Overview of the oil and gas regime in Pakistan

Written by James Varanese, Niazi Kabalan and Jameel Tarmohamed

By numbers alone, Pakistan is a major world oil and gas player. Crude oil recoverable reserves are estimated at over 300 million barrels and current oil production is over 65,000 barrels per day, while gas production is at 4 billion cubic feet per day. Over 700 wells have been drilled by local and international exploration and production companies with over 250 discoveries – a success rate of slightly over 1 in 3. US$ 810 million was spent in 2010 alone on drilling activities with 30 new wells drilled.

In addition to the numbers, the well developed legal regime offered by Pakistan is another attraction. Petroleum exploration in Pakistan is highly structured and regulated. The discovery of the Sui Gas Field in 1952 was the first major milestone in the search for hydrocarbons in Pakistan with Pakistan’s first oil field being found shortly thereafter. However, it was Pakistan’s independence in 1947 that prompted the need for the new country to develop its own oil industry and legislation governing the sector. The oil and gas industry was largely guided by general mineral rights legislation enacted in 1948 and modified by successively “modern” legislative acts specifically for oil and gas in 1969, 1976 and 1984. This structure benefits exploration and production companies by providing a solid and predictable relationship with the State.

But as with any highly regulated regime, operators and new entrants into Pakistan require expert guidance to the complex legal environment to which they are exposed. The intricacies of that regulatory environment must be navigated deftly from the outset to ensure smooth operations. Poor understanding of legal obligations at the negotiation stage can lead to all types of unforeseen issues down the road.

This note addresses the current legislation and applicable regulations for oil and gas exploration in Pakistan, with further detail on the fiscal regime for production including royalties and production bonuses and income tax and windfall levies.
This note does not address, as you might expect, the procedural steps in granting exploration and production rights, related fiscal terms and the customary licence and lease provisions in respect of the onshore and offshore rules. These specific areas will be covered in further updates to follow.

This note provides a hint of the complexities that operators and new entrants face. The sooner any exploration company either in Pakistan or planning a new venture in Pakistan seeks professional legal advice, the better placed it will be to avoid the pitfalls. Clyde & Co's oil and gas team has worked extensively in Pakistan, and is well placed to advise from the structuring stage any company looking to venture into this exciting emerging market.

Legislation and Regulatory Authority

Pakistan is a federal parliamentary republic comprised of four provinces (Balochistan, Khyber Pakhtunkhwa, Punjab, and Sindh), the federal Capital Territory of Islamabad and the Federally Administered Tribal Areas.

The oil and gas regime in Pakistan is governed by a series of acts, ordinances, rules and regulations enacted to amend and supplement the Regulation of Mines and Oilfields and Mineral Development (Government Control) Act 1948 (as amended by the Oilfields (Regulation and Development) Amendment Acts 1969, 1976 and 1984) (the "Act").

These acts, ordinances, rules and regulations are in turn supplemented by conditions set forth by the Government of Pakistan ("GOP") and issued in the form of a ‘policy’ which is subject to revision from time to time (the "Policy").

The Directorate General of Petroleum Concessions (the "Directorate") is one of the Directorates of the Ministry of Petroleum and Natural Resources functioning as the regulatory authority for all upstream exploration and production activities in Pakistan. The chart at the end of this note sets out the organisation of the divisions of the Ministry of Petroleum and Natural Resources.

Onshore Rules

The Act is implemented by two sets of rules: one set applicable to onshore operations (the "Onshore Rules") and a separate set of rules applicable to offshore operations (the "Offshore Rules"). These Onshore Rules and Offshore Rules are enacted by the GOP pursuant to its powers under s.6(1) of the Act.

The Onshore Rules provide for a licensing system on the basis of a model Petroleum Concession Agreement ("PCA").

Offshore Rules

The Offshore Rules set out a licensing system on the basis of a model Production Sharing Agreement ("PSA"). A model PSA will apply to all offshore blocks. In the offshore acreage, Exploration and Production companies’ profit splits with the GOP will depend on the water depth (shallow, deep or ultra-deep) and the sub-surface depth from which oil and gas are produced. No royalty is payable in the first four years after commencement of commercial production, however 5% is payable in the fifth year, 10% is payable in the sixth year and 12.5% is payable in the following years. Income tax is also be payable at the rate of 40%.

Exploration Right and the Production Right

Exploration and production rights are awarded by the Directorate on the basis of the following licensing system:

1. reconnaissance permits for undertaking studies and multi-client surveys ("Permit");
2. licences for petroleum exploration ("Licence") which typically set out a work programme which the contractor will be required to follow during the term of the Licence, and
3. leases for petroleum development and production ("Lease") which set out a Development Plan which the contractor will need to comply with throughout the development and production phase.

Any eligible contractor, whether incorporated in Pakistan or elsewhere, can apply for a Permit, Licence or Lease to carry out onshore operations.
Oil & Gas Development Company (“OGDC”)
Pakistan’s largest upstream company, OGDC holds a portfolio of 34 exploration licences in Pakistan with the largest proportion of the country’s recoverable reserves, estimated at 214 million barrels of oil and 10,660 billion cubic feet of gas as of September 2011. Its total acreage covering more than 61,000 square kilometres is the largest in Pakistan and this also includes 22 operated blocks as well as interests in another seven blocks.

Government Holdings (Pvt) Limited (“GHPL”)
GHPL manages the GOP’s working interest in 35 Development & Production leases and 23 Exploration licenses with the object of optimising investment to maximise petroleum production in Pakistan. It is among the top 5 petroleum Exploration and Production Companies operating in Pakistan with its production share at over 45,000 barrels of oil equivalent per day.

Royalty
The Onshore Rules and the Offshore Rules specify that a royalty is payable on the value of petroleum produced and saved.

The royalty under the Onshore Rules is set at 12.5%, whereas the royalty under the Offshore Rules ranges from 5% to 12.5% based on a time-triggered sliding scale.

Income Tax
The regulations governing the calculation of profits and gains from exploration and production are set out in the Fifth Schedule of the Income Tax Ordinance 2001.

Tax on income will be payable at the rate of 40% of the profit or gains derived by an offshore petroleum exploration and production undertaking and 50% of the profits or gains derived by an onshore petroleum exploration and production undertaking.

Windfall Levy
The Policy also provides for a windfall levy applicable to crude oil and condensate, in addition to a production bonus on the basis of formulas set out in the Policy and the relevant PCA or PSA (the “Windfall Levy”).

The Windfall Levy on crude oil and condensate is typically calculated on the following basis:

$$ Windfall\ Levy = 0.5 \times (Net\ Production - Royalty) \times (Market\ Price - Base\ Price) $$

The Policy will specify the Royalty, the Market Price and the Base Price. Net Production is typically calculated with reference to petroleum produced and saved. The Base Price is as of 2009 USD 30 per bbl subject to an annual increase of USD 0.25 per barrel starting from the date of first commercial production in contract area.

Notwithstanding the formula set forth in the Policy, in the event that the Market Price of Crude Oil/Condensate exceeds US$100/barrel, the 100% benefit of Windfall Levy will pass onto the GOP. The ceiling would be reviewed as and when pricing dynamics significantly change in the international market.

The Windfall Levy applicable to the sale of natural gas to parties other than to the GOP will be applicable on the difference between the applicable GOP Zone price and the third party sale price using the following formula:

$$ Windfall\ Levy = 0.5 \times (Third\ Party\ Sale\ Price - Base\ Price) \times Volume\ Sold $$

The Base Price will typically be the applicable zone price for sale to the GOP as set out in the Policy. Where the third party sale price of gas is less or equal to the Base Price, the Windfall Levy is zero. The Windfall Levy does not apply to sales of natural gas made to the GOP.

Production Bonus
Production bonuses will typically be payable to the GOP on a contract area basis ranging from $600,000 being paid at the start of commercial production to $7,000,000 being paid when cumulative production reaches 100 Million Barrels of Oil Equivalent.

The chart below provides an example of the sliding scale used to calculate the production bonus.

<table>
<thead>
<tr>
<th>Cumulative production (MMBOE)</th>
<th>Amount (USD)</th>
</tr>
</thead>
<tbody>
<tr>
<td>At start of commercial production</td>
<td>600,000</td>
</tr>
<tr>
<td>30</td>
<td>1,200,000</td>
</tr>
<tr>
<td>60</td>
<td>2,000,000</td>
</tr>
<tr>
<td>80</td>
<td>5,000,000</td>
</tr>
<tr>
<td>100</td>
<td>7,000,000</td>
</tr>
</tbody>
</table>
Ministry of Petroleum & Natural Resources

Minister
Dr Asim Hussain

Parliamentary Secretary
Engr. Muhammad Tariq Khattak

Secretary
Muhammad Ejaz Chaudhry

Additional Secretary
(Admn & Dev)
BS-21
Abid Saeed

Additional Secretary
(Policy)
BS-21
Mohammad Naeem Malik

Further information
If you would like further information on any issue raised in this update please contact:

James Varanese
E: james.varanese@clydeco.com

George Booth
E: george.boothe@clydeco.com

Jason Rosychuk
E: jason.rosychuk@clydeco.com

Niazi Kabalan
E: niazi.kabalan@clydeco.com

Jameel Tarmohamed
E: jameel.tarmohamed@clydeco.com

Julia Vaynzof
E: julia.vaynzof@clydeco.com

Clyde & Co LLP
The St Botolph Building
138 Houndsditch
London EC3A 7AR
T: +44 (0)20 7876 5000
F: +44 (0)20 7876 5111

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