

Turkmenistan's Oil and Gas Overview: Legal Regime of the Oil and Gas Industry of Turkmenistan

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Introduction

The legal regime applicable to foreign investments in Turkmenistan's oil and gas industry is based on the general rule that oil, gas and other subsoil resources are the exclusive property of the State. Rights to engage in subsoil activity, however, may be granted to foreign individuals and legal entities.

The principal statute regulating the activities in the oil and gas sector in Turkmenistan is the *Petroleum Law*¹ which was followed by subsequent legal acts, such as the *Petroleum Law Implementation Decree*², approving the *Regulations on the Competent Body for the Use of Hydrocarbon Resources*, a *model production sharing agreement as well as a model joint activities agreement*, *Customs Clearance Rules*³, and *Petroleum Development Rules*⁴.

This article examines the legal regulation of petroleum operations performed by foreign investors in Turkmenistan, providing a short review of licensing aspects, taxation of petroleum operations, the choice of law and arbitration applicable to petroleum operations contracts and other relevant legal issues.

Licensing of Petroleum Operations

The *Petroleum Law* establishes a legal framework for the exploration, development and other activities related to the production of hydrocarbon resources in Turkmenistan, including provisions relating to the licensing of petroleum operations. Under the *Petroleum Law*, a mineral license is defined as a legal instrument instituted in the form of a legal act, and, when issued by the competent authority of Turkmenistan, grants its holder the right to conduct all or any specific type of petroleum operations.

Under the *Regulations on the Competent Body for the Use of Hydrocarbon Resources*, the Competent Body is an administrative agency which has the exclusive authority to conduct negotiations, issue mineral licenses and conclude agreements relating to hydrocarbon resources, as well as to moni-

tor the implementation of agreements relating to the use of hydrocarbon resources in Turkmenistan.

Types of Licenses

Pursuant to Article 7 of the *Petroleum Law*, the following types of mineral licenses may be issued to a contractor:

- ! an exploration license – this grants the right to carry out petroleum operations in order to search for and appraise hydrocarbon resources as well as to carry out other necessary activities relating to the exploration stipulated by the relevant agreement;
- ! a production license – this grants the right to carry out petroleum operations in order to develop and produce hydrocarbons including development, completion, production, sales and other types of activities necessary for, or relating to, carrying out the foregoing activities; and
- ! a combined license for both exploration and production – this grants the right to carry out petroleum operations within the combined scope of activities allowed under an exploration and production licenses.

Pursuant to Article 8 of the *Petroleum Law*, all three types of licenses may be issued either by:

- ! tender proceedings; or
- ! direct negotiations carried out by the Competent Body with a prospective contractor.

The method for the issuance of a mineral li-

¹ See Turkmenistan Law "On Hydrocarbon Resources" dated 30 December 1996.

² See Presidential Decree No. 3189, On Measures to be Taken for the Implementation of Turkmenistan Law "On Hydrocarbon Resources" dated 6 June 1997.

³ See Rules for Customs Clearance Procedures for the Importation of Goods, Materials and Equipment Required for the Implementation of Petroleum Operations, and for the Export from Turkmenistan of Such Goods, Materials and Equipment, and also for the Export of Crude Oil and Natural Gas Due to Contractors Carrying Out their Activities under the Petroleum Law, approved by Presidential Decree No.4390 dated 28 September 1999.

⁴ See Rules and Regulations for the Development of Hydrocarbon Fields of Turkmenistan in the Golden Age of the Turkmen Nation, approved by Presidential Decree No. 4416 dated 22 October 1999.

license is, in each case, determined by the Government of Turkmenistan.

Turkmenistan still operates a dual system whereby contractors require both a subsoil use contract and a license, albeit there is a large overlap between the two documents. According to the *Petroleum Law* a contractor may operate on a basis of a production sharing agreement, a joint activities agreement, a combined agreement or other type of agreement and the agreements are to be finalized, and the agreement executed, simultaneously with obtaining a license. Article 13 specifically provides that a foreign individual or a legal entity may be granted a license only upon the individual's registration in Turkmenistan as an individual entrepreneur or after a foreign legal entity has established a branch in Turkmenistan or registered as a participant of a joint activity.

The Government can decide to award rights by way of tender proceedings, which can be either open to all applicants or closed (i.e. open only to a limited number of short-listed participants). The tender specifications are to be forwarded to all potential bidders not later than 90 days prior to the tender commencement date. The *Petroleum Law* introduces a quite standard two-stage tender proceedings: submission of applications as to the participation in the tender and subsequent submission of bids.

Pursuant to Article 15, a mineral license is issued by the Competent Body after such license has been approved by a Presidential decree. The license granted shall specify the particular type of petroleum operations which the contractor may conduct. No contractor shall be entitled to carry out petroleum operations other than those specified in the license. The contract terms and conditions shall be fully correspondent to the license terms and conditions.

Term and Termination

Under Article 18 of the *Petroleum Law*, an exploration license may be granted for a period of up to six years with a provision allowing for two possible 2-year renewals, provided that the license holder has fulfilled the work program and other obligations stipulated by the exploration license and the respective agreement. A production license may be issued for a period of twenty years and can be renewed for another five years provided that the relevant application for the license extension is submitted not earlier than two and not later than one year prior to the expiration of the term of the produc-

tion license. A combined license for exploration and production may be granted for a period which includes the validity periods of both exploration and production licenses including their possible extensions, i.e., for a period of up to thirty-five years.

The term of a license starts from the date of its registration and simultaneous registration of the agreement by a competent governmental authority.

Article 20 of the *Petroleum Law* stipulates that the validity of a license ceases **(i)** upon expiration of its term or the term of its extension, **(ii)** upon its revocation on the grounds detailed below and **(iii)** upon termination of a respective agreement on the grounds stipulated therein.

Under Article 21 of the *Petroleum Law*, a mineral license may be suspended by the Competent Body on the following grounds:

- ! a contractor performs petroleum operations that fall outside the scope of a license;
- ! a contractor performs petroleum operations that fall within the scope of a license, but the operations are not carried out in accordance with the work program stipulated by the relevant agreement; or
- ! while performing its activities, a contractor repeatedly violates Turkmenistan subsoil law, environmental protection law and work safety rules.

The Competent Body issues a written notice to a contractor on the suspension of the license detailing the reasons for such suspension and sets reasonable deadlines for such contractor to rectify indicated problems. The Competent Body, however, is obligated to reactivate the suspended license immediately after the violations that caused the suspension have been rectified. Pursuant to Article 21 of the *Petroleum Law*, the suspension or reactivation of a license automatically suspends or reactivates a respective agreement.

Under Article 22 of the *Petroleum Law* the Competent Body may revoke a license on the following grounds:

- ! the license holder refuses to cure the violations which caused the suspension of a license, or if such violations have not been cured within a certain period of time;
- ! the license holder provided the Competent Body with false information that materially affected the Competent Body's decision to grant the license;

! the license holder deliberately violates the timetable for the signing and registering an agreement as well as the timetable established by the underlying agreement for the commencement of petroleum operations; and

! in other cases stipulated by the Petroleum Law.

According to this article of the *Petroleum Law*, the revocation of a license results in the termination of the respective agreement, as it was concluded on the basis of such license.

Assignment

Article 50 of the *Petroleum Law* allows a contractor to assign its rights under a respective agreement and a mineral license in whole or in part to any third party with the prior written consent of the Competent Body. Pursuant to Article 27.2 of the *model production sharing agreement*, which was approved by the *Petroleum Law Implementation Decree*, if the rights are assigned to a third party which is neither an affiliated company to a contractor nor another contracting company (a contractor's participant), the Competent Body should not unreasonably withhold its consent to such assignment, provided the assignor is not in breach of its obligations under the production sharing agreement and the assignee undertakes to be bound by the terms and conditions of such agreement.

Further, under the *Petroleum Law* a contractor may, without obtaining written approval of the Competent Body, also assign its rights to its affiliated company or any of a contractor's participants, in the instance when several participants form part of such contractor, provided, however, that the contractor furnishes the Competent Body with a written document signed by an authorized person confirming that the contractor shall be jointly liable for all of the actions of its successor. In addition, the *model production sharing agreement* (Article 27.1) provides that a contracting company (a contractor's participant) may assign its rights to an affiliated company or another contracting company under the production sharing agreement without prior written consent, provided that the assignor is not in default of its obligations, and its successor undertakes to be bound by and fulfill the terms and conditions of the agreement.

It should be noted that despite the fact that a *model production sharing agreement* was approved by the *Petroleum Law Implementation Decree*, its provisions and the wording are arguably not binding on a prospective investor but rather repre-

sent a set of basic legal guidelines which should be followed by the parties negotiating a production sharing agreement, by virtue of Article 24 of the *Petroleum Law*. It is, however, not clear which of the provisions of the indicated model agreements may be modified, or to what extent, in the course of negotiations.

Taxation of Petroleum Operations

Among other issues, the *Petroleum Law* covers provisions relating to the taxation of contractors and their subcontractors involved in petroleum operations. The *Petroleum Law* defines a contractor as an individual or a legal entity that holds a license (exploration, production or a combined license) to operate within the boundaries of a specified territory, and has concluded a contract with a competent governmental authority in accordance with the *Petroleum Law*.

The *Petroleum Law* provides a favorable tax and customs regime for a contractor and its subcontractors. Chapter 9 of the *Petroleum Law* is specifically dedicated to the financial and fiscal regime for contractor's and its subcontractors' activities.

Article 48 of the *Petroleum Law* provides that a contractor is liable to make mandatory payments to the government in the form of:

- ! profits tax;
- ! a royalty on petroleum production; and
- ! signing and production bonuses.

Profits Tax

Under the *Petroleum Law*, a contractor and its subcontractors are subject to profits tax at the rate set by Turkmenistan law. The current rate for profits tax is 25% and is generally applicable to a contractor. Article 48 of the *Petroleum Law* provides that subcontractors are subject to profits tax at the same rate as the contractor, that is 25%, and are liable to pay the same types of taxes, which are applicable to the contractor. It should be noted, however, that neither a contractor nor its subcontractors are exempt from paying other taxes, which may be due in connection with their activities unrelated to petroleum operations.

Under a general rule set forth in the *Profits Tax Law*⁵ and the *Law on Amendments to the Profits Tax Law*⁶, those

⁵ See Turkmenistan Law "On Profits Tax" dated 8 October 1993, as amended.

⁶ See Turkmenistan Law "On Amendments to the Profits Tax Law" signed on 12 July 1999 and effective as of 1 August 1999.

foreign legal entities doing business in Turkmenistan through a permanent establishment or receiving income from sources in Turkmenistan are subject to the profits tax. *The Law on Amendments to the Profits Tax Law* defines a permanent establishment as the following: (i) a branch or divisional office, a place of management, office, bureau, factory, workshop; (ii) a mine, oil and gas well, quarry or any other place of business activity relating to the exploration and production of mineral resources as well as related supervisory activities; or (iii) performance of work stipulated by construction, installation, setup, assembly, service and repair contracts as well as supervisory activities relating to these works with a total duration of the aforesaid works/activities exceeding 6 (six) months.

Those foreign legal entities whose activities do not constitute a permanent establishment in Turkmenistan, are subject to a withholding tax at the rate of 15% on income received from a source in Turkmenistan, including payments for services rendered in Turkmenistan. Therefore, those subcontractors whose activities do not constitute a permanent establishment in Turkmenistan are subject to a withholding tax at the rate indicated.

The *Petroleum Law* provides that the tax base for profits tax is determined by the respective agreement. The *model production sharing agreement* approved by the *Petroleum Law Implementation Decree* provides that the tax base is determined by deducting the following: (i) operating expenses, fully deducted when such expenses are incurred; (ii) exploration expenditures, depreciated at a maximum depreciation rate of 50% per annum by the straight line depreciation method; (iii) completion and production expenditures, depreciated at a maximum depreciation rate of 25% by the straight line depreciation method; and (iv) any other expenditure which under the accounting procedures outlined in the agreement fall under the definition of operating, exploration, completion and production expenditure deducted or depreciated in a manner described in items (i) – (iii) above.

It should be noted that despite the fact that the *model production sharing agreement* was approved by the *Petroleum Law Implementation Decree*, its provisions and the wording are commonly viewed as not binding on a prospective investor, but rather represent a set of basic legal guidelines which should be used and followed by the parties in the course of negotiating a production sharing agreement. It is, however, not clear which of the provisions of this model agreement may be modified in the course of negotiations, nor to what extent.

Finally, Article 48 of the *Petroleum Law* contains a provision whereby in the event new taxes or levies are introduced after the respective agreement has been concluded, the contractor will be obliged to make only those payments which have been introduced to replace those that the contractor is already subject to, provided that the amount of overall mandatory payments of the contractor does not exceed its fiscal liabilities at the time the agreement was concluded.

Royalty on Petroleum Production

Pursuant to Article 48 of the *Petroleum Law*, the rates of royalty payments are to be established by agreement, that is, through negotiations between the parties. The *model production sharing agreement* (Article 34.1) provides for royalty payments calculated on the basis of daily oil and gas production. According to this model agreement, such payment should be made within fifteen days of the end of each calendar quarter.

Signing and Production Bonuses

Under the *Petroleum Law* the respective agreement may provide for the payment of bonuses by a contractor. Such bonuses may be payable on signing the agreement or upon achieving a certain production rate.

The *model production sharing agreement* stipulates that a signing bonus should be paid within thirty days from the effective date of the agreement, that is after the respective agreement has been duly executed and registered, and after receipt by the contractor of the operating license. Production bonuses are payable on a sliding scale depending on the level of cumulative production established by the agreement, within thirty days of achieving such levels.

Social Security Contributions

Article 54 of the *Petroleum Law* provides that issues of social security for a contractor's local personnel are regulated by Turkmenistan law. Therefore, in addition to mandatory payments mentioned above, a contractor is liable for an employer's mandatory contributions to the Social Security Fund payable monthly on local employees' salaries at the rate of 20%. According to Article 48 of the *Petroleum Law*, a contractor's and its subcontractor's personnel are subject to personal income tax in accordance with Turkmenistan law and

the provisions of the agreement. The current personal income tax rate varies from 8% to 12% for residents, non-residents and stateless individuals depending on the amount of their particular personal income. Residents are, generally, individuals that are physically present in Turkmenistan for 183 days or more in a single calendar year.

Above all, the contractor must arrange for the insurance of life and health of its employees and all other persons engaged from time to time in petroleum operations conducted by the contractor.

Customs Duties and Charges

Under Article 47 of the *Petroleum Law*, all materials and equipment required for the conduct of petroleum operations may be imported into Turkmenistan free of any customs duties. Pursuant to this article, however, a contractor and, by analogy, its subcontractors, shall not be exempt from paying customs duties while performing other activities that are not related to petroleum operations.

The procedure for customs clearance of such goods is further detailed in the *Customs Clearance Rules*. Article 3 of the *Customs Clearance Rules* established the procedure whereby the customs clearance of imported goods and exported hydrocarbons is carried out without payments of any customs duties, excise taxes, clearance fees, export or import taxes or other payments due on imports or exports. The *model production sharing agreement* contains a provision stipulating such an exemption for a contractor and its non-Turkmen subcontractors, provided, however, that the imported materials and equipment are related to the conduct of petroleum operations, and no similar goods are locally manufactured and available for timely delivery to the contractor at a price equal to the cost of imported goods. Article 23.7 of the *model production sharing agreement* contains wording exempting the exports of a contractor's share of oil and gas from either obtaining any special export licenses or paying any duties, levies or any other charges on such exports.

Choice of Law and Dispute Resolution

It appears that there are no strict requirements established by the *Petroleum Law* or the *Civil Code*⁷ of Turkmenistan regarding the choice of law applicable to the petroleum operation agreements. Therefore in order to better secure the foreign investor's interests, a petroleum operation agreement and all disputes between the parties arising

from this agreement, especially the ones related to its early termination or amendments of its terms, may be governed and resolved in accordance with foreign (i.e. non-Turkmenistan) law and in foreign dispute resolution forums.

However the *model production sharing agreement* (Art. 29.1) as well as the *model joint activities agreement* (Art. 29.1) stipulate clearly, that both model agreements shall be governed, interpreted and construed in accordance with Turkmenistan laws. Although these model contracts are generally considered to be only recommended templates, rather than mandatory, it should be noted that even if the parties to a petroleum operation agreement specify foreign (i.e. non-Turkmenistan) law as the governing law, their actual activity would still be subject to the imperative norms of Turkmenistan law (e.g. environmental, labor, industrial safety, tax norms, etc.), unless otherwise specifically allowed by exceptions in the Turkmenistan law.

Pursuant to Article 56 of the *Petroleum Law*, disputes relating to the issuance, refusal to issue, suspension and revocation of a mineral license, as well as disputes in respect to the implementation of the agreement, are to be resolved through negotiations, including negotiations involving international independent experts, or in accordance with the procedures provided for in the relevant agreement. In the event that the dispute has not been resolved in this manner, the parties may resort to international arbitration provided for by the agreement. The *model production sharing agreement* contains a provision whereby a party to a dispute may submit the disputed matter to arbitration in accordance with UNCITRAL Arbitration Rules at a place selected by the parties. If such place has not been agreed upon within thirty days, the place of arbitration shall be Stockholm, Sweden. The *model production sharing agreement* provides that Turkmenistan law will be the governing law.

All other disputes, including those between a contractor and Turkmen legal entities and individuals, are to be resolved by competent courts of Turkmenistan unless otherwise agreed by the parties.

Article 61 of the *Petroleum Law* provides for a contractor's obligation to ensure that the Government is held harmless with respect to any actions and claims that may be brought against the Government in connection with the relevant mineral license activities of the license holder under the *Petroleum Law*.

⁷ See The "Civil Code of Saparmurat Turkmenbashi" effective as of 1 March 1999, introduced by the Turkmenistan Law "On Adoption and Introduction of The Civil Code of the Turkmenbashi" dated 17 July 1998.