

PRODUCTION SHARING AGREEMENTS IN AZERBAIJAN

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Abstract

The article discusses the concept of the Production Sharing Agreement (hereinafter referred to as the PSA), the characteristics of its implementation in Azerbaijan, as well as the advantages the agreement brings to the country. The limited availability of local research and literature on the subject, coupled with the general scarcity of educational resources, has highlighted the need for a more thorough investigation of the topic. The article also examines the methods of implementing PSA agreements by operating companies, the obligations and guarantees designated for them, as well as the preferential features such as tax and other exemptions for contractors and subcontractors. The article discusses the rules for imposing and exempting import and export taxes on goods, works and services provided in connection with hydrocarbon activities in the Republic of Azerbaijan, as well as the procedures to be used in their application, as well as the Customs and Tax regulations related to the export of hydrocarbons based on the Agreements. It also discusses the requirements of local legislation in this area and the procedure for compliance with these requirements by operating companies and their contractors/subcontractors, and the necessity of this.

Keywords: *Production Sharing Agreement, operating companies, contractors, subcontractors, guarantees, main features, advantages, obligations, import and export regulations, exemptions and concessions.*

I. Introduction

A Production Sharing Agreement (hereinafter referred to as the PSA) is a contract concluded between one or more oil companies (contractors) and the government, defining the rights for the exploration, development, and extraction of mineral resources from a specific area for a certain period.

Under the standard terms of a PSA, the government engages the investor(s) as contractors for the exploration, development, and extraction of mineral resources, while retaining overall ownership rights to the resources [6, p. 3-4].

The contractor initially bears the risk of finding hydrocarbons and the financial risk of the venture, and explores, develops, and ultimately produces the field in accordance with the terms of the agreement. If successful, the contractor is permitted to use the proceeds from the sale of the oil produced, after paying the concession fees to the government, to recover capital and operating expenses, known as "profit oil". The remaining money is known as "profit oil" and is divided between the government and the contractor. In some agreements, changes in international oil prices or the rate of production from the field affect the company's share of production.

Typically, the contract period consists of an *Exploration Period* and a *Development Period*, depending on the time frame and work commitments. The time frames can often be extended depending on the circumstances and government approval. In the event of commercial discovery and subsequent identification of the relevant field, the development and production period can even be extended to 15 years or more.

An example of this is the Agreement between the State Oil Company of the Republic of Azerbaijan and BP Exploration (Azerbaijan) Limited and the Joint Oil Company of the State Oil Company of the Republic of Azerbaijan on the *Exploration*,

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Development and Production Sharing of the Shallow Water Area around the Absheron Peninsula in the Azerbaijani Sector of the Caspian Sea in Azerbaijan. The aforementioned agreement was signed on 22 December 2014 and operations under the agreement are currently ongoing

II. Advantages of a Profit-Sharing Agreement

- *Low Risk for the Host Country*
- *Transfer of knowledge/information from foreign oil companies to the host country*
- *Various cost recovery strategies for both parties*

1. Low risk for the host country

Through PSAs, the host country can develop new reserves without incurring risks or significant costs. The host country does not need to make substantial investments in exploration and production activities, as foreign oil companies bear all operational and financial costs and risks.

2. Transfer of knowledge/information from foreign oil companies to the host country

When foreign oil companies enter a host country for exploration activities, they can transfer their expertise to the host country, and the host country can learn important experience from them.

3. Various cost recovery strategies for both parties

When drafting the agreement, both parties should agree on the most effective cost recovery strategy. The biggest differences between the strategies are how the total revenue is divided and how the profits are shared between the two parties.

However, PSAs have certain drawbacks, such as the complexity of their drafting and preparation. Numerous key factors must be discussed and agreed upon by the parties before the agreement is signed. Work commitments and financial obligations are considered crucial factors in negotiations, as they determine the degree of exploration risk.

III. Main features of Production Sharing Agreements in Azerbaijan

The terms of PSAs are typically defined within the national legislation of each country (in most cases, within the Law on Production Sharing). In PSAs, in addition to certain tax and non-tax payments to the state, a portion of the extracted oil (specifically, "profit oil") is delivered to the state in kind. According to the Constitution of the Republic of Azerbaijan and the *Law of the Republic of Azerbaijan "On Subsoil" dated February 13, 1998* [1], ownership rights over all hydrocarbons naturally existing in subsoil both on land and underwater belong to the state. Based on the official documents listed below, the authority to manage and oversee these hydrocarbons has been entrusted to SOCAR [5, p. 2].

In accordance with the Decree No. 200 of the President of the Republic of Azerbaijan "On the Establishment of the State Oil Company of the Republic of Azerbaijan" dated September 13, 1992 [3] and the Decree No. 844 of the President of the Republic of Azerbaijan "On the Improvement of the Structure of the State Oil Company of the Republic of Azerbaijan" dated January 24, 2003 [4] and the Charter of the said company, SOCAR exercises ownership of all hydrocarbons produced and has been entrusted with all powers in the field of exploration and development of all hydrocarbons in the state. Thus, under the Agreements, SOCAR grants the Contractors the sole and exclusive right to conduct oil and gas operations within the boundaries of

the Contract Area and in connection with that area, based on and in accordance with the terms of the Agreement and for that period. Except for the rights specifically provided for herein, the Agreement does not provide for the rights to engage in any other type of activity other than oil and gas operations in connection with the surface and seabed, subsoil, as well as any other natural resources or water resources. [5, p. 2-3]

In every Agreement, the guarantees and obligations of both the state (SOCAR) and the contractors are explicitly stipulated. Some of the most significant guarantees and obligations are as follows: [5, p. 8-11]

SOCAR's Guarantees:

It has all the powers prescribed by the legislation of the Republic of Azerbaijan to conclude and execute the Agreement, grant rights and benefits to the Contractor in accordance with the terms of the Agreement, and fulfill its obligations under the Agreement.

Obligations:

- SOCAR, within the full scope of its authority and in accordance with the law, shall make all reasonable efforts before the Government and other relevant authorities of Azerbaijan to assist the Contractor in obtaining the following:

- All necessary government permits and other approvals from relevant Azerbaijani authorities, agencies, and/or organizations;

- Customs clearances, visas, residence permits, communication facilities, licenses for the use of land or water, import and export permits, bank account openings, office spaces, and housing for employees necessary for the efficient conduct of oil and gas operations;

- All geological, geophysical, and geochemical data related to the Contract Area that are not under the control or possession of SOCAR.

Guarantees and Rights of the Contractor Parties

- Each Contractor Party declares and guarantees that it has been duly established in accordance with its founding documents, its existence is lawful, and, subject to obtaining the relevant government approvals, it has the authority to establish and maintain the necessary branches and offices within the state and elsewhere to conduct oil and gas operations in accordance with the provisions of this Agreement.

- Each Contractor Party, its joint companies, as well as the Contractor's subcontractors, are hereby authorized to establish branches, permanent representations, permanent offices, and other forms of economic activities within the state's territory to conduct or participate in economic activities and oil and gas operations, including purchasing, leasing, or acquiring any property required for oil and gas operations. This authorization is subject to compliance with the formalities and procedures prescribed in the legislation of the state regarding such representations, acquisitions, leases, or procurements.

- The Contractor Parties shall provide the financial resources required for conducting oil and gas operations in accordance with the provisions and terms set forth in this Agreement.

- The Contractor has both the right and obligation to carry out oil and gas operations under the terms of this Agreement and in compliance with internationally accepted best practices in the oil and gas industry. The project standards and technical specifications for technological facilities and equipment must adhere to the provisions outlined in Appendix 11. Notwithstanding any conflicting terms in this Agreement, if

any action or inaction by any Contractor Party or its ultimate parent company could result in a penalty under the applicable laws of the relevant jurisdiction, no Contractor Party shall be compelled to undertake such action or inaction.

The aforementioned obligations and guarantees are typically drafted in a more detailed and comprehensive manner and may include varying provisions specific to each agreement.

Additionally, the key terms stipulated in the Agreements include the following: (6, Sections i-iv):

- Duration, development plan of the discovery, and future advancements;
- The management committee overseeing the project and annual work programs;
- The operating company, workforce, and professional training;
- Reporting and inspection of oil and gas operations;
- Land use;
- Use of facilities;
- Reimbursement of costs incurred in oil and gas operations and the allocation of produced oil;
- Taxation;
- Determination of the value of hydrocarbons;
- Ownership, use, and disposal of property;
- Measurement and evaluation procedures;
- Environmental protection and occupational safety practices;
- Calculation of shares.

IV. Current Production Sharing Agreements (PSAs) in Azerbaijan

As of now, the following PSAs are in effect in Azerbaijan:

1. Agreement on the Exploration, Development, and Production Sharing of the D230 Prospective Exploration Block
2. Agreement on the Exploration, Development, and Production Sharing of the Ashrafi-Dan Ulduzu-Aypara Area
3. Agreement on the Exploration and Development of the Offshore Block Including the Umid Field and Babek Prospective Structure
4. Agreement on the Exploration, Development, and Production Sharing of the Absheron Offshore Block in the Azerbaijan Sector of the Caspian Sea
5. Agreement on the Exploration, Development, and Production Sharing of the Exploration Block Including the Zafer and Meshel Prospective Structures in the Azerbaijan Sector of the Caspian Sea
6. Agreement on the Rehabilitation, Exploration, Development, and Production Sharing of the Block Including the Binagadi, Girmaki, Chakhnaglar, Sulutepe, Masazir, Fatmayi, Shabandagh, and Sianshor Oil Fields
7. Agreement on the Rehabilitation, Development, and Production Sharing of the Block Including the Zig and Hovsan Fields in the Republic of Azerbaijan
8. Agreement on the Rehabilitation, Development, and Production Sharing of the Surakhani Oil Field Block in Azerbaijan
9. Agreement on the Rehabilitation, Exploration, Development, and Production Sharing of the Block Including the Zig and Hovsan Oil Fields in the Republic of Azerbaijan

10. Agreement on the Joint Development and Production Sharing of the Azeri and Chirag Fields and the Deepwater Portion of the Gunashli Field in the Azerbaijan Sector of the Caspian Sea

11. Agreement on the Exploration, Development, and Production Sharing of the Araz, Alov, and Sharg Prospective Fields in the Azerbaijan Sector of the Caspian Sea

12. Agreement on the Exploration, Development, and Production Sharing of the Inam Prospective Field in the Azerbaijan Sector of the Caspian Sea

13. Agreement on the Exploration, Development, and Production Sharing of the Shah Deniz Prospective Field in the Azerbaijan Sector of the Caspian Sea

14. Agreement on the Rehabilitation, Exploration, Development, and Production Sharing of the Block Including the Kursangi and Garabaghli Oil Fields in the Republic of Azerbaijan

15. Agreement on the Rehabilitation, Exploration, Development, and Production Sharing of the Block Including the Mishovdagh and Kalamaddin Oil Fields

In accordance with legislation, protocols on the "*Taxation of Employees and Individuals*," "*Import and Export Duties*," and "*Value Added Tax*" have been signed for each agreement.

The mentioned protocols provide exemptions and concessions regarding taxes, duties, and other mandatory payments for contractors and subcontractors.

Under the protocols on "*Taxation of Employees and Individuals*" [11], each Azerbaijani Employee pays personal income tax in the Republic of Azerbaijan in accordance with Azerbaijani legislation. The Employer of each Azerbaijani Employee is responsible for withholding and remitting the Azerbaijani personal income tax from the income paid to each respective Azerbaijani Employee, in compliance with Azerbaijani legislation.

Each Employer's Foreign Employees who are Tax Residents pay Azerbaijani personal income tax on income earned directly from employment activities carried out in the Republic of Azerbaijan. Foreign Employees who are not Tax Residents are not subject to Azerbaijani personal income tax.

The taxation of employees, determination of taxable income for foreign employees, tax rates, responsibilities for the payment of taxes for Azerbaijani and foreign employees, administrative procedures applicable to Azerbaijani and tax-resident foreign employees, verification of Azerbaijani personal income tax information, administrative agents, withholding and reporting of taxes from Azerbaijani and foreign individuals, contributions to the social security system, similar payments and deductions, and other related matters are comprehensively outlined in the *Protocols on Taxation of Employees and Individuals* [11, pp. 2-4].

In accordance with the protocols on "*Import and Export Duties*" [10], each Contractor Party, its Joint Company, Operating Company, Subcontractors, or their Agents (hereinafter referred to as the "Registered Company") has the right to import into and re-export from the Republic of Azerbaijan, without any Taxes and without any restrictions, the following in their own name: all types of equipment, materials, machinery and tools, vehicles, spare parts, and other items deemed necessary, in the Contractor's justified opinion, for the proper conduct and execution of oil and gas operations (excluding food products, alcoholic beverages, and tobacco products). However, if Azerbaijani suppliers are capable of competing with foreign suppliers in all essential aspects such as price, quality, and availability, the Contractor shall give

preference to Azerbaijani suppliers, provided that the contract price offered by the Azerbaijani supplier does not exceed the contract price of the potential winning foreign supplier by more than ten [10] percent.

The Operating Company's contract committee, adhering to the conditions set out in the Import and Export section of the Agreement and in accordance with the exclusive powers granted in the Agreement, shall execute contracts for goods, works, and services specified in paragraph 1.1 of the protocol based on the Contractor's opinion. In addition, representatives of the State Oil Company of the Republic of Azerbaijan oversee the proper implementation of the terms stipulated in the Import and Export sections of the Agreement.

Notwithstanding the above, the Contractor does not have the right to re-export from the Republic of Azerbaijan any tangible assets acquired for oil and gas operations and whose costs have been included in the oil and gas operations account.

Each Contractor Party, its Joint Company, Operating Company, Subcontractors, or their Agents, as well as all their employees and their family members, have the right to import into and re-export from the Republic of Azerbaijan, at any time, without any Taxes and without any restrictions, all types of furniture, clothing, household appliances, vehicles, spare parts (excluding food products, alcoholic beverages, and tobacco products), and any personal property for the personal use of foreign employees and their family members assigned or traveling to the Republic of Azerbaijan for work purposes.

In cases where goods brought into the Republic of Azerbaijan by the Contractor, its Subcontractors, or their employees are sold to any party for personal use, such goods shall be subject to taxation in accordance with the legislation of the Republic of Azerbaijan.

Each Contractor Party, Operating Company, or their Agents, its customers, and their transportation agents have the right, in accordance with the provisions of the Agreement, to freely export at any time, without paying any duties and Taxes (except for Profit Tax), the Hydrocarbons to which such Contractor Party is entitled and their processed products.

Each Contractor Party, its Joint Company, Operating Company, Subcontractors, or their Agents are exempt from any restrictions imposed on the import and export of goods specified in paragraph 1.1 of the protocol, as well as restrictions related to the producer countries and requirements regarding the prohibition or limitation of the export of Hydrocarbons to which the Contractor is entitled under the Agreement, in accordance with any foreign trade regulations in force in the Republic of Azerbaijan.

The procedures for obtaining the Import and Export Tax Exemption Certificate, management of documentation for Import, Export, and Re-export, transfer and disposal rights, fees for customs services (procedures), payment and reimbursement of taxes, and other related matters are comprehensively outlined in the *Protocols on Import and Export Duties and Taxes* [10, pp. 2-5].

In accordance with the "Value Added Tax" protocols, each Contractor Party, the Operating Company, and its Subcontractors are exempt from Value Added Tax (VAT) at a zero percent (0%) rate for activities related to Hydrocarbon operations. This exemption applies to the following [9, pp. 1-2]:

- Goods, works, and services provided to or by any of them;
- The export of Hydrocarbons and all products processed from these Hydrocarbons;

- The import of goods (excluding tobacco, food, and alcoholic beverages), works, and services acquired by them.

Additionally, any supplier providing goods, works, or services related to Hydrocarbon operations to the Contractor Party, Operating Company, or its Subcontractors is deemed exempt from VAT at a zero percent (0%) rate for such goods, works, and services.

Each Contractor Party, Operating Company, and its Subcontractors are issued a *VAT Exemption Certificate* at a zero percent (0%) rate. The procedures for obtaining and using these certificates, transfer and disposal rights granted to VAT-exempt parties, submission of VAT Declarations, reimbursement of paid VAT, and other related matters are detailed in the *Protocols*.

V. Conclusions

Based on the research, the following conclusions can be drawn:

1. There is no existing law in the Republic of Azerbaijan regulating the matters covered by Production Sharing Agreements (PSAs) concerning hydrocarbon reserves, and the selection criteria for potential investors are not defined in the legislation.

2. Negotiations on the preparation of agreements for the development of hydrocarbons are conducted directly with SOCAR, the entity representing the government and holding the authority to manage hydrocarbon reserves on behalf of the government.

These agreements serve as the primary documents regulating the activities of operating companies, contractor parties, and their subcontractors in the fields.

References:

1. *Law on Subsoil* of the Republic of Azerbaijan dated February 13, 1998; URL: <https://e-qanun.az/framework/4273> (last access: 15.08.2024).

2. Resolution No. 27S of the Cabinet of Ministers of the Republic of Azerbaijan dated February 26, 2003.

3. *On the Establishment of the State Oil Company of the Republic of Azerbaijan*, Decree No. 200 of the President of the Republic of Azerbaijan dated September 13, 1992; URL: https://frameworks.e-qanun.az/7/f_7785.html (last access: 18.08.2024).

4. *On Improving the Structure of the State Oil Company of the Republic of Azerbaijan*, Decree No. 844 of the President of the Republic of Azerbaijan dated January 24, 2003; URL: <https://e-qanun.az/framework/1899> (last access: 01.09.2024).

5. Production Sharing Agreement on the Joint Development and Production of the Azeri, Chirag Fields, and the Deepwater Portion of the Gunashli Field in the Azerbaijan Sector of the Caspian Sea.

6. Production Sharing Agreement on the Exploration, Development, and Production of the D230 Prospective Exploration Block in the Azerbaijan Sector of the Caspian Sea; URL: <https://e-qanun.az/framework/39629> (last access: 12.08.2024).

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8. *Protocols on Production Sharing Agreements in Azerbaijan*;
URL: <https://www.taxes.gov.az/az/page/hasilatin-pay-bolgusu-haqqinda-sazise-dair-protokollar-psa> (last access: 21.08.2024).

9. Protocol on *Value Added Tax* under the Production Sharing Agreement on the Absheron Offshore Block in the Azerbaijan Sector of the Caspian Sea.

10. Protocol on *Import-Export Duties and Taxes* under the Production Sharing Agreement on the Absheron Offshore Block in the Azerbaijan Sector of the Caspian Sea.

11. Protocol on *Taxation of Employees and Individuals* under the Production Sharing Agreement on the Absheron Offshore Block in the Azerbaijan Sector of the Caspian Sea.

**Date of receipt of the article in the Editorial Office
(07.09.2024)**