Onshore exploration and production in Pakistan

The Government of Pakistan ("GOP") has been committed for a number of years to accelerating the country’s domestic exploration and production policy to meet the ever growing domestic energy needs of its population, which in July 2011 was estimated at 187 million citizens.

Levels of current oil consumption in Pakistan, estimated at in excess of 400,000 barrels of oil per day, far exceed current oil production which is estimated at 65,000 barrels of oil per day, of which 30,000 barrels of oil are exported per day. Consequently Pakistan remains a large importer of oil meeting 85 per cent of its domestic needs through imports.

Gas supplies are also running short. Daily levels of natural gas consumption are estimated at 1.4 trillion cubic feet per day with gas production estimated at 4 billion cubic feet per day. Demand for natural gas is exceeding supply due to increased usage in the domestic, industrial and power generation sectors. Unsurprisingly Pakistan therefore doesn’t export any of its natural gas.

As a result of these shortages, an estimated 27 per cent of Pakistan’s total energy needs are currently being met through imports.

This article addresses the procedural steps in granting exploration and production rights, related fiscal terms and the customary licence and lease provisions in respect of the Onshore Rules.

This article does not address any of the procedural steps involved in respect of the Offshore Rules. The particular steps in respect of the Offshore Rules will be covered in Clyde & Co’s third and final article.

Clyde & Co’s oil and gas team has worked extensively in Pakistan, and is very well placed to advise from the structuring stage any company looking to venture into this exciting emerging market.

Commitment to Increased Investment

The GOP has shown its commitment to increasing and maintaining local exploration and production activity in Pakistan through the introduction of both the Onshore Petroleum (Exploration and Production) Rules 2009 (the “Onshore Rules”) and the Offshore Petroleum (Exploration and Production) Rules 2003 (the “Offshore Rules”) as well as numerous Petroleum Exploration and Production Policies (hereinafter known as a “Policy”) giving attractive incentives for exploration and production companies.
For instance, the current 2012 Policy allows for 100 per cent foreign equity and no restriction on repatriation of capital, profit and dividends. Coupled with this, the Onshore and Offshore Rules provide for a well structured licensing system modelled on agreements which provide a solid and predictable relationship with the GOP and contain favourable licence and lease provisions.

**History**

In 1991, the GOP introduced the first Policy which was then followed by a series of successively "modern" Policies of 1993, 1994, 1997, 2001, 2007, 2009 and 2012. The purpose of these Policies was to establish the policies, procedures, tax and pricing regimes in respect of the petroleum exploration and production sector in Pakistan.

The 1997 Policy, whilst preserving the provisions of the 1994 Policy with respect to onshore areas, introduced a new offshore package of terms based on a Production Sharing Agreement ("PSA"). This gave existing licence holders in offshore areas an option to convert their concessions agreements into PSAs.

The 1997 Policy was replaced by the 2001 Policy, coupled with the petroleum (exploration and production) rules 2001, a model offshore PSA and a model onshore Petroleum Concession Agreement ("PCA").

The 2007 Policy was amended by the 2009 Policy to reflect the GOP's decision to accelerate the exploitation of indigenous natural resources by attracting foreign investment with technology as well as promoting local companies to participate in exploration and production activities on a level playing field.

The 2009 Policy maintained a system based upon the two different types of agreements required to obtain exploration and production rights in Pakistan, namely a system based upon a PCA for onshore operations and a system based upon a PSA for offshore operations.

The 2009 Policy was recently amended in January 2012 by the 2012 Policy as new market conditions warranted urgent changes required for investment promotion in view of the increasing international energy prices.

The GOP, in February 2011, also introduced a new tight gas exploration policy to further address the gas shortage in Pakistan. This new policy included amongst other provisions, higher tariffs for the sale of gas produced from new discoveries which the GOP hoped would go some way to overcoming the country's gas shortfall and attract foreign investment. Only time will tell whether this has an impact on the Pakistan’s overall gas shortfall.

In 2003, in exercise of powers conferred by s.2 of the Regulation of Mines and Oilfields and Mineral Development (Government Control) Act 1948 (as amended) (the "Act") and s.14 of the Territorial Waters and Maritime Zones Act 1976, a revised model offshore PSA was introduced complemented by the Offshore Rules. These Offshore Rules set out the licensing system applicable to offshore operations on the basis of this model PSA.

In 2009, in exercise of powers conferred by s.2 of the Act, a revised model onshore PCA was introduced complemented by the Onshore Rules. These Onshore Rules set out the licensing system applicable to onshore operations on the basis of this model PCA.

**Onshore Rules**

The licensing system under the Onshore Rules, based upon a model PCA, will apply to all new licences in each of the three zones which onshore acreage in Pakistan is divided up into.

Under these Onshore Rules three types of petroleum rights are established. These are an Onshore Reconnaissance Permit ("Permit"), an Onshore Exploration Licence ("Licence") and an Onshore Development and Production Lease ("Lease").

Any company whether incorporated in Pakistan or elsewhere can apply for a Permit, Licence or Lease. However, as provided for under the Onshore Rules and the model PCA, any transfer or assignment of petroleum rights would not be assignable without prior written approval from the GOP.

If any dispute arose in respect of any petroleum rights granted and amicable settlement could not be reached, the Onshore Rules provides for the matter to first be referred to arbitration under the rules of the International Centre for Settlement of Investment Disputes ("ICSID").

Ultimately if arbitration under ICSID failed or was refused, the matter would be referred to arbitration under the Rules of Arbitration of the International Chamber of Commerce where the language of the arbitration would be English and the venue would be Pakistan or such other venue as may be agreed by the parties to the dispute.

Furthermore, the Onshore Rules provide that any defence available to the parties from any arbitration, suit, pre or post judgement execution or attachment on the basis of sovereign immunity is to be waived.

**Onshore Reconnaissance Permit**

Pursuant to Rule 17 of the Onshore Rules, a Permit is a non-exclusive right to undertake petroleum reconnaissance within the designated area (Rule 17(iii)). The Permit is valid for a period of one year and may at the discretion of the Directorate General of Petroleum Concessions (the "Directorate") be renewed for a period up to one year (Rule 17(vi)).
Onshore Exploration Licence

The award of a Licence to a company creates an obligation on the company to enter into a model PCA for onshore operations with a government SPV, Government Holdings (Pvt) Limited (“GHPL”) within 30 days of the grant of the Licence.

Under Rule 18 of the Onshore Rules, the Directorate may grant a Licence over any area (not exceeding 2500 square km). The licence holder will not be allowed to extract any petroleum from discoveries other than for such testing and early productions as the Directorate may allow under Rule 24.

The customary terms of the Licence are as follows:

Term
The initial term of the Licence shall not exceed five years comprising two phases with the first three years designated as ‘phase 1’ and the next two years designated as ‘phase 2’ (Rule 22).

Renewal
Up to two renewals may be granted after the initial term, the term of each renewal being up to two years (Rule 22(2)). To avail the maximum renewal of two years a reasonable work programme comprising at least an exploration well shall have to be offered (Rule 22(2)).

Royalty
Under the PCA, a royalty will be payable at 12.5 per cent of the value of petroleum produced and can be paid in cash or in kind at the option of the GOP.

Work Programme
The licence holder is required to commit to a work programme to be set out in the PCA. A minimum work programme for ‘phase 1’ shall be determined through competitive bidding whereas a firm exploration well shall have to be committed for entering ‘phase 2’ (Rule 22).

Liquidated Damages
Where the work programme is not fulfilled upon the surrender or the expiry of the Licence, the licence holder shall under the Onshore Rules pay to the GOP liquidated damages which correspond to the minimum expenditure of undischarged work within a period of thirty days from the surrender or expiry of the licence (Rule 28(a)).

The licence holder may transfer its undischarged work obligation to another area if demonstrated to the satisfaction of the Directorate that there is no drillable prospect in the licence area (Rule 28(b)).

Joint Operations
If the licence holder comprises more than two companies then they shall be jointly and severally liable towards the GOP and GHPL, and they shall enter into a joint operating agreement not later than thirty days after the Licence is granted (s.8). No change in the appointment of the operator may be made without the prior approval of the GOP.

Commercial Discovery

Upon completion of agreed appraisal, evaluation and commercialisation work, the licence holder may submit a notice for declaration of Commercial Discovery (as defined below) to the Directorate along with a report and general plan for development. The licence holder may apply for a Lease after the Commercial Discovery is approved.

When the licence holder considers that a discovery is a Commercial Discovery, the operator will select the “Discovery Area” to which the Commercial Discovery applies.

The term “Discovery Area” is defined in the Onshore Rules as:

“an area, within the area of a licence or lease identified by the Contractor as a Discovery Area and which complies with the requirements set out in the Onshore Rules”.

The term “Commercial Discovery” is defined in the Onshore Rules as:

“a discovery of petroleum duly evaluated by appraisal well which discovery, in the opinion of the holder of a licence or lease, with the approval of the Directorate, which shall be not unreasonable withheld, after submission of requisite information to the Directorate, would justify particularly by its quality, quantity, gravity, place and depth where found, its economic development and assures a continuous commercial production for a reasonable period”.

In the event that a discovery so made does not justify the drilling of an appraisal well, then such holder of a petroleum right upon submitting detailed technical and economic justification shall, seek approval of the Directorate or a declaration of Commercial Discovery on an on-well basis.

Relinquishment

Under Rule 22(4) a licence holder shall part relinquish their licence area in accordance with the schedule i.e. at end of phase 1, 30 per cent of the original licence area and at the end of phase 2, 20 per cent of the remaining licence area.

The shape of the area to be relinquished will be determined by the licence holder subject to compliance with conditions set out in the PCA.

Surrender Requests

The licence holder must notify the President of Pakistan of its proposed surrender, provided that such surrender shall not take place during phase 1 of the initial three years of the Licence before due fulfilment of the minimum work programme and ‘other obligations’.
Onshore Development and Production Lease

Under Rule 30 of the Onshore Rules, if the GOP is satisfied that a Commercial Discovery has been made then they may grant a single Lease which will give the lease holder an exclusive right to perform activities in connection with the development and production of petroleum in the area covered by the Lease (Rule 31).

The customary terms of the Lease are as follows:

Term
The lease period shall not exceed twenty five years (Rule 34) and may be renewed for a period not exceeding five years if commercial production is continuing at the time of the application (Rule 34(2)).

Royalty
Under Rule 38 of the Onshore Rules, a royalty shall be paid on the Value of Petroleum produced and saved at the rate of 12.5 per cent and will be paid in cash (Rule 38(2)) unless the GOP elects to take delivery of the royalty in kind upon six months’ notice.

Work Programme
The lease holder is required to comply with the work programme from the Licence (Rule 21) and in addition must commit to a development plan set out in the lease application (rule 36).

Expenditure
Expenditure incurred on exploration, discovery and testing may be considered ‘lost’ and set off against income earned, subject to the conditions set out in the Income Tax Ordinance 2001.

Termination
The President of Pakistan has the right to terminate the PCA if a Commercial Discovery is not made within 5 years from the effective date of the PCA, provided the lease holder has not applied for renewal or extension of its term.