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Upstream Oil and Gas in Africa

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Table of contents

Trends in upstream M&A

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1. Introduction: drivers of African upstream M&A transactional activity

With exploration and production (E&P) activity ongoing in at least 48 of the 54 countries of Africa, the continent's upstream oil and gas sector has experienced recent growth in activity. Upstream merger and acquisition (M&A) transactions worth over an estimated $20 billion were announced in 2022, increasing from an estimated $7 billion in 2021 and a little over $5 billion in 2020.[1] Capital expenditure (CapEx) for upstream oil and gas exploration in Africa amounted to approximately $5 billion in 2022, increasing from approximately $3.5 billion in 2020. These figures suggest an upward trajectory for upstream deal-making.

With global oil and gas demand forecast to grow and huge exploration potential across and offshore the continent, Africa is an increasingly attractive destination for upstream investment. There are multiple drivers of the recent increase in upstream deal-making and projected future transactional activity.

1.1 The energy transition and a changing geopolitical landscape

In 2022, in response to Russia's invasion of Ukraine, the European Council adopted the Versailles Declaration, which included a target to "phase out … dependency on Russian gas, oil and coal imports as soon as possible" including by diversifying supplies and routes. As a result, Russia's share of total EU gas demand fell from approximately 40% in 2021 to approximately 12% in Q3 2023.[2] Given this geopolitical uncertainty, there is an incentive for many countries to seek out non-Russian sources of oil and, in particular, natural gas.

In addition to the changing geopolitical landscape, natural gas – cleaner burning than other 'fossil' fuels and now frequently labelled as the 'transition fuel' – appears set to form a larger part of the global energy mix as many countries seek to reduce reliance on coal and oil imports. More than 600 trillion cubic feet (Tcf) of natural gas has been discovered in Africa.[3] However, many of these reserves are yet to be approved for development. There is, therefore, likely to be a flurry of natural gas-related M&A activity, as well as project development, across the African continent.

1 Ian Lewis, "How can Africa's energy sector attract more investment", *African Business* (13 June 2022), https://african.business/2022/06/energy-resources/how-can-africas-energy-sector-attract-more-investment.

2 *Eurostat*, "EU trade with Russia – latest developments" (November 2023), https://ec.europa.eu/eurostat/statistics-explained/index.php?title=EU_trade_with_Russia_-_latest_developments#:~:text=The%20increase%20of%20imports%20between,2023%20(see%20Figure%206).

3 Lars Kamer, "Natural gas reserves in Africa as of 2021, by main country", *Statista* (September 2022), www.statista.com/statistics/1197585/natural-gas-reserves-in-africa-by-main-countries/.

The African continent is well-placed to meet both the shortfall in supply to Europe and the projected increased demand for gas as a transition fuel, while simultaneously solving its own energy crises. Annual African gas production could increase from approximately 260 billion cubic metres (bcm) in 2022 to as much as 335 bcm by the end of this decade and then to 470 bcm by the late 2030s, which is the "equivalent to about 75% of the expected amount of gas produced by Russia in 2022".[4] Existing physical pipeline infrastructure is in place to facilitate access to European markets – the Medgaz and TransMed pipelines already ship natural gas from Algeria to Europe via Spain and Italy. There is also renewed interest in the Trans-Saharan Gas Pipeline – a project mooted since the 1970s – that could ship Nigerian gas across the Sahara Desert to Algeria for onward shipment to Europe. Nigeria, with Africa's largest natural gas reserves, was in 2022 Europe's fifth largest liquefied natural gas (LNG) supplier. In 2022 Egypt increased LNG exports and the first LNG cargoes were shipped from Mozambique. Africa's LNG terminal capacity is increasing with the majority of new LNG infrastructure intended for export, in particular to Europe and Asia.

1.2 New sources of available capital

As a consequence of environmental, social and governance (ESG)-related pressures, some traditional investors in African upstream projects are withdrawing from the sector, which also continues to struggle to access the capital markets. Oil traders may have an increasingly prominent role to play, with their deep industry knowledge and generally larger appetite for risk. A more recent trend is the inflow of private capital as energy-focused private equity (PE) funds seek diversification beyond North America and more mature basins. US private equity-backed E&P companies seek higher-risk, higher-return exploration, including in less well-established destinations for PE investment such as Ghana, Tunisia and Senegal. Some investors are also seeking to achieve higher returns on investment than available in more mature plays, including in the North Sea where investors can no longer take for granted political and fiscal stability. New sources of capital and types of investor may bring new opportunities and structures to upstream deal-making in Africa.

2. Overview of upstream M&A in general

This section provides an overview of some of the key features of upstream M&A regardless of location.

2.1 Joint venture structures

Due to the capital-intensive and high-risk, high-reward nature of the upstream oil and gas industry, exploration, development and production activities are typically undertaken jointly by two or more entities working together within the framework of a joint venture (JV) arrangement. A JV allows participants to share capex

4 Ian Lewis, "How can Africa's energy sector attract more investment", *African Business* (13 June 2022), https://african.business/2022/06/energy-resources/how-can-africas-energy-sector-attract-more-investment.

requirements, exploration risk, knowledge and best practices, and also to diversify their portfolios to achieve a 'portfolio effect' across multiple assets whereby infrequent (but large) successes compensate for more frequent dry holes. A JV may be structured as an incorporated JV or an unincorporated JV.

(a) Incorporated JV

The parties establish and hold respective shareholdings in a new legal entity that operates separately from its shareholders. The shareholders will typically govern their respective rights and obligations in relation to the JV through the terms of a shareholders' agreement (sometimes called a joint venture agreement or consortium agreement). The JV entity will enter into the relevant granting instrument and enter into other contractual arrangements with third parties, receive revenue, hold assets and liabilities, and be subject to relevant taxes, in its own right.

(b) Unincorporated (or contractual) JV

By far the most common form of JV arrangement used by players in the upstream sector, the JV does not involve the establishment of a new legal entity – rather, the JV and the participants' respective rights and obligations are governed by a joint operating agreement (JOA). An unincorporated JV involves a lesser degree of integration than an incorporated JV meaning it is a (relatively) simple process to buy or sell a participating interest. In addition, this structure enables one participant to be appointed as the operator.

In the context of upstream M&A deals, consideration should be given to protections that are typically granted to non-transferring participants in JV structures, including:

- rights of first refusal (ROFR) or rights of pre-emption – whereby a JV participant is restricted from selling its interest without first offering it to the other participant(s) on terms no less favourable to such other participant(s) than those offered to the proposed third-party transferee;
- rights of first offer (ROFO) – as a less restrictive alternative to a right of pre-emption, under a ROFO a participant is restricted from selling its interest without first allowing the other participant(s) an opportunity to make an offer to purchase the relevant interest. If such offer is rejected, the selling participant is restricted to selling its interest to a third party on terms that are less favourable to the purchaser than those offered to the other participants;
- consent rights for non-transferring participants (or shareholders) – in JOA arrangements, the financial capability of the third-party buyer will be a key concern, as will its technical ability and track record as operator if an operator is replaced; and
- drag-along and tag-along rights – in incorporated JV arrangements, drag-along rights may allow a majority shareholder to force minority shareholders to join a sale and tag-along rights may offer minority shareholders the option to sell so that they are not left behind when a majority shareholder decides to sell its shares in the JV entity.

2.2 Host government involvement

Another aspect of upstream M&A that differs from other private M&A is the theme of host government involvement. Subject to a limited number of exceptions (including the United States), the government of any country will typically have ownership of all subsurface oil and gas resources and the government will then grant certain rights in those resources to private sector participants. The involvement of a host government is often two-fold: through the ministry or department of energy (in their capacity as regulator); and, in many countries, through the national oil company, which represents the host government's commercial participation in upstream activities (frequently through a 'back-in right' established under the granting instrument).

Host governments enlist the technical and commercial expertise of private investors to develop oil and gas resources. The relationship between the host government and a private investor will typically be regulated by a granting instrument, which will broadly follow one of four regimes.

(a) Production sharing contract (PSC)

An investor takes the financial and technical risk of exploration while the host government owns all reserves. The investor receives a share of production plus some pre-agreed cost reimbursement, with the government receiving the remaining share of production.

(b) Concession

An investor takes all financial and technical risk and the host government owns all reserves, much like the arrangements under a PSC – however, the investor will typically own all production and then pay taxes and royalties to the host government.

(c) Licence

An administrative or regulatory act – the licensee is typically entitled to all of the production at the well-head and the government gets its take from levying corporation and hydrocarbon taxes (similar to the concession model).

(d) Service contract

The host government maintains ownership of the hydrocarbons, but outsources all, or a part, of the exploration and development activities to a private E&P company to leverage private sector expertise and capital. A service contract may either be a 'pure service contract' or a 'risk service contract'. For pure service contracts, the E&P company performs the E&P activities in exchange for a flat fee – the recovery of its operational costs is guaranteed and will not depend on a project's commercial viability. In a risk service contract, the E&P company's recovery is directly linked to the commercial viability of a project.

The closing of acquisitions and divestments in the upstream sector may require the consent of the relevant host government. Obtaining such consent is typically a condition precedent to closing, and the process for obtaining consent runs in parallel with the process to obtain other consents and approvals required to allow closing to occur (including those of relevant third parties and any applicable competition or foreign direct investment-related consents). Asset sales almost always require host government consent for the reason that closing will result in a direct change in the person owning the relevant interest. By contrast, structuring a transaction as a share sale could avoid the requirement to obtain host government consent for the reason that the target company holding the participating interest would remain unchanged. However, in many African countries there is increasing scrutiny and regulation of share sales by host governments. As a result, under some regimes, a share sale that results in a change of control may trigger a requirement to obtain the prior consent of the host government.

The process to obtain host government consent is often complex and inevitably impacts on the timeline of a transaction. The consent process may be hampered by local legislation that is unclear as to the process and conditions for consent, or by local elections that may result in legislative changes.

Host government consent is often accompanied by a requirement for a consent fee or premium to be paid to the government, which will also drive the structuring of a transaction and, in particular, the structure of the consideration. Nigeria, for example, imposes a consent premium of between 5% and 10% of the total transaction value.[5] In Egypt, concession agreements usually include a standard term that will require the payment of an assignment bonus equivalent to 10% of the value of the transaction.[6] The determination of consent fees and premia may, in some instances, also involve consultation, negotiation and disclosure processes.

It is common to have a split signing and closing in upstream M&A transactions. The longstop date (the date by which the conditions must be satisfied to allow closing to occur) will vary based on the particulars of the transaction and the anticipated time to obtain relevant consents and approvals. However, it is common to see a longstop date of between 12 and 18 months from the date of signing a sale and purchase agreement. The risks inherent in having such an extended interim period means that interim period covenants, material adverse change provisions, and consideration mechanics are typically heavily negotiated by buyers and sellers.

This is an extract from the chapter ‘Trends in upstream M&A’ by Alexander Msimang, Christopher B Strong, Steven J Wilson and Nonkululeko Zondo in *Upstream Oil and Gas in Africa*, published by Globe Law and Business.

https://www.globelawandbusiness.com/books/upstream-oil-and-gas-in-africa

5 Nigerian Upstream Petroleum Regulatory Commission, “Guidelines and Procedures for Obtaining Minister’s Consent to the Assignment of Interest in Oil and Gas Assets according to Paragraphs 14–16 of the First Schedule to the Petroleum Act Cap P10 LFN 2004, Section 17(5)(d) of the Oil Pipelines Act Cap 07 LFN 2004 and the Petroleum (Drilling and Production) Regulations 1969 as Amended” (12 March 2021), www.nuprc.gov.ng/wp-content/uploads/2021/04/DPR-Guidelines-on-Asset-Divestment-2021.pdf.

6 Girgis Abd El-Shahid and Badawy Asmaa, “In review: oil and gas exploration and production in Egypt” (17 November 2020), www.lexology.com/library/detail.aspx?g=ebbfb7aa-d535-4dd6-9f23-07ef88dfbfb5.

Upstream Oil and Gas in Africa

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This edition combines two previous publications – *Oil and Gas in Africa: A Legal and Commercial Analysis of the Upstream Industry* and *African Upstream Oil and Gas: A Practical Guide to the Law and Regulation*, both published by Globe Law and Business in 2015 – and has two central elements.

First, it discusses the opportunities and challenges found in a variety of topical issues. For example, chapters describe the production sharing contract (PSC) and economic terms governing regional exploration and production activity; and although PSCs are not an exclusive host government instrument, they are of growing importance for countries looking for greater control over and societal benefits from petroleum production. The book also covers OHADA, financing, M&A, security and decommissioning issues in an African context, and new chapters explore natural gas and ESG.

Secondly, the book features a country-by-country analysis of African oil and gas, detailing the oil and gas frameworks and key issues in Algeria, Republic of the Congo, Egypt, Equatorial Guinea, Gabon, Ghana, Kenya, Libya, Mauritania, Mozambique, Nigeria, Senegal, South Africa, Tanzania and Tunisia. Jurisdiction-focused chapters examine the petroleum laws, the types of legal arrangement in place, the fiscal terms, the acquisition of acreage, governing law, dispute resolution mechanisms and governmental control.

This comprehensive edition features contributions from leading experts from across the industry, including from ministries of petroleum, national oil companies, international oil companies, law firms and consultancies. It will be of benefit to all industry participants and advisers pursuing oil and gas opportunities across the continent.

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