



**BALANCING STATE AND INVESTOR INTERESTS IN INTERNATIONAL
PETROLEUM CONTRACTS: COMPARISON OF LEGISLATIONS IN
KAZAKHSTAN AND OTHER CENTRAL ASIAN COUNTRIES.**

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This thesis research addresses the topic of a contractual balance between host state and foreign investor interests, which is highly desired for a mutually beneficial development of an international petroleum production project. While identifying the notion, types and ways for investments into such projects, this work enumerates and explains the respective interests of the parties. Moreover, this study systematically examines the structure of a basic petroleum agreement and its specific provisions used to protect the balance of interests. It also evaluates the fundamental legal differences of the classical international petroleum contract models. By comparing subsoil and investment legislations in all five countries of the Central Asian region, with separate attention devoted to Kazakhstan, this thesis research elucidates legal investment climates created by these recipient countries for foreign investors wishing to inject funds in their petroleum production industries. The findings of the current work have shown that Kazakhstan, being a leader in the region's oil industry, has recently enacted new normative legal acts in the spheres of foreign investment and subsoil use, thus, transforming its previously favorable legal conditions into more onerous ones. Turkmenistan and Uzbekistan at first used a strategy of self-sufficiency for developing their petroleum sectors, but after admitting that their plans have not produced the desired economic outcome, they have started experimenting with the new legislative practices. Although suffering from the lack of hydrocarbon reserves, Kyrgyzstan and Tajikistan also began to bring novelties in their legislation to encourage inward investments in their mining industries. Despite the juridical innovations the legal frameworks of all five countries still seem to be unstable, incomplete and sometimes even contradictory, thus, putting in danger the fragile balance between host state and foreign investor interests.

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Subject Matter.

Mobilization of foreign investments, or in other words attempts to attract capital from the outside of the country, is one of the effective tools used by many developing states with the goal to foster the activity of their oil production industry. The success of this initiative highly depends on the so-called ‘investment climate’ of a country. While deciding on the question whether to invest its capital resources into the oil production industry of a particular country, the potential investor looks at several key issues. Among the most important of them are: (1) the financial worth of the oil resources, located on the territory of the state; (2) the political stability and the overall safety of the region; and (3) the legislative framework, governing the general investment possibilities and natural resources extraction policies. This study will be focused on the third element – the legislative framework governing the possibilities and ways for foreign investors to input their capital into the oil production industry of a country. The first two issues, i.e. the financial worth and the political environment, will be slightly touched by the current work to provide the overall background integrity.

The legislative solution to achieve a proper investment climate lays in the possibility to draft and enforce such international petroleum agreements that can protect both host state interests as well as foreign investor interests in a potential oil production deal. This possibility can be attained by proper legal arrangements in the following spheres of jurisprudence: law of natural resources, environmental law, investment law, taxation law, corporate law, civil law, dispute resolution law and many others. The scope of the current thesis research covers only the analysis of legislation in the areas of natural resources and foreign investments, which particularly is relevant to the formation and enforcement of the petroleum contracts. Moreover, several major classical models of petroleum agreements are compared

scrupulously, with the aspiration to find differences in providing mechanisms to ensure the balance between foreign investor and host state interests.

The legislations of all five countries of the Central Asian region were chosen as examples of practical implementation of concepts discovered in the current academic study. Three of these five countries (Kazakhstan, Uzbekistan and Turkmenistan) are the major oil and gas production players in the region. Thus, it is interesting to compare and analyze their specific ways to organize legislations for the mobilization of foreign investments into their oil industries. Tajikistan and Kyrgyzstan lack significant oil resources within their territories. However, it is academically useful to reveal their attitudes towards the attraction of foreign investment capital into their mineral extraction industries. A separate attention is devoted to the investment climate of Kazakhstan, because this country is an indisputable leader in the Central Asian oil industry. While comparing the legislative approaches of these countries toward the improvement of the investment climate, the main focus is devoted to the models of petroleum contracts, which these countries advocate.

Purpose of the Research.

Therefore, the primary purpose of this thesis research is the examination of a general structure, types and differences in legal features of the classical petroleum contract models, analyzed by the examples of their practical implementation in Kazakhstan and other Central Asian countries, as well as the comparison of legal investment climates in these countries in order to understand if they provide a balance between foreign investor and host state interests with regards to a petroleum investment project.

Method and Structure.

The study achieves the mentioned purpose by the consecutive accomplishment of the following stages. The first chapter identifies the notion, types and legal ways for conducting foreign investments in the petroleum industry. It also reveals the respective interests of host states and foreign investors within the course of a petroleum investment project. The

methodology, used in this chapter, is the combination of descriptive theoretical analysis, simplification and classification. The second chapter observes the fundamental structure of a basic petroleum agreement and its specific provisions used to protect the balance of parties' interests. It also compares the conceptual legal differences of the existing models of petroleum contracts. Comparison and analysis of theoretical materials are the main methods used in this part of the work. The final third chapter looks at the legal frameworks of every Central Asian country with the aim to understand which of the petroleum contract models is employed there and verifies whether the investment climate in these countries provides a balance between the interests of the recipient country and the foreign oil company. The method mainly employed in this chapter is the comparative legal analysis of the primary sources, such as normative legal acts of the Central Asian states. However, the use of secondary sources, such as books, collective works, articles, working papers and informational websites, is performed throughout all chapters of the thesis research, including the third one.

Delimitations of the Research.

The current thesis research is limited in two important dimensions. First dimension of delimitation is the geographical scope. The limits of this academic study cover only the region of Central Asia, more specifically five countries: Kazakhstan, Uzbekistan, Turkmenistan, Kyrgyzstan and Tajikistan. Moreover, separate attention is devoted to the Republic of Kazakhstan which is the major player in the oil production field of the region. The second dimension of delimitation is the legislative scope. It was already stated that this thesis research mainly discusses and analyzes different types of petroleum contracts. However, there are an enormous number of legal issues connected to formation and enforcement of petroleum contracts. Clearly, all of them cannot be covered by this work. This thesis doesn't specifically address the issues of legal regulation in such fields as: environmental protection, labor safety, corporate forms, dispute resolution, taxation and inspection. The study mainly focuses on legislation in the areas of foreign investment and subsoil use.

This chapter reveals several fundamental issues related to foreign investments in the petroleum industry. At first, a general overview is given to provide a background of appearance, formation and development of this subject matter. The basic notion, various types and legal forms of investments are discussed in the second part of this chapter. The final section explains risks and interests held by the participants of investment projects in the petroleum industry, i.e. by foreign investors and host governments.

1.1. General Overview

Since early times oil products have played an extremely important role in the economic lives of many countries and nations in almost all parts of the world, including Europe, both American continents, Africa, Asia and Middle-East.¹ Clearly, not every country's subsoil mineral base possessed this crucial resource. Such countries had three main alternatives to gain this product from other states: to conquer it, trade it or get it through investments. One of the clearest examples of early foreign investments can be found in the colonial era of human history, when oil as well as other minerals were transferred from dependent states to the influential countries.² In exchange of minimum financial, managerial and time expenditures the powerful suzerains were able to receive large amounts of crude mineral resources, which were then transformed into valuable products for further use inside the country and for trade on international markets.

¹ J.Babusiaux, J.Favennec, P.Copinschi, "Petroleum: a strategic product." In *Oil and gas exploration and production: reserves, costs, contracts*, coordinated by Centre for Economics and Management of IFP-School. (Paris: Editions Technip, 2004), 1-4.

² M. Sornarajah, *The International Law on Foreign Investment* (Cambridge: Cambridge University Press, 2010), 40.

According to professor Sornarajah, as soon as the process of liberalization from the colonial oppression had begun, the newly independent countries started to strive not only for the complete removal of the political supremacy of the empire, but also for the total control over their own territories and resources.³ The reason for this aspiration was to open the road to international markets through gaining command of their own economies and particularly natural resource bases. This urge resulted in several resolutions, enacted by the General Assembly of the United Nations, setting the principle of permanent sovereignty over natural resources and ensuring control over the processes of foreign investments.⁴

Different historical, social, political and economic tendencies formed and still continue to form the international incentive for foreign investments in petroleum industries.⁵ In recent years, especially after the collapse of the Soviet Union, many developing countries have joined the race to attract foreign investors to their economies, due to the reason that foreign financial and technological injections became the only available option for most of them to develop their economic potential. The worldwide growing demands for energy resources have encouraged investments in mining projects and especially in the petroleum extraction industry.

As it was stated by Lorenzo Cotula, living conditions and economic prosperity of a beneficiary country can be significantly improved with the help of foreign investments, for instance by means of increased financial inflows to the state treasury.⁶ For developing states,

³ M. Sornarajah, *The International Law on Foreign Investment* (Cambridge: Cambridge University Press, 2010), 1.

⁴ *Ibid*, page 1.

⁵ J.Babusiaux, J.Favennec, P.Copinschi, "Petroleum: a strategic product." In *Oil and gas exploration and production: reserves, costs, contracts*, coordinated by Centre for Economics and Management of IFP-School. (Paris: Editions Technip, 2004), 5-36.

⁶ Lorenzo Cotula, *Investment contracts and sustainable development: How to make contracts for fairer and more sustainable natural resource investments* (London: International Institute for Environment and Development, 2010), 1.

where deposits of oil and other “natural resources may constitute one of the few sectors that can be of any interest to outside [financiers,] incoming investors may bring capital, technology infrastructure, know-how [...], which may play an important role in catalyzing economic development.”⁷ Moreover, foreign investment projects in petroleum production industries can be seen “as a source of such vital real assets as [...] enhanced access to international export markets and management skills, which are all badly needed to sustain or revitalize industrial capital formation and to achieve, or retain, international competitiveness”⁸, as well as to achieve economic development of the state.

1.2. Notion, Types and Means of Investments

1.2.1. Definition

In order to comprehend what constitutes the term ‘foreign investment’ as such, it is necessary to refer to the definition given by professor Sornarajah. According to him, foreign investment in general shall be understood as “the transfer of tangible or intangible assets from one country into another for the purpose of their use in that country to generate wealth under the total or partial control of the owner of the assets.”⁹ Considering this general definition, it can be concluded that foreign investments specifically in the petroleum industry mean the movement of investment assets (financial or technological) into the areas with considerable oil reserves with the main goal to receive profits from its exploration, extraction, and consequent sale at the internal or external market.

⁷ Lorenzo Cotula, *Investment contracts and sustainable development: How to make contracts for fairer and more sustainable natural resource investments* (London: International Institute for Environment and Development, 2010), 1.

⁸ Charles Oman, *New forms of investment in developing country industries: mining, petrochemicals, automobiles, textiles, food* (Paris: Organization for Economic Co-operation and Development. Development Centre, 1989), 10.

⁹ M. Sornarajah, *The International Law on Foreign Investment* (Cambridge: Cambridge University Press, 2010), 7.

1.2.2. Classification

The classification of foreign investments in petroleum industries, which helps to understand the nature of this subject in a more comprehensive way, shall be divided into three main blocks: (1) by the method of foreign investments; (2) by the sector of oil industry and (3) by the level of control over petroleum investment project.

The first block distinguishes two main types of foreign investments, which are: Portfolio Investment and Foreign Direct Investment. Professor Sornarajah explains that in the case of Portfolio Investment the method used by investors is money injections, which are spent on purchasing shares of a company which already exists in a foreign state. As for Foreign Direct Investment, he continues, the method is mainly the transfer of physical assets, such as technological equipment and manufacturing plants, which are used for initiation of operations.¹⁰ The disadvantage of the first method “is that, in Portfolio Investment, there is a divorce between management and control of the company and the share of ownership in it.”¹¹ The negative side of the second method is that the investor usually cannot share the risk.

The second block differentiates foreign investments by petroleum industry sectors, which are: exploration, extraction, refining, transporting and marketing. According to the American Petroleum Institute, all of the above mentioned processes belong to two categories - either upstream or downstream (exploration and extraction belong to the first one; refining, transporting through pipelines or oil tankers, final marketing and distribution to consumers – to the second one).¹² Foreign investors can choose to enter just one sector, several of them or all petroleum sectors at once. Considering the fact that this research is primarily focused on

¹⁰ M. Sornarajah, *The International Law on Foreign Investment* (Cambridge University Press, 2010), 7-9.

¹¹ *Ibid*, page 7.

¹² “Industry Sectors.” American Petroleum Institute (September 22, 2010) [available at <http://www.api.org/aboutoilgas/sectors/> (accessed March 4, 2011)].

foreign investments made within the upstream sector of petroleum industry, it would be helpful to take a closer look at the respective processes.

According to Elizabeth Feuillet-Midrier, the exploration phase shall be considered as a petroleum production cycle, during which professional geologists are examining the subsoil of a particular area in order to discover and appraise the accumulations of hydrocarbons.¹³ She further explains that “if the appraisal stage demonstrates that the characteristics of the reservoir are sufficient to justify the production then the development stage begins. This involves drilling the future production wells and installing all the associated equipment required for production.”¹⁴ When all equipment is installed and wells are ready, the petroleum extraction phase begins, during which the crude oil is lifted from the subsoil to the surface.

The third classification block mainly reveals the difference between Traditional Forms of Investment and New Forms of Investment with regards to control over a petroleum investment project. According to the book of Charles Oman, Traditional Forms of Investments were highly used in petroleum industries of developing countries until the late twentieth century on the basis of agreements (particularly concession agreements¹⁵) “between host governments and foreign oil companies which were given exclusive rights to explore and produce in specified regions over extended periods of time.”¹⁶ As it can be observed from the explanation mentioned above, and especially from the words ‘exclusive rights’, the distinctive feature of Traditional Forms of Investment in the petroleum production industry was the

¹³ Elizabeth Feuillet-Midrier, “Oil and gas exploration and production.” In *Oil and gas exploration and production: reserves, costs, contracts*, coordinated by Centre for Economics and Management of IFP-School. (Paris: Editions Technip, 2004), 59-69.

¹⁴ *Ibid*, page 72.

¹⁵ The concept of concession agreements is discussed in more detail in Subsection 2.3.1. on page 36.

¹⁶ Charles Oman, *New forms of investment in developing country industries: mining, petrochemicals, automobiles, textiles, food* (Paris: Organization for Economic Co-operation and Development. Development Centre, 1989), 21.

investor's high level of control over the natural resources and over the oil production process as a whole.

As for New Forms of Investment, Charles Oman, characterizes them as a concept, the main idea of which is the following: “a foreign company supplies goods (tangible or intangible) to an investment project or enterprise in a host country [...] but local interests in the host country retain majority or whole ownership of the investment project or enterprise.”¹⁷ New Forms of Investment in the petroleum industry are usually performed through the following legal mechanisms: production sharing agreements, equity joint ventures and risk-service contracts.¹⁸

1.2.3. Legal Framework

As it can be seen from the previous subsection, irrespective of their choice between Traditional Forms of Investment and New Forms of Investment, participants of petroleum investment projects have to use certain legislative means and contractual tools to achieve their respective goals with regards to a petroleum investment project. Desired economic benefits would not be attained, risks and costs would not be adequately distributed among the parties, if the conditions of the proposed and negotiated petroleum investment project are not legally justified and lawfully recorded.¹⁹ Without special legal vehicles, provided by law, it would be impossible and too risky to perform any kind of petroleum investment projects, especially at international level. This leads the current discussion to the next important topic of this chapter – the legal framework of a petroleum investment project.

¹⁷ Charles Oman, *New forms of investment in developing country industries: mining, petrochemicals, automobiles, textiles, food* (Paris: Organization for Economic Co-operation and Development. Development Centre, 1989), 10.

¹⁸ All of these legal mechanisms are discussed in more detail in Subsections 2.3.2.-2.3.4. on pages 38-44.

¹⁹ Lorenzo Cotula, *Investment contracts and sustainable development: How to make contracts for fairer and more sustainable natural resource investments* (London: International Institute for Environment and Development, 2010), 2-3.

Initially the process of investment in a petroleum industry was mainly governed by general mining laws. Moreover, some countries still do not have separate petroleum legislation. In order to change this situation and create their own petroleum legal framework, the governments of such countries have “to determine the matters which are to be dealt with by general legislation and those which are to be settled by [individual] negotiation and embodied in contractual documents.”²⁰

According to Kamal Hossain, there are three main approaches: (1) general legislation system, (2) *ad hoc* agreements and (3) hybrid system.²¹ The first two systems are also mentioned by Bernard Taverne, when he states in his book that the purpose of petroleum legislation is to regulate petroleum production activities through the form of either administrative authorization (licensing regime) or contractual relationship.²² The third hybrid system, which combines the two former ones, provides a more flexible and convenient legal framework for all the parties of a petroleum investment project. Nicky Beredjick and Thomas Waelde prove this statement by claiming that the current tendency is directed towards the development of compact legal regime consisted of both: petroleum regulations, which establish key principles for legal relations between the states and foreign oil companies, and options for individually negotiable agreements.²³

Such negotiable agreements are different variations of a regular investment contract, which can be defined as “an agreement concluded between an investor and the host government (or a state-owned enterprise) for the purposes of regulating a specific investment

²⁰ Kamal Hossain, *Law and policy in petroleum development: changing relations between transnationals and governments* (New York: Nichols Publishing Company, 1979), 101.

²¹ *Ibid*, pages 100-102

²² Bernard Taverne, *Petroleum, industry, and governments: a study of the involvement of industry and governments in the production, and use of petroleum* (Kluwer Law International, 2008), 115-117.

²³ Nicky Beredjick, Thomas W Waelde, *Petroleum investment policies in developing countries* (London: Sterling House, 1988), 9-11.

project. Investment contracts may take many different forms, including concessions or production sharing agreements for the exploitation of mineral and petroleum resources”²⁴. Other alternatives of an investment contract used in the petroleum production industry are joint venture agreements, risk and non-risk service contracts. As Lorenzo Cotula states, “some petroleum laws prescribe a specific form, but most new laws tend to leave the choice open [...]”²⁵ The form typically depends on the legal custom and on the case law in a certain state. While comparing different forms of petroleum contracts, one shall remember that “an agreement must be seen as a package of mechanisms designed to secure certain interests and objectives.”²⁶

1.3. Interests, Goals and Risks of Participants

As it was noted by Kamal Hossain, “in order to appreciate how legal frameworks operate to safeguard different interests, it is important to identify the interests which multinationals and host governments respectively seek to safeguard”²⁷. Thus, this subsection deals with the issue of respective interests and risks held by the main parties of an investment contract, more specifically by a recipient state and a foreign investor. At the end of the section a short overview of respective interests and risks held by the third parties of an investment project is provided. This is done to provide the whole picture of the subject matter. But it shall be underlined that the current work is mainly focused on two main actors of a petroleum investment project, i.e. a host state and a foreign oil company.

²⁴ Lorenzo Cotula, *Investment contracts and sustainable development: How to make contracts for fairer and more sustainable natural resource investments* (London: International Institute for Environment and Development, 2010), 4.

²⁵ Nicky Beredjick, Thomas W Waelde, *Petroleum investment policies in developing countries* (London: Sterling House, 1988), 13.

²⁶ Kamal Hossain, *Law and policy in petroleum development: changing relations between transnationals and governments* (New York: Nichols Publishing Company, 1979), 111.

²⁷ *Ibid*, page 43.

1.3.1. Host Countries

Before going into the question of what specific interests a host country may have in a petroleum investment project, it is necessary to understand the notion of a host state itself. A good explanation is given by Lorenzo Cotula: “[a] host country is the country where the investment takes place. In extractive industries, the host country is typically represented by the executive branch (the ‘host government’) or a state-owned company, which owns subsoil resources [...] A single investment project may cover more than one host country (for example, cross border pipeline projects).”²⁸ But, for reasons of simplification we shall consider only the interests of a single recipient state. The core goal of any host country is well described by Kamal Hossain²⁹:

A government’s principal objective in involving a multinational oil company in petroleum exploration and development within its territory is to secure an investment of risk capital and the technical and managerial skills of a multinational to carry out as thorough and as rapid an exploration of its prospective areas as is reasonably possible, and upon any discovery being made to secure the necessary investment and the necessary skills to develop the reservoirs discovered in a manner which will ensure maximum ultimate recovery and yield maximum benefits to the national economy.

Benefits to the national economy of a host country can either have a fiscal or a non-fiscal nature. The fiscal nature of such benefits is expressed by financial revenues and other monetary inflows into the state treasury, which can be used for further development of the country. The non-fiscal nature of a host country’s benefits comes from sources which are not represented by money, but can still be used for advancing the country’s economic or social progress and welfare.

²⁸ Lorenzo Cotula, *Investment contracts and sustainable development: How to make contracts for fairer and more sustainable natural resource investments* (London: International Institute for Environment and Development, 2010), 4.

²⁹ Kamal Hossain, *Law and policy in petroleum development: changing relations between transnationals and governments* (New York: Nichols Publishing Company, 1979), 43.

A closer look at the financial side of benefits for a host state is taken by Lorenzo Cotula. He states that “payments to the host government are an important way in which the host country can benefit from a natural resource investment.”³⁰ Such payments can be done in the following formats: royalties (periodic payments based on volume and value of production), tax payments (such as income taxes, VAT and import/export taxes), fees (including land rentals, application fees for licenses, etc.), bonuses (like one-off payments at oil discovery or regular payments after oil extraction reaches specified levels), share of oil production (usually based on rate of return or output level) and share of profits (for instance dividends).³¹ Different countries prefer different types of payments or even a combination of several depending on circumstances.

Among the most apparent non-fiscal interests chased by host countries are: infrastructure development, technology transfer, professional training, employment opportunities and local marketing.³² The government of a host state sometimes may require a foreign investor to build schools, medical clinics, roads, bridges and other infrastructure for local population residing in the area near the oilfield.³³ Other requests may oblige an oil company to transfer new technologies, inventions and know-how (for instance through joint ventures), hire nationals of a host state for positions in the company and develop skills of

³⁰ Lorenzo Cotula, *Investment contracts and sustainable development: How to make contracts for fairer and more sustainable natural resource investments* (London: International Institute for Environment and Development, 2010), 33.

³¹ *Ibid*, pages 33-34.

³² Lorenzo Cotula, *Investment contracts and sustainable development: How to make contracts for fairer and more sustainable natural resource investments* (London: International Institute for Environment and Development, 2010), 40-44; Kamal Hossain, *Law and policy in petroleum development: changing relations between transnationals and governments* (New York: Nichols Publishing Company, 1979), 51-52.

³³ Lorenzo Cotula, *Investment contracts and sustainable development: How to make contracts for fairer and more sustainable natural resource investments* (London: International Institute for Environment and Development, 2010), 42-44.

local staff through additional trainings. Some states may seek a certain “percentage of the investor’s oil share to be sold on the domestic market.”³⁴

The rate and the extent of oil reserves exploration and production lay somewhere in the middle between fiscal and non-fiscal interests for a host state. As Kamal Hossain explains it, host state governments have a clear interest in rapid exploration of potential oilfields by most sophisticated technological means and in speedy development of any petroleum reservoirs which are revealed in the process of such explorations.³⁵ It is not always the case with foreign investors as we will see in the next subsection. Lorenzo Cotula agrees with Kamal Hossain by claiming that “the host country would gain little if the investor ‘sits’ on the resource”.³⁶ Another case can be the opposite situation, when government wants “to limit the rate of exploitation in order to conserve reserves for future production or it may expect that the long-term trend in prices will be upward.”³⁷ In any case, a recipient state is usually highly concerned about exact amounts of work performed by a foreign investor within specified time limits, which can be presented in the form of geological surveys, drilling the agreed number of oil wells or the extraction of specific volumes of crude oil.³⁸ In order to be sure that rates and volumes of petroleum production correspond to the agreed terms, a host state is in high need of proper reporting from a foreign investor working in the oilfield.

³⁴ Lorenzo Cotula, *Investment contracts and sustainable development: How to make contracts for fairer and more sustainable natural resource investments* (London: International Institute for Environment and Development, 2010), 44.

³⁵ Kamal Hossain, *Law and policy in petroleum development: changing relations between transnationals and governments* (New York: Nichols Publishing Company, 1979), 44-46.

³⁶ Lorenzo Cotula, *Investment contracts and sustainable development: How to make contracts for fairer and more sustainable natural resource investments* (London: International Institute for Environment and Development, 2010), 41.

³⁷ Kamal Hossain, *Law and policy in petroleum development: changing relations between transnationals and governments* (New York: Nichols Publishing Company, 1979), 49.

³⁸ Lorenzo Cotula, *Investment contracts and sustainable development: How to make contracts for fairer and more sustainable natural resource investments* (London: International Institute for Environment and Development, 2010), 40-41.

1.3.2. Foreign Investors

Before revealing specific interests, goals and risks of a foreign investor, it is necessary to understand the meaning of the term ‘investor’ itself. In order to illuminate the idea standing behind this word, it is possible to refer again to Lorenzo Cotula, who states that “an investor is an entity that provides contributions (capital and technology, for example) and carries the commercial risks of an economic activity. An investor may range from a private company through to a state-owned enterprise”³⁹ The current work is focused only on foreign investors and not on local ones. ‘Foreign investors’ are entities established not in the host state which provides the place for an investment activity. ‘Multinational foreign investors’ are those, which perform their investment activities not only in one host-state, but in several states at the same time. For example, an oil company, which is established in Canada and which conducts its oil production operations in USA, Russia and Kazakhstan, shall be regarded as multinational investor.

According to Kamal Hossain, the major goal, which determines the oil production strategy of a multinational oil company during the time period of a petroleum investment project, is the maximization of its long-term profits from the company’s overall worldwide operations.⁴⁰ This means that if a foreign investor’s oil operations are conducted not only in a single host-state, but also in other places of the globe, such investor will seek the cumulative long-run financial benefits from all of its international divisions rather than short-term immediate gains from a particular country.

³⁹ Lorenzo Cotula, *Investment contracts and sustainable development: How to make contracts for fairer and more sustainable natural resource investments* (London: International Institute for Environment and Development, 2010), 4.

⁴⁰ Kamal Hossain, *Law and policy in petroleum development: changing relations between transnationals and governments* (New York: Nichols Publishing Company, 1979), 43.

Foreign investors always preferred Traditional Forms of Investment⁴¹ (particularly concessionary system), because of the reasons, well explained by Kamal Hossain in the following paragraph:⁴²

[Foreign oil companies] traditionally favored the concessionary system under which ownership of any petroleum discovered was vested in them securing for them the powers of management and maximum freedom of action (decision-making) in respect of operations at each stage. The pace of exploration, the amount of exploration work to be carried out, the expenditure to be borne for exploration, the programme of development after discovery, the rate and levels of production, pricing, were all matters which could be exclusively determined by the company: the “ownership” which was vested in them reinforced their claim to exercise such powers.

It can be inferred from this paragraph that, despite the fact that New Forms of Investment⁴³ (which are mostly used today) do not provide such boundless power of control, the desire of foreign investors will always be gaining as much influence on petroleum investment project as possible. And this is rather understandable, especially taking into consideration the main interest of any oil company which is gaining profits out of the petroleum production process. No doubt that the lesser the amount of restrictions imposed by the host-state on activities of the oil producer is, the more control will be obtained by the investor and, therefore, the more income will flow into the pockets of the oil company.

Another important objective of a foreign investor, which is non-fiscal in its nature, is the elimination of all possible risks connected to the performance of petroleum production operations in the host-state. Such risks usually come from several social, political, economic and legal spheres. Professor Sornarajah lists the following risks for a foreign investor: (1) political and nationalistic hostility or xenophobia towards the nationals of a country, where the oil company is established or registered; (2) instability of political and legal order, when

⁴¹ The notion of ‘Traditional Forms of Investment’ is discussed in the subsection 1.2.2. on pages 8-9.

⁴² Kamal Hossain, *Law and policy in petroleum development: changing relations between transnationals and governments* (New York: Nichols Publishing Company, 1979), 44.

⁴³ The notion of ‘New Forms of Investment’ is discussed in the subsection 1.2.2. on pages 8-9.

the host-state government cannot control marauders, criminal gangs and rebels; (3) changes in industry patterns, as it was during the oil crisis of 1970s, when the major shift from Traditional Forms of Investment to New Forms of Investment has happened; (4) onerous contracts, which become too burdensome for the government of a host-state to perform; (5) contracts made by previous regimes, when these regimes are accused of corruption or illegitimacy; (6) confiscation, nationalization and expropriation of foreign investor's property; (7) cancelation of a license, without which the operations of a foreign investor become illegal; (8) human rights and environmental regulations, the abuse of which can lead to the state's interference into the investor's activities; (9) alterations in the legislation which worsen the investment climate in the oil production sector; and (10) expulsion of the foreign investor with the aim to acquire his property.⁴⁴

The previous subsection has touched the issue of rate and extent of oil reserve production from the perspective of a host-country. Now the same issue shall be explained from the view of a foreign investor. One can suppose that an oil company's objective shall always be the immediate (in the sense of extraction speed) and intensive (in the sense of volume of oil) production of petroleum reserves. But this is not always the case. As it is rightfully noted by Kamal Hossain, "a company 'short on crude' in relation to its marketing outlets is likely to share the government's objective of rapid exploration".⁴⁵ But, if the situation is different, and a multinational oil company has other sources of oil supply at the moment (for instance, from its divisions in other countries) and got the rights to perform petroleum production activities in the host-state only to stake out the claim for a particular oilfield (for instance, to eliminate risk of possible competition), it probably will try to leave

⁴⁴ Kamal Hossain, *Law and policy in petroleum development: changing relations between transnationals and governments* (New York: Nichols Publishing Company, 1979), 75-87, 97-131, 387-400.

⁴⁵ *Ibid*, page 45.

such oilfield untouched (as an additional reserve) or to carry the minimum amount of work (just to give an appearance that activities are going).⁴⁶

1.3.3. *Other Parties*

Not only interests of a state government and a foreign investor shall be taken into consideration, while drafting terms of an agreement for a petroleum investment project, but also of other parties as well. For instance, the performance of a petroleum agreement may significantly influence local communities which inhabit the investment area. The ‘community’ in this sense shall be defined as “a group of people that is directly affected by an investment project. For example, the implementation of a natural resource investment may entail the taking of lands on which a group of people depend for their livelihood and food security.”⁴⁷ Among the issues of possible conflicts between the affected communities and the main parties of a petroleum investment agreement can be environmental pollution, labor and human rights violations. Besides local communities, there are often many other parties, which have different direct or indirect interests in a petroleum investment project. They can be contractors, creditors, borrowers, insurers, suppliers, government agencies, civil society in general and many others.⁴⁸

⁴⁶ Kamal Hossain, *Law and policy in petroleum development: changing relations between transnationals and governments* (New York: Nichols Publishing Company, 1979), 45.

⁴⁷ Lorenzo Cotula, *Investment contracts and sustainable development: How to make contracts for fairer and more sustainable natural resource investments* (London: International Institute for Environment and Development, 2010), 4.

⁴⁸ However, the interests of these parties do not fall under the scope of this thesis research and, thus, will not be discussed at all.

To deal with the matters at which interests of a host-state (being a sole owner of hydrocarbons reserves) and a foreign oil company (being a supplier of capital, technological equipment and managerial personnel) differ, as well as to build some kind of alliance rather than confrontation between them, a group of conditions of the petroleum investment project that would satisfy both parties have to be negotiated, formulated and fixed in a proper legal form.⁴⁹ This can be done through a petroleum contract, which would clarify all problematic issues and would affirm those ones on which parties had already reached a mutually satisfactory solution. Therefore, the first part of this chapter deals with the general structure and major terms contained in every petroleum agreement irrespective of its contractual form.

The second section discusses several protective mechanisms used as special legal instruments and effective contractual devices to secure the fair balance between foreign investor and host state interests.

However, it is obvious that the easier way for both parties of a petroleum investment project would be to select the existing (and proven by long-lasting practice) set of terms and provisions than to create them from scratch. Host states and foreign investors “are, thus, called upon to choose between different options and types of petroleum development arrangements”⁵⁰. In a legal sense, such arrangements are represented by petroleum contract models, the types and features of which will be compared, examined and analyzed in the third section of this chapter.

⁴⁹ Kamal Hossain, *Law and policy in petroleum development: changing relations between transnationals and governments* (New York: Nichols Publishing Company, 1979), 54.

⁵⁰ *Ibid*, page 54.

2.1. Major Provisions of a Petroleum Agreement

Denis Guirauden states that “a petroleum exploration and production contract [...] generally consists of a document of, typically, about a hundred pages, with several sections: the preamble, the main text, and appendices which form an integral part of the contract.”⁵¹ The preamble, being the first part of the contract, lists several general statements, which traditionally start from the word “Whereas”, thus, setting the purpose of the contract and certifying the wills of a host-state and a foreign oil company to conduct the particular petroleum investment project. The last part of the contract usually consists of additional supplementary materials, which are called appendices. They often include: (a) plans, maps and descriptions, which specify geographical coordinates of an oilfield; (b) documents, which reveal the methods of accounting to be used during the financial processes; (c) work commitments in the form of a detailed programme for parties to perform their respective amounts of petroleum activities; (d) letters of guarantee from the parent company or a bank.⁵²

The main text of a petroleum contract is apparently the central and the most important part of the legal document. It contains specific terms, which basically are conditions of the oil business deal, agreed by the parties. Besides some regular provisions that are usual for almost any contract, the main text of the international petroleum agreement, according to Denis Guirauden, includes four major categories of articles, among which are the following: (1) technical provisions, (2) financial provisions; (3) legal provisions and (4) miscellaneous provisions.⁵³

⁵¹ Denis Guirauden, “Legal, fiscal and contractual framework.” In *Oil and gas exploration and production: reserves, costs, contracts*, coordinated by Centre for Economics and Management of IFP-School. (Paris: Editions Technip, 2004), 178.

⁵² *Ibid*, page 182.

⁵³ *Ibid*, page 182.

2.1.1. Technical Provisions

William T. Onorato agrees with Denis Guirauden that most of the technical provisions of the contract shall be correlated with the phases of the petroleum investment project, such as exploration, appraisal and exploitation periods, which can also be divided into sub-phases.⁵⁴ These scholars further explain that an agreement shall provide “for defined, minimum petroleum operations [known as work programme] to be performed by the rights-holder during each phase of the contract”⁵⁵ and shall “specify whether the contract holder must comply with both work and expenditure obligations or only one of these, and what the priority is.”⁵⁶ Muhammed Mazeel then provides an example by saying that a “phase commitment will then usually be defined as a quantity of seismic data to be acquired, processed and interpreted [for instance, during exploration period], or as a number of wells to be drilled [for instance, during the appraisal stage]”⁵⁷.

As it was mentioned by Nicky Beredjick and Thomas W. Waelde, the contract shall also stipulate: (a) the duration of each phase, (b) the size of area available to oil companies and (c) possibilities for relinquishment after the completion of certain stages of a petroleum production process.⁵⁸ According to Denis Guirauden, the total term of an exploration period is commonly from 5 to 10 years (but often subdivided into a number of sub-periods, at the end of each the oil company has an option to continue or terminate the agreement) and the total term of a production phase is typically from 20 to 25 years (which may be renewable if

⁵⁴ William T Onorato, *Legislative Frameworks Used to Foster Petroleum Development* (World Bank Publications, 1995), 35-36; Denis Guirauden, “Legal, fiscal and contractual framework.” In *Oil and gas exploration and production: reserves, costs, contracts*, coordinated by Centre for Economics and Management of IFP-School. (Paris: Editions Technip, 2004), 182-183.

⁵⁵ William T Onorato, *Legislative Frameworks Used to Foster Petroleum Development* (World Bank Publications, 1995), 36-37.

⁵⁶ Denis Guirauden, “Legal, fiscal and contractual framework.” In *Oil and gas exploration and production: reserves, costs, contracts*, coordinated by Centre for Economics and Management of IFP-School. (Paris: Editions Technip, 2004), 184.

⁵⁷ Muhammed Mazeel, *Petroleum Fiscal Systems and Contracts* (Hamburg: Diplomica Verlag, 2010), 45.

⁵⁸ Nicky Beredjick, Thomas W. Waelde, *Petroleum investment policies in developing countries* (London: Sterling House, 1988), 30-34.

further production is economically reasonable).⁵⁹ As for the area of a potential oilfield, it is usually for the benefit of the government to provide smaller sizes of land for oil exploration and production, because “if the area is too large there is a risk the holder will only explore a small part of it.”⁶⁰ Relinquishment provisions serve a two-fold objective: (1) they stop foreign investors from ‘sitting on the resource’⁶¹, when they do not use it, and (2) they allow foreign investors ‘to get rid of’ the land plots, if exploration results showed their unprofitability.⁶²

Discovery, appraisal, declaration of commerciality as well as a clause concerning submission of development and production plan govern the processes which take place between the exploration and development phases of the petroleum production project. The discovery provision shall proclaim that if the foreign oil company discovers oil reserves during the exploration, it shall notify the government of a host state about it and start the petroleum evaluation activities.⁶³ As for the appraisal provision, it is essential to ascertain whether the discovered area constitutes a commercial oil field.⁶⁴ Practically, such appraisal is performed through drilling the sufficient number of wells across the area of the potential oilfield. The development-and-production plan which shall be prepared after the declaration of commerciality deals with: time-schedules of the production process, installations of equipment for drilling and extraction and operating costs for a petroleum extraction process.⁶⁵

⁵⁹ Denis Guirauden, “Legal, fiscal and contractual framework.” In *Oil and gas exploration and production: reserves, costs, contracts*, coordinated by Centre for Economics and Management of IFP-School. (Paris: Editions Technip, 2004), 183-186.

⁶⁰ *Ibid*, page 184.

⁶¹ The problem of ‘sitting on the resource’ has already been discussed in the subsection 1.3.1. on page 14.

⁶² Nicky Beredjick, Thomas W. Waelde, *Petroleum investment policies in developing countries* (London: Sterling House, 1988), 33; William T Onorato, *Legislative Frameworks Used to Foster Petroleum Development* (World Bank Publications, 1995), 37.

⁶³ Denis Guirauden, “Legal, fiscal and contractual framework.” In *Oil and gas exploration and production: reserves, costs, contracts*, coordinated by Centre for Economics and Management of IFP-School. (Paris: Editions Technip, 2004), 185.

⁶⁴ Nicky Beredjick, Thomas W. Waelde, *Petroleum investment policies in developing countries* (London: Sterling House, 1988), 37.

⁶⁵ Denis Guirauden, “Legal, fiscal and contractual framework.” In *Oil and gas exploration and production: reserves, costs, contracts*, coordinated by Centre for Economics and Management of IFP-School. (Paris: Editions Technip, 2004), 185-186.

Provisions such as good oilfield practice and environmental protection also belong to the technical category. The provision governing good oilfield practice “relates particularly to resource conservation [...] and safety.”⁶⁶ The environmental protection clause establishes the following principles: (a) minimizing and prevention of pollution to land, water, flora and fauna; (b) avoidance of waste disposal to petroleum; (c) clean-up obligations in case of emergency and (d) restoration of environment after the completion of works.⁶⁷

There are also provisions regulating obligations of the oil company to employ and train local personnel. As it was discussed earlier in the first chapter, the host state is highly interested in situations when a foreign investor: (1) employs local staff, thus, fighting with the unemployment rate in the country; (2) provides training programs, thus, lifting the professional level of workers and transferring the technical knowledge to the country. As it is mentioned by Daniel Johnston, “some contracts will stipulate up to 85% employment of nationals”⁶⁸.

2.1.2. *Financial Provisions*

Provisions describing who and in what proportions is responsible for financing petroleum operations shall also be included in an international petroleum agreement. Usually it is fully the foreign investor’s obligation to fund petroleum operations by providing financial and other resources either out of its own capital or by the means of a loan.⁶⁹ However, sometimes a host-state also tends to participate in the petroleum investment project. The

⁶⁶ Denis Guirauden, “Legal, fiscal and contractual framework.” In *Oil and gas exploration and production: reserves, costs, contracts*, coordinated by Centre for Economics and Management of IFP-School (Paris: Editions Technip, 2004), 187.

⁶⁷ William T. Onorato, *Legislative Frameworks Used to Foster Petroleum Development* (World Bank Publications, 1995), 41-42.

⁶⁸ Daniel Johnston, *International petroleum fiscal systems and production sharing contracts* (Tulsa: PennWell Books, 1994), 164.

⁶⁹ Denis Guirauden, “Legal, fiscal and contractual framework.” In *Oil and gas exploration and production: reserves, costs, contracts*, coordinated by Centre for Economics and Management of IFP-School (Paris: Editions Technip, 2004), 188.

conditions of such participation shall be fixed in an international petroleum agreement either through special articles setting options to participate or through separate agreements, like participation agreements (also known as joint venture contracts).⁷⁰

Other financial provisions govern the valuation of the extracted oil for the purposes of export trading. The export price of crude oil is usually calculated by a special committee consisting of the host state's representatives and the foreign oil company's personnel, which has "to monitor the international market price and maintain the realistic value of crude [oil]."⁷¹ After the price is established, the crude oil becomes ready for export sale. However, the government may propose to include a marketing provision in the contract, which would state "that the domestic market should have a first call on national production."⁷²

Among the most important provisions of any petroleum contract are conditions based on which a host state and a foreign investor company get their portions of revenues from the petroleum investment project. As Denis Guirauden claims, "the manner in which revenues are calculated depends of the [fiscal] regime applying."⁷³ Konoplianik and Subbotin state that there are four categories of such regimes: (1) bonuses, (2) rentals, (3) royalty and (4) taxes.⁷⁴ However they are not completely correct in their classification. According to Kamal Hossain, there is one more fiscal regime under which the parties get their portions of profit, which is the dividend payment.⁷⁵

⁷⁰ Nicky Beredjick, Thomas W. Waelde, *Petroleum investment policies in developing countries* (London: Sterling House, 1988), 42-46.

⁷¹ Daniel Johnston, *International petroleum fiscal systems and production sharing contracts* (Tulsa: PennWell Books, 1994), 162.

⁷² *Ibid*, page 190.

⁷³ Denis Guirauden, "Legal, fiscal and contractual framework." In *Oil and gas exploration and production: reserves, costs, contracts*, coordinated by Centre for Economics and Management of IFP-School. (Paris: Editions Technip, 2004), 188.

⁷⁴ A. Konoplianik, M. Subbotin, *Gosudarstvo i investor: ob iskusstve dogovarivatsia* (Folio Publishing House, 1996), 31-47.

⁷⁵ Kamal Hossain, *Law and policy in petroleum development: changing relations between transnationals and governments* (New York: Nichols Publishing Company, 1979), 213-215.

Bonuses, being non-cyclic one-off payments, shall be regarded as an additional rather than a primary source of profits for the host-state.⁷⁶ Normally several ‘milestones’ are set along the petroleum production process, upon the reaching of which the oil company has to pay specific amounts of money to the host state. Scholars usually provide three examples of such indication points: (1) signature, (2) commercial discovery and (3) production levels.⁷⁷ In the first example the “bonus is normally payable upon signature of the petroleum agreement”⁷⁸, as a sort of prepayment certifying the seriousness of the foreign firm’s intentions. The second example represents the payment of the bonus after the discovery of a commercially valuable oilfield. In the last example, the bonus “is payable in an agreed or specified amount upon the achievement of stipulated levels of petroleum production.”⁷⁹

The second type of payments is rentals, which is a fee for the purpose of land usage within the scope of a petroleum investment project. These payments do not depend on production levels or profitability of a petroleum project and provide an opportunity for the host-country to receive constant systematic revenue (as opposed to bonuses).⁸⁰ The so-called sliding scale rentals with the progressive scheme of payments are commonly preferred by the host states which use them “as an instrument to discourage the retention of areas over which exploration is not being conducted.”⁸¹

⁷⁶ A. Konoplianik, M. Subbotin, *Gosudarstvo i investor: ob iskusstve dogovarivatsia* (Folio Publishing House, 1996), 32.

⁷⁷ William T Onorato, *Legislative Frameworks Used to Foster Petroleum Development* (World Bank Publications, 1995), 38; Nicky Beredjick, Thomas W. Waelde, *Petroleum investment policies in developing countries* (London: Sterling House, 1988), 36.

⁷⁸ Nicky Beredjick, Thomas W. Waelde, *Petroleum investment policies in developing countries* (London: Sterling House, 1988), 36.

⁷⁹ *Ibid*, page 37.

⁸⁰ A. Konoplianik, M. Subbotin, *Gosudarstvo i investor: ob iskusstve dogovarivatsia* (Folio Publishing House, 1996), 35.

⁸¹ Kamal Hossain, *Law and policy in petroleum development: changing relations between transnationals and governments* (New York: Nichols Publishing Company, 1979), 216.

Nevertheless, the major types of financial revenues (in the case of successful exploitation of the oilfield) for the government remain the payments based on production, also known as royalty, and the payments based on profitability, also known as taxes.⁸² Both of these fiscal regimes have their own benefits and drawbacks. As Kamal Hossain states, “the basic advantage of a royalty is that it is a guaranteed payment to the government for the depletion of the resources irrespective of whether the company makes a profit or not.”⁸³ Thus, royalty creates a certain minimum level of revenues for the host state (lower than which they will not fall) in contrast to taxes, which sometimes may not be received by the government for a couple of first years of the oilfield’s exploitation.⁸⁴ Moreover, royalty payments do not depend on oil market prices.

However, despite the fact that royalty payments serve as the basal fiscal regime for constant inflow of revenues for the recipient country, taxes provide *a fortiori* a much greater portion of revenues (for instance, the level of tax payments may vary from 50% to 70% of the profitability, while the level of royalty payments are usually within the limits of 10-15%).⁸⁵ From the perspective of foreign investors the choice is also controversial. On the one hand, the amount of royalty payments seems to be much less. On the other hand, paying taxes may be less risky, because “if there are no profits, the company has no obligation to pay taxes to the host government.”⁸⁶

⁸² A. Konoplianiuk, M. Subbotin, *Gosudarstvo i investor: ob iskusstve dogovarivatsia* (Folio Publishing House, 1996), 35-36; Muhammed Mazeel, *Petroleum Fiscal Systems and Contracts* (Hamburg: Diplomica Verlag, 2010), 45-46.

⁸³ Kamal Hossain, *Law and policy in petroleum development: changing relations between transnationals and governments* (New York: Nichols Publishing Company, 1979), 203.

⁸⁴ A. Konoplianiuk, M. Subbotin, *Gosudarstvo i investor: ob iskusstve dogovarivatsia* (Folio Publishing House, 1996), 36.

⁸⁵ A. Konoplianiuk, M. Subbotin, *Gosudarstvo i investor: ob iskusstve dogovarivatsia* (Folio Publishing House, 1996), 36; Kamal Hossain, *Law and policy in petroleum development: changing relations between transnationals and governments* (New York: Nichols Publishing Company, 1979), 206-213.

⁸⁶ Kamal Hossain, *Law and policy in petroleum development: changing relations between transnationals and governments* (New York: Nichols Publishing Company, 1979), 206.

The fifth type of payment originates from the concept of government participation in the petroleum investment project, for example in the form of a joint venture. In this case, Kamal Hossain explains, “as a participant in the equity, the state in addition to royalty and taxes becomes entitled also to a dividend.”⁸⁷

Other financial terms (which are sometimes called audit and accounting provisions), which oblige rights-holders “to maintain clear and accurate records, in an agreed unit or currency [...] and provide periodic (e.g. monthly; quarterly) reports [...] pursuant to the requirements and formats contained in an Accounting Procedure”⁸⁸ are provided (as it was already discussed earlier in this chapter) in the appendices of a petroleum contract.

2.1.3. *Legal Provisions*

Legal provisions name the participants of the international petroleum agreement, who most of the times are the foreign oil company and the host-state, which can be represented by a governmental authority or a national oil company. These provisions also cover the respective rights and obligations of the parties. According to Daniel Johnson⁸⁹,

The rights and obligations of the host-state may include: the right to access to the data acquired by the contractor; the right to assist and expedite the contractor’s execution of the work program; the right to appoint its representatives with respect to the contract and the joint venture management team; the right to remove at the contractor’s expense any of the contractor’s employees if the employee is incompetent, and/or unacceptable to the national oil company due to political or social behavior [...]. The rights and obligations of the contractor may include: fulfillment of all technical requirements; funds furnished for the performance of the work program; the right to sell, assign, convey, or otherwise dispose of all or any part of its rights and interests under the contract [...].

Other legal clauses may be: responsibility, indemnity, penalties, force majeure, date of entry into force, insurance, modification and termination or revocation of a contract. They are rather usual for any ordinary contract and, thus, there is no need for further scrutiny.

⁸⁷ Kamal Hossain, *Law and policy in petroleum development: changing relations between transnationals and governments* (New York: Nichols Publishing Company, 1979), 213.

⁸⁸ William T. Onorato, *Legislative Frameworks Used to Foster Petroleum Development* (World Bank Publications, 1995), 39.

⁸⁹ Daniel Johnston, *International petroleum fiscal systems and production sharing contracts* (Tulsa: PennWell Books, 1994), 161-162.

2.1.4. *Miscellaneous Provisions*

Miscellaneous provisions deal with other important issues, which may be of special importance to a petroleum production process, such as definitions, accounts, production rates, confidentiality of information and currency exchanges.⁹⁰ One of the most commonly used miscellaneous provisions out of the listed above is the article with definitions. Considering the fact that a petroleum investment project contains a large amount of professional terminology, this standard contract section “defines specifically technical and financial terms to promote a common understanding”⁹¹.

2.2. **Protective Mechanisms for Balancing Parties’ Interests**

The previous chapter has examined major provisions of a standard international petroleum agreement. Such provisions fix a particular set of conditions, which were agreed by the parties after the completion of a negotiation process. This is apparently done before starting the petroleum production activities, when a host state and a foreign investor both have more or less equal haggling position with regards to the terms of the petroleum investment project. However, the principle of the so-called ‘obsolesce bargain’, which is explained by many scholars⁹², can take place at the later stage of the foreign investment project.

As Sornarajah explains, “the bargaining power of the foreign investor is at its greatest at the moment of entry, and he is best able to secure terms favorable to himself.”⁹³ In addition, the host state usually lacks financial and technological resources to develop its potential

⁹⁰ William T. Onorato, *Legislative Frameworks Used to Foster Petroleum Development* (World Bank Publications, 1995), 42-44.

⁹¹ Daniel Johnston, *International petroleum fiscal systems and production sharing contracts* (Tulsa: PennWell Books, 1994), 157.

⁹² Humphrey Onyeukwu, “Obsolescence bargaining in transit pipelines: what options exist for securing resource supply.” *Centre for Energy, Petroleum, Mineral Law and Policy University of Dundee* (2008): 9-10; M. Sornarajah, *The International Law on Foreign Investment* (Cambridge: Cambridge University Press, 2010), 402-404.

⁹³ M. Sornarajah, *The International Law on Foreign Investment* (Cambridge: Cambridge University Press, 2010), 402.

oilfields and, thus, needs the power of foreign investors to perform petroleum production operations. According to Humphrey Onyeukwu, “at this point, it is in a poor bargaining position relative to the [...international oil company...] to undertake the risk of exploiting its natural resources.”⁹⁴

However, as the petroleum project progresses, the situation can be transformed into the opposite one. According to Sornarajah, “once the investment has been made and the project is under way, the foreign investor becomes a captive of the host state.”⁹⁵ When the commercially valuable petroleum reserves are discovered, oil production is going well and profits are coming on a regular basis, the level of risk to the foreign investor decreases.⁹⁶ As a result, the recipient country may not want to share such a high return (or at least not on the same conditions) any more.⁹⁷ Moreover, according to Humphrey Onyeukwu, “the national priorities may have changed for the host government, with new political leaders entering power and realignments in perceptions of economic development.”⁹⁸ It is possible that a host state may decide to interfere and alter the initially agreed conditions of a deal. As it is stated by Lorraine Eden, Stefanie Lenway and Douglas A. Schuler, “once bargaining power shifts [...] to the host country, the government imposes more conditions on the [...] foreign investor...], ranging from higher taxes to complete expropriation of [...] assets.”⁹⁹ The reason

⁹⁴ Humphrey Onyeukwu, “Obsolescence bargaining in transit pipelines: what options exist for securing resource supply.” *Centre for Energy, Petroleum, Mineral Law and Policy University of Dundee* (2008): 9-10.

⁹⁵ M. Sornarajah, *The International Law on Foreign Investment* (Cambridge: Cambridge University Press, 2010), 403.

⁹⁶ Humphrey Onyeukwu, “Obsolescence bargaining in transit pipelines: what options exist for securing resource supply.” *Centre for Energy, Petroleum, Mineral Law and Policy University of Dundee* (2008): 10.

⁹⁷ *Ibid*, page 10.

⁹⁸ *Ibid*, page 10.

⁹⁹ Lorraine Eden, Stefanie Lenway, Douglas A. Schuler, “From the obsolescing bargain to the political bargaining model.” *Bush School Working Paper* 403 (2004): 3.

for this is “the fact that it has the legislative machinery of the state at its disposal and [...] a legislative supremacy to interfere with any domestic event.”¹⁰⁰

Thus, there is a great need in special protection devices to counteract or even prevent the occurrence of such a situation. Among the most famous and the most efficient mechanisms to secure the balance of interest between a host state and a foreign oil company are: stabilization clauses, renegotiation clauses, umbrella clauses, choice-of-law clauses and dispute resolution clauses.

2.2.1. *Stabilization Clause*

The basic idea behind the notion of a stabilization clause is not to allow any laws and regulations issued by the legislative authority of a host state after the signature of the contract to change the legal or fiscal regime of the petroleum project. As it is mentioned by Margarita Coale, “by agreeing to a stabilization clause, the foreign government purports to alienate its right to unilaterally change the rights promised to and relied upon by the foreign oil company.”¹⁰¹ In other words, “the government undertakes to put the investment agreement beyond the grip of laws or administrative measures that may be issued subsequently.”¹⁰²

According to Lorenzo Cotula, there are four main categories of stabilization clauses: (1) ‘freezing’ clauses, (2) ‘intangibility’ clauses, (3) ‘consistency’ clauses and ‘equilibrium’ clauses.¹⁰³ Freezing clauses are merely provisions, which “stipulate that the agreement will be

¹⁰⁰ M. Sornarajah, *The International Law on Foreign Investment* (Cambridge: Cambridge University Press, 2010), 403.

¹⁰¹ Margarita Coale, “Stabilization clauses in international petroleum transactions.” *Denver Journal of International Law and Policy* (2002): 2.

¹⁰² Abebe Ababayehu Chekol, “Stabilization clauses in petroleum development agreements: examining their adequacy and efficacy.” *Centre for Energy, Petroleum, Mineral Law and Policy University of Dundee* (2010): 8.

¹⁰³ Lorenzo Cotula, *Investment contracts and sustainable development: How to make contracts for fairer and more sustainable natural resource investments* (London: International Institute for Environment and Development, 2010), 67-74.

governed by the laws in place [...] at the time of the agreement.”¹⁰⁴ Intangibility clauses permit the modification of the contract only after the mutual consent of both parties. Consistency clauses mean that the newly enacted host state’s legislation can be applied to the petroleum investment project only if it is consistent with the provisions of the agreement. According to Muhammed Mazeel, an equilibrium clause means that “in the event of [...] introducing a new measure that has a negative financial impact on the contractor then the profit oil split would be adjusted to maintain the economic balance.”¹⁰⁵

2.2.2. *Renegotiation Clause*

Among the main incentives for inputting a renegotiation clause into the petroleum contract are: (1) possible future changes in business circumstances and (2) the long time duration of the contract.¹⁰⁶ According to John Y. Gotanda, such provisions usually “require all parties to return to the bargaining table and renegotiate the terms of their agreements”¹⁰⁷ at some future point in time. In order to be effective, renegotiation clauses shall “link the trigger of the procedure to the occurrence of one or more events defined more precisely in the clause, such as tax increases, price changes for raw materials”¹⁰⁸ and any other conditions. As Daniel Johnston noted, this type of clause provides the possibility “of reaching agreement on basic issues and leaving the more uncertain issues for a time when better information is available to decide.”¹⁰⁹ The scholar further provides an example of a gas clause, with the help of which oil

¹⁰⁴ Muhammed Mazeel, *Petroleum Fiscal Systems and Contracts* (Hamburg: Diplomica Verlag, 2010), 48.

¹⁰⁵ *Ibid*, page 48.

¹⁰⁶ Lorenzo Cotula, *Investment contracts and sustainable development: How to make contracts for fairer and more sustainable natural resource investments* (London: International Institute for Environment and Development, 2010), 67.

¹⁰⁷ John Y. Gotanda, “Renegotiation and Adaptation Clauses in Investment Contracts.” *Vanderbilt Journal of Transnational Law* 36 (2003): 1.

¹⁰⁸ Klaus Peter Berger, “Renegotiation and Adaptation of International Investment Contracts: The Role of Contract Drafters and Arbitrators.” *Vanderbilt Journal of Transnational Law* 36 (2000): 1362.

¹⁰⁹ Daniel Johnston, *International petroleum fiscal systems and production sharing contracts* (Tulsa: PennWell Books, 1994), 173.

producers leave the decision on the percentages of its allocation for a future, when and if the gas will be revealed during the petroleum production.¹¹⁰

2.2.3. *Umbrella Clause*

Although the umbrella clause is traditionally used in bilateral investment treaties between two states, umbrella-type clauses can also be inputted in the international petroleum agreement between a host state and a foreign oil company. The clear definition of an umbrella clause is provided by Nkiru Okobi, according to whom, “the umbrella clause, also called mirror clause, parallel effect clause or *pacta sunt servanda* clause, is a treaty provision that requires the observance of all investment (contractual) obligations and commitments entered into by the contracting states with investors.”¹¹¹ If such a clause is employed by a petroleum contract, this creates an international legal duty mainly for the recipient state to guarantee the adherence to the commitments and obligations it has entered into with regards to the petroleum investment project.¹¹²

2.2.4. *Choice-of-law Clause*

Despite the fact that there is not a single view on the legal nature of international petroleum agreements, the majority of international judicial decisions, according to Zhiguo Gao, tend to demonstrate that the applicable law in such contracts is a domestic law of the recipient country.¹¹³ However, if the foreign investor wishes to “exclude the application of the host state’s domestic law which it perceives would be to his disadvantage”¹¹⁴, he shall insist

¹¹⁰ Daniel Johnston, *International petroleum fiscal systems and production sharing contracts* (Tulsa: PennWell Books, 1994), 173.

¹¹¹ Nkiru Okobi, “The umbrella clause: a panacea for contractual instability? A look at production sharing contracts.” *Centre for Energy, Petroleum, Mineral Law and Policy University of Dundee* (2009): 10.

¹¹² Yannaca-Small, Katia. “Interpretation of the Umbrella Clause in Investment Agreements.” *OECD Working Papers on International Investment* (2006): 3.

¹¹³ Zhiguo Gao, *International petroleum contracts: current trends and new directions* (Graham & Trotman, 1994), 208-210.

¹¹⁴ Nkiru Okobi, “The umbrella clause: a panacea for contractual instability? A look at production sharing contracts.” *Centre for Energy, Petroleum, Mineral Law and Policy University of Dundee* (2009): 9.

to include the choice-of-law clause into the text of the contract. As Sornarajah states, “the assumption is that, as in the case of other international contracts, parties have autonomy to choose the law which is applicable to the foreign investment contract.”¹¹⁵

2.2.5. Arbitration Clause

Along with negotiation and mediation, arbitration provides the possibility of alternative dispute resolution for the parties of the petroleum investment project. As scholars state, “the arbitration clause is included in the contract so as to allow the choice of a neutral forum for settlement of disputes”¹¹⁶ in a special international arbitration body (such as UNICTRAL, ICSID or ICC)¹¹⁷ rather than “in the domestic courts of the host state – where, depending on the country, there may be risks of political interference in the judicial process.”¹¹⁸

Other benefits of inclusion of the option to arbitrate future conflicts are: (1) participation of tribunal members, who will be competent not only in legal science, but also in technical issues of petroleum operations; (2) absence of lengthy and cumbersome litigation procedure, which can last for several years; (3) possibility of conducting the proceedings in a regime closed for public; and (4) free choice of place and language of the proceedings.

2.3. Types and Features of Petroleum Contract Models

The provisions examined above can be combined through different variations in the so-called legal templates (also known as contract models), which are generally used by the host states in their legislations as an *a priori* set of conditions “for distributing the risks, costs

¹¹⁵ M. Sornarajah, *The International Law on Foreign Investment* (Cambridge: Cambridge University Press, 2010), 411.

¹¹⁶ *Ibid*, page 413.

¹¹⁷ Muhammed Mazeel, *Petroleum Fiscal Systems and Contracts* (Hamburg: Diplomica Verlag, 2010), 48.

¹¹⁸ Lorenzo Cotula, *Investment contracts and sustainable development: How to make contracts for fairer and more sustainable natural resource investments* (London: International Institute for Environment and Development, 2010), 75.

and benefits of an investment project.”¹¹⁹ Moreover, according to William T. Onorato, the existence of one or several variants of a petroleum contract model is “the final essential component of successful petroleum legislative frameworks”.¹²⁰ The choice between the traditional types of petroleum contract models to be made by legislative authorities of the recipient states usually depends on many circumstances, “according not only to the economics of the industry, but also, for instance, depending on the ability of [... the] host country to contribute capital and share project risk.”¹²¹

There are many kinds of petroleum contract models. Some scholars recognize only three particular types of agreements, such as concessions, production sharing contracts and service contracts.¹²² Other scholars specifically single out the additional fourth model, which is a joint venture agreement.¹²³ Some of those who distinguish three classes of petroleum contracts claim either that a joint venture is a deviation of a service contract¹²⁴ or that it is a form of a production sharing agreement¹²⁵. While these controversies are not yet resolved

¹¹⁹ Lorenzo Cotula, *Investment contracts and sustainable development: How to make contracts for fairer and more sustainable natural resource investments* (London: International Institute for Environment and Development, 2010), 23.

¹²⁰ William T. Onorato, *Legislative Frameworks Used to Foster Petroleum Development* (World Bank Publications, 1995), 45.

¹²¹ Lorenzo Cotula, *Investment contracts and sustainable development: How to make contracts for fairer and more sustainable natural resource investments* (London: International Institute for Environment and Development, 2010), 23.

¹²² Tengku Nathan Machmud, *The Indonesian production sharing contract: an investor's perspective* (Kluwer Law International, 2000), 34-42; Muhammed Mazeel, *Petroleum Fiscal Systems and Contracts* (Hamburg: Diplomica Verlag, 2010), 8-37; Nicky Beredjick, Thomas W. Waelde, *Petroleum investment policies in developing countries* (London: Sterling House, 1988), 86-89; Daniel Johnston, *International petroleum fiscal systems and production sharing contracts* (Tulsa: PennWell Books, 1994), 29-112;

¹²³ Kamal Hossain, *Law and policy in petroleum development: changing relations between transnationals and governments* (New York: Nichols Publishing Company, 1979), 120-138; M. Somarajah, *The International Law on Foreign Investment* (Cambridge: Cambridge University Press, 2010), 133-134; Bernard Taverne, *Petroleum, industry, and governments: a study of the involvement of industry and governments in the production, and use of petroleum* (Kluwer Law International, 2008), 379-395.

¹²⁴ Daniel Johnston, *International petroleum fiscal systems and production sharing contracts* (Tulsa: PennWell Books, 1994), 87-112.

¹²⁵ Tengku Nathan Machmud, *The Indonesian production sharing contract: an investor's perspective* (Kluwer Law International, 2000), 34.

completely by the academic community, the current work will take the position of the existence of four types of contract models.

All four types of petroleum agreements which exist in the current global oil production industry can be divided into two major categories – concessions and contracts – as it was proposed by A. Konoplianik, M. Subbotin and M. Mazeel.¹²⁶ The principal difference between the two categories is the following: in case of concessionary regime the recipient country, the owner of subsoil and any natural reserves within it, cedes its ownership rights to the foreign investor, while in the case of a contractual regime it does not do so.¹²⁷ The further subdivision of these two categories (concessionary regime – into traditional and modernized concessions; contractual regime – into production sharing, joint venture, risk and non-risk service agreements) will be examined further in this chapter taking into consideration the evolutionary aspect of their appearance.

It is also necessary to mention that despite the undisputable theoretical acceptance of several major types of petroleum contract models, “it is important to look at each contract’s detailed provisions, rather than its name, in order to understand its content and implications.”¹²⁸ Lorenzo Cotula clarifies this statement by providing a good example, where “despite its name, Mozambique’s Model ‘Exploration and Production Concession’ (EPC) for petroleum projects is in effect a production sharing agreement, not a concession.”¹²⁹ Thus, in order to be able to differentiate between different forms of petroleum contract models, the

¹²⁶ A. Konoplianik, M. Subbotin, *Gosudarstvo i investor: ob iskusstve dogovarivatsia* (Folio Publishing House, 1996), 18; Muhammed Mazeel, *Petroleum Fiscal Systems and Contracts* (Hamburg: Diplomica Verlag, 2010), 8.

¹²⁷ A. Konoplianik, M. Subbotin, *Gosudarstvo i investor: ob iskusstve dogovarivatsia* (Folio Publishing House, 1996), 18.

¹²⁸ Lorenzo Cotula, *Investment contracts and sustainable development: How to make contracts for fairer and more sustainable natural resource investments* (London: International Institute for Environment and Development, 2010), 24.

¹²⁹ *Ibid*, page 24.

following subsections will reveal the distinctive features of the most commonly used agreements in the world of oil production.

2.3.1. *Concession Agreements*

Scholars say that “the concession was the original system used in the world petroleum arrangements”¹³⁰ and still is “used by around half of the countries worldwide including the US, UK, France, Norway, Russia, Australia, New Zealand, South Africa, Colombia and Argentina.”¹³¹ Some authors say that it is possible to use other terms (such as license, permit or lease) instead of a word ‘concession’.¹³² The main feature of a concessionary system is the transfer of ownership rights. According to Daniel Johnson, “in most countries the government owns all mineral resources, but under concessionary systems it will transfer title of the minerals to a company if they are produced.”¹³³

The definitions offered by several scholars assist in better understanding the legal nature of this type of international petroleum agreement. One definition is provided by Lorenzo Cotula, who states that “concessions are contracts whereby the government grants the investor the exclusive right to exploit natural resources [...] in a given area for a specified period of time”¹³⁴. According to Muhammed Mazeel, “under a concessionary system, the state government grants a Concession or License [...] which gives rights [to an international oil company] for a fixed period to explore for and produce hydrocarbons within a certain area”¹³⁵. Another definition is given by Denis Guirauden, who claims that “under a concession arrangement the State grants the contract holder exclusive exploration rights

¹³⁰ Nicky Beredjick, Thomas W. Waelde, *Petroleum investment policies in developing countries* (London: Sterling House, 1988), 89.

¹³¹ Muhammed Mazeel, *Petroleum Fiscal Systems and Contracts* (Hamburg: Diplomica Verlag, 2010), 12.

¹³² Nicky Beredjick, Thomas W. Waelde, *Petroleum investment policies in developing countries* (London: Sterling House, 1988), 89.

¹³³ Daniel Johnston, *International petroleum fiscal systems and production sharing contracts* (Tulsa: PennWell Books, 1994), 21.

¹³⁴ Lorenzo Cotula, *Investment contracts and sustainable development: How to make contracts for fairer and more sustainable natural resource investments* (London: International Institute for Environment and Development, 2010), 24.

¹³⁵ Muhammed Mazeel, *Petroleum Fiscal Systems and Contracts* (Hamburg: Diplomica Verlag, 2010), 12.

(exploration license), as well as an exclusive development and production right (lease or concession) for each commercial discovery.”¹³⁶

According to the famous scholar, Zhiguo Gao, the history of petroleum agreements in general and the concessionary system in particular finds its origin in 1901, when the Persian state granted exclusive rights to perform petroleum production operations within the borders of the Persian Empire to an Englishman, William Knox D’Arcy.¹³⁷ Thus, “D’Arcy concession” can be regarded as a starting point for the first generation of concession-type international petroleum agreements, also known as ‘traditional concessions’¹³⁸. According to Tengku Nathan Machmud, the traditional concession regime had a severe disadvantage – the host state was “excluded from participation in the ownership of the undertaking, the management of petroleum operations, as well as the petroleum profits.”¹³⁹ Moreover, as it is mentioned by Daniel Johnson, “the earliest agreements consisted of only a royalty payment to the state.”¹⁴⁰ Mainly, because of these reasons “the first generation of petroleum arrangements generally failed to develop a broadly balanced, persistently stable and mutually beneficial relationship between the contracting parties.”¹⁴¹

The significant decay of a traditional concession regime and the dawn of a new generation of concession agreements (more known as modernized concessions) started in the 1940s, when Venezuela imposed additional financial burdens (such as profit sharing scheme

¹³⁶ Denis Guirauden, “Legal, fiscal and contractual framework.” In *Oil and gas exploration and production: reserves, costs, contracts*, coordinated by Centre for Economics and Management of IFP-School. (Paris: Editions Technip, 2004), 193.

¹³⁷ Zhiguo Gao, *International petroleum contracts: current trends and new directions* (Graham & Trotman, 1994), 9.

¹³⁸ For further details about Traditional Foreign Investments refer to the Subsection 1.2.2. on page 8-9.

¹³⁹ Tengku Nathan Machmud, *The Indonesian production sharing contract: an investor's perspective* (Kluwer Law International, 2000), 36.

¹⁴⁰ Daniel Johnston, *International petroleum fiscal systems and production sharing contracts* (Tulsa: PennWell Books, 1994), 29.

¹⁴¹ Zhiguo Gao, *International petroleum contracts: current trends and new directions* (Graham & Trotman, 1994), 21.

in the form of taxes) on its foreign investors.¹⁴² Konoplianiuk, Subbotin and Zhiguo Gao share the view that the new modernized concession can be differentiated from the old traditional concession by the following features: (1) smaller concession area; (2) presence of a relinquishment provision; (2) much shorter duration (3) the possibility of prolongation in case of the commercial petroleum production initiation; (3) increased state control and possibility of participation in the petroleum investment project; (4) major financial improvements in the form of equal profit sharing, rentals, new royalty payments, bonuses system and income tax.¹⁴³ As Zhiguo Gao notes, “the modern concession is a system that is flexible enough to accommodate different perspectives and interests of the contracting parties.”¹⁴⁴

2.3.2. *Production Sharing Agreements*

Despite the fact that modernized concessions were able to suit most of the interests and demands of parties to a petroleum investment project, many developing countries (such as Malaysia, Oman, Egypt, Libya, Angola, Peru, Philippines, Sudan and Thailand) started to prefer the production sharing agreement after its first appearance in Indonesia in 1966.¹⁴⁵ The reason for such a trend towards the increased use of production sharing contract model was “mainly due to political motivations, for the system creates an image of national control over

¹⁴² Tengku Nathan Machmud, *The Indonesian production sharing contract: an investor's perspective* (Kluwer Law International, 2000), 36.

¹⁴³ A. Konoplianiuk, M. Subbotin, *Gosudarstvo i investor: ob iskusstve dogovarivatsia* (Folio Publishing House, 1996), 18; Zhiguo Gao, *International petroleum contracts: current trends and new directions* (Graham & Trotman, 1994), 14-17.

¹⁴⁴ Zhiguo Gao, *International petroleum contracts: current trends and new directions* (Graham & Trotman, 1994), 57.

¹⁴⁵ Tengku Nathan Machmud, *The Indonesian production sharing contract: an investor's perspective* (Kluwer Law International, 2000), 43-88; A. Konoplianiuk, M. Subbotin, *Gosudarstvo i investor: ob iskusstve dogovarivatsia* (Folio Publishing House, 1996), 22; Zhiguo Gao, *International petroleum contracts: current trends and new directions* (Graham & Trotman, 1994), 59-104; Nicky Beredjick, Thomas W. Waelde, *Petroleum investment policies in developing countries* (London: Sterling House, 1988), 90; Denis Guirauden, “Legal, fiscal and contractual framework.” In *Oil and gas exploration and production: reserves, costs, contracts*, coordinated by Centre for Economics and Management of IFP-School. (Paris: Editions Technip, 2004), 199.

petroleum development”¹⁴⁶. These political incentives are further explained by Tengku Nathan Machmud, when he states that “the title to the mineral resources passes [to the investor] at the point of export, which implies that the nation’s sovereignty is not impinged in any way, as foreigners are barred from having title to the nation’s wealth.”¹⁴⁷

The parties to a production sharing agreement in the oil industry are usually the foreign investor and the recipient state, represented by a state-owned national petroleum company. The foreign investor usually acts as “the operator and the source of necessary funds, and [...] as a simple service contractor whose work is remunerated in kind (in petroleum) only if a commercial discovery is developed.”¹⁴⁸ As for the host state, it “retains all the mineral rights and title [...] therefore creates a *de jure* State monopoly on hydrocarbon exploration and production.”¹⁴⁹ It is necessary to mention that in terms of financial revenues the difference between the production sharing system and the concessionary regime lays in the fact that in the case of the former one “the host state receives the share of petroleum, rather than tax and royalties.”¹⁵⁰

However, the hybrid variations of the production sharing contracts with regards to distribution of financial revenues are also possible. Konoplianik and Subbotin provide an example of such production sharing scheme, where: (1) if commercially valuable oil reserves were discovered, the investor’s costs (for exploration, development and exploitation) shall be

¹⁴⁶ Zhiguo Gao, *International petroleum contracts: current trends and new directions* (Graham & Trotman, 1994), 103.

¹⁴⁷ Tengku Nathan Machmud, *The Indonesian production sharing contract: an investor's perspective* (Kluwer Law International, 2000), 37.

¹⁴⁸ Nicky Beredjick, Thomas W. Waelde, *Petroleum investment policies in developing countries* (London: Sterling House, 1988), 91;

¹⁴⁹ Denis Guirauden, “Legal, fiscal and contractual framework.” In *Oil and gas exploration and production: reserves, costs, contracts*, coordinated by Centre for Economics and Management of IFP-School. (Paris: Editions Technip, 2004), 199.

¹⁵⁰ Lorenzo Cotula, *Investment contracts and sustainable development: How to make contracts for fairer and more sustainable natural resource investments* (London: International Institute for Environment and Development, 2010), 26.

refunded by the so-called ‘compensation oil’; (2) the remaining part of the extracted oil, shall be distributed between the investor and the state (proportions differ from country to country); (3) the share obtained by the investor shall become the object of the income-taxation; (4) royalties based on the value of production shall also be included.¹⁵¹

2.3.3. *Service Contracts*

Service contracts appeared in the second part of the 20th century, when “some developing countries sought to develop a contractual arrangement that was able to assure maximum national control over petroleum development while at the same time having minimum level of foreign involvement.”¹⁵² According to Denis Guirauden, “service contracts are used mainly in the Middle East and Latin America, but their use is not widespread.”¹⁵³ Scholars believe that there are mainly two groups of service contracts, which are risk-service contracts and non-risk service contracts (the latter also known as pure contracts or technical assistant contracts as well as cooperation contracts)¹⁵⁴.

As Daniel Johnston claims, “when the term service contract is used it is normally understood to be a risk service contract.”¹⁵⁵ According to Zhiguo Gao, the concept of a risk service contract gained its worldwide recognition after its successful implementation in Brazil in 1976.¹⁵⁶ This type of international petroleum contract was traditionally used “in countries

¹⁵¹ A. Konoplianiuk, M. Subbotin, *Gosudarstvo i investor: ob iskusstve dogovarivatsia* (Folio Publishing House, 1996), 22-24;

¹⁵² Zhiguo Gao, *International petroleum contracts: current trends and new directions* (Graham & Trotman, 1994), 105.

¹⁵³ Denis Guirauden, “Legal, fiscal and contractual framework.” In *Oil and gas exploration and production: reserves, costs, contracts*, coordinated by Centre for Economics and Management of IFP-School. (Paris: Editions Technip, 2004), 202.

¹⁵⁴ A. Konoplianiuk, M. Subbotin, *Gosudarstvo i investor: ob iskusstve dogovarivatsia* (Folio Publishing House, 1996), 24-27; Denis Guirauden, “Legal, fiscal and contractual framework.” In *Oil and gas exploration and production: reserves, costs, contracts*, coordinated by Centre for Economics and Management of IFP-School. (Paris: Editions Technip, 2004), 202-203.

¹⁵⁵ Daniel Johnston, *International petroleum fiscal systems and production sharing contracts* (Tulsa: PennWell Books, 1994), 21.

¹⁵⁶ Zhiguo Gao, *International petroleum contracts: current trends and new directions* (Graham & Trotman, 1994), 105.

where oil was nationalized or where the national oil company was granted a monopoly, such as Argentina, Brazil, Indonesia, Iraq and Iran.”¹⁵⁷ The major distinction of the risk-service contract from the production-sharing agreement is “that it reimburses the contractor in cash, not in crude oil”.¹⁵⁸ The foreign investor “is therefore not able to market the hydrocarbons extracted.”¹⁵⁹ A good definition is provided by a well-known scholar Denis Guirauden, when he explains the notion of the risk service contract as “a contract by which a contractor undertakes to explore for hydrocarbons at his own risk and expense on behalf of a national company, and by which he is reimbursed [...] and remunerated in cash depending on the success of the exploration.”¹⁶⁰

Risk service contracts can be of two types: (1) with a risk, which is not distributed among the parties, and (2) with a risk, distributed among the parties. Within the first type of risk-service contracts the whole amount of risk and obligation to fund exploration activities is on the foreign oil company. Moreover, if the commercially valuable petroleum reserves are not discovered during the agreed term, the contract is usually terminated without any compensation for exploration costs from the host state.¹⁶¹ The second type of risk-service contract is traditionally used by the governments of recipient countries only if they expect high oil-bearing capacity from a potential oilfield.¹⁶² In this case they can share part of the

¹⁵⁷ Denis Guirauden, “Legal, fiscal and contractual framework.” In *Oil and gas exploration and production: reserves, costs, contracts*, coordinated by Centre for Economics and Management of IFP-School. (Paris: Editions Technip, 2004), 203.

¹⁵⁸ Nicky Beredjick, Thomas W. Waelde, *Petroleum investment policies in developing countries* (London: Sterling House, 1988), 92.

¹⁵⁹ Denis Guirauden, “Legal, fiscal and contractual framework.” In *Oil and gas exploration and production: reserves, costs, contracts*, coordinated by Centre for Economics and Management of IFP-School. (Paris: Editions Technip, 2004), 203.

¹⁶⁰ *Ibid.*, page 203.

¹⁶¹ A. Konoplianik, M. Subbotin, *Gosudarstvo i investor: ob iskusstve dogovarivatsia* (Folio Publishing House, 1996), 24-26.

¹⁶² A. Konoplianik, M. Subbotin, *Gosudarstvo i investor: ob iskusstve dogovarivatsia* (Folio Publishing House, 1996), 26.

exploration risk with the foreign oil company with the aim to reduce compensation payments to the investor after the discovery of the oil reserves.

In pure service contracts the host state takes the whole risk, and “the contractor carries out exploration and/or development work.”¹⁶³ In other words, “there is no risk element, [and] the contractor is paid a fee for performing a service.”¹⁶⁴ Such non-risk service contracts are usually used not in the government-investor relationship, but in the investor-subcontractor relationship in the form of outsourcing, i.e. getting technical assistance or any other kind of a cooperation, including the so-called ‘turnkey projects’.

2.3.4. *Joint Venture Agreements*

In its general sense, according to M. Sornarajah, “the joint venture is a collaborative arrangement between two or more businesses to achieve a particular objective [...] which may be more successfully pursued as a result of their pooling of resources or technology.”¹⁶⁵ The global oil industry has faced them at the first time in the Middle East several years after signing the D’Arcy concession.¹⁶⁶ The joint-ventures may be created either between the recipient country and the foreign oil company or between several investors. Due to the fact that the main purpose of the current thesis is to examine the balance of interests between the host state and the foreign investor, the first type of the indicated international relationship shall be considered here.

¹⁶³ Daniel Johnston, *International petroleum fiscal systems and production sharing contracts* (Tulsa: PennWell Books, 1994), 24.

¹⁶⁴ Tengku Nathan Machmud, *The Indonesian production sharing contract: an investor's perspective* (Kluwer Law International, 2000), 39.

¹⁶⁵ M. Sornarajah, *The International Law on Foreign Investment* (Cambridge: Cambridge University Press, 2010), 133.

¹⁶⁶ Bernard Taverne, *Petroleum, industry, and governments: a study of the involvement of industry and governments in the production, and use of petroleum* (Kluwer Law International, 2008), 375-379.

As Muhammed Mazeel states, “international oil companies often form a joint venture [...] to share risk and reward for large scale or high risk ventures.”¹⁶⁷ Moreover, according to Lorenzo Cotula, “compared to concessions and PSA [Production Sharing Agreements], joint ventures tend to give the host country partner a greater control over the project and its benefits.”¹⁶⁸ However, it is necessary to mention that joint ventures have disadvantages as well. For instance, “if the project fails, the host country partner may incur major losses, which is not the case under concessions, leases and PSAs.”¹⁶⁹

Besides sharing high financial costs of the international petroleum project, the reason to create a joint venture, according to Bernard Taverne, may be the minimization of possible risks, such as: (1) the geological risk that oil reserves will not be discovered during the exploration procedures; (2) the technical risk to perform in difficult or even extreme conditions (including terrain, weather and temperature); (3) the development risk that the found petroleum reservoir will have such bad characteristics as to hamper the extraction activities and (4) the political risk that riots or a uprisings affect the petroleum project.¹⁷⁰

However, there are other reasons for the creation of joint venture arrangements. Firstly, state participation in the joint venture is a good way for developing countries to obtain new petroleum technologies, know-how and professional training from a more developed foreign investor.¹⁷¹ Secondly, collaboration with the state-owned petroleum enterprise can increase the chances for an investor to win the tender for a petroleum project or become

¹⁶⁷ Muhammed Mazeel, *Petroleum Fiscal Systems and Contracts* (Hamburg: Diplomica Verlag, 2010), 32.

¹⁶⁸ Lorenzo Cotula, *Investment contracts and sustainable development: How to make contracts for fairer and more sustainable natural resource investments* (London: International Institute for Environment and Development, 2010), 26.

¹⁶⁹ *Ibid.*, page 29.

¹⁷⁰ Bernard Taverne, *Petroleum, industry, and governments: a study of the involvement of industry and governments in the production, and use of petroleum* (Kluwer Law International, 2008), 380.

¹⁷¹ Kamal Hossain, *Law and policy in petroleum development: changing relations between transnationals and governments* (New York: Nichols Publishing Company, 1979), 175.

successful in any other bidding procedure.¹⁷² Thirdly, if a state enterprise already has the license for petroleum activities, the creation of a joint venture will allow a foreign investor to benefit from this already awarded document.¹⁷³

There are two main possibilities to create a joint venture – either as an incorporated joint venture or as an unincorporated one. Under the first option, the participants set up “a jointly owned company incorporated in the host state and managed by the board where both parties are represented”.¹⁷⁴ Under the second option, “joint ventures may also be run on the basis of contracts alone, without the creation of a separate legal entity”.¹⁷⁵

The passage provided by Zhiguo Gao gives a perfect summary of all petroleum contract models discussed in this chapter with regards to legal relationships between the host state and foreign investor:¹⁷⁶

Under the modern concession contract, the concessionaire works essentially for itself. Under the production-sharing contract and the risk service contract, the contractors work primarily for the government. Under the hybrid contract or a joint venture contract, the foreign company works in association with the state oil companies.

The following chapter will provide the examples of how these long-established petroleum contract models are incorporated into the legislations of Central Asian states of Kazakhstan, Turkmenistan, Uzbekistan, Kyrgyzstan and Tajikistan.

¹⁷² Bernard Taverne, *Petroleum, industry, and governments: a study of the involvement of industry and governments in the production, and use of petroleum* (Kluwer Law International, 2008), 380.

¹⁷³ *Ibid*, page 380.

¹⁷⁴ Lorenzo Cotula, *Investment contracts and sustainable development: How to make contracts for fairer and more sustainable natural resource investments* (London: International Institute for Environment and Development, 2010), 26.

¹⁷⁵ *Ibid*, page 26.

¹⁷⁶ Zhiguo Gao, *International petroleum contracts: current trends and new directions* (Graham & Trotman, 1994), 204.

According to Boris Rumer, “the term ‘Central Asia’ in its current geopolitical meaning applies to the southern part of the [former] USSR and includes five [...] independent states – Kazakhstan, Uzbekistan, Kyrgyzstan, Turkmenistan, and Tajikistan.”¹⁷⁷ The reason for choosing these countries as a basis for the current thesis research is “not only a geographical grouping, but also similarities in the types of transition challenges faced by these countries”¹⁷⁸ after “the collapse of the Soviet Union in 1991 [which] gave the former Soviet republics an opportunity to create their own form of national independence and to adopt new economic policies.”¹⁷⁹ Among the major challenges for revitalizing their economies was the struggle with newly exposed technological weaknesses in “export-oriented industries such as oil, natural gas, and metals desperately needed to be reequipped in order to compete effectively in the world markets.”¹⁸⁰

Some scholars claim that “the Republics of Central Asia [...] are still struggling [...] to enact legislation that will attract significant new capital to explore for and develop their ample mineral resources.”¹⁸¹ According to Boris Rumer, “the reserves of oil and gas are concentrated primarily in Turkmenistan and Kazakhstan [...] while Uzbekistan...] possesses

¹⁷⁷ Boris Z. Rumer, *Central Asia in transition: dilemmas of political and economic development* (New York: M. E. Sharpe, Inc, 1996), 1.

¹⁷⁸ Emine Gorgen, Harry Snoek, Jon Craig, Jimmy McHugh, Ivailo Izvorski, Ron Van Rooden, *Economic reforms in Kazakhstan, Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan* (Washington DC: International Monetary Fund, 1999), vii.

¹⁷⁹ Elizabeth Bastida, Thomas W. Waelde, Janeth Warden-Fernández, *International and comparative mineral law and policy: trends and prospects* (Kluwer Law International, 2005), 1009.

¹⁸⁰ Emine Gorgen, Harry Snoek, Jon Craig, Jimmy McHugh, Ivailo Izvorski, Ron Van Rooden, *Economic reforms in Kazakhstan, Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan* (Washington DC: International Monetary Fund, 1999), 52.

¹⁸¹ Elizabeth Bastida, Thomas W. Waelde, Janeth Warden-Fernández, *International and comparative mineral law and policy: trends and prospects* (Kluwer Law International, 2005), 1009.

more modest reserves of hydrocarbon raw materials”¹⁸². The author further mentions that despite the scanty amount of oil reserves, “rich deposits of precious metals are [...] found in Kyrgyzstan [...] and Tajikistan.”¹⁸³ Considering the important role of the natural resources extraction sector for their economic development, the Central Asian states “have adopted laws on subsurface use to regulate the mining industry and to encourage direct foreign investment in mineral exploration and development.”¹⁸⁴ Despite the fact that “these laws are quite similar in nature, showing the continuing influence of the common Soviet heritage as well as attention to legislative developments in near-by republics”¹⁸⁵, the investment climate for conducting petroleum (or other mineral resources) production projects has its own distinctive legal features in every Central Asian country.

This chapter is focused on the comparative analysis of the respective legal frameworks in all five states of the region. To reveal what types of international petroleum contract models are employed by the above mentioned states and to check whether the legislative systems provide a fair balance between the interests of a host state and a foreign investor, the special attention is devoted to the normative legal acts in the spheres of foreign investment and subsoil use. The first section examines the legislative framework of Kazakhstan, which has “the most comprehensive and developed legislation”¹⁸⁶ due to its leading position in the petroleum production industry of the Central Asia. The second section provides the analysis of legislations in other countries of this region, which are: Turkmenistan, Uzbekistan, Kyrgyzstan and Tajikistan.

¹⁸² Boris Z. Rumer, *Central Asia in transition: dilemmas of political and economic development* (New York: M. E. Sharpe, Inc, 1996), 68.

¹⁸³ *Ibid*, 68.

¹⁸⁴ Elizabeth Bastida, Thomas W. Waelde, Janeth Warden-Fernández, *International and comparative mineral law and policy: trends and prospects* (Kluwer Law International, 2005), 1010.

¹⁸⁵ *Ibid*, page 1010.

¹⁸⁶ *Ibid*, page 1010.

3.1. Situation in Kazakhstan

This section reveals the situation in Kazakhstan with regards to the legal investment climate existing in its petroleum sector. The discussion is divided into three parts: (1) general overview, (2) foreign investment legislation and (3) petroleum production legislation.

3.1.1. General Overview

As it is stated by Yelena Kalyuzhnova, “after obtaining independence, Kazakhstan became one of the most promising regions for world oil companies”¹⁸⁷, at the same time, according to Jan Schuijjer, “the size of its current proven reserves is highly uncertain.”¹⁸⁸ Steve Fast claims that “at the end of 2002, Kazakhstan had proven reserves of 9 billion barrels of crude, ranking it 17th place in the world, with many unproven reserves and promising geological structures yet to be explored.”¹⁸⁹ However, by the estimates of the US Department of Energy, the prospective total deposits of petroleum resources in this country can reach the level of 85 billion barrels, which “would put Kazakhstan’s reserves at the same level as the UK and Norwegian sectors of the North Sea combined.”¹⁹⁰ By the year of 2011, the oil production in Kazakhstan has already reached the level of 1.7 million barrels per day.¹⁹¹

Kazakhstan’s petroleum reserves are located mainly “in the four western regions (Atyrau, Aktyubinsk, Western-Kazakhstan and Mangistau), along and under the Caspian Sea [Tengiz field], as well as in the two southern regions of Dzhezkazgan (Kumkol Basin) and

¹⁸⁷ Yelena Kalyuzhnova, *The Kazakstani economy: independence and transition* (St. Martin's Press, 1998), 123-124.

¹⁸⁸ Jan Schuijjer, *Investment guide for Kazakhstan*. (Organization for Economic Co-operation and Development, 1998), 103.

¹⁸⁹ Steve Fast, “A Country Profile.” In *Doing business with Kazakhstan*, edited by Marat Terterov (Kogan Page, 2004), 8.

¹⁹⁰ Jan Schuijjer, *Investment guide for Kazakhstan*. (Organization for Economic Co-operation and Development, 1998), 103.

¹⁹¹ “Oil Market Report.” International Energy Agency [available at <http://omrpublic.iea.org/supplysearch.asp> (accessed March 17, 2011)].

Kzyl-Orda (Southern Turgay Basin).¹⁹² Most of the oil fields located in these regions are now developed “by joint ventures in which foreign shareholders play an important role both in the funding and in the supply of up-to-date technology and equipment.”¹⁹³ As it is stated by Jan Schuijjer, “a great deal of investment funds is flowing into the upstream¹⁹⁴ oil segment of the sector.”¹⁹⁵ Among the well-known international oil companies investing now into the petroleum industry of Kazakhstan are: Chevron (United States), Mobil (United States), British Gas (United Kingdom), Agip (Italy), Chinese National Petroleum Company (China), Gazprom (Russia), Lukoil (Russia), Japanese National Oil Company (Japan).¹⁹⁶

However, according to scholars, in the middle of 1990s many of the foreign investors “were cautious about investing in a politically risky and unfamiliar environment [of Kazakhstan].”¹⁹⁷ Among concerns, mentioned by Jan Schuijjer, were “the lack of clear and contractual framework, the apparent or perceived lack of transparency in some government decisions, and a confusing layer of authorities with overlapping responsibilities.”¹⁹⁸ In order to diminish the fears and “to bolster its attractiveness to [Foreign Oil Companies], [...] the Kazakhstani government set in place a legislative framework”¹⁹⁹, directed towards the improvement of the investment climate in the oil industry.

¹⁹² Lutz Hoffmann, Peter Bofinger, Heiner Flassbeck, Alfred Steinherr, *Kazakstan 1993-2000: independent advisors and the IMF* (Physica-Verlag Heidelberg, 2001), 136.

¹⁹³ Jan Schuijjer, *Investment guide for Kazakhstan*. (Organization for Economic Co-operation and Development, 1998), 105.

¹⁹⁴ The further explanation of the ‘upstream sector’ can be found in the subsection 1.2.2. on pages 7-8.

¹⁹⁵ Jan Schuijjer, *Investment guide for Kazakhstan*. (Organization for Economic Co-operation and Development, 1998), 111.

¹⁹⁶ Lutz Hoffmann, Peter Bofinger, Heiner Flassbeck, Alfred Steinherr, *Kazakstan 1993-2000: independent advisors and the IMF* (Physica-Verlag Heidelberg, 2001), 139-142.

¹⁹⁷ Pauline Jones Luong, Erika Weinthal, *Oil Is Not a Curse: Ownership Structure and Institutions in Soviet Successor States* (New York: Cambridge University Press, 2010), 263.

¹⁹⁸ Jan Schuijjer, *Investment guide for Kazakhstan*. (Organization for Economic Co-operation and Development, 1998), 121.

¹⁹⁹ Pauline Jones Luong, Erika Weinthal, *Oil Is Not a Curse: Ownership Structure and Institutions in Soviet Successor States* (New York: Cambridge University Press, 2010), 263.

3.1.2. Foreign Investment Legislation

As Luong and Weinthal claim “the first major piece of legislation introduced was the 1994 Law on Foreign Investment”²⁰⁰. It was followed by the law on State Support for Direct Investments enacted on February 28, 1997.²⁰¹ However, on January 8 of 2003 the new law ‘On Investments’²⁰² has repealed both previous normative legal acts. The American Chamber of Commerce in Kazakhstan states that this new law “seeks to establish a single investment regime for both domestic and foreign investors.”²⁰³ However, in order to understand the real value of the new law for international oil companies, it is necessary to examine the guarantees provided by it for protection against risks²⁰⁴ which usually threaten foreign investors. For instance, according to Zhaniya B. Ussen, the new law guarantees to investors:²⁰⁵

[1] compensation of damages resulting from issuance by a state agency of acts not conforming to the laws of Kazakhstan, as well as damages resulting from illegal actions (or failure to act) by state officials; [2] stabilization of the terms of a contract entered between an investor and a state agency [...]; [3] free use of investment profit [...]; [4] transparency of activities of state agencies regarding investors, including free access to information [...]; [5] compensation of damages in event of nationalization; [6] compensation of the market value of confiscated property in event of requisition; [7] resolution of an investment dispute [...] in a local court, or an international arbitration chosen by an agreement of the parties; [8] any and all protection provided by the Constitution, other legislative acts and international agreements.

However, Ilias Bantekas underlined that “the 2003 law has been criticized for removing some of the guarantees offered in previous [investment] legislation.”²⁰⁶ For

²⁰⁰ Pauline Jones Luong, Erika Weinthal, *Oil Is Not a Curse: Ownership Structure and Institutions in Soviet Successor States* (New York: Cambridge University Press, 2010), 263.

²⁰¹ Ilias Bantekas, John Paterson, Maidan Suleimanov, *Oil and gas law in Kazakhstan: national and international perspectives* (Kluwer Law International, 2004), 119.

²⁰² The Law of the Republic of Kazakhstan “On Investments” # 373-II of January 8, 2003 (Zakon Respubliki Kazakhstan “Ob Investiziyah”).

²⁰³ American Chamber of Commerce in Kazakhstan. “Kazakhstan’s Foreign Investment Climate.” In *Doing business with Kazakhstan*, edited by Marat Terterov (Kogan Page, 2004), 43.

²⁰⁴ The detailed information regarding ‘foreign investor risks’ can be found in the Section 1.3.2. on pages 16-17.

²⁰⁵ Zhaniya B. Ussen, “Foreign Investments: the legal framework.” In *Doing business with Kazakhstan*, edited by Marat Terterov (Kogan Page, 2004), 15-16.

²⁰⁶ Ilias Bantekas, John Paterson, Maidan Suleimanov, *Oil and gas law in Kazakhstan: national and international perspectives* (Kluwer Law International, 2004), 174.

example, in contrast to the famous Article 6 of the 1994 Law, a stabilization clause which is contained in the Article 4 (3) of the new law protecting a contract against adverse changes in the legislation does not mention a “compensation of an investor in event of changes in the laws in the areas of national security, environment, health and morality.”²⁰⁷

The Article 4 (2), concerning “indemnification against harm caused as a result of [...] illegal actions [...] committed by state officials”²⁰⁸, contains another problem. According to Bantekas, the problem of the Article 4 is that it provides “compensation only where an act or omission constitutes a violation of domestic law [and not of international law].”²⁰⁹ One more challenge is the nationalization of property, because “although the law [Article 8] allows nationalization of investments, it does not provide clear grounds for expropriation.”²¹⁰ As for the Article 13, it provides several types of investment preferences, thus, stimulating “investments into so-called priority sectors [...], however, such sectors] do not include upstream subsoil operations”²¹¹. As Denton W. Sapte writes, “among the most important protections available [in the law] is the right to resolve disputes by way of international arbitration”²¹², but the Article 9 which governs this issue “lacks clear mechanisms for access to international arbitration and does not state that awards are final and binding”²¹³.

²⁰⁷ Zhaniya B. Ussen, “Foreign Investments: the legal framework.” In *Doing business with Kazakhstan*, edited by Marat Terterov (Kogan Page, 2004), 16.

²⁰⁸ The Law of the Republic of Kazakhstan “On Investments” # 373-II of January 8, 2003 (Zakon Respubliki Kazakhstan “Ob Investiziyah”), Article 4 (2).

²⁰⁹ Ilias Bantekas, John Paterson, Maidan Suleimanov, *Oil and gas law in Kazakhstan: national and international perspectives* (Kluwer Law International, 2004), 175.

²¹⁰ American Chamber of Commerce in Kazakhstan. “Kazakhstan’s Foreign Investment Climate.” In *Doing business with Kazakhstan*, edited by Marat Terterov (Kogan Page, 2004), 43.

²¹¹ Zhaniya B. Ussen, “Foreign Investments: the legal framework.” In *Doing business with Kazakhstan*, edited by Marat Terterov (Kogan Page, 2004), 21.

²¹² Denton W. Sapte, “Protection of Investment in Kazakhstan.” In *Doing business with Kazakhstan*, edited by Marat Terterov. (Kogan Page, 2004), 275.

²¹³ Ilias Bantekas, John Paterson, Maidan Suleimanov, *Oil and gas law in Kazakhstan: national and international perspectives* (Kluwer Law International, 2004), 183.

Ilias Bantekas is right when stating that “the new law has consolidated [...] previous investment legislation, but has to some degree brought about some uncertainty.”²¹⁴ Moreover, unlike the 1994 law, according to Zhaniya B. Ussen, “the new Law is rather a general act on the issue of investments implying the prevailing power of an industry-specific legislation.”²¹⁵ Therefore, it is necessary to observe legislation designated specifically for oil industry.

3.1.3. *Petroleum Production Legislation*

According to scholars, until recently the primary legislation in the hydrocarbon industry consisted of the Decree of the President of Kazakhstan having the force of law ‘On Subsoil and Subsoil Use’ of January 27, 1996 (also known as the ‘Subsoil Law’ or ‘Subsoil Code’) and the Decree of the President of Kazakhstan having the force of law ‘On Petroleum’ of June 28, 1995 (also known as the ‘Law on Oil’).²¹⁶ However, both of them were repealed by the new law “On Subsoil and Subsoil Use”²¹⁷ which was enacted on June 24, 2010.

The central to the former petroleum legislation “from the standpoint of legal concept were [the] provisions on the licensing and contracts system.”²¹⁸ Any foreign oil company wishing to perform petroleum activities was required “to possess a license and enter into a subsoil use contract with the Ministry of Energy, Industry and Trade [now – Ministry of Oil and Gas].”²¹⁹ However, “the abandonment of the licensing-and-contracts system [...], which

²¹⁴ Ilias Bantekas, John Paterson, Maidan Suleimanov, *Oil and gas law in Kazakhstan: national and international perspectives* (Kluwer Law International, 2004), 184.

²¹⁵ Zhaniya B. Ussen, “Foreign Investments: the legal framework.” In *Doing business with Kazakhstan*, edited by Marat Terterov (Kogan Page, 2004), 15.

²¹⁶ Jan Schuijjer, *Investment guide for Kazakhstan*. (Organization for Economic Co-operation and Development, 1998), 115; Denton W. Sapte, “Oil and Gas Regulation in Kazakhstan.” In *Doing business with Kazakhstan*, edited by Marat Terterov (Kogan Page, 2004), 74.

²¹⁷ The Law of the Republic of Kazakhstan “On Subsoil and Subsoil Use” # 291-IV of June 24, 2010 (Zakon Respubliki Kazakhstan “O Nedrah i Nedropolzovanii”).

²¹⁸ Ilias Bantekas, John Paterson, Maidan Suleimanov, *Oil and gas law in Kazakhstan: national and international perspectives* (Kluwer Law International, 2004), 126.

²¹⁹ Jan Schuijjer, *Investment guide for Kazakhstan*. (Organization for Economic Co-operation and Development, 1998), 118;

operated for a number of years”²²⁰ until 1999, has created in Kazakhstan, “in contrast to the other CIS countries, [...] a unique situation with regards to subsurface use licensing.”²²¹ Now the relationship between the parties to a petroleum project has to be “defined only by contracts on subsurface use, with no preliminary grant of licenses.”²²² However, there is a legal collision contained in the law “On Licensing”, which still makes the upstream petroleum operations, including well-drilling and oil-extraction subject to licensing.²²³

M. Suleimenov and Y. Osipov explain that the former petroleum legislation provided two types of petroleum contract systems: (1) a concessionary system, represented by ‘subsoil lease agreements’, and (2) a contract system, which was represented by production sharing agreements and service contracts.²²⁴ The new law “On Subsoil and Subsoil Use” *prima facie* excludes concession contracts and production sharing agreements, and provides a new type of contract, under the conditions of which petroleum production becomes subject not to royalty payments, but to a sophisticated system of taxation.²²⁵ However, as it is claimed by Suleimenov and Osipov, *de facto* the fiscal regime of the new contract does not differ significantly from royalty payments of a production sharing agreement.²²⁶ Moreover, according to the text of the law, minerals belong to the subsoil user unless it is stipulated

²²⁰ Ilias Bantekas, John Paterson, Maidan Suleimanov, *Oil and gas law in Kazakhstan: national and international perspectives* (Kluwer Law International, 2004), 128.

²²¹ Denton W. Sapte, “Oil and Gas Regulation in Kazakhstan.” In *Doing business with Kazakhstan*, edited by Marat Terterov. (Kogan Page, 2004), 75.

²²² Ilias Bantekas, John Paterson, Maidan Suleimanov, *Oil and gas law in Kazakhstan: national and international perspectives* (Kluwer Law International, 2004), 128.

²²³ The Law of the Republic of Kazakhstan “On Licensing” # 214-III of January 11, 2007 (Zakon Respubliki Kazakhstan “O Lizenzirovaniï”), Articles 11(1) and 12(2).

²²⁴ M. K. Suleimenov, Y. B. Osipov, “Review of the legislative base for investments in oil and gas sector of the Republic of Kazakhstan.” (Obzor zakonodatelnoy bazi dlia investitsiy v neftegazovom sectore respublik Kazakhstan). *IIED/British Embassy in Astana* (2010): 1.

²²⁵ *Ibid*, page 2.

²²⁶ M. K. Suleimenov, Y. B. Osipov, “Review of the legislative base for investments in oil and gas sector of the Republic of Kazakhstan.” (Obzor zakonodatelnoy bazi dlia investitsiy v neftegazovom sectore respublik Kazakhstan). *IIED/British Embassy in Astana* (2010): 2.

otherwise in the contract.²²⁷ This condition resembles a concessionary system.²²⁸ Besides, all contracts concluded and licenses issued before the enactment of the new law remain in force.²²⁹

The new law foresees the possibility of granting the rights for petroleum activities mainly through contracts for exploration, production and mixed exploration-and-production after completion of either tender process or direct negotiations with the competent authority with the emphasis on local social development and signature bonuses payments.²³⁰ One of the major dangers for a foreign investor is that his application for tender can be rejected, if the grant of the subsoil use right to this oil company would be regarded against national safety of the country, while the notion of national safety is not clearly defined in the law.²³¹ Moreover, the rejection will not be explained and cannot be appealed in court.

Another method of conducting petroleum investment projects available for foreign investors in Kazakhstan is the creation of a joint venture with the national company. In 2002, the new national company KazMunaiGaz was created²³² “by merging the assets of the former national oil and gas company Kazakhoil and [the national petroleum transportation company]

²²⁷ The Law of the Republic of Kazakhstan “On Subsoil and Subsoil Use” # 291-IV of June 24, 2010 (Zakon Respubliki Kazakhstan “O Nedrah i Nedropolzovanii”), Article 10 (2).

²²⁸ M. K. Suleimenov, Y. B. Osipov, “Review of the legislative base for investments in oil and gas sector of the Republic of Kazakhstan.” (Obzor zakonodatelnoy bazi dlia investitsiy v neftegazovom sektore respublik Kazakhstan). *IIED/British Embassy in Astana* (2010): 2.

²²⁹ The Law of the Republic of Kazakhstan “On Subsoil and Subsoil Use” # 291-IV of June 24, 2010 (Zakon Respubliki Kazakhstan “O Nedrah i Nedropolzovanii”), Article 129 (4).

²³⁰ The Law of the Republic of Kazakhstan “On Subsoil and Subsoil Use” # 291-IV of June 24, 2010 (Zakon Respubliki Kazakhstan “O Nedrah i Nedropolzovanii”), Articles 35, 46, 56, 61, 67.

²³¹ The Law of the Republic of Kazakhstan “On Subsoil and Subsoil Use” # 291-IV of June 24, 2010 (Zakon Respubliki Kazakhstan “O Nedrah i Nedropolzovanii”), Article 51 (4).

²³² The Decree of the President of the Republic of Kazakhstan “On Methods for the Further Securing the Government Interests in the Oil and Gas Sector of the State Economy” #811 of February 2, 2002 (Ukaz Prezidenta Respubliki Kazakhstan “O Merah po Dalneyshemu Obespecheniyu Interesov Gosudarstva v Neftegazovom Sektore Ekonomiki Stran”).

TransNeftiGaz.”²³³ According to the new law ‘On Subsoil and Subsoil Use’, the share of KazMunaiGaz in the contracts with the obligatory participation of the national company shall be not less than 50%.²³⁴ The foreign investor should remember that in the case of establishing a joint venture with the national company, the exploration financing would be regarded as an investor’s obligation unless the contract stipulates differently.²³⁵

One of the most important provisions securing the interests of foreign oil companies is the guarantee clause protecting investors against legislative alterations which worsen the results of economic activity of the subsoil user with regards to petroleum production.²³⁶ Unfortunately, the provision is very vague, because 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. Moreover, the provision excludes guarantees against legislative alterations made for the purpose of national security, ecological safety, taxation and customs regime, thus, strongly reinforcing the position of the host state.

3.2. Situations in other Central Asian countries

This section examines the situations with regards to the legal investment climate in the petroleum sectors of four other Central Asian countries. The first subsection deals with Turkmenistan and Uzbekistan, being the second and third major oil exporters in the region after Kazakhstan. The second subsection analyzes the respective legal frameworks of Kyrgyzstan and Tajikistan, states that both lack commercially valuable oil reserves.

²³³ Denton W. Sapte, “Oil and Gas Regulation in Kazakhstan.” In *Doing business with Kazakhstan*, edited by Marat Terterov. (Kogan Page, 2004), 76.

²³⁴ The Law of the Republic of Kazakhstan “On Subsoil and Subsoil Use” # 291-IV of June 24, 2010 (Zakon Respubliki Kazakhstan “O Nedrah i Nedropolzovanii”), Article 29 (3).

²³⁵ The Law of the Republic of Kazakhstan “On Subsoil and Subsoil Use” # 291-IV of June 24, 2010 (Zakon Respubliki Kazakhstan “O Nedrah i Nedropolzovanii”), Article 31 (2).

²³⁶ The Law of the Republic of Kazakhstan “On Subsoil and Subsoil Use” # 291-IV of June 24, 2010 (Zakon Respubliki Kazakhstan “O Nedrah i Nedropolzovanii”), Article 30.

3.2.1. *Turkmenistan and Uzbekistan*

Kazakhstan's oil production industry is followed by the petroleum industries of two smaller oil exporters – Turkmenistan and Uzbekistan. Sally N. Cummings refers to the information from the Ministry of Oil and Gas of Turkmenistan, according to which the country's oil potential reserves equal to 15.3 billion barrels of oil reserves.²³⁷ As for Uzbekistan, the author further claims that the government asserts that “the country's energy reserves totaled 5.78 billion barrels of oil.”²³⁸ It is worth mentioning that Uzbekistan, despite fewer amounts of oil reserves, “surpassed Turkmenistan in the production of natural gas, to become the second largest producer (after Russia) among the former Soviet Republics.”²³⁹ Considering the amounts of petroleum reserves which both of these countries possess, it is necessary to review their respective legal frameworks governing international petroleum investment projects.

Until the beginning of the 21st century, both Turkmenistan and Uzbekistan stood “alone among the petroleum-rich Soviet successor states in their decision to retain [...the legal structure of the so-called ...] state ownership with control, and thus to eschew direct foreign involvement”²⁴⁰ from their oil industry. The strategies of both states “envisaged that foreign investors would play only a minimal role in developing the petroleum sector while domestic sources [...] would finance most upstream investment.”²⁴¹ Thus, despite the fact that Uzbekistan technically allowed concessions²⁴² and Turkmenistan authorized production

²³⁷ Sally N. Cummings, *Oil, transition and security in Central Asia* (Routledge Curzon, 2003), 146.

²³⁸ *Ibid*, 146-147.

²³⁹ Boris Z. Rumer, *Central Asia in transition: dilemmas of political and economic development* (New York: M. E. Sharpe, Inc, 1996), 121.

²⁴⁰ Pauline Jones Luong, Erika Weinthal, *Oil Is Not a Curse: Ownership Structure and Institutions in Soviet Successor States* (New York: Cambridge University Press, 2010), 77.

²⁴¹ *Ibid*, page 86.

²⁴² The Law of the Republic of Uzbekistan “On Concessions” # 110-I of August 30, 1995 (Zakon Respubliki Uzbekistan “O Koncessiyah”).

sharing agreements²⁴³, both countries *de facto* continued to favor only risk service contracts²⁴⁴ highly disadvantageous for foreign investors.²⁴⁵ Thus, for instance in Turkmenistan, as a result of such unfavorable conditions “from 1999 to 2000, the foreign oil companies opted to cut production by more than 25 percent”²⁴⁶. However, Turkmenistan has presented the new law ‘On Hydrocarbon Reserves’ in 2008 which allows now all four traditional types of international petroleum agreements.²⁴⁷ As for Uzbekistan, the government’s new legislation enacted in 2001 that allowed for production sharing agreements²⁴⁸ “has spurred foreign investor activity in [...its...] petroleum sector.”²⁴⁹

According to some authors the initial way to invest in the petroleum industry of both countries was through joint venture agreements, which “were subsequently approved by government decree to reflect [...] state’s overall approval of the project.”²⁵⁰ However, there were instances in Turkmenistan when a competent authority of a state started unilaterally revising the terms of a contract (like with a foreign oil company – Bidas of Argentina)²⁵¹. Joint ventures are usually concluded with the national oil companies of the states, for example: Turkmenneft in Turkmenistan and Uzbekneftgaz in Uzbekistan.

²⁴³ The Regulation of the President of Turkmenistan “On the Competent Authority under the President of Turkmenistan for the Hydrocarbon Resources Utilization” # 3189 of June 6, 1997 (Ukaz Prezidenta Turkmenistana “O Kompetentnom Organe po Ispolzovaniyu Uglevodorodnih Resursov pri Presidente Turkmenistana”).

²⁴⁴ The disadvantage of the risk service contract for investors is discussed in Subsection 2.3.3. on page 41.

²⁴⁵ Pauline Jones Luong, Erika Weinthal, *Oil Is Not a Curse: Ownership Structure and Institutions in Soviet Successor States* (New York: Cambridge University Press, 2010), 84-87.

²⁴⁶ *Ibid*, pages 84-85.

²⁴⁷ The Law of Turkmenistan “On Hydrocarbon Reserves” # 208-III of August 20, 2008 (Zakon Turkmenistana “Ob Uglevodorodnih Resursah”), Article 21.

²⁴⁸ The Law of the Republic of Uzbekistan “On Production Sharing Agreements” # 312-II of December 07, 2001 (Zakon Respubliki Uzbekistan “O Soglasheniyah o Razdele Produktii”).

²⁴⁹ Pauline Jones Luong, Erika Weinthal, *Oil Is Not a Curse: Ownership Structure and Institutions in Soviet Successor States* (New York: Cambridge University Press, 2010), 86-87.

²⁵⁰ Elizabeth Bastida, Thomas W. Waelde, Janeth Warden-Fernández, *International and comparative mineral law and policy: trends and prospects* (Kluwer Law International, 2005), 1012.

²⁵¹ Pauline Jones Luong, Erika Weinthal, *Oil Is Not a Curse: Ownership Structure and Institutions in Soviet Successor States* (New York: Cambridge University Press, 2010), 82.

However, in both states before getting the right to conduct petroleum operations through a joint venture contract or any other petroleum agreement, a foreign investor is obliged to obtain a license. In Turkmenistan this obligation is stipulated in the Article 9 of the law ‘On Subsoil’²⁵². The same requirement is promulgated by the Article 26 of the law ‘On Subsoil’²⁵³ in Uzbekistan. Moreover, both states declare “the license precedence over the contract, which means that agreements [...] are declared void as soon as the license is revoked”²⁵⁴.

It is interesting that the guarantees provided for foreign oil companies by both states contain stabilization provisions against alterations of legislations which worsen the legal regime with regards to petroleum investment projects, but unfortunately only for ten years.²⁵⁵ However, in contrast to Kazakhstan, Turkmenistan and Uzbekistan do not declare the changes in the taxation regime as an exception to these guarantees. It is also necessary to mention that in Uzbekistan if a foreign investor wishes to conduct an oil production project through a joint venture, his share of the investment shall not be less than 30% if he wants to enjoy the above mentioned guarantees.²⁵⁶ Both states also provide guarantees which allow dispute resolution with regard to the petroleum investment project in international arbitration courts.²⁵⁷

²⁵² The Law of Turkmenistan “On Subsoil” # 779-XII of December 14, 1992 (Zakon Turkmenistana “O Nedrah”), Article 9.

²⁵³ The Law of the Republic of Uzbekistan “On Subsoil” # 444-II of December 13, 2002 (Zakon Respubliki Uzbekistan “O Nedrah”);

²⁵⁴ Ilias Bantekas, John Paterson, Maidan Suleimanov, *Oil and gas law in Kazakhstan: national and international perspectives* (Kluwer Law International, 2004), 145-146.

²⁵⁵ The Law of the Republic of Uzbekistan “On Guarantees and Means of Foreign Investors’ Rights Protection” # 611-I of April 30, 1998 (Zakon Respubliki Uzbekistan “O Garantiyah i Merah Zashiti Prav Inostrannih Investorov”), Article 3; The Law of Turkmenistan “On Foreign Investments” # 184-III of March 3, 2008 (Zakon Turkmenistana “Ob Inostrannih Investiziyah”), Article 8 (5).

²⁵⁶ The Law of the Republic of Uzbekistan “On Foreign Investments” # 609-I of April 30, 1998 (Zakon Respubliki Uzbekistan “Ob Inostrannih Investiziyah”), Article 6;

²⁵⁷ The Law of the Republic of Uzbekistan “On Guarantees and Means of Foreign Investors’ Rights Protection” # 611-I of April 30, 1998 (Zakon Respubliki Uzbekistan “O Garantiyah i Merah Zashiti Prav Inostrannih

3.2.2. *Kyrgyzstan and Tajikistan*

Despite the fact that Kyrgyzstan and Tajikistan both lack commercially valuable oil reserves, the legislative ways through which foreign investments are attracted to the mineral extraction industries of these countries shall also be discussed in this section to complete the comparative legal analysis of the whole Central Asian region. According to Keith Crane, “in the mining sector, Kyrgyzstan produces metal ores and contributed over 90 percent of the former Soviet Union’s output of mercury and uranium”²⁵⁸, but now “gold is considered to be the only commercially viable metal mining deposit [there].”²⁵⁹ As for Tajikistan, Saidmumin Kamoli states that it “has large lead, zinc and silver deposits, as well as a number of rare elements such as uranium, radium, arsenic and bismuth.”²⁶⁰ Considering the important role of the mining industry for their economies, these “Central Asian Republics [...] have adopted laws on subsurface use [...] to encourage direct foreign investment in mineral exploration and development.”²⁶¹

According to the licensing and subsoil use legislations of Kyrgyzstan and Tajikistan (which are in this respect similar to the laws of the two previously examined countries), foreign investors are required to obtain a license prior to the initiation of petroleum exploration or production activities.²⁶² Except regular joint ventures, the modern legislative

Investorov”), Article 10; The Law of Turkmenistan “On Hydrocarbon Reserves” # 208-III of August 20, 2008 (Zakon Turkmenistana “Ob Ug levodorodnih Resursah”), Article 59.

²⁵⁸ Keith Crane, *Foreign direct investment in the states of the former USSR* (World Bank. PlanEcon Inc, 1992), 81.

²⁵⁹ Elizabeth Bastida, Thomas W. Waelde, Janeth Warden-Fernández, *International and comparative mineral law and policy: trends and prospects* (Kluwer Law International, 2005), 1010.

²⁶⁰ Saidmumin Kamoli, *The problems of economic growth in Tajikistan: Factors and Possibilities* (New Dehli: Jawaharlal Nehru University, 2000), 48.

²⁶¹ Elizabeth Bastida, Thomas W. Waelde, Janeth Warden-Fernández, *International and comparative mineral law and policy: trends and prospects* (Kluwer Law International, 2005), 1010.

²⁶² The Law of the Republic of Tajikistan “On Subsoil” # 983 of July 20, 1994 (Zakon Respubliki Tajikistan “O Nedrah”), Articles 8, 12; The Law of the Republic of Tajikistan “On Licensing of Certain Types of Activities” # 37 of May 17, 2004 (Zakon Respubliki Tajikistan “O Lizenzirovaniy Otdelnih Vidov Deyatelnosti”), Article 17;

base of Kyrgyzstan and Tajikistan provide two forms of international petroleum contract models for the option of foreign investors, which are concession contracts²⁶³ and production sharing agreements²⁶⁴. In contrast to Tajikistan which does not establish specific timeframes for the subsurface use, “according to Kyrgyzstan PSA law, the initial term of the PSA may not exceed ten years [...] however, if necessary this term may be extended.”²⁶⁵

The laws “On Investment” in both countries provide guarantees for foreign investors in the form of the possibility to choose more favorable conditions in the case of alterations in the legislation, including amendments in taxation regime, but except the changes in the laws with regard to national security, health care and environment protection.²⁶⁶ However, the duration of such guarantees differ: ten years in Kyrgyzstan and only five years in Tajikistan. It is also necessary to mention that the legislation of both countries provide the possibility of resolving the investment disputes in international arbitration courts.²⁶⁷

The Law of the Kyrgyz Republic “On Subsoil” # 42 of July 2, 1997 (Zakon Kirgizskoy Respubliki “O Nedrah”), Article 9-11; The Law of the Kyrgyz Republic “On Oil and Gas” # 19 of March 9, 2004 (Zakon Kirgizskoy Respubliki “O Nefti i Gaze”), Articles 11, 12; The Law of the Kyrgyz Republic “On Licensing” # 12 of March 3, 1997 (Zakon Kirgizskoy Respubliki “O Lizenzirovaniy”), Article 9; The Regulation of the Kyrgyz Republic Government “On the Licensing Order of Subsoil Use Activities” # 336 of August 2007 (Postanovlenie Pravitelstva Kirgizskoy Respubliki “O Poriadke Lizenzirovaniya Nedropolzovaniya”).

²⁶³ The Law of the Kyrgyz Republic “On Subsoil” # 42 of July 2, 1997 (Zakon Kirgizskoy Respubliki “O Nedrah”), Article 15; 1. The Law of the Kyrgyz Republic “On Concessions and Concessionary Ventures in the Kyrgyz Republic” # 850-XII of March 6, 1992 (Zakon Kirgizskoy Respubliki “O Konzessiyah i Konzessiionih Predpriyatiyah v Kirgizskoy Respublike”); The Law of the Republic of Tajikistan “On Energy Sector” # 33 of November 29, 2000 (Zakon Respubliki Tajikistan “Ob Energetike”), Article 16; The Law of the Republic of Tajikistan “On Concessions” # 429 of May 15, 1997 (Zakon Respubliki Tajikistan “O Konzessiyah”).

²⁶⁴ The Law of the Kyrgyz Republic “On Production Sharing Agreements during the Subsoil Use” # 49 of April 10, 2002 (Zakon Kirgizskoy Respubliki “O Soglasheniyah o Razdele Produktii pri Nedropolzovaniy”); The Law of the Republic of Tajikistan “On Production Sharing Agreements” # 238 of March 5, 2007 (Zakon Respubliki Tajikistan “O Soglasheniyah o Razdele Produktii”).

²⁶⁵ Elizabeth Bastida, Thomas W. Waelde, Janeth Warden-Fernández, *International and comparative mineral law and policy: trends and prospects* (Kluwer Law International, 2005), 1018.

²⁶⁶ The Law of the Kyrgyz Republic “On Investments” # 66 of March 27, 2003 (Zakon Kirgizskoy Respubliki “Ob Investitsiyah”), Article 2 (2); The Law of the Republic of Tajikistan “On Investments” # 260 of May 12, 2007 (Zakon Respubliki Tajikistan “Ob Investitsiyah”), Article 5 (2).

²⁶⁷ The Law of the Kyrgyz Republic “On Investments” # 66 of March 27, 2003 (Zakon Kirgizskoy Respubliki “Ob Investitsiyah”), Article 18; The Law of the Republic of Tajikistan “On Investments” # 260 of May 12, 2007 (Zakon Respubliki Tajikistan “Ob Investitsiyah”), Article 22.

For centuries hydrocarbon reserves have played a crucial role in the development of economies across the world. Starting from the colonial era, foreign investments in the petroleum production were used as a peaceful alternative in contrast to aggressive conquests to obtain this strategic resource from countries which were lucky enough to possess it. This study has classified foreign investments revealing that they, either in the form of Portfolio Investments or in the form of Foreign Direct Investment, may be targeted into upstream or downstream sectors of the oil industry. Moreover, the research has shown that, throughout global history, the legal frameworks were changing from general mining laws and ad hoc agreements to hybrid systems, while petroleum investment relations went all the way from Traditional Forms to New Forms of Investment depending on the conditions of the region.

In Central Asia after the collapse of the Soviet Union countries have been struggling with the vestiges of the disintegration represented by the lack of modern technology, professional expertise and sufficient funds in their newly separated petroleum extractive industries²⁶⁸, which remain vital for the stable economic development. Some of these states, like Kazakhstan and Kyrgyzstan, tried to cope with these problems by creating a favorable legal investment climate for foreign companies from the very beginning, while others, like Turkmenistan, Uzbekistan and Tajikistan at first chose a strategy of seeking domestic means for developing their petroleum sectors. Nowadays, however, all five countries endeavor to keep a fragile balance between protecting their own local interests and providing incentives for foreign investors to continue old and initiate new petroleum production projects.

²⁶⁸ Despite the fact that Kyrgyzstan and Tajikistan lack commercially valuable oil reserves, their legal strategies for developing natural resource bases are academically important, and thus have been examined together with the respective policies, employed by petroleum-rich states, such as Kazakhstan, Uzbekistan and Turkmenistan.

The respective interests of both parties to an international petroleum production deal were examined in detail by this academic work. The findings have demonstrated that a host state seeks to gain fiscal benefits in the form of royalties, rent payments, bonuses and taxes as well as non-fiscal benefits, such as infrastructure developments, technology transfers, professional trainings, employment opportunities and a local marketing of the extracted oil products. As for foreign investors, except their strong interests in gaining as many profits from the petroleum investment project as possible, they look for the protection against risks of political and legal instability, including alterations in the legislation which worsen the investment climate, the likelihood of property nationalization and the impossibility to resolve disputes by arbitration. Although the legislative frameworks of all five Central Asian countries are similar due to the common historical background, every state faces the challenge of keeping the balance of interests in its own distinctive way.

The research has proved that Kazakhstan had the most developed legislation in the spheres of foreign investment and subsoil use. For instance, the elimination of requirements to obtain a license for petroleum production operations in 1999 was a big and unique (in contrast to other states) step forward. Moreover, the initial petroleum legislation provided a wide range of petroleum contract models, including the concessionary system, production sharing agreements and service contracts. However, the situation was changed by the enactment of recent legislative proposals, which consolidated previous investment legislation for petroleum production, but at the same time have brought about some uncertainty and vagueness.

One of the main conclusions with regard to Kazakhstan is that its new laws, while excluding concession contracts and production sharing agreements, have provided a type of contract under the conditions of which petroleum production becomes subject not to royalty payments, but to a sophisticated system of taxation. Moreover, any changes in the tax code

will directly affect foreign oil companies due to the fact that under new investment law stabilization clauses which protect against legislative alteration worsening investment climate do not apply to modification in the taxation regime. Thus, it becomes clear that, using its undisputable leadership position in the region's oil production industry, the government of Kazakhstan has recently decided to transform its previously rather favorable legal investment climate into a more onerous one, which may lead the country in the wrong direction during the time of increasing competition for foreign investment funds.

Other countries of the Central Asian region differ from Kazakhstan in their strategies to build a legal investment climate for their extraction industries. While Kyrgyzstan and Tajikistan suffering from the hydrocarbon reserves shortage encouraged inward investments in other mining industries, Turkmenistan and Uzbekistan protecting their oil deposits maintained a stable control over all aspects of upstream petroleum operations. However, admitting that their policies have not produced the desired outcome for the development of their economies, all four of them started to experiment with new legislative practices with regards to attraction of foreign investors. Together with the authorization of new types of petroleum contract models, the novelties include the provisions about stabilization guarantees against alterations in the legal investment climate and international arbitration possibilities. Some of the petroleum production conditions remained as they were before, for example: the requirement to obtain a license and options to invest through joint venture agreements.

Unfortunately one negative characteristic typical for the petroleum investment climate in all five Central Asian countries is the fact that their legal frameworks often tend to be unstable, incomplete and sometimes even contradictory. It threatens to destroy the delicate balance between host state and foreign investor interests, which is highly desired by both parties for a mutually beneficial development of an international petroleum production deal.

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