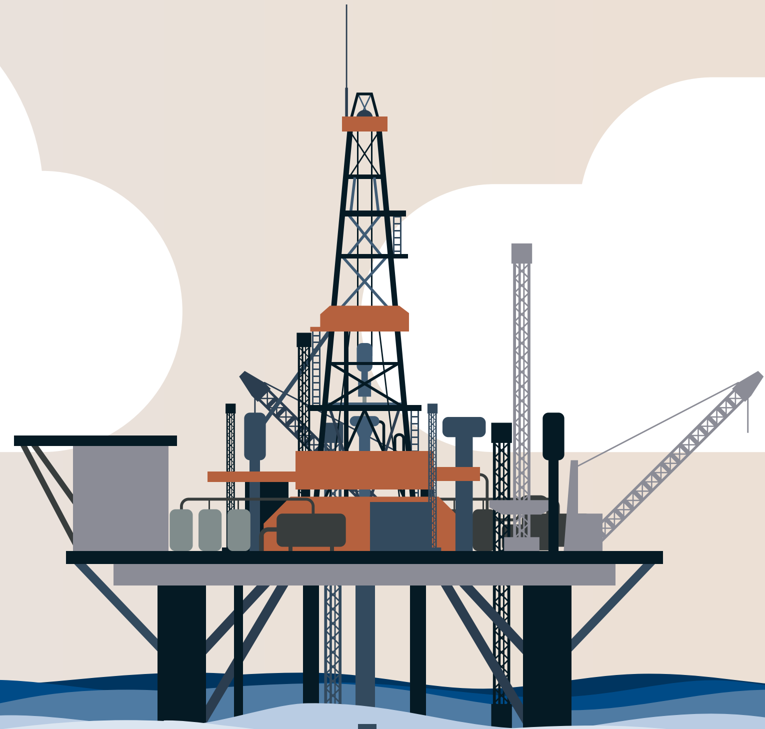
BOWMANS
THE VALUE OF KNOWING

UPSTREAM OIL AND GAS AUTHORISATIONS (SOUTH AFRICA)

The South African oil and gas industry is small by global standards and, despite promising onshore and offshore prospectivity, the country's acreage remains largely underexplored. The advent of a vibrant domestic industry has not been curtailed by geological factors but rather by a combination of above-ground concerns including, amongst other things, ongoing legislative and regulatory uncertainty.

The primary legislation governing the upstream sector, which also covers the mining sector, is the Mineral and Petroleum Resources Development Act 28 of (2002) ("the MPRDA"). Under the MPRDA, the Minister of Mineral Resources ("the Minister") is empowered to authorise companies to explore for, and produce, oil and gas. Since 2013, significant amendments to the MPRDA have been proposed via various iterations of the Mineral and Petroleum Resources Development Amendment Bill 15 of 2013 ("the Bill"). In November 2016, the Department of Mineral Resources ("the DMR") provided the National Council of Provinces ("the NCOP") with a table of proposed changes to the Bill and, although the changes differ significantly from the most recent version of the Bill, they are understood to represent an agreed position between the oil and gas industry and the State. Although the manner in which the proposed changes have been introduced raises questions of due process, what follows is a synopsis, from a commercial perspective, of the most significant of the proposed changes, namely, those that apply to section 86A of the Bill. For an overview of the history and status quo of South Africa's upstream oil and gas industry see Bowmans' recent chapter in *Global Legal Insights: Energy 2017, 5th Edition* **("GLI: Energy 2017")**.

For a more detailed overview of the various laws governing the entire South African oil and gas value chain see Bowmans' chapter in *The International Comparative Legal Guide to Oil & Gas Regulation 2017* **("ICLG: Oil & Gas Regulation 2017")**.



ADDITIONAL COMMERCIAL CONSIDERATIONS

- Royalty – capped at 5%
- Corporate Tax – capped at 28% of taxable income
- Capital Uplift – 100% for exploration expenditure and 50% for post-exploration expenditure
- Value-Added Tax ("VAT") of 14% or Transfer Duty (on a sliding scale of up to 11%) is payable on the acquisition of an oil and gas right

ENACTMENT OF THE BILL (JUNE 2017?)

DO YOU HOLD AN EXPLORATION RIGHT?

NO → HAVE YOU APPLIED FOR AN EXPLORATION RIGHT?

- YES → 20% + RIGHT OF PRE-EMPTION + BEE
- NO → 20% + 30% +BEE

YES → DO YOU HAVE AN AGREED PRODUCTION RIGHT ATTACHED?

- NO → 20% + RIGHT OF PRE-EMPTION + BEE
- YES → TERMS AND CONDITIONS REMAIN THE SAME

THE PROPOSED LAW (SECTION 86A)

(1) The State has, through the designated organ of State, a right to a 20% carried interest in exploration and production rights, from the effective date of such rights.

(2) In existing exploration rights and exploration rights granted in respect of pending applications, the State is in addition to the State carried interest referred to in subsection (1) and in accordance with terms and conditions agreed upon and recorded in the exploration right, entitled to a right of pre-emption in the event of a sale of a participating interest by the holder of an exploration or corresponding production right, entitling it to purchase the participating interest on terms and conditions equal to those offered by the purchaser selected by the holder.

(3) The right of pre-emption shall within a period of 90 days from the date of delivery of a notice setting out the final terms and conditions of the proposed transaction expire, entitling the holder a right to offer such participation interest to a third party.

(4) Where an exploration right application not contemplated in sub-section (2) is received after commencement of Act [Number of MPRD Amendment Bill B15-B2013], the State is, in the prescribed manner, entitled to an additional participation interest of up to 30% taking into account the size of the discovery and rate of production, in the form of—
(a) carried interest;
(b) acquisition at an agreed price; or
(c) production sharing agreements.

(5) The holder of a production right shall recover development costs of the State carried interest referred to in subsections (1) or (4) where applicable, from the proceeds generated from the production right, as may be prescribed in the terms and conditions of such right.

(6) The State shall upon acquiring interest in terms of subsections (1) and or (4) enter into a joint operating agreement with the right holder or become a party to an existing joint operating agreement if one is in place in respect of such right.

(7) The Minister must, acting on behalf of the State, appoint two representatives to the joint operating committee of the exploration or production operation to represent the interest of the State.

(8) The State is entitled to exercise its rights held in the joint operating agreements through-
(a) representation as a non-voting participant in the joint operating committee in accordance with the joint operating agreement during exploration; and
(b) corresponding percentage of voting rights to the interest held in the joint operating agreements during production.

(9) Notwithstanding subsection (1), the Minister must before granting a production right in terms of section 84 and after consultation with the applicant and the Minister of Finance, determine whether the percentage or terms and conditions of the State carried interest referred to in subsection (1) may be adjusted downwards, taking into account-
(a) the nature and scope of the project;
(b) financial and economic profile of the project;
(c) the degree of risk assumed by the holder throughout the projects; and
(d) national interests.

(10) The State carried interest shall not be adjusted below 10%.

(11) The holder of an existing exploration right shall within a period of three years of the coming into effect of Act Number of MPRD Amendment Bill apply to the Minister for a determination of the terms and conditions which will be applicable to a corresponding production right, including State participation in the manner contemplated in sub-section (9).

(12) Notwithstanding anything to the contrary in Act [Number of MPRD Amendment Bill B15-B2015], the terms and conditions of an existing exploration right granted before the commencement of Act [Number of MPRD Amendment Bill B15-B2015] in respect of which terms and conditions for a production right have been agreed to and attached in such exploration right shall, remain unchanged in as far as it relates to State participation and participation by historically disadvantaged South Africans.

(13) Upon making the determination in terms of sub-section (11), the Minister shall record the terms and conditions of the corresponding production right determined in terms of subsection (11) in the exploration right.

COMMENTARY

EXISTING EXPLORATION RIGHTS AND PENDING APPLICATIONS FOR EXPLORATION RIGHTS
At the outset, the State is entitled to a 20% carried interest, the proportionate development costs of which may be recovered from proceeds generated at the production phase. In addition to this, where the holder of an exploration or corresponding production right sells its participating interest in such right, the State has a right of pre-emption. Should it exercise this right, the State will be required to match the terms and conditions of the offer to purchase. Not only does this obligation establish a possible financial hurdle for State participation, it ought to be borne in mind that it is not uncommon in the upstream petroleum industry for companies to invite farm-in partners for the purpose of contributing skills and expertise, rather than simply for limiting exposure or raising capital. If the State were to exercise its right of pre-emption in such circumstances, but cannot contribute the requisite skills and expertise, its participation in a particular project may be detrimental to the success of the project.

EXPLORATION RIGHTS APPLIED FOR AFTER THE PROMULGATION OF THE AMENDMENT ACT
In relation to exploration rights that will be applied for and granted after the enactment of the Bill, the State will be entitled to a 20% carried interest and to an additional 30% interest in the form of either a carried interest, an acquisition at an agreed price, or a production sharing agreement. When considering South African acreage, a map of which can be accessed **here**, it is apparent that the vast majority of it is currently under licence or subject to applications for licences. Consequently, in the near future, only a small portion of the available acreage may be subject to an additional interest of up to 30%. It is only upon the expiry or relinquishment of the licences that currently govern the majority of South Africa's acreage that such acreage will then, following on from new applications for exploration rights, become subject to a 20% carried interest and the relevant additional 30% interest.

"We have put all efforts in place to ensure that amendments to the principal mining legislation – the Mineral and Petroleum Resources Development Act – are processed and finalised as a matter of urgency. This process is well underway and public hearings are taking place towards the finalisation of the Bill. We expect it to be concluded by June 2017."

– Minister Mosebenzi Zwane (6 February 2017).

EXPLORATION RIGHTS WITH PRODUCTION RIGHTS ATTACHED
The State's 20% carried interest is not applicable to this category of rights as the terms and conditions of such rights will remain unchanged to the extent that they relate to State participation and participation by historically disadvantaged South Africans. This is significant because, although State participation is not expressly catered for under the current version of the MPRDA, industry practice has been for exploration and production rights to include State interest of up to 10% together with the reservation of a 10% participating interest for historically disadvantaged South Africans. Consequently, exploration rights with agreed production rights attached will not be subject to State participation, or to participation by HDSAs, in excess of 10% respectively.

For a more detailed discussion of the issue of black economic empowerment and its interaction with the upstream oil and gas industry see Bowman's recent chapter in GLI: Energy 2017.

CONTACT: DAVID FORFAR HEAD OF OIL AND GAS
E: david.forfar@bowmanslaw.com T: + 27 21 480 780

WWW.BOWMANSLAW.COM