



Production sharing

The effective development of oil and gas reserves

Any production sharing agreement must strike the right balance between maximising the financial return to the host country and providing an incentive and a stable framework for investment by the foreign investor.

Overview

Project-financing oil and gas transactions in Africa involves balancing the desire of the international oil company (IOC) to make a return on its investment against the national interest in extracting the maximum financial benefit from the country's natural resources and maintaining a constant and efficient energy supply.

In most project-financed deals in Africa, the IOC receives its revenue as a share of production through a production sharing agreement (PSA), which is the principal method for developing oil and gas reserves in Africa using foreign participation (although Nigeria and Libya are examples of African countries that operate a mixed regime of PSAs, joint ventures, service contracts and licences). PSAs are subject to local law and IOCs would do well to abandon any notion that what works in one African nation will apply in other (even neighbouring) countries, since the application of PSAs varies from nation to nation. In most countries, for example the Democratic Republic of Congo, the host government, in addition to its national oil company (NOC), is a signatory. Gabon is a rare example of a country that has a PSA in which the host government only, and not an NOC, is the local party.

Risks to your business

Cost recovery

Certain jurisdictions are less investor-friendly than others. PSAs may include carry provisions, under which the IOC is on risk for the possibility that exploration yields no oil or gas (and associated costs). Gabon's Mining Code, for example, enshrines this risk into law, whereas Libya has more investor-friendly provisions. PSAs may or may not contain cost-recovery provisions that allow the IOC to recover its costs (in some cases, including tax) before the profit element is shared out. Some host governments may make expenditure incurred through the use of local resources (but not those from abroad) recoverable.

Failed deals

One of the biggest risks facing IOCs is political, namely that the deal will not be honoured in one way or another. The most extreme form of political risk is expropriation through nationalisation of the assets or the shares in the relevant asset-owning company. Of equal or perhaps greater concern is the risk of 'creeping' expropriation, by the host government changing the fiscal regime or passing other laws to make the arrangement less profitable for the IOCs and more profitable for host government and/or its NOC than was originally negotiated.

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Actions to mitigate risk

Stabilisation clauses

The incorporation of stabilisation clauses in PSAs can serve to mitigate the non-commercial and political risks outlined above. Stabilisation clauses address changes in law in the host state during the life of the project and are used to insulate IOCs against the risk that the host state will use a change in circumstances to impose new requirements on them. They provide protection against fiscal, environmental and social legislation. Lenders often view stabilisation clauses as an essential element when assessing the bankability of a project. It is important that there is an effective dispute resolution procedure, whether in the PSA itself or through a bilateral investment treaty (see the note entitled Bilateral investment treaties).

Multilateral and bilateral lenders

Project sponsors have also sought to mitigate such risks by including in the project lender group one or more multilateral or bilateral institutions (on the reasoning that a government is less likely to expropriate or permit political violence to affect a project to which a multilateral or bilateral institution has lent).

Insurance

Another method for risk mitigation would be to obtain a political risk insurance policy from a multilateral or bilateral institution. One of the more attractive features of debt provided by such multilaterals or bilaterals for project financing is political risk protection in the form of 'specified event' political risk carve-outs to sponsors' pre-completion guarantees. This is a mechanism whereby the sponsors' obligations under pre-completion guarantees are extinguished before project completion if certain so-called specified events of political violence or expropriatory actions occur.

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