FOREIGN INVESTMENT IN UPSTREAM OIL AND GAS IN CHINA (PART 1)

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I INTRODUCTION

For decades, Chinese government has been continuously favouring foreign investment in the upstream oil and gas industry in China, although there isn't a comprehensive legal and regulatory regime available that governs the industry. This article is going to go through the many legal and regulatory framework governing the oil and gas industry in China, the considerations that have to be taken into by foreign investors and also the current and latest developments in the oil and gas industry.

It should be noted also that the development of China's economy and the Chinese energy market is constantly hindering each other. As will be discussed, China has been active in the development of shale gas as a new energy source, although it is still too early to say how far it can go.

II LEGAL AND REGULATORY FRAMEWORK

China's legal and regulatory framework for the upstream oil and gas industry consists of comprising pieces of legislations and unorganized government authorities which have resulted in confusing law enforcement as well as inefficient and inconsistent regulatory system in the oil and gas industry. There is no overreaching Petroleum Law governing the exploration, exploitation and production of oil and gas. Chinese market players have been continuously urging the National People's Congress to consider adopting more legislation to govern the oil and gas industry.

And although China has released its first draft of Energy Law in 2007 for public review and to solicit public opinion, such draft has not yet been approved by the central government.

i Domestic oil and gas legislation

The main PRC legislations specific to upstream oil and gas include the following:

- Mineral Resources Law
- Rules for the Implementation of the Mineral Resources Law
- Measures for Registration Administration of Exploration Blocks of Mineral Resources
- Measures for Registration Administration of Mineral Resources Exploitation
- Measure for the Administration of Transfer of Exploration Right and Exploitation Right
- Regulations on the Exploitation of Continental Petroleum Resources in Cooperation with Foreign Parties
- Regulations on the Exploitation of Offshore Petroleum Resources in Cooperation with Foreign Parties

In particular, the two pieces of legislations that are worth discussing are the *Regulations on the Exploitation of Continental Petroleum Resources in Cooperation with Foreign*

Parties ("Onshore Regulations") and *Regulations on the Exploitation of Offshore Petroleum Resources in Cooperation with Foreign Parties* ("Offshore Regulations") because these two pieces govern foreign investment in oil and gas exploration and exploitation in China. These two regulations require that foreign enterprises must partner with the Chinese government or its designated state-owned petroleum companies by entering into PSCs with them in order to explore and develop onshore and offshore petroleum resources in China. They also provide an outline for the nature of the partnership as well as the rights and responsibilities of both the foreign and Chinese parties.

ii Regulation

Energy regulation in China is divided by industry. There has been a lack of unified regulatory authority in the oil and natural gas industries in China, due to the complex industrial interests involved.

As listed below, there is a huge overlap in the authorities of different government departments having an oversight over the upstream oil and gas industry in the China:

The National Development and Reform Commission ("NDRC")
The National Development and Reform Commission is mainly responsible for regulating all projects in China, which includes oil and gas projects. It examines and approves oil blocks available for Sino-foreign co-development plans.

The Ministry of Commerce ("MOFCOM")
The MOFCOM is involved whenever there is foreign participation in oil and gas exploration and exploitation projects. Previously, MOFCOM was the authority responsible for reviewing and approving PSCs.

Upon the issuance of the *Decision on the Cancellation and Amendment of Certain Administrative Regulations* (State Council Decree No.638) by the State Council, MOFCOM's approval of a Sino-foreign PSC is no longer required, although the Chinese party must still report and deliver information about the signed petroleum contract to MOFCOM.

The Ministry of Land and Resources
The Ministry of Land and Resources is responsible for regulating oil and gas in China. It regulates the mining rights for oil and gas, approves mining licenses, regulates the transfer of mining licences and holds biddings. It also regulates the geological survey industry and approves geological survey qualifications.

The State Administration of Work Safety
The State Administration of Work Safety is mainly responsible for monitoring and regulating health and safety matters in respect of oil and gas enterprises and oil and gas projects. It also participates in investigating large accidents.

The Ministry of Environmental Protection
The Ministry of Environmental Protection is responsible for administering environmental policy and legislation in China, preventing and controlling environmental pollution, and protecting the environment and public health.

The State Bureau of Tax

The State Bureau of Tax is responsible for setting up and collecting resource taxes for oil and natural gas and other related taxes.

iii Treaties

Remittance of dividends, interest, royalties and rental is subject to withholding taxes at a rate of 10%, and is due at the time the remittance is made or at the time the relevant transaction and costs are recorded in the accounting books of the Chinese payer, whichever is the earlier.

The treaty withholding tax rates for dividends, interest and royalties varies depending on the particular country. Generally speaking, dividend, interest and royalty withholding rates vary from 5% to 10%.

III LICENSING

According to the Chinese law, the Ministry of Land and Resources is the government authority responsible for granting exploration and exploitation licences through an application process. Before such licences can be granted, the applicants, which can only be a legal person for oil and gas exploration rights and a commercial legal person for oil and gas exploitation rights, must fulfil all the requirements and submit all the required documents to the Ministry of Land and Resources for approval, one of which is to first obtain approval from the State Council, which may be in the form of either the approval of the establishment of an oil company, or the approval of oil and gas exploration or exploitation operations. Upon receipts of applications, the Ministry of Land and Resources will then issues its decisions within 40 days from the date of such receipt. If approval is granted, the applicant must also pay the associated exploration or exploitation bonus for the first year and the registration fee within 30 days from the date of receipt of such approval notice in order to receive the requested licence.

In addition to directly filing an application to the Ministry of Land and Resources, such exploration and exploitation rights can also be obtained through biddings held by the Ministry of Land and Resources, during which the Ministry of Land and Resources evaluates and determines the bid-winner.

Licences for oil and gas exploration can be issued for terms of up to 7 years, and may be extended for up to 2 years subject to approval. Exploitation licence terms can vary depending on the scale of the project, and can be up to 30 years with possible extension subject to the approval of the Ministry of Land and Resources.

However, in practice, such licences for exploration and exploitation are actually not issued and not necessary most of the time. As such, a concluded PSC is basically what it is needed.

IV PRODUCTION RESTRICTIONS

All natural resources including oil and gas in China belong to the state. For foreign-invested oil and gas exploration and exploitation projects, production sharing and tax obligations are imposed on the foreign investors. In particular, any oil and gas production remaining after cost recovery must be shared with the state at a percentage that varies depending on the amount of production. Any production that remains, if any, after such production sharing is then divided between the foreign investor and its Chinese SOE partner in accordance with the PSC.

The Chinese government has been continuously managing China's energy shortage problem by discouraging the export of crude oil by imposing new tariffs such as and encouraging the import of crude oil products from overseas by lowering applicable tariffs. On the other hand, for natural gas, there is no restriction on the export quota and the right to trade.

As regard the sale of crude oil and natural gas products within the Chinese local markets, it is subject to licensing by the MOFCOM. There is no sales restriction in China imposed upon foreign investors and hence foreign investors can also apply for such licences to sell and export their share of production. Enterprises wishing to sell their oil products in China must submit an application together with all the required supporting documents to MOFCOM for approval. The applicant must meet the requirements for business status and facilities, registered capital, and related certificates. Upon MOFCOM's approval, the applicants will receive a sales approval certificate entitling the applicant to engage in the related business activities. In practice, however, foreign parties to a PSC would usually sell their shares of production to the Chinese parties at a price agreed in the PSC instead of selling and exporting their shares of production outside of China.

It is to be noted that enterprises cannot freely set their oil prices. They must set the price by referring to international market prices. Such pricing regime is regulated by the NDRC and its provincial counterparts. As for refined oil, it is instead subject to governmental guidance or government pricing, depending on the use of the gasoline.[1]

In Part 2 of this article, the writer will discuss about assignment of interests, tax issues, environmental and decommissioning, foreign investment considerations and current developments of the industry.

V ASSIGNMENTS OF INTERESTS

Just as there is restriction on oil and gas production, all transfers of oil and gas interests in China are subject to state approval, whether it is a direct transfer of oil and gas interests or change of control of such interests, due to the double approval regime in China. In that regard, the Ministry of Land and Resources is responsible for granting approval regarding any transfers of oil and gas interests.

Upon the receipt of application, the Ministry of Land and Resources must notify both parties of its decision within 40 days from the date of such receipt. If the application is approved, both parties must go through a reregistration process at the Ministry of Land and Resources within 60 days from the date of receipt of such approval. Only after such formality will the transferee be able to obtain the exploration or exploitation licence.[2]

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[1] See http://uk.practicallaw.com/3-525-3038#.

[2] See Administrative Measures on the Transfer of Exploration Right and Exploitation Right.

Regarding such transfer of interests, three things should be kept in mind. First, the transferees must be legally qualified to own the relevant licence. Second, it should be noted that exploration licences cannot be transferred until the minimum exploration investments obligations have been satisfied and also that exploitation licences cannot be transferred without a just cause. Lastly, any gains derived from the disposal of an interest in a PSC are taxable.

VI TAX

Chinese and foreign enterprises engaged in cooperative exploitation of onshore oil resources must pay applicable taxes to the Chinese government according to China's relevant tax regulations. It should be pointed out extra obligations are imposed on foreign investors or foreign-invested oil and gas projects. Listed below is the fiscal regime applicable to the oil and gas industry in China:

Royalty
The royalty for crude oil and natural gas is charged at progressive rates, ranging from 0% to 12.5% and from 0% to 3% for crude oil and natural gas respectively and has to be paid in-kind with the crude oil and natural gas produced.[3] Note that this royalty is no longer applicable to PSCs concluded after 1 November 2011. For PSCs entered after that date, a resource tax is to be paid instead.[4]

Production Sharing
This is applicable to foreign-invested oil and gas projects. Under the production sharing requirement, any production remaining after cost recovery must be shared with the state at a rate that varies according to the amount of production. Andy production remaining after production sharing is then divided between the foreign investor and its SOE counterparty.

Enterprise Income Tax
Enterprise income tax is taxed at 25% on the taxable income.[5]

Value-added Tax ("VAT")
VAT is charged at a rate of 5% on the crude oil and natural gas produced from an oil or gas field operated under a Sino-foreign PSC. This is to be paid in-kind and the tax payable is based on the gross production of oil after deducting the amount of oil used for operation and depletion.

Resource Tax
The resource tax rate for crude oil and natural gas is charged at 5% of the actual sales price of crude oil and natural gas, with certain tax exemption and reduction available in specified situations subject to the approval of tax authorities.[67] It is to be noted

[3] See the Provisional Regulations on the Payment by Sino-Foreign Cooperative Joint Ventures of Royalties for the Exploitation of Onshore Oil Resources (中外合作开采陆上石油资源缴纳矿区使用费暂行规定) and the Regulations on the Payment by Sino-Foreign Cooperative Joint Ventures of Royalties for the Exploitation of Offshore Oil Resource (开采海洋石油资源缴纳矿区使用费的规定).
[4] See Interim Regulations on Resource Tax.
[5] See Enterprise Income Tax Law.
[6] See EY's Global Oil and Gas Tax Guide 2013, p 110.

that oil and gas used for the continuous production of oil and gas are not subject to resource tax.[8]

Mineral Resources Compensation Fee

A compensation fee is charged at a rate of 1% of the sales revenue from oil and gas production arising out of foreign-invested oil and gas contracts entered on or after 1 November 2011. This compensation fee is imposed on the "mineral right holders" of petroleum contracts, which by law are the Chinese national oil companies.[9]

Special Oil Gain Levy (Windfall Tax)

A revenue windfall levy is charged on all oil production enterprises (both domestic and foreign) that sell crude oil produced in China. It ranges from 20% to 40%, corresponding with the price of crude oil sold, and is levied when the monthly weighted-average price of crude oil sold exceeds $55 per barrel.[10]

Consumption Tax

Consumption tax is levied on parties who manufacture, import, sell or commission the processing of taxable consumer goods within China. Such goods include oil and gas and therefore oil producing enterprises are liable to such tax, subject to some exemptions.

Withholding Tax

Enterprises' passive income source such as dividends, interest, royalties and rental are taxed at a rate of 10%.

Tax Incentives

Petroleum enterprises that are engaged in the exploration, development and production of crude oil and natural gas may be eligible for customs duty and VAT exemptions in importing certain qualified equipment and products into China, subject to relevant government approval.

For the purpose of supporting the exploration and development of petroleum in China, during China's 12th Five-Year Period,[11] special VAT treatment applies to petroleum exploration and the development of onshore and offshore projects in designated areas in China. Specifically, import duties and import VAT are exempted to the extent of a specified duty-free import quota on equipment, instruments, parts and accessories and special tools, provided that such products are unavailable domestically or the performance of which cannot be matched by domestic products. To qualify for the exemption, the products must be imported for the purpose of exploitation of petroleum and development of projects in the designated areas in China.

VII ENVIRONMENTAL IMPACT AND DECOMMISSIONING

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7 See Interim Regulations on Resource Tax.

8 See Article 3, Interim Regulations on Resource Tax.

9 See Administrative Rules on the Collection of Mineral Resources Compensation Fees.

10 See State Council's Decision on the Special Oil Gain Levy. See also the Administrative Measures for the Special Oil Gain Levy.

11 China's 12th Five-Year Period starts on 1 January 2011 and ends on 31 December 2015

The major general environmental laws and regulations applicable to all industries, including the energy industry and in particular the oil and gas industry, are:

- Environmental Protection Law
- Marine Environmental Protection Law
- Air Pollution Prevention and Control Law
- Water Pollution Prevention and Control Law
- Solid Waste Law
- Environmental Noise Prevention and Control Law
- Radioactive Pollution Prevention and Control Law
- Law on Environmental Impact Assessment

It should be reminded that there are also environmental provisions within the various energy laws themselves, such as the Energy Conservation Law and Electricity Law.

Also, where applicable, the internal documents of the key state-owned oil companies should also be referred to. See, for example, CNPC's Guidelines on Health, Safety and Environment Management System for Oil and Gas Drilling.[12]

As mentioned above in Part II, the Ministry of Environmental Protection is in charge of administering environmental policy and legislation in China, preventing and controlling environmental pollution, and protecting the environment and public health.

As required by law, an environment impact assessment has to be conducted before any oil and gas extractions and processing activities can be allowed. In particular, an environmental impact report must be prepared for such activities. Note that such assessment must be conducted by an external body.[13] In addition to that, before geophysical prospecting or well drilling, the operator or contractor of offshore oil operation facilities must also complete a filing procedure with the China Offshore Oil Operation Safety Office ("COOSO") which is in charge of offshore oil safety.

As for decommissioning, an enterprise must apply to the government authority for by submitting all the required documents. In addition, the enterprise must complete any work regarding labour safety, conservation of water and soil, land rehabilitation and environmental protection or pay up the related expenses for land rehabilitation and environmental protection.[14] And in an offshore operation, it is necessary for the mining operator to report and submit all the required documents to the local COOOSO 30 days before the proposed decommissioning.[15] After the decommissioning, a post-decommissioning report must also be followed. It must be pointed out that there are different requirements for permanent and temporary decommissioning under the relevant regulations.[16]

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[12] See http://uk.practicallaw.com/3-525-3038#.

[13] See the Law on the Environmental Impact Assessment and the Directory of Construction Projects under Classified Administration for Environment Protection.

[14] See Articles 32 and 33 of the Implementing Rules for the PRC Mineral Resources Law. See also http://uk.practicallaw.com/3-525-3038#.

[15] See http://uk.practicallaw.com/3-525-3038#.

[16] See section 9, Chapter 3 of the Detail Rules on the Offshore Oil Safety Management. See also http://uk.practicallaw.com/3-525-3038#.

VIII FOREIGN INVESTMENT CONSIDERATIONS

i Establishment

Foreign enterprises seeking to invest in oil and gas exploration and exploitation in the China must, by law, partner with one of the Chinese SOEs. Such foreign investment in oil and gas exploration and production is commonly structured through a cooperative joint venture ("CJV") with a Chinese SOE which owns the exploration and production right of the oil fields,[17] and thereafter through entering into a production sharing contract ("PSC") between the foreign and Chinese parties. And according to Chinese law, a foreign party in such a CJV is required to establish a presence in China by establishing a branch, subsidiary or representative office, in a location to be agreed with the Chinese partner.

A foreign party must also obtain a business license from MOFCOM and then a registration approval from the State Administration for Industry and Commerce ("SAIC") by providing the necessary documents. The information requested include the name of overseas enterprise, its registered capital, total amount of investment business scope, proposed investment period, source of investment funds, etc.

In these partnerships, operations are conducted through a joint management committee comprised of representatives of the parties, and rights and responsibilities of each party are not equal. In particular, the foreign party is responsible for bearing all financial risks associated with the oil and gas exploration, as well as the initial investment expenses to carry out the exploration operation.

It has to be remembered that according to the law,[18] foreign investors are not allowed to set up a WFOE engaging in oil and gas extraction and exploitation activities.

ii Capital, labour and content restrictions

There is stringent capital movement and exchange controls in China. For relevant provisions, see the *Regulations on the Foreign Exchange System of the People's Republic of China* (中华人民共和国外汇管理条例). See also the *Notice of MOFCOM on Issues concerning Cross-border Direct Investment in RMB* (商务部关于跨境人民币直接投资有关问题的通知) which stipulates the rules regarding foreign investment into China using RMB that are legally obtained overseas. Despite the stringent capital control in China, foreign parties can still, according to the law, retreat their investments and transfer their revenues and other earnings outside of China, so long as they comply with the *Circular on Further Improving and Revising the Foreign Exchange Control Policy on Direct Investment* (关于进一步改进和调整直接投资外汇管理政策的通知). This Circular eliminates the approval requirements relating to foreign direct investment for opening of foreign exchange accounts, deposits into relevant accounts, purchase of foreign exchange for overseas payment and foreign exchange transfers within China, as well as simplifying the types of foreign exchange accounts under direct investment and abolishing the special foreign exchange account for foreign investors

[17] Hence it could either be a legal entity CJV or a non-legal entity CJV.
[18] See Foreign Investment Guidance Catalogue.

[19] More importantly, this Circular relaxes the restrictions previously applied to fund utilization under direct investments and removes the approval requirements for onshore transfer of investment fund by foreign-invested holding companies ("FIHCs")and remittance of foreign exchange profit and dividends from foreign-invested enterprises ("FIEs") to FIHCs.

As regards to the local element requirement, operators or contractors are obliged to give preference to the use of Chinese goods, equipment, and services, provided that the Chinese goods, equipment and services are competitive in price, quality and performance as compared to their international counterparts. With respect to the personnel employed, operators or contractors are under an obligation to employ a number of Chinese personnel and train Chinese personnel in accordance with the minimum percentage threshold as required by PSCs.

It is to be noted that except for part time worker, all labour contract in China must be in writing and must be registered with the local bureau. Enterprises failing to do so will be subject to heavy penalty.

iii Anti-corruption

The Chinese government is aggressively implementing anti-corruption investigation, in particular targeting former and incumbent senior executives at CNPC, China's largest oil and gas producer and supplier. On 3 September 3 2013, JIANG Jiemin, head of the State-owned Assets Supervision and Administration Commission ("SASAC") and former chairman of CNPC was dismissed on suspicion of serious "disciplinary violations" – a term which now has become synonymous with corruption.

The increasing scrutiny placed on anti-corruption hopes to enable a more market-driven industry and undeniably greatly change the development of the oil industry which is currently still very much state controlled. 5 executives having been "taken away" by the authorities at CNPC and 4 others being investigated has resulted in the Hong Kong listed H shares of PetroChina, a subsidiary of CNPC, to plummet.

Industry insiders believe that although this anti-corruption investigation will not have a profound effect on CNPC, the impact on private companies related to the company will be huge.

IX CURRENT DEVELOPMENTS

The China Oil Enterprises Association has issued the *2013 China Oil and Gas Industry Analysis and Outlook Report Blue Book* (the "Blue Book"). The Blue Book notes that the pace of development regarding the consumption of petroleum would continue to be slow, while the consumption of gas would maintain a substantial growth in China. The amount of oil and gas produced by Chinese enterprises' overseas equities is expected to exceed 100 million tons of oil equivalent. Oil and gas engineering in

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[19] See http://www.chinalawandpractice.com/Article/3139268/Channel/10363/Circular-on-Further-Improving-and-Revising-the-Foreign-Exchange-Control-Policy-on-Direct-Investment.html and http://www.chinalawinsight.com/2013/02/articles/corporate/safe-issues-new-rules-to-further-relax-the-foreign-exchange-controls-over-direct-investment-2/.

China has made obvious progress and therefore, China has gradually become the major purchaser of such engineering equipment.

China has sped up the process of shale gas development and has already conducted two rounds of biding, held by the MOFCOM. However, the technical difficulties, potential environmental pollution to water resources and huge initial stage development costs have become barriers for further development of shale gas in China. In addition, environmental issues are the main concern during the development of oil and gas, especially in offshore oil and gas production. For example, the litigations that are related to Bohai Bay spill by ConocoPhillips has drawn great attention in China.

In conclusion, the economic environment has been continuously impacting the Chinese energy market negatively. In the same way, China's environmental pollution and energy costs has been inhibiting China's economic growth miracle. Now it remains unclear whether developing the domestic shale gas industry in China could allow China to overcome these challenges.