

# Lessons from the first competitive tender

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Since 2005, the legal regime applicable to hydrocarbons activities in Algeria has undergone a transformation. A modernised Hydrocarbons Law was enacted on April 28, 2005<sup>1</sup> which established a new institutional and contractual framework. This law was then amended significantly by an ordinance dated July 26, 2006<sup>2</sup>, which abandoned most of the market liberalisation that had been contemplated initially. However, until recently, the new legal regime established by this body of laws (together the "2005 Hydrocarbons Law") had not been applied in practice as the necessary implementing legislation had not been passed. That has changed with the recent enactment of some implementing legislation, by means of presidential or executive decrees, which enabled a better understanding of the legal mechanisms established by the 2005 Hydrocarbons Law. This implementation has allowed ALNAFT<sup>3</sup>, the State agency in charge of the development of the hydrocarbons sector, to conduct the first national and international competitive tender at the end of the year 2008. As a result, new *contrats de recherche et/ou d'exploitation*, i.e. exploration and/or production contracts ("CRE"), were signed between ALNAFT and foreign partners at the beginning of 2009.

Before discussing the first competitive tender and particular lessons which the process has taught us, we pause to provide a brief reminder of the legal regime applicable in Algeria.

## General principles of the 2005 Hydrocarbons Law

The legal regime governing hydrocarbons activities in Algeria established by the 2005 Hydrocarbons Law altered the legal nature of petroleum contracts. Under the previous legal regime<sup>4</sup>, petroleum contracts were contracts of partnership ("*association*") between Sonatrach and the petroleum companies, based on a production-sharing mechanism. The 2005 Hydrocarbons Law abandoned the production-sharing mechanism. The new contractual regime is close to a concession regime and is based on the following principles:

1. Oil contractors (foreign parties or Sonatrach) are required to enter into a CRE with ALNAFT in order to perform exploration and production activities in Algeria.
2. The mining title is granted to ALNAFT and is issued for the total duration of the CRE, covering both periods of exploration and production.
3. The CRE is entered into after a competitive tendering process<sup>5</sup> which is fair and transparent.
4. If a discovery is made, the commercial rights to production in respect of any commercial discovery are obtained via approval of the relevant development plan by ALNAFT.
5. All hydrocarbon production from the deposit is allocated to the contracting parties, subject to the payment of the relevant taxes and royalties to ALNAFT / the Algerian government; dry gas sold outside Algeria is to be jointly marketed by the contracting parties.
6. Sonatrach will hold a minimum 51% participating interest in any CRE:
  - the foreign partner and Sonatrach enter into a joint

- operating agreement within 30 days of the approval of the development plan by ALNAFT;
- the model joint operating agreement is attached to the CRE;
  - the foreign partner bears all costs and expenses in relation to exploration activities;
  - Sonatrach assumes investment and production costs relating to the development plan for each commercial discovery in proportion to its participation in the CRE; and
  - the joint operating agreement includes the terms and conditions governing the reimbursement by Sonatrach of exploration costs and expenses.

## Procedure governing the competitive tender

The competitive tender process was governed by Decree no 07-184 dated June 9, 2007 and a document issued by ALNAFT, which set out the procedure for participating in the national and international tender.

### Purpose of the competitive tender

The Algerian authorities, through the Ministry of Energy and Mines, launched a competitive tender for hydrocarbons exploration opportunities in Algeria in July 2008. There were 16 onshore blocks selected. Of these 16 blocks, eight blocks were free of any hydrocarbons activities and ALNAFT was mandated to run the tender and to select oil companies. The proposed transaction consisted of a new CRE between ALNAFT on the one hand, and Sonatrach and one or more foreign partners on the other.

Already being operated by Sonatrach, were eight other blocks, which were pursuant to CREs entered into between ALNAFT and Sonatrach on September 18, 2006. For these, the proposed transaction involved one or more foreign partners acquiring a participating interest in the existing CREs from Sonatrach by signing a participating interest assignment agreement. The purpose of the competitive tender was to select the foreign partner or the group of foreign partners with whom the CRE or the participating interest assignment agreement would be signed.

### Prior approval

Oil companies must have first obtained prior approval as an operator/investor from the Algerian authorities in order to be entitled to submit an offer, either alone or together with other companies that have been pre-approved, either as an operator/investor or as a mere investor.

Pre-approved oil companies may set up a consortium for the bid. The consortium members should be oil companies, of which at least one must have been pre-approved as an operator/investor, and the consortium must then be approved by ALNAFT.

### Selection criteria

Under the 2005 Hydrocarbons Law and the regulations governing the competitive tendering process, ALNAFT must choose to apply one of the following criteria in order to select a preferred bid:

- the works programme for the first exploration phase;
- the amount offered as signature bonus;
- any increment offered above the statutory royalty rate.

Under the first ever competitive tender, the criteria applied by ALNAFT to select the preferred bid were the additional works programme proposed by the bidder together with the minimum work programme provided with the CRE.

### Standard CRE created by ALNAFT

The CREs "negotiated" and signed between ALNAFT and Sonatrach set a precedent for the CREs that were entered into by ALNAFT and the foreign partners. Indeed, bidders had little scope or ability to influence the drafting of the CRE and its annexes. It is worth noting that under the new concession regime, the financial conditions applicable to the CREs are defined by the applicable regulatory laws and are not therefore susceptible to alteration by negotiation under a CRE.

The attachment to the CRE of a form of model JOA, to be entered into between the foreign partners and Sonatrach, which is a compulsory partner, constitutes a guarantee for prospective foreign partners that the terms of the JOA may not be challenged later by Sonatrach.

## Necessary clarifications provided by the contractual background

The CRE submitted by ALNAFT put into practice the legal regime set out by the 2005 Hydrocarbons Law and its implementing decrees. Although some uncertainty remains, it provides clarifications as to the legal framework applicable to hydrocarbons activities.

### Issues related to the absence of mining title

Pursuant to the 2005 Hydrocarbons Law, ALNAFT is the exclusive holder of mining titles and is entitled, as such, to enter into CREs with oil companies. We assumed that

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the corresponding mining titles would be delivered when the new CREs would be signed. In addition, as regards CREs previously entered into with Sonatrach, a mining title should have been issued at the time when the CREs were approved. To date however, no mining title has yet been granted to ALNAFT. This absence of mining title raises serious legal concerns.

#### **Clarification as to the duration of the CRE**

The maximum term of any CRE is limited to 32 years. Such term includes the exploration period (up to seven years) and, in case of commercial discovery, the production period (at least 25 years).

#### **Possibility of a retention period**

The CRE may be extended beyond the 32-year term in the event that the contractor benefits from an optional retention period under the CRE. Indeed, in the event that a discovery cannot be declared commercial due to limitations in pipeline transportation infrastructure or absent a market for gas production, the contractor may retain an area for a retention period of up to three years for oil or wet gas and five years for gas. A foreign partner should understand that carrying out production activities on such a field will require significant investment in transportation infrastructure. The retention period system provides an answer to the foreign contracting parties' concerns over transportation.

#### **Limited role of Sonatrach during the exploration period**

Although Sonatrach acquires a vested interest in the CRE "after the approval of the development plan by ALNAFT", Sonatrach is a contracting party to the CRE from the very beginning. However, Sonatrach will not participate in the financing of exploration activities, and the foreign partner is solely liable for the financing of all exploration costs and expenses. Clearly, the foreign partner bears responsibility for the exploration operations.

However, as a consequence of being a contracting party, Sonatrach acquires certain rights during the exploration period, in particular through the creation of a joint consultative technical and financial committee. It allows Sonatrach to be kept informed of important issues relating to exploration activities carried out. Although the rules governing this committee are not yet known, it is to be expected that Sonatrach will not be entitled to impose its views on the foreign partner in relation to exploration issues, nor to participate in the decision on the commercial viability of a discovery. It is anticipated

that Sonatrach's position during the exploration period will, globally speaking, be similar to the position that Sonatrach enjoyed under the previous regime.

#### **Option as to the operating body during the production phase**

It is only from the beginning of the production phase that Sonatrach really becomes part of the project. The parties enter into an operating agreement and set up a management committee. Responsibility for the operation of the field rests with an operating entity created by Sonatrach and the foreign partner. Such entity may, at the sole discretion of the parties, consist of:

- either a *Groupement*<sup>6</sup>, consisting of a legal structure having legal capacity, but completely transparent and with no share capital. A model draft articles of association for this structure is appended to the CRE; or
- a purely contractual joint venture between the parties, with no legal capacity, and functioning on the basis of general principles appended to the CRE.

#### **Reimbursement by Sonatrach of exploration investments**

Sonatrach will reimburse the foreign partner any expenses which it has incurred during the exploration period and which related directly to the discovery of the commercial hydrocarbons find, namely expenses covering seismics, discovery well and the delineation programme. Sonatrach and the foreign partner should first agree between them the reimbursable amount of the exploration costs, which will then need to be approved by ALNAFT.

Sonatrach will reimburse the exploration costs in proportion to its participating interest. Sonatrach will make the reimbursement by paying the foreign partner's share of any cash calls made by the operator corresponding to the payment of the royalties during the production period. This reimbursement mechanism means that the foreign partner bears the risk of financing exploration costs over an extended period.

#### **Additional requirement as to the form of the local company**

Pursuant to the 2005 Hydrocarbons Law, the selected bidder must, before signature of the CRE, establish a legal entity in Algeria for legal and tax purposes<sup>7</sup>, i.e. the signatory of the CRE shall be duly incorporated in Algeria. There is however no legal specification as to the required corporate form, share capital and/or shareholders.

At the signature stage during the 2008 bid round however, one of the four selected bidders faced an additional requirement, as ALNAFT refused to enter into a CRE with an Algerian limited liability company with a sole shareholder ('EURL') and a share capital of DA100,000. ALNAFT considered indeed that such a company would lack credibility and required this selected bidder to incorporate a joint-stock company ('société par actions'), which minimum share capital shall amount to DA1,000,000.

## Conclusion

The number and quality of the offers submitted by bidders allowed a better assessment of the merits of the new regime. Some press releases initially mentioned the "rush" of oil companies to the new blocks<sup>8</sup>, with 73 oil companies pre-qualified, including the majors and other notable players<sup>9</sup>. However, the number of offers submitted was very limited and only four blocks, out of the 16 offered, were eventually granted.

Although the economic crisis has first been raised as the reason of the limited interest shown by oil companies, the Algerian authorities, and notably the Minister of Energy and Mines, Mr Chakib Khelil, then recognised that specifications, notably work programme requirements, were most likely too tough<sup>10</sup>.

ALNAFT launched on June 30, 2009 a second competitive tender for 10 blocks. Although better technical conditions should be proposed, tax conditions, however, probably will not be modified. In today's strenuous market conditions, the success of the second competitive tender fairly depends on the Algerian authorities' capacity to seduce investors.

### Notes:

<sup>1</sup> *Loi no 05-07 of April 28, 2005 relative aux hydrocarbures.*

<sup>2</sup> *Ordonnance no 06-10 of July 10, 2006 modifiant et complétant la loi no 05-07 of April 28, 2005 relative aux hydrocarbures.*

<sup>3</sup> *Agence nationale pour la valorisation des ressources en hydrocarbures.*

<sup>4</sup> *Loi no 86-14 of August 19, 1986 relative aux activités de prospection, de recherche, d'exploitation et de transport par canalisation des hydrocarbures.*

<sup>5</sup> The 2005 Hydrocarbons Law provides for exceptions, in particular with respect to acreage already held by Sonatrach at the time of enactment of the 2005 Hydrocarbons Law.

<sup>6</sup> The Groupement is governed by articles 796 and seq. of the Algerian Commercial Code (*ordonnance no 75-59 of September 26, 1975 portant Code de Commerce de la République Algérienne Démocratique et Populaire, together with the Décret législatif no 93-08 of April 25, 1993*).

<sup>7</sup> Article 44 of Decree no 07-184 dated June 9, 2007.

<sup>8</sup> *Inter alia*, Algeria Watch, *Rush des compagnies étrangères sur les nouveaux gisements*, July 27, 2008.

<sup>9</sup> Including, *inter alia*, Exxon, Shell, BP, Chevron, Total, and CNPC, Conoco Philips, Anadarko, ENI, Gazprom, Gas de France, British Gas, Eon Ruhrgazh.

<sup>10</sup> Financial Times, April 9, 2009.

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