LEGAL STATUS OF PRODUCTION SHARING AGREEMENTS IN TURKMENISTAN

by

Kevin L. Shaw

and

Levon L. Gregorian

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This paper reviews the legal framework provided by the laws of Turkmenistan for the development of petroleum resources through the alternative of the production sharing agreement. In the first part, the paper will summarize the principal characteristics and features of a production sharing agreement in Turkmenistan. The second part of the paper will compare the production sharing agreement to the joint venture, an alternative also offered by modern Turkmen law. Finally, the paper will outline those terms of the form of the model production sharing agreement that are expressly made negotiable by the terms one of the most recent licensing rounds.

I. THE LAWS AND REGULATIONS OF TURKMENISTAN APPLICABLE TO PRODUCTION SHARING ARRANGEMENTS: AN OVERVIEW.

The principal laws and regulations of Turkmenistan which are directly and immediately applicable to production sharing arrangements (as well as to other oil and gas projects) in that country are:

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Mr. Shaw is a partner in the Houston, Texas and Los Angeles, California offices of Mayer, Brown & Platt, with extensive experience in business transactions in the oil & gas industry, and the mining sector. He is admitted to practice in the States of Texas, Colorado and California. Mr. Grigorian is associated with Mayer, Brown & Platt and is admitted to practice law in the Russian Federation and certain other CIS states. Mr. Grigorian works in the Firm’s Houston office. He has extensive experience in international transactions and dispute resolution in the natural resources area. For the last several years, Mayer, Brown & Platt has acted as counsel for certain state-owned entities of Turkmenistan in arbitration proceedings before the ICC International Court of Arbitration. The authors express their gratitude to Mr. Ashir Abdullayev, an associate resident in Mayer, Brown & Platt’s litigation support office in Ashgabat, Turkmenistan, for his assistance and advice in the preparation of this paper. The views expressed in this article are those of the authors and not those of the Government of Turkmenistan.
Despite of the fact that Model PSA, which was prepared with assistance from the European Commission funded TACIS program, was approved by a presidential decree, not all of its provisions constitute mandatory rules and, as it was indicated in the Summary of Petroleum Law and Fiscal Regime released in connection with Turkmenistan 2000 International Licensing Round, a number of Model PSA’s terms are negotiable. While it is clear from the contents of Model PSA that the production sharing percentages, as well as royalty, bonuses and other amounts payable by a Contractor to the government (as well as various other terms) are open for negotiations, it is not clear whether the other terms of Model PSA may be substantively modified and, if so, to what extent.

(1) the Law of Turkmenistan No. 206-1 dated December 30, 1996, entitled “On Hydrocarbon Resources” (the “Petroleum Law”);

(2) the Decree of the President of Turkmenistan No. 3189 dated June 6, 1997, entitled “The Steps to be Taken in Order to Implement the Law of Turkmenistan on Hydrocarbon Resources” (the “Petroleum Law Implementing Decree”);

(3) the Regulations entitled “On the Competent Body for the Exploitation of Petroleum Resources at the President of Turkmenistan” (the “Competent Body Regulations”), approved by the Petroleum Law Implementing Decree; and

(4) the Rules for Development of Hydrocarbon Fields (the “Petroleum Development Rules”), approved by the Decree of the President of Turkmenistan No. 4416 dated October 22, 1999.

The Model Production Sharing Agreement for Petroleum Exploration and Production in Turkmenistan (the “Model PSA”) approved by the Petroleum Law Implementing Decree on June 6, 1997, cannot be characterized as either “law” or “regulation.” Although its legal nature is not completely clear, the Model PSA plays a key role in establishing legal guidelines for the preparation, negotiation and implementation of production sharing arrangements in Turkmenistan.

Contracts for Petroleum Operations. Article 23 of the Petroleum Law provides that in order to conduct petroleum operations in Turkmenistan a petroleum producer (a “Contractor”) must enter into either a production sharing agreement or a joint venture agreement or combined or other type of contract (collectively, a “Contract”) with a governmental agency authorized to enter into the Contract by the Government of Turkmenistan and/or with a state-owned production association in Turkmenistan.

2 Despite of the fact that Model PSA, which was prepared with assistance from the European Commission funded TACIS program, was approved by a presidential decree, not all of its provisions constitute mandatory rules and, as it was indicated in the Summary of Petroleum Law and Fiscal Regime released in connection with Turkmenistan 2000 International Licensing Round, a number of Model PSA’s terms are negotiable. While it is clear from the contents of Model PSA that the production sharing percentages, as well as royalty, bonuses and other amounts payable by a Contractor to the government (as well as various other terms) are open for negotiations, it is not clear whether the other terms of Model PSA may be substantively modified and, if so, to what extent.
In production sharing agreements, a Concern can simultaneously act as the Contractor. Although it is not clear how the particular type of Contract is selected for a particular project, it follows from other provisions of the Petroleum Law that such a selection requires consent of both the governmental agency involved in negotiations over the oil and gas properties at issue and the Contractor. As a matter of historic practice, after the issuance of the Petroleum Law Implementing Decree approving the forms of model contracts for petroleum operations, the government solicited offers as a part of competitive bidding rounds for various oil and gas properties only for production sharing agreements.

A production sharing agreement is signed by a Contractor, on the one side, and on the other side, the Competent Body for the Exploitation of Petroleum Resources at the President of Turkmenistan (the \textbf{Competent Body}) and/or a Concern.\footnote{In production sharing agreements, a Concern can simultaneously act as the Contractor.} The Competent Body is an administrative agency under the President of Turkmenistan which has the exclusive right to conduct negotiations, issue licenses and conclude agreements including production sharing agreements, as well as oversee the implementation of agreements, on behalf of the government of Turkmenistan. The President of Turkmenistan heads the Competent Body. The activities and structure of the Competent Body are described in detail in the Petroleum Law and the Competent Body Regulations.

\textit{Licensing of Petroleum Operations.} Like most of the countries of the Former Soviet Union, Turkmenistan has a system of licensing of the use of its oil and gas resources. The Government owns petroleum in the ground (Petroleum Law, Article 3). The Petroleum Law provides that there may be three types of licenses issued in connection with petroleum operations: (1) an exploration license which is issued for up to 6 years with provision for possible two 2 year renewals; (2) a production license which is issued for 20 years and may be renewed for additional 5 years; or (3) a combined exploration and production license which may be granted for a period that includes the exploration and production licenses’ validity periods, including their possible extensions, \textit{i.e.}, for up to 35 years (Petroleum Law, Articles 7 and 18).

The Petroleum Law provides that a license shall be granted upon reaching agreement with respect to the terms of the Contract and shall be issued simultaneously with the execution of such Contract (Article 13). A license is issued by the Competent Body after it has been approved by a Decree of the President of Turkmenistan (Petroleum Law, Article 15).

The same article of the Petroleum Law qualifies granting a license to a foreign individual or legal entity upon the grantee’s registration in Turkmenistan as individual entrepreneur (in the case of an individual) or upon establishment in Turkmenistan of the
foreign entity’s branch or registration of the entity as a participant of joint activities (in the case of a legal entity). Currently the agency that registers foreign companies’ branches is the Service for State Registration of Legal Entities of the State Agency for Foreign Investments (“Foreign Investment Agency”) at the President of Turkmenistan that operates on the basis of the Regulations and the Rules approved by the Decree No. 4865 of the President of Turkmenistan dated October 2, 2000. The Foreign Investment Agency registers all foreign investment projects in Turkmenistan.

Articles 3.1 through 3.4 of the Model PSA basically reproduce the license-granting scheme of the Petroleum Law described above with respect to exploration and production licenses and extend all benefits of the statute regarding the license renewals to a Contractor. In addition, the Model PSA provides for an opportunity for a Contractor to be granted an extension for up to 5 years of any production license which extension goes beyond the initial term and extensions of such license. Such additional extension, however, may not be granted on the same contractual terms as the initial license and requires a new contract (this right to an additional extension is in fact a preferential, but not absolute, right of a Contractor to negotiate a new contract with respect to the properties which such Contractor already developed).

Suspension of License and Contract. Under the Petroleum Law a license may be suspended by the Competent Body if the licensee conducts petroleum operations that are not provided for in the license, carries out the activities which are within the scope of the license, but not pursuant to the program established in the Contract, or in the course of its activities repeatedly violates the laws of Turkmenistan with respect to the protection of underground resources and environment, as well as labor safety laws. The suspension of a license automatically entails the suspension of the underlying Contract; the effect of suspended license and Contract shall be restored as soon as the violations that caused the suspension have been cured (Petroleum Law, Article 21).

Revocation of License, Termination of Contract. The Competent Body may revoke a license if (a) the licensee refuses to cure the violations that caused the suspension of the license or if such violations are not cured by certain deadline, (b) the licensee deliberately supplied the Competent Body with false information that materially affected the Competent Body’s decision to grant the license to that licensee or (c) the licensee deliberately violated the deadlines for the signing and registration of the contract, or the time frames for the
commencement of petroleum operations provided for in the Contract, as well as in other cases referred to in the Petroleum Law. The revocation of a license terminates the underlying Contract, and it is the only mandatory default ground for the termination of a Contract provided in the Petroleum Law (other grounds may be established in a Contract itself) (Petroleum Law, Articles 22, 26 and 27).

*Registration of the Contract.* Article 25 of the Petroleum Law requires that a contract with the Competent Body in connection with petroleum operations be approved by the governmental agencies of Turkmenistan responsible for health care and sanitation, ecology, protection of underground resources and labor safety and indicates that the time frames for such approvals must not exceed 15 days per each governmental agency. A Contract enters into force from the moment of its state registration (currently such registration is performed by the Foreign Investment Agency), and the statute emphasizes that the failure of the government agencies to issue required approvals in a timely fashion shall not hinder the registration of the Contract (Petroleum Law, Article 25).

*Ownership of Petroleum.* While the Model PSA reaffirms the principle found in Article 3 of the Petroleum Law that the hydrocarbons in the subsoil and on the surface of Turkmenistan’s territory are owned by Turkmenistan on an exclusive basis, Article 2.6 of the Model PSA gives each party to a production sharing agreement the right to receive and dispose of its share of the petroleum produced and saved in the Contract territory, as a reimbursement of costs incurred and remuneration for services rendered, pursuant to the terms of the agreement.

*Cost Recovery.* Pursuant to Article 13.2 of the Model PSA, the parties of a production sharing agreement will agree on the percentage of Available Petroleum to be used by the Contractor for cost recovery (“Cost Recovery”). Such portion of Available Petroleum is called “Cost Recovery Petroleum”; “Available Petroleum” is defined as all petroleum produced in the contract area after deduction of petroleum used by the Contractor in the conduct of petroleum operations and after further deduction of the royalty provided for in the production sharing agreement (Model PSA, Article 13.2). Pursuant to Article 13.4 of the Model PSA, the Contractor is entitled in each calender quarter to take delivery of a portion of Cost Recovery Petroleum equal to the cumulative contract expenses to be recovered by the Contractor up to that calendar quarter. The recovery of allowable Contract Expenses includes (in the following order of priority): operating expenses, exploration expenditures, interest charges on development expenditures, development expenditures, and production expenditures other than operating expenses (Model PSA, Article 13.6). Article 13.7 of the Model PSA states that allowable contract expenses shall not include signature and production bonuses; profit tax paid in Turkmenistan and other taxes paid outside Turkmenistan; interest and fees pertaining to loans incurred for financing of petroleum operations (excluding development); fines and penalties imposed upon the Contractor in connection with violations of the production sharing agreement and laws of
Turkmenistan and donations and contributions by the Contractor which are not previously approved by the Management Committee (as described below).

**Production Sharing.** The amount of Available Petroleum remaining after the deduction of Cost Recovery Petroleum (including any Cost Recovery Petroleum not used for Cost Recovery purposes), referred to as “Profit Petroleum”, is shared, on a calendar year basis, between the Competent Body and the Contractor under a production sharing agreement (Model PSA, Article 13.11). The respective percentages of Profit Petroleum accruing to the Competent Body and the Contractor are determined through a function of the ratio of the cumulative contract revenues to the cumulative contract expenses (“R Factor”). The R Factor is calculated with respect to petroleum produced under any and all production licenses according to the following formula:

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R = \frac{X}{Y}
\]

where:

X means the cumulative sum of all contract revenues (which shall conventionally comprise cumulative revenues from the recovery of interest charges), earned by the Contractor, either from Cost Recovery Petroleum or from Profit Petroleum, from inception of such earnings up to the end of the calendar year immediately preceding the calendar year in question; and

Y means the cumulative sum of all contract expenses incurred by the Contractor from inception thereof up to the end of the calendar year immediately preceding the calendar year in question (Model PSA, Article 13.13). Then, sharing of Profit Petroleum between the Competent Body and the Contractor is determined in accordance with a table where sharing percentage is expressed as a function of the values of the R Factor (Model PSA, Article 13.14).

**Taxation.** The only tax that a Contractor is obligated to pay in connection with its petroleum operations under any Contract, including a production sharing agreement, is Turkmenistan’s tax on profits (“Profit Tax”) payable at a rate established by the tax legislation of Turkmenistan which is in effect as of the date of the Contract (Petroleum Law, Article 48; Model PSA, Article 16.1). As of February 2001, the applicable Profit Tax rate was 25%. No other tax, duty, fee or other impost shall be levied upon the Contractor or its shareholders in respect of profit derived from the petroleum operations of such Contractor (Model PSA, Article 16.6).

A Contractor’s taxable profit is determined by deducting from the Contractor’s contract revenues its contract expenses, as follows:
(a) operating expenses: fully expensed (deducted) when incurred;
(b) exploration expenditures: depreciated at a maximum depreciation rate of 50% per annum, straight line;
(c) development and production expenditures: depreciated at a maximum depreciation rate of 25% per annum; and
(d) all other expenditures which, under the accounting procedure of the production sharing agreement (Annex “D” to the Model PSA contains the model accounting procedure), are categorized as operating expenses, exploration expenditures, or development and production expenditures: expensed or depreciated as described in subparagraphs (a) through (c) above (Model PSA, Article 16.2).

A Contractor and any of its non-Turkmenian subcontractors engaged in such Contractor’s petroleum operations are permitted to import, and are exempt from customs duties with respect to imports of, equipment, materials and other goods in connection with the petroleum operations, unless items of the same or substantially the same kind and quality are manufactured locally and are available for purchase and timely delivery to the Contractor in Turkmenistan at a price equal to the cost of the imported item, in which case the exceptions do not apply to such imported item (Model PSA, Articles 23.1 and 23.3).

A Contractor is not exempt from paying applicable taxes on activities unrelated to its petroleum operations. A Contractor’s subcontractor pays a tax on profit in Turkmenistan at the same rate as the Contractor and it pays only those taxes which are established for the Contractor (currently there is only Profit Tax). The employees of a Contractor and its subcontractors pay a personal income tax in accordance with Turkmenistan’s laws and the provisions of a Contract (Petroleum Law, Article 48).

If after the execution of a Contract, new taxes or levies are introduced, the Contractor shall pay only those new taxes or levies, which replace the ones which are being paid by the Contractor, provided that the total amount of all mandatory payments to Turkmenistan by a Contractor shall not exceed the total of the taxes and other mandatory payments established for the Contractor as of the moment of conclusion of the Contract (Petroleum Law, Article 48).

Other Payments to the Government. The Petroleum Law requires a Contractor to pay to the Government royalty at a rate established in a Contract and also provides that a Contract may provide for a signing and production bonuses payable by a Contractor (Article 48). The Model PSA provides for
(a) a sliding scale royalty schedule with royalty calculated separately based on daily production of oil and natural gas (Article 34.1);

(b) a signature bonus payable within 30 days from the effective date of the agreement (Article 32.1); and

(c) production bonuses payable on a sliding scale based on different levels of cumulative production within a contract area (Article 32.2).

The royalty rates and amounts of bonuses are determined in the course of negotiations of the terms of a production sharing agreement. In practice, according to the information provided by the organizers of the International Licensing Round “Turkmenstan 2000” to its participants, royalty rates have ranged between 2% and 15%, depending on the project.

Management Committee and Operator. The Model PSA provides that a management committee ("Management Committee") shall be created by the Competent Body and a Contractor for:

(a) oversight and supervision of the petroleum operations;

(b) consideration and determination of general policies, procedures and methods of the petroleum operations;

(c) reviewing and approving work and appraisal programs and respective budgets, appraisal reports and the relevant notifications that a commercial discovery was ascertained;

(d) approving of development plans and budgets;

(e) annual production forecasts statements;

(f) insurance program and environmental protection program;

(g) supervising and controlling the award of major contracts in connection with the petroleum operations;

(h) determining the date of commencement of commercial production

(i) ensuring that the accounting and record keeping within the petroleum operations comply with the production sharing agreement, the accounting procedure and accounting principles and procedures generally acceptable in the international petroleum industry;
(j) appointing technical, administrative, financial and other advisory committees which are necessary or appropriate for the timely and efficient conduct of the petroleum operations; and

(k) any other matter relating to the petroleum operations and which is referred to the Management Committee by any party to the agreement and which is not specifically delegated to the operator by the agreement (Articles 9.1 and 9.3).

While the Competent Body’s representatives and the Contractor’s representatives on Management Committee are equal in number (which number is determined by the parties), the Chairman of Management Committee is designated by the Competent Body from among the members it has appointed (Model PSA, Article 9.1). According to the Model PSA, however, the Chairman of Management Committee does not have a casting vote: all decisions of Management Committee must be made unanimously, and, if the committee fails to reach a unanimous decision, then, with respect to any exploration operation included into an annual work program and budget, the Contractor’s view prevails, and, with respect to the determination of general policies, procedures and methods of the conduct of petroleum operations, approval of appraisal programs and budgets, appraisal reports and a commercial discovery notifications and development plans and budgets, a disputed matter may be referred for resolution to a sole expert appointed by agreement between the Competent Body and the Contractor (Articles 9.4 and 29.3).

Although an operator (“Operator”) who is responsible for the day-to-day management of petroleum operations on behalf and in the interest of the Contractor is designated by the latter (Article 10.1), the fact that the name of a specific Operator, as suggested by the Model PSA, should be included into a production sharing agreement indicates that a consent or, at the very least, “no objection” from the Competent Body is necessary for the appointment of an Operator.

**Foreign Exchange Controls.** The Petroleum Law provides that the procedure for conduct of currency operations by the Contractor and its subcontractors shall be established by a Contract and guarantees that a Contractor’s revenues received from sales of its share of hydrocarbons may be deposited into accounts with banks in Turkmenistan or with foreign banks and that a Contractor may open and maintain accounts in domestic or foreign currency with banks in Turkmenistan, subject to the reporting requirements regarding such accounts contained in the laws of Turkmenistan (Article 46).

The rights with respect to foreign exchange matters extended to a Contractor and its subcontractors in the Model PSA, in addition to those described above, include the rights to import foreign exchange and purchase Turkmenistan currency therewith from the Central
Bank of Turkmenistan or other authorized banks and foreign exchange dealers, at the best rate of exchange generally available and without discrimination, and such importation and purchases are exempt from all mandatory foreign currency conversion in Turkmenistan; and to purchase foreign convertible currency available in the open market with local currency previously purchased with foreign convertible currency and not required for the petroleum operations at non-discriminatory rates (Article 25.2).

It is significant that Article 25.4 of the Model PSA makes the US dollar the only unit of currency for all payments (whether revenue or cost), bookkeeping and reporting under a production sharing agreement. Utilizing a single hard currency for these purposes should substantially simplify settlement of accounts and accounting with respect to petroleum operations.

**Assignment.** Article 50 of the Petroleum Law gives a Contractor the right to assign its rights, in whole or in part, under the Contract and the license to its affiliate or one of the Contractor’s participants (a Contractor’s participant is referred to as a “Contracting Company”), which assignment does not require consent from the government, provided that the Contractor provides the Competent Body with a document signed by an authorized person pursuant to which the Contractor shall be jointly liable for all the actions of the assignee. The Model PSA goes a bit further by providing that, in order to be able to assign its participating interest to an affiliate or another Contracting Company, (a) a Contracting Company must not be in default with respect to any of its obligations under the Contract, (b) the assignee shall undertake to be bound by, the terms and conditions of the production sharing agreement, and (c) the assignor shall be jointly and severally liable with the assignee for the performance by the latter of all obligations, duties and liabilities pertaining to the acquired participating interest (Articles 27.1 and 27.3).

A Contractor has the right to assign its rights, in whole or in part, under the production sharing agreement and the license to any interested party with the consent to such assignment of the Competent Body (Petroleum Law, Article 50). The Model PSA provides that, if a Contracting Party wishes to make an assignment of its rights and obligations under the agreement and the license to an unrelated third party, the consent to such assignment by the Competent Body shall not be unreasonably withheld, provided that the assignor is not in default with respect to any of its obligations under the Contract and the assignee undertakes to be bound by the terms and conditions of the production sharing agreement (Article 27.2).

**Governing Law.** Although the Petroleum Law does not contain an express requirement that all components of a production sharing agreement shall be governed only by the laws of Turkmenistan, it follows from many of its provisions that Turkmen law is considered to be applicable to any matter arising out of or relating to petroleum operations conducted in that country. For example, Article 2 of the Petroleum Law provides that the
statute alone regulates (a) the relations arising in the process of performance of petroleum operations in the territory which is under Turkmenistan’s jurisdiction including those at sea and within internal reservoirs, and (b) the issuance of licenses, conclusion and performance of agreements regarding such operations, and the powers, rights and obligations of governmental agencies, as well as companies, enterprises and organizations conducting petroleum operations. Article 55 of the Petroleum Law guarantees the protection of a Contractor’s rights in compliance with principles of international law, laws of Turkmenistan, the license and the Contract.

Furthermore, Article 29.1 of the Model PSA explicitly states that a production sharing agreement shall be governed by, interpreted and construed in accordance with the laws of Turkmenistan and, as applicable, the principles of international law and the decisions of international tribunals and international treaties to which Turkmenistan is a party.

It should be noted that the fact that the location of petroleum operations in Turkmenistan’s territory necessitates the application of Turkmen law to arguably any matter arising out of or relating to such operations. Taking into account the provisions of the Petroleum Law and the Model PSA regarding applicable laws, it seems likely that any agreement purporting to provide for the application of foreign law to a production sharing agreement regarding petroleum operations in Turkmenistan would be ineffective or unenforceable.

Dispute Resolution. The Petroleum Law provides for three methods of resolution of disputes relating to the issuance, refusal to issue, suspension or revocation of a license for petroleum operations, as well as to the performance of a Contract, as follows:

1. negotiations including those with the participation of independent international experts;
2. international arbitration provided for in a Contract; and
3. other dispute resolution procedure provided for in a Contract.

All other disputes including those between a Contractor and entities and individuals of Turkmenistan shall be resolved by appropriate courts in Turkmenistan, unless otherwise agreed by the parties (Article 56).

The Model PSA establishes a general rule that disputes and differences in relation to a production sharing agreement shall be resolved through negotiations first, failing which a party may submit the disputed matter to an UNCITRAL arbitration. This arbitration is to be conducted under the UNCITRAL Arbitration Rules, with a three arbitrator panel, with Turkmen law being the law governing the arbitral proceedings, subject to the UNCITRAL
Arbitration Rules and not being the principle ex aequo et bono or otherwise. The appointing authority is to be the President of the International Court of Justice at The Hague, and the arbitration situs being Stockholm, Sweden, subject in all instances to any modification to this procedure the parties may agree upon.

In addition, any party to a production sharing agreement may elect to bring a dispute in connection with the approval of appraisal programs and reports and development plans, as well as of the relevant budgets, and certain calculation and valuation issues, in all cases listed in the Model PSA (Articles 9.3 (d) through (f), 13.9, 13.17, 14.2 and 19.7) for resolution to a sole expert appointed by agreement between the Competent Body and the Contractor, as provided in Article 29.3 of the Model PSA.

Although Turkmenistan is not a party to the 1958 New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards, foreign arbitral awards may be enforced in that country under certain other treaties to which Turkmenistan is a party such as the Washington (ICSID) Convention and the European Energy Charter.5/

II. PRODUCTION SHARING ARRANGEMENTS AND JOINT VENTURES: A COMPARISON

While production sharing arrangements were introduced in Turkmenistan and other parts of the former Soviet Union relatively recently, joint ventures existed and successfully operated in the countries of the region for more than a decade. (In fact, joint ventures established in the Soviet Union pursuant to the Decree No. 49 of the USSR Council of Ministers dated January 13, 1987 ["Decree No. 49"] were among those commercial entities which pioneered the market reforms in the country.) There have been a number of oil and gas joint ventures in Turkmenistan which were created prior to the adoption of the Petroleum Law, and those joint ventures were arguably the principal form of foreign investment into the energy sector of that country. As indicated above, the Petroleum Law also considers joint ventures, in addition to production sharing arrangements, to be one of the two leading forms of organization of hydrocarbon exploration and production in Turkmenistan. However, the meaning of the term “joint venture” as used in the Petroleum Law is different from the meaning of “joint venture” used in Decree No.49 and subsequent statutes and regulations based thereupon: while in the latter case “joint venture” denotes a joint venture company with a foreign participant which is a separate entity with independent legal personality (in Russian, sovmestnoye predpriyatie; some specialists prefer “joint enterprise” as a translation for the Russian term for this organization), “joint

5/ For more information regarding the enforcement of arbitral awards and other issues relating to international arbitration in connection with Turkmenistan, please visit Mayer, Brown & Platt’s international arbitration site (www.interarbitration.net).
It should be noted that although the term “joint venture” within the meaning assigned to it by the Petroleum Law has been known to Soviet and, more specifically, Turkmen civil law for many decades, the use of joint venture arrangements without creating a separate legal entity in the oil and gas sector is arguably even less known in Turkmenistan than the application of production sharing agreements. At the same time, while the term “joint venture” denoting a company has become obsolete in most of jurisdictions comprising the former Soviet Union (the term which is usually used in lieu thereof is “enterprise with foreign participation”), it is still possible, at least hypothetically, under the Petroleum Law to conduct petroleum operations under an agreement that would provide for the establishment of a separate corporate vehicle since Article 23 of the Law permits “other kinds of agreements” to be used for that purpose.

According to the Model Joint Venture Agreement for Petroleum Exploration and Production in Turkmenistan (the “Model JVA”), which was approved (together with the Model PSA) by the Petroleum Law Implementing Decree on June 6, 1997, a joint venture is very similar to a production sharing arrangement in most respects with one significant exception: in a production sharing arrangement under the Model PSA, a Contractor does not include a Concern, i.e., a Turkmen state-owned company, and usually represents private (i.e., unrelated to the Turkmen government) commercial interests, and is solely responsible for funding of the petroleum operations it conducts. In contrast, in a joint venture under the Model JVA, a Concern does become part of a Contractor and it shares with other Contractor’s participants the responsibilities with respect to financing of the Contractor’s petroleum operations on the following basis:

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6/ It should be noted that although the term “joint venture” within the meaning assigned to it by the Petroleum Law has been known to Soviet and, more specifically, Turkmen civil law for many decades, the use of joint venture arrangements without creating a separate legal entity in the oil and gas sector is arguably even less known in Turkmenistan than the application of production sharing agreements. At the same time, while the term “joint venture” denoting a company has become obsolete in most of jurisdictions comprising the former Soviet Union (the term which is usually used in lieu thereof is “enterprise with foreign participation”), it is still possible, at least hypothetically, under the Petroleum Law to conduct petroleum operations under an agreement that would provide for the establishment of a separate corporate vehicle since Article 23 of the Law permits “other kinds of agreements” to be used for that purpose.

7/ It should be noted that, although the definition of a Contractor contained in the Model PSA does not include a Concern, Article 23 of the Petroleum Law provides that a Concern may participate in a production sharing agreement as a Contractor. According to published reports, in some of production sharing transactions executed in Turkmenistan, a Turkmen state-owned production association was made part of the Contractor. It is unclear, however, whether or not the role of a Contractor by a Turkmen state-owned entity includes sharing by such entity of the obligations to finance the project together with other contracting companies.
First, joint venture participants agree on the percentages of their respective participating interests in and under any license and the joint venture agreement (Model JVA, Article 13.1). Second, the financing of the exploration expenditures is entirely and solely borne by the contracting companies, other than the Concern, in proportion to their respective participating interest percentages (as proportionately adjusted to reflect the exemption of the Concern from the obligation to finance such expenditures) (Model JVA, Article 13.3). Third, the financing of the development expenditures and operating expenses shall be borne by all the contracting companies in proportion to their respective participating interest percentages, provided that the Concern’s share of financing funds shall be advanced, as a loan to the Concern, by the other contracting companies in proportion to their respective participating interest percentages (Model JVA, Article 13.4). The advance or loan is to be recovered by such other contracting companies pursuant to the recovery mechanism described in Article 13 of the Model JVA, based on the surrender in favor of other contracting companies by Concern of the portion of its participating interest percentage of petroleum in satisfaction of Concern’s obligations in connection with the loan (Model JVA, Article 13.4).

It should be noted that, to our knowledge, so far there have been no joint venture agreements executed in Turkmenistan under the Petroleum Law.

III. NEGOTIABLE TERMS OF THE MODEL FORM OF PRODUCTION SHARING AGREEMENT

A company interested in entering into a producing sharing agreement in Turkmenistan must obtain, either alone or along with other contracting parties, a production license, exploration license or exploration and production license. Certain terms of the license and the Contract are expressly made negotiable. According to the materials pertaining to the Turkmenistan 2000 International Licensing Round, the following terms were shown to be negotiable in that round:

- Length of exploration period under the license and Contract;
- Number of contracting companies and identity of Operator;
- Minimum exploration work program;
- Length of production term under the license and Contract;
- Number of members of Management Committee;
Percentage of Cost Recovery Petroleum (i.e. - that portion of Available Petroleum from which costs will be recoverable);

Percentage of Profit Petroleum allocated to each of the parties;

Minimum expenditures for schooling and training of citizens of Turkmenistan;

Annual license fees;

Production royalty percentage (separate for oil and for gas);

Amount of signature and production bonuses payable;

Nature and extent of credit support (e.g. - letter of credit or parent company guaranty) supporting Contractor’s obligations;

Payment currency and terms under which the Government may purchase the Contractor’s share of production; and

Nature and extent of State participation at the equity level.

Further, the Government specifically requested that participants of that international licensing round submit, in the course of direct negotiations with the Government, their proposed terms for a production sharing agreement with respect to at least the following matters:

The duration of the exploration periods;

Relinquishments and related obligations;

Exploration work programs and dollar commitments;

Royalty rates;

Signature, production and other bonuses;

Levels and methods of determination of profit petroleum; and

The proposed environmental, abandonment and decommissioning procedures, taking into account the environmental sensitivities of the particular area of operations.
Finally, the Government published its *recommended* terms with respect to certain provisions of a production sharing agreement, which included the following:

| Relinquishments | With regard to exploration blocks, after the completion of each phase of exploration (2 to 3 years per phase) and before moving on to the next phase, the Contractor shall relinquish 15-50% of the area (subject to negotiation) from the original exploration block, excluding those areas which were already conveyed for evaluation and development. After completion of the last phase of exploration, the Contractor should relinquish all of the area from the exploration block except for those areas which were already conveyed for evaluation and development. |
| Royalty | Contractor shall pay the Competent Body a royalty in kind according to the following: |
| | ![Royalty Table](image) |
| Cost Recovery Petroleum | Contractor shall have the right to recover all reimbursable expenses incurred in carrying out the petroleum operations, from a maximum of seventy percent (70%) of available petroleum (gross production minus royalty). The maximum level of reimbursable expenses is subject to negotiation. If cost recovery petroleum during any one quarter is not sufficient for the recovery of contract expenses, then the unrecovered balance shall be carried forward for recovery in the next quarter(s) for up to seven (7) years (subject to negotiation). |
Profit Petroleum is divided between the Competent Body and the Contractor in accordance with R factor levels.

\[ R \text{ Factor} = \frac{EO}{E_{\mu}} \]

- \( EO \) = the sum of all profits under the PSA;
- \( E_{\mu} \) = the sum of all cost recovery petroleum.

Profit Petroleum is determined according to the following:

<table>
<thead>
<tr>
<th>Share of Contractor</th>
<th>R Factor</th>
<th>Share of Competent Body</th>
</tr>
</thead>
<tbody>
<tr>
<td>50%</td>
<td>up to 1</td>
<td>50%</td>
</tr>
<tr>
<td>40%</td>
<td>from 1 to 1.5</td>
<td>60%</td>
</tr>
<tr>
<td>30%</td>
<td>from 1.5 to 2</td>
<td>70%</td>
</tr>
<tr>
<td>20%</td>
<td>from 2 to 2.5</td>
<td>80%</td>
</tr>
<tr>
<td>10%</td>
<td>more than 2.5</td>
<td>90%</td>
</tr>
</tbody>
</table>

Shares of the parties are subject to negotiation.

Although in the materials of the Turkmenistan 2000 International Licensing Round, the Government emphasized that its recommended terms for a production sharing agreement do not constitute minimum requirements and that all reasonable offers from bidders will be considered, such recommended terms may probably indicate an approximate range for each of these negotiable terms which the Government may have in mind when negotiating actual transactions. On the other hand, prospective bidders in similar rounds should understand that the recommended terms above were created with respect to specific blocks offered at that licensing round and, in that regard, may not be representative of the terms of other projects which were beyond the scope of that initiative.

Various departments of the Competent Body, with the advice of experts, conduct the tender, negotiate the terms of licenses and Contracts, and, with the approval of the President of Turkmenistan, execute the relevant documents. Thereafter, other departments of the Competent Body administer the petroleum operations conducted pursuant to such agreements and enforce compliance with their terms.

While the Government occasionally makes available to the general public information about certain terms of production sharing agreements executed in the country,\(^8\)

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\(^8\) The following information was published in Commercial Brochure for the Turkmenistan 2000 International Licensing Round: (continued...)
the negotiations between prospective Contractors and the Competent Body are confidential and many of the terms of licenses and Contracts that are executed may not be made known. Similarly, information about unsuccessful negotiations may not be widely known.

CONCLUSION.

The legal framework for production sharing agreements in Turkmenistan should be generally familiar to experienced international petroleum companies and their negotiators. The statutes, rules, and regulations appear to offer flexible, workable and profitable terms and conditions for all parties. Sensible implementation of mutually acceptable arrangements within this legal framework should lead to the successful exploration and production of Turkmenistan’s mineral wealth for the mutual benefit of the contractors and the country.

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Summary Details of PSA’s signed since 1996.

<table>
<thead>
<tr>
<th>Operator/Partners</th>
<th>Area Held</th>
<th>PSA Signed</th>
<th>Fields</th>
<th>Work Commitment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Petronas Carigall; (Turkmenistan) SDN. BHD 100%</td>
<td>Block I (Offshore)</td>
<td>July 2, 1996</td>
<td>Gubkin Barinov East Livanov</td>
<td>US$ 45 million during first 6 years, including 4 wells and seismic (2D and 3D)</td>
</tr>
<tr>
<td>Cheleken JV</td>
<td>Block II (Offshore)</td>
<td>November 23, 1999</td>
<td>Lam Zhdanova Kupol</td>
<td>Not known</td>
</tr>
<tr>
<td>Monument Resources Petroleum Limited 35% Partners: Mobil (40%), and Turkmenneft (25%)</td>
<td>Nebitdag (onshore)</td>
<td>August 7, 1996</td>
<td>Burun Nebitdag Gumdag Gyzylgum Karetape</td>
<td>1997 US$ 11.5 million invested - well service/repair, support operations and geological/geophysical surveys. 1998 programme US$ 52.4 million; well workover, service and support</td>
</tr>
<tr>
<td>Mobil Exploration &amp; Production Turkmenistan Inc. 52.4% Partners: Monument (27.6%), and Turkmenneft (20%)</td>
<td>Garashsyzlyk-2</td>
<td>July 10, 1998</td>
<td>Cheleken Barsagelmez Ordekli Ekiysak Guiydxhik</td>
<td>TBA</td>
</tr>
</tbody>
</table>
APPENDICES

Appendix 1 - The Petroleum Law

Appendix 2 - The Model PSA