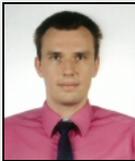


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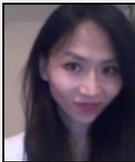
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## Production Sharing Agreements in the Caucasus and Central Asia: A Contextual Study of Azerbaijan and Kazakhstan by H. Sahin

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# Production Sharing Agreements in the Caucasus and Central Asia: A Contextual Study of Azerbaijan and Kazakhstan

Hakan Şahin\*

## Abstract

*Following the dissolution of the Soviet Union, the newly formed resource-rich countries have each striven to occupy a major position in Eurasian economy. Azerbaijan and Kazakhstan are two of the former Soviet republics that arguably have most successfully realised this goal in the petroleum sector, largely by attracting foreign investors. Their success in attracting and securing these investments has been dependent on contractual production-sharing agreements ('PSAs') as well as the implementation of a series of laws designed to protect and secure foreign investment. Production-sharing agreements establish the legal, fiscal and commercial framework between a multinational oil company and a concerned state with respect to each other. This article focuses on the legal and taxation aspects of the PSAs initiated by Azerbaijan and Kazakhstan from a comparative perspective. The article exposes the main legal issues and explores the most controversial contractual commitments inserted into this type of agreement. It goes on to propose practicable solutions to overcome the outlined challenges and makes concrete recommendations to the governments of these states.*

## 1. Introduction

In the aftermath of the dissolution of the Soviet Union, new sovereign states emerged in the Caucasus and Central Asia. Ever since they gained independence in 1991, Azerbaijan and Kazakhstan have engaged in close cooperation with multinational oil and gas companies. In this manner, the two nascent nation-states have managed to distinguish themselves from other Commonwealth of Independent States (CIS) countries. The implementation of a series of laws in Azerbaijan and Kazakhstan with regard to the protection of foreign investors has been fundamental to boosting the attractiveness of these states to the petroleum sector. Notably, in Azerbaijan, foreign investment is supported by a range of laws, such as the Law on the Protection of Foreign Investments,<sup>2</sup> the Investment Activity Law<sup>3</sup> and the Law on International Commercial Arbitration.<sup>4</sup> At present, there are more than 30 foreign petroleum investors actively conducting business in Azerbaijan, among which the USA, the UK, Norway, Russia, Saudi Arabia, Japan and China.<sup>5</sup>

In neighbouring Kazakhstan, the energy sector, and more specifically, oil and gas extraction are a crucial national enterprise in that they form the backbone of the country's economy. To attract foreign investors in the petroleum sector, the state has introduced key new legislation to

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<sup>2</sup> The Law of The Republic of Azerbaijan on Protection of Foreign Investments (15 January 1992).

<sup>3</sup> The Law of The Republic of Azerbaijan on Investment Activity (13 January 1995).

<sup>4</sup> The Law of The Republic of Azerbaijan on International Commercial Arbitration ( 18 November 1999).

<sup>5</sup> Nurlan Mustafayev, 'Production-Sharing Agreements in the Petroleum Industry of Azerbaijan' (2015) 8(4) Journal of World of Energy Law and Business 362.

satisfy the contractual needs of the hydrocarbon sector. Notable examples are The Subsoil Code, the country's new investment law, a new tax code as well as a new arbitration law that provides a more secure framework for arbitral proceedings. Just as its Azerbaijani counterpart, oil-rich Kazakhstan has succeeded in attracting investments from both Western and non-Western petroleum companies. The following foreign petroleum companies are currently operating in Kazakhstan: the multinational oil giants Chevron and ExxonMobil (US-based), as well as European firms BG Group Royal Dutch Shell (UK-Netherlands-incorporated), Total (France-based), and Eni (Italy-based).<sup>6</sup> In addition, non-Western oil companies such as Lukoil from Russia and China's National Petroleum Corporation are also operating in Kazakhstan.<sup>7</sup>

PSAs are the standard type of agreement between foreign investors and host states or, more habitually, a state-owned national oil company in the petroleum industry.<sup>8</sup> This type of agreement grants oil companies the right to explore and develop a petroleum field, while simultaneously holding them responsible for covering all exploration costs and shouldering any ensuing investment risks.<sup>9</sup> According to Bindemann, this type of agreement stipulates that the foreign oil company explores, develops and produces hydrocarbon, while exploration and production costs are divided between the host government and the foreign oil companies. Whereas the investor receives a share of oil to recover costs ('cost oil') and make a profit ('profit oil'),<sup>10</sup> the host government obtains a share of the profit oil.<sup>11</sup>

PSAs have been concluded with foreign investors by the governments of Azerbaijan and Kazakhstan in the petroleum sector as means of attracting foreign investment into their countries. It is worth emphasising that while the use of PSAs in Azerbaijan is ongoing, the 2010 Subsoil use law adopted in Kazakhstan drew a line under the continued use of any such agreements.<sup>12</sup> Notwithstanding that, it was decreed that any active PSAs would remain in force and continue to apply to ongoing petroleum development operations in Kazakhstan.<sup>13</sup> Put in simple terms, this policy update does not challenge the status of any previously signed PSAs between national oil companies and international petroleum investors.

The purpose of this article is to examine the legal and taxation aspects of current PSAs of Azerbaijan and Kazakhstan from a comparative perspective. The article exposes the main legal issues and explores some of the more controversial contractual commitments inserted into this type of agreement. It then proposes practicable solutions to overcome the outlined challenges and makes concrete recommendations to the governments of the two countries.

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<sup>6</sup> Serik Orazgaliyev, 'State Intervention in Kazakhstan's Energy Sector: Nationalisation or Participation?' (2018) 9 *Journal of Eurasian Studies* 146.

<sup>7</sup> *ibid.*

<sup>8</sup> Peter D. Cameron, *International Energy Investment Law: The Pursuit of Stability* (OUP 2010) 37. See also Kirsten Bindemann, 'Production-Sharing Agreements: An Economic Analysis' (October 1999) Oxford Institute for Energy Studies (OIES) WPM no. 25, 1.

<sup>9</sup> Hakan Sahin, *Host Government Agreements and Law in the Energy Sector: The Case of Azerbaijan and Turkey*, (Routledge 2018) 12.

<sup>10</sup> Kirsten Bindemann, (n 8) 1.

<sup>11</sup> *ibid.*

<sup>12</sup> Law No. 291 IV of the Republic of Kazakhstan on Subsoil and Subsoil Use, dated June 24, 2010.

<sup>13</sup> International Institute for Environment and Development (IIED), *How to scrutinize a Production Sharing Agreement: A guide for the oil and gas sector based on experience from the Caspian Region* (IIED 2012) available at <<https://pubs.iied.org/pdfs/16031IIED.pdf>> accessed in May 2019.

## 2. Azerbaijan: The Legal Regime Governing the Petroleum Sector

The hydrocarbon sector is not new to Azerbaijan. The country boasts one of the longest running and most well-established petroleum producing industry in the world.<sup>14</sup> In the second half of the 20<sup>th</sup> century, petroleum production in Azerbaijan stagnated as Soviet oil investment in Siberia took precedence.<sup>15</sup> Conversely, in the early 1990s, Azerbaijan occupied a central place in the global oil industry producing half of the world's oil.<sup>16</sup> The founder of the Republic of Azerbaijan, Heydar Aliyev established a new PSA model as part of his strategy to attract foreign investments into the national energy sector. His policy has been highly effective as since 1994 the country has entered into a total of 32 PSAs with foreign oil companies.<sup>17</sup> The former president of the State Oil Company of Azerbaijan (SOCAR) Sabit Bagirov presented a compelling case for the effectiveness of this legislative model. Bagirov argued that, for a newly founded state, especially one that lacked financial capital, PSAs were the only form of agreement available that could feasibly deliver a return to Azerbaijan.<sup>18</sup>

Azerbaijan's PSAs in principle contain freezing, economic-balancing stability provisions.<sup>19</sup> Generally speaking, these provisions are inserted by international investors in an investment contract to ensure that the contract shall not be unilaterally altered or terminated by a host government's legislative or administrative activities. Unlike Kazakhstan, the stability commitments covered in Azerbaijan's PSAs extend to the environment and public health and safety. This means that Azerbaijan's regulatory or administrative activities in the area of human rights, health and safety should not have an adverse effect on the economic interest of the investors.

The Azerbaijan PSA of 1998 provides that:

[In] the event that any Governmental Authority invokes any present or future law, treaty, intergovernmental agreement, decree or administrative order which contravenes the provision of this agreement or adversely or positively affects the rights or interests of Contractor hereunder, including, but not limited to, any changes in tax legislation, regulations, or administrative practice, or jurisdictional changes pertaining to the Contract Area, the terms of this Agreement shall be adjusted to re-establish the economic equilibrium of the Parties, and if the rights or interests of Contractor have been adversely affected, then SOCAR [The National Company] shall indemnify

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<sup>14</sup> U.S., Energy Information Administration, Background Reference: Azerbaijan, available at <[https://www.eia.gov/beta/international/analysis\\_includes/countries\\_long/Azerbaijan/azerbaijan\\_bkgd.pdf](https://www.eia.gov/beta/international/analysis_includes/countries_long/Azerbaijan/azerbaijan_bkgd.pdf)> accessed in August 2019.

<sup>15</sup> Ibid.

<sup>16</sup> Richard Pomfret, 'Exploiting Energy and Mineral Resources in Central Asia, Azerbaijan and Mongolia' (2010) University of Adelaide School of Economics Research Paper No 2010-16, 6 available at <<https://core.ac.uk/download/pdf/6251053.pdf>> accessed in May 2019.

<sup>17</sup> Hakan Sahin (n.9) 155. For further reading, please see Oksan Bayulgen, *Foreign Investment and Political Regimes: The Oil Sector in Azerbaijan, Russia and Norway*, (Cambridge, Cambridge University Press: 2010) 93.

<sup>18</sup> Sabit Bagirov, 'Azerbaijan's Oil Revenues: Ways of Reducing the Risk of Ineffective Use' (2007), unpublished manuscript cited in Aitor Ciarreta & Shahriyar Nasirov, Analysis of Azerbaijan Oil and Gas Sector, <[https://www.usace.org/usace2011/submissions/OnlineProceedings/Ciarreta\\_Nasirov-Article1.pdf](https://www.usace.org/usace2011/submissions/OnlineProceedings/Ciarreta_Nasirov-Article1.pdf)> accessed in May 2019.

<sup>19</sup> Fatma Babayeva, 'Production Sharing Agreements (PSAs): Azerbaijan's Practice' (June 2016) 4(3) ENERPO, 13.

Contractor (and its assignees) for any disbenefit, deterioration in economic circumstances, loss or damages that ensue therefrom.<sup>20</sup>

With regard to the above-cited contract, Cameron asserts that:

[The] role of SOCAR in the contract underlines an important point. In a number of cases the host country's NOC will play a central role in the operation of fiscal stabilisation. It may provide for adjustment by paying any additional taxes out of its share of profit petroleum or royalty under a PSA or it may reimburse the IOC directly out of general revenues. Under a rate of return system, the NOC could pay from its share of royalty and/or excess profits tax.<sup>21</sup>

As is evident, this in-built stability provision is, in effect, a freezing clause with economic balancing. Traditional stabilisation clauses are designed to protect petroleum investors by freezing the legal status quo of the host state on the point of signing. Due to their function of freezing the legal regime in the host state, such clauses constitute a challenge to the principle of state sovereignty. Conversely, economic balancing clauses do not pose a similar threat to a state's autonomous rule. Instead, they provide a flexible and dynamic contractual framework for both parties over the course of the investment project, listing circumstances under which a host country may choose to assert its sovereign right to change the economic conditions within which the agreement operates.<sup>22</sup> Moreover, Azerbaijan has sought to guarantee stability via foreign investment law. art 10 of The Law on Protection of Foreign Investment regulates guarantees against changes in legislation. As stated by art 10:

[In] case if in future legislation of the Azerbaijan Republic will worsen investment terms, then within 10-years legislation which existed at the moment of implementation of investments will be applied thereto. This does not apply to changes in legislation of the Azerbaijan Republic concerning defence, national security and public order, environmental protection, taxation, credits and finances, public morals and public health.<sup>23</sup>

In the context of this article, the law provides protection against adverse regulatory changes for the 10-year period following the investment. It should be noted that this moratorium has the force of law, and thus, is enforceable and has a binding effect upon all Azerbaijan state bodies. Art 10 also clearly outlines the guarantees, changes in legislation in the area of national security, defence, public health, environmental protection, as well as any acts which may affect credits and finances which fall outside the scope of the moratorium.

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<sup>20</sup> The Azerbaijan Union Texas/Commonwealth Production Sharing Agreement, 1998 (art 22/2) in Mustafa Erkan, *International Energy Investment Law: Stability Through Contractual Clauses* (The Hague, Kluwer International, 2010) 205.

<sup>21</sup> Peter D. Cameron, 'Stabilisation in Investment Contracts and Changes of Rules in Host Countries: Tools for Oil & Gas Investors. Final Report' AIPN, (5 July 2006) <<https://www.international-arbitration-attorney.com/wp-content/uploads/arbitrationlaw4-Stabilisation-Paper.pdf>>, 74.

<sup>22</sup> Klaus P. Berger, 'Renegotiation and Adaptation of International Investment Contracts: The Role of the Contract Drafters and Arbitrators' (2003) 36 *Vanderbilt Journal of Transnational Law* 1361. *See also* Mustafa Erkan (n 20) 208.

<sup>23</sup> Art 10, Law of the Azerbaijan Republic on the Protection of Foreign Investments (n.2).

## *2.1 Legal Status of PSAs in Azerbaijan*

The Azerbaijan's PSA model is unique in its legal process and status. When SOCAR's officials and foreign company's representatives reach a mutual agreement on a PSA, it requires the approval of the president. After this procedure the contract is conveyed to the Azerbaijan's parliament for ratification. When the parliament has ratified a contract, they pass it back to the president for a final assent. With a presidential assent in place and after promulgation, the PSA is accepted as carrying the full weight of law and prevails over all existing or future law or decrees, the provisions of which diverge from or are inconsistent with the contract.

As there is no unique law or regulatory institution that governs such agreements, PSAs have to be ratified by parliament. It is noteworthy that the legal framework for the regulation of oil and gas agreements is based on the Subsoil Act<sup>24</sup> and the Energy Act.<sup>25</sup> However, these regulations only provide a general framework for energy resources in Azerbaijan. Moreover, PSAs received its unique status first in 1994 when the Agreement on Joint Development and Production Sharing for the Azeri-Chirag-Gunesli ('ACG') was enacted.<sup>26</sup>

After the ratification of this PSA from the Parliament of the Republic of Azerbaijan, it was widely expected that the status of PSAs as law would be a temporary measure and that sound domestic legislation would eventually be drafted to govern the terms of energy projects relating to the oil and gas industry. Notwithstanding that, in the period between 1994 to 2019 no such bill of law has been presented to the parliament, nor has any relevant article been passed by the parliament for inclusion in the Azerbaijani Constitution.

## *2.2 Taxation Regime of PSAs in Azerbaijan*

Despite the individual nature of each PSA, all current Azerbaijan's PSAs are similarly designed and include many standard contractual clauses. For instance, such agreements mainly comprise the rights and obligations of each contracting party; the contract area, the clause identifying the development and production period; provisions for the recovery of exploration costs and sharing of production; bonus payments and taxation.<sup>27</sup> There are, however, peculiarities in the taxation-related clauses of such agreements. According to Mustafayev, one of the most inspired features of the fiscal regime of Azerbaijan's PSAs is that it is 'structurally based on the principle of profitability, which is responsive to costs and the recovery of investments, oil price changes, the production profile, the timing of payments and contractual stability'.<sup>28</sup> The second most important feature is that 'the fiscal system is back-end loaded, i.e. the contractor makes tax payments late in the cash flow, which has a positive impact on the economics of upstream projects'.<sup>29</sup>

According to Azerbaijan's PSAs, the Republic is the sole owner of all resources and installations. However, it is noteworthy that unlike PSAs in other resource-rich countries,

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<sup>24</sup> Law No. 439-IQ of the Republic of Azerbaijan on Subsoil Reserves, dated February 13, 1998.

<sup>25</sup> Law No. 541-IQ of the Republic of Azerbaijan on Energy, dated November 24, 1998.

<sup>26</sup> Agreement on the Joint Development and Production Sharing for the Azeri Chirag Fields and Deep Water Portion of Gunashli Field in the Azerbaijan Sector of the Caspian Sea, dated 20 September 1994.

<sup>27</sup> Deloitte, 'Azerbaijan Oil and Gas Taxation Guide,' (2018).

<<https://www2.deloitte.com/content/dam/Deloitte/az/Documents/tax/aze/TaxBrochures2016/Azerbaijan%20Oil%20and%20Gas%20Taxation%20Guide.pdf>> accessed in June 2019.

<sup>28</sup> Nurlan Mustafayev (n. 5) 372.

<sup>29</sup> *ibid.*

investors in the petroleum industry do not pay royalties to Azerbaijan, although the contractors pay profit tax. In Azerbaijan, a different tax regime is applicable to PSAs. If a contractor has entered into a PSA in the oil and gas industry in Azerbaijan, such an agreement would define the taxation regime for the investor's business activity. The tax regime for PSAs in Azerbaijan is called the Oil consortia. It applies to the contractor and all other project participants of a PSA. Currently, all of the PSAs to which Azerbaijan is a party supply a grand total of profit tax of around 25% or 35% of revenues, in accordance with rates negotiated when the contract was first signed. The PSAs also offer protection against future increases in the profit tax rate. Foreign investors are exempted from all the other taxes to which they are ordinarily subject to outside the oil sector.

The PSAs of Azerbaijan include comprehensive tax provisions which are divergent from the national tax regime set out under the Tax Code.<sup>30</sup>

Azerbaijan's PSAs also sets out administrative procedure of tax payments. Contractors of each PSAs are responsible for only the taxes that are stipulated in their agreements. Furthermore, the country's state owned company SOCAR is the unique authority in tax collection from the contractors of each PSAs. The collected tax revenues are delivered by SOCAR to the country's Ministry of Tax of the Republic of Azerbaijan. It should be borne in mind that contrary to most hydrocarbon producing countries, the Azerbaijan's 'PSA regime does not envisage withholding tax on dividends or repatriation of profits sourced from Azerbaijan.'<sup>31</sup> According to Mustafayev, 'the absence of a withholding tax on the repatriation of profits appears insufficient and fails to incentivize IOCs to reinvest their profits.'<sup>32</sup>

### **3. Kazakhstan's Oil Sector: The Legal Framework**

The attraction of foreign investment into the hydrocarbon sector has been a significant focus of Kazakhstan's policymakers ever since Kazakhstan came into being as a nation-state.<sup>33</sup> A number of significant legislative measures and directives were incorporated into the Kazakhstani legal framework more than two decades ago to regulate foreign investment in the energy industry. The most significant of these measures are the Oil Law<sup>34</sup> and the Law on the Subsoil and Subsoil Use.<sup>35</sup> Nonetheless, it should be noted that this legislation has been of a progressive and incremental nature and has been undergoing a series of liberalising reforms over the years by the Kazakhstani government. For instance, in 2010, the country adopted the Law on Subsoil and Subsoil Use<sup>36</sup> which superseded both the prior Subsoil and Subsoil Use Law<sup>37</sup> and the Oil Law.<sup>38</sup> By adopting this law, Kazakhstan sought to increase sovereign control over its natural resources and to strengthen the regulations it enforces upon the petroleum industry.<sup>39</sup> In addition, one of the most significant elements of the Subsoil Use Law was that it related to the structure of future petroleum contracts.<sup>40</sup> Perhaps the most significant

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<sup>30</sup> *ibid.*

<sup>31</sup> *ibid.* (n 5) 374.

<sup>32</sup> *ibid.*

<sup>33</sup> *ibid.*

<sup>34</sup> Law No. 2350 of the Republic of Kazakhstan on Oil, dated June 28, 1995.

<sup>35</sup> Law No. 2828 of the Republic of Kazakhstan on Subsoil and Subsoil Use, dated January 27, 1996.

<sup>36</sup> Law No. 291 IV of the Republic of Kazakhstan (n 12).

<sup>37</sup> Law No. 2828 of the Republic of Kazakhstan (n 35).

<sup>38</sup> Law No. 2350 of the Republic of Kazakhstan (n 34).

<sup>39</sup> Kuanysh Sarsenbayev, 'Kazakhstan Petroleum Industry 2008-2010' (2011) 4(4) *Journal of World Energy Law and Business*, 373.

<sup>40</sup> *International Institute for Environment and Development* (n 13) 33.

reformatory step taken by the Kazakhstani petroleum sector was the adoption of a new Code On Subsoil and Subsoil Use (the ‘Subsoil Code’) on 27 December 2017.<sup>41</sup> The new Subsoil Code revised several articles in the former statute of Law on Subsoil and Subsoil Use dated June 2010.<sup>42</sup>

In Kazakhstan, the legal structures regulating the development of petroleum recourses divide into two main categories: micro and macro governance structures.<sup>43</sup> The government of Kazakhstan enacts legislation to regulate foreign investment in the area of mining and hydrocarbon sectors at the macro level.<sup>44</sup> At the micro level, the government of Kazakhstan provides contractual agreement frameworks for the governance of specific oil and gas projects.<sup>45</sup> The Subsoil Code introduces a variety of modifications. For instance, the stability regime in the Subsoil Code is one of the major legislative developments. Subsoil use contracts related to hydrocarbon is regulated in art 36 of Subsoil Code, under the section of ‘Contents of Subsoil Use Contracts’. According to the relevant art 36.7:

[A]mendments and additions to the legislation of the Republic of Kazakhstan that negatively impact on the outputs of entrepreneurial activities of a subsoil user under subsoil use contracts shall not apply to the contracts concluded before making such amendments and additions.

The guarantees set forth by one of this party do not apply to changes in the legislation of the Republic of Kazakhstan in the field of national security, defence, environmental safety, health, taxation, customs, regulations and competition protection.<sup>46</sup>

The guarantees established by this article stipulate that subsoil users are only granted exemption from parliamentary or legislative changes that would be detrimental to their business activities. It should be noted that while the first paragraph of section 7 of the art provides narrower stability guarantees to the Subsoil use contractor, the second paragraph of this section stipulates several exceptions in favour of the state. These exceptions are intended to protect the interests of the country’s national security, defence, environmental security, health, taxation, customs and regulations and freedom of competition. It could be argued that art 36 of the Subsoil Code is beset with ambiguity as “it does not specify, what constitutes the result of the economic activity, who defines that it was or was not worsened and what the parameters of worsening are.”<sup>47</sup>

### *3.1 The Legal Characteristics of Kazakhstan’s PSAs*

Following the dissolution of the Soviet Union, Kazakhstan is one of the few post-Soviet countries “...where production sharing contracts as one of the main forms of contractual relations in civil law between the state and foreign investors in the sphere of hydrocarbon

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<sup>41</sup> The Code of the Republic of Kazakhstan on Subsoil and Subsoil Use No.125-VI ZRK (the Subsoil Code), December 27, 2017.

<sup>42</sup> Law No.291 IV of the Republic of Kazakhstan (n 12).

<sup>43</sup>International Institute for Environment and Development, (n 13) 20.

<sup>44</sup> *ibid*

<sup>45</sup> *ibid*.

<sup>46</sup> Art 36/7 of The Subsoil Code (n 41).

<sup>47</sup> Ruslan Sulaimanov, ‘Balancing State and Investor Interest in International Petroleum Contracts: Comparison of Legislations in Kazakhstan and other Central Asian Countries’ (LLM Thesis, Central European University 2011) 54.

exploration and development are being successfully applied in practice.”<sup>48</sup> Kazakhstan offers three types of contractual frameworks to prospective foreign investors, namely concession, PSA and joint venture (participation agreements).<sup>49</sup> Nevertheless, it should be borne in mind that no specific legal instruments exist to regulate existing PSAs in Kazakhstan. Rashidova notes that, “accordingly, experience of the legal treatment of PSAs in other jurisdictions may be helpful in seeking to clarify the situation.”<sup>50</sup>

In 2005, a new PSA law was adopted in Kazakhstan.<sup>51</sup> This was the first legislation on PSAs and it presented a number of conditions and requirements for future agreements. Kazakhstan’s PSA model ‘have a civil law character, and so they are subject to the civil code grounds and procedures for contract termination as well as the provisions of the PSA law’.<sup>52</sup> Although the parliament of Kazakhstan issued a new law which applies specifically to PSAs contracted in 2005, the country decided to discontinue use of such agreements. This was confirmed by the adoption of the Subsoil Use Law in 2010.<sup>53</sup> Nevertheless, it should be noted that this does not mean that existing PSAs will be unilaterally amended or terminated through the legislative or administrative activities of Kazakhstan.

Conversely, existing PSAs remain in force and such policy transformation will not affect current PSAs signed between Kazakhstan and foreign investors in the hydrocarbon sector. Indeed, Karachaganak and Kashagan, widely accepted as the largest fields in Kazakhstan, were developed under the PSA model. The question remains as to why the country decided to eliminate the PSA regime, notwithstanding the key role these agreements played in the country’s investment policy in the petroleum sector. Campaner and Yenikeief provide a plausible explanation:

[H]igh commodity prices and the desire to increase the control and involvement of the government in the oil and gas industry have impelled the authorities of Kazakhstan to abandon the use of PSAs. Constant production delays and escalating costs have certainly given the Kazakh authorities a unique opportunity to renegotiate the contract in order to gain greater control over the field.<sup>54</sup>

### 3.2. *Kashagan-PSA: An Example*

The Kashagan petroleum field was first discovered in the 1990s and keeps the status of one of the largest exploited hydrocarbon fields outside of the Middle East. In 1997, ENI-led equity

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<sup>48</sup> Andrey S. Udartsev, ‘Improving the Law Relating to Production Sharing Contracts in Kazakhstan’, Chapter 15 in Ilias Bantekas, John Paterson, and Maidan Suleimenov (eds.), *Oil and Gas Law in Kazakhstan: National and International Perspective* (Kluwer International 2004) 189.

<sup>49</sup> See Mark J. Kaiser, ‘A Review of the Oil and Gas Sector in Kazakhstan’, *World Energy Policy*, Vol.35, Issue 2 (2007) 1300-1314.

<sup>50</sup> Zoya Rashidova, ‘Legal Nature of Production Sharing Agreements: A Comparison with the Russian Federation’ Chapter 17 in Bantekas, Paterson, and Suleimenov (n 48) 216.

<sup>51</sup> The Law of Republic of Kazakhstan on Agreements (Contracts) Product Sharing for Petroleum Operations on the Sea, dated June 9, 2005.

<sup>52</sup> Peter D. Cameron, ‘Stabilisation in Investment Contracts and Changes of Rules in Host Countries: Tools for Oil & Gas Investors’, *Association of International Petroleum Negotiators (AIPN)*, Final Report 5 July (2006) 81.

<sup>53</sup> Law No. 291 IV of the Republic of Kazakhstan, (n.12).

<sup>54</sup> Nadia Campaner & Shamil Yenikeief, ‘The Kashagan Field: A Test Case for Kazakhstan’s Governance of Its Oil and Gas Sector’ (October 2008).

<[https://inis.iaea.org/collection/NCLCollectionStore/\\_Public/42/050/42050161.pdf?r=1&r=1](https://inis.iaea.org/collection/NCLCollectionStore/_Public/42/050/42050161.pdf?r=1&r=1)> accessed in June 2019.

investors signed a 40-year PSA with the Kazakhstani government.<sup>55</sup> The Kashagan field's recoverable reserves are estimated to be between nine and 13 billion barrels of oil.<sup>56</sup> The PSA was designed in favour of the equity investors of the project and included very flexible terms and conditions. The terms of this agreement are not limited to economic arrangements, but also provide for the legislative activities as well as regulatory measures for the course of the investment project.

Petroleum exploration activities in Kashagan began in 2000. However, the commercial activities of the project had to be delayed a number of times due to unfair taxation terms and conditions. Disputes began with the statements of the Kazakhstani government about the reconsideration of the terms and conditions of the Kashagan PSA.<sup>57</sup> According to the Kazakhstani government, the Kashagan PSA “was upset by delays and costs overruns that plagued the project since its inception.”<sup>58</sup> Muttitt claims that most of the delays and cost overruns were supposed to be incurred by the investors, however the ensuing burdens had to be borne by Kazakhstan according to the terms of the contract.<sup>59</sup> The author ultimately blames the fiscal terms of the Kashagan for these delays noting that “the result of fixed economic terms is that for 40 years the sharing of revenues reflects the risk, the low oil price and the government weakness at the time of signing, in other words, Kazakhstan is locked into the economic situation of 1997 for more than a generation.”<sup>60</sup>

In September 2007, the Kazakhstan's lower house of parliament voted unanimously to make amendments on the art 45-2 of the Law on Subsoil and Subsoil Use.<sup>61</sup> This amendment enabled the Kazakhstani government to modify or terminate any previously signed contract that might pose a threat to ‘national security’ and the ‘economic interest’ of the country.<sup>62</sup> New amendments enabled Kazakhstan to initiate renegotiation from a stronger bargaining position. By way of example, in January 2008, the Kazakhstani government and the Italian petroleum company ENI-led project partners agreed to renegotiate the Kashagan PSA.<sup>63</sup> Hence, Kazakhstan finally succeeded in effectively safeguarding its sovereign rights over its national and economic interests.

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<sup>55</sup> KazMunayGas (Kazakhstan): 16.88%; Eni (Italy) 16.88%; ExxonMobil (US) 16.81%; Royal Dutch Shell (Netherlands/UK) 16.81%; Total (France) 16.81%; CNPC(China) 8.33%; INPEX (Japan) 7.56%. <<https://economictimes.indiatimes.com/industry/energy/oil-gas/ongc-gets-project-operators-nod-for-5-billion-kashagan-stake-buy/articleshow/17506284.cms?from=mdr>> accessed in June 2019

<sup>56</sup> <[https://www.eia.gov/beta/international/analysis\\_includes/countries\\_long/Kazakhstan/background.htm](https://www.eia.gov/beta/international/analysis_includes/countries_long/Kazakhstan/background.htm)> accessed in June 2019.

<sup>57</sup> Kuanysh Sarsenbayev (n 39) 375.

<sup>58</sup> *ibid.*

<sup>59</sup> Greg Muttitt, ‘Hellfire Economics: Multinational Companies and the Contracts Dispute over Kashagan, the World's Largest Underdeveloped Oilfield’, December (2007) 17 <[https://bankwatch.org/wp-content/uploads/2008/01/platform\\_hellfire\\_economics.pdf](https://bankwatch.org/wp-content/uploads/2008/01/platform_hellfire_economics.pdf)> accessed in July 2019.

<sup>60</sup> *ibid.*

<sup>61</sup> Art 45-2 of the Law on Subsoil and Subsoil Use, September 2007.

<sup>62</sup> R Kennedy and A Nurmakov, Resource Nationalism Trends in Kazakhstan, 2004–2009’ (March 2010) Working paper of research project RUSSCASP (2009) 6. <<http://citeseerx.ist.psu.edu/viewdoc/download;jsessionid=DE73912BC4F36715D742970BC6360C74?doi=10.1.1.620.4517&rep=rep1&type=pdf>> accessed in August 2019.

<sup>63</sup> David. L., Stern, New York Times, September 27, 2007, <<https://www.nytimes.com/2007/09/27/business/27kazakh.html>> accessed in August 2019.

### 3.3 Taxation Regime in the Existing PSAs in Kazakhstan

Similar to Azerbaijan, in Kazakhstan, all existing PSAs include tax stability provisions. It should be noted that aside from existing PSAs and subsoil use contracts, other types of subsoil use contracts including concession agreements do not include tax stability provisions. Under the Kazakh PSA model, the contractor makes a contribution to the state to reflect its share of production, along with payment of some taxes and any other contingent payments explicitly set out by the PSA itself.<sup>64</sup>

Likewise, Azerbaijan's PSAs, each PSA of the Kazakhstan provides a separate tax regime. According to Minnehan<sup>65</sup>, foreign oil companies were in such a stronger position that they have 'negotiated their own tax incentives'<sup>66</sup> and that 'these are not part of the code and not published anywhere'.<sup>67</sup> For instance, 'Nations Energy negotiated a three-year grace period wherein it initially paid royalties of three percent before they gradually increased to five percent, which was far below what Chevron and Hurricane Hydrocarbons were purported to pay'.<sup>68</sup>

PSAs have also included advance forms of taxation, in particular bonuses. There are three types of bonuses applicable to petroleum development and extraction in Kazakhstan. These are signature bonuses, commercial discovery bonuses and production bonuses. It is noteworthy that these bonuses are non-reimbursable.<sup>69</sup> Oil companies usually pay the bonuses to the state at the initial stage of the PSAs' operation.<sup>70</sup> Perhaps, the main benefits of having these bonuses are that they help safeguard the national economy against some of the more brutal effects of an economic downturn.

The insertion of a tax stability provision into a PSA signifies that the state binds itself and provides guarantees to the subsoil user that any future tax policy or any legislative activities with regard to taxation will not affect the subsoil user's contractual rights, unless both parties make a separate arrangement. In other words, under the Kazakh PSA model, the government affords stability guarantees that the government will not be able to undertake any legislative activities which may adversely affect the tax provisions in a PSA. However, it should be noted that as a sovereign state Kazakhstan may wish to initiate the implementation of newly-enacted taxation legislation in its own economic interests, in which case mutual consent of both parties would be required. In cases where the government of Kazakhstan wishes to abolish certain taxes or other obligatory payments to the budget, "...due under the terms of a PSA, the subsoil user will continue with any such taxes or compulsory payments as stipulated in the PSA relevant amendments are agreed."<sup>71</sup>

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<sup>64</sup> International Institute for Environment and Development, (n13) 35.

<sup>65</sup> Tom Minnehan is a tax consultant. He was also one of the interview participants in Jones Luong and Erika Weinthal's research project. For further reading, see Pauline Jones Luong & Erika Weinthal *Oil is Not a Curse: Ownership Structure and Institutions in Soviet Successor States* (CUP 2010).

<sup>66</sup> *ibid.*

<sup>67</sup> *ibid.*

<sup>68</sup> *ibid.*

<sup>69</sup> International Institute for Environment and Development, (n 13) 35.

<sup>70</sup> *ibid.*

<sup>71</sup> *ibid.*

## 4. Concluding Remarks

Azerbaijan and Kazakhstan are hydrocarbon-producing states that heavily depend on the petroleum sector. In the aftermath of their independence, both countries have managed to establish an externally attractive, investment-friendly environment through the legislative tool of PSAs. Many oil-producing countries around the world do not have the ability to maintain true economic freedom or effectively manage their own petroleum resources. In this respect, it is worth questioning whether oil is a blessing or a curse to a healthy development of the budding nation-states like Azerbaijan and Kazakhstan.

This is not to gainsay that having rich natural resources can contribute to the economic growth and development of a country. However, it is worth emphasising that gaining symbolic political independence is one thing, while enjoying true economic independence is another. It is fair to state that during the 1990s, Azerbaijan and Kazakhstan had only a feeble hold over the management of their own resources. The attraction of foreign oil companies into petroleum sectors was seen as a quick solution for their economic development. To this end these countries felt pressed to sign up to a number of PSAs with terms that favoured the rights and rewards of international petroleum companies and exploited the weak bargaining power of these nascent states.

The most distinctive features of PSA regimes in Azerbaijan and Kazakhstan are that both countries have provided extensive stability guarantees for foreign oil companies in these contracts. On top of that, such stability guarantees can be found in the Subsoil Code of Kazakhstan and the Law of Foreign Investment of Azerbaijan.

PSAs include stabilisation clauses which protect petroleum investor's rights and interests against legislative or administrative activities which may adversely affect the terms of the contract that the petroleum investor and host government originally entered into. It should be borne in mind that a sovereign state is able to make changes to the terms of a PSA subsequent to signing, but only with the contractor's express consent. Although Kazakhstan modified the stability tax regimes of existing PSAs through a mutual agreement as well as a revision of its tax code, Azerbaijan has not acted according to their national interests by revisiting existing PSAs. Understandably, Azerbaijan is eager to be perceived as a loyal and reliable host government which takes the principle of the sanctity of contracts seriously. However, receiving fair tax revenue from oil profit is an inarguable legal right of every sovereign state. To this end, the government of Azerbaijan should urgently modify tax stability provisions in its existing PSAs via the renegotiation process.

Neither Azerbaijan nor Kazakhstan have a specific petroleum law which governs existing PSAs. In fact, the government of Kazakhstan issued its PSA Law in 2005. Whereas this law was the first dedicated legislative attempt to govern the country's future PSAs, the Subsoil Law 2010 confirmed that this type of agreement will not be applied in the future. Unlike Kazakhstan, Azerbaijan has demonstrated willingness to enter into further PSAs with foreign oil companies in the future. It is worth noting that this contract type cannot be found in more economically developed oil producing states, such as Norway or Canada. With these facts in mind, the government of Azerbaijan should seek recourse to alternative contract types for future agreements or at the very least implement a carefully crafted petroleum law to govern the PSAs.

In Azerbaijan, PSAs are regarded chiefly as administrative contracts. When PSAs are conveyed from parliament for the presidential assent, these agreements automatically become normative

instruments which prevail over other domestic laws. Contrary to Azerbaijan, Kazakhstan regards PSAs as civil law contracts. Ironically, despite the agreement's apparent civil status, no single definition for these contracts has been written into the country's civil code. It can be speculated that pragmatic reasons underlie Kazakh lawmakers' reluctance to draft binding definitions of a legal nature for this type of agreement into the civil code, namely the likely inhibitory effect this would have on the country's willingness to enter into any new PSAs in the future.

Both Azerbaijan and Kazakhstan have provided stable tax commitments in their PSAs. However, unlike Azerbaijan, petroleum investors have found entering into contractual relationships with Kazakhstan to be beset with challenges due to the government's continual contract renegotiation requests with a view to inserting tax provisions into existing PSAs. There has been an increasing drive in recent years from the government to exact higher tax revenues and a larger stake in the profits than the original PSA terms permitted. Multiple revisions of the Subsoil Law also attest to this.

As newly independent countries, both Azerbaijan and Kazakhstan signed a number of PSAs with foreign petroleum investors in the early 1990s. The PSAs that they entered into provide strong stability commitments in investors' favour. Azerbaijan is likely to continue offering PSAs to investors in the hydrocarbon sector. However, Kazakhstani government should realise that PSAs is no longer available in the country. Perhaps the main reason why Kazakhstan has abandoned the use of PSAs in the future was because of the country's resource nationalism policy. Further research into PSAs may concentrate on landlocked oil importer countries in Eurasia and may introduce the question of what driving forces affect geographically disadvantaged hydrocarbon importing countries' bargaining position in PSA negotiation with major petroleum companies.