

Mongolia revises its legal framework for the petroleum sector



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Mongolia is nearly entirely dependent on the import of finished petroleum projects. Given the risk to the country's national security posed by this dependence, Mongolia has been trying to develop its domestic petroleum sector by attracting foreign investors through a revision of its legal framework and by introducing tax incentives for oil refineries.

This note concentrates on the revised version of the Petroleum Law, which is the most recent and fundamental revision to Mongolia's petroleum laws. In addition, we also provide a brief update about other significant changes to the legal regime governing petroleum products.

1. New Petroleum Law

The Mongolian legal and regulatory regime divides the petroleum sector into two subfields, viz., "petroleum" ("газрын тос" in Mongolian), or upstream activities (extraction and drilling), and "petroleum production" ("газрын тосны бүтээгдэхүүн") or downstream activities (finished products and distribution).

On 1 July 2014, the Parliament of Mongolia approved the revised version of *Law of Mongolia on Petroleum* (the "Petroleum Law"), which came into effect on 20 July 2014. The Petroleum Law sets out a comprehensive legal framework for the petroleum sector - the former petroleum law enacted in 1991 had been criticised as being out of date.

1.1 General content

The Petroleum Law distinguishes between two main categories of petroleum products, being: (i) "oil" ("газрын тос") and (ii) "unconventional" oil ("уламжлалт бус газрын тос"). Oil refers to crude oil and natural gas in addition to refined petroleum, whereas unconventional oil refers to oil sands and oil shale.

Under the old regime, a business entity needed to obtain a licence in order to undertake "petroleum-related activities". Several activities in connection with petroleum fell under the category of "petroleum-related activities", namely (i) exploration, (ii) preservation, (iii) production, (iv) processing, (v) transportation, (vi) storage, and (vii) trade. It was not clear in the former legislation whether a legal entity that intended to engage in just one of these activities needed to obtain a licence that would cover all petroleum-related activities. This, in turn, caused complications in the approval process for a company seeking to engage in petroleum sector activities.

As a welcome development, the new Petroleum Law identifies just three types of petroleum-related activities: (i) research, (ii) exploration, and (iii) extraction. Exploration and extraction

activities for oil and unconventional oil are subject to licensing procedures under the Petroleum Law whilst other activities, such as research and the storage and transportation of petroleum, are subject to the issuance of permissions or approvals from the relevant authorities. Such permissions ("зөвшөөрөл") usually involve a simple approval process, whereas licences ("тусгай зөвшөөрөл") involve more complicated procedures whereby applicants must satisfy more rigorous requirements provided under the relevant laws and regulations.

The Ministry of Mining and the Petroleum Authority of Mongolia ("PAM") are the two primary regulators for the petroleum sector. The Ministry of Mining is responsible for policy issues, the issuance of licences and organising tenders for exploration sites. PAM is the main implementing authority responsible for matters such as concluding production sharing agreements (as authorised by the Cabinet), approval of annual plans, and the supervision of fee payments.

1.2 Contractor, operating company and subcontractor

The Petroleum Law sets out and defines separate terms for "contractor", "operating company" and "subcontractor". A "contractor" is defined as a company which has entered into an agreement to conduct oil and/or unconventional oil exploration or extraction activities in the territory of Mongolia. "Operating company" is defined as "a contractor's company" incorporated and registered as a taxpayer in Mongolia which shall conduct the exploration and extraction activities. "Subcontractor" is defined as a company incorporated and registered as a taxpayer in Mongolia to conduct certain petroleum-related activities in accordance with an agreement concluded with a contractor or an operating company. Operating companies and subcontractors must be Mongolian-incorporated entities, whereas contractors can be foreign companies. It is not clear whether an operating company must be a direct subsidiary of the contractor, or simply an affiliate of some kind. It seems that some form of direct equity link between these entities will be required.

1.3 Research and Production Sharing Agreements

The term "research" ("эрэл") is defined as "geological, geochemical and geophysical research conducted in order to determine the presence and condition of oil and unconventional oil in a certain area".

Research is not a licensed activity in itself. The Petroleum Law provides that a legal entity wishing to conduct research must submit a request to PAM, which, in turn, should respond within 30 days of the submission of the request. However, the Petroleum Law does not provide clear provisions as to

whether a foreign company without a subsidiary in Mongolia can make such request. In theory, a foreign company may not be able to make such request, as the Petroleum Law uses the general term "legal entity" ("хуулийн этгээд"), which under the Civil Code of Mongolia is a defined term used for a Mongolian-incorporated legal entity. Conversely, in our view it is arguable that a foreign company could make such request based on analogies with other provisions of the Petroleum Law - for example, a foreign contractor can enter into a production sharing agreement with PAM after the completion of research activities.

A research contract may have a term of no more than three years. A company engaged in research must prepare a performance report and obtain an opinion from PAM on the report before entering into a production sharing agreement. Within 60 days of PAM's issuance of its opinion on the performance report, the company needs to submit a request to PAM to conclude a production sharing agreement. The Petroleum Law further requires that the company must submit to PAM a draft production sharing agreement containing certain prescribed provisions¹, but it is not clear whether such draft agreement must be submitted along with the request to conclude a production sharing agreement. The production sharing agreement may take several months to conclude as the process involves the completion of negotiations with PAM, the procurement of an approval from the Ministry of Mining, and the issuance of an authorisation from the Cabinet.

1.4 Exploration

The Petroleum Law defines the term "exploration" ("хайгуул") as "geological, geochemical, geophysical activities, drilling and test extractions conducted in order to explore an oil deposit and determine the amount of its reserves".

The Ministry of Mining will issue an exploration licence to a Mongolian company that has entered into a production sharing agreement with PAM. Alternatively, an exploration licence may be issued to a company that has won a bid for a reserve where PAM and a company conducting research have not been able to conclude a production sharing agreement. The company's application to the Ministry for an exploration licence must include supporting materials, such as a copy of the production sharing agreement, an environmental impact assessment report, an annual work plan, and evidence that an environmental bond has been deposited in an escrow account with a Mongolian commercial bank.

The term of an oil exploration licence may be no more than 8 years and can be extended twice by up to two years for each extension. Unconventional oil exploration licences are issued for a term of no more than 10 years which can be extended once for a maximum of a further five years.

The exploration licence holder is obliged to inform PAM if it discovers oil and must register the well within 15 days of the discovery. Within 90 days of the initial registration, the exploration holder must provide notice to PAM if the well is a

"discovery well" ("нээлтийн цооног"), which is simply defined as a well where the exploration licence holder has discovered an oil reserve. Upon registration of the discovery well, the exploration licence holder has a further 90 days to submit assessments and budget plans for the well for PAM's approval. Finally, upon completion of the assessment activities, the exploration licence holder has a further 90 days to submit to PAM an assessment report along with information on economic viability.

The Petroleum Law provides that the exploration licence holder can conduct exploration tests ("олборлолтын туршилт") for a period of up to 180 days. However it is not clear when this exploration test period commences. After the expiry of this period, the well must not be used again until the commencement of commercial extraction.

1.5 Extraction

The term "extraction" ("ашиглалт") is defined as "extraction site development and the extraction of oil and unconventional oil".

Extraction is also a licensed activity. Within 90 days of the expiry of the exploration term, an exploration licence holder must present a reserve report to the Ministry of Mining in order to obtain its approval of the reserve. The Ministry of Mining will approve a reserve on the basis of an opinion issued by a committee formed under the Ministry and PAM. Within 30 days of such approval, the exploration licence holder must submit an application for an extraction licence along with supporting documents to the Ministry of Mining.

The term of an oil extraction licence may not exceed 25 years and can be extended twice by up to five years for each extension. The term of an unconventional oil exploration licence can be no more than 10 years and can be extended once for a maximum extension of five years.

The Petroleum Law provides that extraction licences can be also issued by way of open tender in six different circumstances, such as where there the exploration activities were funded by the state or where an exploration licence holder does not submit an application for extraction licence.



¹ Article 17.3 of the Petroleum Law

1.6 Fees, expenses and product sharing

The Petroleum Law sets out the different fees for petroleum exploration and extraction. These include:

Licence fee	<u>Exploration licence:</u> <ul style="list-style-type: none"> • US\$ 3 per square kilometre for initial term; and • US\$ 8 per square kilometre for any extension period <u>Extraction licence:</u> <ul style="list-style-type: none"> • US\$ 100 per square kilometre for initial term; and • US\$ 200 per square kilometre for any extension period • both fees payable annually; • fines if fees not paid on time
Royalty fee	<u>Oil and gas:</u> <ul style="list-style-type: none"> • 5 - 15 percent of extracted crude oil and gas <u>Unconventional oil:</u> <ul style="list-style-type: none"> • 5 – 10 percent [of extracted unconventional oil]²
Recovery cost and cost oil	<ul style="list-style-type: none"> • the recovery cost will be the cost oil in the amount approved by the state audit and agreed under the production sharing agreement; • the cost oil will be up to 40 per cent of the total oil after deducting the oil used to pay the royalty fee; and • the applicable amount of cost oil for unconventional oil will be determined by a specific regulation
Product Sharing	<ul style="list-style-type: none"> • profit oil will be shared in accordance with the terms of the production sharing agreement

² It is not clear from the Petroleum Law about the basis for the 5 - 10 per cent royalty fee. By analogy to the provisions relating to conventional oil, we assume that this 5 - 10 per cent is based on the total amount of extracted unconventional oil.



2. Recent Changes to the Petroleum Products Law Regime

The *Law of Mongolia on Petroleum Products* enacted on 1 July 2005 as revised (the "**Petroleum Products Law**") defines petroleum products as "all types of fuel products, special liquids, combustible gas, lubricating materials, bitumen, black oil and other products that are produced through the refining of petroleum and other chemical compounds."

The Petroleum Products Law provides five sub-classifications of activities in relation to petroleum products, being: (i) import; (ii) production; (iii) trade; (iv) transportation; and (v) storage. The import, production and trade of petroleum products requires a licence, whereas transportation and storage activities must be carried out in compliance with the Petroleum Products Law and relevant rules and regulations issued by PAM, but without the need for a specific licence. Furthermore, on 7 February 2013, an amendment was made to the Petroleum Products Law requiring an additional licence for the retail trade of petroleum products, which until such time was an unlicensed activity.

The Ministry of Mining approved the *Specific Regulation of Petroleum Products Licences by Ministerial Order #171* on 29 August 2013 ("**Regulation**"), although the Regulation was only publicly available from the end of November 2013 following registration with the Ministry of Justice. Pursuant to Article 2.2 of the Regulation, a Mongolian company must obtain a separate licence in order engage in (i) the importation of petroleum products, (ii) retail trade, and (iii) wholesale trade.

In addition, the Regulation stipulates that licences are to be issued to a Mongolian company, rather than to the facility itself as under the previous regime. However, a licensed Mongolian company is in any event required to register its fuel stations and storage facilities with PAM. Each registered facility or fuel station must be identified in the company's wholesale or retail licence.

3. Conclusion

The long-awaited revised version of the Petroleum Law is an important step in the improvement and development of the petroleum sector in Mongolia. In addition to the *Law of Mongolia on Investment* adopted in 2013 (which replaced the controversial *Law of Mongolia on the Regulation of Foreign Investment in Business Entities Operating in Sectors of Strategic Importance*), it is another positive step in attracting more investors, foreign and domestic alike, into the petroleum sector.

Anthony Woolley, Senior Associate
anthony.woolley@hoganlovells.com
+976 7012 8904

Erdenedalai Odkhuu, Associate
erdenedalai.odkhuu@hoganlovells.com
+976 7012 8913

If you would like further information on the Petroleum Law and Petroleum Products Law please contact a person mentioned below or the person with whom you usually deal:

Contacts

Michael Aldrich, Partner
michael.aldrich@hoganlovells.com
+852 2840 5049

Chris Melville, Partner
chris.melville@hoganlovells.com
+976 7012 8910

www.hoganlovells.com

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