

Another amendment to the hydrocarbons legislation in Algeria: Back to square one?

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The hydrocarbons law dated April 28, 2005¹ (the '2005 Hydrocarbons Law') is aimed primarily at liberalising the Algerian hydrocarbons market through the break-up of the state-owned company Sonatrach. It reconsiders the regime formerly set out in the hydrocarbons law of August 19, 1986² (the '1986 Hydrocarbons Law'). As such, the 2005 Hydrocarbons Law, initiated by the Ministry of Energy, Chakib Khelil, and passed last year following several years of discussion, could have led to an actual revolution in the petroleum industry in Algeria³. However, the new regulations were never implemented and on July 29, 2006⁴ the 2005 Hydrocarbons Law was significantly amended by the Algerian President, A. Bouteflika by **ordonnance** [order]⁵ (the '2006 Hydrocarbons Order'). Although the institutional framework and the new contractual regime set up by the 2005 Hydrocarbons Law remain unchanged, the market liberalisation has been almost entirely abandoned. In addition, the 2006 Hydrocarbons Order introduces a new windfall profit tax for all contracts entered into under the 1986 Hydrocarbons Law.

A brief reminder of the hydrocarbons legislation as per the 1986 Hydrocarbons Law and the 2005 Hydrocarbons Law will help the reader to better understand the amendments provided by the 2006 Hydrocarbons Order.

1986 Hydrocarbons Law

The 1986 Hydrocarbons Law confirmed the monopoly of Sonatrach, the national oil company, over hydrocarbons exploration, exploitation and transportation activities⁶.

The state would only entrust these activities to national companies such as Sonatrach. Therefore, international oil & gas companies (IOCs) could not carry out hydrocarbons exploration and exploitation activities except through a partnership with Sonatrach. The following basic rules applied to those partnerships:

1. The mining titles and licences pertaining to hydrocarbons exploration and production activities (prospecting authorisation, research permit, provisional exploitation authorisation and exploitation permit) were exclusively granted to Sonatrach.
2. Hydrocarbons pipeline transportation was the monopoly of Sonatrach. Partnerships pertaining to hydrocarbons pipeline transportation were not authorised. However, foreign entities could finance, build and operate hydrocarbons pipeline transportation on behalf of Sonatrach, in cases where there was a lack of spare transportation capacity, although Sonatrach always remained the owner of said transportation infrastructures.
3. Partnerships pertaining to hydrocarbons exploration and production activities were authorised. Most of the partnerships were organised through a production sharing contract pursuant to which the IOC was allocated a share of crude oil and oil products FOB Algeria⁷ as a lump sum for cost oil and profit oil, free from any tax and duties whatsoever. The IOC's share could not exceed 49% of the total production each year.⁸
4. Sonatrach used to issue and manage tenders to

select the IOC with which Sonatrach would enter into a partnership in relation to a specific exploration permit. In many instances, Sonatrach requested to participate in the PSC, not only as mining title holder but also as a private investor. However, the share of the exploration expenses in relation to Sonatrach's share as private investor had to be carried by the IOC.

5. Sonatrach was consequently allocated two shares of crude oil, oil products and/or revenues generated by the sale of natural gas: (i) one share pertaining to its capacity as private investor and (ii) one share pertaining to its capacity as mining title holder and allocated to the payment of the royalty payable by Sonatrach on the net total production (including the IOC share), the payment of income tax on the profit made by the partnership and transportation costs that have to be incurred by Sonatrach.

2005 Hydrocarbons Law

The 2005 Hydrocarbons Law terminated Sonatrach's monopoly over hydrocarbons exploration, production and transportation activities, altering Sonatrach's position to one of a common player in the hydrocarbons sector, in competition with other IOCs investing in the liberalised upstream, midstream and downstream activities in Algeria. In order to achieve the liberalisation of the sector, the 2005 Hydrocarbons Law introduced a new institutional framework, a new contractual regime and a new fiscal regime. The 2005 Hydrocarbons Law also deals with the existing production sharing contracts (PSC).

The institutional framework

Two new agencies are created by the 2005 Hydrocarbons Law in order to ensure regulation of the liberalised hydrocarbons sector:

- L'Agence Nationale de Contrôle et de Régulation des Activités dans le domaine des Hydrocarbures (ARH); and
- L'Agence Nationale pour la Valorisation des Ressources en Hydrocarbures (ANALFT).

ARH will implement and enforce the regulations pertaining to hydrocarbons exploration and production activities in Algeria, including technical regulations as well as regulations pertaining to transportation tariffs, third party access to transportation infrastructures, health, safety and environmental standards. ARH is also responsible for considering applications for pipeline transportation concessions.

ANALFT will promote the hydrocarbons industry, manage the Algeria hydrocarbons database, evaluate competitive bids and award exploration and exploitation areas, as well as exploration and exploitation contracts, and approve development plans. It must be noted that the new 2006 Hydrocarbons Order seems to exclude ALNAFT's liability toward contractors or third parties for "all damages or consequences, whatever its nature, resulting from the petroleum operations and/or from their management"⁹. This point will need further clarification.

Contractual regime

Exploration and production agreements provided by the 1986 Hydrocarbons Law included joint ventures, production sharing contracts and risk service contracts. The 2005 Hydrocarbons Law only includes one instrument for hydrocarbons exploration and/or exploitation purposes: the '*contrat de recherche et/ou d'exploitation*' (CRE) (exploration and/or production contract).

The CRE is entered into between the IOC and ANALFT in its capacity as mining title holder, further to a competitive, fair and transparent bid process. It must be approved by decree and enters into force as of the date the said decree is published in the *Journal Officiel de la République Algérienne* [official gazette].

The CRE entitles the IOC to undertake exploration activities in Algeria as well as exploitation activities in the case of a commercial discovery, on an exclusive basis. The 2005 Hydrocarbons Law provides that title to the hydrocarbons production shall pass to the IOC at the agreed measurement point. It should be emphasised that the 2005 Hydrocarbons Law no longer includes any reference to a production sharing mechanism. To that extent, it would seem that the entire production should be allocated to the IOCs and the CRE should be analysed as a tax royalty agreement.¹⁰

As an exception to the full liberalisation of the hydrocarbons sector, each CRE awarded to an IOC should contain a clause granting Sonatrach an option to acquire a participating interest of 20% to 30% within 30 days further to the approval of the development plan of a commercial discovery.

The 2005 Hydrocarbons Law further provided that Sonatrach and the IOC had to enter into a joint operation agreement (JOA) within 30 days of the exercise of the option by Sonatrach. The JOA will be approved by ALNAFT and further ratified by decree.

The tax regime

Under the 2005 Hydrocarbons Law, IOCs are subject to the following main taxes:

1. *Redevance (Royalty)* – a monthly proportional royalty, based on the location of the field and the level of hydrocarbons production, to be paid to ANALFT in its capacity of mining title holder. The Royalty rates range from 5.5% to 23% depending on the area and the monthly production.
2. *Taxe superficière (TS)* – an annual surface tax, based on the surface area covered by the contract, to be paid to the Public Treasury. The TS rates range from Ad4,000 to Ad32,000 (Algerian dinars) per square kilometre depending on the area and the contractual period.
3. *Taxe sur le revenu pétrolier (TRP)* – a monthly petroleum income tax, based on a sliding scale, which increases as and when the cumulative value of hydrocarbons production increases, to be paid to the Public Treasury. The TRP rates amount to 30% for the first tranche and 70% for the second tranche.
4. *Impôt complémentaire sur les résultats (ICR)* – an annual additional income tax, calculated as per the *impôt sur le bénéfice des sociétés (IBS)* or corporate tax. The ICR rate amounts to 30%.¹¹
5. *Taxe foncière* – a land tax based on assets other than exploitation assets, a gas flaring tax, a water tax and a CO² emission tax.

It should be emphasised that whereas Sonatrach, in accordance with the 1986 Hydrocarbons Law, was liable for the royalty pertaining to the whole production and income tax on behalf of the IOC for all contracts entered into, the 2005 Hydrocarbons Law provides that the IOC must pay taxes directly. Indeed, the operator¹² must pay the Royalty, the TS and the TRP on behalf of the parties to the JOA. To this extent, it would seem that the operator also pays the same on behalf of Sonatrach in its capacity as party to the JOA. However, in principle, each party to the JOA remains liable for its own share of ICR. It should also be noted that the direct payment of the said taxes by the operator under the 2005 Hydrocarbons Law was consistent, since the IOC was allocated the entire hydrocarbons production but it entailed a complete change of tax strategy for the IOC.

Under the 2005 Hydrocarbons Law, exploration and production activities are exempt from value added tax, customs taxes and importation fees, royalties and duties, and any other tax or duty on production revenues. In

addition, assignments of participation are subject to a 1% transfer tax, based on the value of the transaction. However, it is still unclear whether assignments of participation related to contracts executed before the 2005 Hydrocarbons Law entered into force, will be subject to the said transfer tax.

Existing PSC

Under the 2005 Hydrocarbons Laws any PSC entered into before the publication of the 2005 Hydrocarbons Law will remain valid and in full force until their initial term. Therefore, Sonatrach will remain a party to those contracts in its initial capacity of mining title holder.

However, since the mining titles are to be exclusively awarded to ANALFT under the 2005 Hydrocarbons Law, Sonatrach and ANALFT will enter into a contract to provide for their respective rights and obligations, including but not limited to the payment by Sonatrach of the Royalty, TS and TRP. Once Sonatrach and ANALFT have entered into such contracts, Sonatrach will transfer the mining titles back to the ministry in charge of hydrocarbons, which will award the same to ANALFT.¹³

This mechanism seems rather complicated and may have been more consistent with the aim of the 2005 Hydrocarbons Law. Certainly, it is easier to transfer the mining titles to ANALFT, who would simply substitute Sonatrach for the performance of those PSCs that were entered into before the publication of the 2005 Hydrocarbons Law.

2006 Hydrocarbons Order

The 2006 Hydrocarbons Order reallocates a majority stake to Sonatrach for almost all upstream, midstream and downstream activities in Algeria and aims at increasing the state's stake in such activities. In this way the 2006 Hydrocarbons Order reduces the IOC's stake significantly.

Sonatrach's majority stake

Under the 2006 Hydrocarbons Order, Sonatrach must now participate in each upstream contract and its participation can not be lower than 51%. To this end, the parties must enter into a JOA within 30 days after the approval of the development plan by ANALFT. Sonatrach will assume all investment and exploitation costs relating to the development plan for each commercial discovery to the extent of its participation. This JOA will also include the modalities and conditions pertaining to the refund by Sonatrach of the exploration costs. It should be emphasised that all exploration costs

related to the participation of Sonatrach will therefore be financed by the other parties to the JOA and should be refunded by Sonatrach only in the case of a commercial discovery.

The 2005 Hydrocarbons Law was relatively consistent with international petroleum industry practise. It allocated the entire production to the IOCs, but the operator had to pay the Royalty, the TS and the TRP on behalf of the parties to the JOA. Sonatrach was allocated an option to acquire 20% to 30% participation, in line with international practice. However, a mandatory 51% participation is not longer consistent with international practice and reduces the IOC's stake significantly, plus the 2005 Hydrocarbons Law also gives a pre-emption right to Sonatrach for any assignment of a participating interest.

In addition, with a mandatory participation of a minimum 51%, Sonatrach has majority control over both the CRE and the JOA and as such, may (reasonably) request to be involved in all important decision making, such as decisions regarding commerciality of projects and the approval of development plans. The 2006 Hydrocarbons Order does not provide, however, any information pertaining to decisions regarding commerciality of projects and Sonatrach can only enter into the JOA within 30 days of the approval of a development plan by ANALFT. Therefore, Sonatrach's majority participation not only reduces the IOC's stake but is also likely to involve issues with ANALFT.

In addition, transportation activities may now only be undertaken by either Sonatrach or a local company in which Sonatrach owns at least a 51% participation, and the transportation concession may only be awarded to Sonatrach. Also, refining activities may now only be undertaken by either Sonatrach or an association in which Sonatrach owns at least a 51% participation.

Therefore, only hydrocarbons transformation¹⁴ activities remain liberalised.

Increased stake for the state

The 2006 Hydrocarbons Order introduces a *taxe sur les profits exceptionnels* or windfall profit tax (WPT).

Indeed, all IOCs, operating in Algeria in accordance with any association contract governed by the 1986 Hydrocarbons Law, are now subject to a non-deductible WPT from August 1, 2006. The WPT is based on the share of production allocated to the IOC when the Brent price exceeds US\$30/barrel. It is calculated at a rate, which ranges from a minimum of 5% to a maximum of

50%. However, the 2006 Hydrocarbons Order does not provide any information pertaining to the method of calculation and assessment of the WPT, which is to be provided at a later date.

All IOCs operating in Algeria in accordance with an association contract that already provides a profit skimming mechanism similar to the WPT, were initially not included within the scope of the WPT¹⁵. Adding the WPT on top of an already existing profit skimming mechanism may reduce the profitability of operations significantly.

Finally, it remains unclear whether the WPT will also apply to natural gas production that is jointly marketed with Sonatrach. In addition, the 2006 Hydrocarbons Order only refers to Brent prices.

Conclusion

The major issue with the 2006 Hydrocarbons Order lies in the mandatory participation of Sonatrach with a 51% stake. Indeed, the 2005 Hydrocarbons Law was mainly aimed at liberalising the hydrocarbons market in Algeria. The 2006 Hydrocarbons Order, by reintroducing the mandatory participation of Sonatrach with a minimum 51% for exploration, production, transportation and refining activities, is clearly a step back for the liberalisation of the Algerian hydrocarbons industry.

More importantly, the mandatory participation of Sonatrach with a minimum 51%, together with the direct payment of taxes by the operator and the WPT, are likely to reduce significantly the overall profitability of operations.

In spite of the introduction of a new institutional framework and a legal regime by the 2005 Hydrocarbons Law, the mandatory participation of Sonatrach is likely to involve issues with ANALFT. It is even rumoured that Sonatrach may already be preparing the next licensing round, which if confirmed would seriously challenge the institutional framework established by the 2005 Hydrocarbons Law.

In addition, it is difficult to assess the full impact of the 2005 Hydrocarbons Law, as amended by the 2006 Hydrocarbons Order, as implementation of the new regulations has still not taken place.

Notes:

¹ Loi n° 05-07 du avril 28, 2005 relative aux hydrocarbures

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- ² Loi n° 86-14 du août 19, 1986 relative aux activités de prospection, de recherche, d'exploitation et de transport par canalisation des hydrocarbures
- ³ Refer to our article «The new 2005 Algerian Hydrocarbons Law» (International Oil & Gas Finance Review Yearbook 2006)
- ⁴ Ordonnance n° 06-10 du juillet 29, 2006 modifiant et complétant la loi n° 05-07 du avril 28, 2005 relative aux hydrocarbures. Journal Officiel de la République Algérienne #48 dated July 30, 2006.
- ⁵ The 2006 Hydrocarbons Order was passed by the President A.Bouteflika as the Parliament was away on recess. It shall be null and void if it is not ratified by the Parliament during the next session, which started beginning of September 2006.
- ⁶ The monopoly of Sonatrach was established by Ordinance n° 71-22 dated April 12, 1971, after nationalisation of the foreign companies interests in the hydrocarbons sector.
- ⁷ and/or a share of the revenues generated by the sale of natural gas as natural gas production was required to be marketed through a joint marketing company, in which Sonatrach had the majority of voting rights.
- ⁸ The total share allocated to Sonatrach therefore represented at least fifty-one percent (51%) of total production each year.
- ⁹ Article 44 of the modified 2005 Hydrocarbons Law.
- ¹⁰ It is interesting to note that Algeria is one of the few countries to abandon production sharing contracts and implement a tax royalty agreement, whereas most of North and West African has been progressively shifting to production sharing contracts for the past 20 years.
- ¹¹ Article 88 of the 2005 Hydrocarbons Law, as amended by the 2006 Hydrocarbons Order.
- ¹² Operator shall mean *Opérateur*, as this term is

defined in article 29 of the 2005 Hydrocarbons Law.

- ¹³ To the best of our knowledge at time of writing, the mining titles were still not re-issued in the name of ANALFT, more than fifteen months after the 2005 Hydrocarbons Law was passed, although it seems that Sonatrach and ANALFT already entered into those contracts.

¹⁴ Transformation shall mean *transformation*, as this term is defined in article 5 of the 2005 Hydrocarbons Law as modified by the 2006 hydrocarbons Order.

¹⁵ See draft project of the 2006 Hydrocarbons Order.

¹⁶ See newspaper *Le Soir*, October 6, 2006. Indeed, it would seem that the 2005 Hydrocarbons Law was not submitted to the *Conseil d'Etat*, which non-binding opinion is required by the Constitution.

¹⁷ To the best of our knowledge, the ratification process started was not completed at the time of writing this article.

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