An offshore oil rig is silhouetted against a dramatic sunset sky with orange and yellow clouds. The rig is positioned in the center of the frame, with the dark blue, choppy ocean in the foreground.

End of PSA

Key issues to consider



Freshfields Bruckhaus Deringer

Introduction

A significant number of production sharing agreements/contracts (PSAs), signed in the early 1990s (or before) are coming to an end.

As a result we have seen a flurry of opportunism from states and state-owned oil and gas companies, and have represented a number of international oil and gas companies (IOCs) in arbitrations brought against them under recently expired PSAs. These claims are last-ditch attempts by states to extract any final value from the IOCs before, in some cases, they exit the country for good.

Our objectives

On the basis of our experience in a number of arbitrations, we have collated a list of 'lessons learnt', which covers the crucial issues to consider as the end of the PSA approaches and the conditions are set for potential claims. The considerations apply whether there is a handover of ongoing operations or where the block has no remaining economic life and production will cease. Many will also be relevant in cases where an IOC is considering an early relinquishment or termination in light of depressed oil prices and/or geopolitical uncertainties.

The optimal solution for many IOCs facing expiring PSAs is to negotiate some form of settlement agreement with the state and/or state-owned oil and gas company, pursuant to which the latter agrees to waive any claims arising out of the PSA. We have negotiated similar agreements in the past, but in many situations the state is unlikely to agree to an expansive release, especially where it has not had an opportunity fully to inspect the condition of the block before handover. So what steps should IOCs take to minimise their exposure in the event of a future dispute?

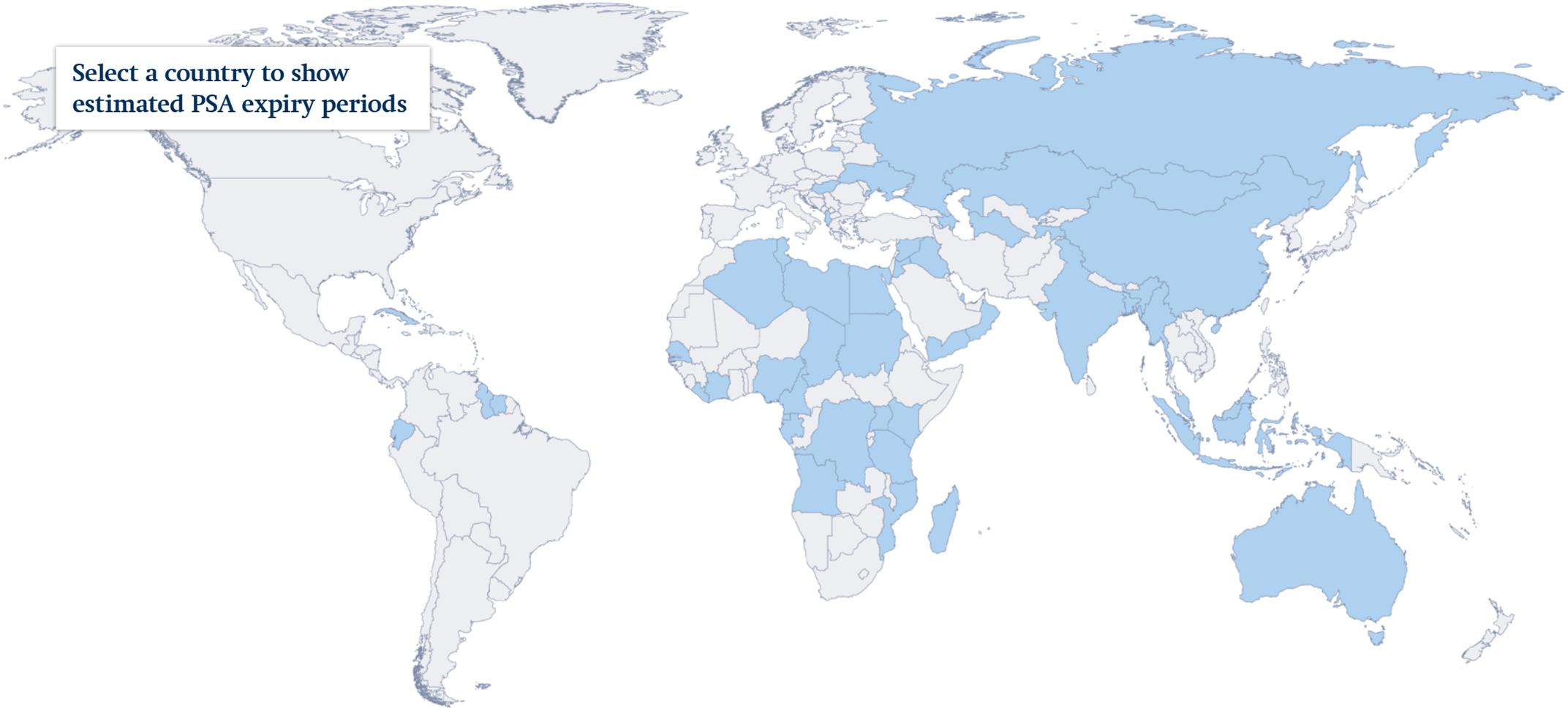
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PSA expiry map

Select a country to show
estimated PSA expiry periods



2

Generally speaking...

We have seen a number of clients caught out by not allowing sufficient time to plan for the end of the PSA and/or by relying too heavily on a 'plan B' scenario of an extension to the PSA. In our experience, it is prudent to commence end-of-PSA planning as early as possible. It is likely to be a complicated process involving a number of different stakeholders so we recommend it starts at least two years before the contractual termination date.

Handover plans should be developed in parallel with any alternative options (eg negotiating for an extension), regardless of the relative likelihood that the PSA may or may not terminate in accordance with its terms.

The contractor should consider preparing a close out report that can be presented to the state authorities and/or an incoming operator before the contractual termination date. It can be used to implement any handover or termination and gives the contractor an opportunity to set the terms of the process.

The contractor should also consider initiating discussions with the state authorities as early as possible to identify any areas of uncertainty regarding end-of-PSA obligations and to clarify what is expected of it in terms of satisfying such obligations. If there is disagreement over the extent of the end-of-PSA obligations (eg in relation to the handover of any ERP system – see section 7), the contractor should document its position carefully, and in writing. This can be very important when defending a claim in any future arbitration.

Settlement

As mentioned in the introduction, the optimal solution when faced with a soon-to-expire PSA may be to negotiate some form of settlement agreement with the state and/or state-owned oil and gas company, whereby the latter agrees to waive any claims arising out of the PSA. Such an agreement may be difficult to negotiate in practice, particularly in circumstances where the state has had limited access to the block prior to expiry. However, based on our experience of negotiating settlement agreements in the past, there are certain key issues that the contractor will need to consider should the opportunity arise, including:

- using ongoing cost recovery audit negotiations as leverage to agree to negotiate a wider set of waivers and releases relating to other end-of-PSA issues (such as operational and environmental issues);
- obtaining an acknowledgement and release regarding the condition of the block and status of all assets at handover, including with respect to ongoing and anticipated engineering, construction and maintenance projects;
- depending on the terms of the PSA, the need to ensure that the contractor has the right to keep copies of documents and data produced in connection with operations on the block, without which the contractor will be exposed in the event of a future dispute; and
- ensuring that any settlement agreement is carefully and comprehensively documented and includes all relevant parties, including the state and any relevant ministries (including, to the extent necessary, ministries responsible for taxation and customs, in addition to those with responsibility for oil and gas matters), and any incoming operator.

3

Documentation

It may be useful to prepare a categorisation of potential end-of-PSA risks (such as handover risks, operational risks that may arise after handover and/or legal risks), and gather documentation that proves the relevant due diligence has been undertaken. Should any claims be brought by state authorities or an incoming operator, this documentation will be necessary for the contractor's defence.

However, it is critical that such documents (including any related source documents and correspondence) are kept confidential and offsite (if practicable). Circulation should be restricted and should not include individuals who risk being employed by the state and/or the new operator in the future. Consideration should be given to instructing external counsel to manage the process in order to ensure there is a defensible basis for asserting privilege over materials produced in connection with the exercise.

Arrangements should be made to ensure that copies of documents (hard copy and electronic) are saved and stored in an organised fashion offsite. This ensures that the backup set is both comprehensive and easily accessible for future use.

The contractor may have obligations under the PSA to hand over originals and/or copies of documents at the end of the PSA. The contractor will need to have reference to the precise wording of the PSA in this regard: we are aware of a number of PSAs in Middle Eastern jurisdictions that require the contractor to hand over both originals and copies of documents and data produced in connection with operations on the block. However, it is important that any documents handed over or left behind are reviewed and filtered in order to minimise the risk of potentially damaging materials falling into the hands of the state and/or the new operator.

The contractor should maintain organised records of any data and/or documentation provided to relevant state authorities and/or an incoming operator during the course of the PSA and after termination. Wherever possible, the contractor should endeavour to obtain signed and/or stamped acknowledgement of the data and documentation that has been provided.

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It may be useful to prepare a categorisation of potential end-of-PSA risks, and gather documentation that proves the relevant due diligence has been undertaken.

4

Operation

The contractor should document the state's involvement in and awareness of all aspects of operations on the block, including, for example:

- any inspections of the block by the state;
- the role of the state in any operational committees or related subcommittees; and
- the state's review and approval of key contracts.

This will assist the contractor in bringing any potentially applicable waiver or estoppel defences in the case of future disputes.

The contractor should also consider undertaking an end-of-PSA environmental impact assessment (EIA) to assess:

- any changes relative to the baseline EIA and/or EIAs conducted during the course of the PSA; and
- the state of the environment at handover/termination.

It is arguable that there is no obligation as a matter of good oil field practice (GOP) for the contractor to procure an EIA, but depending on the state of the block towards the end of the PSA it can be useful to commission one while the contractor still has access to and control of the block. Contemporaneous evidence of this nature can be critical in defending future claims for environmental damage. As mentioned in section 3, the contractor should consider instructing external counsel to manage this process.

It is also important to consider abandonment and decommissioning obligations (including on behalf of third parties, such as subcontractors) for which the contractor may be held liable at the end of the PSA, either by way of an express provision set out in the PSA or as part of GOP.

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Operation *(continued)*

If a 'staggered' or 'staged' approach to abandonment of wells has been adopted, the contractor should ensure that clear and comprehensive records are maintained, detailing the steps taken to suspend and/or abandon wells, as well as the status of all such wells at the end of the PSA. This status should be communicated to the relevant state authorities and/or the incoming operator.

The contractor should also check that operational policies are updated to reflect contemporaneous standards/GOP and document their compliance with both internal and relevant external standards.

Assets and inspections

It is prudent to ensure that organised and up-to-date maintenance records are kept, including a record of the status and condition of fixed and movable assets, facilities and equipment at the end of the PSA. The contractor may consider commissioning a third party to prepare an asset integrity assessment, to assist it in identifying engineering, construction and maintenance projects that can be completed prior to handover and those that will become the responsibility of an incoming operator. As mentioned in section 3, the contractor should consider instructing external counsel to manage this process.

If possible, the contractor should make sure that necessary inspections of facilities and equipment (especially inspections required to be undertaken

by third parties) are completed prior to the end of the PSA and that the status of all facilities and equipment due to be handed over is communicated to the new operator. The contractor should obtain sign-off on the status by the state and/or the new operator, and formally document the process.

If the PSA requires an inventory of assets that have been cost recovered and/or will be handed over to the state or new operator, this should be completed before the end of the PSA.

Environmental concerns

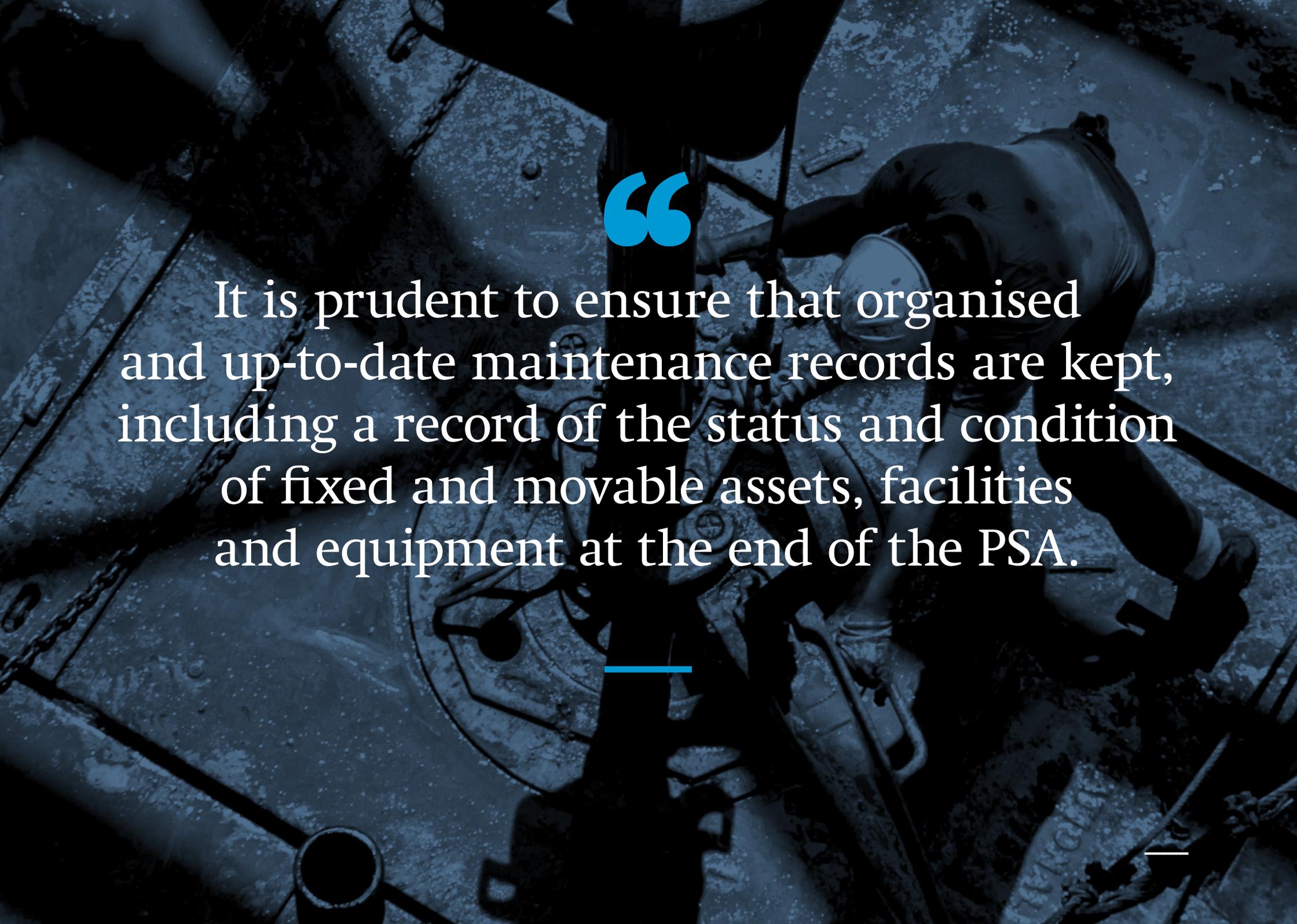
The contractor should make sure that organised and up-to-date records of all environmental monitoring activities are maintained, for example:

- groundwater monitoring;
- leak detection;
- sump soil samples;
- marine impacts;
- produced water disposal; and
- any other potential contamination sources.

The status of all such activities should be communicated to any relevant state authorities and/or the incoming operator.

The status of ongoing waste management activities should also be well documented and communicated to the relevant state authorities and/or the incoming operator. They may include:

- storage and remediation of oily sludge and/or contaminated earth;
 - produced water management facilities;
 - management and disposal of NORM-contaminated equipment;
 - landfill, incinerator and recycling plant operation;
 - hazardous waste disposal; and
 - abandoned and redundant facilities (flow lines and surface facilities, borrow pits, etc).
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It is prudent to ensure that organised and up-to-date maintenance records are kept, including a record of the status and condition of fixed and movable assets, facilities and equipment at the end of the PSA.

5

Cost recovery

It is likely that, following the end of the PSA, there will be ongoing cost recovery audits in relation to which the parties have not yet reached a final settlement. In previous years, parties may have been keen to reach an agreement to avoid any disruption to operations. However, following the end of the PSA, that incentive disappears and positions on both sides may harden.

Whilst the settlement of cost recovery disputes during the life of the PSA may involve a certain amount of 'horse trading', the contractor should ensure that, in the years before the PSA's end, its position is well-reasoned and documented.

It can be difficult in disputes following the end of the PSA for the contractor to adopt a position that is contrary to the one taken, explicitly or impliedly, during the course of the PSA. Consideration should be given to instructing external counsel to document the contractor's position in the last few cost recovery audits under a soon-to-expire PSA.

A careful record should also be kept of all documentation provided to the auditor and/or the state or state-owned oil and gas company in the context of a cost recovery audit.

We have seen states request copies of documents already provided in the audit process in subsequent arbitrations, and it can be extremely useful in defending future document production requests to be able to demonstrate that the documents requested have already been provided to the state and/or its auditors.

6

Human resources

Sufficient time should be devoted to planning for workforce separation requirements. The contractor should determine, in advance of the contractual termination date, what workforce ongoing operations will require and which staff will remain in place following handover. The contractor should also ensure that those who remain with the operation following handover have been adequately trained, and should document the steps taken to achieve this.

Provision should be made for the settlement of any employee bonuses, severance payments, discretionary bonuses/awards or other salary and/or benefits prior to handover.

In addition, the contractor should document which responsibilities will be handed over to an incoming operator (particularly in relation to any incentive payments/measures designed to ensure employee retention towards the end of the PSA).

If certain individuals have been instrumental in the handover of the block and/or the operations in the last few years of the PSA, steps should be taken to ensure that they are retained (in some capacity) by the contractor in the years following the end of the PSA to assist in any future dispute.

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7

IT

The contractor should plan for the handover, separation, termination and/or replacement of any ERP system(s) and/or other IT systems necessary for operations. They may include software licences, particularly where the relevant licence is held by

another corporate group entity, such as a parent company. If such systems will not be handed over, this should be communicated to the new operator and carefully documented.

8

Further considerations

The contractor should take steps in advance of termination to prepare for the transfer of any ongoing subcontracts required for operations (including consultants and externally provided professional services), paying particular attention to 'change of control' type clauses. Any necessary approvals from state authorities in connection with the above should be obtained and documented.

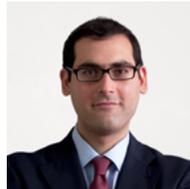
Consideration should be given to any possible exposures to disputes with state authorities regarding taxation and customs duties (or similar), including those in respect of any amounts withheld on behalf of third parties, particularly where tax or other concessions are a feature of the PSA.

If operations are conducted on an accruals (rather than a cash) basis, the contractor should ensure that provision is made for accruals for which it may be liable following termination/handover.



Consideration should be given to any possible exposures to disputes with state authorities regarding taxation and customs duties.

For more information on end-of-PSA planning, please contact:



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