**KHAZAR UNIVERSITY**

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**IPAG BUSINESS SCHOOL**

**PARIS**

# MASTER OF BUSINESS ADMINISTRATION THESIS

Topic: Production Sharing Agreements (PSAs) in Azerbaijan.
The case of Azeri–Chirag–Guneshli

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**SUMMARY**

*My name is Mohamed Ghandour and my thesis topic is, "Production Sharing Agreement PSAs in Azerbaijan, The case of Azeri–Chirag–Guneshli (ACG)." The objective of this Thesis is to define the characteristics of PSAs in Azerbaijan with a specific focus on the case of the ACG contract. The aim of this Thesis is to demonstrate the characteristics of PSAs in Azerbaijan using the contract which is considered to be the most important ever signed in Azerbaijan, the Azeri-Chirag-Gunashli (ACG) PSA. In this thesis, firstly an analysis is done on the various types of oil contracts most commonly used in oil producing nations around the world, followed by a discussion on the choice of PSAs as the principle form of oil contract in Azerbaijan. Following this, the general principles and components of PSAs are discussed; subsequently the specifics of PSAs in Azerbaijan are analyzed in depth and illustrated in the ACG contract. Moreover the benefits and shortfalls of these specifics are outlined. The research in this thesis is based strongly on information gathered from the ACG contract as well as expert publications on the topic of the oil industry and oil contracts, both in Azerbaijan and abroad. A large amount of information is gathered here to support the objective and aims of the thesis. In conclusion, this thesis identifies the characteristics of PSAs in Azerbaijan with a specific focus on the ACG contract. Based on the research performed, suggestions are made concerning possible changes that could be implemented in these types of contracts to attract further investment from International Oil Companies IOCs such as those involved in the ACG contract. The involvement of IOCs is essential in as the technology and knowhow they bring to the table is necessary to extend the current known reserves of the country through exploration and production in new, challenging areas.*

# XÜLASƏ

*Mənim adım Mohamed Ghandour. Tezis mövzum "Azərbaycanda İstehsal bölgü müqavilələri (PSA), Azəri-Çıraq-Günəşli (ACG) nümunəsi." adlanır. Tezisin tədqiqat obyekti ACG müqaviləsi nümunəsini əsas götürməklə PSA müqavilələrin Azərbaycanda xüsusiyyətlərini müəyyən etməkdir. Tezisin məqsədi Azərbaycanda indiyə kimi imzalanmış ən önəmli müqavilə hesab olunan Azəri-Çıraq-Günəşli müqaviləsindən istifadə etməklə PSA müavilələrin xüsusiyyətlərini göstərməkdir. Tezisdə ilk növbədə dünya üzrə neft istehsal edən ölkələrdə tətbiq olunan müxtəlif neft müqavilələri analyze olunmuş və Azərbaycanda PSA müqavilələrin əsas neft müqaviləsi kimi seçilməsi müzakirə edilmişdir. Bundan sonar PSA müqavilələrin ümumi prinsip və komponentləri müzakirə olunmuş; nəticədə Azərbaycanda PSA müqavilələrin xüsusiyyətləri dərindən analyze edilmiş və ACG müqaviləsində təsvir olunmuşdur. Bundan başqa bu xüsusiyyətlərin fayda və çatışmamazlıqları vurğulanmışdır. Bu tezisdəki tədqiqat əsasən ACG müqaviləsindən toplanmış məlumatlara, həmçinin Azərbaycanda və xaricdə neft sənayesi və neft müqavilələri haqqinda yazılmış ekspert nəşrlərinə əsaslanır. Burada toplanan geniş məlumat tezisin əsas məqsədinlərini dəstəkləmək üçündür. Nəticədə, tezis ACG müqaviləsinə diqqəti çəkməklə Azərbaycanda PSA müqavilələrin xüsusiyyətlərini üzə çıxarır. Edilmiş tədqiqata əsaslanaraq tezisdə ACG layihəsindəki kimi Beynəlxalq Neft Şirkətlərindən gələcəkdə də investisiya cəlb etmək üçün bu tip müqavilələrə mümkün dəyişikliklərin edilməsi təklifləri irəli sürülmüşdür. Beynəlxalq Neft Şirkətlətinin cəlb edilməsi çox mühümdür. Belə ki, onların gətirdikləri texnologiya və üsullar bilinən neft ehtiyatlarının istismar və istehsalını yeni və çətin yataqlara da tətbiq etmək üçün çox əhəmiyyətlidir.*

## LIST OF ABBREVIATIONS

| | |
|---|---|
| $ | US Dollars |
| ACG | Azeri-Chirag-Gunashli oil fields |
| AIOC | Azerbaijan International Operating Company |
| bbl | Barrel of Oil |
| bcm | Billion Cubic Meters (gas) |
| BP | British Petroleum |
| bpd | Barrels per day (oil) |
| BTC | Baku-Tbilisi-Ceyhan |
| CAPEX | Capital Expenses |
| EIA | U.S. Energy Information Administration |
| EITI | Extractive Industries Transparency Initiative |
| FDI | Foreign Direct Investment |
| GDP | Gross Domestic Product |
| IMF | International Monetary Fund |
| IOCs | International Oil Companies |
| NGO | Non-Governmental Organization |
| NOC | National Oil Company |
| OPEX | Operational Expenses |
| PSA | Production Sharing Agreement |
| PFMC | Public Finance Monitoring Centre |
| RROR | Real Rate of Return |
| SOCAR | State Oil Company of the Republic of Azerbaijan |
| SOFAZ | State Oil Fund of the Republic of Azerbaijan |
| tcf | Trillion Cubic Feet |
| tcm | Trillion cubic meters (gas) |
| VAT | Value Added Tax |

CONTENTS

## INTRODUCTION

The Republic of Azerbaijan is situated in the South Caucasus region, at the crossroads of South west Asia and Europe, It is surrounded by the Caspian Sea to the east, Armenia to the west, Georgia to the northwest , Russia to the north, and Iran to the south. Azerbaijan covers an area of 86.600 square kilometers and the population currently reaches about 8,303,512 (July, 2010 EST.).[1] As far as oil is concerned, Azerbaijan is considered one of the most important places in the world for oil and gas industry.

Azerbaijan has a very long history of oil exploration and production; according to the U.S. Energy Information Administration (EIA), Azerbaijan is a key oil and natural gas exporter, with proven oil reserves of 7 billion barrels. Additionally, there is a growing significant international interest in developing Azerbaijan's oil and its natural gas reserves.[2]

In 1991, Azerbaijan regained its independence after collapse of the Soviet Union; the government took the initiative to develop a new strategy for the oil and gas sector based on the efficient long-term management of oil and gas revenues. The goal of such an initiative was to ensure macroeconomic stability, as well as supporting the economic situation of the country.[3]

Being the major source of the national revenue, Azerbaijan government felt that there would be great potentiality for encouraging international foreign oil companies to invest in oil and gas sector of Azerbaijan which has huge reserves of oil and gas. The government was extremely keen to attract foreign direct investment to minimize cost as well as risk on one hand and to develop the oil and gas industry in the country on the other hand.[4]

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[1] Aitor Ciarreta and Shahriyar Nasirov. "Impact of Azerbaijan's Energy Policy on the Development of the Oil Sector." 2010. www.iaee.org/en/publications/newsletterdl.aspx?id=118
[2] Ibid.
[3] Sabit Bagirov. "Oil of Azerbaijan Revenues, Expenses and Risks (view from 2007)" 2007.http://www.eiti-az.org/ts_gen/eng/news/2007/nac-14.htm
[4] Ibid.

In this respect, the government of Azerbaijan adopted a new approach to attract foreign direct investment into the Oil and gas sector; they have provided Production Sharing Agreement (PSAs) contracts. The main benefits to the government of choosing PSAs are the low levels of risk, the development of oil and gas reserves by International oil companies IOCs thus eliminating the need for large investments from the government, and the government retains ownership of sub-soil resources.

In 1994, the government negotiated with IOCs for the joint exploitation of oil fields. Consequently, the government, represented by the State Oil Company of Azerbaijan Republic (SOCAR), signed an agreement with a consortium of IOCs for the development of the Azeri, Chirag and Guneshli oil fields (ACG).[5] This contract was the most important PSA oil contract to be signed after independence of Azerbaijan.

Azerbaijan, since 1994, has pursued a distinguished policy towards the signing of oil and gas contracts. Over the years, Azerbaijan has concluded thirty two production-sharing agreements with various IOC, this lead to the inflow of foreign direct investment into the oil sector of the country. Considering that ACG currently produces the main part of the total oil production in Azerbaijan, this PSA contract has been the largest contributor of revenues, which have been distributed throughout the socio-economic sectors, driving Azerbaijan's development.

The oil and gas industry in Azerbaijan plays an essential role in the national economy. According to the International Monetary Fund (IMF), "in 2010 Azerbaijan's gross domestic product increased by 9.3%".[6] Furthermore, According to Asian development outlook 2010 update Report, the oil sector represented 55 % of the total GDP of the state.[7]

[5] Ibid.

[6] U.S. Department of State. "Background Note: Azerbaijan." June 14th 2009. http://www.state.gov/r/pa/ei/bgn/2909.htm

[7] Asian Development Bank. "Asian development outlook 2010 update." Page (111) 2010. http://www.adb.org/documents/books/ado/2010/update/ado2010-update.pdf

These figures indicate that the economy of Azerbaijan is dominated by the oil and gas industry which has been the leading force behind the rapid development of Azerbaijan. Moreover this expansion as a result of huge foreign direct investment (FDI) in oil and gas sector which accompanied by rising of oil prices in the world market.

Most of the oil and gas revenues in Azerbaijan flow into the State Oil Fund of the Republic of Azerbaijan (SOFAZ) which plays a crucial role in promoting macroeconomic stability and financing large investments in social and economic projects. Through SOFAZ, oil revenues are directed into projects such as funding for refugees and internally displaced persons, agricultural projects, international projects such as the BTK (Baku-Tbilisi-Kars) Railway, as well as oil-related projects such as the BTC (Baku-Tbilisi-Ceyhan) Pipeline. Taxes from oil-related industries are transferred into the state budget which also distributes oil related revenues throughout the economy.

As a result of the successful energy policy, Azerbaijan is currently enjoying huge oil revenues which used for development "According to the UNDP, Azerbaijan has made the most significant advances in human potential development among 169 countries over the past five years. The country ranked 67th on the 2010 Human Development Index, Azerbaijan has progressed from the group of countries with medium human development to the group of countries with high human development".[8]

**The objective of this thesis**: To define the characteristics of PSAs in Azerbaijan with a specific focus on the case of the ACG contract.

**The aim of this thesis**: To demonstrate the specifics of PSAs in Azerbaijan using the contract which is considered to be the most important ever signed in Azerbaijan, the Azeri-Chirag-Gunashli (ACG) PSA.

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[8] Trend Agency. "U.N.: Azerbaijan makes advances in human potential development." 2010. http://en.trend.az/news/society/1776883.html

**Methodology:** To begin with, the recent oil history of Azerbaijan is reviewed. Then an investigation is done on the different types of oil contracts, commonly used in oil-producing countries around the world, followed by an analysis of the benefits and shortfalls of each type of contract in the case of Azerbaijan. This leads to the choice of PSA contracts in Azerbaijan as opposed to other types of contracts.

Furthermore, the specifics of PSAs in Azerbaijan are examined in depth, and the benefits to Azerbaijan are highlighted, as well as the benefits for foreign investors and IOCs. Moreover the ACG PSA contract is used as a model for analysis. The particular elements which constitute the ACG contract are examined, including benefits and deficiencies to the social and economic well-being of Azerbaijan. These elements include company's participation, rights and obligations of the parties, cash flow, bonus payment, transparency, environmental protection and safety.

# CHAPTER ONE

# THE DEVELOPMENT OF THE OIL INDUSTRY IN AZERBAIJAN AND AN INTRODUCTION TO COMMON OIL CONTRACTS

The aim of this chapter is to emphasize the importance of oil contracts in defining the relationship between oil companies and the state. This chapter consists of two parts. Firstly, a brief discuss the history of Azerbaijan and the development of the oil industry over the last century, with a focus on the period since its independence in 1991. Secondly, the different types of oil contracts, commonly used in oil and gas countries throughout the world, are analyzed with a focus on their history and terms of implementation. The types of contract discussed in this chapter include concession agreements, joint ventures, and service contracts. PSA contracts are discussed in detail in the following chapters.

## 1.1 A BRIEF HISTORY OF OIL IN AZERBAIJAN

Azerbaijan has a long history of involvement with oil. It is one of the few places on this planet where oil has been extracted and used for over a thousand years. Charles Marvin (1877) argues that there was irrefutable proof that, 2500 years ago, oil was exported from the Apsheron peninsula according to Marco Polo. He also contended that the Apsheron peninsula was dotted with oil wells which were supplying the fuel used for lighting. According to historical data, in 1594 an inhabitant of Apsheron dug a simple oil well to a depth of thirty-five meters.[9]

In ancient times, the villagers of that area extracted oil by digging wells, just as they did for water. In 1806 there were fifty oil wells on the Apsheron peninsula. This number dramatically increased and reached about one hundred and twenty in 1821. At that time, the production capacity of most individual oil wells did not exceed ten barrels per day (bpd).[10]

[9] Sabit Bagirov. "Azerbaijani Oil: Glimpses of a Long History" http://www.sam.gov.tr/perceptions/Volume1/June-August1996/AZERBAIJANIOILGLIMPSESOFALONGHISTORY.pdf
[10] Ibid.

The world's first oil well was drilled in 1848 in Apsheron, eleven years prior to the drilling of the first oil well in Pennsylvania in North America. In 1859 the first oil refinery was built in Baku and connected in 1878 by the first pipeline to the Balakhani oil field. In 1910, Azerbaijan had become the number one oil producer in the world with an annual production of 11.5 million tons of oil. At that time, more than 60 per cent of the oilfields were under the control of IOCs and by 1913 in Baku area there were about 3500 wells.[11]

In 1917, Russia occupied Azerbaijan; the Soviet Union nationalized 165 independent oil companies in Azerbaijan. These companies were denationalized after the independence of Azerbaijan, but in 1920 the Soviet army invaded Azerbaijan and the oil industry was nationalized once again. In 1940, Azerbaijan provided 71.5 percent of the total oil output of the USSR. Between 1947 and 1963 there was a steady increase in oil production with output stabilizing at 21 million tons per year in the period between 1964 and 1968.[12]

However, from 1969 to 1985 there was decrease in oil production followed by a period of stagnation due to the exhaustion of the on-shore fields, the high cost of drilling and maintaining off-shore oil fields and significantly, the discovery of oil in Siberia and Kazakhstan. After the independence of Azerbaijan in 1991, oil production fell sharply between 1992 and 1997 and production hit a low of 9.1 million tons in 1997.[13]

In September 20th 1994, the government of Azerbaijan, represented by The State Oil Company of Azerbaijan Republic (SOCAR), signed the first Production Sharing Agreement contract with a consortium of international oil companies for the development of the Azeri Chirag Guneshli oilfields (ACG).[14] It is considered by the international press to be the 'contract of the century'.

[11] Ibid.
[12] Ibid.
[13] Ibid.
[14] Aitor Ciarreta and Shahriyar Nasirov. "Impact of Azerbaijan's Energy Policy on the development of the Oil Sector." 2010. www.iaee.org/en/publications/newsletterdl.aspx?id=118

The signing of this contract was the conclusion of four years of intense and complex negotiations that began in 1990. It was to be the most important historical event for the nation of Azerbaijan since its independence from the Soviet Union, and it was believed that it would have huge impact on the nation's future.[15] According to the State Statistical Committee of Azerbaijan, in 2009 Azerbaijan produced 50,376,000 tons of oil. This was considered a significant total increase in volume of 13.5% from the year 2008 and the rate of oil production increased by 1.9% between January and September 2009.[16]

According to the Oil and Gas Journal, in January 2009, Azerbaijan's proven crude oil and gas reserves are estimated at 7 billion barrels (about 950 Mt) and 30 trillion cubic feet of natural gas. Furthermore development of the ACG deposits and also the possibility of developing other new oil and gas condensate offshore deposits enabled SOCAR to predict growth in oil production to between 66 and 67 million metric tons per year in 2015.[17]

Over recent years, Azerbaijan has signed several contracts in the form of PSAs thus increasing significantly the inflow of foreign investment into the oil sector. This has provided a large flow of revenues which have been beneficial to all sectors of the economy.

Moreover, these investments have contributed to making Azerbaijan more attractive for further investment in different sectors from non-oil investors. Even though the oil industry provides little employment opportunities, compared to other industries, the profits can lead to the expansion of non-oil sectors providing jobs and other opportunities to the population of Azerbaijan.

As a result of expansion of oil and gas production, the government established the pipelines in order to transport oil and gas to international markets is essential for Azerbaijan as it is a landlocked country. Despite being on the coast of the Caspian Sea, access to the open ocean for the transportation of oil and gas by ship is extremely limited, with the only access being through the river Volga in Russia.

[15] Sabit Bagirov. "Azerbaijani Oil: Glimpses of a Long History" http://www.sam.gov.tr/perceptions/Volume1/June-August1996/AZERBAIJANIOILGLIMPSESOFALONGHISTORY.pdf

[16] Rufat Abbasove. "Azerbaijan increases oil production" October 20th 2010. http://www.news.az/articles/economy/25123

[17] Richard Levine and Glenn Wallace. "The Mineral Industry of Azerbaijan" April, 2010. http://minerals.usgs.gov/minerals/pubs/country/1998/9404098.pdf

Moreover, the market in the Caspian region does not provide enough demand to consume the supply of oil and gas from Azerbaijan as most neighboring countries have resources of their own. This is not the case for Georgia and Armenia; these are limited markets, these projects need successful policy to attract foreign investment and the participation of the government as another party.

Most of Azerbaijan's oil is exported via pipelines; Azerbaijan has 3 main pipelines to export its oil, Baku-Tbilisi-Ceyhan (BTC), Baku-Novorossiysk which was built in 1997 and Baku-Supsa pipeline also called the Western Early Oil Route, which was constructed in 1999. The majority of Azeri oil exports via the Baku- Tbilisi-Ceyhan (BTC) pipeline, which was commissioned in May 2006. [18]

BTC pipeline has the capacity to deliver up to one million barrel of crude oil daily. The length of BTC pipeline is about 1,768 kilometer, it is the second longest oil pipeline in the world after the Druzhba pipeline. It is owned by a consortium of IOCs operated by BP (British Petroleum) Azerbaijan announced that it would supply only 60% of the oil for the pipeline. [19] BTC also opened the way for Kazakhstan to ship oil through it, BTC runs from Sangachal terminal near Baku, via Georgia, to the Ceyhan terminal in Turkey, where it is shipped by tankers to world markets.

As a result of expected increases in gas production (mainly from the Shah-Deniz field), in 2009, Azerbaijan was involved in negotiations with both Turkey and Russia for the establishment of new pipelines, Nabucco and South Stream; both are still in the early planning stages. The proposed Nabucco pipeline would run for 2,050 Kilometers from Erzurum in Turkey to Baumgarten in Austria.[20]

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[18] Richard M. Levine and Glenn J.Wallace. "The Mineral Industry of Azerbaijan" April, 2010. http://minerals.usgs.gov/minerals/pubs/country/2007/myb3-2007-aj.pdf

[19] Ibid.

[20] http://www.nabucco-pipeline.com/portal/page/portal/en

The BTC pipeline does not only benefit to Azerbaijan as a means of transportation but also provides income in the form of transit fees. This investment, financed by oil revenues, also provides income for the economy of Azerbaijan which is an example of sustainable investments. The role of the BTC pipeline as a transit pipeline will benefit Azerbaijan, in case of decreasing oil production, for many years to come. This does not negate the fact that pipelines can have a negative impact on environment.

## 1.2 DIFFERENT TYPES OF COMMONLY USED OIL CONTRACTS

Petroleum legislation forms the most important basis for a relationship between a government, usually represented by a National oil company, and the International oil companies which negotiate and commit the country to oil agreements. It is essential that the government chose the right type of oil contract to ensure that it maximizes its potential benefits through the balance of revenues, risk and ownership rights.

Each contract contains different mechanisms and terms which determine the nature of the relationship between the oil companies and the state. These terms include detailed information on: mechanism of recovering expenses and costs between the parties, bonuses and relevant tax payments, insurance and Force Majeure, environment and observance of safety, transportation of the raw materials, contracted area and other terms may the parties agree.[21]

Each country establishes long-term specialist policies for the efficient management of its own petroleum wealth in order to gain the greatest benefits for the nation, this part of the chapter briefly describes and distinguishes the four most prominent oil contract types; Concession agreements, Joint Venture Contracts (JVCs), Service agreements. Also it illustrates the main differences between these types of contracts drawn up between oil companies and the governments, the level of sharing of national oil companies.

[21] Baker&McKenezie. "CIS Energy notes." May 2003. http://www.bakernet.com/NR/rdonlyres/96C48FAD-3213-4109-B241-6A44944451A06/29451/CISEnergyNotesFeb03fin.pdf

## 1.3 CONCESSION AGREEMENTS

Historically, this type of oil contract appeared initially in 1901, during the era of Mozaffar ad-Din Shah Qajar Shah of Iran. The first agreement was signed between the Shah and an English businessman William D'Arcy, in order to explore and develop oil fields in Iran. In 1909, the Anglo-Persian Oil Company, later known as British Petroleum (BP), signed a 60- year concession agreement to develop oil fields in the south of Iran. [22]

According to Professor A.A.Fatouros, a concession contract is ""'an instrument concluded between a state and a private person and providing for the grant by the state to the individual of certain rights or powers which normally would belong to and be expected by the state'"". Over time many changes were made to this type of contract throughout the various developed or developing countries that employ them. [23]

Under this agreement the host country grants to an IOC the exclusive rights to explore, develop oil in a given area for a specified period of time in exchange for payment of royalties, taxation and fees, with no risk to the host country. The IOC invests its own capital and pays money to the state entitling it to the free use of the petroleum produced.

This means that the investor controls and runs the operation and the government receives revenues, also in Concession agreements the national oil company (NOC) can participate in the contract. This is usually done through tenders invited by the host country in order to choose the most lucrative financial offer that best serves the interests of the host country.

A company , that wishes to win such a concession, is often in extreme competition with other companies that have the same objective. This is why companies always make the best offer possible in order to attract the host government, Concession agreements are commonly used in extractive industries, particularly in the oil sector where a state owns resources under the sub-soil and may also participate through the contract as a partner, usually the state represented by the

[22] Homayoun Mafi. "Iran's Concession Agreements and the Role of the National Iranian Oil Company: Economic Development and Sovereign Immunity." Natural Resources Journal, Volume 48, 2008.
[23] A.A. Fatouros, Government Guarantees to Foreign Investors 125 (1962)

NOC. Concession agreements are commonly used in Kuwait, Sudan, Thailand, Angola and Ecuador.[24]

Recently there are many examples of concession agreements which were put in place in the Sultanate of Oman (1967) and Abu Dhabi (1974) included granting the foreign contractor the rights to exploration, development and the export of oil.[25]

Currently, there are some concession agreements included shorter term contracts which required higher bonuses payments and royalties as an example in Abu Dhabi the royalties were paid in oil. Where, the IOC has complete ownership of any oil that is produced, and is therefore free to sell it at the world market.[26]

As well, concessions may be used in public services as part of 'build-operate and-transfer' (BOT) deals, whereby the investor undertakes the construction of any infrastructure, operates it for an agreed period of time and at the end of this period the ownership of the facility is transferred to the government.

### 1.4 JOINT VENTURE CONTRACTS (JVCs)

The first joint venture oil contract appeared in 1957 in the Middle East when the Italian National Oil Company, Ente Nazionale Idrocarburi (ENI), via its subsidiary AGIP (Azienda Generale Italiana Petroli - General Italian Oil Agency), signed JVCs with Egypt and Iran. ENI and other oil companies merged and were referred to as the "New Entrants" after World War II.[27]

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[24] Dr. Ingilab Ahmadov. "Contracts and revenue sharing mechanisms – an international perspective." 2009. PFMC

[25] Kirsten Bindemann. "Production-Sharing Agreements: An Economic Analysis" .October1999. http://www.oxfordenergy.org/pdfs/WPM25.pdf

[26] Simon Brinsmead."Oil Concession Contracts and the Problem of Hold-Up." http://www.dundee.ac.uk/cepmlp/journal/html/Vol17/Vol17_11.pdf

[27] Talal Al-Emadi "Joint Venture Contracts (JVCs) among Current Negotiated Petroleum Contracts: A Literature Review of JVCs Development, Concept and Elements.".2010. http://gjil.org/wp-content/1_1_al_emadi.pdf

They subsequently increased their share of oil production and introduced Joint venture; In fact there is controversy about the definition of JVC contracts, because no common definition exists. It implies two or more parties follow an undertaking in some still to be clarified form and that the parties involved should know and understand each other's objectives and interests. [28]

The benefits accruing to a government from JVCs are, sharing in the profits and not having to stand alone in the decision-making process leading up to the creation and execution of the project. On the other hand, the government must share in the costs and risks.

In addition joint venture contracts take a long time to negotiate. For example: Nigeria, Russia, and the North West Shelf in Australia.[29] To set up JVCs, the government, represented by the national oil company, agrees with one or more IOCs to create a joint venture project through the establishment of a framework for sharing risks, which may be high when exploration is involved, sharing costs including those of production and sharing total profit.

The formation of OPEC in 1960 and concerns over United Nations decisions relating to host states control over resources, led to a shift in policy of some countries concerning the type of contracts acceptable to host countries.[30]

SOCAR has signed two joint venture contracts with IOCs by about 50% participation for each contract, one of these contracts to develop the onshore Kyurovdag field, and the other contract signed in order to develop the onshore fields of Nefchala and Babazanan management. Occasionally there is political interference, for example, the Russian Government's intervention in the Sakhalin-project, a joint venture with foreign companies, the Russian Government claimed that the existing contract was useless and demanded a change to a profit sharing agreement contract.[31]

[28] Ibid.
[29] Jenik Radon. "The ABCs of Petroleum Contracts: License-Concession Agreements, Joint Ventures and production-sharing Agreements." Pages (61-84) Open Society Institute
[30] Talal Al-Emadi "Joint Venture Contracts (JVCs) among Current Negotiated Petroleum Contracts: A Literature Review of JVCs Development, Concept and Elements.".2010. http://gjil.org/wp-content/1_1_al_emadi.pdf
[31] Dr. Ahmadov. An Agreement Is Worth More Than Money, 2010

Benefits of JVCs are that the state retains control over operations and receives higher financial returns, transfer of technology and direct access to the world market .A thorough assessment of each type of agreement is required before any decision is taken, with the clear need to carry out cost-benefit analyses and risk assessments before the state commits to involvement in equity participation.

## 1.5 SERVICE CONTRACTS

Service contracts involve the government, represented by the national oil company, signing an agreement with an international oil company to explore and develop oil fields. The state receives revenues in the form of profit sharing and sometimes taxes and royalties.

The main reasons for signing service contracts are (1) service agreements are usually used for field development and re-development of projects in resource-rich countries, (2) the state oil company may participate,(3) the state retains ownership of the reserves in the ground and on the surface,(4) the IOC invests the capital and is paid in cash from the proceeds of the project, supporting the risk of failure alone, and (5) the state extracts revenues as a profit share according to an agreed formula and also sometimes in the form of taxes and royalties.[32]

Service contracts by definition generate the largest stake for the state where a 90% take is considered an accepted average; service contracts are usually agreed with oil-rich countries, which have strong nationalist tendencies. Under the service contracts, there are different sets of costs, fees and different payments spending by the IOC is subject to minimum work and minimum expenditure.[33]

[32] Dr. Inglilab Ahmadov. Power Point: "PSAs". Khazar University 2009/2010
[33] Kirsten Bindemann. "Production-Sharing Agreements: An Economic Analysis" .October1999. http://www.oxfordenergy.org/pdfs/WPM25.pdf

Obligations according to approved plans such as: service fees included petroleum costs a remuneration fee and supplementary fees comprising of supplementary costs. The disadvantages for the operators are that risks exist of other types of contracts being operated at the same time by competitors and that the operators of the hydrocarbon reserves of the contracted field cannot count it as part of their assets.[34]

Recently there are some forms of service agreements that are similar to PSAs, called risk service agreements. In this type of contract, the IOC bears all financial risk and engages in exploration and development for which it receives a fixed fee or another form of compensation, due to the combination of risk and services.

They are usually used for field development and re-development projects in resource-rich countries with an aversion to foreign investors (constitutional restrictions). An example of the use of this type of contract is visible in Saudi Arabia and in Venezuela.[35] Another example the contract between Gazprom of Russia and ExxonMobil to develop the Shtokman gas field. The Gazprom claimed that the contract was not profitable and it proposed changing to a production sharing agreement (PSA).[36]

[34] Ibid.

[35] Kirsten Bindemann. "Production-Sharing Agreements: An Economic Analysis" .October1999. http://www.oxfordenergy.org/pdfs/WPM25.pdf

[36] Dr. Ahmadov. An Agreement Is Worth More Than Money, 2010

The various oil contracts can be classified based on the variables of ownership, control over operations, and exploration risk. Table 1 below describes these classifications.

| | Concession contracts | | | Joint Venture contracts | | | Service contracts | | |
|---|---|---|---|---|---|---|---|---|---|
| | Ownership | Control | Risk | Ownership | Control | Risk | Ownership | Control | Risk |
| IOCs | Yes | Full | Full | No | Share | Share | No | No | Exploration |
| Host State | No | No | No | Full | Share | Share | Full | Full | All Risks |

Table1.[37] Classification of Oil Contracts

**Summary:**

In this chapter, it was made clear that Azerbaijan has a long history of oil and gas production. During the Soviet era, all the country's resources belonged to and were managed by the Soviet Union. After independence, the government had to decide which approach to take in the development of its oil and gas industry. In light of its extremely limited resources, the government realized the need to attract foreign investment.

This would be beneficial in two ways; firstly the foreign investment would enhance the suffering economy of the newly independent state. Secondly foreign involvement in the region would act as a stabilizing force, politically and socially.

Three types of oil contract were discussed. Concession contracts, which allocate full ownership, control and risk to the IOC, this is beneficial to the state as there is no risk involved for it but the state does not retain ownership of the resources and does not control their development.

[37] Talal Al-Emadi "Joint Venture Contracts (JVCs) among Current Negotiated Petroleum Contracts: A Literature Review of JVCs Development, Concept and Elements.".2010. http://gjil.org/wp-content/1_1_al_emadi.pdf

Joint ventures contracts allow the state to retain ownership of the resources and distribute control and risk between the state and the IOC. Finally, service contracts allow the host country to maintain ownership and full control over the resources as well as incurring all of the risks except the risks associated to exploration which are allocated to the IOC.

Azerbaijan was faced with the decision of which type of contract to engage in with the foreign investors. In the case of concession contracts, the government found that they could not retain ownership or control over the countries resources. Having just gained independence from the Soviet Union, the government did not want to put the country in the same position of not having control and ownership over its resources. Thus the decision was made, Concession agreements would not be used in Azerbaijan.

In the case of service contracts, the government would have to bear all risks with the exception of the risks associated to exploration, the exhausted of oil wells during Soviet Union as well as considering the economic situation at that time, these risks were unacceptable for Azerbaijan and no service contracts were signed.

Joint ventures were considered a good option for Azerbaijan compared to concession contracts and service contracts, but the problem at the time was the financial limitations that did not permit the government to accept the share of risk allocated by the contract. In later years, due to increased revenues from oil and gas, Azerbaijan engaged in some joint ventures, but remains of limited use compared to PSAs.

From information provided above, it can be said that Azerbaijan, at the time, was risk averse and was intent on maintaining ownership of its resources as well as partial control, this would provide the best solution for current and future generations , which is consistent with the policy of the country which aims to retain the resources .

The only type of contract which fulfilled these criteria was production sharing agreement PSA contracts. The next chapter will focus and discuss the main principles in details and specifics of such type of contracts in Azerbaijan.

## CHAPTER TWO

## THE PRODUCTION SHARING AGREEMENT (PSAs): GENERAL PRINCIPLES, AND THE CHARACTERISTICS OF PSAS IN AZERBAIJAN

This chapter will focus on PSA contracts, their history, and general principles. Then an analysis is done to discuss the reasons for which Azerbaijan chose PSA contracts, as well as an investigation into the characteristics of the PSAs that have been signed to date between Azerbaijan and IOCs. This chapter consists of three parts, introduction and background of PSAs, general principles and components of PSAs, and particularities of PSAs in Azerbaijan. In addition, a comparison is made between PSAs and the only other form of oil contracts used in Azerbaijan, joint ventures.

### 2.1 INTRODUCTION AND BACKGROUND OF PSAs

Production Sharing Agreements (PSAs) are one of the most common types of contracts used in the oil and gas industry. PSAs focus on the sharing of the output of oil and gas operations in agreed proportions between the IOCs and the government. PSAs originated and were first applied in Indonesia in 1960s and are believed to have been developed in the 1950s by Dr. Ibnu Sutowo the founder and long term head of Pertamina state oil company of Indonesia. It is a long term contract (normally 25 years) between the government, usually represented by a national oil company (NOC), and one or more international oil companies IOCs.[38]

Over time PSA contracts spread around the world with the exception of North America and Western Europe (The island of Malta being the exception). Currently PSAs are a very important type of petroleum contract, especially in developing countries, with more than 300 contracts signed to date; especially in central Asia for example: Kazakhstan and Turkmenistan, in the Caucasus for example: Azerbaijan and Georgia, in Africa for example: Egypt and Libya and in Central America, it is also used as a common entrepreneurship activity, particularly in several countries.[39]

[38] Dr. Inglilab Ahmadov. Power Point: "PSAs". Khazar University 2009/2010
[39] Dr. Ahmadov. An Agreement Is Worth More Than Money, 2010

PSA contracts as a form of participation between the government and the IOCs, where the state grants the rights to the IOC to: explore, develop and produce oil and gas in specific subsoil area within a specified period of time.[40] For its part the IOC as a contractor provides technical and financial services for exploration and development operations and to perform works related to the agreement.

Moreover, the contractor , who is usually the IOC, bears the entire cost and risk of exploration and development activities, performs the assigned works at its own cost and risk in expectation of subsequent compensation for the investment expenditure as a portion of future generated profit.[41]

Following the development of PSAs, oil companies were afraid to invest large sums as they were under the impression that these contracts would limit the amount of control and management they would have over the extraction and production process. Then, as more experience was gained with PSAs, the oil companies realized that their involvement in management and control was more than they initially expected.

This can be seen in Azerbaijan by the level of involvement of BP for example, which is the leader of a consortium of IOCs, in the management of oil fields as well as other projects such as the BTC pipeline which spans 3 countries.

PSAs have the following characteristics: Firstly, the IOC carries out the activities stipulated in the agreement concerning prospecting, exploration and extraction at its own cost and risk. The government as the other party of the agreement does not bear any costs or risks, If they did not find oil or the extracted quantity is unprofitable, in that case the IOC receives no compensation.[42]

[40] William Hogan and Federico Sturzenegger. "The Natural Resources Trap: Private Investment without Public Commitment", 2010
[41] Dr. Inglilab Ahmadov. Power Point: "PSAs". Khazar University 2009/2010
[42] William Hogan and Federico Sturzenegger. "The Natural Resources Trap: Private Investment without Public Commitment", 2010

Secondly, the government owns both the resource and the installations; after discovery and extraction of oil the IOC has to pay a royalty to the government, levied on gross production. This Royalty guarantees a minimum revenue flow to the government that is independent of the profitability of the project and it recovers the costs by retaining a certain percentage of output with a fixed limit. This is called cost oil, which is assumed to be sufficient to recover production and exploration costs. [43]

The remainder of the production is called profit oil, shared between the IOC and the government at a defined rate according to the terms stipulated in the agreement, considering that the government receives income tax from IOC on its share of profit oil. Furthermore, the IOC is often subject to paying out one or more types of bonuses. The most common ones are signature bonus which are paid by the IOC upon signature of the contract, and production bonuses which are paid with commencement of production.[44]

Over time PSAs have changed substantially and today they take many different forms, the operation for paying expenses and sharing profit oil in production sharing agreements are shown clearly in Figure 1 below.

[43] Kirsten Bindemann. "Production-Sharing Agreements: An Economic Analysis." October1999. http://www.oxfordenergy.org/pdfs/WPM25.pdf

[44] Ibid.

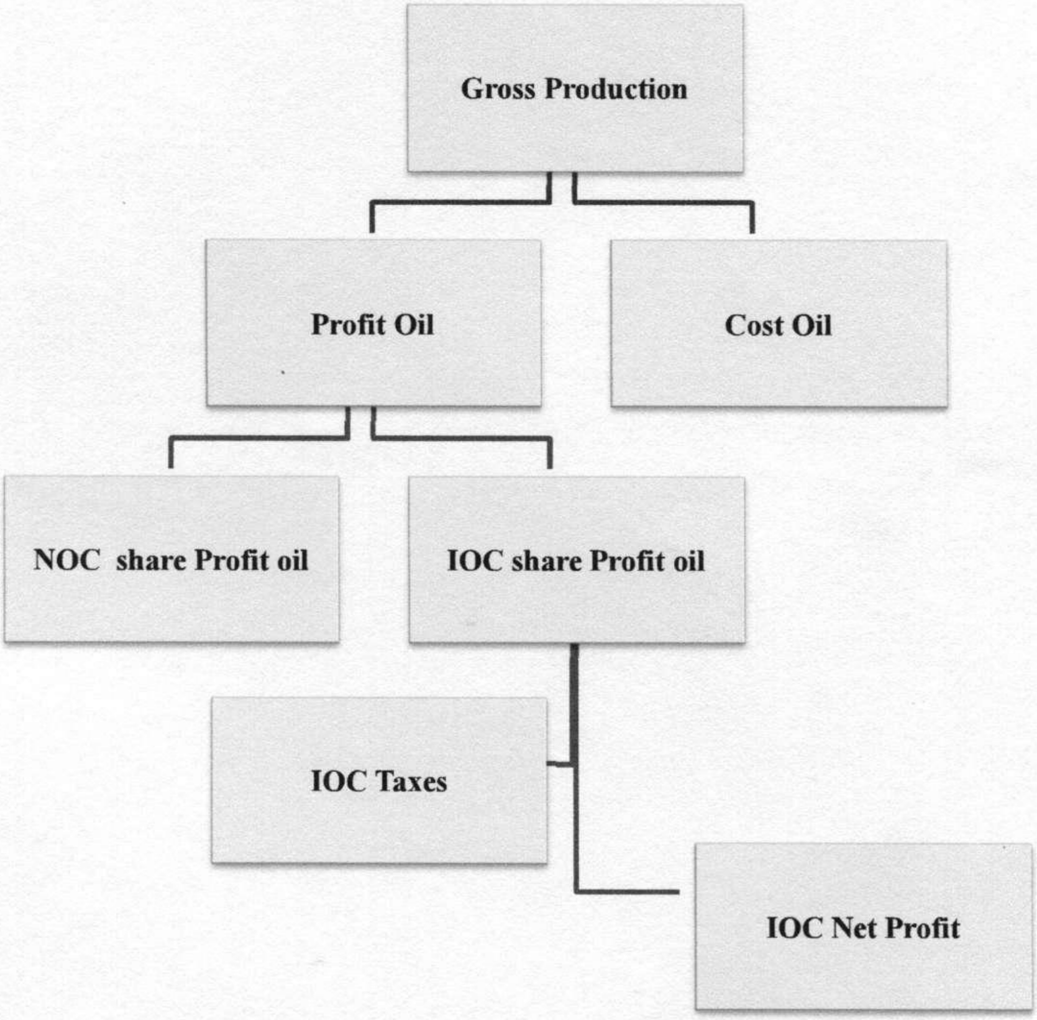


Figure1. [45] PSAs mechanism for sharing oil between the IOCs and the government.

The above diagram illustrates the mechanism used to share oil between the government and the IOCs for the most PSAs. The total extracted oil (gross production) is divided into two parties: The first one is called cost oil which the IOCs receive to cover investment costs throughout the whole exploration and development process.

[8] Madaki O. Ameh. "The Shift from Joint operating Agreements to Production Sharing contracts in the Nigerian Oil Industry: Any Benefits For The Players?". February 20th 2007. http://www.dundee.ac.uk/cepmlp/car/html/CAR10_ARTICLE32.PDF

The second part is called Profit oil which we can calculate by subtracting cost oil from gross production. The profit oil is divided between the IOCs and the NOC, taxes are then deducted from the IOCs share of profit oil, and this is called profit tax. The NOC does not pay profit tax on profit oil. What remains, after tax, is the net profit for the IOCs.

The net profit for the IOCs is not paid in currency, the IOCs get a share of the oil extracted which they are free to sell on international markets at world market prices or sell to the government also at world market prices.

## 2.2 GENERAL PRINCIPLES AND COMPONENTS OF PSAs

A production sharing agreement (PSA) is an international long- term contract between an IOC, as an investor, and a sovereign state, whereby the state grants the IOC exclusive rights for the exploration, development and production of petroleum from a specific area over a specified period of time.[46] According to the terms of a contract, the state retains ownership of the mineral resources, and the IOC bears all costs and risks involved with extracting the mineral resources with subsequent compensation of costs accruing as a portion of profit oil production.[47]

PSAs have gained popularity and become widespread throughout oil producing regions of the world. They were created to protect developing countries from the predominance of IOCs, and at the same time they protect the IOCs from political instability which is often accompanied by arbitrary tax legislation or the risk of nationalization in some inexperienced unstable developing countries.[48]

[46] Dr. Ahmadov. An Agreement Is Worth More Than Money, 2010

[47] Kirsten Bindemann. "Production-Sharing Agreements: An Economic Analysis" .October1999. http://www.oxfordenergy.org/pdfs/WPM25.pdf

[48] Timothy Fenton Krysiek. "Agreements from Another Era: Production Sharing Agreements in Putin's Russia, 2000-2007.".November 2007. http://www.oxfordenergy.org/pdfs/WPM34.pdf

**General principles and rules of PSAs are as follows:**

1. After obtaining the license for a PSA contract, intensive negotiations take place between the two parties covering the whole period of activity; setting deadlines and specifying all related operations. In effect, the state is hiring the IOC to perform the work stipulated in the contract, thereby establishing a legally binding contractual relationship between the two parties that gives them equal rights and responsibilities.[49]

2. Under the PSAs the government retains ownership of the subsoil reserves and transfers profit oil to the IOC at a specified surface sharing point for example, the sharing point for the Azeri-Chyrag-Guneshli project is the Sangachal Terminal near Baku.[50]

3. Profit share is determined by the rent factor curve which is based on the pay back of expenditure as well as on exit to net revenue, and also Profit share between the parties is continued during the whole period of activity and income tax is paid by companies on net revenue only. Bonuses are paid at the beginning of the IOC activities and also at each contractually stipulated stage of the project, PSAs are not subject to different types of traditional taxes and the IOC performs its obligations to the state through profit sharing.[51]

4. In case of discovering commercially unprofitable wells, compensation is paid and the company may find a way out of the contract, Under the PSAs, the state does not invest its own funds in oil exploration and extraction and does not incur any financial risks which may be involved with these activities. The IOC invests the capital for the exploration and development of oil fields and it bears the risk of failure. If the IOC does not discover oil or finds that extraction is economically unprofitable, the state does not pay any compensation. This is a generally accepted clause included in any profit sharing agreement. However it is possible for the two parties to decide to include other provisions in the PSA as they see fit for the project under discussion.[52]

[49] Dr. Ahmadov. An Agreement Is Worth More Than Money, 2010
[50] Ibid.
[51] Ibid.
[52] Dr. Inglilab Ahmadov. Power Point: "PSAs". Khazar University 2009/2010

5. Under the PSAs the state transfers to the IOC the exclusive rights to carry out its activities within a subsoil area, but it does not transfer this area for lease or ownership and the state pays to the IOC, a portion of produced oil according to the terms stipulated in the agreement. A part of the gross production of oil is deducted by the IOC in order to recover its own costs and referred to as "cost-recovery production." The remaining part of the total production is referred to as "profit production" and is divided between the IOC and the state according to the agreement.The conditions for PSAs between the state and the IOCs are determined in each specific agreement and include a transparent and clear method of tax payment to the state treasury and also under PSAs a national oil company may be participating in the contract.[53]

6. PSAs allow the IOCs to avoid the unfavorable taxes normally payable in joint venture projects. Under PSAs, the international oil companies are normally exempt from value added tax, may pay out non-taxable dividends, and may benefit from the elimination of restrictions on banking issues including restrictions which may normally be imposed on foreign bank accounts, payroll currency and dollar withdrawals.[54]

7. PSAs are regulated under Civil law, which cannot normally be changed by the State unilaterally, this is important for the IOC which seeks the reassurance of stability in its legal relations with the state during the whole period of the agreement.[55]

8. Each profit sharing agreement has specific conditions, currently there are two recognized options for replacing taxes with production sharing:
   - Full replacement: an example is Libya where the rate of shares between the state and the IOC are at about 81:19 and exempts the IOC of any taxes and charges.[56]
   - Partial replacement where profit sharing is combined with certain taxes: an example is Russia where profit tax and subsoil use fees are levied on IOCs.[57]

[53] Ibid.
[54] Aitor Ciarreta and Shahriyar Nasirov. "Impact of Azerbaijan's Energy Policy on the Development of the Oil Sector.".2010. www.iaee.org/en/publications/newsletterdl.aspx?id=118
[55] The RULG - Ukrainian Legal Group. "Application of Production Sharing Agreements (PSA) Regime for the Use of Subsoil on Ukraine's Continental.". December 2005 www.rulg.com/documents/PSA_Report_Dec_23_05.eng.doc
[56] Ibid.
[57] Ibid.

## 2.3 THE SPECIFICS OF PSAs IN AZERBAIJAN:

Following the declaration of independence of Azerbaijan, which attracted the attention of IOCs after a 70 –year break, the representatives of IOCs started visiting Azerbaijan in order to invest in the oil and gas sector. The ACG oil field was a major interest; this field is located in the depths of the Caspian Sea, and it was discovered between 1985 and 1987 during the Soviet Era and has huge oil deposits.[58]

Also attractive was the existence of oil infrastructure and experience in Azerbaijan, despite needing new technologies and substantial investments for development. For these reasons and because of the economically difficult situation of the country, the signing of new oil contracts for exploration and development of oil fields with IOCs was a practical solution.[59]

In January1991, the soviet government announced a tender on the Azeri deposit and in the summer of 1991, the US Company Amoco won the tender. However, the Azerbaijani government invited other consortiums of IOCs under the leadership of Amoco, like Unocal, BP, Statoil, McDermott and Ramco to prepare technical feasibility studies and draft contracts.[60]

In October 1991, the government of independent Azerbaijan continued the negotiations with IOCs on the joint exploitation of oil fields, in 1992, the state signed two agreements the first was with the BP/Statoil alliance on the Chirag deposit and the Shah Deniz, while the second was signed with the Pennzoil/Ramco alliance on the Gunsheli deposit.[61]

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[58] Sabit Bagirov. "Oil of Azerbaijan Revenues, Expenses and Risks(view from 2007)" 2007. http://www.eiti-az.org/ts_gen/eng/news/2007/nae-14.htm

[59] Ibid.

[60] Ibid.

[61] Ibid.

After the signing of the agreement with BP/Statoil, they paid a bonus of 30m dollars to the government of Azerbaijan. In 1993, The IOCs signed a memorandum of understanding with SOCAR about the development of Azeri, Chirag and Guneshli deposits, under specific conditions such as:[62] Creating effective development by reducing the costs of exploitation in order to increase Azerbaijan's profit and maximize local production. SOCAR would select the operator, all previous agreements, which may conflict with this agreement, would be invalid.[63]

The participation of SOCAR share was 30 percent, provided within two years. Each IOC would pay a bonus of three million dollars for every per cent of their participation, one third in 10 days, and the remaining two thirds would be paid 30 days after the oil contract took effect. All previous agreements, which may conflict with this Agreement, would be invalid.[64]

All IOCs accepted the conditions and informed SOCAR within two months, they had agreed on the commercial conditions of the contract. In 1993, the negotiations were suspended then, they were resumed again. On September 20th 1994, Azerbaijan represented by SOCAR signed an international oil contract declared by the media as "the Contract of the Century", with a consortium of IOCs that included: BP (Britain), Amoco (USA), Lukoil (Russia), Pennzoil (USA), Unocal (USA), Statoil (Norway), McDermott (USA), Ramco (Britain), TPAO (Turkey) and Delta Nimir (Saudi Arabia).[65] The participation of IOCs in this contract has changed over time with some IOCs selling off or buying shares from others.

[62] Ibid.
[63] Ibid.
[64] Ibid.
[65] ACG PSA oil contract. http://www.bp.com/sectiongenericarticle.do?categoryId=9029334&contentId=7053632

According to the law of Azerbaijan all natural resources including subsoil resources and energy-related activities are governed by the 1998 Law on Subsoil Reserves. All subsoil in Azerbaijan is under state ownership and may not be owned by any private sector, but may acquire exploration or production rights from the state pursuant to tenders, through licenses such as PSAs.[66] The exploration and production rights were granted to IOC. Currently, each PSA creates a specific regulation regime for the exploration activities carried out in the relevant oil fields.

The PSAs which signed by the government of Azerbaijan approved and ratified by Milli Majlis (the National Parliament).After authorization by the Milli Majlis, PSA legislation a law of Azerbaijan and takes priority over current law or may be enforce in the near future law, decree or governmental order of the state.[67]

By this way foreign investors can have additional guarantees against possible adverse changes in the law. Moreover, PSAs usually provide fewer requirements for foreign investors, compared to the general regulatory scheme of Azerbaijan law.

The development of Azerbaijan's oil fields started in 1994, with the signing of the most important oil contract often referred to as the "Contract of the Century". In 1995 only one PSA oil contract was signed. In 1996 two PSAs oil contracts were signed. In 1997 Azerbaijan signed five PSAs contracts, and, in 1998 it signed eight PSAs contracts.[68]

In 1999 three PSAs contracts were signed. However, in 2000 and 2001 only one PSA contract was signed. In 2002 the government did not signed any PSA contracts. In 2003 one contract was signed. In 2004, three PSAs were signed while in 2005 only one contract was signed. This mean the total number of PSAs contracts were signed by the government of Azerbaijan from 1994 to 2005 was about (26) contracts.[69]

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[66] Permanent Representation of the Republic of Azerbaijan to the Council of Europe.". Oil and Gas." http://www.azmissioncoe.org/eng/about.shtml
[67] Aitor Ciarreta and Shahriyar Nasirov. "Impact of Azerbaijan's Energy Policy on the Development of the Oil Sector.".2010. www.iaee.org/en/publications/newsletterdl.aspx?id=118
[68] Sabit Bagirov. Oil of Azerbaijan Revenues, Expenses and Risks(view from 2007). 2007. Pages(23-25)
[69] Ibid.

It is worth mentioning that according to the contract , IOCs are only required to pay profit tax; they are exempt from most other taxes, such as VAT. Concerning profit tax, it is used as a replacement for royalties and is usually between 10 and 35 percent. In addition, cost oil in Azeri PSAs is above average and this allows IOCs to recover operating costs immediately.[70]

In Azerbaijan, profit tax is fixed for the full duration of the PSA contract. On the other hand, the profit oil sharing mechanism allows for a constantly changing share of oil between the IOC and the NOC and is based on either RROR (Real rate of return) or R-factor in Azerbaijan.[71]

Profits reinvested are excluded from taxation. Moreover, the IOCs are also exempt from customs duties on the totality of imported drilling equipment, methods of transportation, all spare parts as well as supplies used for surveying petroleum operations.[72]

One element which distinguishes PSAs signed in Azerbaijan from others is that detailed information about the agreements is open to the public and to NGOs, which make it more credible and easy to analyze. This is an advantage for IOCs and is not the case for other countries in the area such as Kazakhstan and Georgia, who do not even elevate PSAs to a legal status.

Flexibility of PSAs in Azerbaijan is another distinguishing factor. If the government and the IOCs mutually agree, new participants can join the PSA and any new participation equity can be partly used to repay existing loans.[73] This allows IOCs to adapt to changing situations by modifying their level of participation as they deem necessary.

[70] Kirsten Bindemann. "Production-Sharing Agreements: An Economic Analysis." October1999. http://www.oxfordenergy.org/pdfs/WPM25.pdf
[71] Ibid.
[72] Center for Energy Economics. "Oil Monetization in Azerbaijan." http://www.beg.utexas.edu/energyecon/new-era/case_studies/Oil_Monetization_in_Azerbaijan.pdf
[73] Kirsten Bindemann. "Production-Sharing Agreements: An Economic Analysis." October1999. http://www.oxfordenergy.org/pdfs/WPM25.pdf

Any unutilized associated gas is delivered at no cost to the State. For example, in Azerbaijan, ACG associated gas is delivered to the Sangachal terminal from offshore by the IOCs, via pipeline, at no cost to the SOCAR.[74]

All accounting processes are done in US dollars in PSAs signed in Azerbaijan. This allows for standardization throughout the processes, from extraction to sale.[75]

According to Bindemann, bonus payments in Azeri PSAs are considerably higher than other countries, He states that Ashrafi/Dan-Ulduzu contracts required payments of up to US$75 million depending on production thresholds. This may be viewed as negative characteristics of Azeri PSAs.[76]

Finally, PSAs signed in Azerbaijan apply international standards and require that environmental and social impact assessment is done for each project. This is essential to protect Azerbaijan's population, fauna and flora, from what is essentially a potentially harmful industry.

The clauses aim to avoid environmental and social disasters that have occurred in oil producing countries, such as the events in the Gulf of Mexico in 2010, which had disastrous environmental effects as well as leading to the death of employees.

[74] ACG PSA oil contract.http://www.bp.com/sectiongenericarticle.do?categoryId=9029334&contentId=7053632
[75] Center for Energy Economics. "Oil Monetization in Azerbaijan."http://www.beg.utexas.edu/energyecon/new-era/case_studies/Oil_Monetization_in_Azerbaijan.pdf
[76] Kirsten Bindemann. "Production-Sharing Agreements: An Economic Analysis" .October1999. http://www.oxfordenergy.org/pdfs/WPM25.pdf

Azerbaijan has signed 32 PSA oil and gas contracts with IOCs in the period from 1994 to 2010.[77] Having looked at the particularities of PSAs in Azerbaijan, it is important to note that a small number of joint ventures also exist in Azerbaijan. As can be seen in Table 2, below which highlights some of the main differences between these two types of contracts.

| Issue | Joint Venture | PSAs |
|---|---|---|
| Profit Tax | 32% tax on Profits | 5% tax withheld on revenues |
| Value Added Tax (VAT) | Must be paid | Exempt from VAT |
| Dividends | Taxable at 15% | Not Taxable |
| Banking | needs permission from Central Bank to open foreign bank account ,Payroll must be in Manats | No restriction on foreign bank Accounts ,No restriction on payroll currency |
| Accounting | Must be done in accordance with Azeri standards in Manats | According to international practices |
| Government Audits | various governmental audits | Not applicable |
| Labor laws | Subject to Azeri Labor Code | Subject to international provisions |
| Import/Export Protocol | Subject to existing import/export Regulations | Similar to provisions of the PSAs |

Table 2.[78] Shows the differences between PSAs and Joint Ventures in Azerbaijan.

Examining Table 2, PSAs appear to be much more attractive for IOCs than Joint Ventures. Among the benefits there are lower profit tax, exemption from VAT and tax on dividends, favorable banking and accounting measures as well as labor laws and trade protocols.

[77] Dr. Inglilab Ahmadov. Power Point: "PSAs". Khazar University 2009/2010
[78] Center for Energy Economics. "Oil Monetization in Azerbaijan." http://www.beg.utexas.edu/energyecon/new-era/case_studies/Oil_Monetization_in_Azerbaijan.pdf

**Summary:**

Azerbaijan selected PSA contracts in order to attract direct foreign investment to the country facilitating economic growth as economic performance of the newly independent state was very low due to difficulties faced after its independence from the Soviet Union in 1991. There was a need for foreign investment as, at the time, Azerbaijan did not have the necessary funds to discover and develop oil and gas resources to the extent that was made possible by the cooperation with IOCs.

The country's GDP contracted by close to 60 percent from 1990 to 1995. The first PSA was signed in 1994, marking a new era in Azerbaijan's economic development.[79] Due to this new interest from foreign investors, the economy began to recover in the mid-90. As more PSAs were signed, more foreign investment was injected into the economy.

Azerbaijan adapted the PSA contracts to suit foreign investors. Some of the specifics seen in this chapter include, flexibility concerning the sales and acquisition of shares in the contract between IOCs, the higher than average cost oil as well as the ability of operating costs being recovered immediately. Furthermore taxes are paid on a rate of return basis, avoiding royalties. Profit oil is shared between the NOC and the IOCs according to a sliding scale.

One of the most important factors which Azerbaijan has implemented is that PSAs are elevated to law status thus eliminating a large risk for IOCs. Tax exemption in some cases, such as VAT and tax on dividends is another factor which increases the attractiveness for FDI.

In addition measures are taken by the Azeri government to avoid double taxation on IOC's profits in their countries of origin.

Overall, Azerbaijan has been successful in the implementation of specific clauses in their PSAs, this is proven by the number of PSAs signed in the last 15 years, and the total is now at 32

[79] "European Neighbourhood and Partnership Instrument Azerbaijan Country Strategy Paper 2007-2013" http://ec.europa.eu/world/enp/pdf/country/enpi_csp_azerbaijan_en.pdf

contracts. Further proof of IOCs interest in Azeri PSAs can be seen in BP. Following the Gulf of Mexico disaster, BP chose to sell off numerous assets around the world, despite this they chose to sign a new PSA with Azerbaijan, the PSA is 30-year agreement on the deepwater to explore and develop a big Caspian Sea gas field, Shafag-Asiman. Thus shows that they consider the country to have a good climate for investment.

"The agreement was important for Azerbaijan as it marks a major step forward in deepwater exploration and noted that French energy firm total would also be starting exploration works in deep water in the Caspian sea next year, Even if no huge deposits are found, these explorations will produce an enormous amount of material for the study of deepwater areas of the Caspian Sea," said Ilham Shaban, the director of the Baku-based Centre for Oil Studies.[80]

Despite all these positive specifics of Azeri PSAs, there are some negative factors. For example, bonus payments are considered relatively high in Azerbaijan, they are on a par with bonus payments required in the Middle East. Furthermore the Trade Press has, in the past, labeled the contracts in Azerbaijan as being "tough". It can be argued that this is not the case as taxes take profit into account and profit oil is shared according to a comprehensive, nine step sliding scales according to Bindenmann.[81]

The following chapter will discuss the case of the ACG PSA contract. The specifics seen in this chapter will be highlighted.

[80] "BP signs 30-year deal with Azerbaijan for Caspian Sea Gas". October 8th2010http://asbarez.com/86360/bp-signs-30-year-deal-with-azerbaijan-for-caspian-sea-gas/

[81] Kirsten Bindemann. "Production-Sharing Agreements: An Economic Analysis" .October1999. http://www.oxfordenergy.org/pdfs/WPM25.pdf

## CHAPTER THREE

## THE CASE OF THE AZERI–CHIRAG–GUNESHLI (ACG) PSA

This chapter will discuss the specifics of PSAs in Azerbaijan utilizing the ACG PSA oil and gas contract as a case study. There are 9 parts in this chapter; each one is a clause which demonstrates the specifics of Azeri PSAs comparatively with international PSAs. These parts include companies' participation, rights and obligations of the parties, cash flow, bonus payment, localizations and training citizens, arbitration, transparency, natural gas.

Since 1994 Azerbaijan has been implementing the new oil strategy and the main principles of these strategies indicate the effective utilization of the rich natural resources of the country including oil and gas resources in order to support the economy and fund the development the country.[82] Despite widespread belief that the ACG contract was the first PSA signed in Azerbaijan, in fact it was the second.

According to the Azerbaijan Oil Studies Center, the first PSA was signed on August 10$^{th}$1994, between foreign oil companies and Azerbaijan, represented by SOCAR. This contract was signed in regard to the Umbaki, Northern Garadagh, and Korgez onshore oil fields. Said Ilham Shaban

Negotiations were started with foreign oil companies on the development of Azeri, Chirag and deep-water Gunashli, followed by signing of the contract in September 1994.The contract was approved by the Milli Majlis (Azerbaijan Parliament) in December 2$^{nd}$1994 and went into effect on December 12$^{th}$1994.[83] The ACG Contract is often referred to as the "Contract of the Century".

[82] ACG PSA oil contract.http://www.bp.com/sectiongenericarticle.do?categoryId=9029334&contentId=7053632
[83] Sabit Bagirov. "Problems of Good Governance in Extractive Industries.".2005/2006. www.policy.hu/document/200808/bagirov_f3.pdf&letoltes=1

According to BP 2010 report, ACG production through the first three quarters about 835,100 pbd, which represent most of total Azeri oil output. According to Statoil statistics 80% of ACG oil is exported through the BTC pipeline , 10% via the Western route pipeline through the Black Sea and 5% via Railway through the Black Sea.[84]

As seen in Table 3, below which illustrate that the ACG oil fields rank third in the top 5 largest oil fields in the world, with a production of 850, 000 bpd according to the American Consulting Association. It is also believed that there are large untapped gas reserves under ACG oilfields which can be used for the planned Nabucco pipeline.

| Country | Field Name | Production bpd |
|---|---|---|
| Saudi Arabia | Ghawar | 5,000,000 |
| Kuwait | Burgan | 1,200,000 |
| Azerbaijan | Azeri-Chirag-Guneshli | 850,000 |
| Mexico | Ku-Maloob-Zaap | 800,000 |
| Abu Dhabi | Zakum | 750,000 |

Table 3.[85] The Top five largest oil fields in the world

[84] "Azeri,Chirag and Gunashli"
http://www.statoil.com/en/About/Worldwide/Azerbaijan/Pages/AzeriChiragGunashli.aspx
[85] "Azerbaijani oil field third in IHS CERA ranking of world's 20 largest oil fields".2009
http://en.trend.az/capital/pengineering/1524740.html

## 3.1 COMPANY PARTICIPATION

On September 20th 1994, SOCAR signed a PSA with Azerbaijan International Operating Company (AIOC), a consortium of 10 foreign oil companies from 7 countries to develop and manage the reserves found in the Azeri, Chirag and the deep-water Portion of the Gunashli field in the Azerbaijan Sector of the Caspian Sea.[86] The partners of the contract and their shares on the signing day were illustrated below in Figure 2.

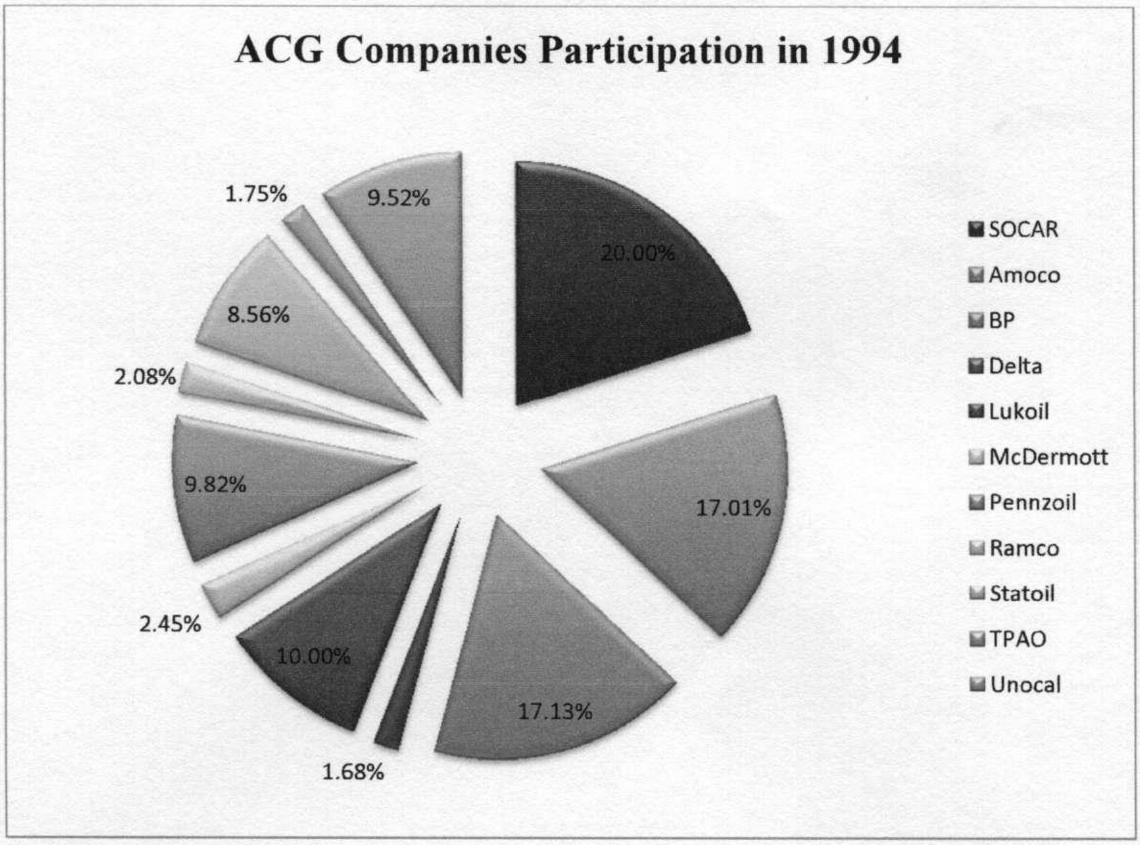


Figure2. [87] The ACG Companies Participations in 1994

The figure 2 above shows the parties in the ACG contract, which the biggest share held by SOCAR, BP and Amoco. The shareholding companies according to the date of execution of the Contract are: SOCAR (Azerbaijan), Amoco (USA), BP (UK), Delta Nimir (Saudi Arabia/UK), Lukoil (Russia), McDermott (USA), Pennzoil (USA), Ramco (UK), Statoil (Norway), TPAO

[86] ACG PSA oil contract. http://www.bp.com/sectiongenericarticle.do?categoryId=9029334&contentId=7053632
[87] ACG PSA oil contract. http://www.bp.com/sectiongenericarticle.do?categoryId=9029334&contentId=7053632

(Turkey), Unocal USA),. The PSA agreement will continue for a period of thirty years and in the case of an extension of the contract would require approval from SOCAR and the Contractor.[88]

The ACG is one of the largest oil fields in Azerbaijan. It is located in the Azeri sector of the Caspian Sea about 100 km south east of Baku with the Contractual area covering about 432.4 sq. km. The operations started in November 1997, with the initial production extracted from Chirage-1 at a rate of over 130,000 bpd.[89]

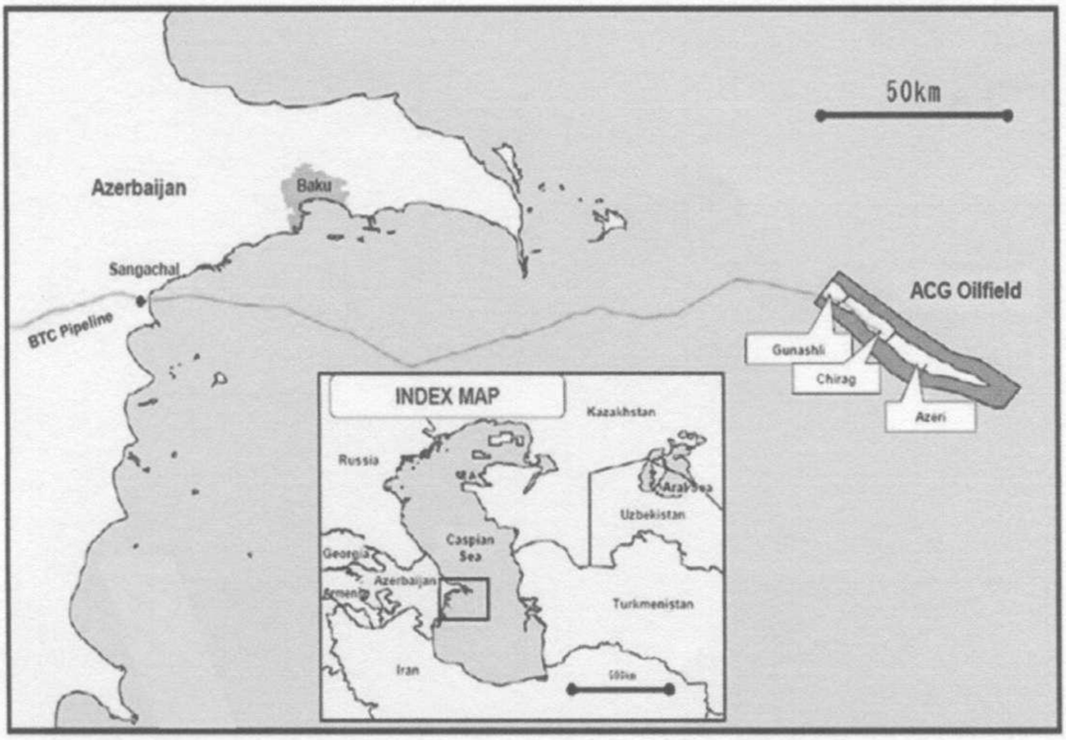


Figure3.[90] ACG oil fields Map

[88] Ibid.
[89] Ibid.
[90] Inpex Corporation http://www.inpex.co.jp/english/business/nis.html

**The Main Parts of the ACG oil fields:**

**Chirag**: An offshore production, platform located 120 km east of Baku in the Caspian Sea. Average oil production is 125,000 bpd, and which has been in operation since November 1997.[91]

**Central Azeri**: An offshore production, platform located 100 km east of Baku in the Caspian Sea. Average oil production is 420,000 bpd, and it has been in operation since February 2005.[92]

**East Azeri:** An offshore production, platform located 100 km off Baku in the Caspian Sea, which has been in operation since November 2006.[93]

**Deep-water Gunashli:** An offshore production platform, with Average oil production of 320,000 bpd, it has been in operation since April 2008.[94]

The full field development was scheduled to take place in three phases: The first phase is concerned with the development of the central Azeri field, with first oil production started in 2004, second phase is concerned with the development of East and West Azeri field, which started production in 2006 and the third phase is concerned with the development of the Deep-water Gunashli, which started production in 2008.[95]

From the above there is a huge investment in the ACG project which enhances the oil industry in Azerbaijan. Lately, there have been changes in the composition of participating companies, as showed in Figure 4 below which illustrates the recent important parties in the ACG contract. The main share part is held by, BP with 37.4% which leads the consortium and operates the project. Moreover there is unclear point in the ACG contract, which in case of IOCs sells part of their production to the government which currency they use.

[91] "BP Azerbaijan business update 3Q 2010"
http://www.bp.com/genericarticle.do?categoryId=9029616&contentId=7066262
[92] Ibid.
[93] Ibid.
[94] Ibid.
[95] Ibid.

In the previous chapter, the flexibility of PSAs in Azerbaijan was discussed as being one of the particularities of this country. In the case of company's participation, PSAs allow companies to buy and sell share in the contract. As a result the participation of each company is susceptible to change over time.

As we can see from the Figures above, BP began with a share of 17% at the time of signing. Figure 4 below illustrates the ACG companies' participations in 2010; BP holds 37.4% of the share of the ACG PSA contract. Some companies that owned a share of the contract at the time of signing have since sold their shares and left the project such as RAMCO.

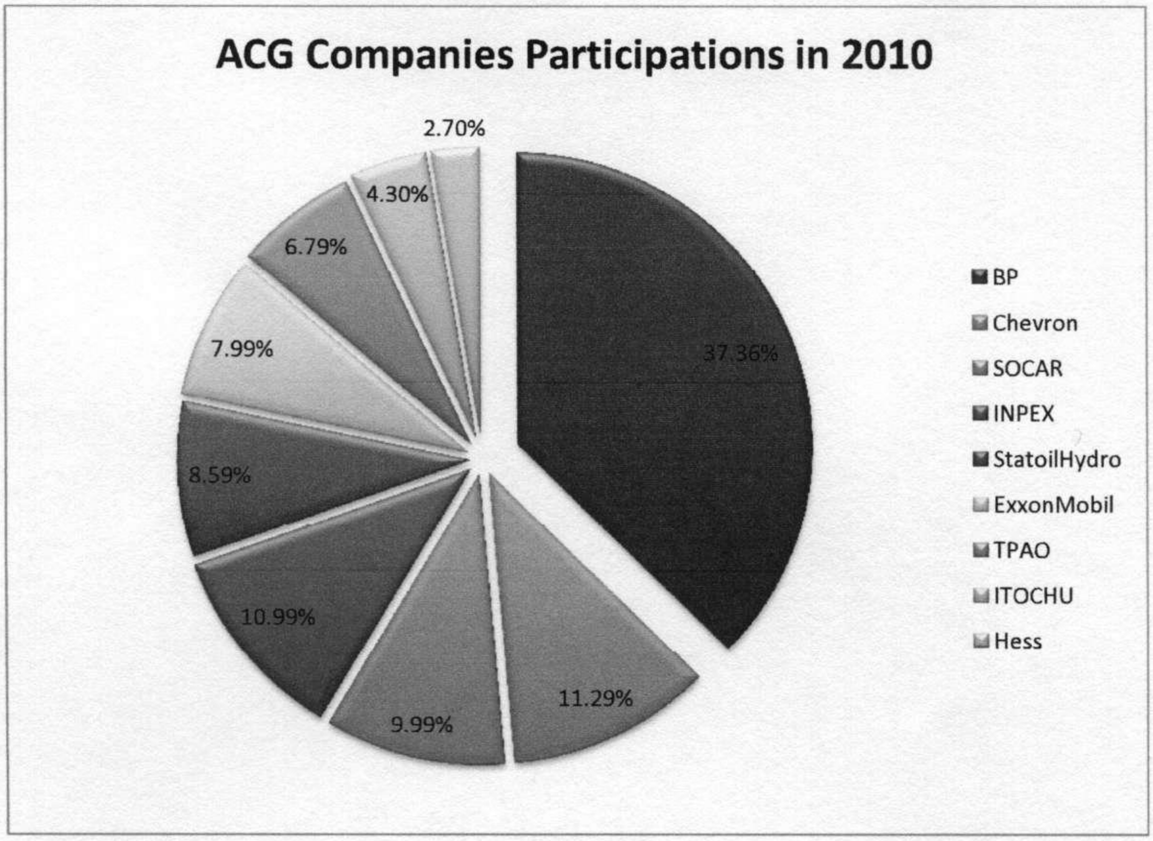


Figure 4. [96] The ACG Companies Participations in 2010

[96] "BP Azerbaijan business update 3Q 2010"
http://www.bp.com/genericarticle.do?categoryId=9029616&contentId=7066262

As can be seen the ACG contract in terms of company's participation is flexible in comparison with Algerian PSAs which apply tough conditions in the case of company's Participation. For example Algeria apply at least 51% fixed rate of participation of the national oil company in most Algerian PSAs.[97] Consider these advantages of the ACG PSA which offered good opportunity for investors.

## 3.2 RIGHTS AND OBLIGATIONS OF THE PARTIES

In using the terms rights and obligations, the aim is to identify the legal regulations and the procedures used to establish a system of permits, licenses and energy contracts between the IOCs and the government. In the case of the ACG contract, the agreement between the Parties that was Implemented under articles II and III refers to the general rights and responsibilities of the parties, whereby SOCAR grants the exclusive right to the contractor to explore and develop oil and gas in the contractual area in accordance with the terms and conditions established in the Contract.

The contract stipulates that, the IOCs only carry out activities relating to oil and gas operations in the specified contractual area. This is important for the environment such as surface areas, sea beds, and sub-soil. Furthermore, the contractor is entitled to recuperate his expenses and make a profit exactly as it is provided for in the contract.[98]

**General commitments of SOCAR:**

SOCAR agrees to offer the IOCs as much as possible all information in order to facilitate the execution of the contracts that were signed, with respect to the government and other relevant authorities or organizations, furthermore SOCAR has to provides the Contractor with all necessary well data, geological, geophysical, geochemical data as well as maps and technical data concerning the contractual area under SOCAR's possession or control.[99]

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[97] Dr. Bassam Fattouh SOAS & Oxford Institute for Energy Studies.
"North African Oil and Foreign Investment in Changing Market Conditions." April 30th2008.
http://www.oxfordenergy.org/presentations/North_African_Oil.pdf
[98] ACG PSA oil contract. http://www.bp.com/sectiongenericarticle.do?categoryId=9029334&contentId=7053632
[99] Ibid.

SOCAR with its limits work to establish suitable conditions for the IOCs so that they may improve the running of the petroleum operations. The IOCs receive help to obtain necessary licenses for the various operations including import-export, customs documents and with the opening of bank accounts. Assistance is also given in the areas of communications, with obtaining residence permits and visas for foreign staff, and with land plots.[100]

**General commitments of the contractor:**

In the international Petroleum operations under principles of safety and effectiveness, which the IOCs assume to respect these principles when implementing the oil and gas operations and also agree to minimize the use of extracted hydrocarbons for their operations. Moreover the Contractor is sure to provide the funds required to carry out exploration and according to the terms of the contract, undertake the development of all the oil and gas operations through the Contract area.[101]

According to the terms of the contract, IOCs must reimbursed SOCAR for any direct costs as a result of service fees, with such claims for payment supported by the relevant documentary evidence.[102] The PSAs in Azerbaijan help the contractor to focus only on the process of exploration and development.

This is achieved through government assistance with administrative issues such as visas, assistance with bank accounts. The government also provides a certain amount of safety in terms of investments through protective laws. Moreover if a clause in the contract conflicts with national law, the contract takes precedence. Along with tax breaks concerning oil related materials imported by foreign countries and the absence of VAT, Azerbaijan PSAs are designed to promote foreign investment.

[100] Ibid.
[101] Ibid.
[102] Ibid.

The ACG contract is ratified by the National Parliament which gives the contract legislation of Azerbaijan law and takes priority over current law or any governmental .And without the agreement of companies it cannot be changed by the local government. In comparison with Similar PSAs in Russia, Kazakhstan and in Turkmenistan these cases are not elevated the state of law by the Parliament. This gives ACG contract more reliability and allows foreign oil companies to invest in the project.

### 3.3 CASH FLOW

The mechanism of Azerbaijan oil contracts according to profit share takes several forms. The first form is "Sharing profit according to R-Factor" for example: Shakh-Deniz PSA contract, the second form "Sharing profit Based on production" which was used in early PSAs, the third "Sharing profit according to Rate of return (RROR)" an example is the ACG PSA, the fourth form is called a Hybrid of which an example is the Kashagan PSA and includes both the R-Factor and rate of return.[103]

This diversity in Azeri PSAs concerning the choice of cash flow mechanism provides an opportunity to foreign oil companies to choose the appropriate financial instruments. This is another factor which is a key to promoting foreign investment in Azerbaijan.

| Real Rate of Return (RROR) | Profit share of SOCAR | Profit share of IOCs |
|---|---|---|
| RROR < 16.75% | 30-25% | 70-75% |
| 16.75% ≤ RROR <22.75% | 55-50% | 45-50% |
| 22.75% ≤ RROR | 80-75% | 20-25% |

Tables 4.[104] ACG Sharing Profit Oil according to RROR

[103] Dr. Ingilab Ahmadov. An Agreement Is Worth More Than Money. 2010
[104] Dr. Inglilab Ahmadov. Power Point: "PSAs". Khazar University 2009/2010

In the case of the ACG contract, share of profit is linked to the RROR as shown in the above Table, meaning that increasing of RROR for the IOCs led to decrease in the profit oil share, calculations for covering expenses and sharing profit oil are done on a quarterly basis, using the financial indicator RROR These figures take into account the overall transportation cost equal to or higher than $3 per barrel.[105]

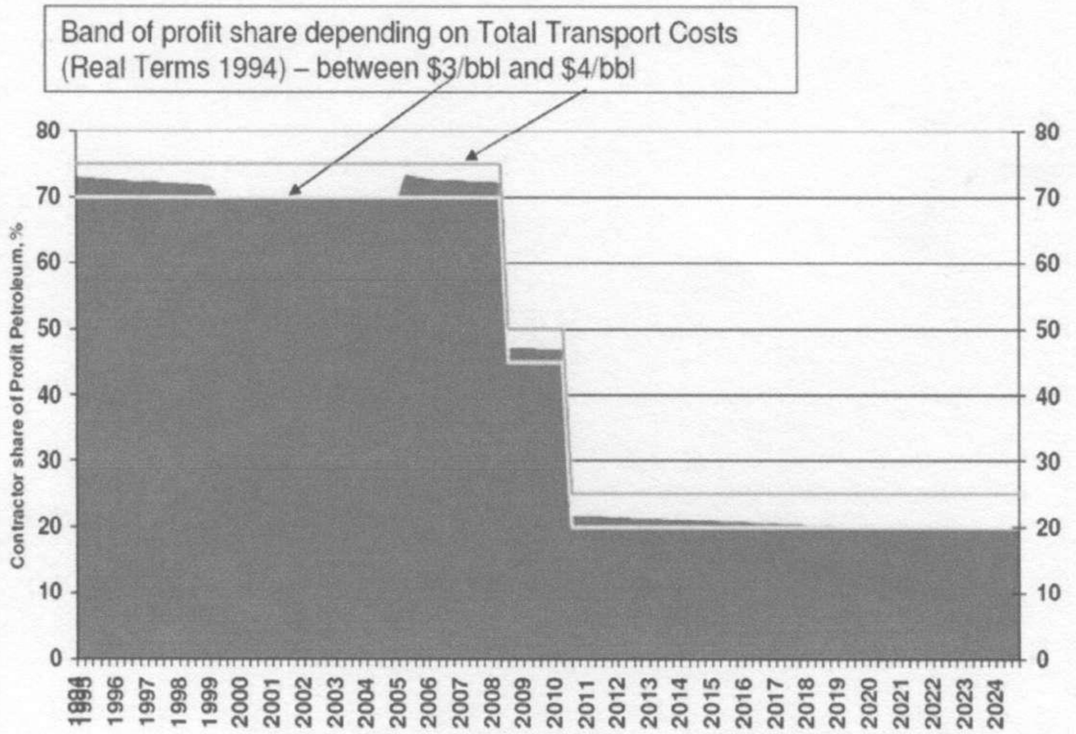


Figure 5.[106] ACG PSA – Profit oil Sharing

Figure 5, shows the correlation between the RROR and the profit oil share which appears clearly viable in the diagram. When the ACG project started to produce first oil in 1997 a huge amount of money was invested for exploration and development by the IOCs. The IOCs profit oil share about 70%. In contrast, the government received an average about 30% this disparity was present in order to cover exploration, development and capital costs.

[105] Sabit Bagirov. Oil of Azerbaijan Revenues, Expenses and Risks(view from 2007). 2007.page 33
[106] Extractive Industry Transparency Initiative(EITI).April, 2006.http://www.eiti-az.org/ts_gen/eng/eiti_news/intconference_PeterWells_presentation_e.pdf

It is clear in Figure 5 that starting from 2008 to 2010 there has been a drop in the profit oil which the IOCs received with a profit share average of about 48% and on the other hand the average RROR increased. Moreover, starting from 2010 till the end of ACG contract, the IOCs profit oil share about 20% and SOCAR profit oil share about 80% as a result of the break-even point of costs. Taking into account the difference in the figure which reaches about 5% in the profit oil share depending on the total cost of transportation per barrel, which stands currently at between ($3and$4)bbl.

It is also noticeable that the ACG project Payback covered by 2008 at $30/bbl oil price and the PROR is considered high (~17% to 23%). In comparison with Kashagan in Kazakhstan, the Project Payback is expected to be covered by 2018 at ($30/bbl) or by 2013 at oil price ($50/bbl), and the RROR is about 12.5% ($30/bbl) and 18% ($50/bbl).[107] One of the specific characteristics of ACG is the rapid recovery of investments made by IOCs which is preferable for the IOCs, thus making ACG a better investment than Kashagan.

The ACG profit oil sharing mechanism is calculated on a very detailed sliding scale, thus offering flexibility in case of oil market price changes. "Cost oil treatment is on the generous side in line with many Asian contracts".[108] For example, in the case of many Indonesian PSAs, Egyptian PSAs, Yemen's PSAs, and some Malaysian PSAs they still quietly depend on volume-based scales and sometimes on fixed cost-oil percentages.[109] This means that the ACG contract offered an appropriate profit oil sharing mechanism and shows how the ACG was a profitable project for the investors.

**ACG PSA cost of recovery:**

In case of ACG oil contract cost recovery, the contractor parties allocate fixed percentage in order to recover all operations which calculated from total gross revenues. The percentage is about 50% from the revenues according to the contract stipulations. The IOCs are allowed to recover petroleum costs in the following way:

[107] Ibid.
[108] Kirsten Bindemann. "Production-Sharing Agreements: An Economic Analysis" .October1999. http://www.oxfordenergy.org/pdfs/WPM25.pdf
[109] Ibid.

**Operational expenses (OPEX)**

This covers Current operational expenses, for purchasing materials and paying for all work done. It is permitted for these costs to be recovered from the total production, the OPEX calculated daily. [110]

**Capital expenses (CAPEX)**

This covers the Current expenses incurred by the purchasing of equipment and drilling expenses including the capital costs of Platforms and pipelines. All of these Capital costs are allowed to be recovered from a maximum of 50% of the remaining crude oil, in case of unrecovered capital costs it collected on a quarterly basis and the Capital Cost Recovery oil that was not used considered as additional Profit oil. [111]

It is also obvious that the profit oil remaining after cost recovery is divided between SOCAR and the IOCs on the basis of the contract conditions and according to the cumulative after-tax RROR, the percentage of profit oil share may differ from one time period to another depending on the time table of the project.

The next figure predict the economic outcome of the ACG project, also the CAPEX and OPEX, Figure 6, shown the correlation between expenses and the profits, considering the average rate of oil barrel about $50 bbl (Brent blend), As seen the CAPEX for the project started in 1994 and grew with the development of the project Phases. It peaked between 2002 and 2006, this means that increasing the CAPEX rate will reduce SOCAR profit oil share.

[110] Bakhtiyar A. Aslanbayli. "The International Agreements signed with Foreign Investors in Azerbaijan Oil and Gas Industry: Production Sharing and International Taxation matter". http://userpage.fu-berlin.de/ffu/veranstaltungen/caspian_region_workshop06/Aslanbayli.pdf

[111] Ibid.

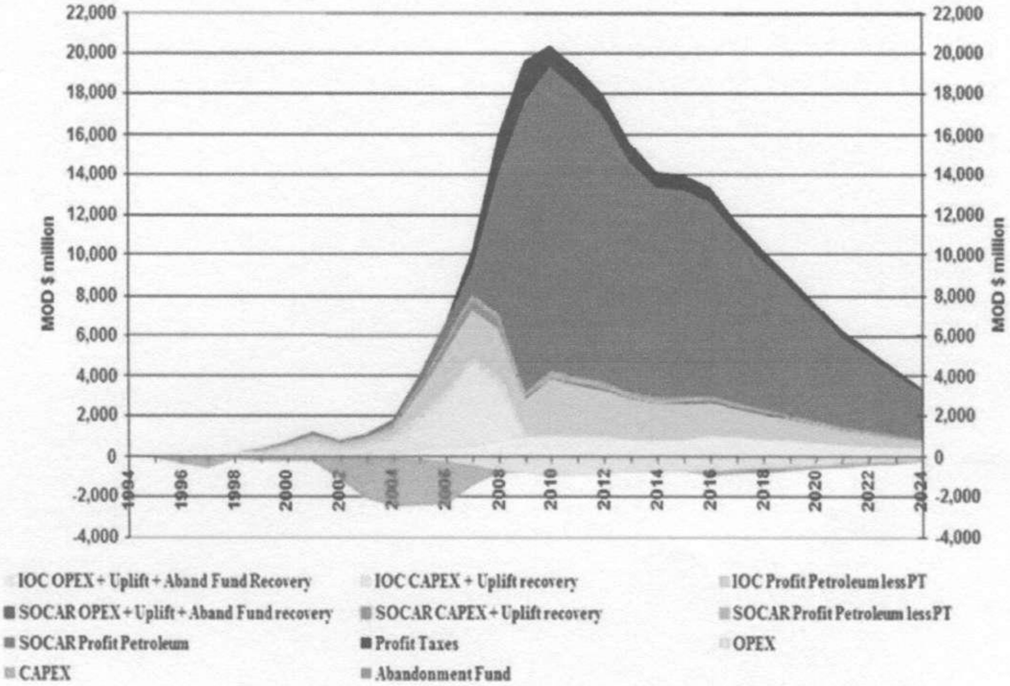


Figure 6. [112] ACG PSA – Economic Outcome Brent Blend $50/bbl

By contrast, during the period 2004 to 2008 there was growth in SOCAR profit oil. The curve is expected to peak between 2010 and 2012 with SOCAR expected to receive the maximum profit oil as the result of the break-even point of CAPEX. This is accompanied by Profit taxes, taking into account the continuation of OPEX through the whole period of the contract.

Covering exploration expenses In Azerbaijan usually takes place by different annual rates. In the case of the ACG project the annual interest rate for the financial expenses are fixed at a rate of 4%. Different contracts in Azerbaijan, for example the Garabag contract had the same level of interest applied to them. [113] It is also noticeable that from Figure 6 In the case of ACG, the CAPEX was recovered over a period of 12 years. The recovery of CAPEX in comparison with the Kashagan field in Kazakhstan was relatively short, considering that the Kashagan field will is expected to break even at least in 2013, about 16 years after the contract was signed.

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[112] Extractive Industry transparency initiative (EITI) .April, 2006 http://www.eiti-az.org/ts_gen/eng/eiti_news/intconference_PeterWells_presentation_e.pdf
[113] Sabit Bagirov. Oil of Azerbaijan Revenues, Expenses and Risks (view from 2007) 2007.pages(36-37)

**ACG PSA – Cash Movements 2010**

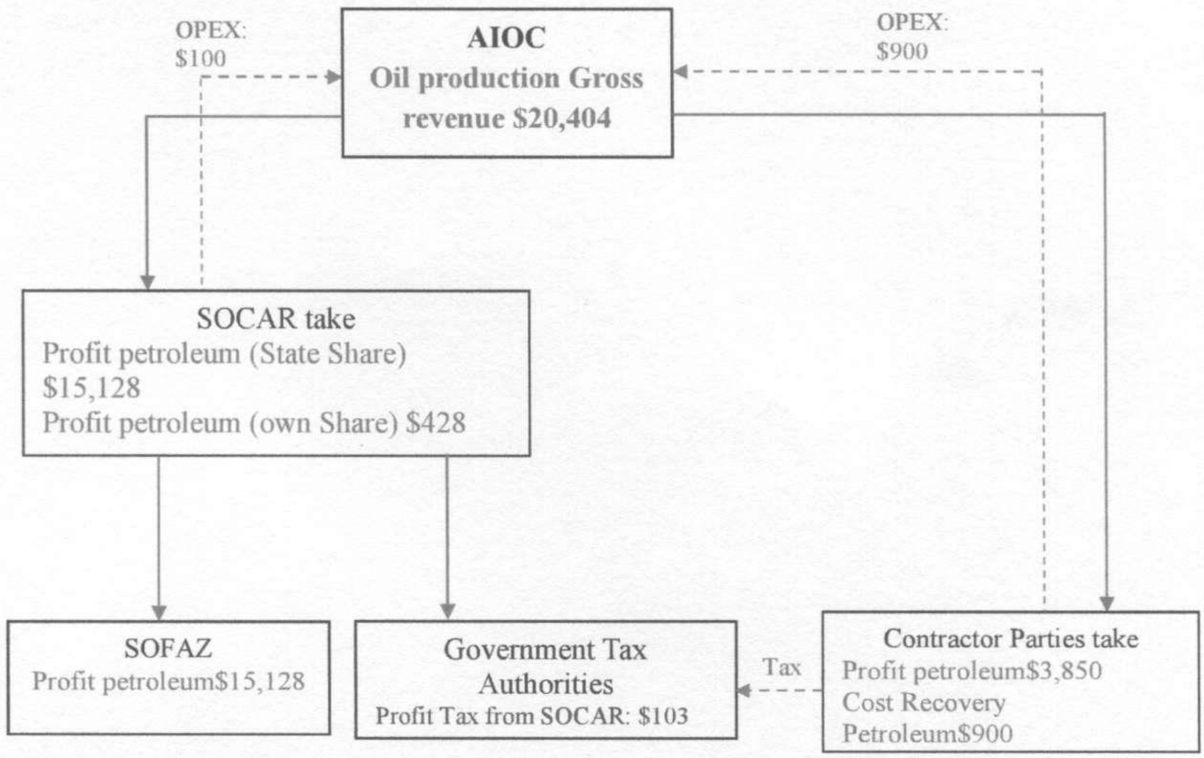


Figure 7. [114] ACG PSA – forecasting Cash movement in 2010

The above diagram explains the mechanism of cash flow for the ACG PSA, taking into account a Brent oil price of $50/bbl. There is no CAPEX and total OPEX is $1 billion. The diagram also shows that SOFAZ received the state's share of profit petroleum through SOCAR and SOCAR also paid tax on its own share of the profit petroleum. Considering that in 2010, oil prices have been higher than those used in the diagram so revenues are considerably higher.

[114] Dr. Inglilab Ahmadov. Power Point: "PSAs". Khazar University 2009/2010

In case of the ACG tax payment its levy of 25 % on profits oil tax for IOCs in fact is not tough in comparison with the Angolan PSAs which are in many respects similar to Azeri PSAs. Angola's PSAs apply 50 % income tax which is considered comparatively high. Moreover Indian PSAs apply 50 % profit oil tax, the tax rate in Malaysian PSAs is about 45 % and also Nigerian PSAs has slightly higher income tax. [115] In view of Kazakhstan the situation is different they have no fixed percentage degree in PSAs and changes in state law.

It is clear from this comparison between the ACG contract and similar PSAs in different countries around the world that Azeri PSAs have a strong advantage in profit oil tax. Certainly the ACG project provides an excellent opportunity for foreign oil companies.

Also one of specifics of the ACG comparatively with international PSAs which ACG foregoes any royalty payment in comparison with Indian PSAs which applied royalties of 5 % for deep-water fields, Malaysia PSAs has royalty rate of 10 %, and Algerian PSAs applied at least 12% royalties.[116] Furthermore in case of oil fields in caspian region for example the Sakhalin 2 oil field in Russia. Where the later apply a royalty tax of 6 % on gross revenues.[117]

Overall we can conclude that the non-existence of royalties in the ACG contract played an important role in attracting foreign investment. Because usually the IOCs dislike royalties, and desire taxes based on profits

### 3.4 ACG: BONUS PAYMENTS

Bonuses are a cash payment paid by a foreign oil company to the government for the extraction or development of an oil and gas fields usually given in US Dollar. The bonus is paid at the time of signing the contract, bonuses payment are common in most of PSAs contracts around the world. Usually there are three types of bonus.

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[115] Kirsten Bindemann. "Production-Sharing Agreements: An Economic Analysis" .October1999. http://www.oxfordenergy.org/pdfs/WPM25.pdf

[116] Ibid.

[117] Dr. Ian Rutledge. "The Sakhalin II PSA –a Production 'Non-Sharing' Agreement Analysis of Revenue Distribution." November 2004 http://www.foe.co.uk/resource/reports/sakhalin_psa.pdf

**Signature Bonus:** This is a fixed, one-off lump sum payment made to government authorities soon after the two parties sign the contract. The calculation of this type of bonus differs from other payments because most countries invite tenders in order to select the most competitive offer for the granting of mineral rights and the signature bonus must suit the criteria: that is to say the higher the bonus offered, the more chance the bidder has of winning the contract. [118]

Furthermore, the state sets the minimum acceptable amount for signature bonuses. It must be emphasized that signature bonuses are not illegal or any form of bribe, but are widely accepted throughout the world as giving an opportunity to a country to receive immediate benefits from the investment.[119]

**Commercial discovery bonus:** Is a fixed payment made by the subsoil user every time there is a commercial discovery made on the territory covered by the contract. [120]

**Production bonus:** It is paid upon the achievement of certain levels of production; Oil companies often give up this bonus, opting to pay higher income taxes.[121] The most common types of bonus in Azerbaijan PSAs contracts are the signature bonus and production bonus. The first and biggest bonus payment it was combined into the ACG contract with sum of US$300 million .Which was made to SOCAR as the official representative of the Azerbaijan government.

According to the ACG Contract, a bonus of US $300 million was allocated to the government of Azerbaijan. The First installment payable by the IOCs to the government was US$150 million, on the date the contract came into effect. [122] According to Ilham Shaban oil expert they allocated as "80 million dollars had already been paid before the signing of the contract (30 million dollars were paid back in September 1992). Seventy million dollars were to be paid after the ratification of the contract by the Azerbaijani parliament".[123]

[118] Dr. Ingilab Ahmadov. An Agreement Is Worth More Than Money. 2010
[119] Ibid.
[120] Ibid.
[121] Ibid.
[122] Azeri- Chirage –Guneshli http://www.bp.com/sectiongenericarticle.do?categoryId=9006667&contentId=7015091
[123] "Halfway Through Journey: What Did Azerbaijan Gain from ACG Project?" http://www.azerbaijantoday.az/ARCHIVE/25/politics.html

The second installment payable by the IOCs was 50% of the total bonus agreed which in this case US$75 million would have to be paid when the daily oil production reached to 40,000 bpd and the last US$75 million would have to be paid after pumped the oil through the pipeline.[124]

According to Public Finance Monitor Center (PFMC) the first bonus tranche of ACG contract is US$ 30 million was paid in 1992 .The largest part of the bonuses agreed in ACG contract is US$ 122 million was paid in 1995. Some of money received was used by the government to support the national currency rate, and some went to the country's foreign exchange reserve. The final bonus tranche was paid in 2004, by developing the deepwater areas of the Guneshli field.[125]

It is important to note that bonus payments in Azerbaijan for the ACG contract are considered to be particularly high in comparison with other countries such as Kazakhstan. This has given Azerbaijan PSAs the reputation of being tough, other factors contributing to this reputation are the high taxes and the mechanism for sharing profit oil. [126]

This can be argued as taxes take profit into account and replace royalties, moreover, a new nine step profit oil sharing mechanism has been developed since the ACG contract, replacing the three step mechanism previously used in PSAs

Bonus payments constitute a large part of the revenues received by the state from the oil industry. The bonus payments at the start of the ACG contract were especially important as the state was in financial difficulty and state budget expenditures were higher than revenues. The added revenues provided by the ACG bonus payments played an essential part in kick starting Azerbaijan's economy.

[124] Ibid.
[125] Dr. Ingilab Ahmadov. An Agreement Is Worth More Than Money. 2010
[126] Kirsten Bindemann. "Production-Sharing Agreements: An Economic Analysis" .October1999. http://www.oxfordenergy.org/pdfs/WPM25.pdf

**Profitability of the ACG**

The Potential revenues to the government of Azerbaijan and IOCs from the ACG project according to PFMC, which predict by the most important financial indicators of the Azeri-Chyrag-Guneshli Project by billions of dollars. As can be seen in Table 5, the calculations are done according to different oil prices. At a price of $60 per barrel, the government will earn about $200 billion which appears the importance of the ACG for Azerbaijan economy. Also the IOCs will earn $44 billion; this gives opportunity to make large profits.

| Oil price (US$ per barrel) | 60 | 50 | 40 | 20 |
|---|---|---|---|---|
| Internal profitability (%) | 27 | 25 | 24 | 18 |
| Companies' net profit | 44 | 40 | 32 | 24 |
| Government's profit oil | 180 | 152 | 112 | 24 |
| Income tax | 15 | 13 | 11 | 8 |
| Government's total revenue (including SOCAR's share) | 199.4 | 169 | 126.2 | 34.4 |

Table5. [127] The important financial indicators of the ACG (US billions of dollars)

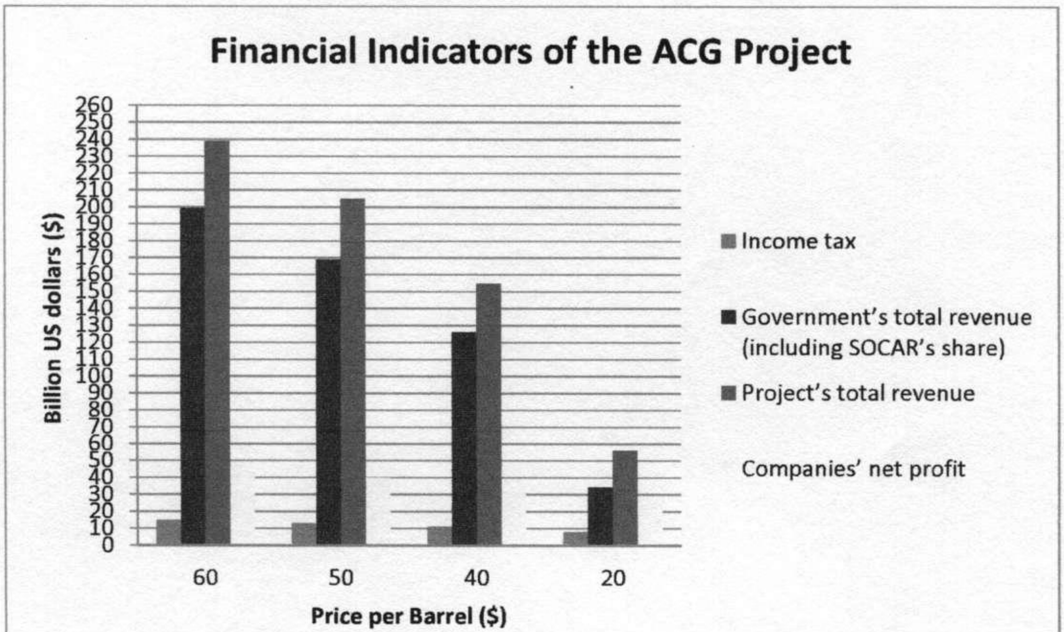


Figure8. [128] Financial indicators of the ACG project.

[127] Ibid.
[128] Ibid.

As shown in Figure 8, the maximum oil price was estimated at US$60 per barrel. By 2008, the real price of a barrel of oil on the world market reached US$120, which means that revenues of the government and the IOCs will be higher than the forecasted. Starting from the year 2014 80% of profit oil share would belong to Azerbaijan, and 20% to the IOCs. Due to the sharp growth of oil prices in world market since July 2008 Azerbaijan began to gain 80% of profit oil share. Thus if Azerbaijan applied another mechanism the state may not have achieved this profit so early.

The ACG is an extremely profitable field. For example, if we consider the cost for one barrel of oil is US$10 and now the price for oil is more than $90 in the world market and most probably the price for Brent type oil will not be less than $ 80 for the rest of 2010. It means there is 800% profit. After subtracting the investments and the government taxes the net profit will be about 250-300%.

From this viewpoint the ACG project is very successful compared to Kashagan which is still delayed in terms of production, causing Kazakhstan to incur losses. In addition, neither the investors nor the government can predict the cost per barrel by the beginning of production.

Exactly five years after the ACG contract was signed, Azerbaijan started to receive the first profit oil. In comparison, so far, no oil has been extracted from Tengiz, the largest oil field in the Caspian which lies in the Kazakh sector of the sea, although a contract on its development was signed in 1997. Oil extraction from the field is expected delay.

## 3.5 LOCALIZATION AND TRAINING CITIZENS

The arrival of IOCs in Azerbaijan provided opportunities for the local labor force. Considering that Azerbaijan has had a long history of oil extraction and production, there was already a base of knowledge to build upon through training and employing the local work force.

According to ACG contract, which the government requested to the IOCs to provide the opportunity to local companies and suppliers in order to maximize utilization of local employees, and also the contract include the overall target ranges for the local employees, this percentage including both of professional and non-professional employees. Moreover, the IOCs shall provide training Programs related to the project for local employees which lead to enhance the skills and ability of local workforce in the future.

From the terms of ACG contract the localization of Azeri citizens should be reach to 90% through five years from starting of first oil from the field development in the project and Non-professional 95% of the total workers in the project.[129]

According to BP 2009, sustainability reports the objective of the BP in Azerbaijan "to create a local company run by qualified Azerbaijani citizens". That requires more and more development in order to increase the total number of qualified local workforce in both junior and senior positions. Also the company focused on ethical awareness programs and workshops for contractors.[130]

The report mention reveals that most of BP business operations in Azerbaijan is run in co-operation with local Partners, By 2008 the total permanent Azerbaijani citizens in BP were 1,839 workers. This number grew during the end of 2009 to 1,975 worker including about 399 women due to expansion in operations. BP was invested in staff training programs about $6 millions, other part of BP efforts to improve the staff qualifications by offering scholar education abroad which reached by end of 2009 about 92 scholar. Twelve of them graduated.[131]

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[129] ACG PSA Oil contract http://www.bp.com/sectiongenericarticle.do?categoryId=9029334&contentId=7053632
[130] "BP in Azerbaijan sustainability report.".2009.www.bp.com/caspian/sr
[131] Ibid.

AIOC expects that development of ACG project should involve about 9 million man-hours during construction around 80% will be performed by the local workforce.[132] Despite the fact that the oil industry in Azerbaijan employs only about 1% of the labor force, the transfer of technology and knowhow from the IOCs is a vital part of the role they play in the country.

### 3.6 ENVIRONMENTAL PROTECTION AND SAFETY

By 1994 United Nations Development Program introduced the term "Environmental Security" in order to protect nature from threats and deterioration.[133] As a result of petroleum activities, Azerbaijan needed to improve the environmental strategy to protect the Ecosystem especially in polluted areas like the Apsheron peninsula,. Azerbaijan government pursued new strategy which based on sustainable development, protection of available ecological systems, and the efficient use of natural resources in order to meet the needs of existing and future generations.[134]

According to the ACG contract terms which explain and systematize the relationship between the government and the IOCs which obligate the contractor to run the operations with safe and efficient manner according to international Petroleum industry standards in order to minimize any environmental impacts effects and in case of any damage .

From the terms of the ACG contract the IOCs shall be responsible to fix the damage in accordance to the international practices the contract regulate the most important issues related to environment and systemize the conditions and limits for example: produced water, drilling fluids, drill cuttings. Now we will explain some important environmental Issues related to the ACG oil and gas contract.[135]

[132] Offshore magazine. "AIOC kicks off Chirag Oil Project."2010. http://www.offshore-mag.com/index/article-display/3398367080/articles/offshore/production/caspian-sea/2010/07/aioc-kicks_off_chirag.html
[133] United Nations. "Human Development Report."1994. http://hdr.undp.org/en/reports/global/hdr1994/
[134] http://www.eco.gov.az/en/es-esasistiqametler.php
[135] ACG PSA Oil contract http://www.bp.com/sectiongenericarticle.do?categoryId=9029334&contentId=7053632t

**Produced Water Disposal:** The IOCs will endeavor to utilize produced water for reservoir, not be allowed to discharge the water in the Caspian Sea this water it will be monitored daily, and in case of emergency the IOCs may discharge part of produced water to the Caspian Sea after treatment.[136] This means that the governments taken into account the environmental interests in ACG oil contract.

According to BP sustainability report 2010, Oil produced from the ACG field contains a percentage of water 95% of produced water is re-injected into the reservoir and the remaining 5% are transported with oil to Sangachal Terminal, which separated then pumped the oil into BTC pipeline the received produced water was treated by Operating Company and the rest evaporated naturally.[137]

**The discharge air emissions will be limited and monitored as follows:** Under the ACG contracts any buildings or an installation, which has atmospheric emissions (greenhouse gases), shall install the best available control technology in order to reduce the emissions.[138] Recently, there is an international, effort to reduce emissions of greenhouse gases.

**Drill Cuttings and Drilling Fluids:** The ACG contract terms referred to there is no discharge of drill cuttings or drilling fluids association with the use of oil or drilling fluids that contain waste engine oil, this system will be monitored and tested under specifications of U.S. Environmental Protection Agency.

**Safety:** According to the terms of the ACG contract, IOCs shall make allowances for the international safety standards such as: Use of associated gas as fuel gas for offshore and onshore facilities and for re-injection offshore for reservoir pressure maintenance, lower concentrations of chlorine being discharged to sea and treat sewage waters.

[136] Ibid.

[137] http://www.bp.com/liveassets/bp_internet/bp_caspian/bp_caspian_en/STAGING/local_assets/downloads_pdfs/c/COP_ESIA_07_Introduction_en.pdf

[138] Ibid.

According to BP sustainability report in 2008 all offshore drill untreated drill cuttings was received and the oil were recovered and returned to supplier for re-use, the same oily/chemical waste re-injected, BP's dedicated non-hazardous waste landfill cell in Sumgait It is designed and constructed under European Union environmental standards.

Azerbaijan has improved the cooperative environment for the solution of environmental problems by adopting there oil contracts according to environmental international standers, The catastrophic oil spill in the Gulf of Mexico has highlighted the environmental risks, in Azerbaijan and elsewhere, BP aim to develop oil spill plans for ACG project and also aim to manage their operations in a safe and responsible manner, BP audit the environmental management systems under ISO 14001 environmental standards.[139]

Despite the environmental issues related to oil industry in Azerbaijan, such as the environmental impact of the BTC pipeline, the impact of the fishing industry which effected by marine pollution, environmental issues are very complicated problems and there are no magic solutions to solve them, even in developed countries. But still careful attention is required from the governments and the contractors.

The requirements in the ACG contract in terms of environmental security are part of the particularities of PSAs in Azerbaijan. The IOCs as well as the state oil company are required to conform to international standards. Despite this, environmental challenges still remain concerning the oil industry; these require cooperation between NGO's, IOCs and the state to find solutions.

[139] BP in Azerbaijan sustainability Report ,2009 www.bp.com/caspian/sr

### 3.7 ARBITRATION

According to ACG contract "This Contract shall be governed and interpreted in accordance with principles of law common to the law of the Azerbaijan Republic and English law" and also be subject to the international law, after ratification by the Parliament this contract shall constitute a law and shall take precedence.[140]

This framework between the contractors and the government, should give more opportunities to the IOCs which always seek to maximum degree of flexibility, stability and safety regimes. Furthermore, in case of rising conflict between parties, in the worst case if there is compensation the used currency will be US Dollar, which are widely used and have a good reputation.

Azeri PSAs has specifics of a three step process for the resolution of conflicts. Especially in case of the ACG contract offered a flexible mechanism for Arbitration First, the resolution of the conflict is mitigated by local law, if this fails to satisfy the parties, English law is consulted. If these two methods are not accepted by the parties involved, the third option is to consult Canadian Alberta law which is related to international arbitration which usually risky.

### 3.8 TRANSPARENCY

Transparency in extractive industries is very important, particularly in case of signing contracts, mainly in countries which the GDP is heavily dependent on such sectors. It is possible to use resource revenues for sustainable development programs such as: spending oil revenues for social needs, at the risk of causing inflation or having to borrow when oil prices fall, and for promoting the non-oil sector, thus making it more competitive.[141]

[140] ACG PSA oil contract. http://www.bp.com/sectiongenericarticle.do?categoryId=9029334&contentId=7053632
[141] Svetlana Tsalik, of the Caspian Revenue Watch. Caspian Oil Windfalls: Who will Benefit? Copyright 2003 by Open Society Institute.

In Azerbaijan, the extractive sector, mainly the oil and gas sector, has provided the country with stable GDP growth in recent years. In order to achieve sustainable development within oil and gas contracts, the extractive sector needs to become more transparent with good proportions of oil revenues which can be used to raise living standards for citizens and future generations. [142]

Absence of transparency may lead to loss of huge amounts of money, governments in resource-rich countries, during signing any oil contract; have to keep in mind society's interests. In order to protect them from any suspicious deals, to avoid such problems, Azerbaijan joined to Extractive Industries Transparency Initiative (EITI), on June 17th 2003. [143]

PSAs are the most standard form of extractive industry contract and have become an integral part of Azerbaijan's energy policy. In the case of ACG, the contract is consider one of most transparent contracts not only in Azerbaijan, but also in the Caucasus, all the information about the contract is available to the public which gives the opportunity to talk about the average of expected profit margin. This means ACG has a good legal status in comparison to other contracts such as the Kashagan contract in Kazakhstan for which there is no possibility to access any information.[144]

Azerbaijan government in order to ensure more transparency was established Sovereign Wealth Fund, the State Oil Fund of the Republic of Azerbaijan SOFAZ. It was established in December 29th 1999 which playing a very important role to ensure equality of public utility of Azerbaijan oil wealth, protection of the economy from over-injection of revenues into the budget, corruption and Dutch Disease effects. According to International Monetary Fund (IMF) report in 2003 concerning to SOFAZ it was established in order to ensure transparency in management of oil revenue. [145]

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[142] Ibid.

[143] Sabit Bagirov. Oil of Azerbaijan Revenues, Expenses and Risks(view from 2007). 2007.page 125

[144] Dr. Ingilab Ahmadov. "Why Is Oil Contract Transparency Necessary?." http://www.pfmc.az/index.php?option=com_content&view=article&id=261:why-is-oil-contract-transparency-necessary&catid=36:our-products&Itemid=60

[145] SOFAZ. "Goals and objectives." http://www.oilfund.az/en/content/3

In 2007 SOFAZ won the UN Public Service award for improving Transparency, Accountability and Responsiveness in Public Service.[146] SOFAZ publish its annual report for officials and public more fairly, the report exactly refers to transparency as a key objective.

Azerbaijan followed transparency policy in oil and gas contracts, it can be seen that the government as well as NGO's have taken important steps in promoting transparency in the entire oil industry, with specific focus on contract transparency. This is particular to Azeri PSAs, compared to other countries in the region such as Kazakhstan. This plays an important role in attracting foreign investment, as well as involving civil society and the general public in the economics of the oil industry in Azerbaijan. This promoted sustainability of the economy as a whole.

### 3.9 NATURAL GAS

According to ACG contract, the Contractor has right to extract associated Natural Gas within the Contract area, the associated gas delivered to SOCAR free of charge.[147] Before 2003, the AIOC had already given Azerbaijan 9.9 billion cubic meters (bcm) of associated gas, the ACG has recoverable associated natural gas about 100 bcm, which is very small amount compared to Shah Deniz field which has about 850 trillion cubic meters of natural gas and about 200 million tons of gas condensate.[148]

Azerbaijan became a net exporter of natural gas in 2007 with the startup of the Shah Deniz natural gas field. By 2008, Azerbaijan produced 572 billion cubic feet of natural gas and consumed 376 billion cubic feet, the rest has been exported which estimated 196 bcf, Almost all of natural gas is produced from offshore fields like ACG and the new Shah Deniz. Azerbaijan's natural gas exports by South Caucasus Pipeline (SCP), also known as the Baku-T'bilisi-Erzurum pipeline (BTE), which runs parallel to the BTC oil pipeline.[149]

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146 http://www.oilfund.az/en/account#

147 ACG PSA oil contract. http://www.bp.com/sectiongenericarticle.do?categoryId=9029334&contentId=7053632

148 Sabit Bagirov. "Oil of Azerbaijan Revenues, Expenses and Risks(view from 2007)" 2007. http://www.eiti-az.org/ts_gen/eng/news/2007/nae-14.htm

149 Ibid.

As can be seen above the potential target of ACG natural gas is not high, where the volume generated from the field is not in large scale, and still believes that there are undiscovered reserves so it is preferable that, the government has to offer more benefits in order to attract foreign oil companies to explore and develop this sector.

**Summary:**

This chapter has shown that the ACG contract demonstrated many of the Azeri PSAs characteristics discussed in chapter two. Those specifics not included in the ACG PSA were developed after the signing of the 'contract of the century'. Despite this, the ACG contract set the trend for future PSAs. Listed below are the specifics seen in chapter two put in practice in the ACG contract:

- In terms of company's participation, it was revealed that the ACG contract allowed companies to buy and sell shares according to their interests. This shows the flexibilities of PSAs in Azerbaijan.

- The ACG contracts offers above average cost oil with operating costs being recoverable immediately, there is no royalty. The ACG contract stipulates 25 % profit oil tax income for the IOCs.

- The fact that the clauses in the contract take precedence over the local law is a further specific concerning rights and obligations of the parties involved. Meaning that if a condition exists in the contract which conflicts with local laws, the contract terms prevail.

- PSAs in Azerbaijan use one of four mechanisms for the sharing of profit oil. RROR, R factor, sharing profit Based on production, and a Hybrid (RROR and R factor). In the case of ACG, the mechanism used is the RROR. This mechanism is considered to be costly for the IOCs in comparison to the Kashagan contract in Kazakhstan. Moreover, Azeri PSAs replace the common royalties used in other countries with taxes on profit.

- Concerning bonus payments, the specifics of Azeri PSAs has a negative reputation. Bonus payments are considered to be high relative to other countries.

- The ACG contract dictates that the labor force in the operational areas be split between foreign and local workers. The ratio of foreign workers to Azeri workers shifts from about 80% foreign to 20% local at the beginning of the contract and ideally, as the contract period progresses, the ratio will be inversed. This occurs as the local labor force is trained to replace the foreign workers.

- Environmental security and safety in Azeri PSAs is subject to international standards to ensure minimum impact on the environment and maximum security for the labor force. The issue of environmental sustainability and safety was not commonly addressed in the region before the implementation of the ACG contract.

- The specifics of the approach to arbitration, introduced by the ACG PSA, is that firstly, the PSA contract is elevated to the status of law in the Republic of Azerbaijan after being approved by the parliament. Secondly, if conflicts develop concerning principles of law, they are to be resolved following the local law, if this fails, English law is consulted and in the case that conflict remains international laws of arbitration are implemented.

- Transparency is a key issue in Azeri PSAs which distinguishes them from PSAs in other countries. The transactions between the government and the IOCs are open to be viewed by the public which is not the case in other countries. Transparency is further promoted in the principles of SOFAZ, the sovereign wealth fund as well as the various NGOs present in Azerbaijan.

- IOCs transport the associated natural gas which is recovered from the ACG oil fields to the Sangashal terminal in Baku at no cost to the government.

## CONCLUSION

The objective of this thesis is to define the specific characteristics of PSAs in Azerbaijan with a precise focus on the case of the ACG contract. This is done through the analysis of Azerbaijan's extensive oil history, followed by a brief look at different types of oil contracts commonly used in oil producing countries, and then an analysis of the general terms of PSA's. Once the general information is covered, the focus shifts to the specifics of PSAs in Azerbaijan and the application of those specifics are underlined in the so called "contract of the century" the ACG PSA.

The following points are the findings resulting from the research performed:

- Oil contracts represent the relationship between oil producing countries and international oil companies that are invited to perform certain tasks. The most important part of the process is choosing a type of oil contract which corresponds to the needs and expectations of both parties.

- The policy of Azerbaijan, at the time of their independence in 1991, was risk averse and the country wanted to maintain ownership of its resources as well as partial control, this would provide the best solution for current and future generations, which is consistent with the policy of the country whose aim was to retain its resources. Also, Azerbaijan was in need of foreign investment to begin developing their oil and gas resources in order to facilitate economic growth as economic performance of the newly independent state was very low due to difficulties faced after its independence. The combination of these factors led to the choice of PSA contracts.

- The choice of PSAs would be beneficial in two ways, firstly the foreign investment would enhance the suffering economy of the newly independent state, and secondly foreign involvement in the region would act as a stabilizing force, politically and socially.

- Azerbaijan adapted the PSAs to meet their needs and make their PSAs more attractive to foreign oil companies. The following points list some of the important specifics discovered during my research:

    - One of the most important factors which Azerbaijan has implemented is that PSAs are elevated to law status thus eliminating a large risk for IOCs.

    - Flexibility for companies participations, concerns buying and selling shares in the contract between IOCs.

    - Higher than average cost oil as well as the ability of operating costs being recovered immediately.

    - Four mechanisms for calculating the share of profit oil between IOCs and the state are available in Azeri PSAs. One of the four must be agreed upon in each PSA contract.

    - Taxes are paid on a rate of return basis, avoiding royalties. Profit oil is shared between the NOC and the IOCs according to a sliding scale. Accounting is done in US dollars.

    - Tax exemption in some cases, such as VAT, tax on dividends, and tax on reinvested revenues, are another factor which increases the attractiveness for FDI. Furthermore measures are taken by the Azeri government to avoid double taxation on IOC's profits in their countries of origin.

    - Relatively high levels of transparency.

    - Azeri PSAs respect international standards for environmental security and safety of the labor force.

- Overall, Azerbaijan has been successful in the implementation of specific clauses in their PSAs this is proven by the large number of PSAs signed in the last 15 years.

- Some of the negative factors seen in Azeri PSAs include the fact that bonus payments are considered relatively high in Azerbaijan; they are on a par with bonus payments required in the Middle East. Furthermore he Trade Press has, in the past, labeled the contracts in Azerbaijan as being "tough". It can be argued that this is not the case as taxes take profit into account and profit oil is shared according to a comprehensive, nine step sliding scales.

- The ACG contract marked the beginning of the post-soviet oil production in Azerbaijan. It has played an essential role in directing the oil industry down a prosperous path, setting an example to be followed by subsequent PSAs. It is important to note that the ACG contract ensure the fivefold increase of oil production from 1997 to 2009. [150]

- The ACG case study seen in chapter three demonstrated the specifics of PSAs in Azerbaijan by relating them to specific clauses in the contract.

In conclusion, considering that current oil reserves in Azerbaijan are expected to begin to dwindle within about 20 years, it is important that the country promote further exploration, especially in offshore in the Caspian Sea. This requires the technology and knowhow of IOCs.

**To make these projects more attractive to IOCs, the government should consider:**

- Reducing the size of bonus payments, or delaying the payments to allow more incentive for exploration.
- Adapt the mechanisms for sharing profit oil between the IOCs and the state, giving IOC a larger percentage to encourage costly, more risky exploration.
- Higher risk should be compensated with higher rewards.
- Azerbaijan may consider offering other types of contracts such as concession agreements in order to share the risk with the IOCs. PSAs could also be adapted to allow a risk sharing mechanism which would be attractive.

[150] News.Az. "Investment within oil and gas contracts in Azerbaijan to be $60bn" September 23rd2010http://www.news.az/articles/economy/23251

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