REVIEWING PRODUCTION SHARING CONTRACTS FOR GAS COMPANIES*

Gas projects cover a wide range of activities, from upstream to midstream and downstream sectors. These activities include exploration, development, production, transportation, importation and marketing of products.

Possibility of Risk

The risk of not finding gas in commercial quantity is worth considering, the drop in the price of gas for International Gas companies, political risks of expropriation by host states, make the gas industry a bit risk intensive.

The nature of the Gas industry in Nigeria makes it a bit unattractive for commercial lenders to agree to finance such projects when they are embarked upon by smaller companies. Even when such financing is available, it comes with high interest rate such that default is not particularly uncommon.

Reluctance of Oil and Gas Companies to Explore for Gas

Nigeria needs clear growth in critical areas of the gas sector such as exploration, production, processing, supply and distribution.

Monetizing natural gas would require fairly decent investments in infrastructure that address the five component areas of gas availability, affordability, deliverability, funding, legal and regulatory framework.

In this paper we will examine **Production Sharing Contracts which** have been used as a means of finance and risk management for exploration activities in the gas industry. It has been extensively used in the oil industry as an alternative means of financing exploration activities, most likely because such funds are not readily available through corporate lending due to the high risks involved in carrying out these activities.

Model PSC for Gas?

The Senior Technical Adviser, Upstream and Gas, to the Minister of State for Petroleum Resources, Mr Gbite Adeniji, was quoted as having said that, “We are working hard on gas terms for PSC concessions. We should consider gas development a matter of strategic importance. Therefore, we need to develop an appropriate legal and regulatory framework.” It is this writers opinion that once the gas terms are ready, it may be in order to expect a model PSC for gas.

Model Gas Contracts Are Initial Negotiating Points

"Model contracts" are the initial negotiating points from which the government and the Gas Company proceed in their journey towards a mutually beneficial Gas PSC contract. Consequently, negotiating Gas contracts requires acumen, knowledge, foresight and plenty of common sense as well.

Production Sharing Contract (PSC)

In a PSC, the NNPC engages a competent contractor usually an International Oil Company (IOC) to drill for gas on NNPC's wholly held acreage. The contractor undertakes the initial exploration risks and recovers his costs if and when gas is discovered in commercial quantities and extracted.

History of Production Sharing Contracts

Indonesia pioneered the first PSC in 1966 through Permina, the state oil company. The contract system was evolved due to the imbalance in the traditional concessionary system regarding Government Take.

Reviewing a PSC

This analysis is based on publicly available information such as model PSC terms published in Nigeria and other countries petroleum legislation and websites.

In reviewing a PSC, it might be wise to use a basic checklist that covers issues like; who are the Parties to the contract? What exactly, is the subject of the PSC? What is the Description of contract area? What is the Duration of contract? What are the terms for Obligatory Exploration, Evaluation work and Declaration of Commercial Discovery? What is the format for Production Sharing?

What is the Tax rate? Is there need for a Stabilization Clause? Where is the venue for Settlement of Disputes? What is the preferred Choice of Law?

Are the essential safety clauses properly worded? What are the provisions for risk allocation and indemnity clauses?

Contract Review and Environmental Protection

There is a possibility that basic contract review and negotiation can help stem the tide of pollution and environmental degradation by making sure we negotiate and include clauses that enact stringent conditions for environmental protection.

Contract terms are very important because they determine how much Nigeria as a producing country earns from it natural resources; and they can strengthen the regulatory power of government to enforce environmental, health and other standards, if standard legal and regulatory systems are not well established…

Agreed damages clause for pollution

Insert a clause stipulating the minimum fine for gas flared, especially after a certain period of grace.

Examples of Key Provisions in a PSC:

Parties to the contract: The parties are usually the IOC and the national oil company (NOC).

Description of contract area: The contract area has to be delineated into blocks and authorised for Exploration and Production by the Federal Government. Questions arise; will the existing OMLs which cover both oil and gas be split into two, what happens when the original holder of the OML is not interested in gas? Will the new OML cover either oil or gas? Is there legislative backing for any modification of the existing license regime?

Duration of contract: The PSC stipulates the validity period of the contract. The IOC is not allowed to exceed the contract period and must ensure that all commercial discoveries of gas are exploited within the contract period.

Work Commitment: The IOC must carry out exploration and evaluation work until a commercial discovery of gas is made. There is a Minimum Work Programme and Expenditure clause. This clause provides for the minimum operations and expenditure.

Management and Supervision of the operations: The Model PSC provides for a Management Committee to provide the direction in respect of all matters pertaining to the gas operations and work programs and budgets.

Funding of the operations:

The IOC/contractor in a PSC is responsible for funding the gas exploration work. The NOC'S exploration payment obligations are often "borne" by the IOC and repaid by the NOC out of production of gas. In addition the IOC bears exploration risk if no gas is discovered.

National Interest Provisions/ local content:

A PSC usually contains clauses to enhance or protect the national economic interest, by providing in some case provisions relating to the transfer of technology, training of local employees and the exercise of a clear preference for local contractors. This is in addition to the Local content legislation already in force.

Production Sharing: The PSC provides for how the IOC/contractor will recover his costs, the allowable percentage of recovery and how production will be shared. Common items found in PSCs are royalty gas, cost (recovery) gas and profit gas.

Tax: The PSC states the taxes that the IOC/contractor would be subjected to.

Stabilisation Clause:

Modern stabilisation clauses tend towards mutual agreement before legislative changes that affect the contract are carried into effect. Where a state acts contrary to its stability guarantee in the PSC, such acts tend to justify the award of damages for contractual breaches.

Settlement of Disputes:

Disputes between the parties arising from the PSC are settled by arbitration by an independent expert or, in the event there is no reconciliation, by arbitration, pursuant to the rules of the UNCITRAL Arbitration Rules.

Choice of Law:

Parties are allowed to choose the law that would govern the contracts and any disputes that may arise. In choosing the law, the IOC/contractor tends towards general principles of international law which they are seemingly more familiar with.

The umbrella clause might also be useful

This means that the contracting state is under interstate obligation to observe investment commitments, allowing the IOC'S the right to resolve breaches of state contracts under international law by an international arbitration.

Abandonment/Decommissioning

The PSC provides for a Decommissioning clause for each Development Area. This is quite commendable as the IOC is under obligation to properly clean up after gas operations.

Benefits of Production Sharing Contracts

Control

PSC'S give the host government and its National Oil Company a high degree of control and participation, (well this is in comparison to the limited control given to a non-operator under a JOA).

Frees up cash flow

The funding arrangement is beneficial for an NOC participating in the project. The good thing is that even after production begins and the NOC is required to finance the project payments are made from gas production rather than cash.

Reliance on the technical expertise of IOC'S and perhaps Tech Transfer

A PSC allows government to rely extensively on the technical expertise of IOC'S. However the Nigerian experience is that we have been unable to achieve technology transfer through the use of technology transfer clauses. A key issue often neglected with transfer of technology is how to construct a receptor to capture the transferred technology and ensure that it is fully internalized to enable it blossom and grow to create similar new technologies on its own within a given time frame without external support.

Government profits…

Government shares potential profits without having to make a direct investment

Demerits of PSC'S; the Nigerian Experience

Artificial Expenses

The IOC may decide to slow down the pace of production, be wasteful or extravagant in its exploitation especially when the operator knows his expenses would be fully met by the sale of gas produced.

Mild Sanctions

PSC'S are contracts. Violation of a legal statute is an offense, subjective to legislatively approved sanctions and penalties while violating a contractual provision is less costly than violation of a regulation because only in the case of a serious or material breach of contract is the termination of the agreement a possibility.

Minefield of Exceptional Situations

Making contracts into law creates a legal infrastructure of exceptional situations; little possibility of developing a coherent and comprehensive legal system as can be seen in the medley of laws regulating oil and gas in Nigeria.

Less Exposure for Government

Government generally has less knowledge about potential of the gas field than the gas company, even when there are lengthy tech transfer clauses.

Governmental Conflict Of Interest

This occurs where government holds significant share. It has to balance the desire for higher profits with the enforcement of environmental and other regulations, and most times it succumbs to the desire for more profit at the expense of proper enforcement of the law.

Emergence of Social Normative Norms in Oil Pollution?

Lax enforcement of the law in the area of environmental degradation eventually results in whiplashes and hostility from the host communities targeted at the International Oil Company.

IP/Data Protection in the Gas Industry

Gas monetization is intensely Intellectual Property ('I.P.') centric, it is critical that gas companies get timely advice on IP issues in Gas. It is also critical that Nigeria begins to develop home grown gas technology protected by IP. The unique value proposition is that gas contracts are enforceable against the parties to the contract, but IP rights are negative rights, which are potentially enforceable against the whole world!

Research and operations in the gas industry constantly produce new pipelines, ideas, procedures, software, equipment and plenty of data, especially in areas bordering on pipeline integrity, gas leak detection systems and pipeline safety.

This innovation has potentially transformed the oil and gas industry from a commodity market to knowledge/innovation/intellectual property-based industry.

In addition, the divestment of assets by oil and gas companies can lead to employee mobility - the kind of employee mobility that usually makes the loss of valuable data or even intellectual property more probable.

It may seem wise for gas companies to pay more attention towards protecting such IP and proprietary information - especially as it concerns former and disgruntled employees.

Conclusion

Negotiating a Production Sharing Contract requires legal knowledge, foresight and common sense. The number of model clauses successfully incorporated in the Final Production Sharing Contract depends largely upon negotiating power of the parties involved. Even so, the information contained in this piece will enlighten the Government and International Oil Company (IOC)/contractor as to some possible alternatives, and possibly foster frank discussion between the Government and the Oil Company prior to signing any agreements.

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