reimburse, at the expense of the State budget, the difference between the approved tariffs and full commercial price, regardless of the status of the authority which set the former.*
- *Amend article 14 of the PPP Law in order to regulate step-in in the event of a defaulting private partner and without a new tender.*
- *Provide in the PPP Law and related laws that all disputes arising from any type of PPP arrangement concluded with a non-residents of Ukraine or an enterprise with foreign investments may be settled by international arbitration tribunals with the seat outside of Ukraine or in Ukraine (depending on the agreement of the parties) notwithstanding limitations provided by other legislation (except "exclusive" competence of Ukrainian courts).*
- *Clarify that disputes relating to real estate which fall within the exclusive competence of Ukrainians court are disputes related only to property rights over the real estate.*
- *Amend the PPP Law and related laws so that if tariffs do not include the investment component or are not properly adjusted by the public partner to the full commercial level, the parties should be allowed to agree on a respective modification to the investment programme. Until such agreement is reached, the private partner should have the right to suspend the investment programme without any penalties.*
- *Amend the tariffs legislation so that if the private partner is responsible for maintaining networks up to the point of connection to the end consumer (in-house infrastructure), tariffs should be set in consideration of this type of expenses, as well as interests paid by the private partner under loans associated with the PPP project.*

- *Amend the Budget Code and provide for a mechanism for issuance by self-governing authorities to privately owned PPP companies of guarantees for the performance of its financial undertakings under the PPP agreement.*
- *Clarify the types of state and municipal support that may be granted by the State and self-governing authorities and provide the respective mechanism of implementation in the Budget Code.*
- *Provide in the Land Code accelerated procedures concerning title use formalization over land plots and buildings transferred to the private partner, notwithstanding the nature of the landowner (state owned or municipally owned).*

1.2 Second Priority (necessary to increase attractiveness of the PPP framework)

- *Adopt a clear policy framework and PPP strategy where the Government underlines its commitment to PPPs, implements the legislative changes proposed and ideally proposes a list of pilot projects*
- *Consider simplifying the general PPP framework by abrogating the Concession Law and the sector-specific laws so that a single PPP Law applies to all PPP projects or amend the legislation to the effect that whenever the PPP Law grants specific rights and privileges, which are neither provided for, nor disallowed by other legislative acts, such provisions must prevail over any other rules and regulations.*
- *Clearly identify and define the powers of government institutions and agencies involved at all stages of the PPP process on both state and local level: from initiation of the PPP project up to its implementation and monitoring; and the entities that may enter into PPP agreement as contracting authorities.*
- *Provide for a unified private party selection procedure for all PPP agreements irrespective of the legislation under which they fall (the criteria for choosing of the private party will vary for each PPP).*
- *Amend the PPP Law so that the only mandatory conditions for PPP agreement are those required under the PPP Law and tender documentation. Remove the sanction of invalidity from PPP legislation and procedure.*
- *Clarify the conditions of delivery of work permits to foreign citizens.*
- *Allow the possibility to set long-term tariffs without any adjustments by the public partner in order for the private partner to introduce power and resource saving equipment.*
- *Provide for accelerated procedures concerning tariff adjustment.*
- *Provide for the possibility for parent companies (private partner) to participate in the tender under the condition that, subsequently to winning the bid, the parent company establishes a Ukrainian incorporated company for the project's implementation.*
- *Clarify or amend the licensing conditions that restrict the private partner's right to receive licenses only on the basis of documents confirming title of use or title of*

ownership over respective networks: allow granting of licenses on the basis of any other PPP agreement providing the right to operate respective infrastructure.

- *Include reimbursement of concession payments made by the private partner in tariffs.*

1.3 Third Priority (necessary to increase long-term efficiency of the PPP framework)

- *Provide for the possibility of the private partner (Ukrainian subsidiary) to indicate the parent company's past projects and experience during the tender application process to confirm the application's quality and experience.*
- *Remove the requirement that self-governing authorities seek approval for PPPs from the governmental authorities since this contradicts the principles of self-governance. However, if state support is required under the contract, then, the relevant State agency should be involved during all the stages.*
- *Clarify whether the PPP private partners' representative office has the right to apply for licenses*
- *Amend Article 5 of the Law of Ukraine "On Privatisation of State Property" to allow leasing of public infrastructure, save for that designated as 'strategic', for PPP purposes, and clarify the notion of the "strategic sector".*
- *Amend the conditions of licensing to allow accelerated procedures for licensing, including PPP companies.*

2. CONCEPT OF PPP

One of the key issues raised by different stake-holders during the meetings in Kyiv is the fact that the concept of "PPP" in Ukraine needs to be clarified. The concept of PPP appears unclear as to its exact meaning and some would include privatizations and public procurement of goods and services in the scope of PPP. This Report thus begins by proposing clear boundaries for the concept of PPP, based on international practice.

It should first be noted that there is no simple definition of the concept of PPP as the term "Public-Private Partnership" is itself very broad and may cover many kinds of partnership between the private sector and the public sector.

International best practice has progressively refined the concept of PPP thanks to the efforts of major international institutions such as the European Union Commission or the United Nations Commission on International Trade Law ("**UNCITRAL**"). Such definitions are now generally acknowledged by international PPP players (e.g. sponsors, banks, development institutions) as standard definitions for PPPs and will be developed in the present Section.

2.1 European Commission Definition of "PPP"

The European Commission Green Paper on Public-Private Partnerships and Community Law on Public Contracts and Concessions (the "**EU PPP Green Paper**") published in 2004⁵ defines PPP as different "*forms of cooperation between public authorities and the world of business which aim to ensure the **funding, construction, renovation, management or maintenance of an infrastructure or the provision of a service.***"⁶

The EU PPP Green Paper lists four elements which usually characterise PPPs⁷:

- (i) The relatively **long duration of the relationship**, involving cooperation between the public partner and the private partner on different aspects of a planned project;
- (ii) The **method of funding the project**, in part from the private sector, sometimes by means of complex arrangements between the various players. Nonetheless, public funds - in some cases rather substantial - may be added to the private funds;
- (iii) The **important role of the economic operator**, who participates at different stages in the project (design, completion, implementation, funding). The public partner concentrates primarily on defining the objectives to be attained in terms of public interest, quality of services provided and pricing policy, and it takes responsibility for monitoring compliance with these objectives; and
- (iv) The **distribution of risks between the public partner and the private partner**, to whom the risks generally borne by the public sector are transferred. However, a PPP does not necessarily mean that the private partner assumes all the risks, or even the major share of the risks linked to the project. The precise distribution of risk is determined case by case, according to the respective ability of the parties concerned to assess, control and cope with this risk.

⁵ *European Commission Green Paper on public-private partnerships and community law on public contracts and concessions*, COM (2004) 327 final, 30.4.2004

⁶ EU PPP Green Paper, p. 3.

⁷ *idem.*

According to the EU PPP Green Paper, PPPs *per se* are not regulated by EU legislation and shall therefore be governed by general principles of the EU Treaty and/or EU rules on public works contracts or concessions.

In its communication *on Public-Private Partnerships and Community Law on Public Procurement and Concessions* published in 2005⁸, the EU Commission reiterated that there was no need for a specific PPP legislation at EU level as it considered that PPPs shall be governed by either the EU legislation on public contracts or on concessions, as follows:

- (i) Further to the general principles of the EU Treaty, **public works contracts, public supply contracts and public services contracts** are governed by Directive 2004/18/EC⁹ and Directive 2004/17/EC¹⁰; and
- (ii) As for **concessions**, the EU PPP Green Paper states that "*the rules governing the award of services concessions apply only by reference to the principles resulting from Articles 43 and 49 of the Treaty, in particular the principles of transparency, equality of treatment, proportionality and mutual recognition*".¹¹ In other words, no specific EU legislation exists on concessions, even though the EU Commission has been considering preparing new rules to clarify the award of concessions since 2005.¹²

In order to evaluate which legal regime is applicable between the public works regime and the concession regime, the "key criterion" according to the EU Commission is whether or not "*the risks arising from the operation of the concession are transferred to the concessionaire with the right of exploitation*".¹³ In short, if the operation risk is borne by the private partner, the contract is a concession and the corresponding legislation shall apply. Alternatively, if the operation risk is borne by the public partner, the contract is a public works contract.

By way of example, the French Partnership Contracts¹⁴ are considered by EU standards as public works, whereas a distinct so-called "public works" legislative regime already exists in France, which may prove to be confusing. It also demonstrates the extent to which several legislative and regulation layers co-exist, designating different things by the same name, adding to the complexity and sometimes rigidity of the PPP legislative framework in EU countries.

The above elements demonstrate that EU PPP practice is especially complex as it implies the interaction of EU public works and services directives and the Treaty of Rome, combined with policy papers on concessions and PPPs, as further provided in the

⁸ *Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions on Public-Private Partnerships and Community Law on Public Procurement and Concessions*, Brussels, 15.11.2005 COM(2005) 569 final

⁹ Directive 2004/18/EC of the European Parliament and of Council of March 31st, 2004 relating to the coordination of procedures for the award of public works, supply and services contracts

¹⁰ Directive 2004/17/EC of the European Parliament and of the Council of March 31st, 2004 relating to the coordination of procedures for the award of contracts in the water, energy, transport and postal services sectors

¹¹ EU PPP Green Paper (p. 11). The EU Commission then refines the rules resulting from the Treaty applicable to concessions as follows: "*fixing of the rules applicable to the selection of the private partner, adequate advertising of the intention to award a concession and of the rules governing the selection in order to be able to monitor impartiality throughout the procedure, introduction of genuine competition between operators with a potential interest and/or who can guarantee completion of the tasks in question, compliance with the principle of equality of treatment of all participants throughout the procedure, selection on the basis of objective, non-discriminatory criteria*".

¹² COM(2005) 569 final, (p. 4)

¹³ *Commission Interpretative Communication on Concessions under Community Law*, (2000/C 121/02), 29 April 2000 (p. 3)

¹⁴ Established by the Ordonnance n° 2004-559 du 17 juin 2004 *sur les contrats de partenariat*

aforementioned EU Green Paper. For this reason, and even though we believe it is important for Ukraine to bear in mind the EU interpretation of the concept of PPP in view of a future potential EU membership, we also believe that the EU definition of PPP is too specific to be easily transposed in Ukraine, hence the necessity to look at alternative definitions such as UNCITRAL's, as further discussed below.

2.2 UNCITRAL definition of "Privately Financed Infrastructure Projects"

In its *Model Legislative Provisions on Privately Financed Infrastructure Projects* (the "**UNCITRAL Report**"), UNCITRAL pays special attention to "*infrastructure projects that involve an obligation, on the part of the selected investors, to undertake physical construction, repair or expansion works in exchange for the right to charge a price, either to the public or to a public authority, for the use of the infrastructure facility or for the services it generates.*"¹⁵

By "infrastructure", UNCITRAL targets what it calls "*public infrastructures*" which it defines as "*physical facilities that provide services essential to the general public*" which in short refers to the notion of "**public service**" well known to most civil law countries.

The UNCITRAL definition includes different forms of contracts which are well known to international PPP players, such as concessions¹⁶, licences, leases ("affermage"), Build-operate-transfer (BOT)¹⁷, Build-transfer-operate (BTO)¹⁸, Build-rent-operate-transfer (BROT)¹⁹, Build-own-operate-transfer (BOOT)²⁰, Build-own-operate (BOO)²¹, etc.

Because public works do not imply the performance of a public service, they are generally not included in the definition of PPP and their regime is subject to specific public procurement legislation.

Privatisation, meaning the sale of shares or assets of publicly owned companies, is also not a form of PPP as it amounts to divestiture by the State, rather than partnership.

Furthermore, UNCITRAL expressly excludes projects for the exploitation of natural resources, such as mining, oil or gas exploitation projects even if they are performed under licence or concession issued by public authorities.²² The rationale behind such exclusion is that mining, oil or gas exploitation projects do not imply the performance of a public service, as defined above. Further, such projects are generally subject to a distinct legislation with specific provisions governing tender, exploration phase, operation phase, terms of the contract, revenues, tariffs etc.

¹⁵ UNCITRAL Model Legislative Provisions on Privately Financed Infrastructure Projects, 2003, p. 3.

¹⁶ A Concession usually consists in the provision of a public service by an entity other than a public authority and which typically requires an act of authorization by the appropriate governmental body.

¹⁷ An infrastructure project is said to be a BOT project when the contracting authority selects a concessionaire to finance and construct an infrastructure facility or system and gives the entity the right to operate it commercially for a certain period, at the end of which the facility is transferred to the contracting authority.

¹⁸ This expression is sometimes used to emphasize that the infrastructure facility becomes the property of the contracting authority immediately upon its completion, the concessionaire being awarded the right to operate the facility for a certain period.

¹⁹ These are variations of BOT or BTO projects where, in addition to the obligations and other terms usual to BOT projects, the concessionaire rents the physical assets on which the facility is located for the duration of the agreement.

²⁰ These are projects in which a concessionaire is engaged for the financing, construction, operation and maintenance of a given infrastructure facility in exchange for the right to collect fees and other charges from its users. Under this arrangement the private entity owns the facility and its assets until it is transferred to the contracting authority.

²¹ This expression refers to projects where the concessionaire owns the facility permanently and is not under an obligation to transfer it back to the contracting authority.

²² Idem.

In our experience, the UNCITRAL definition of "*Privately Financed Infrastructure Projects*" has progressively become the international standard definition for PPP, and is widely used by governments for their PPP framework. As such, the UNCITRAL definition can be considered as "standard" definition of PPP and our recommendations in the present Section will be based on such interpretation.

3. COMMENTS AND RECOMMENDATIONS ON UKRAINIAN PPP FRAMEWORK

The present section's objective is to provide our comments and recommendations on the existing Ukrainian PPP framework. Our comments will be based on international best practice as well as on our experience in past projects in Ukraine. Our work in this section will be structured basing on the selected core areas used by EBRD (as detailed in Schedule 1).

3.1 Preliminary comments on the Ukrainian PPP Framework

In the EBRD PPP Report published in July 2008, we considered that the Ukrainian PPP regulatory framework was in "medium compliance" with international best PPP practice. In particular, we made the following comment thereon:

"A policy framework for improving the legal environment and promoting PPP has not been identified in Ukraine.

The Ukraine Concession Law was adopted in 1999. The Economic Code of Ukraine dated 2003 also contains provisions on concessions (Chapter 40).

Numerous amendments to the Decision of the Cabinet of Ministers of Ukraine "On Confirmation of the List of the Objects of State Ownership which may be given into concession" have taken place since 2006. The most recent amendments were made on 15 March 2006. "Amendments to the Law of Ukraine 'On Concessions' concerning the specifics of application of concession contracts with regard to the objects of the State or communal ownership, that are used for realisation of centralised water and heat supply and water discharge activity", on "Concessions on Construction and Exploitation of Highways", on "Distinctions of Transfer into Concession of the Objects of Heating Supply, that are in Communal Ownership", "On Distinctions of Transfer into Concession of the Objects of Water Supply and Water Discharge, that are in Communal Ownership" was put before the Verkhovna Rada of Ukraine and either accepted or rejected by the Parliament of Ukraine in 2007. At the time of writing, the review of the Draft Law by the Parliament of Ukraine is postponed because of the dissolution of the Verkhovna Rada of Ukraine.

The Law as it currently stands clearly defines its scope of application. It would be advisable to develop in the Law or, as an implementing regulation, clearer and more detailed tender rules (with principles of transparency, non - discrimination, proportionality and efficiency, clear regulation of the pre-selection procedure and of review procedures). The identification and collaboration between different public entities involved could be improved.

The provisions regulating the PPP agreement give relatively clear guidance on the main issues to be covered, and they remain sufficiently flexible to allow the parties to freely negotiate its terms (existence of a model PPP agreement the use of which is optional).

The Law should place an emphasis on lenders' requirements with respect to security and step-in provisions (not regulated at this stage). We note the possibility of obtaining government support for the concessionaire "of disadvantageous and low-profit concession objects."

Thus, the Law constitutes a relatively solid legal basis for the development of PPP in infrastructure and utility services. Certain improvements may however be required."

Since the publication of the latest EBRD PPP Report in 2008, a number of changes were introduced to the Ukrainian PPP framework. In particular:

- (i) Adoption of the Law "On State-Private Partnership" No. 2404-VI on 1st July 2010 and came into force on 31st October 2010 (the "**PPP Law**").
- (ii) Adoption of the Law of Ukraine "On the National Commission for Regulation of the Utility Services Market of Ukraine", No. 2592-VI, October 10, 2010;
- (iii) Adoption of the Law of Ukraine "On Peculiarities of Leasing Out or Giving in Concession of Communal Facilities of District Water and Heat Supply and Sanitation" No. 2624-VI dated October 21, 2010 (the "**Law On Lease and Concession of the Infrastructure**");
- (iv) Adoption of the Regulation by the Cabinet of Ministers of Ukraine "On Approval of the Rules for Reporting by the Private Partner on Execution of the PPP Contract" No. 81, dated February 9, 2011 (the "**Regulation 81**").
- (v) Adoption of the Regulation by the Cabinet of Ministers of Ukraine "On Approval of the Methodology of Risks related to PPP, Evaluation Thereof and Identification of Ways to Manage the Risks" No. 232, dated February 16, 2011 (the "**Regulation 232**").
- (vi) Adoption of the Regulation by the Cabinet of Ministers of Ukraine "On Approval of the Procedure for Providing State Support for PPP" No. 279, March 17, 2011 (the "**Regulation No. 279**");
- (vii) Adoption of the Regulation by the Cabinet of Ministers of Ukraine "On Certain Issues of Implementing PPP" No. 384, April 11, 2011 (the "**Regulation No. 384**"); and

No clear policy statement or strategy of Government support for PPP at the country level has otherwise been made however. International experience is such that the mere existence of PPP laws, without clear government commitment to PPPs, is often not sufficient for a robust PPP program. Experience suggests also that a proactive Government policy to stimulate PPP projects can be a decisive factor in the competition for foreign investment in such projects.

There are no general rules how to design the PPP policy in the country, Ukraine should adopt a realistic and consistent PPP policy based on its particular situation and needs. Ideally, Ukraine's publicly expressed commitment to private sector participation in PPP projects should meet three objectives:

- Convince the private sponsors, investors and lenders that the Government is firmly committed to PPP projects;
- Disseminate information on private sector involvement in infrastructure services and gain public acceptance for this involvement; and
- Ensure the support of interested stakeholders in Ukraine for private sector involvement in what have traditionally been public sector projects and services.

In addition, it is important to let private investors and their lenders know that not only the Ukrainian Government is committed as a matter of policy to private sector participation in infrastructure development, but also that the Government has a strong rationale for supporting particular PPP projects and is not likely to withdraw that support, delay the project or renounce to its obligations. This rationale, in terms of both financial and technical approach, should be clearly and convincingly defined.

3.1.1 General PPP Legal Framework

In accordance with its Article 5, the PPP Law is a legislative framework applicable to all forms of PPP, including concession agreements, joint venture agreements, product sharing agreements, and other agreements (in particular leasing or property management agreements). Each of the said agreements is regulated by a separate law.

Rather than asserting prevailing force of its provisions, the PPP Law refers interested parties to other laws for rules and regulations. Therefore, while considering a form of PPP for the project's implementation, partners usually need to refer to numerous legislative acts that often contradict each other, as shall be further discussed below.

To add even more confusion, at the local level, PPP projects are regulated by various decisions of numerous self-governing authorities. As a result, we believe that the number of PPP related laws and the contradictions among them serve to make PPPs more difficult to implement in Ukraine.

This Report shall describe the most common contradictions and inconsistencies, as well as possible solutions. Such important inconsistencies include:

- (i) The possibility for the parties to set tariffs and adjustments under the PPP agreement *versus* the relevant authority's right to approve the tariffs at a level below what is considered economically sound;
- (ii) The regulator's obligation to compensate the difference between established tariffs and economically sound levels *versus* the absence of powers to introduce such compensations into the State's budget; and
- (iii) The obligation to include State support in the annual budget *versus* the possibility to refuse to include the said amount during the vote of the respective law or decision.

Further, the PPP Law also establishes many rules that cannot, in practice, be implemented because other legislative acts forbid it (i.e. creating unregistered servitudes on behalf of the public partner).

3.1.2 Institutional Framework for PPP projects

Ukrainian legislation does not provide for any single authority responsible for support of PPP projects. In contrast, several authorities at the State and municipal levels are empowered to control, issue authorisations, and verify the implementation of PPP projects, as shown below.

(a) State Agency for Investments and Management and National Projects of Ukraine (SAINP)²³

SAINP's core responsibility includes the elaboration of public policies in order to attract foreign investments as well as the preparation and implementation of so-called "National Projects", which may, of course, involve certain forms of PPPs. SAINP is also responsible for preparing amendments and draft regulations to improve PPP legislation.

We believe that SAINP should concentrate on foreign investment and on the investments made under the National Project program, and should closely follow up their implementation. It should also be responsible for the technical issues related to such investments (i.e. receiving the relevant permits and approvals) through "regional investment centers." Regional investment centers' functions are to implement the "one window" principle for all public formalities related to investments projects, including, notably, PPPs.

At the same time, during our meeting with the SAINP's representative, he mentioned that overlapping between their functions and that of the MOEDT considerably complicated the identification of the responsible authority. However, they expect that once the ongoing administrative reform is completed, the final division between the different authorities' competence will be defined more clearly.

(b) Role of the MOEDT

The MOEDT plays a role of a specially designated authority in the field of PPP projects in Ukraine.²⁴ Its responsibilities include in particular preparation and implementation of PPP policy, as well as any modification to the legislation in force. Additionally, it aims at facilitating both state and municipal PPP implementation. It enjoys extensive powers with regard to PPP projects involving the State, including, but not limited to: analysis of the efficiency of the projects, supervising the projects, initiating lawsuits against the private partner, taking part in out-of-court settlements between the partners, etc.

At the same time, its prerogatives concerning the supervision of PPP projects concluded by the self-governing authorities are limited, and can be seen as recommendations only.

(c) Other governmental authorities

Under Ukrainian legislation, other Ministries and the State Property Fund may also control the implementation of PPP projects by (i) controlling the public partner, if it is subordinated to such authorities, (ii) approving tender documentation and (ii) issuing various permits and approvals. As an illustration, the Ministry of Infrastructure is responsible for approving the concession tender documentation for road related PPP projects. Further, the Ministry of Finance is responsible for the verification of the status of the project when state financing is required.

When the private partner receives state support, a distinct procedure is established to control the governmental financial authorities' disposal of State funds.

²³ Order of the President of Ukraine dated May 12, 2011 "On the State Agency for Investments and Management of National Projects of Ukraine".

²⁴ The Decree of the President of Ukraine "On the Ministry of Economic and Trade of Ukraine" No. 634/2011, dated May 31, 2011.

At the local level, self-governing authorities are responsible for preparing legal documents concerning the support to the private partner, and thus may foresee the right to control the activities.

(d) National Commission On Public Utility Services²⁵

According to the Law of Ukraine "On the National Commission for regulation of the utility services market of Ukraine ", the National Commission of Utility Services Market Regulation (the "**Commission**") was formed to institute state policy on sectors performing utility services (centralized heating and water supply). Under the said regulation, until the new authority is formed, the rights and obligations were given to the National Commission for Electricity Regulations ("**NERC**"). On July 8, 2011, the President of Ukraine ordered the creation of the Commission. The Cabinet of Ministers of Ukraine (the "**CMU**") was required to prepare the regulation detailing the internal structure of the Commission. All NERC regulations adopted earlier are effective for the Commission.

The Commission is responsible for issuing licenses to providers, distributors, and utilities producers, carriers and distributors of water, heating, sewage, as well as setting tariffs to the entities to which it issued a license. It must also prepare licensing conditions, control their implementation, and impose potential fines.

To perform the above-mentioned functions, the Commission issues resolutions and regulations. Such resolutions and regulations are mandatory for natural monopolies and commercial entities that take the form of utility services market players. The Commission operates through its state and regional offices.

3.1.3 Recommendations

- ***adopt a clear policy framework and PPP strategy where the Government underlines its commitment to PPPs, implements the legislative changes proposed and ideally proposes a list of pilot projects***
- ***consider simplifying the general PPP framework by abrogating the Concession Law and the sector-specific laws so that a single PPP Law applies to all PPP projects or amend the legislation to the effect that whenever the PPP Law grants specific rights and privileges, which are neither provided for, nor disallowed by other legislative acts, such provisions must prevail over any other rules and regulations.***
- ***clearly identify and define the powers of government institutions and agencies involved at all stages of the PPP process on both state and local level: from initiation of the PPP project up to its implementation and monitoring; and the entities that may enter into PPP agreement as contracting authorities.***
- ***remove the requirement that self-governing authorities seek approval from the governmental authorities since this contradicts the principles of self-governance. However, if state support is required under the contract, then, the relevant State agency should be involved during all the stages.***

²⁵ Order of the President of Ukraine dated July 8, 2011 "On establishment of the National Commission on Regulation of Public Utility Services in Ukraine".

3.2 Definitions and Scope of the PPP Law

3.2.1 Presentation

The PPP Law defines PPP as a *cooperation between the State of Ukraine, the Autonomous Republic of Crimea, or territorial communities, as represented by respective state or local self-government authorities, (public partners) and legal entities, other than state or municipally owned companies, or individual entrepreneurs (private partners) implemented on a contractual basis in the manner prescribed by this Law and other laws.*"

The above definition is very broad. Basically, because there is no exhaustive list of PPP agreements, any contractual cooperation between governmental authorities and private investors could be considered as PPP, including public procurement.

The PPP Law does not clearly distinguish between PPP and public procurement even though it mentions risks sharing. Such an ambiguous definition of PPP leads to the misconception of the aim and nature of the projects, and results in the lack of public and political support.

3.2.2 Eligible sectors

The PPP Law provides for a non-exhaustive list of sectors where PPP implementation may occur. Consequently, PPP implementation may happen in any sector of activity. The only exceptions include business activities which, under the law, may only be carried-out by state enterprises, institutions, and organizations (i.e. national security, defence enterprises, etc). Such an exception also encompasses privatizations that may not be subject to any PPP arrangements.

3.2.3 Scope of authority to award PPP agreements

Depending on the nature of the property, state or local, a decision pertaining to a PPP project should be taken by different entities. With regard to state owned property, such decision-making should be in the hands of the CMU or a special government body empowered by the CMU, while, with regard to municipally owned property, it should be local self-governing authorities (i.e. city/town/village council²⁶). The special body empowered by the council of ministers of the ARC decides on PPP projects as regards the property of the ARC. Such decisions should be adopted during, respectively, a session of the CMU or that of the appropriate council.²⁷ Further, such a decision should designate the authorized representative responsible for the PPP project. At the same time, the said authorities should receive the following approvals/authorizations in order to launch a PPP project, hold a tender, or enter into a PPP agreement:

(a) Approval of tender documentation

Depending on the nature of the activity subject to the concession or PPP, tender documentation conditions should be reviewed by different authorities. For instance, the Ministry of Housing and Utilities should be the competent authority to approve tender conditions concerning concessions or leases of heating and water supply, as well as sewage infrastructures. Further, the Ministry of Infrastructure should be the competent authority to approve tender conditions pertaining to motor roads concessions.²⁸ Lastly, under the

²⁶ The Law of Ukraine "On Local Governance" No. 280, dated May 21, 1996

²⁷ Article 10 of the PPP Law and Article 6 of the Concession Law

²⁸ Article 3 of the Motor Roads' concession Law

Law on Concession of Highways,²⁹ approval should be given pursuant to the procedure established by the CMU. However, because no procedure has been set-up, there is a risk of delays when considering tender documentation conditions.

(b) Selection of the winner

The decision on a PPP project should be adopted either by the CMU, its authorized representative, self-governing authority (including the Cabinet of Ministers of the Autonomic Republic of Crimea), or its authorized representative based on the results of a PPP tender.

(c) Approvals for concluding a PPP agreement

Before concluding the PPP agreement, the public partner should send the draft of the PPP agreement to the MOEDT for approval. The agreement may be concluded either by the representative of the CMU, or a representative of a self-governing authority.

The legislation does not provide for any correlation with regard to the approvals from different Ministries, moreover, the approval given by one Ministry may not guarantee approval from another.

At the same time, the powers of the Ministries (governmental authorities) to influence PPP projects initiated by the self-governance authority are very ambiguous. Indeed, Article 71 of the Law of Ukraine On Local Governance provides that the governmental authorities may intervene into the area of responsibilities of the self-governing authorities only if it is provided for by the law." Pursuant to Article 14 of the Law of Ukraine "Law On Lease and Concession of the Infrastructure," the public partner should agree on the tender conditions with the Ministry of Housing and Utilities, and Article 3 of the Highways Concession Law provides that the tender conditions should be approved by the Ministry of Infrastructure. In such a case, cooperation between the authorities is based on coordination rather than on subordination. In principle, self-governance authorities may adopt a decision which does not comply with the recommendation of the Ministry, however, as a results it may be refused state support for the PPP.

Yet, the requirement of Regulation No. 384 that imposes the self-governing authorities to receive prior approval from the MOEDT when entering a PPP agreement contradicts with the Law of Ukraine On Local Governance.

(d) Subsequent registrations

The concluded PPP agreements are subject to registration:

- (i) PPP agreement should be registered with the MOEDT³⁰;
- (ii) concession agreements over state property should be registered with the State Property Fund³¹ by means of receiving a notification on execution of the agreement from the public partner;

²⁹ Article 3 of the Law on Concession of Highways

³⁰ Regulation No. 384

³¹ Article 10 of the Law On Lease and Concession of the Infrastructure

- (iii) concession agreements over municipal property should be registered with the respective self-governance authority which should notify the State Property Fund about the registration;
- (iv) lease and concession agreements over water supply, sewage and heating infrastructure are subject to registration with the Ministry of Housing and Utilities. The Ministry of Housing and Utilities then delivers a copy of the registered agreement to the State Property Fund.

Regulation No. 384 provides for generally applicable rules and does not provide for any exceptions with regard to registration of concession agreements and lease agreements over water supply, sewage and heating infrastructure. Regulation No. 384 does not apply to PPP in relation to tender rules if a different procedure is provided for by law. However, certain tender procedures and rules for registration are established by orders, regulations and, therefore, it is not clear which procedure should apply.

3.2.4 Power of public authorities to delegate functions and responsibilities to the PPP company

Article 4 of the PPP Law provides that under the PPP agreement the public partner may delegate the functions related to: construction, financing, design, renovation, modernization, development, operation, studying, and other functions required for performance under the PPP agreement.

Ukrainian legislation does not foresee any limitations with regard to utilities supplied by private companies (if the PPP project can be implemented in a particular field). Before the adoption of the Law On Lease and Concession of the Infrastructure, Ukrainian legislation did not authorize the private partner (lessee) to operate heating, water supply, and sewage for the purposes of utilities services supply under a lease agreement. He would receive such right only upon conclusion of separate services (operational) agreement. For instance, this concept was used in the Odessa project where infrastructure lease agreements and operation agreements (for utilities supply) were concluded. However, after adoption of the Law On Lease and Concession of the Infrastructure, the lease agreement automatically foresees the right to operate the infrastructure for the purposes of utilities services supply. However, the right to operate does not allow rendering services to consumers and invoicing them. In practice, upon liquidation of the municipal or state services provider, the PPP company may not be regarded as its legal successor and, therefore, the issue of conclusion of new utilities agreement with the consumer arises.

Further, if, under the PPP agreement (i) the operation and/or management of electric power lines, pipelines, and other communication lines by the private partner is required; and (ii) the respective right is established by the servitude in the name of the public partner, then such servitude may be exercised by the private partner³² on behalf of the public partner. However, Article 401 of the Civil Code states that the servitude is (i) either a personal property right that may not be alienated; or (ii) is attached to the land plot and may be alienated only together with the land plot (right to use the land plot). Further, Article 101 of the Land Code provides that servitude may not be transferred to any third person. Therefore, this provision of the PPP Law is only declarative, and in practice, the private partner would be obliged to undertake all the formalities related to the formalization of a servitude in its own name.

³² Article 8 of the PPP Law

3.2.5 Definition of the private partner

The PPP Law does not provide for any limitations with regard to the individual/legal entity that may be regarded as a private partner (limited liability partners, joint stock companies, etc). Further, several legal entities may jointly represent the private partner. The PPP Law explicitly provides that foreign and Ukrainian business entities shall enjoy equal rights concerning to participation in PPP procurements.

However, from a practical point of view, it is recommended for the foreign private partner to incorporate the legal entities in Ukraine for the following reasons:

- (i) any services rendered in Ukraine under a contract with the effective term exceeding 6 month within any 12 month period³³ creates the foreign company's permanent establishment³⁴, and thus all income received in Ukraine shall be taxed in Ukraine;
- (ii) only Ukrainian legal entities or representative offices may receive licenses due to the specific requirement to provide documents issued at the time of registration of the legal entity or the representative office in Ukraine; and
- (iii) certain legislative acts clearly require the activity to be conducted only by a legal entity.³⁵

Further, it is recommended to incorporate a legal entity rather than only a representative office of the foreign company in Ukraine. In practice, it is complicated to receive a license for the representative office and impossible for a legal company incorporated outside Ukraine.

From a practical perspective, the private partner's Ukrainian subsidiary should be established before the tender or the project's commencement, since the winner of the tender should enter into agreement. Unlike in most best practice PPP laws, Ukrainian legislation does not provide the right for the parent company or consortium to participate in the tender under the condition that in event of success it will establish a Ukrainian subsidiary which will further enter into PPP agreement. Moreover, there is a risk that such agreement may be challenged based on the fact that the company which enters into PPP agreement was not chosen on competitive basis.

3.2.6 Recommendation:

- ***provide for the possibility for parent companies (private partner) or consortium to participate in the tender under the condition that, subsequently to winning the bid, the parent company or consortium establishes a Ukrainian incorporated company for the project's implementation.***

3.3 Selection of the Private Partner

3.3.1 General

A special tender procedure is established for PPP projects.³⁶ Under the PPP Law, the private partner should be selected on a competitive basis unless otherwise provided by the law.

³³ Unless another is provided

³⁴ which among the other means obligation to register with the tax inspector as a payer of taxes in Ukraine

³⁵ The Law of Ukraine "On Potable Water" provides that water supply and sewage services may be done only by the legal entity

The tender procedure is required notwithstanding who initiated the project (private or public).

A tender is not required for lease and concession agreements over heating or water supply infrastructure if the project is held within one village. The same rule applies to leases if the private partner is the entity created by the former employees of a municipal company. This entity has a pre-emptive right for entering into lease agreements. We recommend that these exceptions be removed.

Resolution No. 384 and the PPP Law provide that the established procedure is not applicable to PPP projects where a separate procedure is established by the law. The main steps of the separate procedures are provided by the Concession Law (general tender regulation with regard to all concession agreement) and Law on Lease and Concession of the Infrastructure (tender procedure applicable only to lease and concession of the heating, water supply and sewage infrastructure). At the same time, the tender for Highway concession projects is established by a CMU regulation. A separate tender procedure is established for the PPP projects in fuel and energy industry by the Order of the Ministry of Energy and Fuels of Ukraine.³⁷ There is a risk that the results of the tender held pursuant to a different regulation and order will be disputed on formalistic grounds because these procedures are not established by the PPP Law and, therefore, the rules set in the Regulation No. 384 should apply.

In principle, the different concession laws, regulation and orders provide for the same stages during the tender process. However, certain peculiarities arise concerning how the winning bidder is announced, the authorities approving tender documentation, etc. The tender conditions for the lease and concession projects in water, heating supply, and sewage should be approved by the Ministry of Housing and Utilities, and those for other PPP projects - by the MOEDT.

Under the Regulation No. 384, the tender should include the following stages:

- (i) adoption of the decision on launching PPP project;
- (ii) informing potential bidders about the tender. The respective information should be posted on the web-site of the public partner and the Ministry of Economy or other responsible authority³⁸ and in local printed mass media and news paper "Golos Ukrainy" and "Uryadovyi Kuryer". It should be done at least one (1) month prior to the deadline for the submission of tender applications by bidders³⁹. The announcement should include general information about the tender (type of agreement, PPP object, deadlines for submitting proposals, etc);
- (iii) the public partner should concurrently form a tender committee. The tender committee is responsible for selecting the winner;
- (iv) when the information concerning the tender is available in print, mass media bidders may submit their applications. Please note that the regulation sets an exhaustive list of

³⁶ Article 1 of the Regulation of the Cabinet of Ministers "On Certain Issues Related to PPP"

³⁷ The Order of the Ministry of Energy and Fuels of Ukraine "On Approval of the Procedure of Consideration of Projects for Development of the Fuel and Energy Industry that are owned by the State under Lease or Concession"

³⁸ The Ministry of Housing and Utilities

³⁹ Article 18 of the Regulation of the Cabinet of Ministers "On Certain Issues Related to PPP"

documents to be provided by the bidder. If the bidder is represented by several companies, they should submit only one application;

- (v) the tender committee makes a preliminary selection of the list of bidders that are allowed to participate in the tender because they correspond to the established requirements, and then informs the public partner who should transfer the said information to the successful bidders. At this stage, bidders may receive more information about the PPP object and should submit their tender propositions;
- (vi) the tender committee analyses the tender propositions, defines the winner, and prepares the protocol concerning the tender and its results. The regulation provides for a list of criteria to be considered by the tender committee;
- (vii) the tender protocol should be approved by the public partner (within 1 day);
- (viii) the approved tender protocol should be sent by the public partner to the MOEDT;
- (ix) the information about the tender should be posted on the web-site of the public partner and through mass media;
- (x) the MOEDT should then approve the draft PPP agreement (within 30 days); and
- (xi) the public partner finally signs the agreement with the private partner.

Regulation No. 384 provides for detailed requirements to the tender documentation to be prepared for holding the tender as well as a detailed description of criteria for selecting winners of the tender, whereas other legislation (including the Concession Law and the Law On Lease and Concession of the Infrastructure, etc) provides for only general description of the procedure and the required criteria. However, the authorities may use these regulations as a basis for any other concession or lease project. Most of other tender procedures indicate that the soundest bid economically should be selected as the winner, while Regulation No.384 contains more specific requirements on the evaluation procedure. However, contrary to international best practice, Ukrainian legislation does not provide the possibility for the private partner to indicate and does not oblige a tender committee to consider the parent company's past projects and experience during the tender application process to confirm the application's quality and experience.

Regulation No. 384 also provides for the obligation of the tender committee to publish the information concerning the propositions that were adopted as well as the propositions that were rejected. The information should also contain the reasoning that justified such decision-making.

3.3.2 Recommendations:

- ***to provide for a unified procedure for private party selection for all PPP agreements irrespective of the legislation under which they fall (the criteria for choosing the winner will vary for each PPP).***
- ***the private partner (Ukrainian subsidiary) should have the possibility to indicate the parent company's and past projects and experience during the tender application process to confirm the application's quality and experience.***

3.4 Project Agreement

3.4.1 Presentation

The PPP Law provides for a non-exhaustive list of types of PPP agreements that may be concluded, including notably: concessions, leases, joint activity agreements, production sharing agreements, etc. In practice, management and operation agreements, asset management agreements, and lease and operation agreements (used as equivalent of Rehabilitate-Own-Operate or Build-Own-Operate, Build-Operate-Transfer) are used in Ukraine for PPP projects.

In fact, Ukrainian legislation does not allow implementation of those types of PPP if the private partner receives ownership over the infrastructure. Under the PPP Law, the property transferred to the private partner and the property constructed under the project remains the ownership of the public partner.

The final decision on the type of PPP agreement should be adopted by the public partner on efficiency grounds. The most common types of cooperation between public and private partners are described below.

3.4.2 Peculiarities of the certain types of the projects

(a) Technical assistance

As a general rule, all technical assistance agreements concluded with the public partner are subject to a tender if their value is equal to or exceeds:⁴⁰ UAH 300,000 (for works) and UAH 100,000 (for services)⁴¹.

Such tender should be conducted pursuant to the provisions of the Law of Ukraine "On Public Procurement."⁴² The technical assistance option is widely used for solid waste collection and processing all over Ukraine.

(b) Operation and Maintenance Contract

Under an Operation and Maintenance Contract, the public partner grants the infrastructure to the private partner through a so-called "*trust ownership*."⁴³ The latter will own, operate, and transact with the infrastructure exclusively in the interest and for the benefit of the local/state authority.⁴⁴ Ukrainian legislation only provides for general regulation of this particular type of project and leaves room for the partners to negotiate a considerable number of issues. Under this scheme, prior approval of the public partner may be required for certain transactions (if it is provided by the PPP agreement).

The risk-sharing conditions in the Operation and Maintenance Contract are not provided by default provisions of the law. Therefore, it is highly recommended to include detailed risk-

⁴⁰ The Law of Ukraine "On Public Procurement" dated June 1, 2010

⁴¹ The authorities are obliged to publish the information about the tender in the international mass media only if the price of the works and or services equal to EUR 500,000 (for works) or EUR 300,000 (for services)

⁴² Article 6 of the PPP Law

⁴³ Under the Ukrainian conception of "*trust ownership*" a fiduciary receives a right to possess and use the property in order to achieve a goal established by the owner of the property. The title of ownership over the property may not be transferred to the fiduciary pursuant to the asset management agreement.

⁴⁴ This type of contract was concluded between Kyiv City Council and Kievvodocanal for management and operation of water infrastructure of Kiev

sharing provisions in the Operation and Maintenance Contract. Despite the limited risks of operation and maintenance companies, the Civil Code of Ukraine subjects the private partner to a rather broad liability. Pursuant to Article 1043 of the Civil Code of Ukraine, the private partner will be obliged to compensate losses caused by ineffective management. Further, it bears secondary liability for debts connected with management of the property. Therefore, the agreement should specifically foresee and stipulate the circumstances where such liability will be totally excluded or very limited.

(c) Lease

A Lease is understood as a contract pursuant to which the private partner ensures delivery of certain public services while operating the infrastructure and paying a fixed amount of fees to the public authority in exchange for the infrastructure's use. The differential between the income received from consumers and payments to the authorities should be the income of the private partner. In Ukrainian practice, the operator bears the operational risk as well as investment obligations related to capital repairs and reconstruction/construction. In particular, such obligations of the private operator were indicated as mandatory conditions for implementing a similar infrastructure development project in Odessa.⁴⁵

The major issue concerns the possibility and legality of concluding a lease agreement over certain types of infrastructure under Ukrainian law.

Ukrainian legislation provides for certain limitations with regard to the object that may be transferred into a lease. The Law of Ukraine "On Lease of State and Municipal Property" No. 2269-XI dated April 20, 1992 and the Law of Ukraine "On Privatisation of State and Municipal Property" No. 2163-III dated March 4, 1992 prohibit the following leases:

- (i) infrastructure included in so-called "*facilities securing social safety and functioning of the State in general*."⁴⁶ Yet, Ukrainian legislation does not define "*facilities securing social safety and functioning of the State in general*." Therefore, there is a risk that any lease agreement over infrastructure (except for water supply, heating, and sewage⁴⁷) may be declared invalid.
- (i) objects that are not subject to privatization. A specific list of such objects is provided by the Law of Ukraine "On the List of Objects of State Property Privatization of which is Disallowed." Moreover, the general list of such property is defined under Article 5 of the Law of Ukraine "On Privatization of State and Municipal Property."

Due to inconsistencies in Ukrainian legislation, there are cases when the object is included into the list of state property that is not subject to privatization despite no longer being state property. In this case the conclusion of a lease agreement is possible. However, there remains a risk of disputing its validity on formalistic grounds.

Please also note that lease agreements may currently not be concluded over sea ports, municipal transport, and certain other areas that are potentially of interest to investors.

⁴⁵ In Odessa project Infoxvodocanal undertook the obligation to invest a certain amount and to perform capital repair of infrastructure. The parties signed a payments schedule to the Cooperation Agreement.

⁴⁶ Article 5 Law of Ukraine "On Privatization of State and Municipal Property"

⁴⁷ The lease of these infrastructure is clearly allowed by the law of Ukraine "On Peculiarities of Leasing and Giving in Concession of Centralized Water and Heat Supply and Drainage (Sewage) Facilities Owned by Municipalities, and Peculiarities of Taking Lease and Concession of Such Facilities "

Yet, at the same time, Ukrainian legislation does not provide for any specific restrictions over the management or concession of these particular facilities.⁴⁸

Ukrainian legislation does not provide for any particular regulation for the project under Build-Operate-Transfer. In practice, these types of projects are implemented under the concession or lease options.

3.4.3 Permits and approvals in connection with PPP projects

Ukrainian legislation does not require the private partner to obtain any specific permit to enter a PPP agreement. On the other hand signing the PPP agreement does not allow the private partner to proceed with operating of infrastructure if such activity requires receiving of licenses and/or special permits. The licenses and permits issued to a municipal or state company are not transferable. The PPP company should apply for the permits to be issued in its own name.

The list of required licenses and permits depends on the scope of the private partner's activity and the PPP's sector of activity. Generally, the licenses that a private partner may receive can be divided into two main categories:

- (i) Licenses that may be issued to the private partner without any PPP agreement (i.e. a construction license issued to the company that meets the licensing requirements). In practice, companies that wish to enter into the PPP agreement already hold the required construction licenses.
- (ii) Licenses that may be issued to the private partner after the PPP agreement is concluded. In such areas as heating, water supply, and sewage, the private partner must obtain a license authorizing it to exercise the agreed activity within three (3) months following the conclusion of the PPP agreement. Please note that there is no simplified system for issuance of a license for the PPP company. The draft agreement of Lugansk Voda imposes the private partner to obtain the license following the conclusion of the agreement. Further, please bear in mind that such issuance must occur prior to the commencement of the operations.

The Concession Law provides that the private partner shall be solely responsible for procurement of all permits and licenses related to his respective area of responsibility. However, under Article 5 of the Highway Concessions law, the public partner is obliged "*to assist the concessionaire with procurement of all required permits, licenses.*" In practice, it is highly recommended to include into the respective agreement provisions detailing the form of such assistance.

3.4.4 Restrictions on the provisions permitted in a PPP agreement

Ukrainian legislation does not provide for a list of provisions which may not be included into a PPP agreement. Instead, it provides for a list of provisions, so-called mandatory conditions, without which the contract is invalid. For instance, Article 10 of the Concession law establishes the mandatory requirements applicable to concession agreements, and the conditions should be established: (i) by tender conditions; (ii) upon consent of the parties; and (iii) provisions provided by the other legislation acts (the Civil Code of Ukraine, the

⁴⁸ Foreign company may not manage the water infrastructure pursuant to the Law of Ukraine "On Potable Water and Potable Water Supply" and the Licensing Conditions

Commercial Code of Ukraine, etc). The risk of invalidity of a contract has a chilling effect on innovation and flexibility in PPPs and should be removed. *In order to secure the interests of the private partner and decrease the risk of invalidity of the agreement it is required to accumulate all mandatory conditions under the PPP Law and tender documentation.*

3.4.5 Model agreement and Essential Conditions

As of today, Ukrainian legislation provides for the following model contracts:

- (i) concession model contracts; and
- (ii) concession model contracts for highways.

In practice, all municipal authorities also have templates or model agreements for leases/concession of property.

The model agreements are not mandatory and may be used by the parties as recommendations.

Under Ukrainian legislation, any contract is valid only if it contains all the essential conditions. The essential conditions are set by the several legislative acts. In practice, for fear of the agreement's invalidity, the agreement should contain all the conditions mentioned in the different acts.

Further, the essential conditions should also be mentioned in the tender documentation, in particular in the draft of the respective PPP agreements. Yet, in practice, the authorities refuse to re-negotiate the essential conditions set in the tender documents because they may not be changed.

3.4.6 PPP company's freedom to contract with third parties

(a) General

Under the Concession law, the private partner may involve third parties to perform the services required under the concession contract. However, he shall remain responsible before the public partner with regard to the deliverables.⁴⁹

In practice, the private partner insists on including the said provisions in the PPP agreement.⁵⁰

(b) Sub-delegation

The Ukrainian legislation does not prohibit sub-delegating the right to manage (operate) the infrastructure received into concession or lease if: (i) the contract foresees transfer of exclusive rights, and (ii) the concessionaire approves the sub-delegation beforehand.

Further, Article 15-3 of the Law On Lease and Concession of the Infrastructure provides:

⁴⁹ Article 18 of the Concession Law

⁵⁰ Article 7.7 of the Draft Lugansk Concession agreement

"if the concession agreement foresees the exclusive right of the concessionary to build and operate the infrastructure it has the right to delegate the management (operation) of the heating object to a third party only upon consent of the concessioner"

The same right is provided for the lessee. The said provision may be interpreted as the right of the concessionary/lessee to sub-delegate the operation of the heating object to a third entity. Yet, at the same time, the Law On Lease and Concession of the Infrastructure explicitly prohibits to sub-delegate the "*property rights*" received under the concession agreement.⁵¹

From a practical perspective, there is an issue that arises concerning the receipt of the relevant licences. The licensing conditions for supply of heating,⁵² water supply, and sewage require the PPP company to communicate any document confirming the title of ownership or right of use over the infrastructure. Yet, due to the formalistic approach taken by licensing authorities, such documents are often understood as concession agreements or lease agreements over infrastructure. Accordingly, the private partner that receives the right to operate infrastructure on other grounds than a concession or lease agreement bears the risk of not obtaining the license.

3.4.7 Ability of the public authority to override explicit terms of PPP agreement

Article 10 of the Concession law and Article 20 of the PPP Law provide that the terms of the PPP agreement are deemed valid during the entire effective term of the concession contract, notwithstanding changes in civil and commercial legislation. In other words, the private partner's rights under the contract may not be restricted by subsequent legislation.

Further, any modification to the PPP agreement is possible so long as the parties' consent is given. The public partner does not hold any privileges in that respect.

On the other hand, pursuant to Article 20 of the PPP Law, the requirements for a concession contract should be brought into compliance with amendments in the licensing, customs, tax, environmental, public order legislation, foreign exchange rules, and "*other changes in any other field of legislation that is not based on the equality of partners.*" Yet, such a broad definition leaves the private partner's bearing of the risk almost entirely to the public partner's discretion. Such regulatory risks may include: demand, low income, currency, etc. That is the reason why the agreement should include provisions on effective risk-sharing as well as indemnification of losses incurred due to legislation changes.

3.4.8 Rights of the parties upon termination of the PPP agreement

Notwithstanding the grounds for termination of the PPP agreement or its expiration, the PPP partner is obliged to return the object of the PPP agreement to the public partner under the conditions set forth in such agreement.⁵³ The heating, water supply, and sewage

⁵¹ Article 15-2 of the Law. There is no express definition of the property rights under Ukrainian legislation, however, in practice these rights are interpreted as the right to own, use and alienate property (e.g. *sub-lease, sub-concession*). Therefore, concessionary will not be authorized to transfer the heating supply infrastructure into sub-lease or sub-concession of the Company.

⁵² Order of the Ministry of Housing and Utilities "On Approval of the Licensing Conditions for Heating Supply" No. 370, dated November 24, 2009 and the Regulation of the Cabinet of Ministers of Ukraine "On Approval of the List of Documents that should be Submitted Together with the Application for Issuance of the License for each Separate Type of Commercial Activity" dated July 4, 2001

⁵³ Article 7 of the PPP Law

object should be returned to the public partner within ten (10) days following the termination/expiration of the agreement. The agreement may provide penalties for the delays in returning the object. In the draft Lugansk Concession Agreement, a penalty was set where the private partner delayed the transfer of the PPP object.⁵⁴

The termination/expiration of the lease or concession contract over heating, water supply, or sewage infrastructure does not allow the private partner to stop supplying respective utilities until the object is transferred back to the public partner.

Pursuant to the termination/expiration of the agreement, the respective rights of the private and public partners are as follows:

(a) Rights of the private partner

- (i) after termination/expiry of lease agreement to separate the objects that were constructed at his expense and if it is expressly allowed by the contract and if they were not reimbursed through depreciation charges;
- (ii) The private partner may request compensation for early termination. He may receive the old equipment if new equipment was installed (i.e. in case of concession of heating, water supply, and sewage infrastructure);
- (iii) The private party may request compensation for the improvements consented by the lessor (i.e. heating, water supply, and sewage infrastructure leases), if it was provided under the agreement;
- (iv) The private party may request compensation for the costs of construction of new facilities if it was not compensated through depreciation charges, and if such a right was foreseen in the lease agreement;

"If the concessionaire considerably improved the property granted into concession, created the property as required under the concession contract, the principal shall be obliged to reimburse all expenses that arose in connection with substantial improvements or for the value of the created property to the extent, which was not recovered by the concessionaire as a result of the concession activities in accordance with conditions of the concession contract."

The Ukrainian legislation does not provide for any other cases of compensation for loss sustained as a result of termination.

It is important to underline that notwithstanding the grounds for termination of the PPP agreement, such termination should not result in the unjust enrichment of either party. Thus, even if termination is due to the private party's breach, it should not entail a right for the contracting authority to take over assets without making any payment to the private party. An equitable solution to deal with this issue should be allowed by the legislation. This is a key issue for "bankability" by international banks and financial institutions

Alternatively, if termination is due to the contracting authority breach, then the private party should be entitled to compensation that may reimburse other losses such as outstanding debt, equity investments and lost profits. Such items should also be included in

⁵⁴ Article 32.1 of the Draft Lugansk Concession agreement

the compensation payable upon termination for reasons of public interest, though not necessarily to the full extent.

(b) Rights of the public partner:

- (i) The public partner has the right to have the PPP object returned to it;
- (ii) The public partner may request reimbursement for the losses incurred if the private party caused the concession object's deterioration. Reimbursement shall not occur however if the private partner demonstrates that the object's deterioration or loss was not of his own doing.
- (iii) The public partner may request the postponement of the PPP agreement's termination/expiration, for a term that should not exceed three (3) months in order, to secure the supply of the needed services⁵⁵ (only in case of lease of heating, water supply, and sewage infrastructure);
- (iv) The public partner may request the payment of penalties if such were provided by the agreement.

Please note that the parties are free to foresee complementary rights and obligations under the agreement. However, during the negotiations, the public partner generally wishes to avoid any additional financial obligations, and therefore, is unwilling to add any compensation provisions under the contract.

3.4.9 Recommendations:

- ***amend the conditions of licensing to allow accelerated procedures for licensing of PPP companies.***
- ***clarify or amend the licensing conditions that restrict the private partner's right to receive licenses only on the basis of a document confirming the title to use or own the infrastructure: allow receiving licenses on the basis of any other PPP agreement providing the right to operate respective infrastructure.***
- ***amend Article 5 of the Law of Ukraine "On Privatisation of State Property" to allow the leasing of public infrastructure for PPP purposes, except if in the presence of a strategic sector and precise the notion of the "strategic sector".***
- ***foresee the possibility of equitable compensation solutions upon early termination of the PPP agreement aimed at (i) reimbursement of the private partner's reasonable loss (depending on the grounds for termination) and at (ii) avoiding the situations of unjust enrichment of either party following such termination.***
- ***amend the PPP Law so that the only mandatory conditions for PPP agreement are those required under the PPP Law and tender documentation. Remove the sanction of invalidity from PPP legislation and procedure.***
- ***clarify whether the PPP private partners' representative office has the right to apply for licenses.***

⁵⁵ Article 17 and 18 of the Law On Lease and Concession of the Infrastructure

3.5 **Security and Support Issues**

3.5.1 **Possibility to take security interests over public assets in the PPP**

Generally, the property in PPP projects can fall in two different categories: (i) property that may not be privatized (property transferred to the private partner, or property that should be created/bought and then transferred to the public partner during the PPP), and (ii) property of the private partner (e.g. property of the private partner created along the right of way, etc). Ukrainian legislation does not restrict the issuance of securities on the private partner's property, nor on the public partner's property where that property is disconnected with the PPP and may be privatized.

However, public assets related to the project may not be transferred into private ownership within the effective period of the project.⁵⁶ Thus, the public partner, as well as the private partner, are prohibited from alienating assets transferred/created under a PPP project to any third persons, even to finance its obligations before lenders.

Yet, Ukrainian legislation does not prohibit mortgage and pledge over other property (not related to the project) of the public partner if the following general limitations concerning security interests over public assets are met:

- (i) the mortgage of public assets requires prior approval by governmental authority controlling the owner of such assets;⁵⁷ the same rule applies to movable property pledges, except for assets controlled by state enterprises;⁵⁸
- (ii) state-owned assets that are not subject to privatization should not be pledged or mortgaged. However state enterprises which may not be privatized are authorized to pledge their movable property;⁵⁹
- (iii) it is prohibited to pledge objects of cultural heritage registered with the State Register of National Heritage;
- (iv) sales of mortgaged assets should be performed in accordance with specific provisions of the Law of Ukraine "On privatization of small state enterprises" and the Law of Ukraine "On peculiarities of privatization of unfinished construction objects" (i.e. as a rule through the special tender).

Further, the right to lease municipal or state land property cannot be mortgaged.

Moreover, securities are valid towards third persons only if properly registered with public registers, such registration being a pre-condition for its priority over other creditors' claims.⁶⁰ However, it is currently not possible to register a mortgage over unfinished

⁵⁶ See, *inter alia*, Article 3 and Article 7 of the Law.

⁵⁷ Article 14 of the Law of Ukraine "On mortgage".

⁵⁸ Article 11 of the Law of Ukraine "On pledge".

⁵⁹ Article 4 of the Law of Ukraine "On pledge"; Article 14 of the Law of Ukraine "On mortgage". Respective assets are listed in the Article 5 of the Law of Ukraine "On privatization of state-owned property", the Law of Ukraine "On the list of objects of state-owned property which are not liable to privatization", the Law of Ukraine "On the list of cultural heritage, which is not liable to privatization".

⁶⁰ Article 4 of the Law of Ukraine "On mortgage"; Article 15 of the Law on Ukraine "On pledge"; Article 12 of the Law of Ukraine "On security interests of creditors and registration of encumbrances". There are two public registers currently functioning in Ukraine: the State Registry of Movable Property Encumbrances and the Unified State Registry of Prohibitions

constructions and the entire property complex of an enterprise.⁶¹ Therefore, on purely formalistic grounds, formalization of the mortgage was rendered impossible. However, on January 1, 2012, the Unified State Registry of Prohibitions of Immovable Property Transfers⁶² shall be terminated and the State Registry of Immovable Property will come into a force. It constitutes a new type of register, which envisages registration of both unfinished constructions and finished enterprises' property complex.

In principle, Ukrainian law provides different options for enforcing a security: a court decision,⁶³ enforcement deed from a public notary, or a contractual arrangement between the parties.⁶⁴

The sale of *mortgaged* assets (i.e. immovable property or fixed assets) enforced through a court decision or a deed from a public notary requires a public tender, unless the court decides otherwise.⁶⁵ At the same time, the sale of *pledged* assets (i.e. movable property and shares) requires a public tender only if the assets' owner is a State enterprise or a joint-stock company fully owned by the state.⁶⁶

As of now, it is not possible to enforce court decisions rendered on shares or fixed assets owned by state enterprises as well as companies where the State holds a twenty five percent (25%) interest minimum. This specific limitation is set out in the Law of Ukraine "On introduction of a moratorium on compulsory sale of property."

3.5.2 Step-in rights

(a) Replacing the defaulting private partner in the PPP

The Ukrainian PPP legislation does not provide clear rules concerning the substitution of the private partner in a PPP project. This right, called "step-in" or "substitution" is a key issue for bankability of PPPs. Such a step-in should be included both in PPP law and in PPP contracts. It should be clear that no new tender is required.

In principle, the replacement of the private partner is only conditioned upon the public partner's prior consent. This follows from the general rules of civil law,⁶⁷ and subject to the receipt by the new entity of the relevant licenses and permits beforehand.

However, there is a risk that such replacement may be disputed by third parties on grounds of an alleged violation of the competitiveness principle while choosing the private partner.

of Immovable Property Transfers. Both of them are coordinated by the Ministry of Justice of Ukraine and accessible to public notaries.

⁶¹ The notion which is similar to *fonds du commerce* in France; the entire property complex is classified as the fixed asset in Ukraine which includes the real estate property and underlying land. Most of the infrastructural objects (water supply, sewage, water treatment, heating supply, etc) are registered as entire property complex.

⁶² Clause 2 of the Cabinet of Ministers Resolution dated June 22, 2011 No. 703.

⁶³ Court decision is obligatory to enforce the security, if the asset is owned by a State or municipal enterprise or by a company, in which the State owns for a participation interest of more than 50% - in case of mortgages - or at least 50% in case of pledges.

⁶⁴ Article 33 of the Law of Ukraine "On mortgage"; Article 20 of the Law of Ukraine "On pledge".

⁶⁵ Articles 33, 41 of the Law of Ukraine "On mortgage".

⁶⁶ Article 21 of the Law of Ukraine "On pledge".

⁶⁷ Article 520 of the Civil Code of Ukraine.

(b) Taking corporate control over the defaulting private partner or troubled PPP Company by acquiring its shares

The Ukrainian corporate and PPP Law do not hinder the use and enforcement of step-in rights, provided they do not concern shares owned by the public partner in the PPP company (because in such circumstances, step-in would equate privatization).

Some formal requirements should be taken into account when exercising step-in rights amounts to the acquisition of the private partner's shares or privately-owned shares of the PPP company.

More particularly, any acquisition of shares in the defaulting private partner, or troubled PPP Company in a Limited Liability Company (LLC) form, or private Joint Stock Company (JSC) form, would necessarily need to take into account any existing pre-emptive rights of existing participants/shareholders.

Ukrainian law provides for the right of first refusal of existing participants to an LLC or closed JSCs to buy-out the withdrawing participant's participation interest if: (i) payment is made at the same price as the price proposed to third parties, and (ii) payment is proportional to their existing participation shares.⁶⁸ The difference between the implementation of this rule for LLCs and closed JSCs is that the said pre-emptive rights can be modified by the LLC by-laws (i.e. the rule is dispositive, while the by-laws of closed JSCs may only disregard the said rule completely, but never modify it).

At the same time, Ukrainian corporate law does not impose any specific requirements on the creation of pre-emptive rights for non-compensatory transfers of shares. Consequently, participants/shareholders to PPP companies or private partners can freely regulate their respective pre-emptive rights in the company's by-laws, or fully disregard the pre-emptive rights as such.

Besides, taking corporate control may require the acquiring party to first notify and obtain a formal authorization from the Antimonopoly Committee of Ukraine concerning the contemplated transfer. The latter shall verify that the parties to such transfer, including the target, the withdrawing party, and the acquiring party or their affiliates, are not in exceed of financial or market thresholds.

3.5.3 Support Issues

The Regulation No. 279 provides for the following types of state support available for the private partner:

- (i) state or municipal guarantees;
- (ii) partial financing of the project; or
- (iii) other forms not prohibited by the law.

The decision on involving State or municipal support may be adopted at any time during the implementation of the project. Its issuance may be initiated either by the public or by the private partner at any stage of the PPP project. The conclusion on the necessity and the

⁶⁸ Article 147 of the Civil Code of Ukraine; Article 7 of the Law on Joint-Stock Companies.

form of such state support should be adopted by the MOEDT and approved by the Ministry of Finance. The final decision on state support should be issued by the CMU on the basis of the prepared conclusion and draft regulation.

The municipal guarantees should be issued under the decision of the respective city/town /village council.

Before voting the Regulation 279, the Ukrainian legislation did not prescribe any special procedure for receiving state or municipal financing under a PPP project, and thus, a risk existed that the private partner would be obliged to seek inclusion of such financing into the annual budget. Under the Regulation No. 279, the funds for state and municipal support of the PPP project must be allocated, still this obligation is not supported by the Budget Code.⁶⁹ Moreover, these types of expenses should be separately voted while adopting the annual budget. Therefore, the risk of failure to secure enough political support for the inclusion of the related expenses remains very high.

Despite the provisions of Regulation 279 the Budget Code of Ukraine does not provide for any specific procedure for granting such state support, except for state and municipal guarantees.

State support may be given within the amount provided for in the annual budget, therefore, before adopting any decision on state support the public partner should know in advance the amount of support to be paid under the particular project.

(a) Loan guarantees

(i) State guarantees

Under Article 17 of the Budget Code, it is foreseen that State guarantees for the loan agreement may be issued only to residents of Ukraine or governmental authorities and agencies. Yet, the Budget Code of Ukraine does not define the notion "*Ukrainian residents*." Under Ukrainian law, all legal entities and representative offices registered in Ukraine are considered as Ukrainian residents. The guarantees are issued pursuant to the decision of the CMU.

(ii) Municipal guarantees

Municipal guarantees should be respectively issued by the self-governing authorities to guarantee the full or partial re-payment of loans taken by the municipal companies⁷⁰ that carry out their activity pursuant to approved programmes aimed at the development of infrastructure and installation of the energy saving technologies. The procedure for issuance of municipal guarantees and other types of support should be defined by the respective self-governing authorities. Despite that fact that the PPP Law provides for a possibility for self-governing authorities to issue municipal guarantees for securing obligations of private companies (PPP companies) the Budget Code does not foresee any mechanism for implementation of such option. The maximum amount of indebtedness, loans and guarantees issued by self-governing authorities may not exceed one hundred

⁶⁹ Regulation No. 279 provides that while preparing the amendments to the law of Ukraine "On State Budget" the MOEDT and the Ministry of Finance should prepare the proposition for including the amounts required for state support. Further, it requires foreseeing such amount in all subsequent years.

⁷⁰ Companies are fully or partially owned by the municipality (50% and more)

percent (200%) (four hundred percent, (400%) for Kyiv) of the average annual indicative forecast of budget income (loan taken by the municipalities from other budgets excluded). The maximum amount of the guarantees and loans should be defined by the respective budget. The issued guarantees and received loans by the State and municipalities are subject to registration with the respective register of the Ministry of Finance.

In Kyiv, guarantees are issued on the basis of decisions taken by the Kyiv City Council authorizing the Head of Kyiv City Council to sign the respective guarantee agreements.

The guarantees are issued for a fixed term.

In order to secure performance of obligations under the principal loan agreements, the CMU has the right to request certain securities either from the PPP company, or from its mother company (grantor).⁷¹

Under the Regulation, the company that receives loan guarantees is obliged to pay annually one percent (1%) from the amount of the issued guarantee. On a PPP the effect of this obligation is that the guaranteed party will simply increase its tariff or fee to include this amount.

All subsequent payments under state and municipal guarantees should be paid regardless of the fact whether or not they were budgeted⁷².

(b) Loans that may be taken by municipalities under a PPP⁷³

The Regulation provides for rather restrictive procedures for municipalities to receive loans. Prior to receiving any loan, self-governing authorities need an authorization from the Ministry of Finance, which could be quite a time-consuming procedure. The amount of loans that can be taken should not exceed twice the amount of the budget of development (ten percent (10%) from the annual budget).

(c) Loans to be issued by the municipality or State

Ukrainian legislation does not authorize the State or municipalities to grant direct loans to any legal entities. As a rule the State loans are given through special programs elaborated to support specific activities. They are granted through State owned banks with, in general, lower interest in comparison with commercial loans. As a rule, State loans are issued under the State programs of development.

(d) Subsidies

The PPP Law does not specify which type of subsidies may be issued by the public partner. However, the Law On Concessions provides:

"The principal may provide privileges with regard to concession payments and provide for contractual provision of grants, compensations and privileges to concessionaires of loss-making and low-profit objects which serve important public needs."

⁷¹ Regulation of the CMU "On Procedure of Issuance of Guarantees for Securities to Be Provided while Taking Loans under State Guarantees" No. 460, dated April 13, 2011

⁷² Article 17 of the Budget Code

⁷³ To be reviewed/confirmed

The same provision exists under the Law On Lease and Concession of Infrastructure that provides for the public partner with the right to decrease the amount of the lease and concession payments. The types of privileges should be defined by the partners in the agreement. After, public partners should confirm this decision in their respective decisions on approval of the annual budget. There is thus a practical risk for the private partner who will need to seek the inclusion of the privileges in each year's budget.

(e) Other guarantees, expropriation

Ukrainian legislation does not specify any provision concerning performance guarantees that may be given to the public partner. However, the parties may negotiate and include such a guarantee in the PPP agreement. At the same time the private partner should bear in mind that in order to enforce the provisions of the respective PPP agreement, any guarantees provided by public partner should (i) be provided by the Budget Code; (ii) be budgeted every subsequent year.

Ukrainian legislation⁷⁴ provides for a very limited list of cases where expropriation may apply. In most cases, it is applicable to privately owned land and real estate. The role is that the private company should receive fair compensation for expropriated property.

3.5.4 Recommendations

- ***amend the Budget Code so that authorities are obliged to include compensation of the difference between the approved tariffs and the full commercial price, without following a separate procedure of voting such amounts.***
- ***amend the Budget Code and provide for mechanism for issuance by self-governing authorities to privately owned PPP companies of the guarantees for the purposes of performing its financial undertaking under the PPP agreement.***
- ***clarify the types of state and municipal support that may be granted by the State and self-governing authorities and provide the respective mechanism of implementation in the Budget Code;***
- ***amend the Law of Ukraine "On pledge" and the Law of Ukraine "On mortgage" in order to increase the minimal threshold of state participation, after which the securities enforcement shall be obliged to require a court's decision (and not otherwise contractually arrange, or the notary's enforcement deed), however only in event of default of the public partner under the PPP agreement.***
- ***waive moratorium on enforcement of court's decisions regarding shares or fixed assets of companies in which the State controls a participation interest of at least 25%, provided that such decisions relate to the enforcement of security interests within PPPs.***
- ***amend article 14 of the PPP Law in order to regulate step-in in the event of a defaulting private partner and without a new tender.***

⁷⁴ The Law of Ukraine "On Expropriation of the Land Plots and Privately Owned Real Estate for Public Needs" No.1559-VI, dated November 17, 2009

- ***provide an accelerated procedure to receive the approval for taking the loans in preparation for the PPP project by the public partner (self-governance authority).***

3.6 Settlement of Disputes and Applicable Laws

3.6.1 Settlement of Disputes

The ability to use international arbitration is a key bankability issue in PPPs. Investors, contractors and lenders will be encouraged to participate in projects in Ukraine if they have the confidence that any disputes arising out of contracts forming part of the PPP project may be resolved fairly and efficiently through international arbitration.

(a) International Arbitration

Depending on the type of the PPP agreement and the parties thereto, Ukrainian law imposes certain limitations as to the possibility of the parties to submit their disputes to international arbitration with seat outside of Ukraine or in Ukraine.

Under the Law on International Commercial Arbitration, a dispute may be settled by a foreign arbitral institution if at least one of the parties to the contract is a foreign legal entity or if it is an "*entities with foreign investment*"⁷⁵. However, this general rule does not apply to concession agreements because the Law On Concessions clearly states that only those disputes with non-residents may be considered by the international arbitration institution.

(i) Foreign legal entities and "entities with foreign investment"

For licensing purposes, the private partner often needs to establish a Ukrainian company (subsidiary). Therefore, under the general rule all disputes arising from the contract concluded between the Ukrainian subsidiary (the private partner) and the public partner must be settled before a Ukrainian State court,⁷⁶ or a Ukrainian arbitration institution. However, this rule is not applicable if the private partner is represented by the representative office of a foreign company. Such a representative office would be considered a foreign legal entity and thus be allowed to apply for dispute resolution before an international arbitration institution. Most investors do not use representative offices however but set up special purpose local companies.

In principle, the Ukrainian subsidiary of the private partner may use the possibility provided by the law and claim that due to status of "*enterprise with foreign investment*" arbitration may be used. Under the Commercial Code of Ukraine the notion "*enterprise with foreign investment*" is definite as an enterprise in which at least 10% is owned by the foreign legal entity⁷⁷. However, in order to secure this status it is also recommended to undergo the registration of the foreign investments. Still, certain limitations should be taken into consideration while drafting the PPP agreement.

Ukrainian legislation does not clearly state which type of an international arbitration may be used for consideration of disputes between an "*enterprise with foreign investment*" and

⁷⁵ Article 2 of the Law of Ukraine "On International Commercial Arbitration"

⁷⁶ Article 76 of the Law of Ukraine "On International Private Law" foresees that if the property of the defendant that is being seized is situated on the territory of Ukraine, the dispute should be settled by a Ukrainian state court.

⁷⁷ Article 116 of the Commercial Code

the public partner. Furthermore, the Law on International Commercial Arbitration does not clarify whether the international arbitration institution its seat outside of Ukraine or in Ukraine. Therefore, there is a risk that after receiving of the arbitration award from the arbitration institution abroad the Ukrainian court will not recognise it due to breach of procedural rules, notably, absence of jurisdiction of the respective institution for consideration of this type of disputes.

(ii) Limitations

Firstly, the Law "On International Commercial Arbitration" specifies that submission of disputes to international arbitration is subject to limitations or prohibitions set forth by any other law.

Secondly, article 77 of the same Law provides for exclusive competence of Ukrainian courts with respect to the following disputes:

- (i) Disputes related to real estate if such real estate is situated in Ukraine. This provision may lead mandatory submission of any dispute arising from the PPP agreement to exclusive competence of Ukrainian courts as long as every PPP agreement is in some way related to real estate construction, development, etc. Moreover, there is no established court practice in this regard; therefore different interpretations of this provision may be expected.
- (ii) All disputes related to registration of the company or other types of registrations made in Ukraine.
- (iii) Disputes related public procurement of public works and services.
- (iv) Disputes related to bankruptcy if the company is established in Ukraine; etc.

Thirdly, article 76 of the same Law provides that the following disputes may be considered by a Ukrainian court:

- (i) if the place of registration of the defendant is in Ukraine; or major part of property that may be seized is situated in Ukraine; or if the representative office of the foreign legal entity - defendant is located in Ukraine;
- (ii) if the damages were caused in Ukraine;
- (iii) if the ground for action arose in Ukraine, etc.

The wording of this article 76 allows referring the wide range disputes arising from PPP agreement to the courts of Ukraine.

From our practical experience we may confirm that courts do not hesitate to consider such disputes despite the existence of an "*arbitration clause*". The position of the Ukrainian High Commercial Court is that applying to the arbitration institution is a right of the parties and should not be interpreted as an obligation⁷⁸.

The particular attention should be paid to drafting of the arbitration clause due to a very formalistic approach of the Ukrainian court to the validity of the arbitration clause.

⁷⁸ Presidium of the High Commercial Court of Ukraine "On Certain Questions related to Consideration of Disputes with Foreign Enterprises and Organizations" N 04-5/608

(b) Domestic Arbitration

The Ukrainian PPP Law does not prohibit "out of court" settlement of disputes arising from the PPP agreement (i.e. settlement of the dispute before Ukrainian arbitration institutions - domestic arbitration). However, depending on the nature of the dispute it may fall into the exclusive competence of the commercial court of Ukraine.⁷⁹ Under Article 6 of the Law of Ukraine "On Ukrainian Arbitration Institution" the domestic arbitration may not consider the following disputes:

- (i) related to real estate;
- (ii) related to related public procurement of public works and services;
- (iii) where one of the parties is non-resident of Ukraine; etc.

(c) Enforcement of Arbitral Awards

Ukraine is a member of the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards, thus any decision adopted by an arbitration institution shall be recognized by the Ukrainian court. The grounds under which the Ukrainian court may refuse to recognise the decision are (i) when the disputed considered by arbitration institution is related to exclusive competence of the Ukrainian court (e.g. disputes related to real estate located in Ukraine); or (ii) if the enforcement of the decision will violate the public order of Ukraine.

In practice, Ukrainian courts seem to readily recognise and enforce foreign arbitral awards, provided that relevant formalities are observed by the pleading party.

3.6.2 Applicable Laws

The PPP Law does not include any regulation of the laws that should govern PPP agreements. However, the Law of Ukraine "On Private International Law" provides that only if one of the parties under the agreement is a foreign company the parties may choose the law of a different jurisdiction, not Ukraine, as applicable law. It also provides for certain limitations with regard to the applicable law, and provides for the application of Ukrainian law in the following agreements:

- (i) agreements related to real estate property located in Ukraine;
- (ii) agreements on rendering services in Ukraine; and
- (iii) agreements concluded on a competitive basis.

Basically, all PPP agreements are concluded on a competitive basis and are related to real estate located in Ukraine. Therefore, the partners may not choose another applicable law to govern the agreement. We do not see this as a major issue since public parties in PPPs worldwide generally require that local law apply. Thus, in the tender documentation, public authorities tend to define Ukrainian law as the governing law and as one of the essential conditions to enter into the agreement.

⁷⁹ If it contains information that is considered a State secret, all disputes where the defendant is self-governing authorities. Article 16 of the Commercial Procedural Code

Ukrainian legislation does not specify any limitation concerning the law applicable to financial agreements in PPP. As such, such contracts could very well be governed by a foreign law. This is very important as international financial institutions will always chose their own law (usually England or New York) for financing documents.

3.6.3 Recommendations

- *provide in the PPP Law that all the disputes arising from any type of PPP arrangement concluded with the non-residents of Ukraine or an enterprise with foreign investments may be settled by international arbitration tribunal with the seat outside of Ukraine or in Ukraine (depending on the consent of the parties) notwithstanding limitations provided by other legislation (except "exclusive" competence of Ukrainian courts).*
- *clarify that disputes relating to real estate which fall within the exclusive competence of Ukrainians court are disputes related only to property rights over the real estate.*
- *allow international commercial arbitration as a method of dispute resolution where the parties under the PPP project are two Ukrainian residents.*

3.7 Other issues

3.7.1 Use and ownership of site and assets for a PPP

3.7.1.1 Assets

Under a PPP agreement, the land (site) and assets may be transferred to the private partner only for the temporary duration of the PPP agreement.

Article 20 of the Concession Law provides for the following *scenarii* with regard to assets ownership:

- (i) the public partner retains the ownership right over the property given into concession, or newly built, by the concessionaire;
- (ii) the private partner acquires the property during the performance of the concession contract, and thus retains ownership.

The private partner may not acquire ownership rights over the transferred property, as well as over the newly built objects if it is so foreseen by the PPP agreement.⁸⁰ All kinds of property (constructions, buildings, land) mentioned in the PPP agreement shall not be privatized until the PPP agreement's expiration term.

The property should be registered in a separate balance sheet as "property in concession/lease/management/etc." During the contract's effective term, such property is considered to be state-owned/municipally-owned but granted for use to the private

⁸⁰ Article 7, of the PPP Law

partner. Such assets should be returned to the public partner upon the PPP agreement's expiration.⁸¹

Depending on the PPP tender conditions, private partners could perform repairs, reconstruction, modernization, and new construction works on the transferred assets. However, the ownership rights for all improvements that could not be separated from the PPP object, and the newly constructed objects, will be held by the public partner.⁸² We do not feel that the above property regime presents any particular problems for PPPs and as such it does not require any changes.

3.7.1.2 Peculiarities of lease and concession of water supply, heating, and sewage infrastructure

The general rule is that all improvements financed by the private partner from the depreciation charges belong to the public partner and should not be reimbursed.

Under a lease, improvements made to the assets by the private partner that could be removed without damaging the PPP assets could be disassembled by the private partner, and considered the property of the private partner.⁸³ But under a concession, all improvements should be transferred together with the PPP assets to the public partner.⁸⁴

Following the concession's termination, the private partner will own the old equipment if the new equipment was installed under the lease agreement.

3.7.1.3 Peculiarities of highway concession

Under Article 2 of the Law Highway Concessions Law, any property created during the performance of the concession agreement, or received in concession, and located along the right-of-way of the highway⁸⁵ shall be owned by the State and shall be transferred to the private partner for holding and use during the concession agreement's effective agreement. Other property belongs to the private partner.

3.7.1.4 Depreciation charges

Please note that the concessionaire should use the depreciation charges accrued on the assets solely for the property's development and maintenance.⁸⁶ Otherwise, a penalty in the amount of one hundred percent (100%) of the charges and one hundred and twenty percent (120%) of the discount rate of the National Bank of Ukraine may be imposed on the private partner.

3.7.1.5 Land

The public partner must transfer to the private partner the use, or other related rights, on any land plots required for the PPP project's implementation. The PPP Law's main advantage is that it makes the public partner responsible for the preparation of land allotment documents and the reception of all approvals thereto.

⁸¹ The concessionaire has the right to include investments made for construction, maintenance and development of public assets into the tolls.

⁸² Part 3 of article 7, of the PPP Law

⁸³ Article 778 of Civil Code of Ukraine and Article 14 of Law On Lease and Concession of the Infrastructure

⁸⁴ Article 18 of Law On Lease and Concession of the Infrastructure

⁸⁵ The land plot allocated for construction of the road and objects of engineering infrastructure, etc.

⁸⁶ Such charges are not considered to be income of the private partner.

Land allotment documents should be obtained at the expense of either the public or the private partner. However, the private partner shall only bear such expenses if he initiated the PPP project. Obtaining land allotment documents at its own expense does not cause the private partner any advantages during the tender. Please note that the expenses of the public partner related to the formalization of the land title should be compensated by the private partner - if provided under agreement.

The procedure and conditions governing the transfer of rights over land plots should be established in the PPP project's documentation. Another positive feature of the PPP Law is that it removed the necessity to pass a separate land auction to obtain rights over the land plots needed to implement the PPP project.

The Ukrainian legislation does not provide any simplified procedure to formalize the right to use the land plot. Accordingly, the private partner must formalize the title in conformity with the standard registration procedures. Please note that, without the formalized right to use a land plot, the private partner may not begin to use the land plot for construction, which consequently may result in considerable delays in the PPP project's implementation.

All the land in Ukraine is divided between privately-owned, State-owned, and municipally-owned land. The division between the State and municipally owned land plots is not completed yet. Therefore, it is often complicated to identify the owner of land plots. This leads to considerable delays in land plot formalization, and bears severe consequence since formalization is the first step in preparation of the PPP project.

PPP legislation contains certain declarative provisions authorizing the private partner to acquire the servitude rights on the land plot on behalf of the public partner. However, the legislation does not provide for any procedure of enforcement.

Under Article 8 of the PPP Law, the private partner should release the land plot following the PPP's agreement expiration. The land legislation does not provide de-registration of the title of use after expiration of the respective lease/superficies agreement in the land cadastre. In practice, the de-registration is possible only after the new user of the land plot is registered. This means that until the new user is registered, the private partner will be obliged to pay the land tax.

Further, most of municipally and state owned companies use the land plot on a permanent basis, which renders the land plot ownership not transferable. Therefore, to prepare the land plot for the private partner's use, it is required to go through a procedure of waiver from the permanent use and formalization of lease. Yet, such a procedure is often time consuming.

3.7.1.6 Ability to transfer rights over public assets to the PPP company

As outlined above, PPP legislation does not provide for the possibility to transfer ownership rights on public assets to the PPP company. Should a private partner wish to secure ownership rights for public assets made available under a PPP agreement, this would only be possible following the expiration of the PPP agreement and after the decision⁸⁷ for the privatization of the PPP object is adopted.

⁸⁷ Article 5;6;11 of Law of Ukraine "On Privatization of State and Municipal Property"

However, the public partner should transfer the rights to use the public assets under the relevant contract.

Depending of the type of PPP assets, limitations may apply concerning the use of certain parts of the object by the private partner (e.g. assets that are defined as belonging to strategic sector or assets related to state secrecy). The existence of such assets, as well as applicable limitations, should be clearly stated by the public partner in the tender documentation and the relevant PPP agreement.

3.7.1.7 Recommendations:

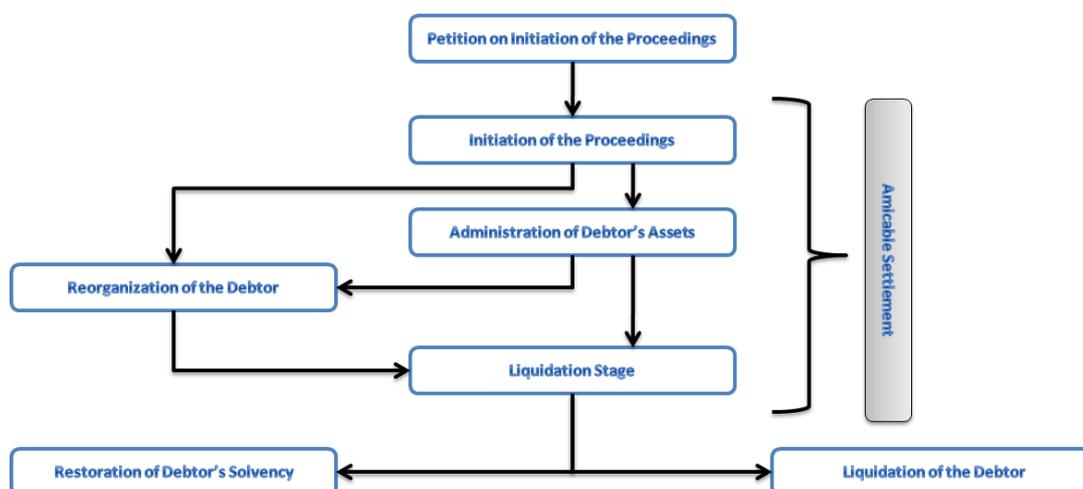
- ***provide in the Land Code for accelerated procedures concerning title use formalization over land plots transferred to the private partner, notwithstanding the nature of the landowner (state owned or municipally owned).***

3.7.2 Bankruptcy provisions

The laws of Ukraine recognize bankruptcy proceedings as the statutory set of rules and proceedings designed to restore a debtor's solvency or declare his bankruptcy.⁸⁸ The general rules and procedures shall apply to PPP companies that are totally privately owned.

Under the laws of Ukraine, *insolvency* is understood as the *actual* inability to settle a monetary obligation within the specified period. The *actual* failure to do so constitutes grounds for initiation of bankruptcy proceedings. Insolvency of a debtor is subject to a commercial court's jurisdiction.

A general scheme of bankruptcy proceedings in Ukraine is shown below:



Administration is the first stage of the proceedings where the licensed and independent administrator tries to improve the debtor's solvency. The Court appoints an administrator to ensure the effective management of the debtor's assets, and to analyze the debtor's financial conditions.

⁸⁸ Bankruptcy proceedings in Ukraine are governed by the Law of Ukraine on Restoring Debtor's Solvency or Declaring It Bankrupt, the Commercial Procedural Code of Ukraine and other laws.

Liquidation is the final stage where creditors' claims are settled. As a result, the debtor can either (i) continue its business activities, if all creditors' claims have been settled, or (ii) be liquidated. In practice, the liquidation process is controlled by those creditors, who have the largest amount of claims against the debtor.

Claims not settled by the debtor in the course of liquidation, because of the insufficiency of the funds derived from the sale of all of its assets, are deemed to be written-off.

The Law of Ukraine "On introduction of a moratorium on compulsory sale of property" protects any state enterprise, as well as any company in which the State holds a participation interest of at least twenty five percent (25%), from the sale of assets during liquidation. Accordingly, liquidation is never an option for those State entities. The only solution is to attempt to administer the assets and restore their solvency.

3.7.3 Labour Law Issues

3.7.3.1 Employment of Ukrainian Citizens

The concessionaire was once under the obligation to employ ninety percent (90%) of Ukrainian citizens for the duration of the concession. Such obligation was established under Article 11 of the Highway Concessions Law's previous version, and was cancelled on January 15, 2009. As of today, the Law of Ukraine On Lease and Concession of Infrastructure provides for the obligation of the private partner to employ a majority of Ukrainian citizens.

Article 10 of the Concession Law provides that using Ukrainian labour force is an essential condition of the concession agreement, and thus requires the private partner to employ predominantly Ukrainian citizens. Nevertheless, it does not impose a specific proportion.⁸⁹ In practice, tender regulations⁹⁰ often require the bidder to include into its bid conditions the use of local labour force.

We note that such requirements are not best international practices and would point out that such an approach may (i) limit the ability of private operators to provide the best employees and (ii) increase cost to public and government of PPPs. We would recommend that such compulsory language be removed to allow private operators to best manage PPP projects, especially taking into account that in practice and for sound economic reason most of the employees of the PPP company will still be Ukrainians. In order to comply with various provisions of the licensing conditions and requirement for issuance of the permit the PPP company will be obliged to have qualified Ukrainian personnel.

Following the termination of direct operations by a municipal or State enterprise, the PPP company is not considered to be its legal successor. Therefore, all the labour agreements concluded with the employees of such enterprise should be concluded by the PPP company. Further, the PPP company is free to define the employment conditions of employees, unless they were set by the tender documentation⁹¹.

Corporate and labour legislations do not provide for any restrictions with regard to the management or the exercise of any other activity by foreign personnel. However, foreign

⁸⁹ At the same time under the Draft of concession agreement used in Lugansk project the private partner was obliged to employ 90% of Ukrainian employees without any definition of the posts that such employees should take.

⁹⁰ Regulation of the Cabinet of Ministers of Ukraine No 1521 dated October 4, 2000 on Order of Conducting of the Concession Tender for the Construction and Operation of Highways

⁹¹ Regulation No. 384

citizens may not be employed on positions that provide access to State secrets. Therefore, before determination of the number of foreign employees to be employed and their positions, it is recommended to verify possible restrictions with the public partner.

3.7.3.2 Work Permits for Foreign Citizens

The Order on Granting, Extension and Cancellation of Work Permits for Foreign Citizens and People without Citizenship, approved by the Cabinet of Ministers of Ukraine of April 8, 2009 n°322 specifies that the work permit may only be delivered to a foreign citizen in the case if in the country (or in the region) there are no candidates capable of handling this type of work, or there are sufficient reasons of using foreign work force, unless international treaties of Ukraine specify otherwise.

The wording of conditions of delivery of work permits to foreign nationals is not very clear and may give rise to different interpretations of the precise scope of the requirements and thus serve as an obstacle to efficient and timely delivery of authorisations to work in Ukraine to the Project Company foreign personnel.

3.7.3.3 Recommendations:

- *clarify the conditions of delivery of work permits to foreign citizens.*

3.7.4 Tariffs

3.7.4.1 General

In Ukraine two authorities hold the power to set tariffs: the self-governing authorities and the Commission⁹² (depending on the volume of services to be provided and the territory). The Ukrainian legislation prescribes the procedure for the tariffs' enactment, as well as the methodology used by the authorities for establishing the tariffs. The authorities are not authorized to ignore the legislation' provisions and establish the tariffs otherwise, even if it is provided in the PPP agreement.

The customer tariffs' may not be separated from the remuneration of the PPP company because, pursuant to the Law On Concession and Law On Lease and Concession of the Infrastructure, the private partner's remuneration constitutes the payment for the utilities provided.

Under Article 9 of the Law of Ukraine "On Prices and Pricing Procedures" and "On Self-governing," the governmental authority responsible for setting tariffs should reimburse the private partner for all the expenses caused by its decision to set tariffs at a level that is below the economically sound level.

Further, while approving the tariffs' at the level that is below the economic sound level, the executive authority or/and the self-governing authorities should allocate funds to compensate the difference between the established tariffs' and what would have been an economically sound level in the state or municipal budget.

Therefore, in principle compensation under the tariffs set by the regulator should come from the State budget, and the self-governing authorities may indemnify the said amount

⁹² The NCUR was created by the Decree of the President of Ukraine dated July 8, 2011

only if: (i) such function will be re-delegated to them; and (ii) they receive identical financing from the State budget. Moreover, private partners may receive compensation only if the respective funds were allocated in the budget which requires separate voting of these expenses. Very often the authorities cannot allocate such funds due to political and social reasons, and their indebtedness towards the private partner is very important.

However, recent changes in the status of the Commission, defined as a state collective body instead of state executive authority, lead to the impossibility of receiving any compensation from the State budget. Under the Budget Code, only the compensation requested by the State executive authorities may be included into the budget. Therefore, despite the Commission's power to establish the tariffs, it is not entitled to request the State budget to include the reimbursement of the difference. Subsequently, there is a high risk that, if the tariffs are established at a level lower than the economically sound standard, the private partner will have no recourse to demand reimbursement from the municipal authorities or from the State budget.

However, such problem may be worked around in the PPP agreement through, either the "Fait du Prince" or "material adverse government action" concept, or through substantial change of conditions doctrine under which the contract was concluded.

Ukrainian legislation provides for a similar concept to the "fait du Prince" or "material adverse government action".⁹³ Under this concept, the public partner or governmental authorities are obliged to compensate any losses caused to the private partner by its adverse decision.⁹⁴ Further, it also grants the private partner a right to claim the reimbursement of losses caused by the adverse decision of the public partner, by its failure to act, and by improperly performing under the PPP agreement and Ukrainian legislation.

Alternatively, in order to compensate the difference between the established tariff and the economically sound ones the private partner may request that the public partner provides privileges with regard to concession and lease payments and/or agrees to contractual provisions with regard to grants, compensations and privileges. Where the public partner refuses to introduce the respective modification, the private partner may use the doctrine of "substantial change of conditions."

In accordance with Article 652 of the Civil Code of Ukraine and Article 17 of the PPP Law, parties are entitled to modify conditions or terminate the contract if the conditions under which it was initially concluded substantially changed.

The doctrine of "substantial change of conditions" requires the following conditions:

- (i) the parties could not have predicted them at the time the agreement was concluded;
- (ii) the party acting in good faith cannot eliminate the adverse impact of the changed conditions;
- (iii) no party should bear the risks caused by the changes under business customs;

⁹³ Under "*Le fait du Prince*" we understand the concept pursuant to which the public partner is obliged to compensate all expenses of the private partner caused by an adverse decision adopted by the public partner.

⁹⁴ Article 20-5 of the PPP Law

- (iv) the correlation between interests of the parties changed in such a way that if the party could have predicted that at the moment of the agreement's execution it would have refused to enter into the agreement.

In practice, modifications of the contract based on such a doctrine are possible only pursuant to a court decision (as the court is the only forum empowered to determine the importance of changes). Please note that there is no single approach to the definition of change of substantial conditions and, as a rule, it is defined on a case-by-case basis.

3.7.4.2 Peculiarities of road concessions

With regard to tolls received by the private partner under the road concession, Section 2 of Article 4 of the Highway Concessions Law states that:

"the maximum and minimal amount of fees for passage through highways constructed on the terms of concession, procedure for calculation, and granting of subsidies, compensations, as well as procedure for calculation of the payment for operational readiness of the highway shall be determined by the Cabinet of Ministers of Ukraine."

According to the CMU's current regulations,⁹⁵ there is no minimum amount of fees for passage (tolls), and no fixed subsidy or guarantee of minimum base revenue. As there is no generally applicable methodology for calculation of tolls, each time, the Ministries of Infrastructure prepare a temporary and project-specific methodology to set the maximum tolls for the project.⁹⁶

3.7.4.3 Peculiarities of the heating, water supply, and sewage sectors

Peculiarities of the heating, water supply, and sewage sectors mainly consist in the PPP company's ability to collect tariff revenue directly from users, and to impose sanctions against non-paying customers.

In practice, the following schemes are used for invoicing consumers:

(i) Direct invoicing of consumers

Direct invoicing is possible if: (i) the private partner has a direct contract with the consumer, (ii) the consumer has a meter, and (iii) the competent local self-governing authority declares the private partner a *utilities service provider*. Generally, the private partner is only regarded as a producer of heating, water supply, and sewage services. Direct utilities service providers are called "ZHEK" for municipally owned buildings and "condominium" for privately owned buildings. The utilities services producers are responsible for supplying utilities services to buildings, while the utilities services providers are responsible for distributing the services to the consumers (i.e. residents of the building).

As a rule, utilities service providers are responsible for the upkeep and development of in-house networks, which requires substantial investment. In practice, private partners try to

⁹⁵ The Regulation of the Cabinet of Ministers of Ukraine "On Approval of the Procedure for Establishment of Maximum Amount of Fees for Passage through Highways Constructed on the Terms of Concession" No. 1299 dated August 22, 2000 and the Regulation of the Cabinet of Ministers of Ukraine "On Approval of the Procedure for Compensation for Toll-Free Passage through Highways Constructed on the Terms of Concession" No. 1065 dated July 6, 2000

⁹⁶ Similar temporary and project specific methodologies were used when calculating maximum amount of toll payment for concession projects in Lviv - Krakovets, however not available for public access.

avoid such obligations and thus their designation as *utilities service provider*. Accordingly, private partners may not invoice and receive direct payments from individual consumers.⁹⁷ Further, the fact that reimbursements of within-building investments cannot be included under tariffs is another critical issue because it increases the cost for the private partner.

Direct invoicing and payment is widely used for consumers who are legal entities, as well as governmental and municipal organizations. These types of consumers are in a direct contract with the private partners and individual meters. At the same, it is rarely used for consumers who do not have individual meters (i.e. natural persons). In practice, the private partner may not identify the volume of consumed services, and cannot therefore invoice consumers who do not have meters. There, municipal housing and utilities providers (utilities service providers) are responsible for invoicing.

However, mass media sources inform that Kyivenergo⁹⁸ is currently taking part in a pilot project in the Golosiyiv district of Kyiv where it plans to enter into a contract with each consumer (owner of the apartment) for heating⁹⁹ supply. Under the pilot project, Kyivenergo will be considered the provider of housing utilities (similar to the functions of ZHEK), and thus be able to invoice the consumers directly. If the results are positive, Kyivenergo is expected to take over such functions from ZHEKs. However, this would consequently raise liability issues concerning in-house uses and repairs.

(ii) Invoicing consumers through ZHEK

ZHEKs or condominium associations remains the most widely used scheme for invoicing. For Report purposes, we shall limit ourselves to the scheme as applied in Kyiv, which can be described as follows:

- (i) ZHEKs or condominiums submit to CICA¹⁰⁰ information concerning the number of consumers, and the volume of consumed heating in each apartment. As a rule, it is calculated taking into consideration the useful area of the apartment;
- (ii) CICA calculates and prepares bills for utility services and thereafter submits bills to ZHEKs or condominiums;
- (iii) ZHEKs or condominiums receive bills and deliver them to consumers;
- (iv) Consumers—individuals pay through banks and CICA for the services of utilities producers;
- (v) Banks transfer the received monies to CICA; and

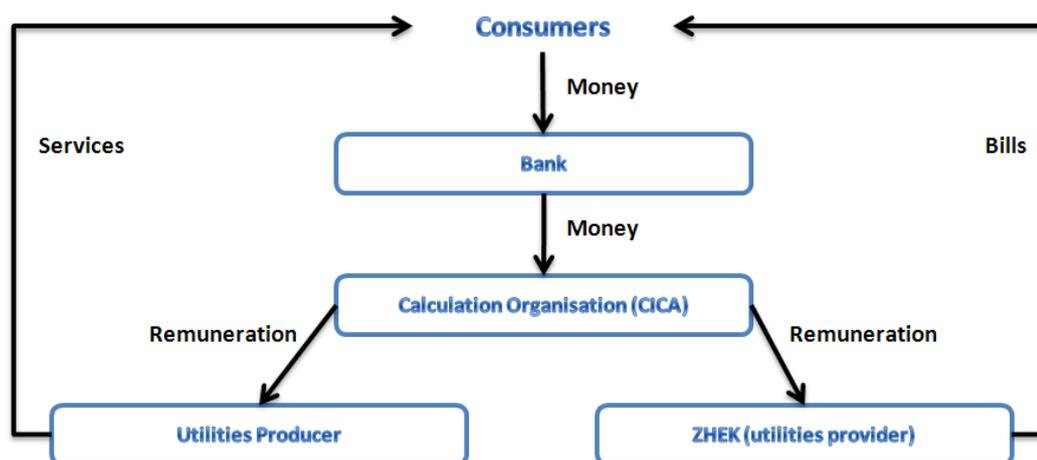
⁹⁷ As an example, we can cite the case when in 2005 the Kyiv City Council adopted the Decision "On Definition of Utilities Services Providers for the Individuals Consumer Residing at the Municipally Owned Property" No. 427/2888, dated November 24, 2005, where it appointed Kyivvodokanal and Kyivenergo⁹⁷ as *utilities service providers*. Both companies disputed the decision in the court and the court recognized it as invalid⁹⁷, based on the fact that the companies did not agree to becoming utilities services providers and that the charters of both companies do not provide for the possibility to conduct this type of activity.

⁹⁸ Kievenergo is producer, supplier and distributor of heating in Kiev, It is a private company who is partially owner by Kyiv City Council who operate the infrastructure pursuant to the management agreement

⁹⁹ <http://kyivenergo.ua/ua/news/company/9165-2011-04-13>

¹⁰⁰ <http://www.gioc-kmda.kiev.ua/main/document/31/>. The Municipal Entity "Head Centre of Information and Calculation" is responsible for preparation bills and calculation of housing and utilities services, including water supply. It receives the income from consumers and afterwards distributes the income between companies that render different company that provide housing and utilities services.

- (vi) CICA receives the monies from the banks and distributes them among ZHEKs, condominium associations, and utilities producers. Under the tariffs approved by the Kiev City Council the tariff for the supply of utilities services as a rule, already includes the fees for the services of CICA and ZHEKs at the same time the validity of such decision is disputable as the legislation does not expressly allow for the expenses relating to services of ZHEKs and condominiums to be included into the tariff.¹⁰¹



Under this scheme, an agreement is concluded with a ZHEK or a condominium association which should not be regarded as consumers. They are responsible for invoicing owners of apartments for the services rendered by utilities producers and maintaining of in-house networks.¹⁰² This scheme is especially useful when owners of apartments do not have meters and the amount to be paid is calculated on the basis of the apartment's space-area or number of residents. Indeed, only ZHEKs can have access and obtain full and accurate information.

3.7.4.4 Ability of the PPP company to impose sanctions against non-paying customers

The PPP company can impose sanctions only on consumers with whom it has a direct contract (*e.g.* legal entities, etc). The agreement should mention the specific sanctions for non or delayed payments. The Law of Ukraine "On Liability of Legal Entities for Non Timely Payments of Consumed Communal Services and Housing area" No. 686-XIV, dated May 20, 1999, provides for a special penalty for legal entities that do not pay in time for consumed services. The amount of penalty should be set in the agreement. The minimum amount is one percent (1%) of the debt per day. However, the maximum amount should not exceed one hundred percent (100%) of the debt. Moreover, no particular procedure is established for individual consumers.

In practice, utilities producers may recover debt and impose a sanction only on the basis of a court decision. The court may order to satisfy the claim by means of levy execution over

¹⁰¹ Article 2.1 of the Resolution of the Executive body of Kyiv City Council (Kyiv State Administration) No.857, dated May 31, 2011

¹⁰² <http://kyivenergo.ua/ua/for-consumers/sp-p/4/10-faq/1170-2003-04-27>

the property of the consumer. However, enforcement of the decision against natural persons-consumers is hard.¹⁰³

Please note that utilities producers, as a rule, may not stop supplying services based on the consumer's indebtedness due to:

- (i) technical aspect: The representatives of water supply companies often claim that it is impossible to stop supplying one individual consumer in a multi-storey building.
- (ii) legal aspect: though case law contains an exhaustive list of situations where the utilities supply can be stopped, the indebtedness of a consumer-natural person is not one of them.¹⁰⁴

3.7.4.5 Recommendations:

- *amend the Budget Code so that authorities are obliged to include compensation of the difference between the approved tariffs and the full commercial price, without following of separate procedure of voting such expenses.*
- *amend the Budget Code with provisions allowing the public partner to grant subsidies to the private partner, if tariff increase is politically or socially problematic.*
- *amend the Budget Code and related legislative acts to provide for the obligation to reimburse, at the expense of the State budget, the difference between the approved tariffs and full commercial price, regardless of the status of the authority which set the former.*
- *include reimbursement of concession payments made by the private partner in tariffs.*
- *amend the PPP Law so that if tariffs do not include the investment component or are not properly adjusted by the public partner to the full commercial level, the parties should be allowed to agree on a respective modification to the investment programme. Until such agreement is reached, the private partner should have the right to suspend the investment programme without any penalties.*
- *amend the tariffs legislation in order to allow the possibility to set long-term tariffs without any adjustments by the public partner in order for the private partner to introduce power and resource saving equipment.*
- *if the private partner is responsible for maintaining networks up to the point of connection to the end consumer (in-house infrastructure), tariffs should be set in consideration of this type of expenses, as well as interests paid by the private partner under loans associated with the PPP project.*
- *provide for accelerated procedures concerning tariff adjustment.*

¹⁰³ In practice, the obligation to find the respective property is the responsibility of the utilities producers. It is very complicated to identify the property that may be seized, especially if the consumer does not have any registered property except for an apartment (bank accounts, cars, etc).

¹⁰⁴ Article 23 of the Law of Ukraine "On Potable Water"

3.7.5 Tax

3.7.5.1 General

In addition to possible tax incentives that may be generally available in the host country or that may be specially granted to PPP projects, the general taxation regime of the country plays a significant role in the investment decisions of private investors. Above the assessment of the impact of taxation in the project cost and the expected margin of profit, private investors consider questions such as the overall transparency of the domestic taxation system and the clarity of guidelines and instructions issued to tax payers and the objectivity of the criteria used to calculate tax liabilities.

The scope of this Report does not include a detailed study of the taxation system in Ukraine. Our general remarks are the following:

- The current tax legislation does not provide for any exemptions or favourable tax regime applicable to the private partner within the framework of a PPP project. It does not contain any provisions foreseeing different tax rates depending on the complexity of the project or stage of completion of works or granting of certain permits/licenses as it is foreseen for example in France¹⁰⁵.
- Ukrainian legislation provides for a national regime of taxation of the private partner under the PPP projects. Therefore, the private partner should pay all taxes and mandatory contributions applicable to its activities in Ukraine. However, certain privileges may apply to taxation and custom duties with regard to sector specific industry¹⁰⁶ or imports of particular types of products (i.e. energy saving equipment). We do not recommend a special regime for PPP tax privileges, however.
- Moreover, the equipment imported into Ukraine for performance of the concession contract is also subject to customs duties, CPT (at 25% rate), VAT (at 20% rate), excise duty depending on the category of the imported equipment.
- In case dividends are to be distributed to a non-resident shareholder of a Ukrainian company, such dividends would be subject to a withholding tax at 15% unless otherwise provided for by a Double Tax Treaty entered into between the home country of the investor and Ukraine. For example, under the Ukrainian-French Double Tax Treaty, dividends distributed to a French company are taxed at (i) the 5% rate if the French shareholder owns at least 20% of the share capital in the Ukrainian company, (ii) the 15% rate in other cases. A zero per cent (0%) rate applies if the French shareholder owns at least 50% of the share capital and the value of the total investment amounts to at least 700,000 EUR or its equivalent in UAH.

¹⁰⁵ For instance, for *la taxe locale d'équipement* which as a rule is paid after permit for construction was issued

¹⁰⁶ Chapter 20 Section 4 of the Tax Code of Ukraine

Schedule 1.

General Principles Governing International Best Practice in PPP Legislative Framework

1. Overview

In accordance with the Contract, the present Section will be based on our experience gained in the course of the PPP study we performed on behalf of the European Bank for Reconstruction and Development (the "EBRD") in 2008 (the "EBRD PPP Report").¹⁰⁷

The EBRD PPP REPORT was an attempt to apply the standards commonly acknowledged as "*best international practice*" in terms of PPP regulatory framework and consists in a detailed analysis of PPP Laws in the 27 EBRD countries of operation, including Ukraine, benchmarked against selected core areas (the "**Core Areas**") which are the followings:

- (i) general policy framework;
- (ii) general PPP legal framework;
- (iii) definitions and scope of the PPP Law;
- (iv) selection of the private sponsor;
- (v) PPP agreement;
- (vi) security and support issues; and
- (vii) settlement of disputes and applicable law.

The selection of those Core Areas and the drafting of questions were accomplished on the basis of international standards developed in the PPP and concession field (mainly the UNCITRAL Model Legislative Provisions on Privately Financed Infrastructure Projects, 2003¹⁰⁸).

Other international standards and guidelines used in our EBRD PPP Report are listed below:

- (i) UNCITRAL Model Legislative Provisions on Privately Financed Infrastructure Projects, 2003;
- (ii) Commission Interpretative Communication on Concessions Under Community Law, 2000;
- (iii) UNIDO BOT Guidelines, 1996;
- (iv) European Commission Guidelines for Successful Public-Private Partnerships, 2003; and
- (v) OECD Basic Elements of a Law on Concession Agreements, 1999-2000.

¹⁰⁷ The EBRD worked with the Legal Advisor to finalise the EBRD concession checklist, undertake initial assessments of each national law, develop a methodology for rating concession laws, arrange for verification of the assessments by experts from each of the 27 countries of operations and ensure consistency of information and scoring. The project team comprised Alexei Zverev (EBRD), Bruno de Cazalet, John Crothers and Milica Zatezalo.

¹⁰⁸ John Crothers has taken an active role as Member of *UNCITRAL panel of experts* for the drafting of the *Legislative Guide on Privately Financed Infrastructure Projects* (2000) and its *Addendum on Model Legislative Provisions* (2003). Such guide and provisions are currently used by legislators in most countries to elaborate their PPP legal framework and the drafting of corresponding legal provisions.

For each Core Area, we determined the main objective that needs to be satisfied for the development of PPPs in each EBRD country of operation, based on the standards and guidelines provided above as well as on our extensive experience in international PPP projects.

The table below summarizes the key elements of the methodology used by us in the EBRD PPP Report regarding the elements generally acknowledged as best international practice for each Core Area:

CORE AREA	AIM	BEST PRACTICE
General Policy Framework	<ul style="list-style-type: none"> ▪ Appreciates the country's overall policy framework and efforts in improving the legal environment for PPPs and promoting PPPs 	<ul style="list-style-type: none"> ▪ Existence of policy framework documents ▪ Existence of a "task force" (PPP Unit)
General PPP Legal Framework	<ul style="list-style-type: none"> ▪ Evaluates the existence of a specific Law or of a comprehensive set of laws regulating PPPs and allowing easy access to a clear and stable legal environment for PPP projects to facilitate PPP project structuring, negotiation and closing 	<ul style="list-style-type: none"> ▪ Existence of sector-specific laws regulating PPPs in specific sectors ▪ Existence of a "local services law", regulating "municipal PPPs" ▪ Existence of such laws is not considered as a positive element per se. What is considered positive is the clarity of the legal regime applicable to a particular sector/infrastructure/service
Definitions and Scope of the PPP Law	<ul style="list-style-type: none"> ▪ Assesses the existence of a clear definition of the boundaries and scope of application of the PPP legal framework 	<ul style="list-style-type: none"> ▪ Clarity to limit the risk of a challenge to the validity of a PPP agreement, irrespective of the name given to the document ▪ Precise identification of public authorities empowered to award PPPs and enter into PPP agreements ▪ their coordinated functioning and non-discrimination of domestic and/or foreign persons in becoming private partners

CORE AREA	AIM	BEST PRACTICE
Selection of the Private Partner	<ul style="list-style-type: none"> ▪ Measures the existence of a mandatory application of a fair and transparent selection process and tender rules, limited exceptions allowing direct negotiations, competitive rules for unsolicited proposals and the possibility to challenge illegal awards 	<ul style="list-style-type: none"> ▪ Reference to the principles of transparency, non-discrimination, proportionality and efficiency ▪ Publicity of project information and award. ▪ Existence of provisions providing at the same time clear guidance - guaranteeing a certain degree of objectivity and minimum standards - and sufficient flexibility for Contracting Authorities while organising procedures for pre-selection and requests for proposals is also measured. ▪ Elements that avoid long and non-transparent PPP agreement negotiations ▪ Procedures for aggrieved bidders and third parties
PPP agreement	<ul style="list-style-type: none"> ▪ Assesses flexibility with respect to the content of the provisions of PPP agreements which will allow a proper allocation of risks without unnecessary or unrealistic/not bankable/compulsory requirements/interference from the Contracting Authority (obligations, tariff, termination, compensation) 	<ul style="list-style-type: none"> ▪ Existence of a "model PPP agreement" or model provisions is not in itself considered a positive element but this may be the case where use of such models is not compulsory
Security and Support Issues	<ul style="list-style-type: none"> ▪ Addresses the availability of reliable security instruments on the assets and cash flow of the private partner in favour of lenders 	<ul style="list-style-type: none"> ▪ "Step-in" rights ▪ Possibility of government financial support or the guarantee by the contracting authority of proper fulfilment of its obligations
Settlement of Disputes and Applicable Laws	<ul style="list-style-type: none"> ▪ Assesses notably the possibility of obtaining proper sanctions for breach under the applicable law through international arbitration and enforcement of arbitral awards 	<ul style="list-style-type: none"> ▪ Ratification by the country of relevant international conventions ▪ Parties free to agree on the governing law and choice of dispute resolution procedure

As a practical illustration of the aforementioned EBRD methodology, we attach to the present Report in **Schedule 2** a comparative legislative review of countries which have recently implemented a modern PPP legislative framework and on which we acted as Legal Counsel (*i.e.* Egypt, Kuwait, Albania) as well as two EU countries (Portugal and Greece).

We are conscious that every country is specific and presents very distinct issues. However, our objective in **Schedule 2** is to provide an example of how to apply the EBRD methodology (and therefore best international practice) to any PPP framework, including Ukraine's, whatever the maturity of its national PPP market may be. This is the reason why we mentioned along with Egypt, Albania and Kuwait, the cases of Portugal and Greece which are EU countries with a more mature PPP market.

The Sections below will further develop the best practice principles provided in the table above and will give more precise guidance on the different features that a PPP legislative framework shall include in order to comply with international best practice and reassure private international investors.

2. General policy framework and PPP Unit

The existence of **clear policy framework documents related to PPP** (e.g. government resolution), distinct from privatisation, is generally acknowledged as international best practice. If there are municipal or sector-specific policy frameworks, contradictions and/or overlapping should be avoided.

Further, the existence of a **PPP task force/central PPP unit** that favours harmonization and learning across industries is acknowledged as a positive point. Such unit could be under the direction of the Ministry of Finance/Ministry of Economy of the country (in our case the Ministry of Economic Development and Trade or "**MOEDT**") and its role should be to help monitor the implementation of PPP programs.

3. General PPP legal framework

Generally, it is considered good practice to have **single and general concession/PPP law**, as opposed to multiple sector-specific concession/PPP laws.

The inclusion of provisions in the general concession/PPP law providing that sector-specific laws are complimentary to rather than overriding the general PPP law is also useful (e.g. the Macedonian and Romanian PPP Laws).

Further, as opposed to a rigid mandatory prescriptive regime, a good PPP law should favour **legal flexibility** to provide for easier individual frameworks, designs, and implementations.

4. Definitions and Scope of the PPP Law

A good PPP Law should include a **definition of the term "PPP" / "concession"** with clear boundaries, especially with respect to:

- (i) sector-specific legislation permitting PPP;
- (ii) municipal legislation permitting PPP; and
- (iii) public procurement legislation.

For further details, please refer to **Section Error! Reference source not found.** above for details about the definition and scope of "PPP" in an international context.

Further, special attention shall be given to the following concepts and definitions:

- (i) Definition of **the public authorities empowered to grant PPPs/enter into project agreements** (the "**Contracting Authority**"). The Contracting Authority should be legally entitled to enter into a PPP agreement;
- (ii) Definition of **the private persons to whom PPPs can be granted**. There should be no discrimination on the basis of nationality. To protect their respective interests and act efficiently as the Project Company implementing the PPP project, private investors should have the right to incorporate a locally registered privately-owned limited liability company. Further, there should be no legal restriction on the ability of foreign investors to dispose of their equity investment in the Project Company at market price and remit the proceeds out of Ukraine; and
- (iii) Inclusion of a **non-limitative list of sectors** where PPPs may/may not be granted.

5. Selection of the Private Partner

A good PPP Law should ensure that both the selection process and the tender rules are **fair and transparent**. To achieve such objective, the PPP Law should generally include the following elements:

- (i) Mandatory competitive procedures for PPP award;
- (ii) Publication of information related to the competitive procedure; requirement of international publication for "important"/"strategic" projects;
- (iii) Registration and public access to PPP-related information;
- (iv) Limited/exceptional circumstances allowing direct negotiations (e.g. urgent need for ensuring continuity of services, short duration/low investment value, national defence/security, existence of only one source capable of providing the service, unsuccessful competitive procedure);
- (v) Provisions that provide clear guidance (guaranteeing a certain degree of objectivity and minimum standards) and sufficient flexibility for Contracting Authorities;
- (vi) Provisions that avoid long and non-transparent PPP agreement negotiations;
- (vii) Procedure for aggrieved bidders and third parties; and
- (viii) A selection process ensuring that the public sector eventually obtains from project sponsors the best "value for money" proposal. The selection process should also ensure that the selected proposal is "affordable" by the public sector.

6. PPP agreement

A good PPP Law should allow the parties to conclude PPP agreements that enable a **proper allocation of risks**. It should also allow the parties to obtain the **necessary permits** to effectuate the performance of the PPP project. To achieve such objectives, the PPP Law should generally satisfy the following elements:

- (i) There should not be unnecessary or unrealistic requirements, or interferences, from the public (e.g. obligations, tariff, termination, compensation);
- (ii) The PPP Law might identify a number of core issues to be addressed in any type of PPP agreement but should not regulate in detail the content of its clauses as it might deprive

the parties of the necessary flexibility to negotiate an agreement that takes into account the needs and particularities of a specific project;

- (iii) The private partner should be able to obtain all the necessary administrative documents (authorizations, licenses) to implement the PPP project, ideally with the assistance of the Contracting Authority, within a reasonable time and without undue or unnecessary costs;
- (iv) An effective regulatory framework should exist to ensure that there is no abuse of dominant position, that consumers are protected, and that the private sector service providers and investors are able to earn a fair return for the risks that they are taking. Such regulation can operate through the contract or via independent single-sector or multi-sector regulators; and
- (v) Subject to the rules and regulations in force, there must be no legal constraint to the Project Company that operates the PPP project and provides the public service.

Further, specific attention should be given in the PPP Law to requirements related to property and land use rights. Indeed, the PPP Law should include **rules that safeguard essential property rights in a PPP project** such as:

- (i) Legal provisions and restraints on expropriation;
- (ii) Recognition/protection of private ownership, possible transfer of ownership rights, proper registration of ownership rights, clear enforcement mechanisms, no restrictions for foreigners; and
- (iii) Rights of way over neighbouring land should be permitted for purposes of supplying utilities and for access.

Finally, and subject to compliance with all the required rules and regulations, there must be **no legal constraint on the Project Company's ability to use the land forming the site of the PPP project**. The Project Company should also be able to construct the necessary assets that it uses to provide the required public services under the PPP contract.

7. Security and Support Issues

A good PPP Law should provide for the possibility of **public authorities "support"** to the PPP project. It should also ensure that **reliable security instruments** are available.

Given the importance of such an issue to attract international private investors to a PPP market, especially in emerging countries such as Ukraine, we chose to deal in detail with such issues in a separate Section (cf. **Section 2.3** below).

8. Settlement of Disputes and Applicable Law

A good PPP Law should contemplate the possibility for the parties to the PPP contract to **choose the dispute resolution procedure** they believe is most appropriate for their peculiar project.

In particular, the PPP Law should expressly mention the possibility for the parties to have recourse to **international arbitration**.

It is normal that the PPP Law designates national law of the host country as the law governing the relations between the parties of a PPP agreement; the freedom of choice of

applicable law should however be granted for associated contracts (e.g. construction contracts and especially financing agreements).

9. Best Practices related to Security Instruments and Support issues

9.1 Rationale of the Public Authority "Support"

In the present Section, the term "support" shall be construed as the special measures or decisions that a government (or any relevant public authority) may take to support the implementation of a PPP project.

A decision to support a PPP project's implementation is based on the government's assessment of the project's economic or social value, and whether it justifies some form of government support. Indeed some projects cannot be financed by the private sector alone at an acceptable cost, while others cannot materialize without government support given the appreciation of the overall investment climate in the country.

Three distinct justifications are generally presented in favour of government support:

- (i) the existence of uninsurable political risks;
- (ii) a policy decision that certain services should be provided below the real cost; and
- (iii) the theory that the government has a lower cost of risk bearing than private investors.

Traditionally, political risks include expropriation, political violence (war, terrorism, etc), and convertibility and transfer risks. However, the definition of political risks may also extend to changes in the legal framework, unfavourable regulatory decisions, or failures by publicly-owned enterprises to perform under the PPP contract.

Government financial support can be provided through three basic instruments: (i) subsidies, (ii) financial investment (debt or equity), or (iii) guarantees.

When defining public authority support, some degree of care should be exercised to, *inter alia*:

- (i) not breach the country's international or regional obligations;
- (ii) choose the most appropriate methods for estimating the budgetary costs of support measures, which should take into account the present value of future costs, or loss of revenue; and
- (iii) ensure transparency (e.g. timely communication to all bidders).

9.2 Forms of public support

9.2.1 Public loans

Support to the PPP project from the government may take the form of **interest-free or low-interest loans** to the Project Company to lower the project's financing cost. Such loans may:

- (i) be subordinated, and thus enhance the financial terms of the project by supplementing senior loans provided through commercial banks;

- (ii) be available to all Project Companies in a given sector or be limited to temporary assistance to the Project Company in the event that certain project risks materialize; and
- (iii) have the total amount limited to a fixed sum or to a percentage of the total project cost.

As an illustration, in the M5 Toll Motorway project in Hungary, the government compensated the private sector consortium in the form of a subordinated loan facility for the first six and a half years of commercial operations, which was repayable after discharge of project indebtedness to senior lenders in the event that the consortium's actual revenues, for whatever reason, fell below certain levels.

9.2.2 Loan guarantees

Support to the PPP project from the government may take the form of **public guarantees** by the Contracting Authority or other Government agency for the repayment of loans taken by the Project Company protecting the lenders against default (which list can be limited to certain events) by such company. Such guarantees usually have a lower cost than loan guarantees provided by commercial lenders.

Generally, loan guarantees are not recorded as expenses until the time where a claim is made. However, they may represent a substantial contingent liability (e.g. significant exposure in the event of total failure by the Project Company).

The guarantee can be limited:

- (i) In its amount: to a fixed sum or percentage of the total project cost; and/or
- (ii) In its duration: to defined circumstances under which guarantees may be extended (e.g. prior exhaustion of all other remedies available to lenders under the PPP agreement, the loan agreements or a direct agreement with the Contracting Authority).

9.2.3 Equity participation

Public support may take the form of **direct or indirect equity participation** in the Project Company. This assures public involvement throughout the project's implementation and operation. It also helps achieve a more favourable ratio between equity and debt, notably by supplementing equity provided through the project sponsors when other sources of equity capital such as investment funds are not available.

If the government chooses to participate in equity, equity participation and total public guarantee should be clearly distinguished.

9.2.4 Subsidies

Public support may also come in the form of **public subsidies**. The public authority may grant subsidies to cover the differential between the real commercial price of the service and the price charged to the user of the service.

Subsidies are normally granted as **direct payments** to the Project Company. This can be a lump-sum payment or a payment that is specifically calculated to supplement the Project Company's revenue (e.g. The Perpignan-Figueras Rail Concession between France and Spain where state subsidies cover 57% of the construction costs). If so, the PPP agreement would need to contain provisions pertaining to audit and financial disclosure. Allowing the Project

Company to cross-subsidise less profitable activities with revenue earned in profitable ones may constitute an alternative to direct subsidies.

Tariff subsidies would supplement the Project Company's revenue if the project income falls below a certain minimum level. Tariff subsidies are generally conceived as an alternative to the full commercial freedom to determine tariffs, tolls, etc.

However, there are limitations to the ability of a public authority to grant subsidies. Such limitations may be:

- (i) competition laws requirements (for instance, many countries prohibit public subsidies that are not expressly authorized by legislation); and
- (ii) requirements of international or regional agreements on economic integration or trade liberalization.

9.2.5 Sovereign guarantees

Public support may also come in the form of **sovereign guarantees**. Under a sovereign guarantee mechanism, the State or sub-sovereign entity guarantees neither the Project Company nor the lenders. Instead, the State or sub-sovereign entity guarantees "the proper behaviour" and the commitments made by the Contracting Authority and/or the other concerned public authorities. However, failure to respect such commitments will give rise to pecuniary damages, which may include, *inter alia*, the loans acceleration costs incurred by the lender upon default.

There are two types of sovereign guarantees: (a) **performance guarantees**, and (b) **guarantees against adverse acts of government**.

(a) Performance Guarantees

Performance guarantees are guarantees issued by the host government to cover the Contracting Authority's breach of performance under the PPP agreement. They are useful instruments because they protect the Project Company and the lenders in the event that the Contracting Authority or other public authority defaults under the PPP agreement.

Performance guarantees are generally used where the Contracting Authority is a separate legal entity that cannot trigger the government's own liability. However, if a Contracting Authority functions entirely as a corporate entity, the risk allocated to the performance under the PPP agreement will not be considered a political risk, but a commercial one.

Central governments may provide guarantees against risks pertaining to the behaviour of other entities (e.g. decentralized political authorities). Additional instruments can be used to strengthen the government's credibility in light of its commitments. These instruments include, notably, government performance guarantees, or guarantees by multilateral institutions that are counter-guaranteed by the government itself. Additionally, performance guarantees can also be issued in the name of a public financial institution of the host country.

Good legislation should enable the government to efficiently manage and assess the project's risks, and determine the level of direct and contingent liabilities it can bear.

Performance guarantees may take the form, for instance, of **supply guarantees** which are guarantees that protect the Project Company from the consequences of default by public

sector entities providing goods and supplies required for the operation of the facility (e.g. fuel, electricity, or water). It may also secure the payment of indemnities for which the Contracting Authority may become liable under the supply agreement (e.g.: Off-take guarantees where the Government guarantees payment of goods and services supplied by the Project Company to public entities).

General guarantees are guarantees that protect the Project Company against any form of default by the Contracting Authority rather than default on specifically enumerated terms and conditions. General guarantees are not very frequent, but may be used where the Contracting Authority's obligations under the PPP agreement are not commensurate with its credit-worthiness (e.g. municipal concessions).

(b) Guarantees against Adverse Acts of Government

Guarantees against adverse acts of government assure that the Government shall not impair the Project Company to exercise its rights under the PPP agreement, or other rights derived from the country's legislation.

Foreign exchange guarantees are one form of guarantees against adverse acts of government. They guarantee:

- (i) the convertibility of local earnings into foreign currency;
- (ii) the availability of required foreign currency to meet all foreign debt-service obligations, foreign dividend as well as management payment; and
- (iii) the transferability abroad of the converted sums.

Expropriation guarantees are another form of guarantees against adverse acts of government. Their function is to guarantee the Project Company and its shareholders against expropriation without adequate compensation (e.g. confiscation and nationalization).

9.2.6 Tax and customs benefits

Legislations on foreign direct investment often provide special tax regimes to encourage foreign investment (e.g. tax exemptions, reductions, benefits). Such regimes should be carefully examined and enacted only to the benefit of the Project, or to attract investors.

Such tax and customs benefits may come under the following forms:

- (i) Exemption from corporate tax during the concession period (tax "holiday");
- (ii) Exemption from income tax for foreign project staff or lenders;
- (iii) Exemption from, or reduction of, real estate tax;
- (iv) Exemption from, or reduction of, import duties on equipment, raw materials, and components for the construction, operation and maintenance of the project;
- (v) Tax concessions on royalties;
- (vi) Tax refunds for foreign investors who reinvest their profits in new infrastructural projects in the country;

- (vii) Deductions from taxable income for the cost of certain expenses such as electricity, water, and transport; and/or
- (viii) Capital allowances in the form of depreciation or amortization.

9.2.7 Protection from competition

Public support may also come in the form of **protection from competition**. Such protections are assurances given by the host government to the Project Company that no competing infrastructure project shall be developed for a certain duration and within a certain perimeter, up to a defined threshold (e.g. traffic, consumption, etc.). Such protections also ensure that no Government agency will compete with the Project Company, directly or through another concessionaire. This may be particularly important in toll road projects, where an additional road could undercut the revenue flow.

However, there are limitations to government enacted protective measures, such as:

- (i) competition laws requirements (e.g. risk of monopolies that disadvantages national customers); and
- (ii) the country's obligations under its international or regional agreements.

9.2.8 Ancillary revenue sources

Public support may also take the form of ancillary revenue sources. This enables the Project Company to diversify its investment through additional concessions by ancillary services or the exploitation of other activities (e.g. right to collect a toll on an existing bridge, or the right to charge a fee for the use of a facility built by the Contracting Authority).

However, it would be necessary to enact specific legislation that authorizes the Project Company to use the Contracting Authority's land, or to charge fees for the use of a facility constructed by the Contracting Authority (e.g. The Sidney Harbour Tunnel Project where sponsors were incentivized through (i) the grant of a concession that gave them the right to operate the existing Sydney bridge, and (ii) the bridge toll's increase to match tunnel's toll level).

9.3 Possibility to create, perfect and enforce reliable security instruments

In the context of non-sovereign transactions, lenders look into the cash flow and assets of the Project Company to secure payment of their loans. Lenders will pay particular attention to how much and how quickly they can recover their unsatisfied claim through realization of charged assets, and how simple the whole process would be.

The creation, perfection, and enforcement of loan security instruments require the legal system to be free of legal or regulatory impediments. Such impediments may include:

- (i) When **creating** a security: an unspecific description of collateral, a lack of cadastre, an unregistered mortgage, and an absence of pledge, or other attachment on movable or immovable assets;
- (ii) When **perfecting** a security: difficulties in assessing the existence of prior ranked claims (poor state of corresponding registries), unclear - and consequently - costly registration procedures, impossibility to attach public property, and immunity; and/or

(iii) When **enforcing** a security: difficulties to repossess and sell the collateral.

9.3.1 Security interests on project assets

Security interests may take the form of **security interests on project assets**. Such security interests include:

- (i) Mortgages over land, buildings, and other fixed assets;
- (ii) Charges (floating) over moveable assets (including project inventory and receivables), production or work in progress, intangibles, and other personal property and interests;
- (iii) Pledge on a shareholder's equity participation in the borrower, or on the borrower's interest in the major PPP agreements; and/or
- (iv) Assignment of rights underlying major project authorizations.

9.3.2 "Step-in" clauses

Lenders are particularly concerned with the risk of interruption or termination of the project prior to repayment of the loan. Consequently, they will want the right to "step into the shoes" of a default borrower, and, subject to the Contracting Authority's consent, select unilaterally a new concessionaire to perform under the existing PPP agreements.

Accordingly, lenders must have the right to implement a direct agreement between the Contracting Authority and themselves, which shall govern the assignability of the contract and enable the exercise of step-in rights.

Schedule 2. Kick-off meetings agenda in Kyiv with Ukraine's PPP stakeholders

Monday, 11 July 2011

9-30 am – Ms. Danishevskaya Valentina, Director of **Commercial Law Center**

11-00 am - Mr. Valeriy Iusba, deputy head of **Council of Entrepreneurs under the Government of Ukraine**

1 pm – **LINC Project**, Expert on procurement Semyon Zagaydachnyy

1-30 pm – **Municipal Development Institute**, Ms Alona Babak, expert (tariff regulation)

4 pm – **The State agency for investment and national projects of Ukraine**. Participants: Valeriy Karpunzov - 1 deputy head, Yulia Radchenko - chief of legal and contracting division of legal department, Yuriy Kulik - chief of Projects compliance to the investment legislation division

Tuesday, 12 July 2011

9-30 am- Iryna Zapatryna - deputy head of **Inter Agency Working Group on PPP**

11-30 am - Mr. Myroslav Pittsyk, Vice-President of **Association of Ukrainian Cities**

2 pm - Mr. Denis Gaiovy, Principal Banker at **EBRD**

4 pm – Investment and innovation policy department, **Ministry of Economy Development and Trade**. Deputy head Yuriy Gusev, Senior specialist Viktor Mazyarchuk

Wednesday, 13 July 2011

9-30 am. – **USAID** meeting. Program Analyst, Office of Economic Growth Darya M. Lisyuchenko, Project Management Specialist Glib Krivenko, P3DP Allan Pieper (COP), Larry Hearn (DCOP)

11-30 am. – **IBSER (Institute for Budgeting and Socio-Economic Researches)**, Manager of Public Private Partnership Projects

1 pm – **Committee on Industrial and Regulatory Policy and Entrepreneurship Member of the Parliament**. Head Ms. Natalia Korolevska, deputy assistants: Oleg Bevz; Yuriy Ordenko

Schedule 3.
Analysis Based on EBRD Methodology of Recently Implemented PPP Legislative Reforms

	PPP REFORMS (DRAFTS)			EU PRECEDENTS	
CORE AREA	KUWAIT	EGYPT	ALBANIA	PORTUGAL	GREECE
General Policy Framework	<ul style="list-style-type: none"> Government willing to foster PPP transactions. <u>No</u> PPP projects implemented yet. 	<ul style="list-style-type: none"> Government willing to foster PPP transactions. Implementation of <u>several</u> pilot PPP projects. 	<ul style="list-style-type: none"> Government willing to foster PPP transactions. Implementation of <u>one</u> PPP project so far. 	<ul style="list-style-type: none"> Government willing to foster PPP transactions. Implementation of <u>several</u> PPP projects. 	<ul style="list-style-type: none"> Government willing to foster PPP transactions. Implementation of <u>several</u> PPP projects.
General PPP Legal Framework	<ul style="list-style-type: none"> Specific law drafted but not yet enacted (2006 draft). 	<ul style="list-style-type: none"> Specific law drafted but still under discussion. 	<ul style="list-style-type: none"> Specific law drafted and enacted. 	<ul style="list-style-type: none"> Specific decree law drafted and enacted (Decree law n°141/2006 of July 27th, 2006). 	<ul style="list-style-type: none"> Specific law drafted and enacted (Law No 3389/2005 introduced in September 2005).
Definitions and Scope of the PPP Law	<ul style="list-style-type: none"> PPP defined (Definition of "PPP Projects" in Article 1.2 draft Law). Scope of the law delimited ("<i>All sectors of the national economy shall be eligible for PPPs except where prohibited by law</i>" in Article 1.4 draft Law). 	<ul style="list-style-type: none"> PPP defined (definition of "<i>Partnership Contract</i>" in Article 2 draft Law). 	<ul style="list-style-type: none"> PPP defined (definition of "<i>concessions</i>" in Article 2 Law). Scope of the law delimited (list of sectors in Article 4 Law). 	<ul style="list-style-type: none"> PPP defined (in Article 2 Law). <u>No</u> list of sectors provided or sectors excluded. Exclusion of specific forms of contracts (e.g. concession contracts for public works and public service, management contracts) and of projects < 25 million Euros in investment value or 10 million Euros in government payments (Article 2 Law). 	<ul style="list-style-type: none"> <u>No</u> express definition of PPP. Any work or service under the competence of the concerned public authority may become the subject of a PPP Agreement <u>except</u> where the Constitution expressly prohibits it (e.g. defence, award of justice, police patrolling). Projects shall not exceed €200,000,000 (excluding VAT).
Selection of the Private Partner	<ul style="list-style-type: none"> Satisfaction of the principles of fair and transparent selection process and tender rules, competitive rules for unsolicited proposals (Article 2.3 draft Law and Article 4.6 draft By-Laws) and possibility to challenge illegal awards (Article 5.6 draft By-Laws). 	<ul style="list-style-type: none"> Satisfaction of the principles of fair and transparent selection process and tender rules, possibility to challenge illegal awards (Article 19 draft Law). <u>No</u> mention of unsolicited proposals in the draft Law. 	<ul style="list-style-type: none"> Satisfaction of the principles of fair and transparent selection process and tender rules, limited exceptions allowing direct negotiations (Article 22 Law), competitive rules for unsolicited proposals (Article 23 Law) and possibility to challenge illegal awards (Articles 25 and 26 Law). 	<ul style="list-style-type: none"> <u>Directive 2004/18/EC</u> applies. Application of general EU principles of transparency, proportionality, equal treatment, mutual recognition, protection of environment and freedom of competition. 	<ul style="list-style-type: none"> <u>Directive 2004/18/EC</u> applies. Application of general EU principles of transparency, proportionality, equal treatment, mutual recognition, protection of environment and freedom of competition. 4 different awarding procedures: open, restricted, negotiated and competitive dialogue procedures (Article 8 Law). 2 latest only for complex transactions.

	PPP REFORMS (DRAFTS)			EU PRECEDENTS	
CORE AREA	KUWAIT	EGYPT	ALBANIA	PORTUGAL	GREECE
PPP agreement	<ul style="list-style-type: none"> Flexible as <u>no</u> "model PPP agreement" is provided in the draft Law. 	<ul style="list-style-type: none"> <u>No</u> "model PPP agreement" provided in the draft Law <u>but</u> PPP Unit requirement to reuse substantive parts of previous PPP agreements (e.g. Schools PPP agreement required to be reused in a Wastewater Treatment Plant project) leads to a lack of flexibility. 	<ul style="list-style-type: none"> Flexible as <u>no</u> "model PPP agreement" is provided in the Law. 	<ul style="list-style-type: none"> Flexible as <u>no</u> "model PPP agreement" is provided in the Law. 	<ul style="list-style-type: none"> Flexible as <u>no</u> mandatory "model PPP agreement" is provided in the Law. Law contains explicit though <u>indicative</u> descriptions of the provisions that may be included in a PPP Agreement.
Security and Support Issues	<ul style="list-style-type: none"> "Step-in" rights Possibility of government financial support or the guarantee by the contracting authority of proper fulfilment of its obligations (Article 3.4 draft Law "<i>The PPP Contract shall set out the extent, if any, that the PPP Contract shall be supported by the State, public authorities, state-owned corporations or other entities, including subsidies, guarantees, contributions in-kind, etc</i>"). 	<ul style="list-style-type: none"> <u>No</u> mention of "step-in" rights <u>No</u> mention of the possibility of government financial support or the guarantee by the contracting authority of proper fulfilment of its obligations. 	<ul style="list-style-type: none"> <u>No</u> mention of "step-in" rights Possibility of government financial support or the guarantee by the contracting authority of proper fulfilment of its obligations (Article 11.3.b Law). 	<ul style="list-style-type: none"> <u>No</u> mention of the possibility of government financial support or the guarantee by the contracting authority of proper fulfilment of its obligations. 	<ul style="list-style-type: none"> "Step-in" mentioned as a contractual provision. <u>No</u> mention of the possibility of government financial support or the guarantee by the contracting authority of proper fulfilment of its obligations.
Settlement of Disputes and Applicable Laws	<ul style="list-style-type: none"> Parties <u>not</u> free to agree on the governing law, Kuwaiti law shall apply to PPP Agreements (Article 5 draft Law). Parties free to choose dispute resolution procedure <i>i.e.</i> Kuwaiti courts or international arbitration (Article 5 draft Law). 	<ul style="list-style-type: none"> Parties <u>not</u> free to agree on the governing law, Egyptian law shall apply to PPP Agreements (Article 34 draft Law). "<i>The inclusion of the arbitration condition shall be approved by the Government</i>" (Article 34 draft Law). 	<ul style="list-style-type: none"> Parties <u>not</u> free to agree on the governing law, Albanian law shall apply to PPP Agreements <u>but</u> "<i>The Concessionaire, its shareholders and other business partners shall be free to choose the law governing their relations</i>" (Article 30 Law). Parties free to choose dispute resolution procedure <i>i.e.</i> Albanian courts or international arbitration (Article 31 Law). 	<ul style="list-style-type: none"> Parties <u>not</u> free to agree on the governing law, Portuguese law shall apply to PPP Agreements. <u>No</u> mention of the availability of international arbitration. Mention of a "negotiating committee" empowered by the Ministry of Finance to resolve the dispute. 	<ul style="list-style-type: none"> Parties <u>not</u> free to agree on the governing law, Greek law shall apply to PPP Agreements. Litigation shall be resolved through arbitration, PPP Agreement shall set out the rules that shall govern arbitration. Parties free to choose between domestic and international arbitration, if the contractor is not Greek.

Schedule 4. The PPP legislation

The Legal Adviser performed the review of the following pieces of Ukrainian legislation which are related to PPP, which in Ukraine, is a complex area that includes corporate, tax, environment protection, occupational safety and other laws:

- (i) the Law of Ukraine "On Lease of State and Municipal Property"
- (i) the Law of Ukraine "On Privatization of State and Municipal Property";
- (ii) the Law of Ukraine "On Concession";
- (iii) the Civil Code of Ukraine;
- (iv) the Budget Code of Ukraine;
- (v) the Commercial Code of Ukraine
- (vi) the Tax Code
- (vii) Law of Ukraine "On Public Utilities Services";
- (viii) Law of Ukraine "On Local Governance";
- (ix) Law of Ukraine "On Prices and Formation Thereof";
- (x) Law of Ukraine "On the Antimonopoly Committee of Ukraine";
- (xi) Law of Ukraine "On Potable Water and Potable Water Supply";
- (xii) Law of Ukraine "On Natural Monopolies";
- (xiii) Law of Ukraine "On Motor Roads' Concession";
- (xiv) Law of Ukraine "On Public Procurement";
- (xv) Law of Ukraine "On Lease and Concession of the Infrastructure";
- (xvi) Law of Ukraine "On Mortgage";
- (xvii) Law of Ukraine "On Pledge";
- (xviii) Law of Ukraine "On Payment Systems and Money Transfers in Ukraine";
- (xix) Law of Ukraine "On Joint-Stock Companies";
- (xx) Law of Ukraine "On State Budget";
- (xxi) Regulation of the Cabinet of Ministers of Ukraine "On Procedure of Issuance of Guarantees for Securities to Be Provided while Taking Loans under State Guarantees";
- (xxii) Regulation of the Cabinet of Ministers of Ukraine "On Order of Conducting of the Concession Tender for the Construction and Operation of Highways";

- (xxiii) Regulation of the Cabinet of Ministers of Ukraine "On Approval of the Procedure for Establishment of Maximum Amount of Fees for Passage through Highways Constructed on the Terms of Concession";
- (xxiv) Regulation of the Cabinet of Ministers of Ukraine "On Approval of the Procedure for Compensation for Toll-Free Passage through Highways Constructed on the Terms of Concession";
- (xxv) Law of Ukraine "On International Private Law";
- (xxvi) Regulation of the Cabinet of Ministers of Ukraine "On Certain Issues related to PPP"
- (xxvii) Water Code of Ukraine;
- (xxviii) Law of Ukraine "On Licensing of Certain Types of Business Activities";
- (xxix) Law of Ukraine "On Wastes";
- (xxx) Order of the Ministry of Housing and Utilities of Ukraine "On Approval of the Licensing Conditions for Heating Supply";
- (xxxi) Regulation of the Cabinet of Ministers of Ukraine "On Approval of the List of Documents that should be Submitted Together with the Application for Issuance of the License for each Separate Type of Commercial Activity";
- (xxxii) Decree of the Cabinet of Ministers of Ukraine "On Approval of the Procedure for Preparation, Approval and Review of the Limits on Generation and Disposal of Wastes";
- (xxxiii) Decree of the Cabinet of Ministry of Ukraine "On Approval of the Procedure with regard to Issuance of Permits for Special Water Use";
- (xxxiv) Law of Ukraine "On Protection of the Atmosphere";
- (xxxv) Law of Ukraine "On Occupational Safety and Health";
- (xxxvi) Law On Peculiarities of Leasing and Giving in Concession of Centralized Water and Heat Supply and Drainage (Sewage) Facilities Owned by Municipalities, and Peculiarities of Taking Lease and Concession of Such Facilities;
- (xxxvii) Order of the Ministry of Energy and Fuels of Ukraine "On Approval of the Procedure of Consideration of Projects for Development of the Fuel and Energy Industry that are owned by the State under Lease or Concession"
- (xxxviii) Law of Ukraine "On Product's Sharing Agreements"
- (xxxix) Decree of the President of Ukraine "On Agency on Investment and National Projects"
- (xl) Decree of the President of Ukraine "On the Ministry of Economic Development and Trade of Ukraine "

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