

Evolution and Developments of Oil and Gas Legislation in Uzbekistan

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On December 7, 2001 Oliy Majlis (Parliament) of the Republic of Uzbekistan adopted Resolution No. 313-II On Enactment of the Act "On Product Sharing Agreements" ("PSA Act"). The importance of this Act for attraction of foreign investment in the oil and gas sector and in general is difficult to overestimate.

Enactment of the PSA Act became the logical continuation of the State policy in the oil and gas sector, which has been taking shape during the last several years. Beginning in 1998, the Government of Uzbekistan conducted a program to attract foreign investors to develop oil and gas deposits in the territory of Usturt plato in the Southwest of Uzbekistan, which, according to preliminary estimates, contains 4 billion tons of oil. Although initially Western oil companies did not show the expected interest in deposits, in the beginning of the last year the Government's efforts finally provided positive results. In March of 2001, the National Holding Company "Uzbekneftegaz" signed Uzbekistan's first agreement on product sharing ("PSA"), with the British company "UzPEK Limited" to conduct prospecting and exploration of deposits in the territories of Central Usturt and Southwest Gissar.

It is interesting that on the signing date of the above-mentioned agreement, a draft of the PSA Act was still being reviewed by the ministries and agencies. The Decree of the President No. UP-2598 "On Measures on Attraction of Direct Foreign Investment in Prospecting and Development of Oil and Gas" of April 28, 2000 ("Decree No. UP-2598") served partially as a legal basis for signing the PSA. Within the scope of the Decree No. UP-2598 it was defined that "intensive prospecting and exploratory work in Usturt region and other regions of the Republic with promising oil and gas reserves and extensive attraction of direct foreign investment for such work are impor-

tant priorities in the development of the oil and gas sector." Although Decree No. UP-2598 does not mention the PSA, the content of the decree and, particularly, provisions on granting most favorable regime to foreign companies indirectly allowed the use of the decree for purposes of drafting the PSA.

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. First, in order to create such a complex mechanism as the PSA it is required to have more detailed legal regulation. Second, it is necessary to point out that certain provisions of the decree did not correspond to existing Acts "On Subsoil" and "On Concession". If the letter of the law is to be followed, Acts stand above Presidential decrees in the hierarchy of laws. However, considering that the executive branch's power in Uzbekistan is quite strong, it is not entirely clear which legal act would prevail in the event of controversy. Third, it was not clear, how on the basis of separately enacted legal acts it would be possible to create a unified, consistent set of legal rules that are necessary to draft and sign a PSA.

This led to enactment of a full-fledged PSA Act at the end of last year. The main purpose of the Act is to regulate relations arising in the process of entering into, implementing and terminating a PSA, when investing in prospecting and exploration of deposits and extraction of minerals in Uzbekistan. The principal idea of the PSA, according to the PSA Act, is that the 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 ex-

tracted product or its monetary equivalent to the State.

In accordance with the PSA Act, the parties to the agreement consist of the Cabinet of Ministers of the Republic of Uzbekistan (or its authorized body) and the foreign investor, which can be represented by a consortium of legal entities without status of a legal entity.

The PSA Act contains the following main provisions:

- ! 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.
- ! Parties are free to determine the terms 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 investor's 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.

Although the PSA Act calls for issuance of a subsoil use license within five days, legislation that regulates the procedure of issuance of such a license does not exist. Act "On Subsoil", although establishing the necessity to obtain a subsoil use license, does not provide an answer to where and how the necessary license can be received. 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.

Note, that for a PSA to operate effectively, conditions of recovery of the investor's expenses, tax regime and guarantees of its stability granted by the State to the investor, its contractors and subcontractors are especially important. The PSA Act contains fairly standard provisions on tax regime, components and recovery of expenses. At the same time, the Act contains provisions on recovery of expenses that reduce the economic attractiveness of the PSA to potential investors. For instance, Article 14 of the Act states that recoverable expenses should be compensated from the recovery product in the same calendar year that the expenses were accrued. This requirement virtually prohibits carrying expenses over to the following calendar years, which may not allow an investor to be compensated for a large portion of incurred expenses. This is particularly true at stages of the PSA when the investor undertakes main capital investments in development of appropriate subsoil segment. Also, Article 14 contains a long list of investor's expenses that cannot be included in the recoverable expenses.

Another shortcoming of the PSA Act is that it contains almost no provisions on the tax regime of an operator under the PSA, which means that the tax regime of the investor does not necessarily apply to the operator. It is not clear whether under current language of the PSA Act it would be possible to establish within the content of the PSA the tax regime of an operator similar to the investor's tax regime.

The absence of legal regulation of activity of foreign companies' branches on the territory of Uzbekistan is one of the indirect limitations of Uzbek legislation for projects based on the PSA. According to common international practice,

a foreign investor or a group of investors as a party to the PSA will create a company-operator in an offshore jurisdiction to run the project through a branch. This is done to optimize the tax consequences. Article 13 of the PSA Act provides a general possibility to create a separate branch to conduct the operation. However, at the present time, the legal regulation on creation of branches of foreign companies in Uzbekistan does not exist. Subsequently, the procedure of creation and carrying out activities of a branch operator under the PSA is ambiguous and, in the absence of an appropriate Act that regulates this matter, the possibility of amending relevant provisions of the PSA itself appears problematic.

In accordance with the PSA Act, an investor receives guarantees of protection of property and other rights acquired by the investor in the process of implementation of the PSA. In addition, the PSA Act directly provides for the possibility of international arbitration as a venue to settle disputes between the State and an investor. It is necessary to indicate that for the PSA to be able to effectively protect an investor's rights, in particular to file a suit, provide for enforcement of arbitration tribunal award, attachment of property or use of provisional remedies, the PSA should, in accordance with common international practice, include the waiver of State franchise, waiver of immunity concerning provisional remedy and waiver of immunity with respect to enforcement of judgment/award. If the authorized agency of the Cabinet of Ministers represents the State in the agreement, the investor should obtain written guarantees of the Cabinet of Ministers in order to secure implementation of obligations under the PSA, including the abovementioned provisions.

In general, by adopting the PSA Act, the Government of Uzbekistan demonstrated that it is serious about improving the investment climate in the oil and gas sector. At the same time, the PSA Act requires certain amendments to make it truly an effective instrument for attraction of foreign investment. Also, it is necessary to develop or bring into compliance with the PSA Act certain legal acts that correlate with the PSA Act. Recent legislative developments in Uzbekistan indicate that potential investors can hope that it will not be long before necessary changes to improve oil and gas legislation are passed. (© 2002) □