In a newsletter dated 30 September 1993, the Nieuwezijds Collective advised its clients within the danger zone to accept the offer. The Bijlmermeer Collective used its veto power effectively: they went over to Washington and succeeded in getting higher compensations for 20 clients in the first two categories.

'We were the pain in the ass of the Speiser firm. We discussed each individual claim one by one, and ignored their offer of a lump sum for our expenses.'

It remains an open question to what extent the law firms of Trenité van Doorne and Pels Rijcken were able to free ride on the efforts of the Podhurst and the Speiser connection, but it is quite certain that their clients did not have to pay percentages of the claim awarded. A tricky legal question was whether the clients on welfare would have to pass on their compensations to the State. According to legal theory the answer is in the affirmative, but the authorities turned a blind eye to this: they thought it better not to add to the hardship of being a victim by debt collecting.

At the time of writing, several of the Dutch attorneys interviewed have tried to get compensation for clients who were outside the danger zone or who have suffered from post-traumatic stress syndrome. As the distinction drawn between inside and outside the danger zone is unknown in Dutch law, some court-awarded compensation might be expected, but based only on the low Dutch standards.

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India

Legal aspects of oil and gas projects for foreign investors

by Dimple S Bath

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This article discusses the current legal and regulatory framework of the oil and gas sector in India and looks at the main factors within this framework that private investors, in particular foreign investors, should ideally take note of, including issues such as production sharing, canalisation, pricing and taxation. The Government of India has responded to globalisation and the concerns of foreign investors by making significant efforts towards further liberalising policies and guidelines governing this sector. The steps that it has taken towards deregulation are considered and in the light of these, some conclusions are drawn.

BACKGROUND

The distinct advantages of oil and gas over other forms of energy have led to their increasingly important role in displacing coal and other hydrocarbons as fuel in various sectors, particularly in the power sector. Oil contributes 40 percent of the world's energy sources, and India (along with China) accounts for approximately 12 per cent of global energy demand; natural gas contributes nearly 8 per cent to the primary energy supply in the country.

There is vast unexplored terrain in India: over 50% of its sedimentary basins are totally unexplored, approximately 35% of these basins are moderately or poorly explored, and fields offered in the past for acreage have been small and marginal.

Development during the 1980s saw a rapid rise in indigenous crude oil and natural gas production. The production from the Bombay High offshore basin contributed to the increase in oil production. In 1988–89 the production from the Bombay High region was 21.7m tonnes, accounting for 64 per cent of the total crude oil produced in the country, and the gross production of its associated and free gas accounted for about 7 per cent of the total gas produced in India in that period. Since the early 1980s the recoverable reserves of natural gas doubled from 352 billion m^3 to over 707 billion m^3. The net production of natural gas in 1994–95 alone was 17.3 billion m^3 and by the end of the century the power sector is expected to emerge as the largest single user of natural gas.

REGULATORY FRAMEWORK

To understand the legal aspects of oil and gas projects in India it is important to appreciate the manner in which this area is regulated and dominated by the two major public sector enterprises: Oil India Limited (OIL) and the Oil and Natural Gas Corporation (ONGC). Both these undertakings are state-owned companies engaged in the exploration, development and production of hydrocarbon resources, accounting for approximately 92 per cent of the total oil and gas produced in the country. Their role in management and decision making, particularly with regard to private investment and along with that of the Ministry of Petroleum and Natural Gas (MPNG), was further strengthened in 1974, when this sector was nationalised.

Refining and marketing of oil is conducted by several public sector companies including the Indian Oil Corporation Limited (IOC) and Hindustan Petroleum Corporation Limited (HPCL). The state owned enterprises do not seem, at present, keen to give up acreage and in fact ONGC is still contesting existing awards of acreage on the grounds that with their indigenous knowledge and expertise they are potentially the best operators. Furthermore, these undertakings are currently, and quite prudently, awaiting the Administered Price Mechanism (APM) to be dismantled before giving up acreage, to ensure that they can compete on equal terms with private companies such as Bharat Petroleum Corporation Limited (BPCL), Madras Refineries Limited, Cochin Refineries Limited and the Indo-Burma Petroleum Company Limited. The Gas Authority of India is the main regulator of the transportation and marketing of gas. The newly conferred 'Navratna' status to all the oil sector state enterprises should allow these undertakings more autonomy and independence from the Central Government and the Department of Comptroller and Auditor General.

GENERAL LEGAL ISSUES

The 1980s and early 1990s in India witnessed the emergence of large oil and gas projects with cross-border and structured transactions to support these projects. The legal aspects of such projects and their financial needs are even more emphasised by the environment in which they are currently being developed, i.e. one of high demand, relatively low savings rates and developing domestic capital markets.

Of specific interest to foreign businesses keen to invest in the oil and gas sector is government policy in respect of the establishment of fully foreign-owned companies or representative or project offices for the principal purpose of managing and administering business in India and of entering joint ventures for actual operations. The law provides enterprises in the oil and gas sector with certain import duty exemptions, exemptions from the requirement for certain licenses on the importation of machinery and equipment, tax exemptions for certain specified periods on income invested in projects in these sectors and, furthermore, the possibility of being able to employ foreign business and technical staff without cumbersome consents and clearances.

Other laws, regulations and policy which will impact on a foreign investor doing business in the oil and gas sector in India broadly include those relating to:

- investment criteria for foreign and domestic companies;
- consents and approvals from authorities such as the Foreign Investment Promotion Board (FIPB), the Cabinet Committee for Foreign Investments, the Reserve Bank of India (RBI), the MPNG and the Petroleum Investment Board, etc.;
- repatriation of profits and capital;
- personal and corporate taxation;
- protection of foreign investment;
- export-import and customs rules and procedures;
- the framework and legislation applicable to pledges, loans and guarantees;
- terms and conditions of production sharing contracts;
- foreign currency transactions and exchange control regulations;
- land acquisition and state property privatisation;
- procedures and rules for the resolution of business disputes;
- petroleum regulations;
- environmental and safety policies; and
- financing oil and gas projects in the Indian context.

It is not possible here to discuss in detail production sharing, acreage, canalisation, pricing taxation, the new exploration licensing policy, financing, pipelines and liquified material gas projects, but a summary of the principal issues relating to each of those issues is provided below.

PRODUCTION SHARING

The operative and fiscal regime of oil and gas projects is governed by the production-sharing contract. At present, private and foreign ownership in the oil and gas sector in India is allowed in joint-venture arrangements with one of the state-owned companies on a production-sharing basis. Entry into the sector with regard to exploration, prospecting and extraction rights has to date been by concessionary agreements concluded between the investors and the government, after the investors have completed a competitive bidding process administered by the MPNG.

FOREIGN INVESTMENT IN THE OIL AND GAS SECTOR	
Activity	**Foreign Equity Allowed**
Exploration	Up to 100% in the case of blocks offered under the new exploration licensing policy and already discovered small fields; up to 60% in the case of unincorporated joint ventures with state-owned companies; and 51% for incorporated joint ventures in the case of medium-sized fields.
Export-orientated refineries	Up to 100% foreign equity allowed.
Domestic tariff area refineries	Up to 26% in joint ventures with state-owned oil companies; up to 49% has been allowed in some joint ventures with private Indian companies.
LNG Terminal	Up to 74% is allowed as in the integrated LNG terminal and associated power plant proposed by Total and HPCL; the FIPB has also approved an 83.25% stake for Trans-Asia Petroleum in an LPG terminal and marketing venture. To an extent, proposals for foreign investment in the LNG sector are being decided on a case-by-case basis and this may continue until specific guidelines for the sector are formulated.
Infrastructure related to marketing	Up to 74% is automatically approved by the RBI for investment in ports.
Trading and marketing	Up to 74%; foreign-invested companies allowed to market LPG, SKO, low speed heavy sulphur, lubricants, paraffin wax, refined petroleum coke, calcined petroleum coke, toluene, benzene and hexane; they may not sell products reserved for the state-owned oil companies under the APM (a recent application by Caltex-IBP to market all petroleum products was turned down).
Holding companies	Up to 100% in subsidiaries engaged in investment/financing or market studies and project formulation.

Until now, the main features of production sharing contracts and terms offered by the government have included:

- a 25-year term for crude oil extraction with the maximum period for exploration being no more than 7 years from the effective date. For gas exploration a period of 35 years is allowed, the longer period being on account of the fact that an initial gas discovery may not in itself be commercially exploitable without further exploration and discovery, infrastructure arrangements and/or market evaluations;
- no royalty;
- profit oil and/or profit gas (oil or gas produced and saved from the contract area and not used in petroleum operations) tied to post-tax profitability;
- the government's share to rise as production crosses pre-determined;
- the government to have first option to purchase up to 100 per cent of crude oil produced, at international market;
- certain exemptions from customs duty on imports;
- payment of corporate tax by the contractor on its share of oil or gas;
- the risk of exploration to be borne by the contractor;
- sharing of development and production costs between the government and the contractor in proportion to the equity contributed by each.

Other features of the production-sharing contract include: provisions addressing title to assets and technical data, appraisal of commercial discovery, notification periods, minimum work obligations, liquidated damages, completion of work obligations, the scope of force majeure and its impact on extensions, completion guarantees and verification of completion, rights to sell or market gas (if at all), creation of infrastructure and third -party access to such facilities including pipelines, their construction, tariff, title and operation, retaining profit up to a certain percentage of the total marketable oil or gas, sales for domestic consumption, definition of costs recovery, prices and valuation of petroleum and termination events. A provision that contractors often seek to include in the production-sharing contract relates to appropriate indemnities by the government regarding loss and damage to operations resulting from wrongful acts of the government.

Despite terms such as these, which are generally regarded as reasonably favourable, both foreign and domestic private interest in this sector has been slow to materialise. Several issues have contributed to this: offers of fields of low prospectivity to the private sector while more promising areas are reserved for national oil companies to explore; lack of adequate seismic field data; delays by the government awarding bids, granting approvals and finalising contracts; limited involvement regarding downstream functions for contractors; and unclear profit oil/gas sharing formulae and cost recovery provisions. These, therefore, appear to be the areas where appropriate government action should be taken.

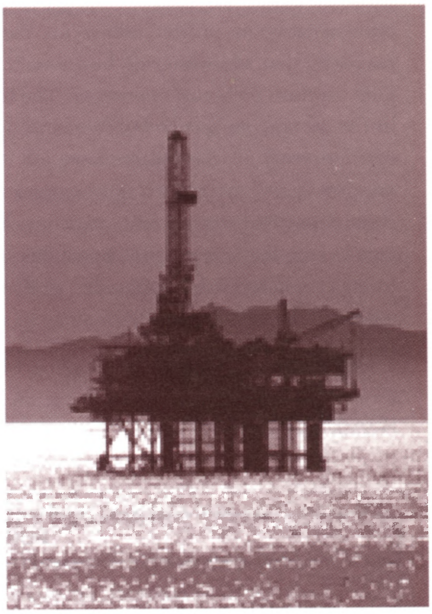
Changes have also resulted in the production-sharing contract as a result of the new exploration licensing policy announced in late 1997. Current production sharing arrangements allow for ONGC to elect for 10 per cent participation during the exploration stage and often this is taken up by the ONGC. In the event that a commercial discovery is made, ONGC can automatically participate up to a further 30 per cent. Under the new model contract participation by the ONGC is not mandatory.

With regard to import duties under the new model, public sector undertakings will have the advantage of not making a payment of 30% import premium on imported goods as they have been doing until now. Production sharing arrangements for foreign companies allow for free importation

Other changes which have taken place in the current production-sharing contract include abolishment of cess payments to state petroleum development funds. However royalties will now be payable by both the private and public sector companies instead of ONGC, on behalf of the contractor, on the international value of the crude.

CANALISATION

It may be useful to mention here the canalisation procedure which until now has been observed for import of a majority of petroleum products. This takes place through certain public sector oil companies and in accordance with the Indian export-import policy. The process works in the following manner: first, the company proposing to import the crude oil makes a requisition to the canalisation agent specifying the quantity of the product to be imported; secondly, the canalising agency will import the product from the foreign supplier. Thereafter, the canalising agency will sell the product to the importer by making a 'high seas' sale, designed to avoid the imposition of sales tax on the transaction. Payment for the product can be made by the importer either opening a letter of credit in favour of the canalising agency which, in turn, opens a back-to-back letter of credit in favour of the foreign supplier, or opening a letter of credit directly in favour of the foreign supplier. The price payable for the bulk quantity of the crude oil to be imported is negotiated by the canalising agency with the foreign supplier on the basis of the prevailing international price for the crude. A nominal service charge is payable by the importer to the canalising agency as a fee for the canalising services rendered to the importer.



However, with the proposed reforms, discussed later in this paper, there is the distinct possibility that the canalisation process will be dismantled. Investors should therefore be aware of this likelihood and provide for it in project documentation.

ADMINISTERED PRICING MECHANISM

An important constituent of the oil and gas sector in India is the APM, which requires certain petroleum products to be sold at certain prices and to such entities designated from time to time by the government . However, the mechanism is being dismantled and some of the issues an investor will need to consider in those circumstances include product pricing, preferential rights, if any, of state owned enterprises to purchase products, and the prices at which such purchases can be made. The sale, retailing and marketing of products, entitlement of the foreign company to utilise the state-owned enterprises' logistic and marketing facilities for the sale and distribution of products in the local and/or export market, the extent of interference by the state oil companies in the sale or disposal of the product and product off-take guarantees will also need to be considered.

TAXATION

Foreign contractors have, until now, had to pay corporate tax at a basic rate of 48 per cent. However, the equivalent rate for ONGC, is 35 per cent. These rates were introduced in the Indian Budget for 1997–98, announced by the Finance Ministry, when they were reduced from 55 per cent to 48 per cent for contractors and from 45 per cent to 35 per cent for ONGC. Despite much speculation over the tax rates that will apply to new contracts that are awarded under the new Exploration Licensing Policy, it seems that equal tax rates for public sector corporations and private companies is highly unlikely. On the other hand, a seven-year tax holiday is being offered as an incentive by the government which, for small fields, where the plateau production period comes within this timeframe, may prove to be very attractive.

Revenue expenses are generally deductible in the year in which they are incurred. Deduction is also allowed for indirect and head office expenses, up to a limit of 5 per cent of the expense. It is possible to carry forward unabsorbed losses and depreciation for 8 years. Furthermore, relevant guidelines specify different rates of depreciation for plant and machinery that is underground (100 per cent) and above ground (25 per cent). Two points that should be noted at the very outset are that production-sharing contract participants are assessed individually, and not as an association of persons, and that Indian tax laws apply up to 200 nautical miles from India's base line.

Up to 100 per cent of revenue and capital expenditure is allowed for cost recovery. The production-sharing contract classifies expenditure into three categories: exploration, development and production and there is separate assessment for expenses incurred towards site restoration.

Exploration costs, including unsuccessful exploration costs, are deductible in full, and this includes drilling costs. For physical assets, depreciation is allowed but for other expenses, deduction is not allowed until the commencement of business.

For production-sharing contract participants all materials and machinery are exempt from import duty under certain conditions. There is also no signature, discovery or production bonus payable to the government. A 12.5 per cent royalty payment to the government is required to be made for onshore fields, 10 per cent for offshore fields and 5 per cent for deep offshore for the first 7 years in upstream activities, but there are no licence fees payable for offshore areas.

In the downstream sector, there is normal tax computation subject to the Minimum Alternative Taxation principles and the tax holiday will be available depending upon the district in which the undertaking is set up. For example, in an undeveloped district falling under a category stipulated as Category A, a tax holiday of 100 per cent per cent will be available for the first 5 years and 30 per cent for the next 5 years; similarly Category B calls for a 100 per cent tax holiday for the first 3 years, and for the next 5 years thereafter the tax exemption offered is 30 per cent.

Other taxes will also need to be considered in situations where, for example, crude oil is being imported, refined and supplied to an Indian company. In such circumstances sales tax would be payable in the state in which the refinery processing the crude is based and where the supplier is foreign, income tax will be payable if the latter has a permanent establishment in India or if title to the oil passes on Indian territory.

In addition to the above general legal issues there are a number of specific guidelines, policies, rules and laws that relate to the oil and gas sector which need to be taken into account when implementing a project. Together these form the basic framework and delineate the technical parameters of projects in the sector. The Petroleum Act of 1934 controls the import, tanker transport, pipelines and storage of petroleum and generally specifies rules for its production, refining and licensing. There is also legislation regarding natural gas, oil pollution and damages, pipelines, the acquisition of right of use of land and control orders relating to petroleum products.

NEW EXPLORATION LICENSING POLICY

The announcement of the new exploration licensing policy in 1997, and efforts made towards its implementation since the beginning of 1998, are encouraging. The policy provides incentives to increase the domestic supply of oil and gas in order to meet the growing domestic demand for oil and seeks to decrease the country's dependence on imported petroleum products. The principal highlights of the policy include:

- no automatic state participation in commercial discoveries;
- companies, including ONGC and OIL, being paid the international price of oil for new discoveries made under the policy;
- royalty payments for exploration in deep waters being charged at half the rate for offshore areas for the first seven years after commencement of commercial production;
- freedom to market crude oil and gas in the domestic market;
- a tax holiday being available for a period of seven years after commencement of commercial production;
- state companies such as ONGC to have the same duty concessions on import of capital goods under the new exploration licensing policy as private company production sharing contracts;
- cess levied under the Oil Industry Development Act of 1974 being abolished for new exploration blocks; and
- tax stabilisation through a separate petroleum tax code approved in principle by the Finance Ministry, which codifies all the existing fiscal incentives provided for oil exploration. It will also give the investor a composite picture of tax levies and concessions.

TOWARDS COMPLETE DEREGULATION

To anticipate and appreciate the legal aspects of oil and gas projects in the Indian context it is important to understand the legal and fiscal reforms and the efforts that are being made towards the structural redesigning of the oil and gas industry.

These reforms are aimed at revising the incentive structure, creating a regulatory framework to promote transparency and restructuring state-owned enterprises in order to promote competition. They are likely to be effected gradually and spread over three phases (each taking, it is understood, approximately two to three years). The approval of the high-level Cabinet Committee on Economic Affairs to these proposals is currently awaited. The MPNG has also directed that the reforms ought to be accompanied, over a period of time, by full freedom for oil producers to market their products either directly or indirectly whilst giving the benefit of competition to the consumer.

The R-Group has been set up to advise on the restructuring of the oil and gas sector. Out of many policy issues being considered by this group and the MPNG some are:

- creating a regulatory framework to promote transparency and competition and reducing the extent of state participation (in terms of political interference);
- ensuring 'fast-track' decision making (by the establishment of an empowered negotiating committee);
- co-ordination of intensive and extensive exploration in known basins;
- encouraging extensive exploratory efforts in lesser-known areas;
- encouraging exploratory inputs in areas with previously encouraging results;
- a phased exploration programme of the deeper continental shelf;
- promoting the efficient use of capital and resources;
- development of basic infrastructure to improve transport and storage facilities;
- faster conclusion of project documents and simplification of procedures;
- liberalising the market and consumer prices;
- reviewing the tariff and pricing policy, reducing import duties further and abolishing subsidies.

CONCLUSION

It is hoped that the policy of deregulation adopted and encouraged by central government, along with the recommendations of the MPNG, the DGH and the R-Group, will bring about the much-needed boost to India's oil industry and facilitate new investments. The aim is to precipitate increased private participation, ease controls, decrease bureaucratic delays and cumbersome approval procedures, and bring about flexibility in the terms offered by the government to private investors for setting up oil and gas ventures.

Fundamental weaknesses in the system need to be overcome: the non-competitive market structure, large capital requirements which cannot be met by the public sector or the domestic capital market, several pricing, structural and market inefficiencies, weak political institutions, patronage, and lack of accountability and transparency. But efforts continue to be made. In the budget for 1997/1998, infrastructure in general and the oil sector in particular found a special place. Oil exploration was included in the category of infrastructure and will be able to benefit from the provision of a five-year tax holiday granted under the Indian income tax laws. Pressure groups and campaigners in the environmental protection lobby are beginning to see the strategic importance of major projects to the Indian economy and have set aside flimsy claims.

If the role of the public sector continues to be decreased, and an efficient operating environment coupled with a progressive fiscal regime are encouraged, then it may prove possible to do away with excessive regulation, the result being a competitive, international environment.

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