

THE DEVELOPMENT AND USE OF PRODUCTION SHARING AGREEMENT LAW IN UZBEKISTAN OIL AND GAS

Michael P. BARRY

*PhD., J.D., Asst. Professor of Economics,
Mount Saint Mary's University
(Emmitsburg, Maryland, U.S.A.)*

Uzbekistan's probable natural gas reserves are approximately 5.1-6.25 trillion cubic meters, with commercial reserves of about 1.62 trillion cubic meters, making Uzbekistan the world's 10th largest natural gas producer. Commercial gas reserves in Uzbekistan are double those located in Britain, which is Europe's largest gas producer, and the Uzbek national holding company Uzbekneftegaz claims the country has developed less than 23% of its gas resources. Given these natural advantages, Uzbek authorities have been working hard to attract foreign investors into ex-

ploration and production in Uzbekistan. Efforts include a much publicized April 2000 Oil And Gas Investments Decree intended to promote Uzbek oil and gas, and the December 2001 introduction of a production sharing agreement (PSA) law. This article will put these efforts into context by examining the Uzbek hydrocarbon industry. This will then be followed by a detailed analysis of the development of a PSA regime in Uzbekistan, provisions of the law, problems with the law, and the limited-to-modest success it has had in attracting foreign investment into Uzbekistan.

A. Executive Summary

- As is common in former Soviet republics, the Uzbekistan Constitution vests ownership of the subsoil in the state. The Law on the Subsoil of 23 September, 1994 and its amendments set out Uzbekistan's framework of statutes governing the exploration and development of all subsoil resources—including hydrocarbons and other minerals.
- On 28 April, 2000, the Uzbekistan Government adopted the Oil And Gas Investments Decree as part of an organized plan to attract more FDI into the Uzbek oil and gas sector. The Oil And Gas Investments Decree contains several provisions of significant interest to foreign investors. Significantly, companies which conduct exploratory work in the Ustiurt Region (and possibly others) may be granted newly discovered oil and gas deposits for a period of up to 25 years with a "right to prolong the development period."
- On 7 December, 2001 Oliy Majlis (Parliament) of the Republic of Uzbekistan adopted Resolution No. 312-II On Enactment of the Act On Production Sharing Agreements (PSA Act). A key concept of the PSA Act is that the Uzbek state grants to a foreign investor for a certain period of time exclusive rights to search for, explore deposits and extract minerals in a specified segment of subsoil. In return the investor is obliged to fulfill work plans determined by the agreement at its own risk and expense, as well as to transfer a share of the extracted product or its monetary equivalent to the State.

- The Uzbek government has been hoping to attract \$400 million of foreign investment through production-sharing agreements (PSAs). Of the 80 fields offered under PSA arrangements, 78 fields are located in 16 exploration blocks. Eight individual fields, with total reserves of some 1.2 bn barrels of oil equivalent, have been opened up for potential foreign participation. Those fields include four in the southwestern Gissar Basin and four in the Amu Darya region. However, success under PSA laws has been limited because foreign companies perceive the PSA terms as less attractive than those offered in other parts of Central Asia and Russia. Investors readily cite increased political risks in Uzbekistan due to Islamic opposition to President Karimov.
- Selected provisions of the 2001 PSA Act include:
 - Rights to the promising subsoil segments without proven mineral resources shall be granted subject to the conditions of the PSA. Rights to the subsoil segments with proven mineral resources shall be granted on the PSA basis only in the following instances:
 - (i) the State lacks necessary financial and technical means for exploration;
 - (ii) attraction of special modern technology is necessary; or
 - (iii) it is necessary to decrease the level of technological losses of minerals and prevention of possible negative socio-ecological consequences.
 - Subsoil segments shall be granted on the basis of the PSA through open tenders. However, in certain instances the PSA can be negotiated directly with the authorized agency.
 - A license for use of subsoil under the PSA shall be issued to the investor according to the procedure established by the Cabinet of Ministers or its authorized body within five working days after conclusion of the agreement.
 - Uzbek citizens should comprise 80% of all workers under the PSA (calculated on an average annual basis).
 - The investor has a right of ownership to a share of the product in accordance with the PSA and can export it out of Uzbekistan without any restrictions.
 - Provisions of the agreement remain in force during the entire term of the agreement. If during the term of the agreement, changes in the legislation worsen commercial results of the investors' activity under the agreement, relevant provisions of the agreement would prevail.
 - Disputes can be settled according to provisions of the PSA in a Uzbek court or, if the parties so choose, in international arbitration.
- Investors have identified several problems with the law, or provisions which make the Uzbek PSA regime less attractive than those in other parts of the world. Some of these problems include the following:
 - Art 5 of the PSA law limits PSA-eligible fields only to those which do not have proven reserves.
 - Although the PSA Law provides for issuance of a subsoil use license within five days, Uzbek legislation that regulates the procedure of issuance of such a license does not exist. Decree No. UP-2598 authorizes the National Holding Company Uzbekneftegaz to issue licenses for prospecting, exploration and extraction of minerals in Uzbekistan, although the decree also fails to define the procedure for obtaining a license.
 - Art 14 of the Act says that that "recoverable expenses should be compensated from the recovery product in the same calendar year that the expenses were accrued," effectively

preventing developers from carrying exploration and production expenses over from one calendar year to the next.

- Other issues, including:
 - (1) the law contains little or no provisions as to the tax treatment of the operator—meaning the tax preferences for the investor might not be applied to the operator; and
 - (2) the PSA law does not spell out regulation of foreign companies' branch offices located inside Uzbekistan—causing further uncertainty in investors' tax liability.
- While success under the PSA regime has been limited, a number of deals have been made. These include a deal with Great Britain's UzPEC and Trinity Energy, Russia's Soyuzneftegaz, Gazprom, and LUKoil. While positive developments, these deals are still very small compared to the government's initial hopes for the PSA law.

B. Investment Decision Factors in Uzbekistan

George Ellinidis suggests a long list of risk factors for investors considering any transition economy.¹ The list suggested by Ellinidis can be augmented with several factors specific to Uzbekistan. Thus, risk factors can be split into:

- (1) general risk factors associated with any developing economy; and
- (2) risk factors specific to transition economies and Uzbekistan in particular. These include both positive and negative risk factors.

On the positive side, Uzbekistan offers several economic benefits, including:

- (1) relatively abundant natural gas;
- (2) relatively inexpensive labor; and
- (3) lower relative overhead costs of land, buildings, and materials—in comparison to similar oil and gas investment projects in the United States or other developed parts of the world.

The attractiveness of an investment in Uzbekistan is also likely to depend on the availability of alternative investment opportunities in other parts of the world. Though risks may be higher in Uzbekistan, so too are possible returns—for at least 4 reasons, including:

- (1) “saturation” of the domestic market in energy investment projects;
- (2) anti-trust policies in the domestic market;
- (3) high taxation levels and environmental standards in the home country; and
- (4) presence of strong labor unions and high wages in the home country.²

However, there are many negatives on the negative side. The first major problem for any prospective investor in Uzbekistan oil and gas is geography. Uzbekistan is a landlocked country surrounded by difficult desert and mountain terrain—a situation which makes oil and gas transport expensive and

¹ See: G.Th. Ellinidis, “Foreign Direct Investment in Developing and Newly Liberalized Nations,” *Journal of International Law and Practice*, Summer 1995 (4 J. Int'l L. & Prac. 299).

² *Ibidem*.

problematic. Uzbekistan does not have a sufficient transport network, and the lines it does have are not suited to significant production increases. The end result is that despite the fall of the former Soviet Union, energy exports from Uzbekistan and its Central Asian neighbors are almost exclusively limited to the Russian Federation and other countries of the NIS.³ Almost all oil and gas pipelines pass through Russia—giving Russia's monopoly gas producer Gazprom a near unbeatable bargaining position in regional trade.

Some countries have tried to build alternative routes, but progress is slow. Turkmenistan and Iran built a 200-km gas pipeline in 1997 which successfully circumvents Russia. Additionally, Kazakhstan wants to build an oil pipeline to the Persian Gulf to sell to countries in Asia, and thinks a route through Iran would be the cheapest route. Turkmenistan also raised the idea of building lines through Iran, but the United States strongly opposes such plans.⁴ Pipelines built in Iran are subject to the United States' Iran-Libya Sanctions Act, which provides sanctions on foreign companies investing in Iran's energy sector. Such sanctions would be prohibitively expensive to countries of Central Asia.

Political instability and the threat of violence is also a factor for investors considering Uzbekistan. Such worries include concerns over: (1) activities of Islamic militants; (2) organized crime; and despite the end of the Taliban to the south, (3) uncertainty over Afghanistan's long-term stability.⁵

C. Uzbek Macroeconomics

Uzbekistan's previous lack of currency convertibility was one of the reasons that foreign direct investment (FDI) inflows dwindled to a trickle. In fact, Uzbekistan has the lowest level of FDI per capita in the Commonwealth of Independent States (CIS). Since Uzbekistan's independence, U.S. firms have invested roughly \$500 million in Uzbekistan. Large U.S. investors include Newmont, reprocessing tailings from the Muruntau gold mine; Case Corporation, manufacturing and servicing cotton harvesters and tractors; Coca Cola, with bottling plants in Tashkent, Namanagan and Samarkand; Texaco, producing lubricants for sale in the Uzbek market; and Baker Hughes, in oil and gas development. No large new investments have taken place from the U.S. in the last 5 years.⁶

In 2003, policy measures, including tight monetary and fiscal policies, were directed mainly toward formally establishing current account convertibility. This has been a long-standing goal of the authorities as part of their efforts to attract greater FDI. The Government made its announcement in October 2003, followed by an IMF statement, that Uzbekistan had accepted its Art VIII obligations for current account convertibility. Uzbekistan has maintained a managed floating exchange rate. However, in addition to the official main reference rate, prior to October 2003 and exchange rate unification, the exchange rate system had included an official depreciated secondary market rate for certain transactions as well as various restrictions on making current payments and transfers. Black-market transactions had been made at spreads generally well above both official rates.⁷

³ See: *Quest Information Limited, Uzbekistan Economy: Regional Overview, Country Report I*, 5 February, 2004.

⁴ *Ibidem*.

⁵ See: G.Th. Ellinidis, *op. cit.*

⁶ See: U.S Department of State, *Background Note: Uzbekistan*, available at [www.state.gov], October 2004.

⁷ See: Asian Development Bank, *Asian Development Outlook 2004: Economic Trends and Prospects in Developing Asia, Uzbekistan*, available at [www.adb.org], March 2004.

D. General Legal Framework for Energy Investment in Uzbekistan

Arts 3-4 and 7 of the Uzbekistan Subsoil Law grant authority over the subsoil (including its natural resources) to: (1) President; (2) Cabinet of Ministers (the “COM”); (3) Local authorities; and (4) Specially designated state agencies.⁸ In addition to these powers, Art 4 of the Law on Natural Monopolies also gives the power of regulatory oversight for natural monopolies to the state. These regulated activities include: (i) the extraction of oil, gas condensate, natural gas, and coal, and (ii) oil, petroleum products, and gas transportation by pipeline.⁹

As is common in former Soviet republics, the Uzbekistan Constitution vests ownership of the subsoil in the state.¹⁰ The Law on the Subsoil and its amendments set out Uzbekistan’s framework of statutes governing the exploration and development of all subsoil resources—including hydrocarbons and other minerals. The Subsoil Law covers state licensing and control, rights and obligations, basic rational use rules, and other issues. It does not specify any particular form of contract favored or allowed for resource.¹¹ There is also a new Law on Licensing of Certain Activities (the Licensing Law),¹² and the older, pre-existing Cabinet of Ministers Decree No. 215 On Licensing of Business Activities of 14 April, 1994, as amended (the Licensing Decree).¹³

Approved licenses are the basis for oil and gas exploration and development in Uzbekistan. The Subsoil Law requires that a license be issued to any physical or legal persons, domestic or foreign. Specifically, under the Subsoil Law Arts 10 through 14 and the Licensing Decree, a license is required only for mineral extraction.¹⁴ However, it is understood that licenses may be granted for exploration, production, or combined exploration and production.¹⁵ Another section of the Subsoil Law says that the period of subsoil usage allowed in the given license may be either limited or unlimited, with or without a right to extend; and the Law itself states no maximum license periods.¹⁶

Another important rule is Uzbekistan’s right to terminate a license. In Russia, where the state has authorized exploration under both a production sharing agreement regime and a subsoil licensing regime, the Russian state reserves the right to terminate, suspend, or limit an investor’s utilization of an approved license.¹⁷

In Uzbekistan, the Subsoil Law (Art 19) provides many excuses for the Uzbek authorities to terminate a license, including:

- (1) a finding of the user’s violation of “the basic terms of the license”;
- (2) non-fulfillment of the Subsoil Law conditions for exploration, development, and workplace safety;

⁸ See: Republic of Uzbekistan, The Law on Subsoil, Arts 3-4, 7, 23 September, 1994.

⁹ See: Republic of Uzbekistan, Natural Monopolies Law: Law No. 398-I On Natural Monopolies (adopted 24 April, 1997).

¹⁰ See: Republic of Uzbekistan, The Law on Subsoil.

¹¹ Ibidem.

¹² See: Law No 71-II On Licensing of Specific Kinds of Activity dated 25 May, 2000 (published on 15 June, 2000).

¹³ See: Cabinet of Ministers Resolution No. 215 On Licensing of Business Activities approving the Regulation On The Procedure for Issuing to Enterprises (Organizations) Special Permissions (Licenses) for the Right to Engage in Certain Types of Activity (adopted 19 April, 1994).

¹⁴ See: Republic of Uzbekistan, The Law on Subsoil, Arts 10-14.

¹⁵ See: J.Hines and E. Sievers, “Legal Regime for Hydrocarbon Development in Uzbekistan,” *The Journal of The Centre for Energy, Petroleum and Mineral Law and Policy*, 11 August, 2001.

¹⁶ See: Republic of Uzbekistan, The Law on Subsoil, Arts 12.

¹⁷ See: The Law of the Russian Federation No. 2395-1 On Underground Resources, *Sobr. Zakonod. RF*, 1992 (hereinafter Law of Subsoil), translation available at LEXIS, Inlaw Library, RFLAW File, Garant 10004313).

- (3) “necessity of confiscation of subsoil plots for other state or public needs”;
- (4) threat to human life or health or to the environment;
- (5) failure to commence work within a year of initial licensing; and
- (6) “systematic” non-payment of resource use payments (which are established under Art 22).¹⁸

If a dispute should arise regarding a license, Uzbek law provides that “in matters of use and protection of the subsoil shall be determined in court in the manner established by law.”¹⁹ This provision likely sounds a little vague to foreign investors, though other provisions of Uzbek law attempts to give priority to international law and treaties in the choice of jurisdiction for disputes. Several documents mention such priority, including:

- (1) Subsoil Law Art 5²⁰;
- (2) provisions of the 1998 Investment Laws affording foreign investors the right to resolve disputes in international arbitration,²¹ and
- (3) Uzbekistan’s obligations under the Energy Charter Treaty.²²

Additionally, the Uzbek Law on Concessions mentions the right to international arbitration.²³

E. Background to a Production Sharing Agreement Law in Uzbekistan

Beginning in 1998, the Government of Uzbekistan conducted a program to attract foreign investors to develop oil and gas deposits in the territory of Ustiurt plateau in the Southwest of Uzbekistan, which, according to preliminary estimates, contains 4 billion tons of oil.²⁴

On 28 April, 2000, the Uzbekistan Government adopted the Oil And Gas Investments Decree as part of an organized plan to attract more FDI into the Uzbek oil and gas sector. The Oil And Gas Investments Decree was introduced at a press conference on 4 May, 2000, and was a main attraction at a major oil and gas convention held in Tashkent on 17-18 May, 2000.²⁵ The Oil and Gas Investments Decree contains several provisions of significant interest to foreign investors. First, companies which conduct exploratory work in the Ustiurt Region (and possibly others) may be granted newly discovered oil and gas deposits for a period of up to 25 years with a “right to prolong the development period.”²⁶

¹⁸ See: Republic of Uzbekistan, The Law on Subsoil, Art 19.

¹⁹ Ibid., Art 50.

²⁰ Ibid., Art 5.

²¹ See: Republic of Uzbekistan, Foreign Investment Law: Law No. 609-I On Foreign Investments (adopted 30 April, 1998). See also: Republic of Uzbekistan, Investment Guarantees Law: Law on Guarantees and Measures for Protection of Foreign Investors’ Rights (adopted 30 April, 1998).

²² See: Republic of Uzbekistan, The Law on Subsoil, Art 26.

²³ See: Republic of Uzbekistan, The Law on Concessions, Art 24 (adopted 30 August, 1995).

²⁴ See: V. Saparov and A. Frolov of Baker and McKenzie, “Evolution and Developments of Oil and Gas Legislation in Uzbekistan,” *Russian/CIS Energy and Mining Law Journal*, January 2003, p. 33.

²⁵ See: Republic of Uzbekistan, Presidential Decree (unnumbered) On Measures to Attract Direct Foreign Investments into Oil and Gas Extraction (issued 28 April, 2000).

²⁶ Ibidem.

Oil and gas deposits may be granted to companies engaged in prospecting and exploration work “on a concession basis.” In addition, such companies are to benefit from an investment regime which includes a number of right, including:

- (1) the exclusive right to prospect and explore various territories with a right to further develop any deposits found in these territories, either through a joint venture or through a concession;
- (2) a preemptive right to acquire new territory for further prospecting and exploration if no valuable industrial resources have been found there;
- (3) a right of ownership and a right to freely export extracted hydrocarbons and their products processed on a tolling basis, as set out in the foundation documents of a joint venture or a concession agreement; and
- (4) a guarantee that actual expenses arising from prospecting and exploration will be reimbursed in the event that deposits “of industrial interest” are discovered and then transferred to Uzbekneftegaz for future development.²⁷

Foreign companies engaged in prospecting and exploring oil and gas deposits in Uzbekistan (along with their contractors and subcontractors) are exempted from “all types of taxes, deductions, and payments” in force in Uzbekistan during the period of prospecting and exploration, as well as customs duties (except for those for payment of customs formalization) when importing equipment, material, and technical resources and services needed to conduct prospecting, exploring, and related activities.²⁸

On 25 May, 2000 the Oliy Majlis (Parliament) of the Republic of the Uzbekistan adopted the Law on Licensing of Specific Kinds of Activity (published on 15 June, 2000) (Licensing Law). The Licensing Law is effective from 1 September, 2000 and provides the general legal framework for licensing.²⁹

F. The Uzbek PSA Law: Generally

With all the positive influences on the oil and gas sector provided by Decree UP-2598, its effect on further development of contractual relationships in the sector was limited. This led to enactment of a full-fledged PSA Act at the end 2001. On 7 December, 2001 Oliy Majlis (Parliament) of the Republic of Uzbekistan adopted Resolution No. 312-II On Enactment of the Act On Product Sharing Agreements (PSA Act).³⁰

A key concept of a PSA (according to the PSA Act itself) is that the Uzbek state grants to a foreign investor for a certain period of time exclusive rights to search for, explore deposits and extract minerals in a specified segment of subsoil. In return the investor is obliged to fulfill work plans determined by the agreement at its own risk and expense, as well as to transfer a share of the extracted product or its monetary equivalent to the State.³¹

²⁷ Ibidem.

²⁸ Ibidem.

²⁹ See: Law No 71-II On Licensing of Specific Kinds of Activity dated 25 May, 2000 (published on 15 June, 2000).

³⁰ See: Republic of Uzbekistan, On Agreements on the Division of Products, Law No. 312-II, 7 December, 2001.

³¹ Ibidem.

The Uzbek government has been hoping to attract \$400 million of foreign investment through production-sharing agreements (PSAs). Of the 80 fields offered under PSA arrangements, 78 fields are located in 16 exploration blocks. Eight individual fields, with total reserves of some 1.2 bn barrels of oil equivalent, have been opened up for potential foreign participation. Those fields include four in the southwestern Gissar Basin and four in the Amu Darya region.³²

However, success under PSA laws has been limited because foreign companies perceive the PSA terms as less attractive than those offered in other parts of Central Asia and Russia. Investors readily cite increased political risks in Uzbekistan due to Islamic opposition to President Karimov.³³

Such lack of success has serious implications for Uzbekistan. Uzbek government targets in their long-term resource development plans are rarely achieved. Under a program started in the 1990s, the Uzbek government predicted that Uzbekistan's oil production should reach 450,000 b/d by 2001. However, in 2001 the actual production of oil and condensate averaged only about 171,000 b/d.³⁴

G. Production Sharing Agreements Generally

Both the investor and the host government have incentives to pursue development in oil and gas. But both face significant risks—legal, economic and environmental risks. Balancing these incentives with these risks is the key challenge facing the investor and host government for the development of these projects. The goals of host governments like Uzbekistan: to first attract capital in order to develop the oil infrastructure and the domestic economy as a whole. Once the investment is in place, many host countries turn more attention to both economic growth, protection of the environment, and other domestic issues. The goal of energy companies is to achieve a reasonable rate of return, long term rights to produce and export oil and gas, fiscal and contractual stability for the life of the contract, and management of the operations on good commercial and environmental terms.³⁵

There are special characteristics of an energy investment. First, the contract duration and the exposure to risk are long. Second, the amount of capital is enormous. And third, the types of risk are varied—from commercial to political to environmental. There are risks to property rights and land titles, risks of expropriation, risks of tort liability, risks of depletion and extraction, and currency risks. And one of the biggest problems facing energy companies investing abroad is the risk of unpredictable regulation.

Once an investment proves successful, a host country sometimes tries to change the terms of an investment relationship by imposing new taxes or environmental regulations. When profits are large, domestic public pressure and government priorities can cause a host country to push for a greater share of the investment returns than was provided in the original contract. Among the many techniques used to increase “government take” are the initiation of such taxes as environmental taxes to compensate for alleged extraction damage, taxes to help train the national workforce, taxes to improve public health and safety, or taxes to provide compensation to communities near the project site. Sometimes an environmental law which previously existed but has never been enforced is applied.

³² See: *APS Review Gas Market Trends, Uzbekistan: Privatization*, Vol. 63, Issue 15, 11 October, 2004.

³³ *Ibidem*.

³⁴ *Ibidem*.

³⁵ See: M. Flores, “A Practical Approach to Allocating Environmental Liability and Stabilizing Foreign Investments in the Energy Sectors of Developing Countries,” *Colorado Journal of International Law and Policy*, Winter 2001.

Once a project proves profitable, the energy company is subject to a “*hostage effect*,” where the host government sees the deep pockets of western energy firms, and tries to extract more from them.³⁶ Because the energy firm has now sunk considerable fixed costs into the project, and also sees the proven revenue stream, abandoning the project is more difficult. Bargaining power shifts to the host government, and foreign investors are left to adjust to new circumstances.

One major solution to the hostage effect and its discouragement of foreign investment is the production sharing agreement. This is an avenue used by many oil and gas-producing countries, and is now present in Uzbekistan.

H. Definition of PSA

Production Sharing Agreement (PSA) enabling laws are implemented by a host country to set up an environment for the host country and the foreign investor to conclude a PSA contract. PSA contracts have been around for many years, and have been used by many oil-producing countries to entice foreign investors—examples include Libya, Egypt, Kenya, Peru, and more recently, Russia.³⁷ A typical PSA contract will include special provisions which serve to protect investors by insulating them from the volatile political and economic environments found in these countries.³⁸ Such provisions are one way around the “hostage effect” discussed above.

A PSA works by forcing the investor and host country to enumerate all their rights and obligations for a proposed energy investment—short-term provisions and long-term ones. Given the special jurisdiction provisions of the PSA enabling law of the host country, disputes arising under the specific PSA contract will be settled not by the courts of the host country—but by international arbitration or courts of a third, neutral country.³⁹ This “neutral corner” is a crucial part of the PSA concept.

When oil or gas is found, the revenue provisions of the PSA contract aim to balance several objectives, including:

- (1) cover the enormous up-front costs of exploration and extraction;
- (2) reward the foreign investors for taking the risk of supporting the project; and
- (3) reward the host country for the sale of its natural resources.

Thus, when oil or gas is discovered and sold, the foreign investors are allocated enough oil or gas to pay for the costs of the project (aptly labeled “Cost Oil”). Then the remaining oil and gas is split between the foreign investor (“Profit Oil”) and the host country (“Government Take”). The proportions of “profit oil” and “government take” will have been specified in the PSA contract.⁴⁰

Additionally, according to Mark Stoleson, a crucial part of a PSA contract is that it is entirely “self-contained.”⁴¹ Stoleson writes that “by concluding a self-contained contract, the foreign investor is able to obviate the existing legal environment and acquire guarantees of certainty and protection

³⁶ Ibidem.

³⁷ See: G.B. Conine, *Petroleum Licensing: Formulating an Approach for the New Russia*, 15 HOUS. J. INT’L L. 362, 1993.

³⁸ Ibidem.

³⁹ See: G.C. Moss, *Petroleum Investments in Russia: Newly Enacted Law on Production Sharing Agreements Does Not Solve All Problems*, 10 January, 1996.

⁴⁰ See: E. Smith & John S. Dzienkowski, *A Fifty-Year Perspective on World Petroleum Arrangements*, 24 TEX. INT’L L.J. 13, 28, 1989.

⁴¹ *Investment at an Impasse: Russia’s Production Sharing Agreement Law and the Continuing Barriers to Petroleum Investment in Russia*, 7 Duke J. of Comp. & Int’l L. 671, 1997.

directly from the host state. Similarly, the host state benefits by attracting foreign investment while maintaining control over the specifics of large-scale oil projects.⁴²

For most PSA contracts, the host government will keep ownership over the underground resources from start to finish of the project.⁴³ This differs from other types of contracts, like a concession agreement, where the host government will sign over ownership of the underground oil or gas to the foreign investors.⁴⁴

I. Provisions of the Uzbek PSA Law

The following are selected, significant provisions of the 7 December, 2001 Uzbekistan PSA law:

- Rights to the promising subsoil segments without proven mineral resources shall be granted subject to the conditions of the PSA.⁴⁵ Rights to the subsoil segments with proven mineral resources shall be granted on the PSA basis only in the following instances:
 - (i) the State lacks necessary financial and technical means for exploration;
 - (ii) attraction of special modern technology is necessary; or
 - (iii) it is necessary to decrease the level of technological losses of minerals and prevention of possible negative socio-ecological consequences.⁴⁶
- Subsoil segments shall be granted on the basis of the PSA through open tenders. However, in certain instances the PSA can be negotiated directly with the authorized agency.⁴⁷
- A license for use of subsoil under the PSA shall be issued to the investor according to the procedure established by the Cabinet of Ministers or its authorized body within five working days after conclusion of the agreement.⁴⁸
- Uzbek citizens should comprise 80% of all workers under the PSA (calculated on an average annual basis).⁴⁹
- The investor has a right of ownership to a share of the product in accordance with the PSA and can export it out of Uzbekistan without any restrictions.⁵⁰
- Provisions of the agreement remain in force during the entire term of the agreement. If during the term of the agreement, changes in the legislation worsen commercial results of the investors activity under the agreement, relevant provisions of the agreement would prevail.⁵¹
- Disputes can be settled according to provisions of the PSA in a Uzbek court or, if the parties so choose, in international arbitration.⁵²

⁴² *Investment at an Impasse: Russia's Production Sharing Agreement Law and the Continuing Barriers to Petroleum Investment in Russia*, 7 Duke J. of Comp. & Int'l L. 671, 1997.

⁴³ See: J.W. Skelton Jr., *Investing in Russia's Oil and Gas Industry: The Legal and Bureaucratic Obstacles*, 8 NAT. RESOURCES & ENV'T. 26, 1993.

⁴⁴ See: E.E. Smith, *From Concessions to Service Contracts*, 27 TULSA L.J. 493, 527. 1992.

⁴⁵ See: Republic of Uzbekistan, On Agreements on the Sharing of Products, Law No. 312-II, Art 5, 7 December, 2001.

⁴⁶ *Ibidem*.

⁴⁷ *Ibid.*, Art 6.

⁴⁸ *Ibid.*, Art 9.

⁴⁹ *Ibid.*, Art 12.

⁵⁰ *Ibid.*, Art 16.

⁵¹ *Ibid.*, Art 24.

⁵² *Ibid.*, Art 28.

J. Problems with the Provisions of the Uzbek PSA Law

As Russia found with its PSA Law (and probably most other countries using a PSA regime), the chosen PSA legislation is not immediately perfect. Several provisions of the 2001 Uzbekistan PSA Law have been cited as problematic—or at least candidates for improvement from the prospective of foreign investors. One major problem with the PSA law (in lease in investors' eyes) is Art 5, which limits PSA-eligible fields only to those which do not have proven mineral resources. Essentially, this clause keeps the most promising fields under the control of Uzbek officials while the riskiest fields are left open to foreigners. Because a major portion of Uzbek land has been already surveyed, the location of proven reserves are largely determined already. The attractiveness of the Uzbek PSA scheme is thus severely reduced.

While Art 5 provides one problem, there are others. First, at least one clause of the act appears to reserve *carte blanche* control for the Uzbek authorities in the event of unforeseen developments or disputes. Art 26 of the PSA LAW stipulates that, “the Cabinet of Ministers of the Republic of Uzbekistan or authorized agencies execute state control over implementation of the agreement, including over terms of execution of work by the investor in keeping with the legislation.”⁵³

Second, while it is clear that licensing remains crucial in Uzbek oil and gas exploration, the licensing regime remains less than transparent for foreign investors. The PSA Law is incomplete in terms of subsoil licensing. Although the PSA Law provides for issuance of a subsoil use license within five days,⁵⁴ Uzbek legislation that regulates the procedure of issuance of such a license does not exist. Another act, On Subsoil, agrees that a license is necessary, but fails to completely spell out how to get one.⁵⁵

Decree No. UP-2598 is the only legal act that clarifies the State agency that is responsible for issuance of a license. The decree authorizes the National Holding Company Uzbekneftegaz to issue licenses for prospecting, exploration and extraction of minerals in Uzbekistan, although the decree also fails to define the procedure for obtaining a license.⁵⁶

Third, while the PSA regime provides for expense reimbursement for foreign exploration and production, a peculiarity of the 2001 Act seemed to mean a large portion of expenses would not be reimbursed. Under the original 2001 PSA law, expense compensation was limited to one year—a rule that significantly reduced the attractiveness of PSA agreements to foreign investors. In particular, Art 14 of the Act says that that “recoverable expenses should be compensated from the recovery product in the same calendar year that the expenses were accrued.”⁵⁷ The problem with such a rule is that it prevents investing developers from carrying exploration and production expenses over from one calendar year to the next—which often would lead to no compensation at all for this portion of expenses.⁵⁸ In addition, Art 14 explicitly lists out many inventory expenses for which the PSA Law does not provide compensation to investors.⁵⁹

Finally, Saporov and Frolov of Baker and McKenzie point out several other problems with the Uzbek PSA Law, including:

⁵³ Ibid., Art 26.

⁵⁴ Ibid., Art 9.

⁵⁵ See: Republic of Uzbekistan, The Law on Subsoil.

⁵⁶ See: V. Saporov and A. Frolov of Baker and McKenzie, *op. cit.*, p. 34.

⁵⁷ See: Republic of Uzbekistan, On Agreements on the Sharing of Products, Law No. 312-II, Art 14, 7 December, 2001.

⁵⁸ See: V. Saporov and A. Frolov of Baker and McKenzie, *op. cit.*

⁵⁹ See: Republic of Uzbekistan, On Agreements on the Sharing of Products, Law No. 312-II, Art 14, 7 December, 2001.

- (1) the law contains little or no provisions as to the tax treatment of the operator—meaning the tax preferences for the investor might not be applied to the operator; and
- (2) the PSA law does not spell out regulation of foreign companies' branch offices located inside Uzbekistan—causing further uncertainty in investors' tax liability.⁶⁰

K. So Many Laws to Follow

Possibly the most significant problem with Uzbek investment law is the uncertainty created by having so many investment laws controlling oil and gas FDI into Uzbekistan. Several of these laws are described below.

The Law on Concessions of 30 August, 1995 (the “Concession Law”) provides the legislative basis for this common contractual form of mineral resource development. This Law has not yet been applied widely in practice. A PSA is normally considered a form of a concession, while the Concession Law (like the Subsoil Law) does not expressly provide for PSAs.⁶¹

Presidential Edict No. UP-1652 of 30 November, 1996, as amended, “On Additional Incentives and Privileges for Enterprises with Foreign Investments” (the “Foreign Investment Edict”) offers reduced tax rates to enterprises that attract substantial amounts of foreign investment.⁶²

The Law on Foreign Investments of 30 April, 1998, as amended, (the “FIL”) and the Law on Guarantees and Measures to Protect the Rights of Foreign Investors, also of 30 April, 1998 (the “IGL”) (together, the Investment Laws), provide some basic guarantees to foreign investors meeting certain threshold requirements.⁶³

Presidential Edict No. UP-2598 of 28 April, 2000, On Measures to Attract Direct Foreign Investments into Oil and Gas Exploration and Production (the “Petroleum Investment Edict”) hoped to increase foreign investment in Uzbekistan for the exploration of hydrocarbon fields in the Ustiurt and other areas. This law provided a number of valuable concrete rights, preferences, and tax benefits for foreign companies and their joint venture and concession form investments.⁶⁴

L. Efforts to Improve the Uzbek PSA Regime

In July of 2003, the government of Uzbekistan decided to create a special state commission to examine feasibility studies of projects to be conducted under PSA, determine the conditions for using subsurface resources by investors, and make decisions on specific agreements. The plan of the Commission was to determine the payments for the use of subsurface resources, terms of taxation, procedures for sharing product, and will handle other matters pertaining to PSA projects. The goal was to improve the PSA regime.⁶⁵

⁶⁰ See: V. Saparov and A. Frolov of Baker and McKenzie, *op. cit.*, pp. 34-35.

⁶¹ See: Republic of Uzbekistan, The Law on Concessions (adopted 30 August, 1995).

⁶² See: Republic of Uzbekistan, Presidential Decree No. 1652 On Additional Incentives and Privileges Granted to Enterprises with Foreign Investments (issued 30 November, 1996).

⁶³ See: Republic of Uzbekistan, Law No. 609-I, On Foreign Investments (adopted 30 April, 1998).

⁶⁴ See: Republic of Uzbekistan, Presidential Decree (unnumbered) On Measures to Attract Direct Foreign Investments into Oil and Gas Extraction (issued 28 April, 2000).

⁶⁵ Interfax Petroleum Report, *Uzbekistan Working to Speed Up PSA Projects*, 30 July, 2003.

Later in 2003, formal amendments were made to the PSA Law in the hopes of addressing investor concerns. The 31 October, 2003 amendments were hoped to make it possible to attract even the most demanding investors into PSAs in Uzbekistan. Specifically addressing the concern on expense reimbursement, one of the amendments gave investors in-kind compensation for funds spent on field development under a PSA, beginning in the calendar year when commercial production begins. The new version of the PSA law states that spending by an investor not reimbursed in the current calendar year will be reimbursed in subsequent calendar years during the implementation of the project.⁶⁶

M. Conclusions

The Uzbek government is active on many fronts in their efforts to bring foreign investment dollars into Uzbekistan's abundant oil and gas fields. The centerpiece of the Uzbek legislative effort has become the 7 December, 2001 production sharing agreement law. A number of amendments have been made to the law, and a number of deals have been signed under the PSA regime. However, it appears that certain provisions of the PSA limit its appeal to foreign investors, and the general perception of Uzbekistan as a risky investment seem to have prevented the legislation from fulfilling its drafters' optimistic predictions.

⁶⁶ See: Republic of Uzbekistan, Amendments to the PSA Act, 31 October, 2003.