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Energy Newsletter

February 2015

DISPUTE RESOLUTION
International Arbitration
LEX PETROLEA: Sources and Successes of International Petroleum Law

John Bowman

Despite an initial, notable rebuff of the notion of a *lex petrolea* some thirty years ago by an arbitral tribunal, today four possible sources of a *lex petrolea* can be identified and considered – national petroleum laws, international petroleum contracts, custom and practice in the international oil industry, and international arbitration awards – and questions about the existence and composition of a *lex petrolea* can once again legitimately be asked. More »

TRANSACTIONAL
Transactions
The Top 10 Questions Facing the LNG Industry in 2015

Philip Weems, Monica Hwang

The only constant in the LNG industry again appears to be change – unpredictable change. The LNG supply and demand balance shifted in 2014 as LNG supply appears, at least temporarily, to have surpassed demand. Other conditions also seem favorable to LNG buyers as oil prices start the year at 50% of the level of a year ago and at least eight LNG export projects are scheduled to come on line just this year. Although the current focus is on oil price levels, the LNG industry is influenced by numerous other factors, from technological to political, and changes in a factor may affect the entire LNG market. This article examines some of the top questions that the LNG industry may face in 2015. More »

Transactions
Drilling Contracts – Avoiding Misunderstanding

Kathryn Marietta, Merrick White

Drilling contracts are at the core of upstream operational agreements. They come in many forms and are negotiated to varying degrees depending on the value of the contract, level of risk involved, and existence of regional forms that may dictate terms. Avoiding ambiguity, or silence, in the contract with respect to critical terms, will prevent misunderstandings and conflict should situations arise that require contract interpretation. More »

Transactions
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Jennifer Josefson, Ray Witt, Jane Cohen, Elizabeth Owerbach
Iran had planned to announce a new model petroleum contract intended to encourage foreign investment in its energy sector, but uncertainty relating to the sanctions negotiations continues to create uncertainty regarding the release of the new model contract. **More »**

Upstream Developments – Russia
Russia: Environmental Liability for Off-Shore Oil and Gas Operations
Olga Kozyr, Jennifer Josefson, Alexandra Rotar
After Rosneft's recent discovery of substantial light oil and gas reserves at the Universitetskaya-1 well in the Kara Sea, regular development of subsoil on the Arctic shelf will become just a matter of time. **More »**

REGULATORY

Oil & Gas Regulatory
Broader Regulation of Offshore Contractors on HorizonCNG Facility
Andrew Stakelum
The Bureau of Safety and Environmental Enforcement may propose new regulations that grant it formal oversight over contractors on work place safety.
More »

International Trade
U.S. Government Agency Narrows Scope of Crude Oil Export Ban
Clint Long
By announcing that processed lease condensate is not considered "crude oil," the U.S. Department of Commerce's Bureau of Industry and Security narrowed the scope of the U.S. crude oil export ban and opened the door for increased U.S. oil exports. **More »**

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LEX PETROLEA: Sources and Successes of International Petroleum Law

John Bowman

In the widely cited and sometimes wildly interpreted 1982 arbitration award issued by the tribunal in *Aminoil v. Kuwait*, the Government argued that compensation for its expropriation of Aminoil's concession should be based on precedents resulting from a series of transnational negotiations and agreements arising out of other recent nationalizations in the Middle East. According to the Government, these precedents had generated a customary rule valid for the oil industry – *a lex petrolea* in some way a particular branch of a general universal *lex mercatoria*. For this reason, Kuwait offered no more than net book value of the redeemable assets as compensation for its expropriation. For reasons of fact and law, the arbitral tribunal rejected this characterization of these so-called precedents as a *lex petrolea*. Aware of the complex nature of any negotiations about compensation in this context, the tribunal stressed that these settlement arrangements were more often than not complex, comprising not simply payment of indemnity but also bilateral arrangements of every type, not all of which had been made public or known with certainty. The tribunal also cited several reasons of law that weighed heavily against its finding any *lex petrolea* on this issue, among other things observing that Concessionaires often gave such consents under pressure of strong economic and political constraints having nothing to do with law. Despite this initial, notable rebuff of the notion of a *lex petrolea*, today four possible sources of a *lex petrolea* can be identified and considered – national petroleum laws, international petroleum contracts, custom and practice in the international oil industry, and international arbitration awards – and questions about the existence and composition of a *lex petrolea* can once again legitimately be asked.

National Petroleum Laws as Forming a Lex Petrolea

Perhaps surprisingly, some host governments appear to recognize that the petroleum laws of other oil exporting countries form a universal *lex petrolea*. This recognition ranges from referral to a specific source of law to invocation of general petroleum principles. In the 1995 Karabakh Production Sharing Contract, SOCAR, the national oil company of Azerbaijan, agreed to apply principles of law common to Azerbaijan and England, and to the extent no common principles exist as to a matter then in accordance with the common law of Alberta, Canada. Alberta, of course, is the leading oil producing province of Canada. Ten years later, CNOOC, a Chinese oil company, agreed in its petroleum contracts to application of the laws of China, and failing relevant Chinese law for interpretation or implementation of the contract, to apply principles of laws widely used in countries acceptable to the parties. Even more recently, in its 2012 Model Production Sharing Contract the Kurdistan Regional Government of Iraq expansively proposed: "This Contract, including any dispute arising therefrom, thereunder or in relation thereto, shall be governed by English law . . . together with any relevant rules, customs and practices of international law, as well as by

principles and practice generally accepted in petroleum producing countries and in the international petroleum industry."

Even the petroleum laws of some oil producing countries recognize the existence of a *lex petrolea*. Still in effect today, the 1996 Madagascar Petroleum Law declares in three different provisions that Malagasy law shall apply to hydrocarbon activities, but goes on to state that "Malagasy law and the international principles of law generally agreed on the subject of hydrocarbons are also applicable to contracts entered into by the 'Societe nationale' and the foreign companies operating in the territory of the Republic of Madagascar." For better or worse, no set of petroleum laws has gained wide acceptance internationally. At the end of 1963, the Fifth OPEC Conference resolved "that the Secretary General shall invite a number of experts from Member Countries and, if necessary, from other countries, to work on the compilation of a Code of Uniform Petroleum Laws." But a uniform petroleum law – a *lex petrolea* – failed to materialize from this initiative. In an important paper prepared in 2001, William Onorato and Jay Park identified ten basic elements of petroleum laws dealing with: State ownership of petroleum; establishment and vesting of the Competent Authority to implement policy; petroleum operations; petroleum agreements; petroleum regulations; qualifications, duties, and rights of Rights Holder or Contractor; taxation of profits; other taxes, duties, and exchange controls; fiscal stabilization; and environmental protection and safety. Significantly, however, while observing that the objectives of technical assistance programs in this area were to aid in development of acceptable, international-standard, legal, contractual, and fiscal frameworks, the authors emphasized that their article "concentrates exclusively on providing an explanation of principles and elements of such model regimes, but pointedly offers neither model language, clauses, nor codes for their drafting." In short, the multitude of national petroleum laws, although containing basic elements in common, cannot be considered to provide specific examples of laws of general acceptance or application.

Contracts as the Lex Petrolea between the Parties

International petroleum contracts might be considered, individually and collectively, as forming a *lex petrolea*. At one time, the view that petroleum contracts constituted the law between the parties seemed widespread, and for good reason. National petroleum laws were still in their infancy, or absent altogether. As famously explained by the sole arbitrator in the 1951 award in *Petroleum Development Ltd. v. Sheik of Abu Dhabi*: "it would be fanciful to suggest that in this very primitive region there is any settled body of legal principles applicable to the construction of modern commercial instruments." In more diplomatic terms, and relying directly on the parties' contract, the arbitral tribunal in *Saudi Arabia v. ARAMCO* ruled in its 1958 award that the "Concession Agreement is thus the fundamental law of the Parties, and the Arbitration Tribunal is bound to recognize its particular importance owing to the fact that it fills a gap in the legal system of Saudi Arabia with regard to the oil industry." Not long thereafter, Fouad Rouhani, the first Secretary-General of OPEC, told a United Nations Inter-Regional Seminar on Techniques of Petroleum Development in 1962: "The Petroleum Act lays down the general principles under which agreements may be made, and describes the varieties of authorized relationships, but once an agreement is made and is ratified by the Legislature, the Petroleum Act virtually fades away because the agreement itself is the appropriate and sufficient law." In the same year, and preceding the birth of the short-lived New International Economic Order in the next decade, the United Nations General Assembly, with strong support from developed and developing countries alike, approved Resolution 1803, which declared in part: "Foreign investment agreements freely entered into by or between sovereign States shall be observed in good faith . . . ."

Although much has happened since these relatively early pronouncements to call into question the sanctity of the petroleum contract, under certain circumstances and on the basis of certain contractual language international petroleum contracts continue to constitute the law between the parties. These circumstances and terms include: in those countries, such as Egypt, Qatar, and Azerbaijan, where the host government enacted the contract into law; in civil law countries where under the applicable municipal law contracts have the force of law between the parties; when in the applicable law provision in the petroleum contract the parties have expressly incorporated the international legal principle of *pacta sunt servanda* (the contract shall be honored); when the host government has expressly granted enclave status to the international petroleum contract through "intangibility" and "inopposability" forms of contract stabilization that insulate

the contract from changes in law; and for those contracts in which the parties have incorporated a set of arbitral rules, such as the UNCITRAL Arbitration Rules, which require that "[i]n all cases, the arbitral tribunal shall decide in accordance with the terms of the contract . . . ."

Furthermore, in three basic ways international petroleum contracts can create a *lex specialis*, a special form of *lex petrolea*. First, the parties can agree in their contract to incorporate by reference a host country's law as of a certain date or by other means of identification (e.g., decree number and date of promulgation) as a system of law for the duration of their agreement. These provisions represent the most common form of so-called "freezing" clauses. Second, the parties can include specific elements of the host country's laws by repeating that law verbatim in their contract as a contract term. By "contractualizing" the law in this way, even if the government changes or repeals the law, it remains an express term governing their contractual relationship for the life of their agreement. Third, the parties can by allocation of sovereign risk to the State or state oil company create a *lex specialis* that overrides even the parties' choice of the applicable law, as held by the tribunals in the *Himpurna v. PLN* 1999 Final Award and more recently in the *Mobil Cerro Negro v. PDVSA* Award at the end of 2011.

More than one writer, having in mind the model contracts prepared by the Association of International Petroleum Negotiators, has suggested that the *lex petrolea* of international oil & gas commercial agreements can be determined by referencing the industry's business practices, as captured in its model contracts. Currently, the AIPN has 19 "operative" model contracts and 13 "archived" model contracts. These model agreements may evolve over time, most notably, as seen with the 1990, 1995, 2002, and 2012 Joint Operating Agreements, and most recently the 2014 Unconventional JOA. Most tellingly, however, the AIPN model contracts contain numerous alternative and optional provisions, allowing the parties to adjust the terms of their contract to fit their bargain, relative leverage, and needs. The AIPN model contracts are intended first and foremost to provide a familiar framework from which to start drafting and negotiations, in other words, to function as tools rather than as standards. Notably, at least to any lawyer, the front cover of these model agreements prominently bears an extensive disclaimer emphasizing, among other things, that the model was prepared only as a suggested guide. In short, it may be easier to say that these model contracts represent a *lex petrolea* than to establish these agreements as the law.

Custom and Practice in the International Oil Industry

Custom and practice plays an important role in the international oil & gas industry, and therefore it seems appropriate to ask whether this custom and practice has become so engrained, widely recognized, and followed that it operates as a binding rule or, if such a distinction can be made, as a precedent that tribunals, otherwise unsure of the proper outcome, should apply to resolve disputes and guide future conduct. Most sets of arbitral rules, normally in an article captioned "Applicable Law" or "Applicable Rules of Law," make reference to custom and practice and/or trade usage. The Rules of Arbitration of the ICC International Court of Arbitration, for example, provide that "[t]he arbitral tribunal shall take into account the provisions of the contract, if any, between the parties and of any relevant trade usages." Those few sets of arbitral rules requiring the tribunal to decide in accordance with the terms of the contract assign custom and practice and trade usage a lesser, non-compulsory status, with tribunals instructed to "take them into account." Thus, the AAA ICDR International Arbitration Rules state: "In arbitrations involving application of contracts, the tribunal shall decide in accordance with the terms of the contract and shall take into account usages of trade applicable to the contract." One notable exception, the LCIA Arbitration Rules, makes no reference to industry custom and practice or trade usage.

Custom and practice thus performs an important gap filling role. As explained by the tribunal in the previously referenced award in the *Saudi Arabia v. ARAMCO* arbitration, "the Tribunal will be led, in the case of gaps in the law of Saudi Arabia, of which the Concession Agreement is a part, to ascertain the applicable principles by resorting to the world-wide custom and practice in the oil business and industry." On considering oil industry custom and practice, some tribunals have determined that this practice includes application of general principles of law to petroleum contracts. In the 1982 *RAKOIL* Final Award, the tribunal concluded that application of internationally acceptable principles of law governing contractual relations had become a common practice in international arbitrations particularly in the field of oil drilling

concessions and especially to arbitrations located in Switzerland. It could be fairly asked, of course, whether this custom and practice arose in the international oil industry or in the international arbitration industry.

International oil industry custom and practice has been elevated to a legal obligation in JOAs and host government contracts in one particularly important area, that of petroleum operations. The well-known 1997 Kashagan PSA lists among the obligations of Contractor "the obligation to be responsible for all Petroleum Operations, whether carried out directly or through Subcontractors, to perform them diligently, safely and efficiently in accordance with International Good Oil Field Practice, and the highest reasonable international conservation and environmental standards necessary to protect the special ecological conditions of the Caspian Sea . . . ." The Kashagan PSA defines "International Good Oil Field Practice" to mean "all those uses and practices that are at the time in question then generally accepted in the international petroleum industry as good, safe, economical and efficient in exploring for, developing, producing, processing and transporting Petroleum." The Production Sharing Contracts used by India in recent years impose on Contractor the obligation to perform in accordance with Good International Petroleum Industry Practices ("GIPIP") in more than a dozen provisions in the contract. Unusually, the definition of GIPIP includes a proviso that in the event a question of what constitutes GIPIP cannot be agreed by the members of the Management Committee, the Government will decide the question with input from the Director General Hydrocarbons or from a list of organizations or persons recommended by the DGH, with the Government's decision binding. In this peculiar way, these Indian PSCs arguably contain a mechanism by which these industry practices become the law.

International Arbitration Awards

In theory, international arbitration awards dealing with oil and gas disputes should provide a fertile soil for the flowering of a *lex petrolea*. For one thing, concession agreements dating back at least 60 years have relied upon decisions of international tribunals as a source for the parties' chosen law. The Libyan Model Concession (Second Schedule to Petroleum Law No. 25 of 1955) stated: "This Concession shall be governed by, and interpreted in accordance with, the principles of law of Libya common to the principles of International Law and in the absence of such common principles then by and in accordance with the general principles of law, including such of *those principles as may have been applied by International Tribunals*." (Emphasis added.) Fast forward 50 years to a Ghana 2006 Petroleum Agreement to find: "This Agreement and the relationship between the State and GNPC on one hand and Contractor on the other shall be governed by and construed in accordance with the laws of the Republic of Ghana consistent with such rules of international law as may be applicable, *including rules and principles applied by international tribunals*." (Emphasis added.) This broad reference to rules and principles applied by international tribunals undoubtedly encompasses those rules and principles relied upon tribunals such as the International Court of Justice, the U.S. – Iran Claims Tribunal, the European and Inter-American Courts of Human Rights, and the International Tribunal for the Law of the Sea, but could also be construed to cover rules and principles applied by international arbitration tribunals in commercial and investment disputes, especially those involving the international oil & gas industry.

In his groundbreaking 1998 paper, International Arbitration of Petroleum Disputes: The Development of a *Lex Petrolea*, Doak Bishop, a King & Spalding partner, carefully examined several arbitral awards involving international oil companies, with a large majority concerning disputes with host governments. At the outset, he noted that these awards have created "the beginnings of a real *lex petrolea*." His survey covered virtually all reported international arbitration awards relating to the petroleum industry. In all, however, as the annex to the paper makes clear, he was able to examine only ten awards. In 2011, Tom Childs, a King & Spalding counsel, authored Update on *Lex Petrolea*: The continuing development of customary law relating to international oil and gas exploration and production. This article took up where the Bishop paper left off, the author examining 18 additional awards. In the introduction, Childs observes that the arbitral awards relating to international exploration and production published since 1998 differ in several important respects: (1) many of them arose under bilateral investment treaties; (2) only one award related to nationalization of oil and gas assets, whereas a large number before 1998 dealt with this subject; and (3) several of these new awards deal with claims relating to changes in the host government's fiscal regime. Since the Childs' article appeared, arbitral tribunals have rendered several important additional

awards concerning oil and gas projects, mainly relating to resource nationalism in Venezuela and Ecuador.

In many of the awards in recent investment treaty cases, the arbitral tribunals have declared their intention to pay due regard to earlier decisions of international courts and tribunals. While recognizing that they are not bound by previous decisions, they also recognize a duty to adopt solutions established in a series of consistent cases, absent compelling contrary grounds. As explained in the 2012 Decision on Liability in *Burlington Resources v. Ecuador*, "subject to the specifics of a given treaty and of the circumstances of the actual case, it [the tribunal] has a duty to seek to contribute to the harmonious development of investment law, and thereby to meet the legitimate expectations of the community of States and investors towards the certainty of the rule of law." Most of these investment decisions concern legal issues relating to procedural requirements and substantive State obligations under the applicable investment treaties, rather than issues peculiar to international petroleum contracts or the international petroleum industry. The one important exception: enforcement of stabilization provisions in host government contracts. Time and time again, tribunals have recognized and enforced the State's or national oil company's express contractual stabilization obligations (the only exceptions occurring when tribunals have found waiver of stabilization rights), and in the context of a treaty claim have stressed the probative value of the presence of a stabilization clause in the underlying contract in establishing the international oil company's legitimate expectations.

Sources and Successes of International Petroleum Law

Three of the four potential sources of a *lex petrolea* appear to have contributed to its development, although a *lex petrolea* exists today to only a limited degree. National petroleum laws can now be found in all oil and gas exporting countries and in some merely prospective locales. While they may share a basic framework, their terms vary widely and occasionally even suffer from internal inconsistency. These national laws do not appear to have contributed to formation of an international petroleum law. International petroleum contracts frequently constitute the law between the parties, and in that limited sense form a *lex petrolea*. The effectiveness of some provisions, in establishing a *lex specialis* that overrides even the parties' choice of law, has probably caught some host States by surprise. The AIPN model contracts, while tremendously useful to the industry, cannot be said to form a *lex petrolea*. Custom and practice in the industry can supply rules of conduct that govern pursuant to most sets of international arbitration rules and pursuant to express agreement of the parties. Host government contracts and JOAs that require adherence to good international petroleum industry practices when conducting petroleum operations transform industry practices into legal obligations. Given the nearly universal reliance on these practices to define and set the legal standard for petroleum operations, they can be validly viewed as a form of *lex petrolea*. Finally, international arbitration awards, the most obvious potential source of a *lex petrolea,* have not yet generated a significant body of international petroleum law, undoubtedly because of the generally private nature of commercial arbitration and the focus on treaty obligations in investment arbitration. In one area of special importance to the international petroleum industry, namely, contract stability, available awards have established the clear principle of enforcement of stabilization obligations against host governments. More broadly, these awards also stand for the binding nature of international petroleum contracts between international oil companies and States.

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The Top 10 Questions Facing the LNG Industry in 2015

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The only constant in the LNG industry again appears to be change – unpredictable change. The LNG supply and demand balance shifted in 2014 as LNG supply appears, at least temporarily, to have surpassed demand. Other conditions also seem favorable to LNG buyers as oil prices start the year at 50% of the level of a year ago and at least eight LNG export projects are scheduled to come on line just this year. [1] Although the current focus is on oil price levels, the LNG industry is influenced by numerous other factors, from technological to political, and changes in any one factor may affect the entire LNG market. This article examines some of the top questions that the LNG industry may face in 2015.

Will lower oil prices slow down development of LNG export projects? Will construction costs also decrease?

The steep drop in crude oil prices has already claimed one proposed LNG export project as a victim and some (including from the dozens of proposed North American projects) may soon follow. Excelerate Energy has halted development of its proposed floating liquefaction project in Lavaca Bay, Texas and noted that "renewed interest of potential counterparties" is required to get the project back on track. [2] Will other proposed LNG export projects follow suit? The answer likely depends on the status of the project itself, including whether the project has signed up buyers and/or customers and secured sufficient development funding. As compared to international projects, U.S. projects seem to have one slight advantage: contracting under a tolling model supported by plentiful North American gas versus the traditional take-or-pay model supported perhaps by yet-to-be-developed gas reserves. For potential buyers and users, the tolling model enables them to diversify their LNG supply portfolio at a lower cost because they effectively pay a fixed rate for an option to receive LNG and only pay the full commodity price for the LNG itself if they elect to take.

Assuming that a project's sponsors and potential counterparties remain interested in proceeding with the project, could the drop in oil prices actually benefit projects under development by lowering construction costs? Take the example of Woodside Petroleum, which also recently again postponed its decision to proceed with the Browse LNG project in Australia. In making this decision, Woodside noted that it has started seeing the effect of lower oil prices on its supply costs and hopes to use this postponement as an opportunity to lower its construction costs. [3] Any positive effect on construction costs, however, is likely to vary by locale as construction costs are typically driven by labor availability, productivity and cost.

Will any greenfield export projects in the U.S. or Canada take FID?

Three more North American projects made a positive final investment decision ("FID") to proceed with construction in 2014: Freeport in Texas, Cove Point in Maryland and Cameron in Louisiana. These are all

brownfield projects with existing import facilities. What about the greenfield projects? The answer likely depends on the greenfield project's need for securing buyers or customers in a buyer's market and its access to funding for construction.

In the U.S., it appears that at least one greenfield LNG export project will take FID in 2015 -- Cheniere's Corpus Christi LNG project. Cheniere has signed binding sale and purchase agreements for trains 1 and 2 of the Corpus Christi LNG project and engaged banks to act as lead arrangers to arrange financing for the project. [4] The main challenge for the remaining U.S. greenfield projects will be whether they have the development capital necessary to fund the costly permitting process and sufficient customers contracted to support capital to fund the construction of the project. While the front-running brownfield projects have attracted enough customers that they are focusing on expansion projects [5], few announcements of advancement have been released in respect of the U.S. greenfield projects in the earlier stages of development. Aside from Excelerate, other projects may be cancelled or sold if they are unable to attract customers and/or necessary development capital.

In Canada, one major uncertainty was resolved in late 2014 for Canadian projects when British Columbia passed the Liquefied Natural Gas Income Tax Act. The final legislation provides for a reduced tax rate of 3.5% (compared to the originally proposed 7%). [6] That said, cost concerns remain a potential hindrance to attracting customers and development capital for Canadian projects. Most Canadian projects face steeper infrastructure costs given their remote location and the long-haul pipelines necessary to deliver feed gas to the project. One potential bright spot looks to be the Pacific NorthWest LNG project led by Petronas, with additional LNG-buying sponsors based in Japan, China and India. While Petronas recently announced a postponement of FID for the project, some analysts view the delay as aimed at allowing the project sponsors additional time to lower construction costs. [7] If those efforts are successful and final Canadian government approvals obtained, Pacific NorthWest LNG may soon become the first Canadian LNG export project to take FID.

How will LNG pricing and price reviews be affected by the current market?

The past few years many Asian LNG buyers sought Henry Hub-indexed purchase contracts. Given the numerous contracts signed recently in support of the Sabine Pass, Freeport, Cove Point and Cameron projects, at what point will Asian buyers decide they have enough exposure to Henry Hub pricing? Will lower oil prices diminish buyers' desires to diversify pricing indexation and trigger a return for contracts with traditional oil-linked pricing? The move to hybrid-pricing formulae (with long-term prices being based on both crude oil and Henry Hub) may continue. One market participant cautions that any pricing formula must fully take into account any added delivery flexibility that is now often negotiated by the parties. [8]

One of the motivations for Asian buyers to sign Henry Hub based contracts has been to assist them in their very near term price reviews for non-U.S. sourced LNG. At what point will Asian buyers decide that they have achieved the necessary support for their price reviews and turn their attention to projects that are more conventional and perhaps closer in proximity? Whether LNG buyers will be able to take advantage of current market conditions to achieve lower prices in 2015 depends largely on the actual price review provisions in their contracts (*e.g.* whether prices will be re-determined by an arbitration panel based on pre-agreed criteria or whether no pricing changes are allowed without agreement of the parties).

Who will become LNG importers and help increase global LNG demand?

Demand in 2015 is expected to increase by 9.8 percent to 268 million tonnes per annum, up from 244 MTPA in 2014 and 231 MTPA in 2013. [9]

One of the chief reasons for the unprecedented growth for LNG in the last decade is due to the increase in LNG buyer countries (now over 30) and associated import terminals (now well over 100). New countries that currently have an import terminal under construction include Uruguay, Poland, Jordan and the Philippines. What additional countries will switch to LNG? Will the steady increase in new import terminals continue? As demand forecasts are becoming less optimistic for the traditional Asian LNG markets, will new buyers emerge

to contract for LNG on a long-term basis?

China and India both have been active buyers in the past few years. However, at least one forecaster has lowered the demand growth for China. [10] And Gail is reported as attempting to resell some of the supply that it procured in recent years. [11] Could European countries provide much needed demand? Europe has been used to absorb excess spot cargoes [12], but the economic recovery in the region remains slow to elusive. On the other hand, European buyers make up majority of the buyers for Cheniere's advancing Corpus Christi project.

Floating storage and regasification vessels (FSRUs) have been considered a "fast-track" import technology solution, with at least 16 floating import facilities (including in Argentina, Brazil, China, Dubai, Indonesia, Israel, Italy, Lithuania, Kuwait, and Malaysia) now in use, with many intended to receive LNG on an intermittent basis during the year. Higher LNG demand may arise if additional FSRUs and other "smaller" buyers take advantage of lower prices to underpin initial investments in import infrastructure that may have languished at higher LNG prices.

In any event, emerging buyers in the LNG market may pose special challenges for developers relying on such buyers to support the development and financing for their LNG export projects. First, these new buyers lack the long track record of the traditional Asian buyers. Will the new buyers be as reliable in taking and paying for LNG cargoes? Second, many of the new buyers may be lacking in creditworthiness and financial security and require non-traditional credit terms and arrangements to support their long-term purchase contracts.

How will sales terms change in a buyers' market?

With new buyers in the market and low oil price levels, what changes in LNG sales terms can be expected for 2015? The recent trend of granting buyers more destination flexibility (often at a cost) is likely to continue. With emerging buyers or traditional buyers seeking supply diversity, future contracts may trend toward lower contract quantities and/or shorter durations. [13] Moreover, given the overly exciting "roller-coaster ride" in prices over the last decade, will sellers and/or buyers insist on more certainty and predictability around their ability to re-set prices periodically? It will be fascinating to see how contract terms continue to evolve this year in such a dynamic market.

How will completion of the first floating liquefaction project in 2015 affect the industry?

Petronas' project PFLNG 1 is the first floating liquefaction project scheduled to be completed in 2015. In fact, two floating liquefaction projects are scheduled to be completed in 2015; the other being Pacific Rubiales' project in Colombia. At 1.5 and 0.5 MTPA respectively, these projects are of a much smaller scale than Shell's 5.3 MTPA Prelude project (set for completion in 2017). Industry participants will be watching to see how the first projects to use floating liquefaction technology perform. If these projects prove to be successful, floating liquefaction projects may become more popular, especially for markets with demand for smaller production solutions. In fact, Exmar recently signed a contract for a second floating liquefaction unit with China's Wison Offshore & Marine and has an option for two additional floating liquefaction units. [14]

Will the expanded Panama Canal in 2015 be relevant to LNG shipping?

The expansion of the Panama Canal is expected to be completed during the third quarter of 2015 and will open up transit through the canal to 81% of the worldwide LNG fleet (as compared to 7.2% prior to the expansion). [15] All eyes are on whether the Panama Canal will truly facilitate shipping for contracts signed between U.S. LNG projects and Asian customers. The two key uncertainties surrounding the widened canal for LNG are cost and congestion.

With respect to cost, the Panama Canal Authority just released its proposed rate tolls, which equate to approximately $700,000 round trip for a 173,000 cubic meter ship, which is less than transit through the Suez Canal. [16] One consultant estimates the proposed tolls will permit U.S. cargoes to be shipped to Japan at an estimated cost of $1.75 per MMBtu versus $2.50 per MMBtu via the alternative route around the Cape of

Good Hope. [17] Uncertainty remains, however, as to what additional fees will apply. With respect to congestion, industry participants are concerned about the lack of priority booking for LNG vessels and the canal's limit of six ship movements in each direction per day. [18] These concerns may, over time, affect whether or not LNG participants elect to transit the canal or opt for an alternate route.

Will unconventional gas developments (in China and elsewhere) stifle LNG demand?

Within a short period of time, the U.S. shale revolution has transformed the LNG industry in the U.S. from a country focused on LNG imports to one transfixed on maximizing LNG exports. Other countries are examining their own potential shale assets to see if they can replicate the success of the U.S. and reduce the need for relatively expensive gas imports. Thus far, no other country has been successful. These countries have faced technical difficulties and high costs. One of these countries, China, recently reduced its shale gas production target for 2020 by one third. [19] Will depressed oil prices make unconventional gas plays even less attractive for shale-rich countries?

What challenges face existing projects that are project financed?

Existing LNG export projects are not immune to changes in market conditions. Given that LNG from most export projects is sold at oil-linked prices, lower oil prices will be a big hit to their revenues. Those projects most at risk may include newer projects (such as those in Australia) which are burdened with higher capital costs. For example, BG recently noted a write-down of its investment in the Queensland-Curtis LNG project in Australia. [20]

Will lower revenues from oil-indexed LNG affect merely margin or the pockets of the project owners and lenders? In Egypt's Idku LNG plant, the project owners are subsidizing lowered revenues. Due to feed gas supply shortages, the plant is estimated to produce only a total of five cargoes for 2015. [21] Reportedly, a minimum of 22 cargoes is necessary to cover cost expenditures. [22] Thus, the equity owners in the project are being forced to cover these additional costs, including debt service. [23] Reduced oil prices will likely further worsen the revenue shortfall. Will equity owners at other projects have to face the same situation?

How much will global geopolitics affect the LNG industry?

Gas exports from Russia to Europe dropped to the lowest level in a decade in 2014. [24] The decline can be attributed to reasons of reduced demand as well as politics (*i.e.*, EU's policy to reduce its dependence on Russian gas). [25] Within this past year, Russia also cancelled the South Stream pipeline project, which could have supplied almost 10% of Europe's gas demand from Russia via a route to Bulgaria. [26] On the other hand, Lithuania's new import terminal, aimed at reducing the country's dependence on Russian gas, opened in November 2014 with a cooler than expected reception – with only one company (state-owned Litgas) having agreed to purchase a mere 15% of the terminal's capacity and Estonia and Latvia so far showing no interest in booking capacity. [27]

Will Russian gas imports remain depressed in 2015 and thereby increase Europe's demand for LNG imports from other countries? Or will reduced Russian gas imports merely balance reduced European demand for gas supplies this year? In the meantime, geopolitics seemed to be at the heart of Russia's refocus on major Asian LNG and gas sales. Despite setbacks, including from sanctions, Russia continued to progress construction of the Asia-focused Yamal LNG project. Last year Russia also announced two new gas supply transactions with China; in total, these contracts are expected to cover China's total gas demand by 2020. [28]

Actions have been taken in other countries to counter the influence of Russia in the international gas market. In the U.S., a bipartisan bill has been introduced to expedite the approval of U.S. LNG export projects and reduce Russia's leverage (based on its gas reserves) over the U.S.'s European allies. [29] In Europe, Ukraine and Poland signed a deal to build a pipeline between the two countries as a means to "access to gas from the LNG terminals that have already been built in [Lithuania] and Poland." [30] It remains to be seen if current fiscal crisis in Russia will impede its ability to react to geopolitical pressures and opportunities during the remainder of 2015 and whether other countries will seriously pursue acting on their stated desire to reduce

dependence on Russian gas supplies.

Conclusion

As 2015 begins, oil prices are on everyone's minds and seem to affect every industry. In the LNG industry, however, many other factors can have an impact on LNG supplies, demand or both. Until the answers to the questions above reveal themselves in 2015, it will be uncertain whether the LNG industry will continue to enjoy its earlier-predicted pattern of steady growth.

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[1] These include (i) Australian projects Gladstone (first cargo loaded in December of 2014), Queensland Curtis (first cargo loaded in December of 2014), Gorgon, and Australia Pacific, (ii) Indonesian project Donggi-Senoro, (iii) U.S. project Sabine Pass, (iv) Colombian project Pacific Rubiales (floating facility), and (v) Malaysian project Petronas FLNG 1 (floating facility).
[2] Oleg Vukmanovic, *Oil price crash claims first U.S. LNG project casualty*, Reuters, Dec. 30, 2014.
[3] James Regan, *Australia's Woodside Postpones Decision on Browse LNG Project*, Reuters, Dec. 16, 2014. Note that Woodside instead elected to purchase Apache's stakes in Wheatstone LNG in Australia and Kitimat LNG in Canada for $2.75 billion.
[4] Matt Robinson, *Cheniere Energy Seeks $11.5 Billion in Debt for Gas Plant*, Bloomberg, Dec. 12, 2014.
[5] For example, Cheniere is currently working on the second expansion of Sabine Pass terminal (for trains 5 and 6) and Freeport LNG has signed up customers in connection with its expansion project (for train 3).
[6] Donald Greenfield, Alan Rautenberg and Claire Kennedy, *Dissecting B.C.'s LNG Tax Regime*, Financial Post, Nov. 28, 2014.
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[10] See Stephen Letts, China Gas Squeeze: Demand May Fall as Supply Ramps Up, Nov. 30, 2014 (UBS reduces 2020 demand forecast for China by 14 percent and PetroChina predicts even lower demand levels in 2020).
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[14] *EXMAR Places Order for Second FLNG Unit with China's Wison Offshore*, Rigzone, Dec. 24, 2014.
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[16] *Id*. Panama Canal fees will be calculated based on a vessel's cargo-tank capacity and not by gross tonnage (as used to determine Suez Canal fees).
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[20] Angela Macdonald-Smith, *Oil Slump Stalls Sector Projects*, Brisbane Times, Jan. 7, 2015.
[21] *Egypt – Idku Plant LNG Export Collapses 2014: BG Official* (Daily News Egypt Jan. 5, 2015).
[22] *Id*.
[23] *Id*.
[24] Elena Mazneva, *Russia 2014 Gas Export Seen Lowest in Decade as Demand Falls*, Bloomberg News, Jan. 13, 2015.
[25] *Id*. Noting that, in contrast to a 10% drop in gas imports from Russia, imports from Norway dropped only 1.5%.
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[27] William Powell, *What price European natural gas independence?*, The Barrel, Nov. 26, 2014.
[28] Eric Yep, *New Russia-China Deal Could Further Hit Natural Gas Prices*, The Wall Street Journal, Nov. 10, 2014.
[29] Kurt Orzeck, *Rep. Rolls out Bill to Boost LNG Exports, Thwart Russia*, Law360, Jan. 14, 2015.
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King & Spalding

Energy Newsletter

February 2015

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Drilling Contracts – Avoiding Misunderstanding
Kathryn Marietta, Merrick White

Drilling contracts are at the core of upstream operational agreements. They come in many forms and are negotiated to varying degrees depending on the value of the contract, level of risk involved, and existence of regional forms that may dictate terms. This article focuses primarily on general terms of a typical long term, high-dollar, day-rate, offshore contract; however, many terms discussed apply to the entire spectrum of drilling agreements. The terms selected for discussion are not intended to be exhaustive; they should be considered illustrative, and are intended to highlight the care that should be given to contract terms often unique to a drilling contract.

With $100+ oil over the last few years it has been a drilling company friendly market: high rig rates and driller favorable contract terms; however, as oil prices have fallen to below $50 and the budgets for oil company expenditures have been consequently slashed, there will be a drive, from the oil company perspective, to reduce the costs on their existing drilling contacts and to get better terms (including lower rig rates) on their new drilling contracts. This is likely to have two principal effects:

i. in many cases, oil companies are tied in to long term, multi-well drilling contracts that they will no longer have the revenue to fund – they will be forced to cancel or renegotiate terms for these contracts. This will inevitably lead to an increase in drilling contract disputes.

ii. for new drilling contracts the oil companies, beyond their obvious desire to want lower rig rates, will want increasing flexibility in the contract terms, a re-balancing of the risk/reward profile, and reductions in the fixed cost elements of the contract.

Awareness of critical terms which may be integral to a particular contract is important during the negotiation process to minimize the incidence of misunderstandings and conflict after execution. It is primarily in these areas that the scope for dispute lies for an existing contract, and where the focus of negotiation will lie for new drilling contracts.

Mobilization and Demobilization

It is in the best interest of the rig owner and the operator to be certain that there is a clear and definable point in time and space for both mobilization and demobilization. Depending on the terms of an agreement, day-rates may begin and end at mobilization and demobilization. This is often achieved by designating a location within a specified proximity to the project area. There are often other terms surrounding mobilization which may include place or port of origination (which may impact customs at the destination) and other applicable and

appropriate conditions and/or covenants that apply to a specific transaction. Another important factor relating to mobilization is the pre-mobilization or pre-commencement inspection by the operator. Where and when will the inspection(s) take place and what are the consequences if the rig does not meet the technical requirements of the contract?

The parties should consider how demobilization is effected, particularly if the end of demobilization triggers the cessation of payment of day-rates. How is demobilization determined? What are the criteria for establishing demobilization and are these criteria within the drilling company's control; if so what incentive has the drilling company to achieve demobilization quickly? Are there any government approvals that are needed that could cause delay? Is there any oil company equipment that must be offloaded from the rig and how will this be handled?

The parties will also need agreement as to the demobilization location and the terms either party may require in connection with flexibility of the demobilization location.

Commencement Date

Commencement is often viewed as a benign term; however parties should pay attention to subtleties that could impact the transaction. In some contracts, commencement triggers the beginning of the day-rate payment structure, while in others, mobilization is also paid as a day-rate and the commencement date triggers a change from a mobilization rate to a higher, full operational rate. Is the commencement window firm and binding? Will default arise if the rig is not on location and ready to operate by the end of the commencement window? If the rig arrives early, will a day-rate apply? Are the terms clear with respect to location and condition of the rig at the time of commencement? Is there a specific obligation that the rig be classified properly at the time of commencement? If modifications were required by the operator, does the agreement allocate risk for delays and related issues in connection with the modifications and does the commencement date take such delays into consideration? Does commencement occur at the end of mobilization or is it conditioned on operability and other factors (such as completion of upgrades and/or modifications)? What are the technical/operational tests that the rig must meet to demonstrate that it is ready to commence?

These are often negotiated points in a drilling contract and are driven by a variety of factors including current market terms, unique conditions surrounding a particular rig or project, factors related to timing of commencement, and internal requirements of both the rig owner and operator.

Term

The term of a drilling contract may be defined by time or by the drilling of a specified number of wells. Either approach is common in long term drilling contracts. A combination of project and market factors drive this decision.

When a specified time period is contemplated in a drilling contract, provision must be made for the final well in the event drilling is in progress at the end of the specified term. The parties agree to the contract parameters by which a well-in-progress will be completed or suspended before termination of the contract. Safety dictates minimal terms, and from there the parties agree to specific points in the drilling and completion process that will trigger termination and commence the demobilization process.

When the term of a drilling contract is based on the number of wells drilled, a clear definition of "well" should be included. The drilling company has an expectation that at least a certain number of days will be used drilling the firm wells in the contract giving a minimum revenue stream, whereas the operator (i) needs the flexibility to vary the drilling plan as geology dictates, (ii) needs the right to abandon drilling if the target is technically, or from a budget perspective, not obtainable (including after fishing and sidetracks), and (iii) desires to complete the drilling plan as quickly as feasible in an effort to reduce well costs.

To resolve this issue when defining "what is a well," key questions need to be considered. Does each sidetrack or deepening constitute a new well? During drilling, if the rig encounters a strata that cannot be penetrated and

the drill bit needs to be repositioned or drilling plan modified directionally to continue drilling, does this constitute a new well? It is important to establish the definition of a "well" in the contract as market conditions may pull the operator and rig owner in different directions in their respective desires to complete their obligations under the contract, and each party needs the certainty of knowing a mid-agreement negotiation or dispute will not surface over issues related to the definition of "well."

In addition to the specified number of wells in a drilling contract in which the term is defined by a specific number of wells, the parties may also negotiate option wells into the agreement giving the operator flexibility to drill additional wells under the original contract pursuant to pre-agreed terms. These provisions are effectively pre-agreed contract extensions with the terms for extension built into the agreement.

Day-Rate Triggers

The typical drilling contract implementing a day-rate compensation structure can present ambiguity if not properly drafted. Drilling contracts may include all or some of the following day-rates: (i) mobilization and demobilization rates (payable when the rig is traveling to and from drilling location), (ii) standby rates (payable when the rig is on contract but not used and can have sub-categories of "hot" standby (payable when the rig is ready to re-commence operations on short notice) and "cold" standby (payable when elements of the rig crew and/or services have been demobilized)), (iii) operational rates (payable during drilling activity), (iv) force majeure rates (payable during the period of a force majeure event), (v) repair rates (payable when the rig is not operating and permitted maintenance or acceptable repairs are underway), and (vi) zero rate (payable when the rig is not operating due to fault of the drilling company or under other specified circumstances).

The points in time and causes of the "triggers" at which different day-rates apply need to be clearly defined and documented. One way to capture the pricing structure in a manner that allows each party to perform adequate quality control and insure common understanding is to consolidate all pricing terms in a single contract provision or in a schedule. The triggers for any change in applicable day-rate must be objective and understandable. If a "zero rate" is contemplated under specific circumstances, these should be outlined in the pricing provision or schedule so neither party is caught off-guard should a zero rate be mentioned in one of the other contract provisions.

Allocation of Risk

Allocation of risk under a drilling agreement is often driven by each party's insurance profile and risk management objectives, taking into account proper placement of business risk associated with the operator and the rig owner. The objective is often to place risk of loss associated with people and property with the party who maintains insurance on that risk. This is typically driven by either a "knock-for-knock" liability regime or a negligence-based regime. Location of the drilling activity is sometimes a driver in risk allocation, as different geographic regions may typically follow one regime or the other for numerous reasons (such as anti-indemnity statutes or historic practice and procedure). There may be carve-outs based: (i) on some level of culpability (such as, gross negligence or willful misconduct) or (ii) on the business risk that naturally or typically lies with one party or the other (such as, liability for the reservoir, the environment, or the drilling rig).

Vessels and helicopters may pose a unique challenge in allocating risk. Sharing arrangements in a particular geographic region may also play into allocation of liability associated with vessels and helicopters. The liability associated with vessels and helicopters is sometimes different from the overall scheme for risk distribution and is often negotiated.

Certainty with risk distribution and assumption of liability is critical when negotiating and documenting the terms of a drilling contract. Each party needs a clear understanding of the risk they are assuming in order to assess the practicability of the contractual relationship from a business perspective.

Breach and Termination

While a drilling contract may include breach and termination provisions comparable to other service and

related agreements, there are a number of situations that may arise that are unique to drilling. Unique situations, that may seem obvious, need to be specifically addressed in the agreement if the parties want certainty as to contractual rights and obligations should such a situation occur. For example, if the rig's classification lapses during the term of the agreement does this constitute breach of the agreement? Does breach occur after a specified number of days that the rig is not operable and, if so, are these days cumulative over the term of the contract or during a specified period of time? Should the foregoing give rise to termination rights or are damages an acceptable remedy? The contract should be specific with respect to which breaches may result in termination.

The provisions surrounding termination rights for events of force majeure and loss of the drilling rig should also be carefully considered and documented. The rig owner and operator typically consider proper allocation of force majeure risk and, at times, agree as to how this risk will be apportioned between them. Loss of the drilling rig often results in immediate termination and does not constitute breach under normal circumstances. If an early termination for convenience right exists, clear terms surrounding such termination should be well documented. Early termination is essentially a liquidated damages clause, typically giving the operator a right to terminate before the end of the term. Termination of a drilling contract can pose special problems for both the rig owner and the operator, so it is critical that terms surrounding termination are well understood and well defined.

Assignment and Rig Sharing

While many agreements contemplate assignment rights, in long term drilling contracts the right is often invoked. While the term "assignment" is commonly used, what is often meant (and what the contract terms sometimes reflect) is a novation of the agreement (the legal transfer of all or most of the rights and obligations of one operator to another operator). The contract needs to provide the conditions for assignment (and preferably to a form of assignment agreement). Correct drafting of these provisions and a form of assignment (or novation) can save the parties significant time and frustration when assignment is being contemplated. As assignment agreements often contemplate reassignment of a drilling rig, the assignment agreement will contain terms that may limit certain rights of the assignee, clearly define when assignment and reassignment occur, establish lines of communication during the assignment period that typically involve the assignor, and generally establish the relationship among the parties during a period of assignment.

Operators may elect to collaborate in securing a long term commitment from a rig owner to enable them to share a rig over a specified period of time, or for a given number of wells, in order to maximize efficiencies and flexibility in drilling operations. A longer term contract is typically more attractive to a rig owner and lower rates can be offered and there can also be savings on a per-well cost for mobilization and demobilization.

These rig sharing arrangements may take the form of either (i) a single oil company contracting a rig to drill wells in multiple concessions/PSCs with different subsidiaries holding operatorship under each concession/PSC, or (ii) multiple, unaffiliated operators clubbing together to contract for a rig. These sharing arrangements can apply within in a single country or across borders. These sharing arrangements take many forms and range from a series of assignments and reassignments to full collaboration among the parties. In implementing full collaboration, the parties consider staffing of crews and supervisors and may elect for almost total continuity of personnel, supplies, and most equipment. The general belief is that with higher collaboration the parties realize greater efficiency in their respective drilling programs. These arrangements require significant cooperation on the part of all parties and commitment from each party to plan wells and drilling programs in such a manner that allows smooth transitions between wells and permit areas. Liability issues are addressed contractually and may be managed through secondment and similar arrangements as the rig is transitioned between drilling programs.

Conclusion

Drilling contracts contain unique terms that can result in significant operational and financial implications for both the operator and rig owner. If not drafted well, these contracts can be fertile areas for dispute. Avoiding ambiguity, or silence, in the contract with respect to these critical terms, will prevent misunderstandings and

conflict should situations arise that require contract interpretation. Proper drafting will also help ensure that each party gets what it expected from the contractual relationship.

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King & Spalding

Energy Newsletter

February 2015

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Iran's Upstream Oil and Gas Sector: An Update on Sanctions, Nuclear Talks and the New Petroleum Contract

Jennifer Josefson, Ray Witt, Jane Cohen, Elizabeth Owerbach

Although the Islamic Republic of Iran has the world's fourth largest proven oil reserves and second largest natural gas reserves, UN, U.S. and EU sanctions relating to its nuclear program have significantly affected Iran's energy sector. Negotiations between the P5+1 countries (China, France, Russia, the United Kingdom, the United States and Germany) and Iran to ease those sanctions have been ongoing for almost two years, and the parties' self-imposed deadline to reach agreement has once again been extended, this time to June 30, 2015. But even before the imposition of sanctions, Iran's energy sector suffered from a lack of foreign capital and technology due in large part to the unpopularity of the contractual regime that governed upstream oil and gas activities in Iran. In anticipation of international sanctions being eased, Iran planned to announce a new model petroleum contract intended to encourage foreign investment in its energy sector, but uncertainty relating to the sanctions negotiations continues to create uncertainty regarding the release of the new model contract.

Nuclear Negotiations and the JPOA

On November 24, 2013, the P5+1 and Iran agreed to a framework and timeline under which negotiations relating to Iran's nuclear program would be conducted (the "Joint Plan of Action" or "JPOA"). The JPOA was designed [1] to provide temporary sanctions relief to foster "a mutually-agreed long-term comprehensive solution" for dismantling Iran's nuclear program. The JPOA originally contemplated a six-month negotiation period; the deadline for reaching a deal has since been extended twice, most recently from November 24, 2014 to June 30, 2015 [2] as a result of the parties' negotiations in Vienna this past November, with top diplomats convening in Geneva [3] in mid-January to continue negotiations. The latest extension maintains [4] the provisions of the original JPOA, and provides for the continued "modest" unfreezing of Iran's assets at a rate of about $700 million per month.

Topping the list of contested issues [5] is the size of Iran's nuclear fuel-making capacity. The P5+1 want a large dismantlement of Iran's nuclear centrifuges—used to enrich uranium—whereas Iran has pushed for less significant cuts. Many are skeptical of Iran's professed commitment to nonproliferation, particularly given that as it was negotiating with the P5+1 in November, Iran signed a deal with Russia [6] to build two new nuclear reactor units at the Bushehr plant in Iran. This is the first step in a plan potentially to build eight new reactor units, a project meant to significantly expand Russian-Iranian cooperation.

U.S. Sanctions Relief Extended, U.S. Lawmakers Respond

As King & Spalding reported in 2014 [7], under the JPOA, the U.S. agreed to refrain from pursuing certain

sanctions against non-U.S. persons who engage in specified transactions with Iran. This agreement permitted China, India, Japan, South Korea, Taiwan, and Turkey to continue to import crude oil from Iran provided that such imports do not exceed the current average level of imports of crude oil from Iran to these countries. The Office of Foreign Assets Control ("OFAC") has released new guidance [8] related to the JPOA extension, announcing that the U.S. government will continue to provide sanctions relief for certain activities in the crude oil, as well as the petrochemical, auto, gold and precious metals, and civil aviation sectors in Iran. However, the U.S. government "retains the authority to revoke this limited sanctions relief at any time if Iran fails to meet its commitments under the JPOA."

Importantly, the limited relief of the JPOA by-and-large does not extend to U.S. persons and, where applicable, U.S.-owned or -controlled entities, except for transactions involving certain civil aviation and humanitarian activities. Licenses for civil aviation activities may be specifically applied for and granted by OFAC, and OFAC will continue to authorize certain humanitarian activities. It remains prohibited for U.S. persons to conduct business transactions with persons on OFAC's List of Specially Designated Nationals and Blocked Persons (the SDN List).

Many U.S. lawmakers have criticized the Obama Administration for permitting an extension of the JPOA. In a joint statement [9], Senators Lindsey Graham (R-SC), Kelly Ayotte (R-NH), and John McCain (R-AZ) pronounced that the extension "should be coupled with increased sanctions." U.S. House Speaker John Boehner (R-OH) also released a statement [10] saying "all an extension does is leave open the possibility this administration will make additional concessions," and calling for Iran to be held accountable for its promises. President Obama has also faced opposition from members of the Democratic Party, including Senator Robert Menendez [11] (D-NJ), the previous Chairman of the Senate Foreign Relations Committee.

Bipartisan lawmakers are currently pursuing legislation [12] that would strengthen sanctions against Iran in the event that a nonproliferation deal is not reached by the end of the latest JPOA extension period on June 30, 2015. Iran has threatened to end negotiations [13] if the U.S. imposes new sanctions, and President Obama has promised to veto the proposed sanctions bill [14], urging Congress to have patience with the negotiation process.

Sanctions Status Quo in the EU

The European Union also extended its relief [15] provisions under the JPOA to June 30, 2015. EU relief provisions include the suspension of restrictions on: providing insurance and transport for crude oil; purchasing or transporting petrochemical products and providing related services; and trading in gold and precious metals with the government and related public bodies. Furthermore, the EU's increase on thresholds authorizing financial transfers to and from Iran also remains in effect.

Russia and China Support Negotiations Amidst Complicated Relationships

Russia continues to negotiate with the P5+1 while striving to strengthen its relationship with Iran. Leading up to the previous JPOA deadline, former Russian Foreign Minister Igor Ivanov cautioned against [16] putting additional pressure on Iran, stating that a mutually beneficial solution is in the best interests of all. Following the JPOA extension, Russian Foreign Minister Sergey Lavrov stated [17] that "considerable progress" had been made in Vienna, and expressed optimism that a final agreement could be reached in the next three or four months. Meanwhile, in addition to the new deal for nuclear reactors in Bushehr, Russia is also reportedly planning an oil-for-grain [18] program with Iran. In December, President Vladimir Putin reported that progress had been made [19] in implementing an oil contract with Iran.

Though China's top diplomat Wang Yi was present at the Vienna negotiations, China has been relatively quiet leading up to and following the extension of the JPOA. Mr. Wang indicated [20] that the negotiations with Iran have been "progressing noticeably," and sees China as a mediator [21] who can provide a "comprehensive solution" among the P5+1 countries and Iran. However, some analysts note [22] that while China and Iran have shared a relatively close relationship, China has benefitted from the Western sanctions on Iran, having established a stronger economic foothold in the country in the last several years. However, Iran has pushed

back on China's encroaching presence in the Iranian oil sector, and last spring canceled a $2.5 billion oil field development deal.

Global Firms Stand at the Ready

While the future of Iranian sanctions remains uncertain, members of the global business sector are preparing for what the eventual end of the JPOA could mean for opportunities in the oil and gas sector. While the JPOA was under negotiation in November, Iranian Oil Minister Bijan Zanganeh reportedly claimed [23] that Iran could increase its oil production to 4 million bpd within three months of sanctions being lifted. Iran has reportedly [24] been exceeding the 1 million bpd crude oil export cap for some time.

In the weeks leading up to the November 24 deadline, Iran received visits from leaders of top global firms—though none overtly from the U.S.—interested in exploring future cooperation. Shortly after the JPOA was extended, the Russian company Lukoil indicated [25] its intention to return to the lucrative Aranan oil field when sanctions are lifted.

However, the terms of such potential, future cooperation are not yet clear as Iran has announced that it is in the process of reforming its petroleum regime from its historic buy-back arrangements to a new hybrid petroleum contract.

Iran's Historic Buy-Back Contracts

The Iranian constitution prohibits minerals being owned by any foreign person, and Iranian law prohibits production sharing contracts. Therefore, Iran's buy-back contract was developed as a short-term risk-service contract, allowing title to hydrocarbons to remain with the State and requiring contractors to pay for oil and gas exploration and development activities and then recover their investment from actual production at a prearranged rate of return.

The first generation of these contracts focused on development of existing brownfields; subsequent generations extended to exploration and development of greenfield projects. These contracts were intended to attract much needed foreign capital and technology to Iran's dwindling energy sector while not violating Iranian law nor requiring the National Iranian Oil Company (NIOC) to relinquish control over production. But throughout their various iterations, these buy-back contracts have remained unpopular with international oil companies as compared against other regional contractual arrangements for a variety of reasons, including:

- limitation to exploration and development activities despite payments being based on production as carried out by the NIOC;
- inability to book reserves;
- a shorter term (5-7 years) as compared against typical production sharing agreements, particularly in light of the contracts' technology transfer requirements; and
- lack of flexibility regarding operating targets and recovery of capital expenses.

New Iranian Petroleum Contract (IPC)

In order to rekindle interest in its energy sector and attract foreign capital and technology, in 2013 Iran announced that it was drafting a new model contract to govern upstream hydrocarbon activities (the "Iranian Petroleum Contract" or "IPC"). Although the actual draft IPC has yet to be made public, Iranian representatives have indicated that the IPC will have characteristics of both a buy-back and a production sharing contract, tailored specifically for Western oil companies with an enhanced focus on profit-sharing (*Newsbase*, MEOG-Week 45). While the technology transfer and hydrocarbon ownership requirements will remain, contractors will partner with the NIOC to carry out exploration, development, and production activities, possibly extending to enhanced oil recovery. The IPC is to be a longer-term agreement, first

announced to run up to 20 years and subsequently announced to be up to 25 years. The seven year limitation on capital recovery will remain, but this period may be extended in the event that the contractor's costs are not recouped in that period. In addition, the IPC will aim to reduce delays in the decision-making process with the NIOC as compared against under the buy-back contracts.

Presentation of the IPC

The new IPC was originally scheduled to be presented in London in April of 2014, when Brent crude oil prices were topping $110/barrel. Presumably due to lack of progress with the P5+1, that date was postponed to summer of 2014, then to November 2014. When the JPOA deadline was extended to November 2014, the Iranian oil and gas conference at which the IPC was to be presented was postponed to 23-25 February 2015. A day after the November 2014 deadline passed, it was announced that the Iranian February 2015 oil and gas conference would nonetheless take place together with the presentation of the IPC. Shortly thereafter, however, the event was cancelled. From the time the IPC was first announced in 2014, crude oil prices have crashed to less than $50/barrel. Sources have indicated that the next tentative date for the conference and the IPC unveiling may be September or October 2015.

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King & Spalding

Energy Newsletter

February 2015

TRANSACTIONAL
Upstream Developments - Russia

Russia: Environmental Liability for Off-Shore Oil and Gas Operations

Olga Kozyr, Jennifer Josefson, Alexandra Rotar

Russian off-shore subsoil use operations: status and perspectives

After Rosneft's recent discovery of substantial light oil and gas reserves at the Universitetskaya-1 well in the Kara Sea, regular development of subsoil on the Arctic shelf will become just a matter of time. According to Rosneft's estimates, the resource portfolio for the first discovered trap contains approximately 340 bcm of gas and over 100 million tons of oil, which is just one of the structures in this field.

The importance of developing the Arctic region, and in particular the development of its mineral resources, is stated in a number of policy documents adopted by Russia. [1] The Russian Government's interest in the development of subsoil on shelf is not only documented on paper, it is also portrayed in practical terms by its readiness to stimulate development and provide necessary support. This has been confirmed by recently introduced legal amendments. In particular, these amendments concern the development of oil and gas production at "new offshore fields," which directly target the development of subsoil in the Arctic region.

Along with the described trends, there are increasingly vocal protests from environmental activists, specifically Greenpeace, who are campaigning against the development of shelf resources due to the risk of inflicting environmental damage. Protests, such as those carried out by the Arctic Sunrise Icebreaker team against Gazpromneft's Prirazlomnaya platform in September 2013, are not unique for Russia. Norway put an end to similar initiatives by Greenpeace at the Statoil oil producing platform located in the waters of Norway's exclusive economic zone in the Barents Sea.

The justification of Greenpeace's concerns and the adequacy of steps taken by its supporters are outside the scope of this article. At the same time, matters of liability regarding environmental pollution resulting from the subsoil use of shelf must be taken into account from a legal point of view.

Legal status of continental shelf

The continental shelf, which includes the sea floor and submarine mineral resources, [2] has a special legal status. It is not considered territorially part of the Russian Federation, but is *under jurisdiction* of the Russian Federation. Additionally, operations carried out on the continental shelf are covered by the legal regulations of the Russian Federation.

For this reason, environmental liability for damage caused by operations on continental shelf is regulated effectively by the same laws as environmental liability for the damage caused by operations conducted on the

territory of Russia (save for certain specifics described in this article). The described rule may be applied not only to the ocean floor and submarine resources, which are directly included in the definition of continental shelf, but also to the waters covering continental shelf that are generally included in the exclusive economic zone of the state.

However, it is necessary to keep in mind that this rule applies only if damage inflicted on the environment does not extend beyond the borders of Russia and/or continental shelf of Russia. When oil and gas operations are carried out on the continental shelf there is a possibility that damage could extend beyond the borders of Russia, *i.e.*, there could be "transborder" damage to the environment.

The legislative regulation of liability for inflicting transborder damage on the environment has its own features: Any determination of liability will not be based not on legislation of Russia (except for certain aspects as explained in detail below), but on international treaties and/or national legislation of the state where the damage was inflicted. We review matters of transborder liability for damage inflicted on the environment in the second part of this article.

Grounds for imposing liability for environmental damage caused on Russian continental shelf

As a general rule, the mere existence of environmental damage serves as grounds for imposing liability. For example, liability would be imposed for damage inflicted on the environment as a result of an accident involving an oil platform operating within the Arctic shelf of Russia. The concept of environmental damage does not have a clear legal definition, but may include various negative consequences for the environment, such as damage inflicted as a result of (i) contamination, exhaustion, deterioration, destruction or irrational use of natural resources; (ii) degradation and destruction of natural environmental systems, ecosystems and natural landscapes; or (iii) other violations of environmental legislation. [3]

Nonetheless, infliction of environmental damage as such does not always result in liability. Indeed, almost any industrial activity has a potential to negatively impact the environment (in the form of air pollution, disposal of pollutants in bodies of water, and production of industrial waste). Such impacts do not typically lead to liability for damaging the environment as long as relevant legal regulations are upheld. "Legitimate" impacts of the environment, *i.e.*, impacts according to and within the limits established by relevant permits, are carried out on a fee-paid basis. The amount of fee is determined by the size of the impacts and fixed tariffs for waste disposal.

The notion of "fault" in respect to environmental damage

As a general rule, infliction of damage can be either a result of environmental violation (for example, illegal discharge of oil containing disposals) or a consequence of legitimate acts. For example, environmental liability would be imposed for damage caused by an accident on a floating oil platform that lead to an oil spill, even if that platform operated in compliance with all applicable environmental and safety requirements. Such an accident could occur as a result of force-majeure circumstances, *i.e.*, anomalous natural phenomena or terrorist acts.

It should be noted that liability for environmental damage caused as a result of oil and gas operations is imposed in most cases irrespectively of fault. This is because subsoil use involves the operation of hazardous industrial facilities that are treated by law as "sources of increased danger" and as a result, subject to strict liability. Damages inflicted on the environment as a result of the use of hazardous industrial facilities (irrespective of the class of hazard) shall be compensated irrespectively of fault. [4]

Thus, given that energy companies in the course of their operations use hazardous industrial facilities and given that it is up to the court to decide whether particular facilities are environmentally hazardous at its own discretion, the majority of environmental damage cases inflicted by energy companies should be compensated irrespective of fault. [5]

Types of liability

In the event that environmental damage is caused as a result of the violation of environmental law, civil law liability for damage inflicted on the environment can be imposed along with relevant administrative or criminal liability.

Imposition of administrative and/or criminal liability for violating environmental law does not result in relief from civil liability to compensate damage inflicted on the environment.

Court practice features cases when a party, having inflicted environmental damage and having incurred administrative penalty, tried to appeal its civil law liability on the account of general prohibition of the application of dual penalty for the same deed (which is applicable in Russian legislation). [6] However, courts have rejected such arguments. With respect to violations of environmental law this principle applies in such a way that one and the same party that violated the law can be held either administratively or criminally liable with respect to individuals (in most cases depending on the amount of inflicted damage), or only administratively with respect to legal entities. Yet civil law liability can be applied at the same time.

Environmental law establishes an obligation to compensate damage inflicted on the environment in full. [7] Imposition of administrative liability on a legal entity does not exempt it from the obligation to compensate damage inflicted on the environment, which has been confirmed by court practice. [8] On the other hand, it is important to remember that the absence of environmental damage as such (*e.g.*, violation of environmental legislation that does not result in actual damage to the environment such as a violation of the terms for prolonging a permit for polluting emissions) will not serve as grounds for exemption from administrative liability for a relevant violation.

Types of liability for environmental damages

The "amount" of the environmental liability can potentially consist of the following:

1. The amount of administrative fine for violating environmental law (when applicable given the above discussion).

2. The cost of eliminating the environmental violation (*e.g.*, the elimination of the pollution, with may require the cleaning of the effected Continental Shelf water area).

3. The cost of works aimed at restoring the environment to its initial state (also called "compensation of damages inflicted on the environment in kind"); and/or

4. Compensating the amount of damage inflicted on the environment (usually calculated on the basis of fixed tariffs and formulae for such compensation established by law).

Administrative liability

The amount of an administrative fine may vary depending on the nature of the violation that led to or contributed to an incident. Although the average amount of an administrative fine for violating environmental law varies from 30,000 to 50,000 rubles, stricter penalties are imposed for some specific administrative offences. For instance, violating requirements for the rational use of subsoil leads to the imposition of a fine in the amount of up to 1 million rubles. It should be noted that lately the amount of both administrative fines for environmental pollution and civil law liability have increased, as discussed in more detail below.

In many cases, however, the amount of administrative liability often does not play a key role in determining the amount of expenses a wrong-doer incurs. An exception is an injunctive order for the temporary suspension of the operations, *i.e.*, suspending the operations of a facility or certain type of activity that poses an environmental threat that is set for a period of time pending judicial or official review of the case. Administrative liability expressed in administrative suspension of the operations could exceed the amount of other expenses, [9] as described below.

Cost of eliminating violation of environmental law

Eliminating contamination is an obligation imposed on a wrong-doer. This allegedly stops the violation, which otherwise would be continuous and could lead to an increased amount of damages. Contamination can be eliminated either by removing pollutants from the landscape (for example, gathering spilled oil from the water surface and glaciers of the Arctic shelf) or by performing works aimed at restoring the initial state of the environment.

Cost of restoring the initial state of the environment

Restoration of the initial state of the environment (by analogy with civil law it is often called "remuneration of damages inflicted on the environment") is in fact a reversal of the adverse effects of the damage inflicted on the environment. The initial state of the environment can be restored either voluntarily (along with, or in addition to the works aimed at eliminating damage as described above) or under court order. The number and nature of works required for restoring the initial state of the environment will depend on specific circumstances with consideration given to both the initiative of the wrong-doer itself and obligatory instructions issued by authorities.

Voluntarily restoration of the initial state of the environment would not always exempt the wrong-doer from civil law liability in the form of compensation for the damage inflicted on the environment. [10] As explained by the courts, payment for environmental damage (in the amount calculated on the basis of fixed rates and formulae established by law, as discussed in detail below) can be a measure of enhanced civil law liability, which is supposed to compensate not only actual damage, but also environmental losses that are difficult to restore or that are irreplaceable.

When establishing the amount of liability, courts can take into account costs voluntarily incurred by a wrong-doer for restoring the initial state of the environment (*i.e.*, correspondingly decrease the amount of compensation to be paid for inflicted environmental damage), but such a decision is always made at the discretion of the court. As general court practice demonstrates, courts do not often apply this option.

Compensation of environmental damage

Compensation for damages inflicted on the environment is considered to be "enhanced civil law liability that is established with due consideration for actual damage as well as environmental losses." [11]

The amount of damage inflicted on the environment can be determined on the basis of (i) fixed tariffs and approved formulae (*i.e.*, the established method of calculation) specifically established by law for this purpose in respect to damage caused to particular elements of the environment, or (ii) based on the estimation of the actual cost for restoring the initial state of the environment.

As court practice illustrates, courts prefer to determine the amount of damage on the basis of fixed tariffs and formulae (*i.e.*, special norms). Only when these are absent do courts address methods of determining the amount of damage based on the estimation of the actual cost of restoring the initial state of the environment.

In order to determine the amount of compensation for environmental damage inflicted as a result of subsoil usage on the shelf, we believe that fixed tariffs and formulae will be used for calculating damages inflicted to the following parts of the environment: (i) bodies of water; [12] (ii) aquatic biological resources; [13] (iii) and species of animal life (those rated for hunting, [14] not rated as eligible for hunting or included in the Red Book of Endangered Species of the Russian Federation). [15]

The evaluation of environmental damage by courts on the basis of estimating the actual cost of restoring the initial state of the environment is carried out less frequently due to the complexity of this method. In the process of estimating damage inflicted on the environment one should consider the environmental losses that are nonrenewable or difficult to replace. In the absence of fixed tariffs and formulae this will inevitably be

challenging. In some cases, when there are no fixed tariffs and formulae available, instead of using methods to evaluate actual costs courts prefer to use fixed tariffs and formulae previously used by the legislation of the USSR (the applicability of which at present is rather questionable).

Terms for imposing liability

A legal entity can be held administratively liable within one year from the date of the committed violation, and for continuing violations (for instance, continuous pollution of a water basin by sewage wastes) within one year from the date that such violations were revealed. [16]

Compensation claims for damage inflicted on the environment can be submitted within 20 years, [17] *i.e.*, the party that committed a violation of environmental law can be subjected to civil law liability during a significant period of time after the expiry period of the statute of limitations for imposing administrative liability.

Court practice

The recent court practice confirms the above-described conclusions. For instance, at the Eighth Arbitrazh Appeal Court on June 2014, the court reviewed the appeal of LLC RN-Yuganskneftegaz in the matter of imposing liability on the company for the damage inflicted on the environment as a result of an oil spill at a forest plot, and ruled as follows: [18]

i. *Regarding compensation of damage inflicted on the environment*: the amount of compensation of 5,245,033 rubles has been determined by the court on the basis of relevant formulae.

ii. *Regarding the cost of restoring the initial state of the environment*: in its appeal, LLC RN-Yuganskneftegaz stated that it has in fact been restoring the initial state of the environment. For instance, it has been compensating damages in kind and since the law does not cover dual compensation of damages, the company should be exempted from monetary compensation beyond the actual compensation of damages. The court did not support such reasoning and emphasized that compensation of damage on the basis of fixed tariffs and formulae is "enhanced civil law liability stipulated by civil law, which is imposed on the account of actual losses and inflicted environmental damage". While establishing the amount of compensation the court did not take into consideration costs incurred by the company for restoring the initial state of the environment.

iii. *Regarding administrative liability*: the court ruling refers to the fact that the company has been held administratively liable for polluting forests, which in accordance with article 8.31 of AOC is penalized by a fine up to 300,000 rubles (the ruling itself does not contain reference to the amount of the fine because the imposition of administrative penalty and its amount were not appealed by the company).

Transborder environmental damage

As noted, the nature of oil and gas operations on continental shelf raises a possibility of inflicting environmental damage beyond the borders of Russia, onto territory and/or continental shelf and exclusive economic zones of another state or states, *i.e.*, "transborder harm to the environment". [19]

With respect to damage inflicted as a result of operations performed on the Arctic shelf, it is important to remember that neither geography nor law can give a generally recognized definition of the Arctic. [20] The legal status of the Arctic revolves around a prevailing sector concept which was formed during an extended period of time and the process is still ongoing. The concept refers to the distribution of Arctic territories into sectors according to their fixation to the coastlines of the polar states. The United States and Norway challenged this position as they believe that freedom of the high seas should be in effect, beyond the limits of the territorial waters of the Arctic. This vague definition of whether or not environmental damage is of a transborder nature and the question of what legal regulation should be applied to the relevant measures of liability presents additional difficulties.

In the event of transborder environmental damage, liability can be imposed on both the wrong-doer and the state in which the deed leading to the damages occurred (*i.e.*, if subsoil operations on the continental shelf of Russia led to the infliction of transborder environmental damage then the Russian state can be held liable in accordance with the order outlined below).

Liability of the state

The state can be held liable for transborder damage on account of both the violation of the state's obligations stipulated by international treaties (of regional or universal application), and in the absence of the violations of provisions of the international treaties by the state for damage inflicted in the course of legitimate actions. Despite the fact that the majority of international law regulations are declarative (*i.e.*, they do not expressly establish obligations of the state, violation of which can result in the imposition of liability), a state can be held liable on the grounds of international legal custom. At present, there is a principle of liability for the state under customary international law for transborder damages inflicted on the environment. [21] The state can claim a relevant amount of compensation from a wrong-doer. Such levying by the Russian state of a shelf subsoil user, whose actions resulted in the infliction of damages, will be effected in compliance with Russian legislation.

Liability of legal entities according to international treaties

Unlike states, legal entities can be deemed subjects of international environmental law only in cases expressly stipulated by relevant international treaties. Today there are a number of international treaties in force that contain provisions that envisage environmental liability of legal entities. However, only one of them is potentially applicable to the Arctic – the International Convention on Civil Liability for Oil Pollution Damage of 1969 (as revised by the 1992 Protocol).

The Convention covers damages from polluting the territory of a country-participant of the Convention, including its territorial sea and also territory of its exclusive economic zone (or, if a state did not establish an exclusive economic zone, within 200 nautical miles from the baselines).

The Convention is applied to pollution resulting from the transportation of oil in bulk (oil and oil products). Even though the term "ship" used in the Convention is quite broad it does not cover oil platforms (floating or fixed). Thus, provisions of the Convention cannot be applied to pollution as a result of an accident involving an oil platform at the Arctic shelf.

The Convention establishes the right of the owner of a ship to limit his liability with respect to any accident by a total amount, determined in accordance with the procedure, on the basis of the ship's capacity and units of account established by the Convention. For the purpose of availing himself of the benefit of limitation provided by the Convention, the owner shall constitute a fund for the total sum representing the limit of his liability with the court or other competent authority of any one of the states-participants of the Convention in which a claim can be filed. The fund can be constituted either by depositing the sum or by producing a bank guarantee or other guarantee, acceptable under the legislation of the state where the fund is constituted, and considered adequate by the court or other competent authority.

Liability under the legislation of a foreign state

Inflicting transborder damage to the environment can result in the imposition of liability on a legal entity in compliance with the legislation of a foreign party whose environment was damaged.

Possible grounds for imposing liability and details of imposing liability (including a procedure for estimating the amount of compensation for damages inflicted on the environment) will be determined by the legislation of the relevant foreign state.

For instance, the legislation of Norway expressly provides for liability for damages inflicted as a result of oil

and gas operations outside of Norway's territory if such operations adversely affected the territory of Norway or territory under the jurisdiction of Norway (*i.e.*, the exclusive economic zone of Norway and/or continental shelf of Norway). [22] Thus, legislation of Norway can be applied even if the source of pollution itself (for example, an oil leaking platform) is located beyond the jurisdiction of Norway. In such cases, liability for environmental damage will be imposed irrespectively of the wrong-doer's fault.

Also, the legislation of Norway generally imposes liability in the form of severe fines for contamination of the environment by oil containing materials. It is worth mentioning that the amount of fines has significantly increased in the last several years in order to make fines a preventative measure, *i.e.*, so that they serve as a motivation to take the necessary steps to prevent pollution. For instance, in 2009 Statoil was held liable for damages inflicted on the environment of Norway as a result of an oil spill and the company had to pay a fine of approximately 4.2 million dollars.

Finally, besides liability for environmental damage in the form of a fine, the legislation of Norway stipulates that the wrong-doer shall compensate costs associated with eliminating the pollution, and with restitution and preventive measures incurred by the state and/or third parties in relation to such environmental pollution. [23]

With respect to damages inflicted on the environment of any Arctic state, it is also important to note that article 234 of the 1982 United Nations Convention on the Law of the Sea granted coastal states the right to adopt laws and regulations for preventing pollution and protecting the environment in ice-covered areas within limits not exceeding 200 miles. In accordance with this provision, an Arctic state can adopt laws for the purpose of protecting and preserving the environment in the Arctic region, in relation to the area extending 200 miles beyond the territory of the Arctic state. Effectively the national environmental legislation of an Arctic state can be applicable even beyond its territory, on the territory of its excluding economic zone, under condition that such territory is covered by article 234 of the 1982 United Nations Convention on the Law of the Sea.

This article is a translation from the original Russian language version of the article that was published in "НефтьГазПраво" (Oil, Gas and Law Journal) No. 6'2014.

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[1] Concept of the long term social and economic development of the Russian Federation covering the period up to the year 2020, approved by the RF Government Decree No. 1662-p dated November 17, 2008; RF Government Decree No. 1715-p "On Energy Strategy of Russia for the Period up to 2030" dated November 13, 2009; RF Government Decree No. 1120-p "On Approval of Strategy of Social and Economic Development of Siberia up to 2020" dated July 5, 2010; RF Government Decree No. 2074-p "On Approval of Strategy of Social and Economic Development of North-West Federal Region up to 2020" dated November 18, 2011; RF Government Decree No. 919 "On Federal Target Program "World Ocean" dated August 10, 1998.

[2] In accordance with the Article 1 of the Federal Law 187-FZ dated November 30, 1995 "On continental shelf of the Russian Federation", outer edge of the continental shelf extends to a distance of 200 nautical miles from the baselines, determining width of the territorial sea, if the outer edge of the continental margin does not extend up to that distance.

[3] Cl 1 Article 77 of the federal Law No. 7-ФЗ «On Protection of Environment» dated January 10, 2002 (hereinafter referred to as Environmental Law).

[4] *See*, for example, Ruling of FAC of West-Siberian district dated November 5, 2013, case No A75-4538/2012.

[5] Clause 10 of the Decree of the Plenum of the Supreme Arbitrazh Court of the Russian Federation No 22 On certain aspect of the practical application of the Law of RSFSR On protection of environment dated October 21, 1993.

[6] *See*, for example, Ruling of Federal Arbitrazh Court of the Moscow District dated November 17, 2010 # KG-A40/13697-10 case # A40-31537/10-61-247.

[7] Article 77 of Environmental Law.

[8] *See*, for example, Ruling of Federal Arbitrazh Court of the Moscow District dated November 17, 2010 # KG-A40/13697-10 case # A40-31537/10-61-247, according to which "*…argument of a claimant that recovery of damage inflicted on the environment in this particular case contradicts effective legislation of the Russian Federation which does not provide for application of dual liability for the same offence, is declared ungrounded. Collection of fine in the amount of 300,000 rubles for administrative violation is an administrative penalty, collection of the amount of inflicted damage, being a subject matter of this case [note – 1,500,000 rubles] is a civil law liability.*"

[9] According to clause 38 Decree of the Plenum of the Supreme Court of the Russian Federation No 21 On application by the courts of law of liability for offences of environmental and natural resources law" dated October 18, 2012, "*if inflicted damage is a result of operations of a company, facility or other production activity which inflicted damage or threatened to inflict new damage, then court can enforce a defendant, along with recompensing, to suspend or cease relevant activity…*"

[10] *See*, for example, Ruling of SAC No SAC-8493/13 dated July 16, 2013

[11] Definition of Supreme Arbitrazh Court # VAS-13396/13 dated September 26, 2013

[12] Order of the Ministry of Natural Resources of the Russian Federation dated April 13, 2009 No 87 On approval of formula for estimation of the extent of damage inflicted on water bodies due to violation of water legislation.
[13] Order of Russian Federal Fisheries Agency dated November 25, 2011 No 1166 On approval of formula for estimation of the extent of damage inflicted on aquatic biological resources.
[14] Order of the Ministry of Natural Resources of the Russian Federation dated December 8, 2011 No 948 On approval of formula for estimation of the extent of damage inflicted on hunting resources.
[15] Order of the Ministry of Natural Resources of the Russian Federation dated April 28, 2008 No 107 On approval of fixed rates for estimation of the extent of damage inflicted on the species of animal life included in the Red Book of Endangered Species of the Russian Federation, and other species of animal life not rated as game and fishing resources and their habitat.
[16] Article 4.5 of AOC.
[17] Cl 3 Article 78 of Law on protection of environment.
[18] Ruling of the Eighth Arbitrazh Appeal Court No. 08АП-2528/2014 dated June 16, 2014.
[19] According to the Resolution of the General Assembly of the UN No. 61/36 "Principles on the Allocation of Loss in the Case of Transboundary Harm Arising Out of Hazardous Activities" "transboundary harm" includes damages inflicted within the territory (or other location under the jurisdiction) of the state other than the state which inflicted damages.
[20] Chapter IV, International Environmental Law: Textbook / T.G. Avdeeva, A.I. Aliev, R.R. Amirova et alia.; editor in chief R.M. Valeev, M: Satute, 2012.
[21] In accordance with the article 38 of the Statute of the International Court of Justice of the UN, international custom means "proof of general practice, recognized as a legal rule". Briefly, concept of an international legal custom, formulated in the doctrine of international law, can be characterized as silent or implied agreement of the subjects of international law with respect to the establishment, amendment or termination of their mutual rights and obligations (cf. International Law. General Part: textbook by G.Ya. Bakirova, P.N. Biryukov, R.M. Valeev et alia.; editor-in-chief R.M. Valeev, G.I. Kurdyukov, M.: Statute, 2011). Doctrinal concept of international legal custom has been developed and described at its best in the works of Ian Brownlie (Brownlie I. Principles of Public International Law. 5th ed. Oxford, 1998), Antonio Cassese (Cassese A. International law. Second edition, 2004), Malcolm Shaw (M. Shaw, International Law, Cambridge, 6th edition, 2008). In Russia concept of international legal custom has been described in the works of G.I. Tounkin (Tounkin G.I., Theory of International Law, M. 1970), Yu.M. Kolosov (International law: Textbook / under the editorship of Yu.M. Kolosov and E.S. Krivchkovoy, M., 2007). As noted by all mentioned representatives of the doctrine, in a dispute presence of international legal custom requires proof of existence of two elements: (i) opinio juris (i.e. demonstration of legal understanding, recognition that such rule shall be legally binding) and (ii) practice of application of the principle. Principles of liability of the state for the trans-border damages inflicted on the environment described in this Memorandum, are recognized principles of the customary international law.
[22] Section 54 of the Law of Norway "On Protection from Pollution and Waste" dated March 13, 1981.
[23] Section 7 of the Law of Norway "On Oil Operations" dated November 29, 1996; article 183 and 191 of the Navigation Code dated June 24, 1994.

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KING & SPALDING

Energy Newsletter

February 2015

REGULATORY
Oil & Gas Regulatory
Broader Regulation of Offshore Contractors on Horizon
Andrew Stakelum

On November 12, 2014 the Bureau of Safety and Environmental Enforcement (BSEE) strongly signaled a forthcoming review of its offshore facility decommissioning regulations and regulatory authority over contactors. While the domestic offshore energy industry has grown accustomed to a fluid regulatory environment, this action would represent the one of the most significant reviews of offshore worker safety and operations since the *Deepwater Horizon* disaster in 2010.

Regulators repeatedly cited what they perceived to be a poor safety culture as a leading cause of the *Deepwater Horizon* disaster. This finding ultimately gave rise to the Work Place Safety Rule in October 2010 and its regulations concerning Safety and Environmental Management Systems (SEMS). The SEMS regulations require operators to, among others, design and implement safe work practices, conduct facility wide hazard analyses, identify necessary safety and environmental information, and implement worker training programs. In June 2013, the SEMS II rule imposed additional safety requirements including the development of stop work authority and ultimate work authority programs, and the development of guidelines for incident reporting.

Currently, only operators are required to possess a SEMS program—a point that BSEE clarified in a 2011 Notice to Lessees. [1] Contractors are under no regulatory obligation to maintain a SEMS program. Notwithstanding this, an operator is required to ensure that its contractors comply with the safe work policies and procedures set forth in the operator's SEMS program. This process is often accomplished by the operator and contractor executing a bridging agreement requiring the contractor to adopt and adhere to an operator's SEMS program, including its safe work practices. In practice, most contractors have developed at least an informal SEMS program to demonstrate their commitment to safe work practices and to satisfy the contractor vetting process that SEMS requires operators perform.

This top down regulatory approach where BSEE regulates the operator/mineral lessee who in turn bears the responsibility to regulate its contractors is a hallmark of the pre-*Deepwater Horizon* regulatory scheme under BSEE's precursor, the Mineral Management Services. BSEE has taken several steps to abandon this top down approach in favor of direct authority over all Outer Continental Shelf (OCS) operations, regardless of who is actually performing them. BSEE's first step was to re-interpret its own regulations unilaterally in such a manner that allows for the direct regulation of contractors and, more recently, by enacting regulations that expressly provide for BSEE's direct regulation of contractors who perform certain operations such as drilling. This regulatory "creep" over parties who have not signed an offshore lease has been the focus of much debate within the industry.

BSEE's latest move towards complete regulatory authority stems from a 2014 BSEE panel investigation into a fatality that occurred during prep work in advance of the decommissioning of a shallow water Gulf of Mexico facility. The panel concluded that the contractor performing and overseeing the work failed to plan adequately for the prep activities leading up to actual decommissioning activities. While BSEE determined the appropriate SEMS program and bridging agreement existed at the "corporate level", the documented policies, procedures, and safety systems were not translated into adequate work practices and implemented at the job site.

In response, BSEE's Director issued a letter [2] accepting the panel's findings and instructing the Office of Offshore Regulatory Programs (ORP) to review the adequacy of current decommissioning regulations. Most importantly, BSEE has also sought a review of whether its current SEMS regulations should be modified to provide for direct oversight of contractors, including a requirement that certain contractors maintain their own accredited and audited SEMS program.

The potential expansion of SEMS just four years after it was implemented marks a significant step in BSEE's attempts to regulate all contractors operating on the OCS. As previously noted, the SEMS regulations are very broad, touching upon worker training, incident response, and safe work operations. If BSEE attains direct oversight of contractors through their SEMS compliance, BSEE may attempt to exert direct oversight over other aspects of the contractors' operations on the OCS. In addition to increased regulatory scrutiny and potential penalties, a series of SEMS violations could cause BSEE to disqualify a contractor from working on the OCS. This is a harsh sanction that BSEE has recently demonstrated it is willing to impose on operators with a history of regulatory non-compliance.

Just who will be classified as a contractor is also an important issue that remains unclear. While a contractor physically performing the work on a facility may clearly be a contractor under the regulations, it is less clear whether a manufacturer of specialty chemicals or a manufacturer of key safety equipment that is used on the OCS, but manufactured onshore, would fall under BSEE's direct oversight. While this and many other questions remain, BSEE is clearly continuing its push for direct oversight over contractor operations on the OCS. Ultimately, this direct oversight of contractors will create new risks and regulatory obligations that both operators and contractors will need to assess carefully and address in their contracts or through the insurance market.

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[1] http://www.bsee.gov/Regulations-and-Guidance/Notices-to-Lessees/2011/11-N09/.

[2] http://www.bsee.gov/uploadedFiles/BSEE/Enforcement/Accidents_and_Incidents/Panel_Investigation_Reports/Panel Report 2014-2 Response.pdf.

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KING & SPALDING

Energy Newsletter

February 2015

REGULATORY
International Trade
U.S. Government Agency Narrows Scope of Crude Oil Export Ban
Clint Long

On December 30, 2014, the U.S. Department of Commerce's Bureau of Industry and Security ("BIS") issued answers to six FAQs regarding the longstanding U.S. crude export oil ban. In these FAQs, BIS stated that lease condensate that has been processed through a crude oil distillation tower is not considered "crude oil." Thus, it is not subject to the U.S. crude oil export ban, and U.S. producers can export it without first obtaining approval from BIS. This announcement marginally narrows the scope of the crude oil export ban by clarifying the ban's applicability to lease condensate, and it likely will result in increased U.S. oil exports.

Crude Oil Export Ban

After OPEC's oil embargo against the United States in response to the latter's support of Israel in the 1973 Arab-Israeli War and the resulting oil crisis, Congress passed the Energy Policy and Conservation Act ("EPCA") in 1975. The EPCA required the President to enact a rule "prohibiting the export of crude oil . . . produced in the United States" and authorized the President to enact limited exceptions. *See* 42 U.S.C. § 6212. True to the EPCA's mandate, the U.S. government enacted a rule (currently administered by BIS) that subjected crude oil to "short supply controls" and prohibited the export of crude oil produced in the U.S. without a license. *See* 15 C.F.R. § 754.2.

A key aspect of this rule is its definition of "crude oil." A company wishing to export the following crude oil products that are produced in the U.S. must first obtain a license from BIS:

> "Crude oil" is defined as a mixture of hydrocarbons that existed in liquid phase in underground reservoirs and remains liquid at atmospheric pressure after passing through surface separating facilities and which has not been processed through a crude oil distillation tower. Included are reconstituted crude petroleum, and lease condensate and liquid hydrocarbons produced from tar sands, gilsonite, and oil shale. Drip gases are also included, but topped crude oil, residual oil, and other finished and unfinished oils are excluded.

15 C.F.R. § 754.2(a).

Ambiguity Concerning Lease Condensate

Although the text of this definition clearly classifies "lease condensate" as a crude oil product, the practical

application of the definition introduces some ambiguity. As pointed out by the Congressional Research Service:

> While "lease condensate" is included in the BIS crude oil definition, there is a potential contradiction within the definition. BIS defines crude oil as hydrocarbons that existed in liquid phase underground. However, condensate is generally in a gas phase underground and condenses to a liquid at atmospheric conditions. This apparent contradiction, along with other considerations, raises questions about the applicability of export restrictions to condensate. [1]

In addition, although the definition implies that lease condensate or another crude oil product that is processed through a crude oil distillation tower is no longer "crude oil," it does not explain how much processing is required.

As U.S. oil production boomed in recent years, producers began asking BIS for guidance on these questions and requesting approval to export condensate. Two producers – Pioneer Natural Resources and Enterprise Products Partners – successfully received rulings from BIS in 2014 that allowed them to export processed condensate to customers in Asia. In November 2014, news reports indicated that BHP Billiton planned to export processed condensate that had been processed through a distilling tower without first obtaining approval from BIS. The rationale for doing so, explained the company, was that "[t]he processed condensate that BHP Billiton plans to export is not crude oil under [BIS] regulations." [2]

Guidance from BIS

The FAQs published by BIS on December 30, 2014 confirmed that "lease condensate that has been processed through a crude oil distillation tower is not crude oil but a petroleum product. Petroleum products are subject to few export restrictions." [3] BIS also provided some guidance regarding the processing that transforms lease condensate from crude oil into a "petroleum product." According to BIS, "there must be material processing through a crude oil distillation tower." If lease condensate passes through no processing or de minimis processing in the distillation tower, BIS will continue to classify the product as crude oil. Furthermore, "[p]rocesses that utilize pressure reduction alone to separate vapors from liquid or pressure changes at a uniform temperature, such as flash drums with heater-treaters or separators, do not constitute processing through a crude oil distillation tower. Crude oil processed through such equipment remains classified as crude oil."

In addition to this guidance, BIS reminded companies that they may request a commodity classification from BIS in order to determine if their lease condensate has undergone sufficient processing in order to be considered a petroleum product. BIS also provided a non-exhaustive list of factors that it considers in making case-by-case determinations on whether lease condensate has been "processed through a crude oil distillation tower." The FAQs define these factors as:

1. Whether the distillation process materially transforms the crude oil, by using heat to induce evaporation and condensation, into liquid streams that are chemically distinct from the crude oil input;

2. The change in API gravity between the input of the process and the output of the process;

3. The change in percentage of different types of hydrocarbons between the input and output of the process;

4. Whether the streams resulting from distillation have purposes other than allowing the product to be classified as exportable petroleum products, such as use as petrochemical feedstock, diluent, and gasoline blendstock;

5. Whether the distillation process utilizes temperature gradients and has significant internal structures, such as trays or packing, and differentiated output streams; and

6. Whether the distillation uses towers with more mechanical complexity and heat, higher residence time, internal structures that promote condensation and better separation, and a consistent quality liquid streams (also called cuts or fractions) than equipment used to separate vapors and liquids for transportation needs.

Implications for Crude Oil Export Ban

Both opponents and supporters of the ban see this action as an initial, significant step that could lead to the eventual repeal of the crude oil export ban. Senators Edward Markey and Robert Menendez, consistent supporters of the crude oil export ban, expressed their concerns about this announcement in a letter to Secretary of Commerce Penny Pritzker. [4] According to Senators Markey and Menendez, BIS' decision "weakens the oil export ban" and represents "a new interpretation" of the definition of "crude oil." Citing fears that the recent announcement will lead to higher oil prices and harm national security, Senators Markey and Menendez asked Secretary Pritzker to reverse BIS' announcement.

While the impact of BIS' announcement on the remaining crude oil export restrictions is unclear, it certainly narrows the scope of the crude oil export ban. The FAQs clarified that lease condensate, a product explicitly covered by the rule's definition of "crude oil," is not subject to the ban if it is sufficiently processed through a distillation tower. As a result, some analysts predict that U.S. exports of lease condensate could reach 1 million barrels per day by the end of 2015. [5]

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[1] http://www.energy.senate.gov/public/index.cfm/files/serve?File_id=dfe108c9-cef6-43d0-9f01-dc16e6ded6b4.
[2] http://www.worldoil.com/BHP-Billiton-confirms-Eagle-Ford-condensate-exports.html.
[3] http://www.bis.doc.gov/index.php/policy-guidance/faqs.
[4] http://www.menendez.senate.gov/imo/media/doc/20150116141111210.pdf.
[5] http://www.businessweek.com/news/2014-12-31/u-dot-s-dot-opening-door-to-more-oil-exports-seen-foiling-opec-strategy.

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