


Identifier	Created	Classification	Origin
07KYIV2505	2007-10-02 11:12:00	CONFIDENTIAL	Embassy Kyiv

Cable title: **UKRAINE: CABINET OF MINISTERS APPROVES VANCO PSA**

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E.O. 12958: DECL: 10/02/2017

TAGS: EPET ENRG PINR EINV UP

SUBJECT: UKRAINE: CABINET OF MINISTERS APPROVES VANCO PSA

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REF: A. KYIV 426

B. KYIV 360

Classified By: AMBASSADOR, REASONS 1.4 (B) AND (D)

1. THIS INFORMATION IS COMMERCIALY SENSITIVE AND SHOULD NOT BE SHARED OUTSIDE OF THE USG.

2. (C) Summary. On September 26 the Cabinet of Ministers approved the production sharing agreement (PSA) for oil and gas exploration in the Black Sea with Houston-based Vanco. Vanco told the GOU it would sign the PSA as is. The PSA is the first of its kind for Ukraine. Vanco won a tender to negotiate the deal in April 2006, but encountered drawn-out opposition from senior GOU officials before it finally reached agreement with the GOU. While Vanco has yet to see the final text, its management tells us that the company is confident that the GOU will treat it as a fair and equal partner. Vanco's backers in the deal include Ukrainian oligarch Rinat Akhmetov and Russian businessman Yevgeniy Novitsky. According to Vanco, Akhmetov's engagement will ultimately help the company achieve its objectives and thwart any attempts by the deal's opponents to torpedo the deal. Although the process was anything but smooth, with Vanco apparently making significant last minute concessions on issues that it once considered deal-breakers, the agreement is a signal that modern PSAs are possible in Ukraine, albeit with much difficulty. End Summary.

Opposition from the Get-Go

3. (C) In April 2006 Vanco won a tender to negotiate a PSA for exploration and development of oil and gas in the Prykerchenska area of the Black Sea. Negotiations dragged on



for months, and Vanco assessed that various GOU officials, most importantly Fuels and Energy Minister Yuriy Boyko and Environment Protection Minister Vasyl Dzharty, had tried to torpedo the deal, using stalling tactics and making unacceptable demands that would, in Vanco's view, make the

project unviable. Although it has little evidence, Vanco suspects that the ministers were engaged on behalf of RosUkrEnergo, so it could gain access to the potential energy sources of the Black Sea for themselves. After the personal intervention of Deputy Prime Minister Klyuyev, the original one-year deadline to finish the deal was extended until October 21 of this year, after which the tender would expire in accordance with Ukrainian law. Such a result would have left Vanco empty-handed.

Navigating Landmines

4. (C) Major stumbling blocks in the negotiation have included a GOU demand that Vanco pay \$38 million to remove unexploded military ordinance discovered in the area, and to compensate the Ukrainian military for moving a military test range previously located in the area. Vanco has told us it is now confident that the compensation issue will not torpedo the deal. Vanco was also concerned that the production splits percentages demanded by the GOU would make the deal financially unviable. Gas valuation formulas were another concern, as was GOU insistence that arbitration be conducted on Ukrainian soil, although Ukraine was willing to use internationally acceptable arbitration rules. Vanco feared that this would allow Ukrainian courts to rule on any future disputes related to the PSA, and this in turn could deter potential financial backers.

Vanco Agrees to Production Split, Other Issues

5. (C) Vanco President Gene Van Dyke told Ambassador on September 26 that ultimately Vanco agreed to a production sharing split of 70/30 in Vanco's favor before cost recovery, and 50/50 after cost recovery. Van Dyke said Vanco also agreed to the GOU's gas valuation formulas and to international arbitration on Ukrainian soil. He said he was confident that he had sufficient assurances from the GOU that Vanco would be treated fairly. More importantly, he said, it was worth the risk to secure access to the coveted exploration of the Black Sea. Vanco officials told us they had not seen the text of the version approved by the Cabinet, but presumed it was almost identical with a version of the PSA they were presented on September 24.

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Vanco's Investors

6. (C) When it contested the tender, Vanco originally had financial backing from JMR of London, a Rothschild family investment group. JMR later was replaced by Deutsche Bank, who subsequently dropped out in favor of other investors. Vanco has told us that it now has the financial backing of a powerful group of investors including Rinat Akhmetov's SCM, the Russian Yevgeniy Novitsky, former CEO and now member of the board of Sistema, (a Russian conglomerate with assets that include MTS, the largest Russian cell phone company) and Integra, an Austrian-based investment fund. Vanco told us that all of its prospective investors would pass a due

diligence test performed by the law firm Aiken Gump. Akhmetov played a key role in thwarting opposition from Boyko and others, Vanco's local representative told us.

Comment

7. (C) The deal might be a welcome sign to would-be energy investors that modern PSA agreements are possible in Ukraine. However, by dragging out these negotiations almost to the bitter end, the GOU has likely squandered much of the good will it hoped to attract from international energy companies. The deal, although still not final, moved forward because Vanco was ready to make concessions on issues that it once told us were deal breakers. Vanco may believe that its access to the lucrative Black Sea reserves (if oil and gas are discovered) will be so valuable that the residual concerns it had about the PSA are worth the risk. Still, Vanco is banking on the goodwill of the GOU, and the ability of its powerful backers, such as Akhmetov, to prevent the project from becoming derailed again in the future. End comment.
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