

# Hydrocarbons Legislation In Algeria

## Back to Square One?

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The hydrocarbons law dated 28 April 2005<sup>1</sup> (the “**2005 Hydrocarbons Law**”) aimed primarily to liberalise the Algerian hydrocarbons markets by reconsidering the regime formerly set out in the hydrocarbons law dated 19 August 1986<sup>2</sup> (the “**1986 Hydrocarbons Law**”) in order to break up the monopoly of the State-owned company Sonatrach. As such, the 2005 Hydrocarbons Law, initiated by the Ministry of Energy Chakib Khelil and passed last year after several years of discussion, could have led to an actual revolution in the petroleum industry in Algeria<sup>3</sup>.

However, whereas implementation regulations still have to be issued more than fifteen months after it was passed, the President A. Bouteflika significantly amended the 2005 Hydrocarbons Law by *ordonnance* [order]<sup>4</sup> dated 29 July 2006<sup>5</sup> (the “**2006 Hydrocarbons Order**”): the institutional framework and the new contractual regime set up by the 2005 Hydrocarbons Law remain unchanged but the market liberalisation is almost entirely abandoned. In addition, the 2006 Hydrocarbons Order introduces a new windfall profit tax for all contracts entered into under the 1986 Hydrocarbons Law.

A brief reminder of the hydrocarbons legislation as per the 1986 Hydrocarbons Law and the 2005 Hydrocarbons Law shall allow us to better understand the amendments provided by the 2006 Hydrocarbons Order.

### 1. 1986 Hydrocarbons Law

The 1986 Hydrocarbons Law confirmed the monopoly of Sonatrach, the national oil company, over hydrocarbons exploration, exploitation and transportation activities<sup>6</sup>. The State could only entrust these activities to national companies such as Sonatrach. Therefore, international oil & gas companies (the “**IOC**”) could not carry out hydrocarbons exploration and exploitation activities except through a partnership with Sonatrach. The following basic rules applied to those partnerships:

- The mining titles and licences pertaining to hydrocarbons exploration and production activities (prospecting authorization, research permit, provisional exploitation authorisation and exploitation permit) were exclusively granted to Sonatrach.
- Hydrocarbons pipeline transportation was the monopoly of Sonatrach. Partnerships pertaining to hydrocarbons pipeline transportation were not authorised. However, foreign entities could finance, build and operate hydrocarbons pipeline transportation on behalf of Sonatrach, in cases where there was a lack of spare transportation capacity although Sonatrach always remained the owner of said transportation infrastructures.
- Partnerships pertaining to hydrocarbons exploration and production activities were authorised. Most of the partnerships were organized through a production sharing contract pursuant to which the IOC was allocated a share of crude oil and oil products FOB Algeria<sup>7</sup> as a lump sum for cost oil and profit oil, free from any tax and duties whatsoever. The IOC’s share could not exceed forty-nine percent (49%) of the total production each year<sup>8</sup>.
- Sonatrach used to issue and manage tenders to select the IOC with which Sonatrach would enter into a partnership in relation to a specific exploration permit. In many instances, Sonatrach requested to participate in the PSC, not only as mining title holder but also as a private investor. However, the

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share of the exploration expenses in relation to Sonatrach's share as private investor had to be carried by the IOC.

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

### 2. 2005 Hydrocarbons Law

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

#### **2.1 The institutional framework**

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

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

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

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

#### **2.2 Contractual regime**

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

The CRE is entered into between the IOC and ANALFT in its capacity of mining title holder, further to a competitive, fair and transparent bid process. It shall be approved by decree and shall

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enter into force as of the date the said decree is published in the *Journal Officiel de la République Algérienne* [official gazette].

The CRE entitles the IOC to undertake exploration activities in Algeria as well as exploitation activities in case of a commercial discovery, on an exclusive basis. The 2005 Hydrocarbons Law provides that title to the hydrocarbons production shall pass to the IOC at the agreed measurement point. It shall be emphasised that the 2005 Hydrocarbons Law does not include any reference to a production sharing mechanism anymore. To that extent, it would seem that the entire production should be allocated to the IOCs and the CRE should be analysed as a tax royalty agreement<sup>10</sup>.

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

In the case Sonatrach exercises such option Sonatrach shall (i) bear all development and operational costs to the extent of its participating interest in the contract and (ii) reimburse the IOC a pro rata share of all exploration costs in relation to the discovery upon their approval by ALNAFT. The 2005 Hydrocarbons Law further provides that Sonatrach and the IOC shall enter into a joint operation agreement (“**JOA**”) within thirty (30) days of the exercise of the option by Sonatrach. The JOA shall be approved by ALNAFT and further ratified by decree.

### **2.3 The tax regime**

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

- A *redevance* [monthly proportional royalty] (“**Royalty**”), based on the location of the field and the level of hydrocarbons production, to be paid to ANALFT in its capacity of mining title holder. The Royalty rates range from five point five percent (5.5%) to twenty-three percent (23%) depending on the area and the monthly production;
- A *taxe superficière* [annual surface tax] (“**TS**”), based on the surface area covered by the Contract, to be paid to the Public Treasury. The TS rates range from four thousand (4,000) to thirty-two thousand (32,000) Algerian Dinars per square kilometre depending on the area and the contractual period;
- A *taxe sur le revenu pétrolier* [monthly petroleum income tax] (“**TRP**”), based on a sliding scale, which increases as and when the cumulative value of hydrocarbons production increases, to be paid to the Public Treasury. The TRP rates amount to thirty percent (30%) for the first tranche and seventy percent (70%) for the second tranche;
- A *impôt complémentaire sur les résultats* [annual additional income tax] (“**ICR**”), calculated as per the *impôt sur le bénéfice des sociétés (I. B. S. )* [corporate tax]. The ICR rate amounts to thirty percent (30%)<sup>11</sup>; and as the case may be,
- A *taxe foncière* [land tax] based on assets other than exploitation assets, a gas flaring tax, a water tax and a CO<sup>2</sup> emission tax.

It shall be emphasized that whereas Sonatrach shall pay the royalty pertaining to the whole production and income tax on behalf of the IOC for all contracts entered into in accordance with the 1986 Hydrocarbons Law, the 2005 Hydrocarbons Law provides that the IOC shall pay taxes directly. Indeed, the Operator<sup>12</sup> shall pay the Royalty, the TS and the TRP on behalf of the parties to the JOA. To that extent, it would seem that the Operator also pays the same on behalf of Sonatrach in its capacity of

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party to the JOA. However, in principle, each party to the JOA remains liable for its own share of ICR. It shall be noted that the direct payment of the said taxes by the Operator under the 2005 Hydrocarbons Law is consistent since the IOC is allocated the entire Hydrocarbons production but shall entail a complete change of tax strategy for the IOC.

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

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

### **2.4 Existing PSC**

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

However, since the mining titles shall be exclusively awarded to ANALFT under the 2005 Hydrocarbons Law, Sonatrach and ANALFT shall enter into a contract to provide for their respective rights and obligations, including but not limited to the payment by Sonatrach of the Royalty, TS and TRP. Once Sonatrach and ANALFT entered into those contracts, Sonatrach would transfer the mining titles back to the Ministry in charge of hydrocarbons, which shall award the same to ANALFT<sup>13</sup>.

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

### **3. 2006 Hydrocarbons Order**

The 2006 Hydrocarbons Order reallocates a majority stake to Sonatrach for almost all upstream, midstream and downstream activities in Algeria and aims at increasing the State's stake in the same. To that extent, the 2006 Hydrocarbons Order reduces the IOC's stake significantly.

#### **3.1 Sonatrach's majority stake**

Under the 2006 Hydrocarbons Order, Sonatrach must now participate in each upstream contract and its participation can not be lower than fifty-one percent (51%). To that end, the parties shall enter into a JOA within thirty (30) days after the approval of the said development plan by ANALFT. Sonatrach shall assume all investment and exploitation costs relating to the development plan for each commercial discovery to the extent of its participation. This JOA shall also include the modalities and conditions pertaining to the refund by Sonatrach of the exploration costs. It shall be emphasised that all exploration costs related to the participation of Sonatrach shall therefore be financed by the other parties to the JOA and should be refunded by Sonatrach only in case of a commercial discovery.

It shall be noted that, the 2005 Hydrocarbons Law was relatively consistent as it allocated the entire production to the IOCs but the Operator had to pay the Royalty, the TS and the TRP on

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behalf of the parties to the JOA and Sonatrach was allocated an option to acquire a twenty (20) to thirty percent (30%) participation, which was in line with the practice in force in the international petroleum industry. To that extent, a mandatory fifty-one percent (51%) participation is not consistent anymore and reduces the IOC's stake significantly, not to mention that the 2005 Hydrocarbons Law also gives a pre-emption right to Sonatrach for any assignment of a participating interest.

In addition, with a mandatory participation of minimum fifty-one percent (51%), Sonatrach has majority control under both the CRE and the JOA and as such, may reasonably require to be involved in the most important decisions, such as the approval of the decision of commerciality and the approval of a development plan. However, the 2006 Hydrocarbons Order does not provide any information pertaining to the decision of commerciality and in any event, Sonatrach shall only enter into the JOA within thirty (30) days after the approval of the said development plan by ANALFT. To that extent, Sonatrach's majority participation does not only reduce the IOC's stake but is also very likely to entail issues with ANALFT.

Transportation activities may now only be undertaken by either Sonatrach or a local company, in which Sonatrach owns at least a fifty-one percent (51%) participation and, in any event, the transportation concession may only be awarded to Sonatrach.

Finally, refining activities may now only be undertaken by either Sonatrach or an association, in which Sonatrach owns at least a fifty-one percent (51%) participation.

Therefore, the only hydrocarbons Transformation<sup>14</sup> activities remain liberalised.

### **3.2 Increased State's stake**

The 2006 Hydrocarbons Order introduces a *taxe sur les profits exceptionnels* [windfall profit tax] (the "WPT").

Indeed, all IOCs, operating in Algeria in accordance with any association contract governed by the 1986 Hydrocarbons Law, are now subject to a non deductible WPT as from 1 August 2006. The WPT is based on the share of production allocated to the IOC when the Brent prices exceed thirty US Dollars (US\$30) per barrel. It is calculated at a rate, which ranges from a minimum of five percent (5%) to a maximum of fifty percent (50%). However, the 2006 Hydrocarbons Order does not provide any information pertaining to the method of calculation and assessment of the said WPT, which shall be provided later.

It shall be emphasised that all IOCs, operating in Algeria in accordance with an association contract already providing a profit skimming mechanism similar to the WPT were initially not included within the scope of the WPT<sup>15</sup>. Adding the WPT on the top of the said profit skimming mechanism may reduce the profitability of operations significantly.

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

### **Conclusion**

The major issue with the 2006 Hydrocarbons Order lies in the mandatory participation of Sonatrach with a minimum of fifty-one percent (51%). Indeed, the 2005 Hydrocarbons Law was mainly aimed at liberalising the hydrocarbons market in Algeria. To that extent, the 2006 Hydrocarbons Order, reintroducing the mandatory participation of Sonatrach with a minimum of fifty-one percent (51%) for exploration, production, transportation and refining activities, is clearly a step back to square one.



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More importantly, the mandatory participation of Sonatrach with a minimum of fifty-one percent (51%), together with the direct payment of taxes by the Operator and the WPT, are likely to reduce the overall profitability of operations very significantly.

Still, the 2005 Hydrocarbons Law introduced a new institutional framework and a new legal regime. However, the mandatory participation of Sonatrach with a minimum of fifty-one percent (51%) is likely to entail issues with ANALFT. The rumour even has it that Sonatrach may already be preparing the next licensing round, which if it was confirmed would seriously challenge the institutional framework established by the 2005 Hydrocarbons Law.

In addition, it is difficult to assess the full impact of the 2005 Hydrocarbons Law as amended by the 2006 Hydrocarbons Order since implementation regulations have still not been passed as of today. In the meantime, many outstanding issues remain, such as the WPT and the one percent (1%) transfer tax and simply can not be implemented as such.

Last but not least, some are already challenging the validity of the 2005 Hydrocarbons Law as it would seem that the latter was not adopted in accordance with the required constitutional procedure<sup>16</sup>. If it was confirmed, the validity of the 2006 Hydrocarbons Law would be challenged as well. To that extent (and in any event), the 2006 Hydrocarbons Law may not be ratified by the Parliament and therefore may be null and void. And Algeria would be back to square one: the 1986 Hydrocarbons Law, which in the end may not be such a negative outcome.

### (Footnotes)

<sup>1</sup> *Loi n°05-07 du 28 avril 2005 relative aux hydrocarbures*

<sup>2</sup> *Loi n°86-14 du 19 août 1986 relative aux activités de prospection, de recherche, d'exploitation et de transport par canalisation des hydrocarbures*

<sup>3</sup> Refer to our article «The new 2005 Algerian Hydrocarbons Law » (International Oil & Gas Finance Review Yearbook 2006)

<sup>4</sup> The 2006 Hydrocarbons Order was passed by the President A. Bouteflika as the Parliament was away on recess. It shall be null and void if it is not ratified by the Parliament during the next session, which started beginning of September 2006.

<sup>5</sup> *Ordonnance n°06-10 du 29 juillet 2006 modifiant et complétant la loi n°05-07 du 28 avril 2005 relative aux hydrocarbures. Journal Officiel de la République Algérienne #48 dated 30 July 2006.*

<sup>6</sup> The monopoly of Sonatrach was established by Ordinance n° 71-22 dated 12 April 1971, after nationalization of the foreign companies interests in the hydrocarbons sector.

<sup>7</sup> and/or a share of the revenues generated by the sale of natural gas

as natural gas production was required to be marketed through a joint marketing company, in which Sonatrach had the majority of voting rights.

<sup>8</sup> The total share allocated to Sonatrach therefore represented at least fifty-one percent (51%) of total production each year.

<sup>9</sup> Article 44 of the modified 2005 Hydrocarbons Law.

<sup>10</sup> It is interesting to note that Algeria is one of the only countries which abandons production sharing contracts and implement a tax royalty agreement whereas most of North and West African has been progressively shifting to production sharing contracts for the past twenty years.

<sup>11</sup> Article 88 of the 2005 Hydrocarbons Law, as amended by the 2006 Hydrocarbons Order.

<sup>12</sup> Operator shall mean *Opérateur*, as this term is defined in article 29 of the 2005 Hydrocarbons Law.

<sup>13</sup> To the best of our knowledge as of the date of this article, the mining titles were still not re-issued in the name of ANALFT, more than fifteen months after the 2005 Hydrocarbons Law was passed, although it seems that Sonatrach and ANALFT already entered into those contracts.

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

<sup>15</sup> See draft project of the 2006 Hydrocarbons Order.

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

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