

Oil and gas contracts: concepts and Explanations

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Introduction:

From now until we finish this sentence, five thousand barrels of oil will have come out of the ground. Or ten thousand barrels by the end of this one, worth about a million dollars on world markets today. Suppose we created a World Oil Production Index (WOPI) as a measure of money, like a light year in distance. WOPI would equal a spacious apartment in a minute, in the most expensive tower in the world, Khalifa Tower (1).

Also, WOPI would exceed the GDP of the Democratic Republic of Congo, a country of 70 million people, in a day and a half, and the entire annual aid budget to Africa in four days. It would, in fact, take about two weeks of WOPI each year to eliminate absolute poverty among the 1.3 billion people around the world.

Oil and gas play a fundamental role in our life. Oil is critical for a plethora of industrial processes and products, including the operation of machine technology; electricity generation; and the manufacture of synthetic fibers, fertilizers, pesticides, medicines, plastics, Cleaning Products, food, Medicines, Cosmetics, dyes, Synthetic Rubber, and Synthetic Fabrics (2).

Oil and gas industry is complex, hazardous and capital intensive that makes it remarkably different from other industries. So, it is important not only to determine the suitable type of agreement for each project, but every clause in it. These agreements are interpreted by judges in different countries and jurisdictions. Thus, it is important to understand how indemnity provisions can be incorporated into an agreement in order to be efficient and to make sense at all.

The petroleum agreement is the most important instrument by which benefits and responsibilities from projects will be distributed. Also, the content of agreement clauses may be more important than the choice of agreement type. Consequently, we will focus on the different main types of oil and gas agreements that are standard in the industry of petroleum (Concession agreements, Production-sharing Agreements and service agreements). Then we will address some important Contractual clauses. Finally, we will highlight transparency.

1- Concession Agreements

For most of the last century, the oil industry has been characterized by the concentration of control in a relatively few companies or entities. In the earliest period, Standard Oil of New Jersey controlled the oil supply and price (3).

In the concession system the government assigns the right to explore and develop its petroleum resources to the International Oil Companies' (IOCs) in return for a share of the proceeds. In most countries, the government owns all mineral resources but the title is transferred to a company when it is produced (4).

The earliest grants, such as those made by various sovereigns in the Middle East, often covered an entire country and lasted several decades. For example, the concession which William D'Arcy obtained from the Shah of Persia in 1901 covered 500,000 square miles; concessions granted by the rulers of Abu Dhabi and Kuwait covered their entire countries. In exchange for an initial payment and a right to some fraction of the value of any oil produced, the country or its ruler transferred all managerial and decision making rights over oil exploration and production to the International Oil Companies' (IOCs) or consortium of companies that received the grant (5).

Also, the concessions were intended to last a long time. Generally they were for fixed time periods that were rarely less than sixty years. The 1933 concession that the King of Saudi Arabia granted to Standard Oil of California for a sixty-six year term. The Abu Dhabi and Kuwaiti concessions were both for seventy-five years. There were always some exceptions, of course. The concessions granted in the period following the 1911 Mexican revolution were for a period that could not exceed thirty years and contained cancellation clauses in the event the company failed to comply with its obligations (6).

As indicated earlier, the host governments transferred all managerial and decision making rights over petrol operations to the IOCs. The IOCs were free to drill or not to drill on any of the lands granted. Production of any oil discovered was left to the option of the grantee which was under no obligation to release unexplored and undeveloped territory. The host countries retained no right to participate in managerial decisions, including decisions on drilling and development, even though the only financial benefit received by the countries or their rulers after the initial consideration had been paid was the right to royalty (7).

In addition to the above, the host countries granted many facilities to the IOCs, e.g. the 1901 Mexican petroleum law gave the IOCs companies liberal tax exemptions, the right to import machinery, equipment and material duty-free, and other special privileges including the right to "expropriate" land necessary for their oil operations. Also, some of the Middle East concessions freed the companies from all tax obligations that were not specifically set out in the agreement (8).

The Modern Concession

Oil producing countries recognized of the importance of petroleum to a country's economy. And some countries view domestic production deems an important element in achieving or maintaining a degree of energy self-sufficiency which is essential to the welfare of an industrialized or industrializing economy. Therefore, Oil producing countries must retain some degree of control over development of reserves. So, most Oil producing countries refuse to grant traditional concessions-or, indeed, even to call development arrangements concessions-is closely connected with concepts of national sovereignty.

Modern concession differs greatly from traditional concessions in that they cover a smaller area, last for a shorter period, and require minimum work obligations by the oil company (9).

Since the 1960s, the old form of concession has been replaced by a more modern concession along with other forms of production agreements. Tracts of land are generally divided into numbered blocks that are distinguished by lines of longitude and latitude. Blocks are most commonly used for assigning offshore oil and gas field. The period of time granted in a concession agreement has been significantly reduced. For example, royalties were raised and concession periods were shortened considerably in Venezuela starting in the late 1950s. The Venezuelan government granted concessions that allowed for six years' exploration and thirty years' exploitation. Any land unused during the exploration period was returned to the host government. Hence, the modern concession allows for a relinquishment clause, which forces a foreign company to return developed land back to the government (10).

The original concessions were modified by on-going renegotiations that resulted in significantly different arrangements. The formation and growing power of the Organization of Petroleum Exporting Countries (OPEC), which represented the interests of several similarly-situated countries, helped significantly to expedite the process (11).

2- Production-sharing Agreements

The Production-Sharing Agreements (PSAs) are among the most common types of contractual arrangements for petroleum exploration and development. The PSA was first used in 1966 in Indonesia. At first, international oil companies firmly resisted this change, afraid it would create a precedent that would affect their concessions elsewhere. However, independent companies entered into PSAs and the majors had no choice but to follow. PSAs spread globally and are now a common form of doing business, all over the world (12).

The PSA grants a company the right to explore for natural resources. If resources are not found, then the company is out of pocket. However, if commercially exploitable resources are discovered, then the company has the right to recoup sunk costs and subsequently to share in profits. This is the incentive for shouldering the risk of non-discovery(13).

The PSA differs from the concession in two main respects. First, it does not grant the company ownership rights over the resource. Accordingly, the Government may take a greater interest in technology transfer, preparing for the eventual turning over of the resources to its hands. Further, unlike the concession, which grants the company rights over the resource for a specified period of time, the PSA grants the company an interest in the resource that is tied to the recouping of sunk costs and, then of course, to the garnering of a profit (14).

The PSAs occupy a special place in the history of oil agreements. They were developed in the 1960s and became widespread by the 1990s. While their popularity has waxed and waned over this period, they are still used in the oil and gas industry, especially among IOCs operating in low- and middle-income developing countries. According to the late Professor Thomas Waelde, the PSA produced *“a convenient marriage between the politically useful symbolism of the production-sharing agreement (appearance of a service agreement to the state company acting as master) and the material equivalence of this agreement model with concession/licence regimes in all significant aspects...The government can be seen to be running the show – and the company can run it behind the camouflage of legal title symbolising the assertion of national sovereignty. It is for these reasons that the production sharing agreement is so important in countries where sovereignty needs to be asserted conspicuously, while the financial and managerial resources for national management are absent. This new conceptualisation of the*

relationship between host state and investor helped solve many of the political difficulties concerning the development of national resources.”(15)

Nevertheless, some countries still used it; another have recently decided that PSAs would no longer be used in future exploration and development agreements like Kazakhstan (16).

Similarly, according to International Energy Agency figures, PSAs are only used in respect of about 12% of world oil reserves, in countries where oilfields are small (and often offshore), production costs are high, and exploration prospects are uncertain (17).

3- Service agreements

In recent years, some oil producing countries have shown an increasing interest in adapting variations of service- type agreements rather than PSAs or concessions in their petroleum projects. A service agreement is a long-term contractual framework that governs the relation between a host government and IOCs in which the IOCs develop and explore oil and natural gas fields on behalf of the host government in return for pre-determined fees and in which in most cases the host government does not hand over the control of extracted or sub oil or subservice resources to the IOCs (18).

The move towards service agreements is reminiscent of a similar transition towards PSAs away from concessionary system in 1966 in Indonesia. While the reason behind transition from concession agreements to PSAs is the control of IOCs over the world oil prices and sovereignty issue over natural resources. It seems the new interest in service agreements might be explained partially by heightened sovereignty concerns on one hand and the need for IOCs capital and know-how in developing oil and natural gas fields in the host countries on the other. As argues by Ghandi and lin (2012) regarding the case of Iran several major OPEC (19) and non-OPEC oil producing countries have found service type- agreements a means to address both sovereignty concerns, which mostly are reflected in these countries constitutions and petroleum laws and regulations, and the need for IOCs' capital and expertise capabilities. The political environment is a contributing factor for heightened sovereignty concerns and the move toward service agreements as well (20).

Service agreements and PSAs could differ in four major categories: field ownership rights, produced crude ownership rights, field's operatorship, and the degree of risk that each side bears. These differences are summarized in the following table:

Petroleum fiscal arrangements:

| | Concession | PSAs | Service Agreements |
|----------------------------|-------------------|-----------------------|---------------------------|
| Oil field ownership | IOC | NOC | NOC |
| Crude production ownership | IOC | IOC/NOC | NOC |
| Oil field operation | IOC | IOC | IOC/NOC |
| How the IOC is compensated | N/A | A share or production | Flat fee |
| Who bears the risk | IOC | IOC/NOC | IOC/NOC |

IOC denotes "International Oil Company". NOC denotes "National Oil Company". PSAs denote "Production Sharing Agreements. N/A denotes "not applicable" (21).

One main crucial factor why oil producing countries (OPCs) adopting a variation of service agreements in their projects for maintaining their sovereignty over their natural resources. Under a service agreement, OPCs maintain field ownership and in most cases produced crude ownership rights as well, and not have to allocate them to the IOC. OPCs are interested in service agreements, in addition aforementioned, because the last enable them to gain the expertise from the IOCs. While a service agreement may better address sovereignty concerns, but the potential losses in profit in this agreement is huge (22).

Finally, we will highlight the current service-type agreements in Kuwait. Since the early 1990s, Kuwait has pursued or shown interest in three variations of service –type agreements. The term service agreement was used for the earlier version, which includes five agreements with British Petroleum, chevron shell, Exxon, and Total from 1992 until 1997. At the same time, the Kuwait Ministry of Energy and Kuwait Petroleum Company attempted another initiative, known as Kuwait project (23), in order to open Kuwait's upstream to the IOCs even more. However, the attempt has faced long lasting opposition by Kuwait Supreme Petroleum Council and the National Assembly since 1995. The opposition was based on Kuwait's constitutional restriction on foreign control of Kuwait's natural resources including crude oil (24).

In 1999, the Kuwait government announced a new variation of service-type agreement known as an "operating service agreement"

according to which the government could restrain the control over the ownership of the crude in accordance to constitutional provisions. The dispute over the terms of the new service-type agreement, which was part of a broader quarrel over the jurisdiction of different branches of the government, prevented any new deals (25).

In 210, Shell signed a new version of Kuwait's service agreement, called enhanced technical service agreement to develop a natural gas field. Other IOCs including Chevron, on Burgan field, and ExxonMobil, on Ratqa heavy oil field, have also been in negotiations with Kuwait over enhanced technical service agreement terms (26).

Now, that we have established the differences among different oil agreements and the reason behind adopting these agreements. It's more important than the choice of agreement type, is the content of particular agreement clauses. Therefore, we will explain that, in details, in the following point.

4- contractual clauses

As indicated earlier, the choice of agreement type might be less important than the content of particular agreement clauses. One of the important clauses in oil agreements is setting out reimbursement for sunk exploration costs. In some cases, the project company will shoulder this risk, as under the risk-sharing agreement. In other cases, the host Government may cover all or part of this cost. A clause might indicate the company's responsibilities during the exploration phase. This might include a commitment to spend a specified amount of money on exploration or to undertake an agreed level of exploration. There may be a provision within the agreement indicating the circumstances under which the company may be granted an extension of the time allotted for exploration (27).

A different set of provisions may govern the production phase. This phase may last a number of years and a clause may set out the conditions upon which it may be extended. It may be important for the host Government to set out specific commitments during this phase, because, as indicated earlier, it is possible that host Government and company interests may diverge, that is, it might not be in the commercial interests of the company to exploit fully reserves within a time frame that the Government desires (28).

Oil agreement may also provide that certain local content preferences. For example, an agreement may include a clause indicating

that the IOC must employ local workers, as long as they meet certain qualifications. The host Government might require that the IOC train locals. Likewise, the IOC may agree to source goods locally (29).

It is also worth noting that agreements may require the IOC to keep certain records of its operations. Host governments may find such provisions useful in determining taxation and royalty rates. Host governments may not always have the expertise or capacity to enforce certain revenue schemes. Thus, such clauses may reduce the burden on the Host government.

Among other things, liability has arisen in the offshore petroleum industry since the Macondo oil spill. On April 20, 2010, the Mobile Offshore Drilling Unit (MODU) Deepwater Horizon suffered an explosion, apparently from a blowout in the well it was drilling at the Macondo exploration site in an area of the Gulf of Mexico. After this blow-out, the contractors and operators have put more emphasis than ever before on clauses that indemnify against pollution (30).

5- Transparency

In most developing countries, citizens find it difficult to obtain detailed information about the activities of their governments. In spite of it is widely accepted that, through informed scrutiny of state-investor deals, civil society can provide the ‘checks and balances’ needed to improve governance and outcomes in the oil and gas sector. Even though agreements are commercial transactions, they have a public element that creates a strong argument for transparency and public scrutiny.

We can improve governance and outcomes in the oil and gas sector through Transparency. A crucial aim of Oil producing countries is public awareness about oil agreements and how their terms and conditions affect the distribution of the risks, costs and benefits involved in oil projects. A good understanding of the complex issues involved in oil and gas agreements adds a powerful tool in the civil society toolbox. The civil society can play a key role to increase accountability and public scrutiny in the extractive industries, with a focus on oil agreements. Civil society can help improve transparency of extractive industry contracting in a number of ways, including (31):

- providing the public with state-of-the-art legal, economic and financial analyses of the terms and conditions reflected in the oil and gas agreements
- providing the public with information about the parameters needed to monitor agreement performance
- disseminating information to the broader public, including the results of revenue monitoring activities.

We must promote transparency in agreementing, not only regarding Revenue issues, but also provisions related social or environmental considerations. For example, Agreements may contain local content requirements to promote local participation in project activities through employment or procurement; these requirements are seen as a way of maximizing local economic benefits. Also, oil companies are typically required to adhere to standards for the protection of the environment or human health. Monitoring compliance with these provisions can be as important to civil society as those obligations relating solely to tax liability and rent distribution (32).

Social and environmental considerations are as important as economic ones. And in managing the oil and gas sector, it is important to remember that the oil wealth of a country belongs to both present and future generations (33).

Conclusion

Each form of agreement has its pros and cons, especially from a commercial point of view. The details of the agreement can vary greatly even between similar types of agreements. To add to the confusion, the provisions of concession agreements and PSAs have also come to resemble each other. Host governments and International Oil Company should release the terms of their agreements. If they decline to do so, questions need to be raised about the need for confidentiality since there is no intrinsic reason why such agreements should be kept from the public.

We must bear in mind; there is no standard answer to the question of which type of agreement would serve a government's interests best. Each agreement has advantages and disadvantages. Negotiating oil agreements with foreign oil companies is the first challenge with which governments of natural resource-rich countries are confronted. Therefore, oil producing company must well understand every circumstance related to the project targeted to reach the right decision.

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