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Azerbaijan oil and gas: risk service agreements

Aykhan Asadov
BM Morrison Partners
Baku

In May 2017, the Law of the Republic of Azerbaijan approving the Risk Service Agreement for the offshore block in the Caspian Sea including Umid field and Babak perspective (good) structure was promulgated. It is the first RSA for an oil and gas development approved into law of Azerbaijan.

Consistent with most, if not all, other oil and gas upstream deals in Azerbaijan, the State Oil Company of the Republic of Azerbaijan, SOCAR, acts in the deal for the Republic. Another party to the deal is SOCAR Umid Oil and Gas Limited, which we understand is a venture consisting of commercial partners, including SOCAR, itself, responsible to develop the block. The RSA comes with the agreement on the conduct of oil and gas operations for exploration and development of the block between the JV and a company, Umid, Babak Exploration and Production.

To underline an importance of this RSA, a flashback into the Azerbaijani oil and gas sector would be appropriate.

The Abseron Peninsula in Azerbaijan has long been known for its oil and gas that are often discharging to the surface; together with mud volcanoes, they form a unique landscape stretching along the Caspian. From world's first oil wells and oil barons, the oil industry – upstream, midstream, and downstream – has been and remains a driver of the Azerbaijani economy. Oil revenues accounted for 37.2% of Azerbaijan's gross domestic product in 2017 (up from 34.3% in 2016, but down from 56% in 2010).

Most current oil and gas production is based offshore in the Caspian Sea.

In 2017, Azerbaijan produced 38.7 million tonnes of crude oil and 18.2 billion m3 of commercial gas down from 41 million tonnes and 18.7 billion m3, respectively, in 2016 (source: State Committee for Statistics: <https://www.stat.gov.az/news/macroeconomy.php?page=2>, <https://www.stat.gov.az/news/macroeconomy.php?page=14&arxiv=1>). After the peak production of 50.8 million tonnes (including condensate) in 2010, oil production is expected to gradually decline. Gas production, on the other hand, is expected to increase, mainly for exports, as two important gas export pipelines – the Trans Adriatic Pipeline and the Trans-Anatolian Natural Gas Pipeline – are due to be commissioned in 2020 and this year, respectively.

The primary laws and regulations governing oil and gas industry in Azerbaijan include the Subsoil Law (439-IQ/1998), the Energy



Law (541-IQ/1998), and the Energy Resources Law (94-IQ/1996). On 28 March 2000, the president of Azerbaijan issued Decree on Measures to Improve the Issuance of Special Permits (310/2000), as subsequently amended.

The Subsoil Law governs the exploration, use, protection, safety, and supervision of the use of subsoil resources, including oil located within Azerbaijan and on the Azerbaijani sector of the Caspian Sea's continental shelf. The Energy Law is intended to complete the legal framework for the use of subsoil resources, including oil and gas. It establishes the social, economic, and legal bases of state policy for the energy sector.

Under the recent Law on Licenses and Permits (176-VQ/2016) the following require permits:

- production of gas and processing of natural gas;
- transportation of gas;
- distribution of gas;
- exploration of oil and gas fields;
- development and production from oil and gas fields;
- processing of oil and oil products; and
- transportation of oil and oil products by pipelines.

Azerbaijan is a signatory and a contracting party to the Energy Charter Treaty and the

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Energy Charter Protocol on Energy Efficiency and Related Environmental Aspects (ratification of the 1998 amendment is pending), and is a member of the Energy Charter Conference. It just signed the International Energy Charter.

The industry is managed by the SOCAR, SOFAZ, and Ministry of Energy triad. Further to Presidential Decree 149/2014, the Ministry of Energy helps implement state policy and administer the fuel and energy sector. In addition, SOCAR plays an important (in fact, on most issues a leading) role in such matters – especially in relation to the practical implementation of oil and gas projects. The State Oil Fund of Azerbaijan the Republic of Azerbaijan, SOFAZ, was established in 1999 to manage Azerbaijani oil revenues.

Notwithstanding the regimes set out in the Subsoil and Energy Laws, and underlining the strategic importance of oil to the country, most major oil deals in Azerbaijan have been and are approved by the country's legislature. In the absence of a production sharing agreement (PSA) law and a law on petroleum, an oil deal in the form of a PSA – the main form of oil agreement in Azerbaijan – is approved into law that prevails over any other conflicting Azerbaijani law (arguably, except for the Constitution, acts adopted by public referenda and international agreements).

Following the first approval of a PSA into law, most subsequent oil deals have been concluded as PSAs counting in total over 30 with the

latest approved into law in June 2016.

Considering the number of PSAs, the first RSA approved into law of Azerbaijan poses a natural question whether an RSA is a new PSA and whether an RSA structure will be preferred for all subsequent or even existing deals.

Azerbaijani law does not define or regulate specifically RSAs in the oil and gas industry. Together with PSAs, an RSA is a part of a system of contracts for development of natural resources where the state ownership of the resources is preserved. Unlike PSAs, however, a contractor in an RSA is compensated out of profits (as opposed to production) generated from development of a natural resource.

Together with pure (fixed fee) service contracts, an RSA is a type of service contracts in the oil and gas industry compensating a contractor in cash. Unlike a pure service contract, in an RSA (risk service contract), a contractor is compensated out of profits (calculated based on a flexible scheme, such as R-factor) generated from development of a natural resource.

The largest oil (and gas) deal in Azerbaijan, the Azari, Ciraq, Gunasli PSA, was recently amended with no indication of an RSA regime. It would seem that the RSA approval for Umid-Babak block was a part of experimenting by the state to assess options to develop available to it. Along with the RSA, reports of joint study agreements (JSAs) have been made public.