



THE LAW OF MONGOLIA ON PETROLEUM: PRODUCTION SHARING AGREEMENT

The Parliament of Mongolia approved the revised version of *Law of Mongolia on Petroleum* (the “**Petroleum Law**”) on 1 July 2014, which came into effect on 20 July 2014. The Petroleum Law sets out a comprehensive legal framework for the petroleum sector of Mongolia compared to the 1991 enacted petroleum law, which had been considered as no longer fit into current development of Mongolia.

The Petroleum Law sets out specific provisions in relation to the production sharing agreement, such as the profit oil, which will be shared with the Government of Mongolia (“**Government**”) in accordance with the terms of the production sharing agreement upon the cost oil, which is up to 40 percent of the total oil, has been recovered.

This note briefly concentrates on the production sharing agreement, its nature and issues to be considered for entering into the production sharing agreement with the Government.

Nature of the Production Sharing Agreement

The production sharing agreement is entered upon commencement of exploration. Under the Petroleum Law, the term “*exploration*” is defined as “*geological, geochemical, geophysical activities, drilling and test extractions conducted in order to explore an oil deposit and determine the amount of its reserves*”. Therefore, the nature of entering into the production sharing agreement at the early stage, in order words, not upon discovery of oil, to undertake exploration activities at the investor’s expenses and risks, and if it discovers oil, all costs and expenses incurred during exploration and extraction including costs in relation to demolition of temporary facilities are recovered from the total oil. In order words, no oil is discovered, the investor, who entered into the production sharing agreement, may face risk in losing investment. Nevertheless, Mongolia is an up and coming producer in the World’s oil and gas industry with proven reserves of 2.3 billion barrels and estimated to have 3.1 billion barrels of oil-in-place. Thus potential investor may minimize the investment risks upon a high advanced geological survey is conducted on a carefully selected area.

The main feature of the production sharing agreement is to share the profit oil with the Government in accordance with the terms and conditions of the production agreement upon the royalty fee is paid, and the cost oil is deducted from the total oil extracted.

The production sharing agreement sets out obligations of the Government before the investor including but not limited to limitations for revocation of the exploration license and imposition of additional taxes. Further, the production sharing agreement determines the rate of royalty and other fees, and conditions in relation to provincial development and environmental reclamation related obligations of the investor.

Thus, in one hand, the Government will collect the royalty, in other hand, the Government will share the profit oil with the investor, other than cost oil which is retained by the investor. As such, under the production sharing agreement:



1. the profit oil is shared among the Government and investor under the pre-agreed amounts and terms (*the Petroleum Law only determines the maximum and minimum amounts*);
2. the list of items are determined, and agreed among the Government and investor, as part of cost oil;
3. the investor is entitled to recover all investment costs in order of the first priority through means as cost oil;
4. if the conditions are well understood and agreed by the parties at the time of negotiation and formalization, it will help for both parties from future disputes.

That is to say that the production sharing agreement has the flexible nature, therefore, it guarantees better protection for the investors.

The things to consider when the production sharing agreement to be negotiated and executed

The followings should be well considered when the potential investor to negotiate and execute the production sharing agreement with the Government, such as:

- in one hand, the investors seek an opportunity to increase the amount of cost oil, in other hand, the Government demands to decrease the cost oil. Thus, the both parties involved should determine the potential costs and expenses as detailed as possible in order to avoid future disputes;
- the parties should take into account of recovery costs issues rather than more on production sharing amounts. The Government is interested in entering into the production sharing agreement with the party who proposes minimum recovery costs. The Petroleum Laws determines that the exploration license holder is entitled to recover the cost oil up to 40 percent of the total oil. In other words, setting out the cost oil percentage in the minimum amount may cause delay in time for investment recovery. As such, based on careful consideration, such percentage should be well determined by the investor in advance;
- the Government will not be able to amend the laws and regulations arbitrarily in infringing the investors' rights, provided that the Government guarantees are well determined and acknowledged in the production sharing agreement;
- since the other party is the Government, the requirements of the Government are inevitably enforceable, and any breach occurs, an applicable liability is imposed. Thus, it is well recommended to detail the rights and requirements of the Government in the production sharing agreement. If that is not the case, asking a warranty not to require additional obligations imposed to the investor unless such requirements are legally or contractually permitted and not to use sovereign immunity. Such well-established warranties, further, helps in avoiding potential baseless demand and liability to be brought against the investor; and
- the currency fluctuation is the main issue to be considered as the petroleum sector is sensitive in this respect. Thus a concrete research needs to be completed in determining



the percentage of profit oil and cost oil as convertible depending on market performance for the purpose of maintaining a long term benefit of the project.

Through approval of Petroleum Law, some significant changes have been introduced to the legal regime in the petroleum sector of Mongolia, which include recoverable costs and expenses, obligations of the Government and the investor and maximum and minimum percentage amounts for production sharing to be agreed under the production sharing agreement. As such, introduction of the revised version of the Petroleum Law is unarguably positive step in attracting future investors into petroleum sector as Mongolia is almost entirely dependent on the finished petroleum products.

Ashid Advocates LLP is a full service Mongolian law firm, which specializes Mongolian minerals law, Mongolian petroleum law, projects and infrastructure development and finance in Mongolia, Mongolian energy law, and Mongolian construction law.

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