

Argentina: Amendment of the Hydrocarbons Law

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On 29 October **the Argentine Congress approved an amendment** to the Federal Hydrocarbons Law which will **improve investment conditions in the Argentine oil and gas industry** (the “Amendment”).

The Amendment represents the most significant change to the Federal Hydrocarbons Law since its enactment in 1967. It improves investment conditions for the Argentine oil industry in a number of ways, including: (i) extending exploration and production terms, (ii) creating a special type of concession for unconventional hydrocarbon projects with longer terms and lower royalties, (iii) capping royalties and bonus fees, (iv) reducing Government-take in certain types of projects, and (v) reinstating the right to export a percentage of oil and gas production while maintaining abroad the export proceeds. The benefits introduced by the Amendment are available to both new entrants and existing players.

Importantly, the Amendment has been supported by both the Federal Government and the Organisation of Hydrocarbon Producing Provinces (“OFEPHI”). The initiative was also promoted by Argentina’s state-owned oil company, Yacimientos Petrolíferos Fiscales (“YPF”).

The expectation is that the Amendment will create the regulatory environment necessary to support and attract long term investment in the oil and gas upstream sector in Argentina. This is particularly important for provinces such as Neuquén which will require extensive foreign investment if the huge shale formations found in the Vaca Muerta shale play are to be developed.

The key changes introduced by the Amendment to the Federal Hydrocarbons Law are:

I. Exploration Permits

The Amendment establishes a new distinction in the duration of exploration permits depending on whether the exploration is targeted at conventional or unconventional prospects. Where the objective is to explore for conventional hydrocarbons, the Amendment reduces the maximum term of an exploration permit from 14 to 11 years (two periods of three years and an extension period of five years). For unconventional hydrocarbon exploration permits, the Amendment establishes a new maximum term of 13 years (two periods of four years and an extension of five years).

The Amendment also removes the existing restriction which prevents a company from holding, directly or indirectly, more than five exploration permits and relaxes the acreage relinquishment requirements that apply during the term of an exploration permit. Specifically, the Amendment eliminates the current obligation on a permit holder to relinquish 50% of the acreage at the end of the exploration permit's first period; however, the Amendment makes no attempt to modify the obligations to relinquish 50% of the acreage at the end of the second period before entering the extension period. This relaxation of the relinquishment requirement recognises the particular requirements of unconventional hydrocarbon exploration and exploitation, with economic production often only achievable if large areas can be exploited given the disparate nature of many shale plays.

II. Exploitation Concessions

The Amendment also introduces new exploitation periods for concessions. With the introduction of the Amendment, exploitation concession terms will be as follows:

- (i) For conventional hydrocarbon exploitation projects, the concession term remains at 25 years.
- (ii) A new type of concession has been created by the Amendment, the "Unconventional Exploitation Concession" ("UEC") with a longer term of 35 years. The first five years of a UEC may be allocated to a "Pilot Project" to determine the commerciality of the field (we consider the details of the UEC more fully below).
- (iii) For offshore fields, the Amendment extends the concession term from 25 to 30 years.

A substantial modification introduced by the Amendment is that concessionaires will have the right to request multiple extensions, in each case for periods of up to 10 years, notwithstanding that a concessionaire has already obtained an extension before the Amendment passed into law. This means that, unlike the previous legislation, there would be an express right for a concessionaire to request more than one extension without a limit. A number of conditions must be satisfied by a concessionaire before it will be granted an extension. The concessionaire must have complied with its obligations under the exploitation concession, the area subject to the extension request must still be producing hydrocarbons and the request must be filed at least six months before the expiration of the concession.

The Amendment also introduces some important fiscal changes associated with concession extensions:

- (i) The State (National or Provincial, depending on the location of the hydrocarbon field) has a new right to increase the current 12% royalty rate on actual sales prices (see section VI below) by a further 3% in the event an extension is granted, up to a maximum royalty rate of 18%. This means that the relevant authority may increase the rate by 3% upon the grant of the first extension (taking the rate from 12% to 15%) and by another 3% upon the grant of the second extension (taking the rate to 18%); subsequent extensions will not result in further incremental royalty rate increases.
- (ii) The State may also impose an "extension bonus fee" equivalent to 2% of the applicable oil and gas price of 1P (proven reserves) existing at the end of the concession.

The Amendment also removes the existing restriction on a company holding, directly or indirectly, more than five concessions.

New type of concession: “Unconventional Exploitation Concession” (“UEC”)

One of the most important changes made in the Amendment is the creation of the UEC—a new type of concession with a term of 35 years, of which five years may be allocated to a “Pilot Project” to determine the commerciality of the field.

“Unconventional hydrocarbon exploitation” is defined in the Amendment as "the extraction of liquid and/or gaseous hydrocarbons by unconventional stimulation techniques applied in deposits situated in geological formations of schist rocks or slate (shale gas or shale oil), tightsands, tight gas, tight oil, coalbed methane and/or deposits characterised, in general, by the presence of low permeability rocks."

The concept of “unconventional hydrocarbon exploitation” already exists under Argentine law. It was incorporated in the Argentine oil and gas regulations in 2013 by means of the Federal Decree No. 929/2013 (the "Decree") which created the "Investment Promotion Regime for the Exploitation of Hydrocarbons" (the "Promotion Regime"). The Promotion Regime creates certain benefits for companies making a direct investment of at least US\$1 billion in hydrocarbon projects over a five-year period. The Amendment gives legal hierarchy to those benefits but also introduce some modifications by establishing a new and independent type of concession called the UEC.

The key differences between the Promotion Regime and the new UEC are:

(i) The Amendment regulates the UEC as an independent type of concession that can be accessed by any company that holds an exploration permit and/or conventional exploitation concession, whether or not included in the Promotion Regime. This means that it is now no longer necessary to apply for the Promotion Regime in order to obtain a UEC.

(ii) Under the Promotion Regime, the term of a concession term is limited to 25 years extendable in advance for 10 additional years, subject to a condition subsequent that the concessionaire complies with all of the obligations established by the hydrocarbons legislation for exploitation concessions. The Amendment establishes that the term of the UEC will be 35 years and may be perpetually extended for periods of up to 10 years.

The UEC however retains the following key rights, common to the Promotion Regime also:

(i) The ability for a concessionaire under an UEC to request the unitisation of an adjacent block held by the same title holders, insofar as they can establish the geological continuity of said adjacent blocks, which would benefit from the extended terms of the new concession.

(ii) The right for a concessionaire under an UEC to develop complementary activities to exploit any conventional hydrocarbon reservoirs that also exist in the blocks.

Holders of current exploitation concessions will also have the right to subdivide their concessions into new blocks, governed by the new UEC, provided that they submit a “Pilot Project”. Holders of exploration permits may also request an UEC.

The concept of "Pilot Project" as defined by the Amendment relates to a project plan that “in accordance with acceptable technical and economic criteria”, is intended to determine the commercial exploitation of the field. It is unclear however whether making an application for a Pilot Project results in a concessionaire assuming a firm investment commitment (such as the exploration

work commitments typical of an exploration permit) or if the Pilot Project is only intended to operate as a tentative and flexible investment commitment.

III. Transportation Concessions

In relation to transportation concessions, the Amendment establishes that the term of any transportation concession used to evacuate production from an exploitation concession (both conventional and unconventional) will be extended to match the term of the applicable exploitation concession.

IV. Bidding of New Blocks

The Amendment confirms that a public procurement process must be followed for the award of any new blocks (other than those concessions resulting from an exploration permit or a subdivision of an existing concession), and establishes that the criteria for selecting a bid will be assessed by reference to the level of work commitments proposed by a prospective concessionaire.

It also establishes that the Federal Government will draft a uniform model setting out the applicable bidding terms and conditions. The aim of this amendment is to encourage greater consistency and transparency into the bidding process. The uniform model will need to be discussed with the relevant provinces who in turn may include terms particular to the relevant hydrocarbon field being tendered.

V. State-owned Entities: Reservation of Areas and Carry System

A controversial change introduced by the Amendment is that neither the Federal Government nor the Provinces will be entitled to reserve blocks for any State-owned entity. The Amendment eliminates the privilege that State-owned entities currently have to access hydrocarbon blocks without competing with private companies.

This change has received a certain amount of criticism from a number of Provinces who have already reserved certain blocks for their respective provincial companies (e.g. Gas y Petróleo del Neuquén S.A. in the Province of Neuquén) over much of the known exploration prospects to date. In response to this criticism, the Amendment does now provide that any vacant blocks that have been reserved to Provincial State-owned companies prior to the enactment of the law may be tendered under participation agreements (e.g. PSAs) in which the State-owned company may be carried during the exploration phase, but not during the development phase. PSAs signed before the Amendment entered into law and that contain a carry system during the development phase are not affected.

In summary, the Amendment definitively eliminates the current carry system during the development or exploitation stage of an asset, but the Amendment does not prohibit the carry system during the exploration stage. This is a further example of how the Amendment is intended to improve the attractiveness of hydrocarbon investment in Argentina.

VI. Royalties

The Amendment clarifies that royalties are the only fiscal mechanism available to the granting authority to participate in the production of hydrocarbons. The ability of individual Provinces to impose additional fiscal requirements such as "extraordinary production fees" or "windfall profits" on concessionaires is thus removed. It is hoped that this attempt at standardisation will encourage more

consistency of concession terms from province to province and incentivise exploration and production across Argentina.

The Amendment also clarifies that Provinces may charge no more than the current maximum 12% royalty rate on actual sale prices (netted back to the well-head), plus an additional 3% up to a maximum of 18% where an extension is granted. It also allows Provincial authorities to reduce the royalty rate down to 5% where necessary to ensure continuing production from the field.

The Amendment also allows for the royalty rate to be reduced in certain specific cases:

(i) Oil and gas production from tertiary recovery, heavy crude oil and off-shore projects may attract a 50% reduction in the royalty rate applicable to those operations.

(ii) A 25% reduction in the royalty rate applicable to unconventional hydrocarbon projects may also be available during the 10 years following the completion of a “Pilot Project”. In order to qualify for this reduction, a concessionaire will need to request an UEC within three years from the enactment of the new law. This relaxation of the royalty rate applicable to unconventional projects encourages companies to accelerate the taking of investment decisions in the Vaca Muerta shale play.

VII. Investment Promotion Regime

In addition to amending the Federal Hydrocarbons Law, the Amendment also suggests changes to the “Promotion Regime” created by the Decree. These include an extension of the benefits established in the “Promotion Regime” to companies making a direct investment in foreign currency of at least US\$250 million in hydrocarbon projects during a three year term. The benefits will be enjoyed as from the third anniversary of the start-up of the investment project.

In the case of unconventional hydrocarbon projects, the benefits include the right to: (i) export 20% of the oil and gas produced under the investment project, exempt from export taxes; (ii) maintain abroad the associated export proceeds; (iii) obtain for the 20% share of exportable production, a price that is not lower than the export parity price when domestic production of hydrocarbons is insufficient to cover domestic needs and exports of oil and gas are prohibited; and (iv) provide tax incentives facilitating the import of capital goods and supplies needed for the investment project.

The Amendment states that companies must contribute to corporate social responsibility projects 2.5% of the monies committed to the investment project.

VIII. Agreements to Agree between the Federal Government and Provinces

The Amendment also paves the way for the Federal Government and the Provinces to implement a number of further regulatory enhancements in the future. These include:

(i) The establishment of uniform environmental standards for hydrocarbon projects with the underlying purpose of eliminating any potential fracking banning laws from Provinces or Municipalities.

(ii) The encouragement of uniformity in provincial taxes to encourage investment in the hydrocarbon industry across Argentina. The streamlining of local taxes will need to be addressed in a separate federal treaty. A preliminary agreement has been reached between the Federal Government and the Provinces which addresses the following matters: (i) a cap of 3% in the rate of gross turnover tax; (ii)

a freeze of the current rate of stamp tax; (iii) a guarantee of local tax stability; and (iv) a commitment not to tax “financing agreements” with stamp tax. Further discussion of this area is expected between the Federal Government and the Provinces in 2015.

Conclusion

The Amendment represents a significant step forward for hydrocarbon exploitation in Argentina. It puts in place a comprehensive legal and regulatory regime for unconventional hydrocarbon projects in Argentina as well as offering clarification of, and improvements to, the legal and regulatory framework for conventional hydrocarbon projects. It is hoped that the Amendment will provide the necessary impetus for the extensive investment that will be needed to fully develop the huge Vaca Muerta deposits.

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National Law Review, Volume IV, Number 303

Source URL: <https://natlawreview.com/article/argentina-amendment-hydrocarbons-law>