

# **Ewolucja prawa prywatnego**

## **Evolution of Private Law**

pod redakcją  
Ewy Zielińskiej i Piotra Pinióra

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## The legal regulation of production-sharing agreements

Developing oil producing countries, lacking the technical knowledge for oil exploration enter into Production Sharing Agreements with Foreign Oil Companies usually from developed countries. The nature of these contracts is that in consideration of a share of the oil ultimately produced, the Foreign Oil Companies funds the oil exploration and production and thus bears the risk, while the Government of the developing country gets its share of the produced oil in addition to taxes<sup>1</sup>. From the legal point of view, precisely this form of public-private partnerships provides the foreign investor with the maximum protection of investments. In addition, state's legislation usually provides a number of exceptions in legislative provisions that regulate tax, customs and other relationship for production sharing agreements.

Thus, concluding production sharing agreement is potentially very attractive for foreign investors, especially in case of significant investment sums. Conducting tenders on concluding production sharing agreements for products that will be produced by the investors, including worldwide known oil and gas companies, apparently provoked and keeps on provoking the state's governments to adopt a number of legislative acts that amend the basic documents governing the subsoil area as well as more favorable conditions for investors' activity in taxation were confirmed, import of goods that will be used for the purposes of production sharing agreements, etc.

Oil and gas legislations differs in every country, depending mostly on the purpose and the intention of the countries' internal strategies. However,

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<sup>1</sup> B. Taverner: *Production Sharing Agreements in Principle and Practice* in M.R. David (ed.) *Upstream Oil and Gas Agreements*. London, Sweet and Maxwell, 1996.



the main objectives of each contractual party (the state) are the same: to take control of its assets and to get revenue for the economic development. In order to develop and to make use of its assets, the state will cooperate with Foreign Oil Companies [further also: FOCs] which has the ability, knowledge and experience in this industry. Generally, Ukrainian legislation makes possible three ways in which a foreign investor can conduct geological survey and mining operation activities in Ukraine. First, a foreign investor establishes an affiliate company in Ukraine. It obtains via tender a special permit for subsoil use and then performs the necessary work, either on its own or in concert with contractors. Second way, a foreign investor establishes a joint venture with a state-owned company. That company might already hold all the necessary permits for subsoil use. Even if it doesn't, joint ventures can enjoy a simplified permitting procedure, which is one of the advantages of public private partnerships. Third and the most popular one is the basic contract types between the State and FOCs by making contractual arrangement<sup>2</sup>, which is widely known as Production Sharing Agreements [further also: PSAs].

The major characteristics of this contract lie in the specific PS system, according to which the state will own all of the oil and gas production and the FOCs only act as the contractors who will provide technical and financial services for exploration and development operations, and in return, the production will be shared between the FOCs and the State according to the provision in the Production-Sharing Agreement [further also: PSA]<sup>3</sup>. It should be pointed out that the legislation of many developing countries (including most post USSR countries) allows different contractual forms of subsoil use. Still, the difference between the PSAs and other ways of using subsoil is that in the first case, the main tool is the license for subsoil use that is the administrative act, which is essentially a nonnegotiable document. From this point of view PSAs provide civil and commercial law principles of subsoil use and definitely open a way for the market rules in this specific area of the economy. In this case, the basic characteristics of this agreement are the main object of the discussion of this paper.

Production-Sharing Agreements (PSAs) are among the most common types of contractual arrangements for petroleum exploration and de-

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<sup>2</sup> N. Pongsiri: *Partnerships in oil and gas production-sharing contracts*. University of Manchester, UK, Centre on Regulation and Competition (CRC), 2002.

<sup>3</sup> M. Farhan: *Production Sharing Contract: A Comparison with Concessionary System from the Political, Financial and Functional Point of View*. "Energy Law Journal". Resource document. <http://myenergylaw.blogspot.com/2008/12/production-sharing-contract-comparison.html>.

velopment<sup>4</sup>. Currently there are about 50 oil-producing countries in the world, and production costs differ widely among these geographic regions<sup>5</sup>.

What is so special about the production sharing agreement? The answer is simple: These agreements provide the most modern, stable and attractive legal and fiscal instrument available to investors in the natural resources sector of the country.

Under a PSA the owner of mineral resources, that is represented mostly by the state, engages a foreign oil company [further also: FOC] as an investor to provide technical and financial services for exploration and development operations<sup>6</sup>. The state is traditionally represented by the government or one of its agencies such as the national oil company [further also: NOC]. The FOC acquires an entitlement to a stipulated share of the oil produced as a reward for the risk taken and services rendered.

Defining a PSA as a "commercial contract between the investor and the state, which allows the investor to undertake large scale, long term and high-risk investments"<sup>7</sup>, we outline the purpose of this contractual form, which is to define the terms and conditions for the exploration and development of resources by replacing existing tax and license regimes with a contract based arrangement that exists for the life of the project.

In general, the main points of PSAs are as follows:

- Under the PSAs the government retains its rights and ownership of the oil and gas resources. The company invests all the capital needed to develop the fields and pays bonuses to the country at key milestones during the project development.
- The investor pays a royalty of the oil and gas produced to the government throughout the lifetime of the project. The balance of revenues, less operating expenses from production sales in the early years, is used to repay capital investment. The remaining production, after payback of investments, is shared between the country and the investor.
- The government will receive an increasing proportion of revenues from production as the project progresses. If profitability exceeds certain specified levels then the government receives an increasingly bigger share of the extra revenues, which can be as high as 70 percent. In addition, the investor pays tax on any profit that the company makes.

<sup>4</sup> K. Bindemann: *Production-Sharing Agreements: An Economic Analysis*. Oxford, Institute for Energy Studies WPM, 1999.

<sup>5</sup> I. Ahmadov, A. Artemyev, K. Aslanly, I. Rzaev, I. Shaban: *How to scrutinise a Production Sharing Agreement*. London, IIED, 2012.

<sup>6</sup> K. Bindemann: *Production-Sharing Agreements...*

<sup>7</sup> I. Ahmadov, A. Artemyev, K. Aslanly, I. Rzaev, I. Shaban: *How to scrutinise...*



- The contractor furnishes all the necessary risk capital based on a mutually agreed Work Program, including technical assistance. With this clause, the needs of huge amount of fund and technology including the high skilled and professional workers at that time were able to overcome. Moreover the government did not have to bear the exploration risks, and the contract would be terminated if somehow the oil reserves were failed to be found.
- Ownership of all project-related equipment brought by the contractor can be passed to the state upon being placed in service after its entry into the country; the cost of this equipment is to be recovered and all geological and other field data become state property.

As a result of contractual relationship between the investor and the state, PSA treats both parties as equal. It means that the higher amount production is produced, the larger the party's profit is. PSAs are created for growing the ability of the NOC to become as big as the FOC. In addition, PSA can be a perfect vehicle for FOCs to invest their assets in some countries which do not allow oil and gas privatisation in their constitution. PSA system simply fulfils what FOCs need to invest their assets<sup>8</sup>.

Analyzing the legal nature of PSAs it should be mentioned that mineral resources in accordance with the prevailing number of the legislation acts of different countries are the objects of the exclusive state's property and are only available for use not possession. All attempts to Agreement or actions that directly or indirectly violate the state's ownership rights are invalid. Therefore, understanding of the key characteristics of this contract model and the details of this particular contract type is our priority on this stage of the research. It should be pointed out that the contract terms usually vary over time. Early investors can secure more favourable terms than latecomers since the government has the desire to induce exploration by offering certain incentives.

It is important to determine the purpose of the PSAs that is its' legal result which the parties attempt to reach. According to some researches the PSAs is conducted to achieve the ultimate goal — the mining and distribution of products<sup>9</sup>. We believe that the purpose of this contract is to pass the subsoil to provide opportunities to the investors to develop mineral deposits.

Before starting to analyze the certain contract elements of this particular contractual type our priority is to determine which type of contract this agreement belongs to. From the point of view of civil law the relationships

<sup>8</sup> G. Muttitt: *Production sharing agreements: oil privatisation by another name?* Basrah, Iraq, General Union of Oil Employes' conference on privatisation, 2005.

<sup>9</sup> О. Коморний: *Правова природа угод про розподіл продукції*. „Право України” 2002, №4, s. 43—46.

that presume temporary paid usage of property (in this case natural resource) can be characterized as lease. So using (lease) is an essential characteristic of the nature of the obligation that arises as a result of signing the contract (PSA). Thus, a set of terms that we identify as essential for lease, are fully represented in this case. At the same time identifying PSAs with the lease agreements completely would not be entirely correct. The distinguishing aspect of contractual relations under the PSAs is its' investment character, which slightly alters their meaning. Yet, it doesn't change the essential characteristics of the nature of the obligation that arises — temporary paid use of the natural resource. Furthermore Johnston also states that, "Many of the other features of a PSC are similar to those found under other systems"<sup>10</sup>. We think that the differences of the features are mostly laid on how these features are implemented, but the basic principles are similar. From the FOCs point of view, whichever contract system is used, the decision on making investment will be made only if it is foreseen to get a profitable outcome according to its own particular economic standards and methods of calculation.

According to this we can distinguish such **contract elements** of the PSAa as:

- Essential terms of a contract.
- Contractual parties.
- Contents of the contract.

**Essential terms of a contract.** The **subject** is, probably, the most important term of any contract and is the condition which is always essential. The subject of the contract serves as one of the criteria to determine the fact of reaching an agreement and to create the obligation between the parties. Disagreement about the subject of the contract does not allow any of the parties to achieve their economic goals<sup>11</sup> while contracting. It has to be noticed that there are different points of view about the defining of the subject of the PSAs. So, for example, Irina Paliashvili considers that the subject of the given contract is the agreed program of the parties for the extraction of mineral resources which must be fulfilled by the investor in favor of the state. Such program includes the type, costs and period of the performance. In other words, the state hires the investor as a contractor to perform the work envisioned by the program<sup>12</sup>.

<sup>10</sup> A. Schiffrin, S. Tsalik: *Covering Oil: A Reporter's Guide to Energy and Development*. Open Society Institute, 2005.

<sup>11</sup> В.А. Васи́льева: *Проблеми цивільно-правового регулювання відносин з надання посередницьких послуг*: дис. на здоб. наук. ст. д. ю. н.: спец. 12.00.03, Івано-Франківськ 2006, 409 s.

<sup>12</sup> I. Paliashvili: *The Concept of Production Sharing: Outlines of the Presentation*. Seminar on the Legislation on Production Sharing Agreements: September, 14, 1998.



We are inclined to believe that the most typical approach to the defining of the subject of the agreement is one that indicates that the subject of the agreement depends on the interests of the parties, which generates the appropriate arrangement and is deeply connected with a specific property, the objects of the material world, which can serve as a means to fulfill certain human needs, are of great interest and which push the party into entering a certain contractual relationship. In this case the subject of PSAs is a specific area of mineral resources (mineral deposits), on which the investor is focused and from which the investor plans to get some benefits.

Besides the subject of the contract there are other essential terms of the PSAs which are the specific signs of the contractual obligations and are usually defined by the legislator in the very definition of a contract. The definition of the list of conditions that are essential or necessary for an agreement of this type, reflects the specifics of a particular type of contract and promotes disassociation from other related types of contracts. So we can identify two conditions that are essential for the PSAs: **term and payment**. Still precise terms depend on negotiation between state and the company.

PSAs are often signed for a period of 25 to 30 years, although they can cover longer periods. However, the development of particularly large, capital-intensive fields often requires longer periods subsoil. That is why the term of PSAs can be extended at the initiative of the investor and after fulfillment of obligations undertaken, by signing an additional agreement. Continuation of the contract is not the obligation of the state, so the state party can refuse to continue the contract at the end of its term. As a contractual relationship, PSA could bring disadvantage for the state, because it will bind the government for many years without changing tax and regulation as they extract the oil and make profits, so then they can predict and maintain the stability of their business and profit.

Payment is an important and necessary condition of the contract. Product sharing as a central mechanism of subsoil under the PSAs actually gave the name to these agreements. At the end, the intention of PSA is to give revenue both: to the state and to the FOC. Johnston describes<sup>13</sup> that, using royalty as in concessionary system or profit oil split in PSA system, the financial result for the FOCs and the government is quite similar. Other words production sharing system substitutes the ordinary system of payments still not changing the fact that PSAs are paid contracts. Under a PSA, the work is carried out on a compensated basis, with the state paying the investor not in money, but with a portion of the

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<sup>13</sup> D. Johnston: *International petroleum fiscal systems and production sharing contracts*. Tulsa, Okla, PennWell Book, 1994.



produced product. In order to determine the volume of the extracted raw materials and to carry out production sharing, the concept of the "point of measurement" is used — an arbitrary point related to the movement of extracted raw materials specified by the parties in the agreement (the mouth of the shaft, the delivery point, etc.). At the point of measurement all the raw materials being extracted is the property of the state. The production sharing is also carried out at the same point and usually follows the following procedure<sup>14</sup>:

- 1) from the product produced by the investor is separated that part that goes toward the compensation of the investor's expenditures (cost-recovery product);
- 2) that part of the produced product that remains (profit product) is divided between the investor and the state in a proportion provided in the PSA.

As a result of the production sharing, the state, without investing its own funds into the prospecting, exploration and extraction of mineral resources and without bearing any commercial risks, receives a substantial part of the product produced by the investor. During the term of validity of the activities on the basis of a PSA, a special tax system is used for the investor. Within the period of validity of the PSA, the existing state taxes and other mandatory payments are replaced by a part of the profit product. The existing tax system is simply replaced by production sharing in the case of the use of a PSA. Production sharing between the state and the investor is carried out on the basis of principles determined in each specific agreement.

Therefore, the PSA concept, on the one hand, protects the interests of the state, and on the other — makes the investor immune from the changing tax policy of the state. Production sharing creates a new procedure for subsoil use, as an alternative to the conventional tax system, in accordance with which individual characteristics of subsoil use are taken into account on a contractual basis in each PSA.

**Contractual parties.** The PSA as a civil-law agreement is concluded between legally equal parties: the state and an investor. All conditions for use of the subsoil and the performance of work is established by the parties by mutual agreement.

Still, it has to be taken into account that the state party in the agreement possesses its public prerogatives. Therefore in relations for subsoil use arising on the basis of a PSA, the state acts in two roles: on the one hand it fulfills its obligations under the agreement, and on the other hand it preserves its state public-legal functions.

<sup>14</sup> I. Paliashvili: *The Concept of Production Sharing...*

The investor carries out the activities envisioned in the agreement (prospecting, search, exploration, extraction and other works) at its own expense and risk. The state, as the other party to the agreement does not bear any expenses or risks. If the investor invests funds in the prospecting and exploration but did not discover any minerals, or discovered that their extraction would be unprofitable, the expended funds shall not be refunded to the investor. This is a basic principle of a PSA. The parties, however, may agree otherwise.

Basically there are two parties to the contract, a foreign oil company (FOC) and a government representative which can be a head of state, a ministry or a national oil company (NOC). The latter is the more common case. On the side of the foreign contractor we frequently find joint ventures or consortia rather than an individual firm. However, the number of FOCs involved has no impact on the structure of the contract. As far as the PSA is concerned the members of a consortium or a joint venture are treated as one partner. If two or more investors participate in a production sharing agreement, they shall designate among themselves one investor — agreement operator to represent their interests in relations with the state.

**Contents of the contract.** The contents of the PSAs are the rights and obligations of the parties. The rights and obligations of the parties to production sharing agreements are determined in accordance with the civil legislation. Contractual relations arise between two legally equal parties, each having rights and obligations, the violation of which shall entail their legal liability. Thus, among them are the following:

- The FOC usually bears the risk at the exploration stage (i.e., if no oil is discovered).
- The state or the NOC grants the FOC the right to explore, develop and extract oil.
- The FOC invests capital (along with the NOC in some cases) and initial capital expenditures and on-going maintenance costs are deducted from production in the form of cost oil.
- The FOC receives a share of the produced oil in accordance with the PSA. This is normally called the profit oil.
- Cost oil and profit oil (and any other bonuses, royalties, duties, or taxes) are calculated on the basis of the amount of oil actually produced.
- The parties share profit oil throughout the duration of the contract, with taxes on profit oil only paid to the government once the oil has been received.

The state hires the investor as a contractor for the conduct of work connected with the extraction of useful minerals. At the same time, it takes onto itself the obligation to transfer to the investor for use the subsoil area specified in the agreement. In the majority of countries in the world, the subsoil belongs to the state. The state has a monopoly over



the use of the subsoil and the removal from it of natural resources. The granting to an investor of exclusive rights denotes that the state during the period of PSA's validity, is obligated to abstain on the given subsoil area from activity included in the volume of the transferred rights and not permit such activity on the part of third persons. Only the investor may conduct activity envisioned by the agreement. But this does not mean that the investor shall obtain unlimited rights. The exclusive rights being transferred to the investor are limited by: the types of activity envisioned by the agreement; the types of minerals indicated in the agreement or the terms indicated in the agreement. For example, Ukrainian law provides favorable conditions for import of goods that will be used in PSAs. The government provides the investors with approvals, quotas, special subsoil use permits, licenses and other permits related to subsoil use, performance of work, construction of the structures stipulated by the PSA. (Part 3 of Article 4 of the Law of Ukraine «On Production Sharing Agreements» is the relevant document in this respect).

PSA system has been effectively used by developing countries with potential natural reserves but high exploration or technical risks. It is true that from the legal and functional point of view, PSA and lease system do not differ, but by giving an assumption that 'the government still upholds the national ownership of the resource', PSA serves more 'political function' than anything else. Moreover, Thomas Wälde describes that PSA as a tool which "gives to the government political and to the company commercial satisfaction. The government can be seen to be running the show — and the company can run it behind the camouflage of legal title symbolizing the assertion of national sovereignty"<sup>15</sup>.

In practice, the advantage of PSA for the host state is that PSA system may be used as a highly effective foreign investment tool. If this system has been managed properly by the host country, it may bring large amounts of foreign capital and expertise without relinquishing excessive control and profits to outside interests<sup>16</sup>. Still PSAs' main disadvantage is that the state will be tied by the restrictions in the contract for a long time<sup>17</sup>. Therefore, if the government or political climate changes, the terms of PSA cannot be changed to reflect the state's new priorities. However, this negative side of PSA system can be avoided by the state by negotiating PSA system which can maximize the state's revenue and limiting the FOCs' access to oil, while

<sup>15</sup> Th.W. Wälde: *The Current Status of International Petroleum Investment: Regulating, Licensing, Taxing and Contracting*. „CEPMLP Journal” [University of Dundee] 1995, Vol. 1, No. 5.

<sup>16</sup> A. Schiffrin, S. Tsalik: *Covering Oil: A Reporter's Guide to Energy and Development...*

<sup>17</sup> G. Muttitt: *Production sharing agreements: oil privatisation by another name...*

at the same time creating a legal regime that allows the state the flexibility to modify the terms of the project<sup>18</sup>.

Thus, the production sharing agreement is a complicated document in terms of its content, the drafting of which requires the engagement of a wide range of specialists and attention to the peculiarities of legal regulation under the state law. Taking into account the fact that the investor drafts the production sharing agreement it is he who will have to do most of the work.

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<sup>18</sup> D. Babusiaux et al.: *Oil and Gas Exploration and Production: Reserves, Costs, Contracts*. Paris, Editions Technip, 2004.