



## CONTRACTUAL PROBLEMS OF „PRODUCTION SHARING AGREEMENTS” AND „HOST GOVERNMENTAL AGREEMENTS” IN OIL AND GAS SPHERE IN THE REPUBLIC OF AZERBAIJAN (ON THE EXAMPLE OF SHAH DENIZ GAS VALUE CHAIN PROJECT)

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### SUMMARY

The Production Sharing Agreements and Host Governmental Agreements are commonly used as contractual frameworks when the countries rich with oil and gas are inviting foreign investors to explore and develop those resources. Meanwhile, by executing such agreements, the host countries which are economically, financially and technically lagging behind modern synergies, are losing certain internal leverages. Such circumstances are leading to future problems in those societies.

**Keywords:** Oil and gas pipelines, Shah Deniz, Baku Tbilisi Ceyhan, South Caucasus Pipeline Company, HGA, PSA.

### РЕЗЮМЕ

Соглашения о разделе продукции и Соглашения с правительством принимающей страны обычно используются в качестве договорных рамок в случаях, когда страны богатые нефтью и газом приглашают иностранных инвесторов на разведку и разработку этих ресурсов. В то же время, путем выполнения таких соглашений, принимающие страны экономически, финансово и технически отстают в современной синергии, и теряют некоторые внутренние рычаги. Такие обстоятельства приводят к проблемам в будущем в этих обществах.

**Ключевые слова:** нефть и газопроводы, Шах-Дениз, Баку-Тбилиси-Джейхан, Южно-Кавказская трубопроводная компания, СППС, СРП

**Formulation of the problem:** The richness of hydrocarbon resources of Azerbaijan Republic makes its strategic position more complex and more important in the international arena. Until it gained independence from the Soviet Empire, the main goal of oil and gas industry was to meet the internal consumption needs. Following the adoption of the „Act of Independence” in 1991 the country's foreign policy changed significantly in oil and gas sector, and the main goal was to gain access to world markets, as well as to assist foreign countries to meet their oil and gas needs and to gain political dividends. After gaining independence the situation of the war, the lack of technical and financial resources, lack of capital was making impossible to attract foreign investors which was putting the country in a very difficult test. „Contract of the Century” should be considered a turning point in the country's foreign policy which was the result of the initiative of the national leader Heydar Aliyev on Septem-

ber 20, 1994. The signing of the mentioned agreement resulted with the appearance of foreign investors in local markets and more than 30 Production Sharing Agreements were signed so far since then. By signing these contracts the government is granting special rights and obligations to the international companies which is not in line with local legislation.

**Status of Research:** The various aspects of the research were already analyzed by different scientist, such as, Mehdiyev R.A., Mecedli S.T., Farxutdinov I.Z., Trapeznikov V.A., Bagirov S., Buslaeva L.M., Meshериков V.A., Sherbinina O.E., Bobilev U.N., Idrisov Q.I., Sinelnikov-Murilev S.Q., Zimovech A.V., Suraeva E.M., Daniel P., Leshukov V.S., and others.

The country's main oil export pipelines are Baku-Tbilisi-Ceyhan, Baku-Novorossiysk, Baku-Supsa and the main export route gas pipeline is South Caucasus Pipeline (or so called Baku-Tbilisi-Erzurum pipeline) [1, p 91].

When foreign investors invest

in the country the legal framework between the parties is regulated through Production Sharing Agreements. The Parties to the agreements are the Government as the owner of the natural resources on the one hand, and the companies investing in the consortium on the other hand. I would like to note the current place of Production Sharing Agreements within the legislative hierarchy of Azerbaijan Republic, as, the legal status of the Production Sharing Agreements is regulated in a different manner.

Articles 148 and 151 of the Constitution of the Republic of Azerbaijan sets the hierarchy for domestic legislation, and describes kind of hierarchy of laws as “pyramid” and defines superiority of laws in case of conflict between levels of the pyramid.

„I. Legislative system consists of the following normative legal acts:

- 1) Constitution;
- 2) acts accepted by referendum;
- 3) laws;



4) orders;  
6) decrees of the Cabinet of Ministers;

6) normative acts of central executive bodies.

II. International agreements wherein the Azerbaijan Republic is one of the parties constitute an integral part of legislative system of the Azerbaijan Republic. [8, Article 148].

„Whenever there is disagreement between normative-legal acts in legislative system of the Azerbaijan Republic (except Constitution of the Azerbaijan Republic and acts accepted by way of referendum) and international agreements wherein the Azerbaijan Republic is one of the parties, provisions of international agreements shall dominate” [8, Article 151]. This article explicitly states that in case of inconsistency between Azerbaijani legislation and international agreements adopted by Azerbaijan Government (excluding constitution and referendum acts) the latter prevails [2, p 106].

As seen from the above-mentioned acts the Production Sharing Agreements are not specified in the hierarchy. Production Sharing Agreements specify their legal status in their substance. i.e, the „... Upon approval by the Parliament of the Azerbaijan Republic of this Contract, this Contract shall constitute a law of the Azerbaijan Republic and shall take precedence over any other current or future law, decree or administrative order (or part thereof) of the Azerbaijan Republic which is inconsistent with or conflicts with this Contract except as specifically otherwise provided in this Contract ...” [8, Article 23].

Considering the abovementioned, in case of a conflict between the Production Sharing Agreement and any other local legal act the first superceeds. In my opinion such kind of approach to the legislation is not legally correct and should be changed. Production

Sharing Agreements are legal acts which govern the broad range of rights and obligations between the parties. The agreement regulates the legal framework starting from production area till delivery point. These regulations include, but not limited to, taxation, transportation of petroleum, field development, the exemption of the goods and services from any government fees, release or charge, all kinds of concessions, benefits to foreign companies including contractors and subcontractors and other legal relations. The State already has a number of local legislation to regulate these legal deliverables. However, by signing the Production Sharing Agreements the local legislation is not being applicable to oil and gas sphere and the Government is granting all these regulations to Production Sharing Agreements. The delegation of power to Production Sharing Agreements results the leading oil and gas companies to gain a wide range of trading opportunities, through a variety of mechanisms for political and economic pressure while negotiating and drafting Production Sharing Agreements which results with the adoption of certain provisions in the favor of foreign oil companies.

After production of oil and gas in the production area, the next main step is the delivery process of the product to end user. Moreover to the pipelines constructed for meeting domestic needs of the country, there are also number of oil and gas pipelines in the country for transportation of hydrocarbons to foreign markets, including the Baku-Tbilisi-Ceyhan, Baku-Novorossiysk, Baku-Supsa and South Caucasus Pipeline, as mentioned above.

The transportation of Oil and the transportation of Natural Gas are achieved in different ways. Since it is relatively easy to maintain the oil after production, it may be transported via rail, ships, pipelines and

other kinds of vehicles. In comparison with oil, natural gas is much more difficult to maintain. Prior to production the gas buyers should be defined and negotiated, the main transportation route should be selected, if there is no such kind of route then it should be constructed or defined some how and as the last stage upon completion of all these phases the natural gas may be produced [7]. LNG terminals and gas storage are also used to store the gas, but these tools are expensive, thus the most effective form of the transportation of gas is pipelines. LNG terminal means transportation of liquified gas by sea. The terminals are built on both sides of the sea. Gas is being liquified at the first terminal, after delivery via ships it is being gasificated again at the delivery point terminal.

Oil and gas transportation and transit are regulated through bilateral and multilateral interstate and intergovernmental agreements. For example, Azerbaijani and Georgian governments have signed Host Governmental Agreement with regards to the transportation of Shah Deniz gas through South Caucasus Pipeline with the consortium of the pipeline in 2002 [9]. In accordance with mentioned agreement, the natural gas will be transported without any obstacles and no additional fees levied which are applicable in Georgia and Azerbaijan starting from entry point in Azerbaijan till the exit point in Georgian-Turkish border. At the same time, „the Intergovernmental Agreement” signed by the Presidents of Azerbaijan and Georgia, in 2003, which is the main guarantee by two country leaders for smooth realization of all contractual rights and obligations of pipeline companies. Due to the lack of Law regulating the transportational issues in the country the foreign companies may use political pressures to negotiate conditions in their favor for each occasion as indicated above in



explanation of „Production Sharing Agreement”s. Although „The Host Government Agreement”s are being ratified by parliaments and receiving legal status, I believe that it would be more beneficial for the State if the common code or law would be adopted for all transportation pipelines rather than negotiating each time a new agreement.

In this regard, I would like to share the international experience for regulating oil and gas cross border legislation. In Europe the European Council and European Parliament have adopted 3<sup>rd</sup> Gas Directive in 2009 with the „aim is to deliver real choice for all consumers of the European Union, be they citizens or businesses, new business opportunities and more cross-border trade, so as to achieve efficiency gains, competitive prices, and higher standards of service, and to contribute to security of supply and sustainability”. The Directive also says that „Member States as well as the regulatory authorities shall cooperate with each other for the purpose of integrating their national markets at one and more regional levels, as a first step towards the creation of a fully liberalized internal market. In particular, the regulatory authorities where Member States have so provided or Member States shall promote and facilitate the cooperation of transmission system operators at a regional level, including on cross-border issues with the aim of creating a competitive internal market in natural gas, foster the consistency of their legal, regulatory and technical framework and facilitate integration of the isolated systems forming gas islands that persist in the Community” [6]. As it is indicated the Directive is regulating the cross border regime between all member states of European Union. The specific nature of EU legislation is the prerogative of EU regulations over member state local legislation. If there

is inconsistency with the Member State local legislation and the European Union regulation the latter prevails. This kind of approach is easing the single approach and effective governance regarding all member states.

The general target of regulatory authorities is „eliminating restrictions on trade in natural gas between Member States, including developing appropriate cross-border transmission capacities to meet demand and enhancing the integration of national markets which may facilitate natural gas flow across the Community” [6]. We may underline a lot more articles related to European regulations for cross border matters. But the one is common that the European Union approach is eliminating any kind of discriminatory measures between member states when the issue is related to cross border gas transactions.

As oil and gas is the main source of income in the country, the income from their sale and transportation should be realized with the most favorable conditions for the country. Today, the transportation of oil and gas via pipelines from Azerbaijan through Georgia and later to world markets is contracted with the payment of pre-agreed rate of tariff for transportation of hydrocarbons by the title holders. The transporter is only obliged to pay profit tax after covering its Capital Expenditures. No fee has been envisaged in Azerbaijan legislation for the transportation of hydrocarbons across the border.

The economical potential of Azerbaijan today is quite different from the 90s. In comparison with the conditions while the signing of the „Contract of the Century” in the absence the financial, technical and material resources, currently government is developing the Umid gas field with its own resources.

In international practice the countries are ruling from protectionist point of view in order to save

internal resources and production. To serve for this theory each country may adopt its own scenarios. For such scenarios we may give examples, such as, dumping, taxes for imports, subsidizations, quotes etc. [3, p 4-9]. Notwithstanding the fact that the WTO and other trade organisations are against and prohibiting the member states to use such kind of restrictions inside those states, in order to let the transnational companies to freely enter and invest in those states, it is already adopted that oil and gas sphere is exempted from those restrictions and WTO and similar entities may not regulate in oil and gas sector.

Shah Deniz, discovered in 1999, is thought to be the biggest gas field explored in Azerbaijan. With reserves of 1.2 trillion cubic metres of gas, it is one of the biggest gas condensate reservoirs in the world. It is 70 kilometres south-east of Baku, on the Caspian Sea shelf, where the depth varies between 50 and 500 metres. BP operates Shah Deniz on behalf of its partners in the Shah Deniz Production Sharing Agreement (PSA). Operations are being conducted there in two stages [10]. The first stage begun in 2006 and the second stage is targeted to start by end of second decade of 21st century.

In this article I have elaborately mentioned the European Union practice and local practice to highlight the current legislative problems with regards to Shah Deniz project. As a value chain project Shah Deniz gas is being produced in Azerbaijan which is regulated by Shah Deniz PSA, crossing from Azerbaijan and Georgia regulated by South Caucasus Pipeline HGA(s) with governments of Azerbaijan and Georgia, then crossing from Turkey regulated by Trans Anatolian Gas Pipeline HGA and before the meeting with the buyers the final areas Greece, Albania and Italy regulated by the Trans Adriatic



ic Pipeline HGA(s) with respective governments. We may add SNAM transmission system in Italy as well, but currently it is not subject to my article.

The main complexity of Shah Deniz project is not the number of countries, or the number of companies involved or the amount invested to the project. The difference of approach in legislations of each crossing state makes the project complex and this situation requires the elaborate alignment between all legal regimes, otherwise any misalignment with one legal regime may cause serious problems and hindrance to the whole value chain system and all investment. In Azerbaijan the HGA and PSA are granting the consortium prerogative over local legal regimes. When we move to west we see the HGA's are becoming „weaker”. In Europe the European Union law is not permitting the new projects to dictate the new rules. Although the projects are demanding certain exemptions from certain authorities in Europe and Shah Deniz project also gained several such exemptions, but this was as a result of normal legal procedure which is designated in the EC Directives and in any case serves for enhancing the integration of national markets and increasing the competition in Europe.

I believe that the single law in oil and gas should be adopted in Azerbaijan. The adopted law should fix and regulate as the template the mutual rights and obligations of the state and the companies, taxation, transportation of petroleum, field development, the exemption of the goods and services from any government fees, release or charge, all kinds of concessions, benefits to foreign companies including contractors and subcontractors and other legal relations. Parties should be given the opportunity to discuss only the commercial terms. Commercial terms should include

the interests of the parties, management and technical issues etc. The adoption of laws in Azerbaijan which would be mandatory for all foreign companies that are dealing with hydrocarbon-related activities will be more efficient. Similar laws are being applied in some countries, including Russia. Russian law on Production Sharing Agreements adopted in 1995 [4] is one of the examples. By adopting such law in Russia the hegemony of transnational companies was ended and the government started to act as the equal entity dictating its conditions [5, p 157-158].

One can say that to adopt a single law in Azerbaijan may make the internal market less attractive for foreign investors and may result with the withdrawal of the investments by already existing companies. Some authors consider that the legal regimes in the countries which gained independence after collapse of Soviet Empire is not so reliable and that is the crucial reason for the transnational companies to conclude the contracts referring to English law provisions. For others the adoption of single law in the country may mean the predominance of local law over the international law which may be considered as a threat for certain companies.

Notwithstanding with the ideas of the authors indicating the disadvantages of the adoption of single law for regulating the oil and gas sector of the country, I would argue that the Russian experience explicitly express that the adoption of Production Sharing Law in 1995 in no case negatively affected the investment environment in the country. Besides in the globalized world all circumstances are being changed year by year. We cannot use the Production Sharing Agreement frames in the second decade of 21<sup>st</sup> century which were being used in 90<sup>th</sup>. Only a few countries in the world are remaining which

use the past formats. Thus, the new Law should be adaptation to the new circumstances.

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