LEGAL UPDATE

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VIETNAM OIL AND GAS LEGAL UPDATE

Proposed Changes to Vietnam's Model PSC

*This Oil and Gas Legal Update focuses on our review of the draft (Draft 3) of the new model production sharing contract (**Draft Model PSC**) which was recently released by the Vietnamese Ministry of Industry and Trade (**MOIT**) for industry consultation.*

As a general observation, the proposed changes are relatively substantial and contentious in various key areas (including scope, relinquishment, gas retention, tender procedures, domestic market obligation, local content, stabilisation, termination, change of control, abandonment and unitisation).

It appears the intention is to impose more stringent obligations upon international oil companies (***IOC*** or ***Contractor***) entering into a new petroleum production sharing contract (***PSC***) with Vietnam Oil and Gas Group (***PVN***).

The Draft Model PSC remains focused on oil terms. It is important that the draft should provide more favourable gas terms in order to attract greater levels of foreign investment in the exploration, development and commercialisation of Vietnam's gas resources (particularly deepwater offshore or small, marginal gas fields).

Below is a summary of major changes proposed in the draft and our corresponding recommendations.

Savings Provision

Notably, the draft legal instrument (which will be promulgated by the Government in the form of a decree (***New Decree***) to replace the existing Decree 139/2005/ND-CP) currently contains no savings provision.

We recommend that the New Decree should confirm there are no adverse legal implications to the terms of existing PSCs which were previously executed prior to the effective date of the New Decree.

Scope of Contract

The Draft Model PSC revises the "scope" provision as follows[1]:

"*This Contract establishes the principles, terms and conditions under which the CONTRACTOR is granted the exclusive right to conduct Petroleum Operations aimed at exploring, appraising, developing and producing Petroleum in the Contract Area.*"

[1] Article 1.3.2 of the Draft Model PSC

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The Draft Model PSC should include provisions to recognise the Contractor's non-exclusive right to build required infrastructure (e.g. pipelines and other facilities) both within and outside the Contract Area for the purpose of Petroleum Operations.

In addition, a Contractor's right of access to any regional gas transportation systems which operate adjacent to the Contract Area should also be contemplated (subject always to available capacity of the relevant trunkline and the Contractor's negotiation of tariffs with the transporters).

Incentivised Fiscal Terms

As regards incentivised fiscal terms, it is proposed that the Draft Model PSC includes a new provision in Article 1.3.1 to confirm whether a particular PSC is granted the status of "*encouraged petroleum investment project*" for the purposes of Article 3.12 of the Petroleum Law.

Export Rights

One significant limitation is that the Draft Model PSC seeks to exclude a Contractor's "*right to export, sell or dispose of Petroleum*" in Article 1.3.2. Further, a Contractor's right to export described in Article 5.1.1 (c) of the 2005 Model PSC has also been removed.

This may cause confusion as a Contractor's export rights are recognised as statutory in Article 28.1(g) of the Petroleum Law. It is proposed that the original language of Article 5.1.1(c) of the 2005 Model PSC is reinstated to maintain consistency to the effect that "*subject to the Contractor's domestic sale obligations in Article 17, the Contractor will have the right to freely export its share of Petroleum under the PSC without any prior consent of the Government*".

Relinquishment

In terms of relinquishment, further complications arise due to a new requirement that a Contractor must relinquish the Development Area without any compensation if it does not develop or commence field production within a required 12-month period.

If the CONTRACTOR fails to commence the Development Operations in accordance with the approved Development Plan within 12 months from the date such Plan was approved, or if the time to commence production of the field is later than 12 months as compared to the approved schedule, then the CONTRACTOR must surrender the Development Area and shall not be refunded any expenses, except where such aforementioned tardiness was caused by[2]*:*

- *aforementioned Force Majeure event as stipulated in Chapter XIX; or*
- *PETROVIETNAM's approval.*

[2] Article 4.3 of the Draft Model PSC

This puts a Contractor in a potentially uncertain position where it is difficult to predict whether an approval by PVN will always be obtained (assuming that such approval will not be unreasonably withheld), failing which the Development Area must be relinquished without the Contractor being entitled to any compensation after significant exploration costs would have been incurred.

Under the 2005 Model PSC, a Contractor is required to commence Development Operations as specified in the approved Development Plan within an 18 months period.

It is proposed that this new relinquishment obligation imposed on Contractors be removed.

Development of Natural Gas

In respect of a Commercial Discovery for Natural Gas/CBM, the Draft Model PSC appears to require Contractors to enter into a binding gas sales agreement with PVN or a third party before they appraise the Discovery[3]. In practice, such requirement presents considerable difficulties and should be removed.

Additionally, a Contractor's right to joint marketing arrangements to facilitate the sale of Natural Gas under a long-term gas sales agreement should also be recognised.

In respect of a non-Commercial Discovery, the Draft Model PSC contemplates that a Contractor may retain the non-Commercial Discovery being designated as a Suspended Development Area (subject to the Prime Minister's approval)[4] which might be beyond the end of the Exploration Period pending the development of a gas market.

The draft PSC should clarify that such "*market development phase*" will not exceed seven (7) years from the date of a Contractor's written notice to PVN, with the possibility of an extension to be approved by the Prime Minister, and this period will not count towards the overall term of the PSC.

Management Committee

The voting of the Management Committee (***MC***) is revised as follows[5]:

All exploration and appraisal matters before declaration of the first Commercial Discovery shall be decided by the Management Committee on the basis of a majority vote or as the Parties may otherwise agree.

In our view, the Draft Model PSC should provide for a deadlock mechanism in circumstances where an MC decision cannot be obtained by a majority vote of the parties on certain matters.

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[3] Article 4.6(a) of the Draft Model PSC (which is the reinstatement of Article 6.2.7 of the 2005 Model PSC)

[4] Article 4.6(b) of the Draft Model PSC (which is the reinstatement of Article 6.2.8 of the 2005 Model PSC)

[5] Article 3.8 of the Draft Model PSC

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Tender Procedures

There will be no change to the general rule that a Contractor is "*responsible for the procurement, purchase or lease of all services, materials, equipment and supplies and entering into sub-contracts, service contracts or supply contracts required for the performance of Petroleum Operations under the approved Work Programs and Budgets*"[6].

Nevertheless, a key issue of contention is that the Draft Model PSC proposes significant changes that require a Contractor to obtain prior approval(s) from PVN in respect of its overall tendering plan as PVN attempts to exercise a greater degree of control[7]:

Annually, a CONTRACTOR must prepare an overall tendering plan on purchase and/or lease of services, materials, equipment and supplies and submit same to PETROVIETNAM for approval.

Division into tender packages must be based on the technical nature, ensuring completeness and an appropriate size of tender packages.

Clarifications on the following provisions also need to be sought[8]:

A CONTRACTOR must not divide tender packages into smaller ones in order to avoid the necessity for approval from PETROVIETNAM in accordance with Article 5.1.2(d)(iii). Intentional division of tender packages into smaller ones shall be deemed to be Willful Misconduct or Gross Negligence.

In addition to the above-mentioned general requirements, a Contractor must comply with a new provision when calling for an international tender[9]:

To submit to PETROVIETNAM a tendering plan (including but not limited to the name of the tender package and its price, funding sources, form of selection of contractor, tendering method, time-limit for selection of contractor, form of contract and term for contract performance), tender invitation documents (including but not limited to technical, financial, commercial requirements, and criteria for tendering assessments) for PETROVIETNAM's consideration and approval prior to inviting tenders.

In our view, this involves greater uncertainty and a lengthier approval process for tendering/ procurement rules, while a Contractor prefers a high degree of flexibility. It is proposed that a Contractor is not required to obtain PVN's prior approval for international tenders unless there are major procurement items which do not fall within the scope of the approved ***Work Program and Budget (WP&B)***.

Further, the Draft Model PSC requires that any change to the "legal status" or "current legal situation" of a Contractor must be notified to PVN within sixty (60) days from the effective date of such change. This may also give rise to a Contractor's obligation to apply for the issuance of an amendment to the existing

[6] Article 5.1.2 (d) of the Draft Model PSC

[7] Article 5.1.2 (d)(i) of the Draft Model PSC

[8] Article 5.1.2 (d)(i) of the Draft Model PSC

[9] Article 5.1.2 (d)(iii) of the Draft Model PSC

investment certificate[10].

Local Content

In terms of local content rules, a Contractor should only be required to give preference to the purchase of Vietnamese goods and services in undertaking Petroleum Operations provided that such goods and services are of internationally comparable quality, available at the required time and quantity, and offered at competitive prices.

We recommend that the wording "*in accordance with international standards*" be reinstated in Article 5.1.2(d)(iii) and Article 10.2.2 of the Draft Model PSC.

Foreign Exchange Controls

As regards foreign exchange controls, a Contractor needs to be reassured (especially in respect of major gas development projects) that sufficient foreign currency will be available for conversion from any local currency revenue, and that the Contractor will be entitled to freely remit its income out of Vietnam at any time.

Article 13.2.1 of the Draft Model PSC currently states:

*The CONTRACTOR and the Operator shall, under the terms of this Contract **and in accordance with the applicable Vietnamese foreign exchange laws and regulations**, have the following rights:*

We recommend that the wording of "*and in accordance with the applicable Vietnamese foreign exchange laws and regulations*" be removed.

In addition, in order to circumvent Vietnamese foreign exchange risks on the "*surrender obligation*" of a Contractor, a provision should be inserted into the Draft Model PSC stating that "*a Contractor will be exempt from all legally required or mandatory conversions of foreign currencies into local currency*".

Taxation

Pursuant to the Law on Corporate Income Tax, corporate income tax (***CIT***) rates applicable to petroleum exploration and production operations range from 32% to 50%, depending on each specific project and business establishment[11].

It is proposed that "ring fence" tax calculations be removed, and a Contractor's CIT liabilities be calculated on a consolidated basis for all Vietnam operations if a Contractor is granted multiple PSCs.

The Draft Model PSC contains a more detailed description of other taxes and fees that would be required

[10] Article 5.1.2(z) of the Draft Model PSC

[11] Article 10.2 of the Law on Corporate Income Tax

by a Contractor to pay under Vietnamese law (in addition to royalties, CIT, export duty and VAT), including[12]:

- windfall tax;
- environmental protection fee;
- land lease rentals, water surface fees;
- other taxes, fees and charges; and
- capital gains tax in respect of a Contractor's proposed assignment of a PSC interest.

Bonuses and Data Fees

The Draft Model PSC emphasises bonuses and data fees as non-recoverable costs, and that they will not be tax deductible for the purpose of corporate income tax assessment[13].

It is proposed that various bonuses and data fees payable by a Contractor to PVN under the PSC be tax deductible.

Training

The Draft Model PSC imposes an onerous new obligation that Contractors must pay PVN the equivalent of 0.5% of its annual Petroleum Operations Costs to the Petroleum Scientific Research and Technology Development Fund[14]. This requirement should be removed.

Domestic Market Obligation

A Contractor's domestic market obligation (***DMO***) has been an area of controversy. It was substantially revised in the Draft Model PSC as follows[15]:

Crude Oil produced from the Contract Area must be prioritized for sale on the Vietnamese market at the request of the Government on the basis of the approved annual production plan. The CONTRACTOR and PETROVIETNAM will carry out specific work regarding the annual plan on purchase of Crude Oil.

In addition, PVN may also require a Contractor to sell Crude Oil to PVN "*with an amount exceeding the agreed plan*" (by giving 30 days written notice) in emergency cases at the request of the Government of Vietnam.

[12] Article 7 of the Draft Model PSC

[13] Article 9.6 of the Draft Model PSC

[14] Article 10.1.3 of the Draft Model PSC

[15] Article 17.1 of the Draft Model PSC

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In respect of DMO, we recommend the following:

- a Contractor should only be required to sell its crude oil entitlement to PVN in limited national emergency circumstances;
- the Draft Model PSC needs to provide for circumstances when a Contractor's domestic sale obligations are to be suspended (e.g. when the Government of Vietnam/PVN attains "self-sufficiency" in crude oil);
- the maximum amount of crude oil that a Contractor is required to sell domestically to PVN should be on a pro rata basis with other oil producers in Vietnam and will not exceed the Contractor's share of Profit Oil; and
- the revenue obtained as a result of the forced domestic sales of crude oil should also be based on internationally recognisable prices.

Stabilisation

A significant and contentious change proposed in the Draft Model PSC is the limited scope of economic stabilisation of the contractual relationship between a Contractor and PVN under the PSC. This represents a major challenge to Contractors with only royalties, corporate income tax and export duties being specifically covered[16]. Windfall tax, environmental protection fee and any other applicable taxes and fees that might be imposed on Contractors subsequently have been excluded from stabilisation.

Generally speaking, Contractors needs to be reassured at the time of negotiation of the terms of the PSC with PVN, that both legal and tax regimes will remain unchanged throughout the full term of the PSC, and that all of a Contractor's rights, benefits and interests conferred as at the Effective Date will be "stabilised" from any unilateral adverse legislative changes made by the Government of Vietnam.

It is recommended that in addition to a Contractor's recourse to renegotiate relevant PSC terms, the Draft Model PSC includes a provision in Article 18.1.3 stating the Contractor's right of indemnification to re-establish the economic equilibrium of the PSC.

Further, the Contractor should have the right to submit any dispute between the parties in connection with the interpretation and enforcement of the stabilisation clause to binding and final international commercial arbitration pursuant to Article 15.1.2 (Arbitration) of the Draft Model PSC.

In addition to stabilisation, please note that legal protection is also available under Vietnam's national investment laws to protect foreign investors from subsequent changes in the law.

In particular, Article 11.2 of the Investment Law, which is applicable to all investments, effectively provides for a statutory investment protection regime, as follows:

"If a newly promulgated law or policy affects adversely the lawful benefits enjoyed by an investor prior to

[16] Article 18.1 of the Draft Model PSC

the date of effectiveness of such law or policy, the investor shall be guaranteed to enjoy the incentives provided for in the investment certificate or there shall be resolution by one, a number, or all of the following methods:

- *continuation of enjoyment of benefits and incentives;*
- *deduction of the loss from taxable income;*
- *change of the operational objective of the project;*
- *consideration shall be given to payment of compensation in certain necessary circumstances."*

Termination

The Draft Model PSC remains unchanged to the extent that a Contractor may relinquish its rights and be relieved of its obligations in the PSC by giving a prior written notice to PVN "*if there are circumstances that do not warrant continuation of the Petroleum Operations*". However, the requirement of "*not earlier than 90 days before the end of Phase 1*" has been removed.

The Draft Model PSC also introduces additional instances for termination by PVN[17]:

- Contractor(s) (collectively) becomes insolvent or is dissolved; and
- a Contractor ceases Development Operations for a continuous six (6) months period or ceases Commercial Production for three (3) continuous months, except for cessation (i) with prior approval from PVN, (ii) pursuant to a decision of the Government, or (iii) for reasons of force majeure.

With respect to termination for material breach of the PSC, the Draft Model PSC defines the concept of "*material breach*" as[18]:

- failure to make any cash call or other payment within 30 days from the due date; and
- failure to perform or comply with any material obligations which seriously impact upon the performance or economic, commercial objectives of the PSC (without such failure being remedied within 30 days of receipt of notice by the Non-Defaulting Party).

We recommend that termination by a Contractor should also include the following circumstances:

- where no Commercial Discovery is made in accordance with Article 2.1.2 (specific reference to this event is required in Article 16 of the Draft Model PSC); and
- upon prolonged force majeure (by written notice to PVN).

We propose that any disputes between the parties in relation to the grounds for termination should be referred to arbitration.

[17] Article 16.1 of the Draft Model PSC

[18] Article 16.2 of the Draft Model PSC

Early termination by a Contractor (upon its full discharge of obligations and responsibilities in the PSC and the Petroleum Law) will be effective from the date when the MOIT issues a separate "*ministerial decision*" to expressly approve such termination.

PVN's Pre-Emptive Rights

The statutory pre-emptive rights afforded to PVN under Article 24 of the Petroleum Law applies to a transfer of a PSC interest by a Contractor to a third party.

The Draft Model PSC should clarify applicable timelines and procedures with which PVN must comply if it decides to exercise or waive its statutory pre-emptive rights in such circumstances.

Moreover, any assignment made by a Contractor to an Affiliated Company for the purpose of Article 12.2.1 of the Draft Model PSC should be free from Vietnamese capital gains tax or any other tax liability.

As regards lender security, the Draft Model PSC contains no provision on a Contractor's ability to assign the PSC by way of security.

Change of Control

The Draft Model PSC contains new restrictions on the change of control of a Contractor.

It expressly contemplates that a change of ownership of a Contractor constitutes an "*assignment*"[19] which triggers PVN's statutory pre-emptive rights and a requirement to obtain the Prime Minister's approval.

Certain limited exceptions apply, including "*restructuring*", "*internal financial arrangements*" or "*consolidation*" of a Contractor, however such terms are yet to be defined.

Please note that there might also be potential Vietnamese tax implications on capital gains in respect of such an offshore transaction.

Abandonment

The Draft Model PSC introduces a new provision on a Contractor's funding obligations in respect of abandonment costs[20]:

Notwithstanding approval of the Abandonment Plan, no later than 12 months from the First Production Date, the CONTRACTOR, via the Operator, must temporarily establish a fund ensuring financial obligations for Abandonment Operations in accordance with the field abandonment plan of the approved Field Development Plan.

[19] Article 12.2.3 of the Draft Model PSC

[20] Article 14.3.3 of the Draft Model PSC

However, this provision is inconsistent with Article 22 of the Prime Minister's Decision 40/2007/QD-TTg which specifically requires the abandonment fund to be held and managed by PVN. No guidance has been provided regarding PVN's liabilities in respect of its management of this fund.

Unitisation

Unitisation is only required when any proven accumulation of Petroleum extends beyond the Contract Area into one or more adjacent area(s) held by other parties.

A Contractor, PVN and the relevant party(ies) of another block must agree to secure unitisation agreement(s). The unitisation agreement(s) must be endorsed by PVN and then approved by the Prime Minister within 18 months from the date on which the "overall appraisal report" on the petroleum reserves of the Discovery is duly approved by the Government[21].

The Draft Model PSC also introduces a new provision on cross-border unitisation[22] which expressly contemplates the joint development and production of a common reservoir between Vietnam and a neighbouring country.

It is proposed that the Draft Model PSC should clarify that no unitisation will be considered to be an assignment of the PSC by a Contractor.

Looking Ahead

The Draft Model PSC is yet to be finalised, and the MOIT is seeking written submissions from various IOCs. The MOIT has proposed that the New Decree will be promulgated by the Government in late January/early February 2013.

In our view, it is important that the Draft Model PSC takes into account the comments and legitimate concerns expressed by IOCs. Moreover, the tight timeframe proposed for promulgation of the New Decree should also be considered carefully.

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[21] Article 18.2.1 of the Draft Model PSC

[22] Article 18.2.2 of the Draft Model PSC