BAKER & MCKENZIE

Production Sharing Contracts In Context

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Granting Instruments

Evolution of Oil and Gas Granting Instruments:

- The owner of hydrocarbons can either explore for and develop the hydrocarbons himself or he can grant that right to a third party under specific conditions.
- The legal instrument granting hydrocarbon rights to a third party is generally referred to as a granting instrument.
- There are basically two kinds of granting instruments:

1. Concession Contracts (which include oil and gas leases) and
2. Production Sharing Contracts

IN THE BEGINNING

Here is a picture of the first commercial oil well in the world, the Drake well, drilled in Titusville, Pennsylvania. It was drilled to 69.5 feet (21.545 meters) in 1859.

Drake Well

– "Colonel" Edwin L. Drake (right) and his good friend Peter Wilson, a Titusville pharmacist, in front of the historic Drake well in 1861. This was the second derrick and engine house - the first one burned down in 1859.

Granting Instruments

The granting instrument under which Drake drilled his well in Pennsylvania:

Date: December 30, 1857

From: Pennsylvania Rock Oil Company

To: E. B. Bowditch and E. L. Drake

A copy of the entire document follows:

– ‘Demise and let’ all the **lands** owned or held under lease by said company in the Country [*sic*] of Vanango, State of Pennsylvania, “**To bore, dig, mine, search for and obtain oil, salt water, coal** and all materials existing in and upon said lands, and take, remove and sell such, etc., for their own **exclusive use** and benefit, for the term of **15 years**, with the privilege of renewal for same term. Rental, **one-eighth of all oil as collected** from the springs in barrells furnished or paid for by lessees. Lessees may elect to purchase said one-eight at 45 cents per gallon, but such election, when made, shall remain fixed. On all other minerals, 10 per cent of the net profits. Lessees agree to prosecute operations **as early in the spring of 1858 as the season will permit**, and **if they fail** to work the property for an unreasonable length of time, or fail to pay rent for more than 60 days, the lease to be null and void.’”

Granting Instruments

Basic Elements in All Granting Instruments:

1. Identify the Area
2. Grant Right to Explore and Produce Hydrocarbons
3. Exclusive Grant of Rights
4. Obligation to Pay Royalty
5. Primary Term
6. Secondary Term
7. Obligation to carry out Work Program

Granting Instruments

1. Area

- Drake: ‘Demise and let’ all the lands owned or held under lease by said company in the Country [*sic*] of Vanango, State of Pennsylvania

- ANP Concession: 3.1 The Operations shall be performed in the Concession Area, which is described, detailed and delineated in Annex I (Concession Area).

- Indonesia PSC: Contract Area defined and further described in Exhibits A and B

Granting Instruments

2. Right to Explore and Produce Hydrocarbons

- Drake: To bore, dig, mine, search for and obtain oil, salt water, coal and . . . take, remove and sell such, etc.,

- ANP Concession: 2.1 The objective . . . is the performance, by the Concessionaire, of the Operations specified in Annex II (Work and Investment Program) . . . with the objective of producing Oil and Natural Gas . . .

- Indonesia PSC: 1.1 Contractor responsible to BPMIGAS for carrying out Petroleum Operations

Granting Instruments

3. Exclusive Grant of Rights

– Drake: for their own exclusive use and benefit,

– ANP Concession: 2.2 The Concessionaire shall . . . exclusively assume all costs and risks related to the performance of the Operations . . . and shall receive in return, . . . exclusively, the ownership of the Oil and Natural Gas . . . at the Production Metering Point . . . .

– Indonesia PSC: 1.1 Rights of Contractor to carry out Petroleum Operations are exclusive.

Granting Instruments

4. Royalty

– Drake: Rental, one-eighth of all oil as collected from the springs in barrells furnished or paid for by lessees…. On all other minerals, 10 per cent of the net profits.

– ANP Concession: 23.1 Each Concessionaire shall pay to the Federal Government and to Third-Parties: (i) Royalties, (ii) Special Participation, (iii) Surface Rentals, and (iv) Landowner Use, as indicated in Annex VI.

– Indonesia PSC: No royalty but production split (Many other PSCs have royalties).

Granting Instruments

5. Primary Term

- Drake: Lessees agree to prosecute operations as early in the spring of 1858 as the season will permit.

- ANP Concession: 4.1 This Agreement . . .will be divided into two phases, as follows:

  4.1.1 Exploration Phase, for the entire Concession Area, whose term is defined in paragraph 5.1; and

- Indonesia PSC: II Exploration period of 6 years (which may be extend by 4).

Granting Instruments

6. Secondary Term

– Drake: Term of 15 years, with the privilege of renewal for same term.

– ANP Concession: 4.1.2 Production Phase, for each Field, whose term is defined in paragraph 8.1

(27 years from declaration of commerciality).

– Indonesia PSC: II If there is production, 30 years including the exploration period.

Granting Instruments

7. Work Program

- Drake: (At the cost of the Lessee) If they [the lessees] fail to work the property for an unreasonable length of time, or fail to pay rent for more than 60 days, the lease to be null and void.

- ANP Concession: (To be carried out by Concessionaire) 5.2 Minimum Exploration Program: work units and exploratory well. 30.1 This Agreement shall be terminated if the Concessionaire does not comply with the period determined by the ANP for the performance of any pending contractual obligation . . . .

- Indonesia PSC: 1.1 Contractor shall carry the risk of the cost of the Petroleum Operations.

Granting Instruments

How, then, do PSCs differ from Concessions?

– Under a PSC, the parties divide up the oil instead of the money from sale of the oil.
– The government or the government oil company participates directly in the decision making process.

Production Split Analysis

- 1. PSC: Contractor gets 100% of production until costs are recouped (simplified example).
- 1. Concession Analog: Contractor deducts all costs against income from the sale of oil and gas.
- 2. PSC: After Contractor recovers costs, remaining production is split with the government or government oil company.
- 2. Concession Analog: Income from the sale of oil in excess of costs deducted is net profit and a % is paid as income tax.

Production Split Analysis

- 3. PSC: The government usually gets a share of production before the contractor has recouped its profits (First Tranche Petroleum in Indonesia, for example).
- 3. Concession Analog: The contractor pays royalty on the first barrel of oil long before there is a profit.
- 4. PSC: The government is the direct owner of a share of production.
- 4. Concession Analog: Government can reserve the right to take its royalty share in kind.

Production Split Analysis

- 5. PSC: Usually has a local content requirement.
- 5. Concession Analog: Concession contracts have a local content requirement (see, Brazil).
- 6. PSC: Contractor pays bonus upon acquiring the PSC and surface rentals yearly thereafter.
- 6. Concession Analog: same.
- 7. PSC: Production bonuses are very common.
- 7. Concession Analog: same.

Production Split Analysis

- 8. PSC: PSCs usually have a sliding scale of greater participation by the state that tracks reimbursement (R Factor) recouped by the contractor.
- 8. Concession Analog: same.
- 9. PSC: Relinquishment of areas is required during or after the primary term.
- 9. Concession Analog: same

Contractor / National Oil Company Joint Management

- The “Sharing” in Production Sharing Contracts extends beyond oil and gas.
- The early concession system gave the host government no say in the exploration and production program.
- One of the main purposes of the Production Sharing Contract system is to exert state control over the exploration and production of oil and gas in the national territory.

Contractor / National Oil Company Joint Management

The PSC in Indonesia illustrates the beginning of sharing control along with production sharing.

Indonesia

Clause 5.3.1 of the Indonesia PSC provides: Pertamina shall have and be responsible for the management of the operation contemplated hereunder, however, PERTAMINA shall assist and consult CONTRACTOR with a view to the fact that CONTRACTOR is responsible for the Work Program.

Contractor / National Oil Company Joint Management

The next step is a joint management committee.

Nigeria

- PSC provides for establishment of a management committee within 30 days from execution of the PSC. The management committee has power to approve by unanimous vote all matters pertaining to Operations.
- Failing unanimity the parties will:

  -appoint an expert to give binding advice; or

  -arbitrate if there is no agreement on an expert.

Contractor / National Oil Company Joint Management

China

PSC establishes a Joint Management Committee to ensure proper performance of Operations.   A unanimous vote is required failing which the Contractor’s proposal controls.

Contractor / National Oil Company Joint Management

Equatorial Guinea

PSC provides that the Contractor and the government oil company will enter into an operating agreement based on the latest AIPN model form which will regulate the internal relations of the parties.

-The National Company will be the Administrative Operator and

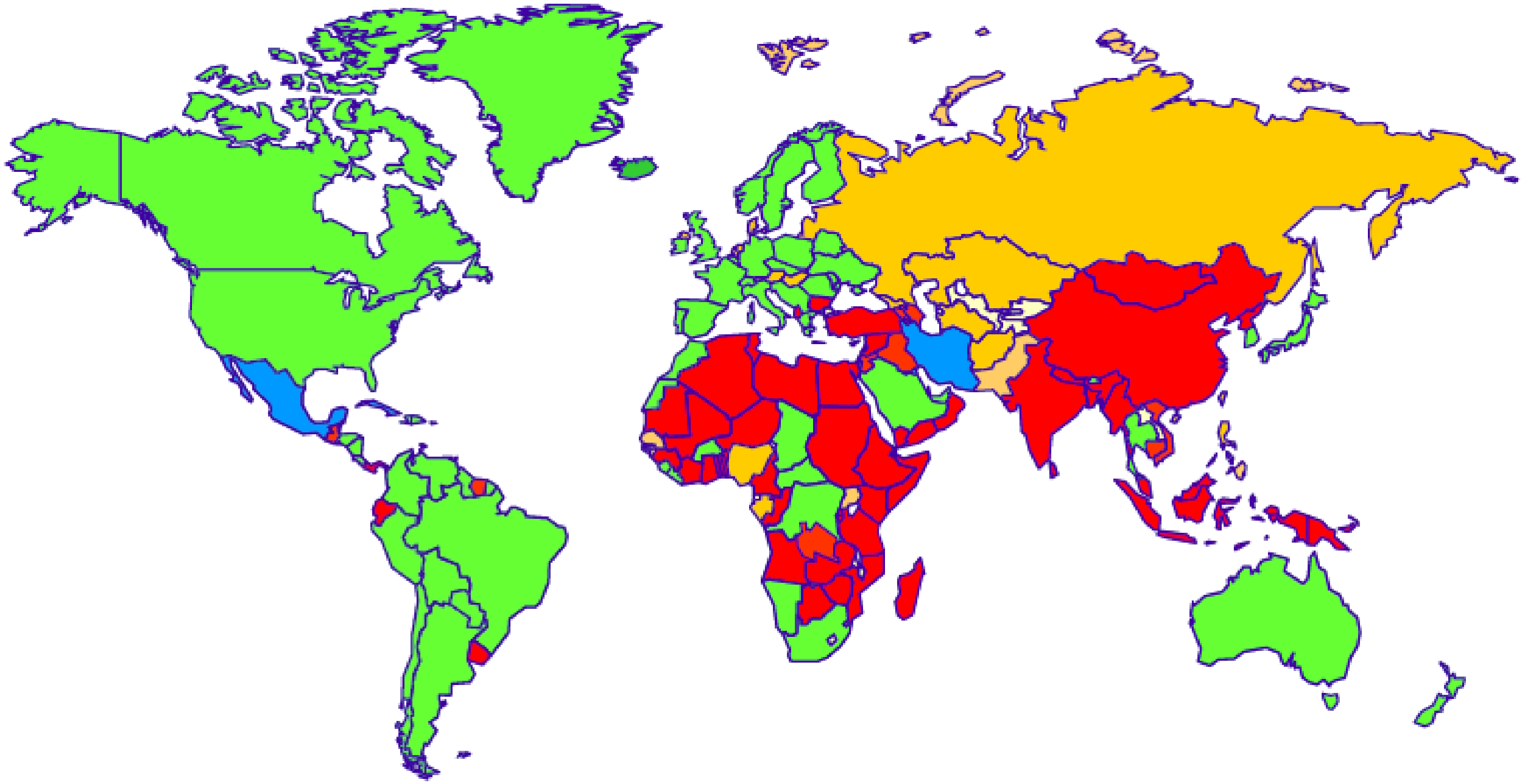
-The Contractor is named the Technical Operator.

Direct State Control With Veto Power

– Examples:
  – Brazil: Proposed powers for Petrosal
  – Argentina: Provinces have extensive veto powers over operating committee actions.

Question: Are we at the point where the owner has decided to develop the hydrocarbons himself?

Answer: It will probably be a political decision on a case by case basis.



Concession PSC
Service Contracts Mix

Who is Using PSCs Now?

- Argentina
- Bangladesh
- Bolivia
- Cameroon
- Chile
- Egypt
- Ethiopia
- Malaysia
- Vietnam
- Yemen
- Trinidad and Tobago
- Equatorial Guinea
- Georgia
- India
- Indonesia
- Iraq
- Kazakhstan
- Madagascar
- Nigeria
- Peru
- Russia
- Thailand

Extensive State Control Under Concessions: ANP Example

- ANP disposes of relinquished blocks and enforces relinquishments by Concessionaire. (Clauses 3 and 5)
- ANP may draw on the letter of credit for noncompliance by the Concessionaire with the Minimum Exploration Program. (Clause 5)
- The ANP must authorize long-term production tests. (Clause 6)
- Evaluation Plans must be approved by the ANP. (Clause 6)

Extensive State Control Under Concessions: ANP Example

- ANP decides on postponement of declaration of commerciality. (Clause 7)
- ANP approves any extension of the Production Term. (Clause 8)
- Approves Installations Deactivation Programs. (Clause 8)
- The ANP approves Development Plans. (Clause 9) and Production Programs. (Clause 10)
- May require the concessionaire to supply the national market. (Clause 11)

Extensive State Control Under Concessions: ANP Example

- The ANP controls Unification of Operations. (Clause 12)
- Remove Operator if it has committed a material breach of the agreement. (Clause 13)
- The ANP has a general oversight function. (Clause 14)
- Require the Concessionaire to post a Deactivation and Abandonment Guarantee. (Clause 18)
- Collect liquidated damages from Concessionaire for failure by the Concessionaire to comply with local content requirements of the concession. (Clause 20)

Brazilian Model PSC

Art. 27. The production sharing contract shall provide for two stages:

I – the **exploration stage**, which shall include the activities of evaluation any oil or natural gas discovery, to determine its merchantability; and

II – the **production stage**, which shall include the development activities.

Art. 28. The production sharing contract for oil, natural gas and other fluid hydrocarbons shall **not extend to any other natural resources**, and the operator shall be obliged to inform its discovery, under the terms of item I of art. 30.

Art. 29. The following items shall be essential clauses of the production sharing contract:

I – the definition of the **block** object of the contract;

II - the obligation for the contractor to **assume the risks** of the exploration, evaluation, development and production activities;

III – the indication of **bonds** to be provided by the contractor;

IV – the contractor’s right to receive the cost in oil, required only in the event of a commercial discovery;

V – the limits, terms, criteria and conditions for the calculation and **payment of the cost in oil**;

Brazilian Model PSC Continued

VI – the criteria for **determining the oil or natural gas value,** in view of the market prices, product specialization and field location;

VII – the rules and terms for the **sharing of the excess oil**, and it may include criteria related to the economic efficiency, profitability, production volume and the price variation of oil and natural gas, in compliance with the percentage established according to the provision set forth in art. 18;

VIII – the attributions, the composition, the operation, the decision making manner and the settlement of disputes in the scope of the **operating committee**;

IX – the **accounting rules,** as well as the procedures to follow up and control the exploration, evaluation, development and production activities;

X – the rules for the accomplishment of the activities, on contractor’s account and risk, which shall not imply any obligation to the Federal Government or accounting in the oil cost value;

XI – the **duration term** of the exploration stage and the conditions for the extension thereof;

XII – the **minimum exploratory program** and the conditions for its revision;

Brazilian Model PSC Continued

XIII – the criteria for elaborating and **reviewing** the production exploration and development **plans**, as well as the relative working plans, including the measurement points and the sharing of oil, natural gas and other fluid hydrocarbons produced;

XIV – the necessity for the contractor to **provide ANP and the public company** addressed in paragraph 1 of art. 8 with reports, **data and information** concerning the contractual performance;

XV – the criteria for the **return and clearance of the areas** by contractor, including the removal of equipment and facilities, as well as reversal of assets;

XVI – the **penalties** applicable in case of default with the contractual obligations;

XVII – the procedures related to the **assignment of rights** and obligations relative the contract, according to the provision set forth in art. 31;

XVIII – the rules on settlement of **disputes**, and it may provide for **conciliation and arbitration**;

XIX – the contractual effective **term, limited to thirty-five years**, and the conditions for its extinction; and

XX – the value and payment form of the **signature bonus**.

Brazilian Model PSC Continued

Art. 30. **PETROBRAS, as the operator** of the production sharing contract, **shall**:

I – inform the operating committee and ANP, within the contractual term, the discovery of any deposit of oil, natural gas or any minerals;

II – submit to the approval of the operating committee the discovery evaluation plan for oil and natural gas deposits, in order to determine their merchantability;

III – carry out the evaluation of the discovery of the oil and natural gas deposit under the terms of the evaluation plan approved by ANP, presenting a merchantability report to the operating committee;

IV – submit to the operating committee the field's production development plan, as well as the working and production plans, describing schedules and budgets;

V – adopt the best practices in the oil industry, in compliance with the applicable technical and scientific rules and procedures, and using the appropriate recovery techniques, aiming at rationalizing the production and control of decline in reserves; and

VI – submit to the operating committee all data and documents relative the activities performed.

Brazilian Model PSC Continued

Art. 31. The **assignment of the rights and obligations** relative the production sharing contract may only take place pursuant to the previous and express authorization of the **Ministry of Mines and Energy**, upon **hearing ANP**, in compliance with the following conditions:

I – protection of the contractual purpose and its conditions;

II – **compliance, by the assignee**, with the technical, economic and legal requirements established by the Ministry of Mines and Energy; and

III – exercise of the **preference right** of the other joint venturers, proportionately to their participations in the joint venture.

Sole Paragraph. PETROBRAS may only assign participation in the production sharing contracts it gets as the winning bidder, under the terms of art. 14.

Brazilian Model PSC Continued

Art. 32. The production sharing contract shall be **terminated** in the following events:

I – by maturity of its term;

II – by agreement between the parties;

III – by the termination reasons set forth therein;

IV – at the **end of the exploration stage, without any commercial discovery**, as defined in the contract;

V – by the exercise of the waiver right **by contractor at the exploration stage**, provided that fulfillment of the minimum exploratory program or the payment of the amount corresponding to the non-complied portion, as set forth in the contract; and

VI – by the refusal to execute the **production unitization agreement**, upon decision of ANP.

Brazilian Model PSC Continued

Paragraph 1 The return of areas shall not imply an obligation of any nature to the Federal Government, neither shall it provide the contractor with any indemnification rights for services and assets.

Paragraph 2 **Upon termination** of the production sharing contract, the contractor **shall remove** the equipment and assets that are not subject to reversal, and it shall be obliged to repair or indemnify the damages arising from its activities and **perform the environmental recovery** acts determined by the applicable authorities.

Production Sharing Contracts In Context

THANK YOU

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