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TURKMENISTAN: OIL AND GAS SECTOR REFORM

Status Report

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EXECUTIVE SUMMARY

The Republic of Turkmenistan, once the southernmost Soviet Socialist Republic, now is struggling alone to provide a life for its people. It has huge hydrocarbon reserves which could help lift the country out of its economic depression, but a stern authoritarian regime and a landlocked geographical position have combined to discourage Western firms from vigorously competing for the rights to explore for and produce such reserves. Recognizing that certain changes will be necessary in the investment and regulatory climates before Western firms will be enticed to begin to produce the bonanza of its legacy, Turkmenistan has initiated, however slowly, reforms in the petroleum sector.

A new Petroleum Law has been adopted, a new regulatory Competent Body has been established, Model Production Sharing and Joint Venture Agreements have been prepared and monetary reforms are underway. Much more work needs to be done, however, before Turkmenistan will be fully integrated into the investment possibilities being considered by Western firms. A host of regulations—from Health and Safety, to Environmental, to Technical Standards—must be written with the unique conditions of Turkmenistan's desert and seaside situs in mind. Officials within the new regulatory agency, and indeed, within the older State corporations and the existing Ministry of Oil & Gas Industry and Mineral Resources will need "consultations" in the ways of Western oil firms and international standards and practices. Such important concepts as pipeline tariff methodologies and western style accounting will be to be instilled in the business practices of Turkmenistan.

CHAPTER 1
MACROECONOMIC CONDITIONS OF TURKMENISTAN

1.1 Current Political and Social Conditions

The Republic of Turkmenistan lies in what had been the southernmost part of the former Soviet Union. On October 27, 1991, Turkmenistan declared its independence from the Soviet Union, but as the Turkmen took back the benefits and privileges of sovereignty, they took on many burdens as well. Turkmenistan had indeed been treated as the bush and back country by the Moscow dominated Soviet Union. The Turkmen had been assigned the task of providing the Soviet Union with little more than a scant two commodities—cotton and natural gas—and when independence came the new country was without the industries, or manufacturing capabilities and skills to forge a robust existence on their own.

Independence notwithstanding, Turkmenistan is guided politically by the same coterie of people who were in power prior to independence. The former Communist Party of Turkmenistan changed its name overnight and became the Democratic Party of Turkmenistan with the same leaders and apparatchiks firmly in place. At the top of the government is President Saparmurat Niyazov, who has adopted the additional title or name of Turkmenbashi, meaning "Father of all Turkmen." Busts or photos of Turkmenbashi dot the city scape, facades and rooftops of government buildings, lobbies of virtually all private business buildings, every denomination of paper and coin currency. The press is tightly controlled, and criticism of the government is not tolerated. There are some restrictions on freedom of movement, with the blocking of certain roads near the President's many palaces (four in the Ashgabat area alone), and access to the Turkmen side of the mountains forming the border with Iran is prohibited. Residents of Mary or other cities must obtain government permission to move to Ashgabat.

Turkmenistan was the fourth largest republic in the former Soviet Union (FSU) with a territory of 488,100 square kilometers (188,540 square miles), an area slightly larger than California. Some 80 percent of its total territory exists as the Kara Kum Desert. The desert is bounded by a series of oases watered by the Amu Darya in the north and by rivers (the Murgap, Tejen, Atrek) descending from the Kopetdag, Gershi and other mountains in the south. The central and western regions have no significant natural waterways, but the Kara Kum Canal brings water from the Amu Darya to the Mary Oasis and onward to Ashgabat. Years of intensive cotton agriculture based on irrigated waters from this canal have resulted in the precipitous decline in the level of the Aral Sea. Water cycles have also affected

northwest Turkmenistan's lagoon-like appendage of the Caspian Sea, Kara-Bogaz Bay. The latter became fully enclosed because of a decrease of the Sea's level, but as the Caspian returns to previous levels the lagoon has rejoined the main body of the Sea. Turkmenistan's administrative subdivisions include provinces or velayets, districts, and cities. Today, it has a population of 4.4 million people, with principal cities of Ashgabat (pop. 450,000), Chardjou (pop. 161,000), Tashauz (pop.112,000), and Mary (pop. 89,000). Much of the current petroleum activity is centered around the Western town of Nebit Dag (pop. 89,000) and the Caspian port town and refinery of Turkmenbashi (pop.65,000). The country is situated almost equidistant from the Atlantic and Pacific Oceans. The country borders Uzbekistan, Kazakstan, the Caspian Sea, Iran, and Afghanistan. (TURKMENISTAN: Economic & Trade Overview, Sept. 1996).

Ethnic groups within the population include: Turkmen 73 percent; Russian 6.7 percent; Uzbek 9 percent; Kazak 2 percent; others 6 percent. The population, which is 45 percent urban and 55 percent rural, is one of the most ethnically homogeneous in Central Asia, although the country's Uzbek population has unsuccessfully sought to secede a couple of times. The Russians in Turkmenistan have dual citizenship. Turkmen, spoken by 75 percent of the population, is the official language. A new alphabet based on a modified Roman alphabet has been the official Turkmen alphabet since January 1, 1996. Approximately 38 percent of Turkmen citizens are also Russian speakers, though a much larger percentage understands Russian. The Turkmen are predominantly Sunni Muslim. (TURKMENISTAN: Economic & Trade Overview, Sept. 1996).

1.2 Current Economic Conditions

Turkmenistan's economy is highly specialized in petroleum and cotton which together account for over 70 percent of its economic activity and contribute 60 percent and 20 percent respectively to export revenues. It's petroleum resources, primarily natural gas, are enormous. Turkmenistan is the second largest natural gas producer in the FSU after the Russian Federation and the fourth largest producer in the world. It is also the fourth largest oil producer in the region. It is estimated that it has 1.3 trillion cubic meters of proven and probable natural gas reserves and 1.1 billion tons of oil reserves.

Such enormous petroleum reserves notwithstanding, Turkmenistan's economy is still predominantly agricultural. (World Bank Country Study, 1994). Half of its irrigated land is planted with cotton, making it the world's tenth largest producer. Although cotton is by far the major crop, some grains, vegetables, and fruits are also produced. Agricultural yields are low by international standard because of years of inefficient water use, high salinity levels, and irrigation of inappropriate land. (World Bank Country Study, 1997). Though it has

mounted a substantial effort to achieve self-sufficiency in grain production, the results have been disappointing.

Turkmenistan remains dependent on the Russian gas pipeline for hard-currency exports to Europe. Moreover, the inability of several former Soviet countries (principally Ukraine, Georgia, Armenia, and Azerbaijan) to pay for their gas imports from Turkmenistan led to a serious problem of arrearage in payback of external loans, not to mention declining gas output. Arrears have a substantially negative effect on revenues, as a large proportion of government revenues consists of hard currency receipts from gas. Over 1993-95, gas production declined by three-fifths. At the end of 1995, the debt owed to Turkmenistan on gas exports stood at about $1.2 billion.

In the short term, Turkmenistan's growth prospects rest on growth in demand for natural gas exports, and the willingness and capacity of its primary customers to pay in cash. Though the physical transport capacity to move gas to export markets is limited to FSU customers and is deteriorating rapidly, Turkmenistan could theoretically expand its output with the turn of a valve. A new pipeline to Iran is virtually complete and should provide some relief in early 1998.

In the long term, Turkmenistan has good potential for development given its wealth of natural gas that offers high potential for export-led growth. That said, the investment requirements to develop this long term potential, especially in the energy sector, are very large indeed. It has been said that for Turkmenistan to maintain its production capacity and ensure access to non-former Soviet Union markets, Turkmenistan would need to invest up to $30 billion by the end of the decade. This can be financed only with significant foreign investment participation. (Trends in Developing Economies, 1995). Foreign investment capital is, however, in short supply. In Turkmenistan's constantly changing market the investor or business must be flexible, persistent, and patient in order to succeed. The risks inherent in doing business in the Former Soviet Union require that potential investors and businessmen proceed cautiously. (1997 Turkmenistan Country Commercial Guide).

Although initially slow to begin reforms, the Government of Turkmenistan has embarked on a macro-economic reform program which should significantly improve the business and investment climate. But the problems inherent in a command economy continue to frustrate Western businessmen. All decisions are made at the highest levels of government. Political considerations continue to strongly influence economic decisions. The regulatory and legal foundations of a market economy are still being developed. Those foundations as they relate to oil and gas are discussed in more detail later in this report. Business infrastructure and know-how are changing less rapidly than in other FSU countries. Chronic problems with repayment of foreign loans and re-negotiation of signed contracts remain. These issues are gradually being worked out as the government and the population becomes more familiar

with the international norms of the world market. (1997 Turkmenistan Country Commercial Guide).

In contrast to some other CIS Asian republics, Turkmenistan has opted for the creation of a market economy which maintains a role for the state in the development of industry, social policy, science, health and national culture. It believes in a gradualist, step-by-step approach to transforming the centrally-planned economy. It has maintained state orders on wheat, milk, meat, cotton and a host of other agricultural products, price controls for over 50 items, and fixed prices for 10 essential food items in the old Soviet mold.

Turkmenistan's social indicators are worse than elsewhere in the FSU. The current social safety net system is not capable of dealing with the social effects of an emerging market economy. If the government does implement major market oriented reforms it will need to restructure the social protection system in order to assist those negatively affected. Turkmenistan has the characteristics of a lower-middle-income country in spite of its rich natural resource base. Incomes per capita (approx. $950 in 1995) are significantly below those of Russia and FSU averages. Turkmenistan's social indicators are low by Western standards and in comparison to those of the other Central Asian countries. Population growth is high at 2.1 percent a year over 1990-1995. (Trends in Developing Economies, 1995). Annual inflation is said to be improving from its extraordinary levels of 1995 wherein it reached well over 1000 percent annually, with monthly rates exceeding 50 percent.

Selected Economic Indicators[1]

	1993	1994	1995	1996
GDP (% change)	-10	-19	-8	-3
Exchange Rates (manat / $US)				
Official	2	75	200	4,070
Commercial	-	-	2,484	5,197
Parallel Market	2	200	2,500	5,200
Prices and Wages				
Consumer Prices (% change)	-	1,328	1,262	446
Wages (manat)	342	1,552	12,238	118,857

[1] Source: IMF staff estimates

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External Accounts ($US millions)

Current Account Balance	776	84	23	43
Gross Reserves	818	927	1,170	1,172
External Debt	168	418	550	668
External Arrears	0	0	125	59

Other indicators of social well being, all of which are lower presently than at independence in 1991, include: highest infant mortality rate in FSU (46 per thousand births); lowest life expectancy among FSU countries (63 for males and 70 for females); proportion of population in poverty (48%); access to safe drinking water supplies (15% of population in rural areas, and 73% in urban areas, resulting in a high incidence of water borne diseases. Since March 1, 1997 there have reportedly been over 300 cases of typhoid fever, with several deaths.

Macroeconomic Indicators for the current year are as follows:

Indicators	**January-April**
Gross Domestic Product, billion manats* In % to the corresponding period of 1995	6611.5 100.1
Volume of industrial production, billion manats (in current prices) In % to the corresponding period of 1996	1773 75.1
Consumer goods production (in selling prices), billion manats In % to the corresponding period of 1996	240 99.2
Wide retail commodity circulation (in actual prices) In % to the corresponding period of 1996	369 93.3
Collated index of retail price and rates for consumer goods and services to the population, in % to the previous month	102.5
Industry wholesale price index, in % to the previous month	87.7
Export, million manats (information of the State Committee on Statistics)	430.7

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Import, million manats (information of the State Committee on Statistics)	367.9
Average salary ,manats (for the last month of the period)	183422
Exchange rate(manat/$) (for the end of the period) -official -commercial	 4170 5500

*for January, 1, 1997

CHAPTER 2
TURKMENISTAN UPSTREAM OIL AND GAS SECTOR

2.1 Industry Structure

Turkmenistan is endowed with significant hydrocarbon resources. The history of oil production from dug-out wells in the Cheleken and Nebit-Dag fields on the Caspian shores goes back to the 19th century. Formal exploration began in 1927 and by 1934, Soviet scientists had identified a number of promising areas. Sustained exploration and the development of oil and gas fields appear to have begun in late 1950s. Today, a total of 145 oil and gas fields have been discovered. Of these, 28 are oil fields mainly located in western Turkmenistan, offshore and onshore along the Caspian Coast.

The rest (117) are gas and gas condensate fields located primarily in the Amudarya oil and gas province covering the eastern half of the country. The largest of the gas discovery is the giant Dovletobad - Donmez field with initial recoverable gas reserves 2 of 1,763 BCM (62 TCF). Foreign investment is bound to increase in Turkmenistan's oil and gas projects. The government is actively courting large energy multinationals with promises of access to its oil and gas reserves; yet, it remains unclear how much control the government plans to relinquish. Currently, the Turkmen government is trying to develop eight major geological blocks with foreign participation. These include: Shelf of South Caspian Depression; Middle Caspian Offshore; Pre-Kopetdag Depression; Western Kopetdag and Misiryanskaya Area; and Right Bank of the Amu Darya.

Turkmenistan has two major refineries, located at Turkmenbashi (formerly- Krasnovodsk) and Chardzhou. Crude capacity for the two refineries totals 238,000 b/d (116,000 b/d and 120,000 b/d, respectively). Both facilities are currently slated for modernization and expansion to meet the country's planned increase in oil production and demand. In February 1996, Merhav Corporation of Israel announced the signing of a $500 million deal to upgrade the Turkmenbashi refinery. The project involves construction of a new lube oil facility, as well as upgrades to the refinery's catalytic reforming and catalytic cracking units.

2.2 Oil and Gas Reserves

Exhibit 2-1 provides a summary of the proved and probable oil and gas reserves in Turkmenistan. Note that the reserves terminology in Turkmenistan is different than that

followed by Western countries and not yet fully understood by the authors. The data is, therefore, subject to further reconciliation. The historical oil & gas production in Turkmenistan is shown in Exhibit 2-2.

Below is the summary of the salient points pertaining to Turkmenistan's petroleum industry.

- The total remaining proved and probable recoverable reserves are 284 Million Tons (MMT) of oil, 62 MMT of condensate, and 4.0 Trillion Cubic Meter (TCM) of gas. In US units, these quantities are approximately equivalent to 2.0 Billion Barrels (BB) of oil, 455 Million Barrels (MMB) of condensate, and 144 Trillion Cubic Feet (TCF) of gas.

- The oil reserves are primarily located onshore in the South Caspian oil and gas province near the Caspian Sea. The Amudarya oil and gas province, on the other hand, is primarily rich in gas.

- The total oil production has declined significantly, from 15 MMT (300,000 B/D) in 1975 to 4.0 to 5.0 MMT per year in recent years. The World Bank, in their 1994 Country Report, attributed the decline to unsatisfactory rate of exploitation (lack of investment) and involuntary conservation of reserves (during the pre-independence period). Further, the report characterizes the oil production by extremely low per-well productivity caused by a combination of poor well-completion practices, poor reservoir management, and sustained production from uneconomic wells.

- As in many other eastern block countries, there probably remains significant potential for further development of the oil reserves in the discovered fields. The remaining exploration potential for oil is also considered to be large in the South Caspian oil and gas province, particularly in the offshore area. Currently, oil and gas recovery is being conducted at only 34 oil and gas deposits of some 144 surveyed.

- Similar to oil, the gas production in Turkmenistan has declined from a peak of about 90 BCM (8.7 BCF/D) in 1989 to 32 BCM (3.1 BCF/D) in 1995. The dramatic plunge in the gas production was apparently not due to declining productivity but due to general economic crisis in the post soviet nations, payments disputes, and lack of independent export pipelines. In 1996, the production picked up slightly to 35 BCM (3.4 BCF/D) due to increase in domestic demand. Existing facilities theoretically would allow an expansion of production to 80 to 85 BCM annually.

While Turkmenistan's gas reserves and productive capacity is large and there is significant exploration potential, there is some question that it can maintain sustained production levels

beyond medium term. Roughly 20 to 30% of the remaining gas reserves are in small fields which remain undeveloped. The development status of the currently producing fields is also not known. The 1994 World Bank study identified two key potential constraints on future productive capacity:

1. the technical capacity of the domestic gas producing industry to appraise and develop reserves on an efficient basis;

2. the financial and technical capacity of the country to replenish and maintain an adequate level of reserves through exploration.

2.3 Foreign Investment Activity

Turkmenistan recognizes the need for new investments and advanced technology for the development of its upstream oil and gas sector; however, so far it has not been able to attract significant foreign investment. The 1994 World Bank study recommended that the Government of Turkmenistan effectively address four areas to achieve its objectives in the oil and gas sector:

- the establishment of a clear and comprehensive legal, contractual and taxation framework to assure potential investors of a stable operating and commercial climate for their activities;

- the required changes in the system of promotion of the country's petroleum resources from the one currently used to promote foreign participation in relatively small low-risk development and rehabilitation ventures in the oil sector to one more appropriate for high risk and large-scale exploration and development activities;

- the arrangements for pricing and marketing gas and the terms of access by third parties to the existing gas transmission network within the country; and

- the Governments strategy for addressing the key export market risks in the short term and for establishing alternative infrastructure access to export markets in the medium to long term. It is clear that the Government of Turkmenistan has been following these guidelines.

To date, foreign investment has been stymied in part by the absence of a legal framework, with the result that only two major energy joint ventures are currently operating in the country. Those two ventures are the venture of Monument Resources Ltd. and Mobil in the Nebit Dag area, and that of Petronas in the South Caspian Sea. These two operating ventures do not count Argentina's Bridas Corporation's joint venture in the Keimir, Ekpatlaukh, and

Chikishlyar oil fields. In November 1995, Bridas had its oil export license suspended by the Turkmenistan government. The joint venture, located in the southern Caspian Sea region, produced more than 15,000 b/d of oil in 1995. In response to the suspension of its export license, Bridas, which has invested around $400 million in Turkmenistan since 1991, has taken its case to international arbitration over breach of contract. According to Bridas, there is no reason - except for the lack of an export route - why the joint venture's oil production could not be boosted rapidly to 50,000 b/d.

Besides those mentioned, Netherlands-based Larmag Energy Assets is involved in a joint venture to develop the Cheleken oil field, currently producing around 8,000 b/d. Larmag, which already has invested $90 million in the project, is hoping to achieve peak production of 85,000 b/d. Larmag has been frustrated by the same obstacles facing Bridas, however, specifically periodic suspension of its oil export license and lack of an export route. During 1995, Larmag exported an average of 6,000 b/d, mainly across the Caspian Sea to Iran, where it is trucked to Persian Gulf ports. In addition, limited amounts of oil were transported to the Black Sea via Russia's Volga-Don canal.

The difficulties experienced by Bridas and Larmag apparently have persuaded some Western companies to hold back from entering the Turkmen energy scene. One significant exception to this rule is U.S.-based Unocal, which is becoming increasingly active in Turkmenistan's gas sector.

2.4 Pipeline Issues

The lack of alternate gas markets and alternate low cost export pipelines is a significant obstacle to the development of the oil and gas sector. The tariffs currently run at $ 60 to $ 70 per ton (roughly $ 10/B) for oil and $ 40+/1000 CM ($ 1.13+/MCF) for gas. Turkmenistan is too dependent on Russian pipeline systems to deliver its gas to markets. Turkmenistan is constructing oil and gas pipelines to Iran. These pipelines which will have limited capacity for export are expected to be ready in 1997. For the long term, Turkmenistan is looking at other pipeline options; however, whether they come to fruition would depend upon markets, costs, financing, and uncertain political conditions in the neighboring countries. Among the pipelines being considered are:

- A Kazakstan-Uzbekistan-Turkmenistan-Afghanistan-Pakistan oil pipeline. It is planned that this pipeline will transport oil from Western Siberia, and Central Asia to one of the Pakistani ports, probably Karachi. Its expected capacity is around 50 million tonnes per year.

- A Turkmenistan-Iran Turkey-Europe gas pipeline. Documents on this pipeline were signed at the Economic Cooperation Organization (ECO) summit conference in

Ashgabat on May 14, 1997. Turkmenistan guaranteed the natural gas resources necessary for distribution through Iran to Turkey and onward to Europe for 30 years, with an annual volume of gas of between 28 and 30 BCM annually. Iran secured the transit of gas through its territory and its passage to Turkey. The Turkish partners, agreed to set a guaranteed volume of annual gas purchases and a volume of transit to third countries over 30 years.

- An Uzbekistan-Turkmenistan-Afghanistan-Pakistan gas pipeline. This project is currently being promoted by an alliance of the American firm Unocal, and the Saudi firm Delta Oil. Documents furthering this project were also signed in Ashgabat during the ECO conference, though notably absent from the signing was Afghanistan. The length of the pipeline would be approximately 1464 kilometers, with more than 760 of those in Afghanistan, and around 530 in Pakistan. Its transport capacity would be 20 BCM annually, and would cost some $2 billion. Already an extension of this pipeline on to New Delhi has been suggested with an added cost of $600 million. Unocal has estimated that the Pakistani marketplace could absorb up to 100 BCM per year—assuming all existing electric power stations in Pakistan that are currently using crude oil switch over to gas, and that several new power stations will be built.

- A gas pipeline from Turkmenistan through Uzbekistan, Kyrgyzstan, and Kazakstan to Eastern Asia, perhaps all the way to Japan. Its estimated cost is $9.5 to 12 billion. Its capacity would be 28 to 35 BCM annually. This project is currently being promoted by a consortium of Mitsubishi, Exxon, and the Chinese Oil & Gas Corporation.

- A gas pipeline along the Caspian Sea floor to Azerbaijan to Turkey.

- A Central Asia-Iran-Persian Gulf oil pipeline. This pipeline will probably start from the Vyshka deposit near Nebit Dag and will reach the Persian Gulf some 1050 kilometers later. Its projected carrying capacity will be 14 million tonnes annually.

One additional factor giving some prospect that the export situation will improve is the Turkmenistan-Gazprom agreement signed in November 1995. It created a joint stock company between Gazprom and the Turkmen government titled "TurkmenRosGaz" (TRAO). The Turkmen government owns the company, holding 51% of the stock, Gazprom holds 44%, and Itera International Energy corp. (US) holds 5%. Under the agreement, Gazprom will purchase and transport all the gas that Turkmenistan can sell to the Ukraine and the Transcaucasus. This would seem to transfer the problem of nonpayment by these countries to Gazprom, but export has not seen enough expansion as yet to assess whether Gazprom will

use its leverage with Turkmenistan's delinquent customers to improve the collection of revenues.

CHAPTER 3
STATUS OF REFORMS

3.1 Legislation

Though the oil & gas industry in Turkmenistan dates back to the 19th Century, an analysis of the legal framework in which the industry now finds itself must necessarily focus on the more recent events of the formation of the country and laws adopted since independence. Accordingly, this section of the report will be guided by the following:

- The Constitution of Turkmenistan, adopted May 18, 1992
- The Decree of the President of July 1, 1996
- The Petroleum Law of Turkmenistan, signed on December 30, 1996, and effective upon its publication on March 10, 1997
- The Presidential Decree establishing the Competent Body, signed by President Niyazov on June 6, 1997

That said, it should be emphasized that the oil & gas industry seems still to be mired in the pre-independence, Soviet model of central planning and much of the "progress" of reforming the legal structure of the oil & gas industry of Turkmenistan remains more on paper than in reality.

The Constitution of Turkmenistan

Turkmenistan declared its independence from the Soviet Union on October 27, 1991, and its scholars and statesmen set to work on a new Constitution, which was finally adopted on May 18, 1992. Its importance to the oil and gas industry is its creation of the executive and administrative structure placing the President at the head of the Government and establishment of the Cabinet of Ministers as his executive and administrative assistants. The Cabinet of Ministers consists of the various Vice-Chairmen who directly control government agencies, state-run enterprises and organizations, and several ministers in charge of certain other industries. The new Petroleum law gives the President, as well as the Cabinet of Ministers, substantial and substantive duties and powers.

3.2 Industry Restructuring

Presidential Decree of July 1, 1996

On July 1, 1996, Turkmenistan's oil & gas industry was reorganized by Presidential Decree. The decree, entitled "Efficient Oil and Gas Industry Administration and Rational Use of Mineral Resources", disbanded the former Ministry of Oil and Gas and created in its place some five State Concerns and one overall policy and strategy-formation body, the Ministry of Oil and Gas Industry and Mineral Resources. The structure of the Ministry is attached hereto as Exhibit 3-1. The five State Concerns are:

- Turkmenneft, responsible for development of all oil fields throughout Turkmenistan
- Turkmengaz, responsible for development of all gas fields throughout Turkmenistan
- Turkmenneftegazstroy, charged with coordination engineering and construction jobs for oil and gas producers
- Turkmenneftegaz, established to control the refining and wholesale facilities
- Turkmengeologiya, set up to prospect for and explore new deposits of oil, gas, and other raw material for the chemical industry and construction.

Each of the foregoing State Concerns "reports" to the Cabinet of Ministers and "answers" to the President. Funding for the five Concerns comes out of the State Fund of Development of Oil and Gas Industry and Mineral Resources of Turkmenistan.

The Petroleum Law of Turkmenistan

Signed by President Saparmurat Turkmenbashi on December 30, and effective upon publication on March 10, 1997, the new Petroleum Law of Turkmenistan declares ownership of all petroleum in its natural state to be in the Nation of Turkmenistan itself. Regulation and control of such hydrocarbon resources are established in a combination of the President, the Cabinet of Ministers, and a new entity thrust into the arena . . . the Competent Body.

The Cabinet of Ministers is given broad authority to set strategic goals for the exploitation and further expansion of petroleum resources, and is given authority to set "rules" for, among other categories, the exploitation of petroleum and for the protection of the natural environment, as well as the health and safety of the Turkmen people, and their historical and holy sites. The Competent Body, on the other hand, is given wide ranging authority to set uniform rules for the development of petroleum fields [with the constraint that such rules are to conform to "international standards"], to prepare and hold tenders for the development of petroleum lands and resources, to draft Model Contracts, to negotiate with potential Contractors, to sign and register Contracts, to issue Licenses, and to engage

in a variety of other ministerial and administrative duties. The structure and composition of the Competent Body are not set by the Petroleum Law, and its relative positioning within the Government of Turkmenistan is not altogether prescribed by the new Law.

The President seemingly has only the final approval power over the issuance of Licenses. In fact, however, as the head of the Government of Turkmenistan, and as the head of the Cabinet of Ministers, he will wield considerable power in the day to day affairs of administering the petroleum resources of Turkmenistan. Other agencies, notably, but not exclusively, the State Concerns created by the Presidential Decree of July 1, 1996, have various consultative authority, and may ultimately have even broader authority depending upon the interpretation given the new Petroleum Law's mandate that any Contract shall be agreed upon by other entities in charge of health protection, sanitation, ecology, subterranean resources protection, and the safe conduct of petroleum operations. Although some agencies are ostensibly relieved of their authority as regards petroleum operations, at least one agency, the Customs office, has yet to get the message. Equipment being shipped to and from oil field operations is being held up pending compliance with customs registration notwithstanding the Petroleum Law's provision for an exception from registration for materials and equipment used in petroleum operations.

On the other hand, the Petroleum Law does provide that in case it conflicts with other provisions of the laws of Turkmenistan, the new Petroleum Law would rule. Such provision does not, however, expressly repeal laws not "in conflict" with the new Petroleum Law, raising the possibility that such other laws remain in full force and effect and therefore in supplement to the new Petroleum Law. That said, at least one agency of the Turkmen Government holds the view that all such laws were repealed, and hence it remains to be seen which view will prevail.

3.3 Regulation

The Presidential Decree of June 6, 1997

On June 6, 1997, President Saparmurat Niyazov signed his Decree No. 3189, in furtherance of establishing the 'Competent Body.' The Decree reaffirms that the Competent Body has authority to set rules and regulations for the development of petroleum fields, to organize and execute tenders of lands for the exploration and production of hydrocarbons, to issue licenses, and to conduct negotiations for the development of the petroleum industry. The Decree imposes upon the Competent Body a structure consisting of three departments—those of Licensing, of Negotiations, and of Control—and authorizes the Body to consult with 'Expert Counsel.'

The President has named himself as the head of the Competent Body. This would seem to eliminate any independence of the Body from the remainder of the functions of government of Turkmenistan, each of which is linked directly to the President.

Occupying positions on the Competent Body are fourteen top level officials of the GOT. We have been informed that Mr. T.H. Kurbanov, Minister for Foreign Economic Relations, is to be the Executive Director of the Competent Body. He is a bright, well connected and well educated 26 year old rising star in the GOT. He does not, however, have any oil & gas experience.

Presently acting as chief 'Expert Counsel' for the Competent Body is an Armenian consultant. He has spent considerable time in Turkmenistan working with the State Agency for Foreign Investment on a variety of matters, including the new Petroleum Law. He has recently informed us that we must submit all future proposals for activities to assist the Competent Body, or for training activities to the "National Coordinator" (Mr. Kurbanov) who will coordinate the provision of technical assistance from the various donor agencies such as USAID, TACIS, EBRD, etc.

Existing Regulations

At present, none of the regulatory schemes called for by the new Petroleum Law, or the President's Decree creating the Competent Body has yet to be drafted or considered for adoption. Those regulatory requirements specified by the new Petroleum Law are numerous, and, aside from the Model Agreements, chapter by chapter they include:

CHAPTER 1

Art. 1 **Definitions**

Art. 2 **Immediate Law**

Procedures for Issuing Licenses

Powers, Rights, and Obligations of State Entities

Powers, Rights, and Obligations of Companies, Enterprises, and Organizations

Legal Research to see if there are any Conflicts in the Laws or Rules

CHAPTER 2

Art. 4 **Cabinet of Ministers**

Rules for the Protection of Petroleum Resources

Rules for the Protection of the Environment

Rules for the Public Life and Health Protection

Rules for the Identification and Protection of Holy Sites, and Historical and Cultural Monuments

Art. 5 **Competent Body**

Uniform rules for the Development of Petroleum fields

Substance and form of Model Contract

Rules for Issuing Licenses

Rules for Registration of Contracts

Rules for Revocation of Licenses

Rules regarding Bank Guarantees or Substitute

CHAPTER 3

Licensing

Art. 8 **Cabinet of Ministers**

Method of issuing Licenses to be determined by the Cabinet of Ministers

Art. 9 **Conditions for Holding a Tender**

Rules concerning the timing and procedures for holding a Tender

Art. 10 **Bidding Proposals**

Rules concerning submission of Bidding Proposals

Art. 11 **Evaluation of Bidding Proposals**

Rules regarding the composition of the Expert Commission for Evaluation of Bidding Proposals

Art. 13 **Issuance of Licenses**

Rules regarding the issuance of Licenses

Art. 15 **Approval of President of Turkmenistan**

Rules regarding transmittal of prospective License to President for Approval

Art. 18 **License Validity Periods**

Rules regarding determination of Exploration Period

Rules regarding the submission and processing of Application For Extension of License

Art. 20 **Termination of License**

Rules regarding the causes and process for termination of a License

Art. 21 **Suspension of a License**

Rules regarding the causes and process of Suspending a License, including the setting of deadlines for compliance

Art. 22 **Revocation of a License**

Rules regarding the causes and process of Revocation of a License

CHAPTER 4--CONTRACTS

Art. 25 **Contract Execution**

Rules regarding the process and transmittal, including time periods, for circulating any Contract among the various State Entities concerned with Health Protection and Sanitation, Ecology, Subterranean Resources, Safety

Art. 27 Termination or Amendment to a Contract

Rules regarding the continuation of obligations following Termination of any Contract, or regarding changes in obligations following Amendments to any Contract

CHAPTER 5—CONDUCT OF PETROLEUM OPERATIONS

Art. 29 **Unitization**

Rules regarding the substance and approval process of Voluntary and Forced Unitization

Art. 30 **Structures Potentially Interfering with Navigation and Fishing**

Rules regarding the location, construction, operation, use and the ultimate dismantling of structures placed in navigable waters.

Rules regarding the protection of the natural environment and bio-resources from such structures.

Art. 31 **Discharge of Wastes from Petroleum Operations**

Rules regarding the discharge and burial of wastes from Petroleum Operations, including the setting of permissible levels of impurity

Art. 35 **Measurement of Petroleum**

Rules concerning the Measurement and weighing of Petroleum, including the frequency, methods.

CHAPTER 6--CONTRACTOR

Art. 37 **Obligations of Contractor**

Rules concerning the protection of natural resources, and the conduct of spill clean-up operations.

Rules concerning the reclamation of land utilized for Petroleum Operations.

CHAPTER 7--PIPELINE

Art. 42 **Submarine Pipelines and Cables**

Rules concerning the laying and operation of submarine pipelines and cables.

CHAPTER 8—ENVIRONMENT PROTECTION

Art. 44 **Ecological Considerations**

Rules regarding the content, and submission requirements relating to an Environmental Protection Plan.

3.4 Additional Reforms

On December 27, 1995, President Niyazov announced a program of macroeconomic reforms affecting all aspects of the Turkmen economy. Principal reforms focus on controlling the expansion of credit, managing budget deficits, and liberalizing foreign exchange. Turkmenistan does not have a balance of payments problem, and thus does not qualify for an IMF stand by agreement. The Government of Turkmenistan (GOT) is voluntarily implementing this IMF-recommended program.

Many observers feel that if these reforms are implemented consistently, trade and investment opportunities in Turkmenistan will improve significantly. In the meantime, the Turkmen economy remains heavily controlled by the government, led by the President and a few close advisors. A commercial code has not been fully developed, and the numerous rules, decrees and acts which regulate commercial activity are susceptible to change and are sometimes contradictory. These factors create unpredictable and often negative conditions for foreign investors and trade.

Turkmenistan's economic development is hindered by the antiquated infrastructure it inherited from the Soviet Union. The GOT has built a new international airport, luxury hotel and conference facilities, and is upgrading transportation routes, telecommunications, and other infrastructure. Development in these areas will continue for the foreseeable future. (1997 Turkmenistan Country Commercial Guide). The State airline, Turkmenistan Airlines has purchased 6 Boeing aircraft to service international routes. Lufthansa Airlines also services Turkmenistan.

The government recognizes the need for infrastructure improvements. In May, a rail link between Iran and Turkmenistan officially opened. The 190-mile long railway connects Central Asia to the Indian Ocean, running from the Iranian city of Mashhad to the Turkmen town of Tedzhen. It should increase the country's international trade, especially aiding large volume shipments and transport of non-perishable goods. Also, the rail is expected to cut travel time between Europe and southeast Asia by up to 10 days. Shipments by road will not be replaced by this system, since cheap Iranian fuel makes road transport less expensive. Turkmenistan has 13,400 km of roads, 13 percent of which are unpaved.

Efficient Capital Markets and Portfolio Investments

Economic reform has been concentrated in the banking sector, but restrictions on currency conversion and currency shortages have impeded the free flow of financial resources. Turkmenistan is considered

by U.S. EX-IM Bank for short and medium-term coverage with a sovereign guarantee. Most American sellers in Turkmenistan have used EXIM funds to finance their projects. Domestic enterprises have access to credit from local commercial banks, but credit is limited by presidential decree to enterprises engaged in production, not trade. The Central Asian American Enterprise Fund and the European Bank for Reconstruction and Development have both opened credit lines for private enterprises.

3.5 Privatization

Privatiozation has been negligible in Turkmenistan. Lack of more liberal legislation for all aspects of privatization, as well as an overall strategy for privatization and necessary expansion of the small -scale privatization program (covering most of the retail and service sector) slows down the process of privatization of the state-owned enterprises.

The government announced ambitious privatization plans for 1996 and 1997. Turkmenistan seeks to privatize its agricultural sector during the second half of 1996, followed by its transportation sector. Details have yet to be released. Additionally, each Ministry is expected to provide a list of 15% of the bodies reporting to it which should be privatized in 1996. This should lead to a further 800 privatizations, according to the head of the Department of State Property and Privatization.

Plans for mass privatization and a voucher system are being developed for larger units (over 330 employees), with the hopes of beginning privatization by the end of 1996. Only the service sector has been completely privatized; however, constantly changing regulations and tax laws have held back entrepreneurial expansion. The government did not formulate an industrial privatization plan until late 1992, and the plan called for privatizing only 10 percent of plants. It allowed creation of 6,000 small businesses beginning in 1992, but postponed auction sales of middle-sized industrial establishments and large enterprises. The government has no plans to privatize the energy sectors of the economy or the cotton industry, although it is actively seeking foreign investment to develop these resources.

Presently, only long-term leasing of land is possible and there can be no private ownership. There are only 100 private farmers. Large state and collective farms still dominate Turkmenistan's agricultural and rural life, retarding incentives. The government maintains a state order system of agricultural procurement which determines crop mix, distribution, and price. Loss-making farms may be restructured into joint-stock companies or private farms. Opportunities for American companies will continue in supplying farm machinery and irrigation equipment, as well as dry land farming technology and seeds. The Turkmen Government has expressed interest in investing in food processing facilities to produce goods for domestic consumption and export; yet it has to date been relatively reluctant to relinquish control of enterprises in this field.

CHAPTER 4
FOREIGN DONOR ACTIVITIES

Foreign donor agencies with representative offices and/or activities in Turkmenistan include the following:

4.1 International Monetary Fund

Turkmenistan is a member of the IMF and has a permanent advisor stationed in Ashgabat. Turkmenistan is a member of the World Bank and the Multilateral Investment Guarantee Agency (MIGA). The World Bank is preparing a project for $26 million which is a broad based technical assistance project in support of various areas of structural reform.

4.2 Central Asian Enterprise Fund.

The Central Asian-American Enterprise Fund, which began operations January 1, 1995, will promote the creation and expansion of small to medium-sized business in Turkmenistan and the other Central Asian republics. The Fund has recently opened an office in Ashgabat.

4.3 European Bank for Reconstruction and Development (EBRD).

Turkmenistan is a member of EBRD. EBRD will finance the final project for Turkmenbashi sea port modernization.

4.4 Asian Development Bank.

Turkmenistan is currently discussing membership in the Asian Development Bank (ADB).

4.5 European Union-Technical Assistance for the Commonwealth of Independent States (EU-TACIS)

EU-TACIS has undertaken a number of projects in Turkmenistan, notably it provided assistance in developing the new Petroleum Law, and has presented written advice on developing pipeline

tariff methodologies and is quite likely going to assist in the first off-shore tender. TACIS currently has about a six-month lull in activity in Turkmenistan. A list of past and current or future projects is attached in Exhibit 4-1.

Chapter 5
Recommended USAID Action

We have proposed to the GOT the following Assistance Projects and Training Programs (referred to in Turkmenistan as "Subjects for Individual Consulting, Exchange of Thoughts, and for the Revision and Preparation of Written Materials").

5.1 Assistance Projects

Priority	Project
1	Review and comment on current drafts of Model Production Sharing Agreement and Joint Venture Contracts. Assist in the development of the Model Offshore Production Sharing Agreement. Provide guidelines for negotiating such agreements.
2	Review and comment on existing and proposed regulations and standards, and recommend changes and additions to attain compliance with international standards and the special needs of Turkmenistan. Assemble a library of model regulations from authorities such as the American Petroleum Institute.
3	Review, summarize and comment on the pipeline tariff methodology and the pipeline economics study currently being considered and recommend changes, if any.
4	Assist in the presentation of the new Petroleum Law and model contracts to other Turkmen governmental agencies, foreign companies, and oil and gas conferences and other interested parties abroad. A part of the effort undertaken in this regard shall include the publication of a brochure setting forth the new Petroleum Law.

5	Assist in the preliminary preparation for the tender for exploration/production areas in the Amudarya basin. Recommend negotiation preparation procedures for those usual negotiation activities in which the Competent Body or other governmental officials would frequently become involved.
6	Develop a proposal for western style chart of accounts for the oil and gas sector. Provide training on how to use such charts and develop at least two or three specialists.

5.2 Training In-Country

Five short courses have been indentified and are currently being developed. The courses will cover the following topics:

- Project Financing

  These include cash flow analysis, time value of money, discount rates(nominal and real), relationship between risk and return, return criteria (IRR and NPV), difference between debt and equity investors, advantage of debt on the weighted cost of capital.

- Basics Of International Contracts

  Fundamental concepts of contracts, choice of law in international contracts, international treaties and conventions, dispute resolution, and common types of international oil and gas contracts.

- Concepts of Administrative agency Law

  The current petroleum law allows the Competent Body to sign PSCs, JVs, and other types of agreements. In our meetings, the Turkmen Government officials expressed the need for explaining the Law and the agreements to people within their organizations. The course could present a comparison of more prevalent oil and gas agreements and their typical economics.

- Oil And Gas Accounting

The course would cover international oil and gas accounting standards and a comparison with accounting practices in Turkmenistan. This would be beneficial in both explaining the Accounting Procedures attached to PSC and other agreements as well as the tariff calculation methodology.

- International Petroleum Economics

The purpose of this course would be to aquatint oil and gas managers in the government and state concerns with worldwide supply, demand, trade, transportation, and economics in crude oil, products, natural gas, and LNG.

Exhibit 2-1

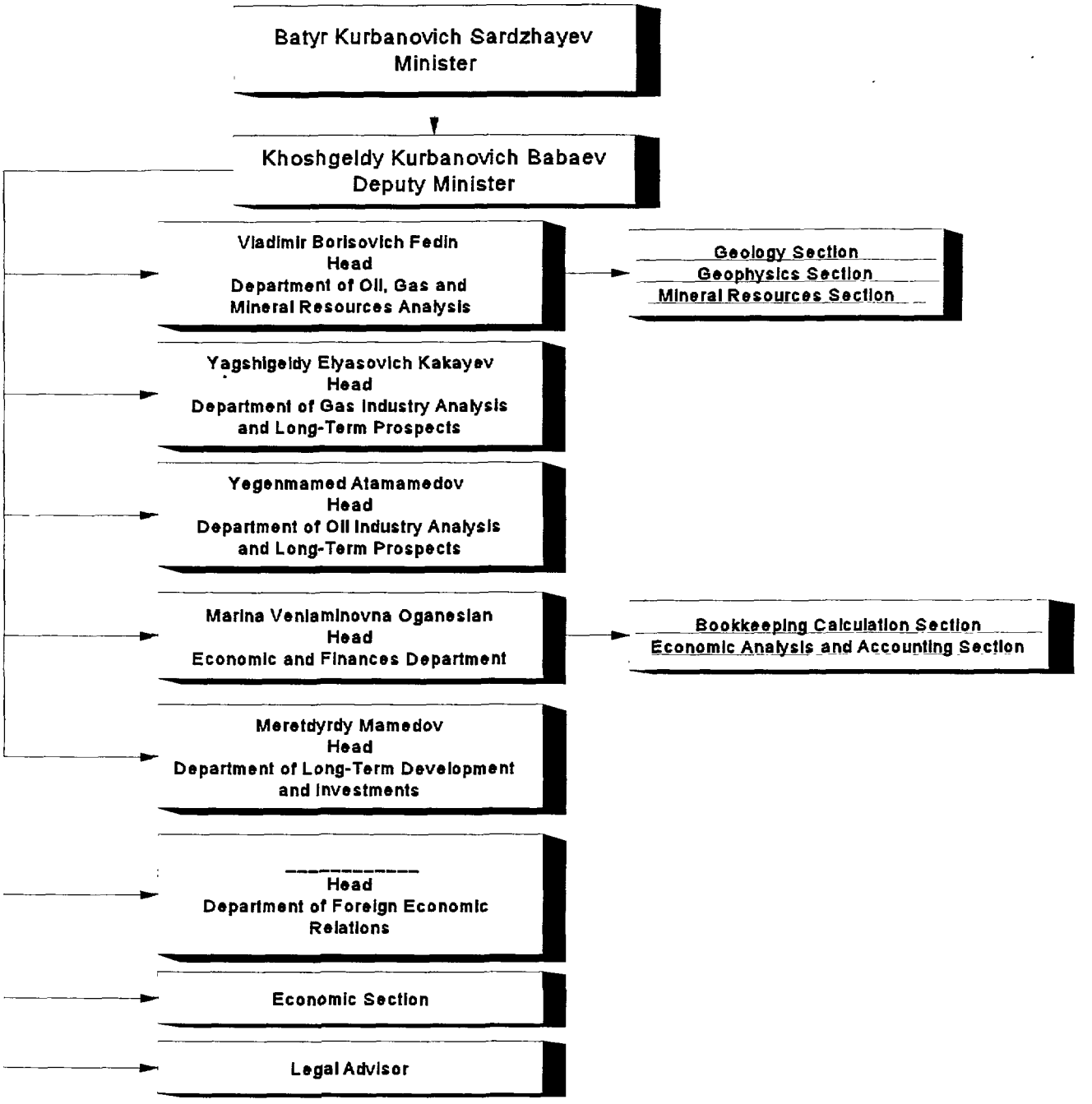

Batyr Kurbanovich Sardzhayev
Minister
Khoshgeldy Kurbanovich Babaev
Deputy Minister
Vladimir Borisovich Fedin
Head
Department of Oil, Gas and
Mineral Resources Analysis
Geology Section
Geophysics Section
Mineral Resources Section
Yagshigeldy Elyasovich Kakayev
Head
Department of Gas Industry Analysis
and Long-Term Prospects
Yegenmamed Atamamedov
Head
Department of Oil Industry Analysis
and Long-Term Prospects
Marina Veniaminovna Oganesian
Head
Economic and Finances Department
Bookkeeping Calculation Section
Economic Analysis and Accounting Section
Meretdyrdy Mamedov
Head
Department of Long-Term Development
and Investments
Head
Department of Foreign Economic
Relations
Economic Section
Legal Advisor

Exhibit 2-1
Oil and Gas Reserves Summary

		Total Oil MMT	Condensate MMT	Total Liquids MMT	Solution Gas BCM	Free Gas BCM	Total Gas BCM
Initial Resources	Amudarya Province	11	57	68	1	4920	4921
	S. Caspian Province Mainland	1523	74	1597	216	586	802
	S. Caspian Province Offshore	150	10	160	30	110	140
	Total	**1684**	**141**	**1825**	**247**	**5616**	**5863**

Initial Recoverable Reserves	Amudarya Province	4	48	53	0	4920	4920
	S. Caspian Province Mainland	579	39	617	166	516	682
	S. Caspian Province Offshore	53	5	57	26	94	119
	Total	**635**	**92**	**727**	**192**	**5529**	**5721**

Cumulative Production	Amudarya Province	-	25	25	-	1465	1465
	S. Caspian Province Mainland	351	4	356	74	102	175

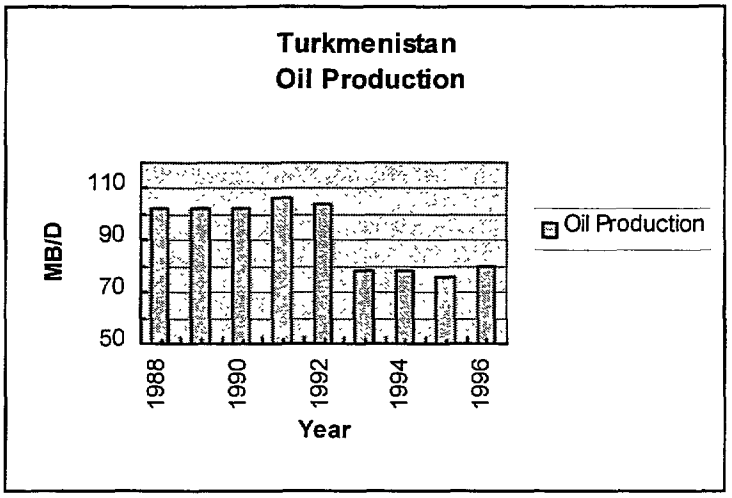
	S. Caspian Province Offshore	-	-	-	-	-	-
	Total	**351**	**30**	**381**	**74**	**1567**	**1641**

Remaining Recoverable Reserves	Amudarya Province	4	23	28	0	3455	3455
	S. Caspian Province Mainland	227	34	261	92	414	507
	S. Caspian Province Offshore	53	5	57	26	94	119
	Total	**284**	**62**	**346**	**118**	**3962**	**4081**

Total in US Units	**2073 MMB**	**455 MMB**	**2528 MMB**	**4 TCF**	**140 TCF**	**144 TCF**

* Source: Conference Documents, 2nd Turkmenistan International Oil & Gas '97 Projects Conference, March 12-13, 1997.
Proved + Provable, or A + B + C1 + C2.

Exhibit 2-2
Historical Oil and Gas Production in Turkmenistan



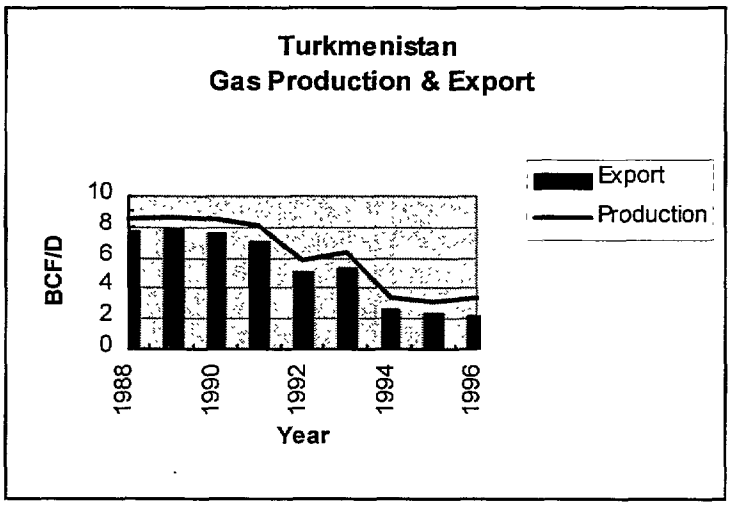
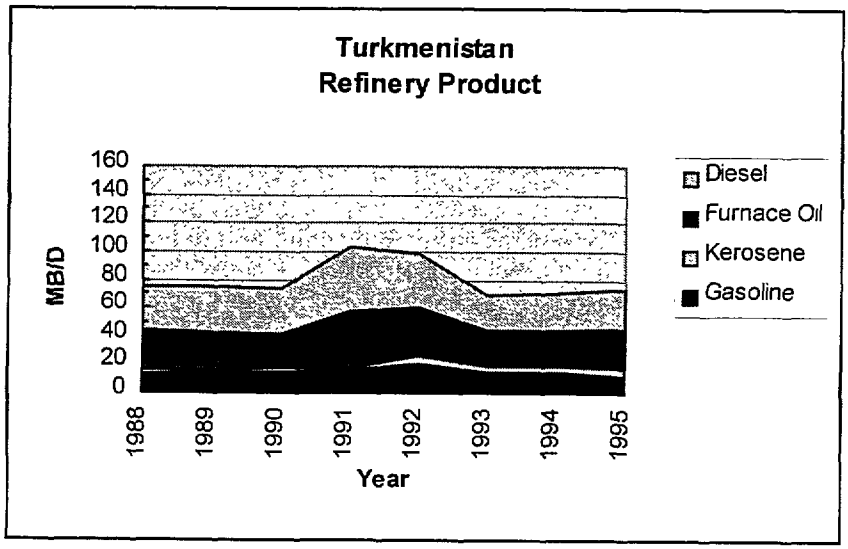


Exhibit 2-2
Refinery Products



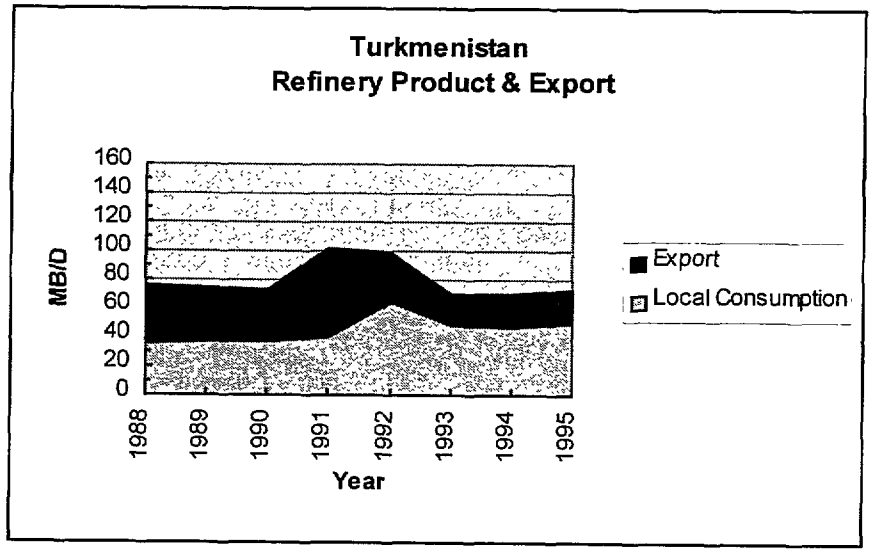


Exhibit 3-1
Ministry of Oil & Gas Industry and Mineral Resources

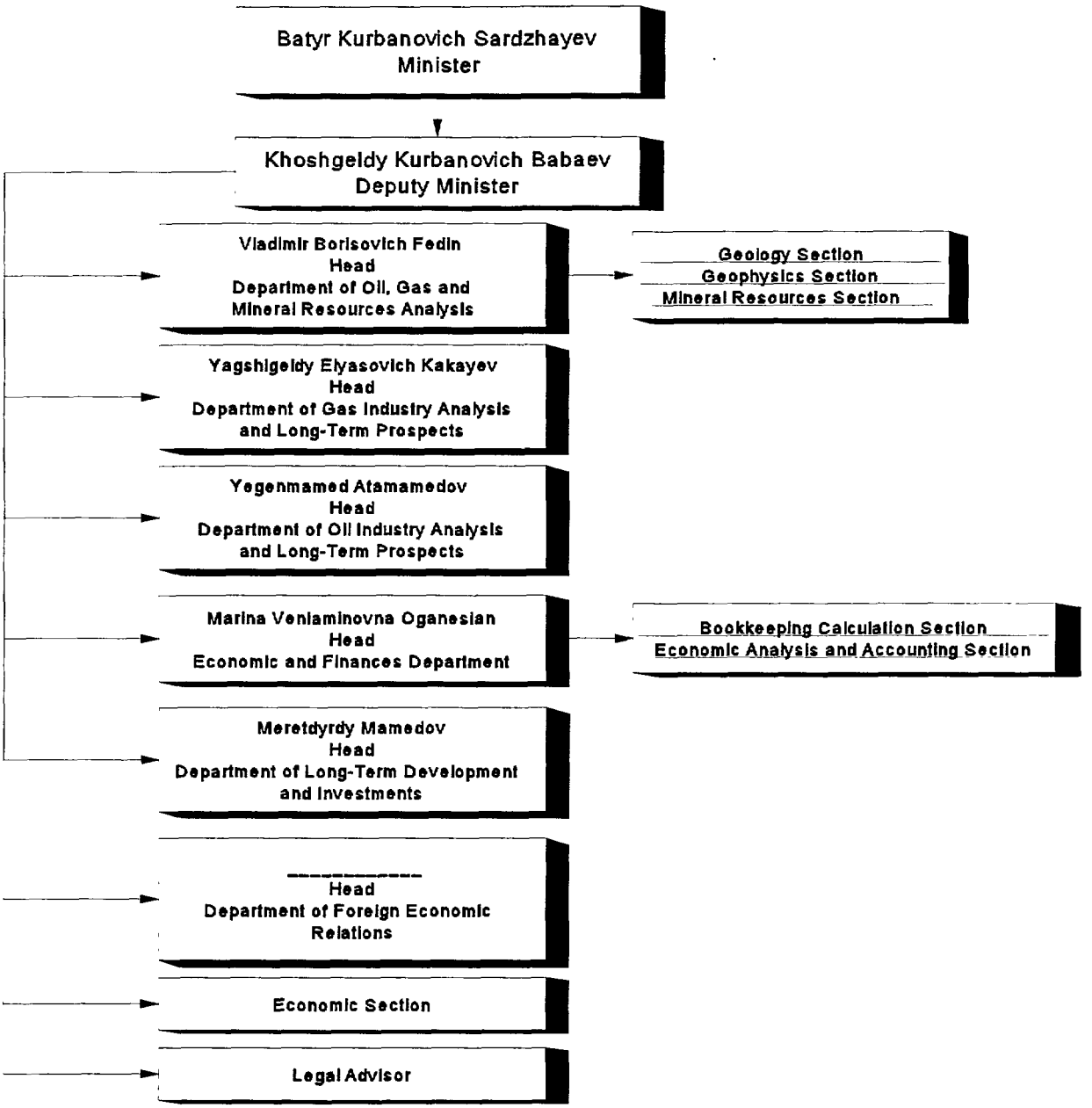


Table I

OIL & GAS RESERVES SUMMARY

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Initial Resources	Amudarya Province	11	57	68	1	4920	4921
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	S. Caspian Province Offshore	150	10	160	30	110	140
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* Source: Conference Documents, 2nd Turkmenistan International Oil & Gas '97 Projects Conference, March 12-13, 1997. Proved + Provable, or A + B + C1 + C2.

Exhibit 4-1

TACIS – Turkmenistan Project List – Oil & Gas Sector

Project	Recipient	Project cost	Time table	Remarks
Energy Advisory Group for Turkmenistan (Turk.1992)	Ministry of Oil and Gas	ECU 1,000,000	November 1994 - May 1996 (18 months)	Contractor: Consortium lead by ENEL. Inception report received. Project has two components 1) Oil & Gas: organizational advice, legal framework development, assessment of feasibility studies of gas/oil export routes and preparation of a "Draft throughput agreement", assistance and training in the procurement of oil & gas equipment, as well as in auditing of oil and gas contracts, 2) Electricity: development of a regulatory framework for privatization, network stability, methods of determination of transit tariffs.
Oil and Gas pipelines in Central Asia and Trans-Caucasia Republics. (Reg.1992)	Ministry of Oil and Gas		18 months	Contractor: SOFREGAS. Fact finding mission visited Ashgabat in January-April 1995. The project responds to the need to have regional integration as to facilitate the distribution of oil and gas and with regard to large scale export to Europe. As Such the project will provide for: 1) a detailed analysis of the current regional problems of the pipeline network; 2) advice to the Government regarding legal framework and regulations, organization and management structure, technical aspects of the pipeline network, regional co-operation, focusing particularly on exports. 3) training of high level executives in pipeline management.

Improvements in system operational planning, operation and control practices in Caucuses and Central Asia. (Reg. 1993 Central Asia & Caucasus)	Ministry of Oil and Gas	ECU 1,100,000	12 months	Contractor: Consortium of ENDESA, ESBI and FICHTNER. The project has two phases: I. audit of current: a)operational planning; b) network control; c) dispatcher training; II. recommendations for improving system operation and control.
Refurbishment of direct-fired oil heaters in oil refineries. (Reg. 1994)	Oil refineries in Turkmenistan	ECU 1,400,000	36 months	Tender announced
Support for the Establishment of a common framework within the New Independent States for addressing energy-related issues. (Reg. 1994 CIS + Mongolia)	Ministry of Energy and Industry / Ministry of Oil and Gas.	ECU 1,000,000	24 months	Tender opened
Assistance to the Ministry of Oil and Gas in 1996.	Ministry of Oil and Gas			The following proposals have been submitted: training on contracts elaboration and running contract's economics, and setting of the optimum structure of the Ministerial entity on control/co-ordination of foreign contractors activity and implementation of a licensing procedure for the conduct of Petroleum Operations' training on tenders preparation and realization of English courses' assistance on procurement procedure and training of personnel on foreign and investigation of markets and assessment of the viability of export Petroleum routes, assistance in setting transit tariffs and drafting Purchase/Sale and Project Financing Contracts, and assessment of the viability of Contracts on the revamping of Refineries and Contracts on Buying and Selling of Oil products.