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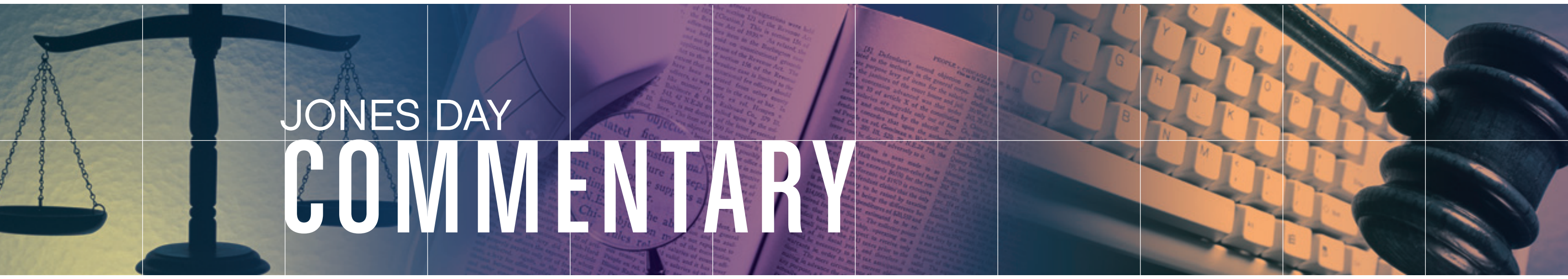

CHINA ISSUES PROVISIONAL REGULATIONS FOR THE ABANDONMENT OF OFFSHORE PETROLEUM FACILITIES

This *Commentary* is intended to provide an outline of the legal and regulatory framework in The People's Republic of China relevant to abandonment, to summarize China's new regulations on abandonment, and to identify areas of concern arising from these new regulations.

On June 23, 2010, the National Development and Reform Commission, the National Energy Administration, the Ministry of Finance, the State Administration of Taxation, and the State Oceanic Administration (the "Issuing Authorities") jointly enacted the Provisional Regulations on Administration and Management of the Abandonment of Offshore Oil and Gas Producing Facilities (the "Abandonment Regulations").[1] The Abandonment Regulations were issued through a notice from the Issuing Authorities to the three national oil and gas companies ("NOCs") in China, *i.e.*, China National Petroleum Corporation ("CNPC"), China Petroleum and Chemical Corporation ("Sinopec"), and China National Offshore Oil Corporation ("CNOOC"), as well as to the various branches of the Issuing Authorities, to "strengthen the administration and management of the abandonment of offshore oil and gas facilities."[2]

The Abandonment Regulations primarily concern the abandonment of offshore oil and gas producing facilities in China under petroleum contracts with foreign investment, but also serve as a guidance for pure domestic offshore oil and gas operations.[3] This is the first time the Chinese government has introduced comprehensive abandonment regulations. The most significant impact of the Abandonment Regulations is the requirement that all investors in an offshore field, including the NOC and the foreign contractors, must deposit abandonment costs on a monthly basis into a domestic bank in China. We examine the provisions of the Abandonment Regulations in greater detail later in this *Commentary*, but first we review the regime in China prior to the Abandonment Regulations.

PRIOR TO THE PROMULGATION OF ABANDONMENT REGULATIONS

Before the Abandonment Regulations were promulgated, the laws and regulations in China that related to the abandonment of offshore facilities focused on environmental concerns. These regulations include The Marine Environmental Protection Law of the PRC,[4] the Regulations of the PRC concerning Environmental Protection in Offshore Oil Exploration and Exploitation,[5] and the Regulations of the PRC on the Control over Dumping Waste into the Sea.[6] These regulations are still in effect and principally address the protection of the marine environment.

The State Oceanic Administration issued the Interim Measures on the Administration of Abandonment of Offshore Oil Platforms (the "Interim Measures")[7] on July 11, 2002. The Interim Measures also focus on environmental protection and include general requirements regarding environmental protection in connection with the abandonment of offshore platforms. The Interim Measures provide procedures that must be observed in order to lawfully abandon platforms.[8] Such procedures include submitting an abandonment application to the State Oceanic Administration.[9] Promulgation of the Interim Measures in 2002 came after the State Council's revisions to the Regulations of the PRC on the Exploitation of Offshore Petroleum Resources in Cooperation with Foreign Enterprises (the "Offshore Regulations").[10] The Offshore Regulations are the principal regulations governing offshore petroleum operations in China by foreign investors, and they provide a general framework for foreign enterprises that wish to exploit petroleum resources offshore of China. The Offshore Regulations do not include any provisions regarding the abandonment of offshore facilities.

The Accounting Standards for Enterprises No. 27—Exploitation of Petroleum and Natural Gas ("Accounting Standards"),[11] effective as of January 1, 2007, establish accounting principles applicable to oil and gas operations. The Accounting Standards were included as one of a series of new accounting standards for enterprises that were promulgated by the MOF on February 15, 2006 ("Enterprise Accounting Standards"), and they were introduced as a result of CNPC, Sinopec, and CNOOC dual-listed subsidiaries in China and overseas. Due to stock exchange requirements following the foreign listings, accounting disclosures for the NOCs became more stringent and comprehensive. The Accounting Standards require that future abandonment costs be booked as a contingent liability in the joint account but do not require any actual deposit of funds into a bank account.[12]

Apart from the Interim Measures and the Accounting Standards, none of the regulations or measures prior to the Abandonment Regulations specifically addresses abandonment of offshore facilities. The Abandonment Regulations are intended to fill some of the gaps in the existing regulations and to provide an overall framework for abandoning offshore facilities.

THE ABANDONMENT REGULATIONS

The Abandonment Regulations provide an overall framework for planning, funding and the abandonment of offshore facilities.

Abandonment Programs. The Abandonment Regulations require that prior to field development, the operator must prepare a "preliminary facilities abandonment program" ("Preliminary Program") in conjunction with the preparation and submission of the overall development program ("ODP") required under the petroleum contract. The Preliminary Program must include a description of estimated abandonment costs, a plan for funding abandonment costs, and plans for conducting actual abandonment operations.[13] For fields already in commercial development prior to June 23, 2010,[14] the operator must file a Preliminary Program within two years after the implementation of the Abandonment Regulations.[15] The Abandonment Regulations provide that all Preliminary Programs must be filed with the National Energy Administration, the Ministry of Finance, and the State Administration of Taxation, but they do not provide any guidance regarding the approval of Preliminary Programs or how approval is connected to ODP approval.[16] Once a Preliminary Program is submitted, the operator may revise it three years after commencement of operations. Prior to the commencement of actual abandonment operations, the operator must prepare a facilities abandonment execution program ("Execution

Program"), which must include more specific details relating to safety, operation, budget, and monitoring.[17]

Accruals and Funding Abandonment Costs. For fields that go into commercial production after implementation of the Abandonment Regulations, abandonment costs shall accrue from the month immediately after the commencement of production. For fields that were already in commercial production prior to the implementation of the Abandonment Regulations, abandonment costs shall accrue from the month after the Preliminary Program has been filed with the relevant authorities.[18] The Abandonment Regulations provide that the operator may choose whether to accrue abandonment costs using a unit-of-production method or a straight-line method provided that, once selected, the accrual method may not be changed,[19] although it appears that estimates of abandonment liabilities may be adjusted downward.

Importantly, investors are now required to deposit funds on a monthly basis into a domestic bank in China for abandonment costs accrued each month, but the Regulations do not specify the account holder. Previously, operators were required to accrue (or book) abandonment costs but were not required to actually fund in advance. Monthly accruals must be deposited into a domestic bank in China, and they will be managed by the joint management committee ("JMC") under the petroleum contract.[20] Further, such accounts are subject to supervision by the National Energy Administration and Ministry of Finance,[21] although it is unclear how the governmental authorities will supervise the accounts and how much power these governmental authorities will have in this regard. The Abandonment Regulations provide that funds deposited into the designated bank account cannot be refunded to investors as a result of revaluations of the abandonment liabilities, but over-deposits can be used to set off abandonment costs for following years.[22]

The Abandonment Regulations provide that in the event the abandonment costs deposited in the bank account are insufficient to cover the abandonment liability, the deficiency must be paid by all investors in one lump-sum, in proportion to their participating interests in the petroleum contract at the end of commercial production.[23] Where the abandonment costs deposited in the bank account exceed the abandonment liability, the surplus will be refunded to the investors in proportion to their participating interests.[24]

Where the petroleum contract expires at the end of the production period but the NOC decides to continue with production on its own account, the NOC and the foreign contractor must jointly engage an independent third party to evaluate the remaining commercially recoverable reserves and abandonment costs.[25] Upon completion of such evaluation, the NOC and the foreign contractor are required to enter into an agreement to confirm the evaluation of the remaining commercially recoverable reserves, as well as the abandonment liabilities and abandonment costs to be borne by the respective parties.[26] The Abandonment Regulations do not include any criteria for the selection of the third party intermediary and appear to leave this issue to the agreement of the parties. A foreign contractor must settle its portion of abandonment costs before it exits China.[27] When the NOC takes over a field, the NOC will assume responsibility for any unexpected abandonment costs that exceed the abandonment fund.

Management of Abandonment Costs. The Abandonment Regulations provide that all investors in an offshore field, including the NOC and the foreign contractors, are responsible for the abandonment of offshore facilities in proportion to each investor's participating interest under the petroleum contract.[28] The operator is required to prepare a utilization plan for the abandonment costs ("Utilization Plan") according to the Execution Program. The Utilization Plan must be reviewed by both the NOC and the foreign contractor; however, the Abandonment Regulations do not specify whether the Utilization Plan requires specific approval by any particular entity or authority. It is expected that future implementing regulations will address this issue. The operator must allocate and withdraw abandonment costs according to the Utilization Plan during the abandonment of the facilities.[29] It is unclear under the Abandonment Regulations whether and how the Utilization Plan may be further revised by the operator and the possible implications if other participants (including NOCs) do not agree with the changes proposed by the operator. We assume the JMC will provide the forum for debating this issue.

POTENTIAL IMPACT OF ABANDONMENT REGULATIONS

On their face, the Abandonment Regulations will have a meaningful impact on international oil and gas companies participating in operations as foreign contractors offshore China. Some contractors may take the position that the Abandonment Regulations amend or contradict the provisions of their petroleum contract since they apply to a preexisting contract. While the petroleum contract in China typically includes an economic stabilization clause covering the impact of new laws or regulations, it is unlikely that the requirement to fund abandonment costs in accordance with the Abandonment Regulations could be regarded as having a material impact on the foreign contractor's economic benefits under the petroleum contract. Therefore, it may be difficult for the foreign contractor to invoke the economic stabilization clause under the petroleum contract.

More problematic is the fact that the regulations do not address a number of important issues affecting foreign contractors, particularly when the foreign contractor is operator. As indicated above, the most significant impact of the Abandonment Regulations is the introduction of the requirement that the NOC and the foreign contractor of an offshore field open and fund an abandonment bank account on a monthly basis. In the past, the NOC and the foreign contractor of an offshore field in China were required by accounting rules to make provision for abandonment costs as a contingent liability on its accounts. Although no regulations existed that required operators to establish an abandonment fund, such funds may have been established as good practice. It is unclear how pre-June 2010 abandonment funds that have been accrued will be treated under the Abandonment Regulations.

Another uncertainty relates to cost recovery. Although the Abandonment Regulations provide in general terms that abandonment costs are recoverable, the absence of detailed provisions regarding cost recovery rights and protocol will likely be a concern for foreign contractors, who will also have to manage the cash-flow impact of the new monthly contributions obligation.

The regulations also are silent with respect to actual responsibility for abandonment. Even though all production facilities will be owned by the NOC by the time abandonment operations commence, the Abandonment Regulations appear to require the operator to be responsible for conducting the abandonment operations. This could be problematic if the operator is the foreign company at the end of the production.

CONCLUSION

The Abandonment Regulations, for the first time in China, establish a new framework for abandonment. It is anticipated that as experience is gained in the implementation of the Abandonment Regulations, additional regulations or guidelines will be introduced to clarify or fill the gaps that inevitably arise with these new regulations, particularly those regulating an area as complex as offshore facilities abandonment. Until that time, foreign contractor issues and concerns should be addressed to the fullest extent possible in the Preliminary Program.

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ENDNOTES

1. Provisional Regulations on Administration and Management of the Abandonment of Offshore Oil and Gas Producing Facilities, NEA circular number [2010] 1305, issued jointly by the National Reform and Development Commission (Zhonghua Renmin Gonghehuo Guojia Fazhan He Gaige Weiyuanhui), the National Energy Administration (Neng Yuan Ju), the Ministry of Finance (Zhonghua Renmin Gongheguo Cai Zheng Bu), the State Administration of Taxation (Guojia Shuiwu Zong Ju), and the State Oceanic Administration (Guojia Haiyang Ju), according to the Notice Regarding the Provisional Regulations on Administration and Management of the Abandonment of Offshore Oil and Gas Producing Facilities.
2. *See id.* at art. 1.
3. *See id.* at arts. 2, 7-23.
4. The Marine Environmental Protection Law of the PRC, adopted at the 24th Meeting of the Standing Committee of the Fifth National People's Congress on August 23, 1982 and revised at the 13th Meeting of the Standing Committee of the Ninth National People's Congress on December 25, 1999, effective April 1, 2000.
5. Regulations of the PRC concerning Environmental Protection in Offshore Oil Exploration and Exploitation, promulgated by the State Council of the People's Republic of China on Dec. 29, 1983.
6. Regulations of the PRC on the Control over Dumping Wastes into the Sea, promulgated by the State Council of the People's Republic of China on March 6, 1985, effective April 1, 1985.
7. Interim Measures on the Administration of Abandonment of Offshore Oil Platforms, promulgated by the State Oceanic Administration (Guojia Haiyang Ju) on July 11, 2002.
8. Interim Measures on the Administration of Abandonment of Offshore Oil Platforms, *supra* note 7, at arts. 6-9 & 11-15.
9. *Id.*
10. Regulations of the PRC on the Exploitation of Offshore Petroleum Resources in Cooperation with Foreign Enterprises (2001 Revision), promulgated by the State Council of the PRC on January 30, 1982, and amended according to the Decision of the State Council on Amending the Regulations of the People's Republic of China on the Exploitation of Offshore Petroleum Resources in Cooperation with Foreign Enterprises on September 23, 2001.
11. Accounting Standards for Enterprises No. 27—Exploitation of Petroleum and Natural Gas, circular No. 3 [2006] issued by the Ministry of Finance (Zhonghua Renmin Gongheguo Cai Zheng Bu) on February 15, 2006, effective January 1, 2007.
12. *See id.* at art. 23.
13. Provisional Regulations on Administration and Management of the Abandonment of Offshore Oil and Gas Producing Facilities, *supra* note 1, at art.8.
14. *See id.* at art. 7.
15. *Id.*
16. *Id.*
17. *See id.* at art. 10.
18. *Id.* Investors of such fields have a two-year grace period to file, as previously mentioned in article 7 of the Provisional Regulations on Administration and Management of the Abandonment of Offshore Oil and Gas Producing Facilities.
19. *See id.* at art. 14.
20. *See id.* at art. 18.
21. *See id.* at art. 19.
22. *See id.* at art. 20.
23. See id. at art. 15.
24. *Id.*
25. *See id.* at art. 16.
26. *Id.*
27. *Id.*
28. *See id.* at art. 5.
29. *See id.* at art. 22.