Legal regime for petroleum contracts

- Petroleum doesn't last forever. It is a nonrenewable resource. This fundamentally drives the business decisions of companies, a key part of which is that most petroleum contracts are structured to contemplate the entire life span of a project, it's beginning, middle, and end. The key stages of a project's life (or "petroleum operations") are:
- **explore** to find it in the first place;
- **develop** the infrastructure to get it out;
- **produce** (and sell) the petroleum you've found;
- **abandon** when it runs out and clean up ("decommission")

- **Exploration**
- Petroleum is rarely found on the surface of the earth. One is very unlikely (though
- would be quite lucky) to step into a puddle of oil, though when this does occur it is
- known as a "seep" which means what one would think it means: oil below the
- ground has "crept up" from below the surface to "seep out" onto the surface. In the
- early years of oil discovery, seeps were probably one of the best means to find oil
- and gas. And oil still does seep to the surface of the earth in many locations across
- the globe. But a seep does not mean an oil boom. Nowadays, we use much more
- scientific and dataintensive
- means of finding petroleum beneath the surface of the
- earth.

Seismic

- Commonly found beneath the earth's surface are various types of rocks, water
- and salt, all of which react differently when hit with a sound wave. Large amounts
- of data are captured from this process and used to give an image of what lies
- beneath the earth's surface.

Exploration drilling

- If the seismic produces promising results sometimes called a "lead" then the next phase of exploration will typically be drilling an exploration well. Here, an extraordinarily large drill bit is cut into the earth's surface in order to bring up a "core" or a cylindrical sample of that portion of the earth.

Discover and appraise

Let us assume that, lucky you, you found hydrocarbons while drilling; you have "discovered" petroleum! Is the pay day coming? Most likely, not quite yet. You may have "discovered" hydrocarbons, but the question then becomes, how much did you find? Enough to make it worthwhile, "commercially viable" or economical to develop and produce? What you will need to do next: "appraise" the discovery. Appraising entails more drilling and seismic to asses what you have discovered, but to a greater degree of accuracy. It will lead to more detailed geological discovery while also involving assessment and reflection on how to build the necessary infrastructure to produce the petroleum you've found. You will want to know more about:

- the chemical composition of the various hydrocarbon deposits
- the quantity of reserves in the area
- how to get these hydrocarbons out of the ground (if the discovery is found to be
- of commercial signficance)

Commercial discovery or not?

- Once hydrocarbons have been found in sufficient quantities and with an economically viable extraction cost, the discovery becomes a "commercial discovery". It is important to stress here that a commercial discovery is not a geologic term but a business term. For this reason, the length of time an appraisal
- takes will likely depend on such considerations as:
- the business considerations of the company that has found the oil
- the local laws and regulations that determine the process of development

Develop

- Once you have explored, discovered and appraised a petroleum deposit and determined that it is worth the cost to get it out of the ground, the next stage is to develop infrastructure to extract it. Depending on a number of factors, including geology, location and local regulations, you will need to determine the best way to get your hydrocarbons out of the ground and to the market.
- This can include decisions about how many wells to drill (yes, there can be more than one, there can be many!), what type of platform you will be building or
- whether to build a platform at all.

Produce

- At long last perhaps a decade after the start of exploration oil or gas will finally flow. As various wells come 'online', petroleum will flow in increasing quantities as production "ramps up". At some point, once most of the first major development has been completed, tested, and refined for any bugs in the system, there will be "commercial production". This occurs when the petroleum is finally flowing at the
- expected rate over a period of a month or so. How long will production last? This is affected by many factors, but probably most significantly by the size of the find.

Abandon

- After anywhere from around seven years of production from smaller areas to fifty years or more from the giants, it is time to take all of the "steel and metal" down, plug the production wells and restore the environment to its original state. A common alternative to this is where the contractor turns the assets over to the state so that it can then continue operations and eventually abondoning themselves at a later time. These processes are generally referred to as "Decommissioning" or "Abandonment".

What is a petroleum contract?

Experts estimate that for a large natural resouce extraction project, there will be well over 100 contracts to build, operate, and finance it all of which could fall under the broad category of 'petroleum contract'. There may also be well over a 100 parties involved, including:

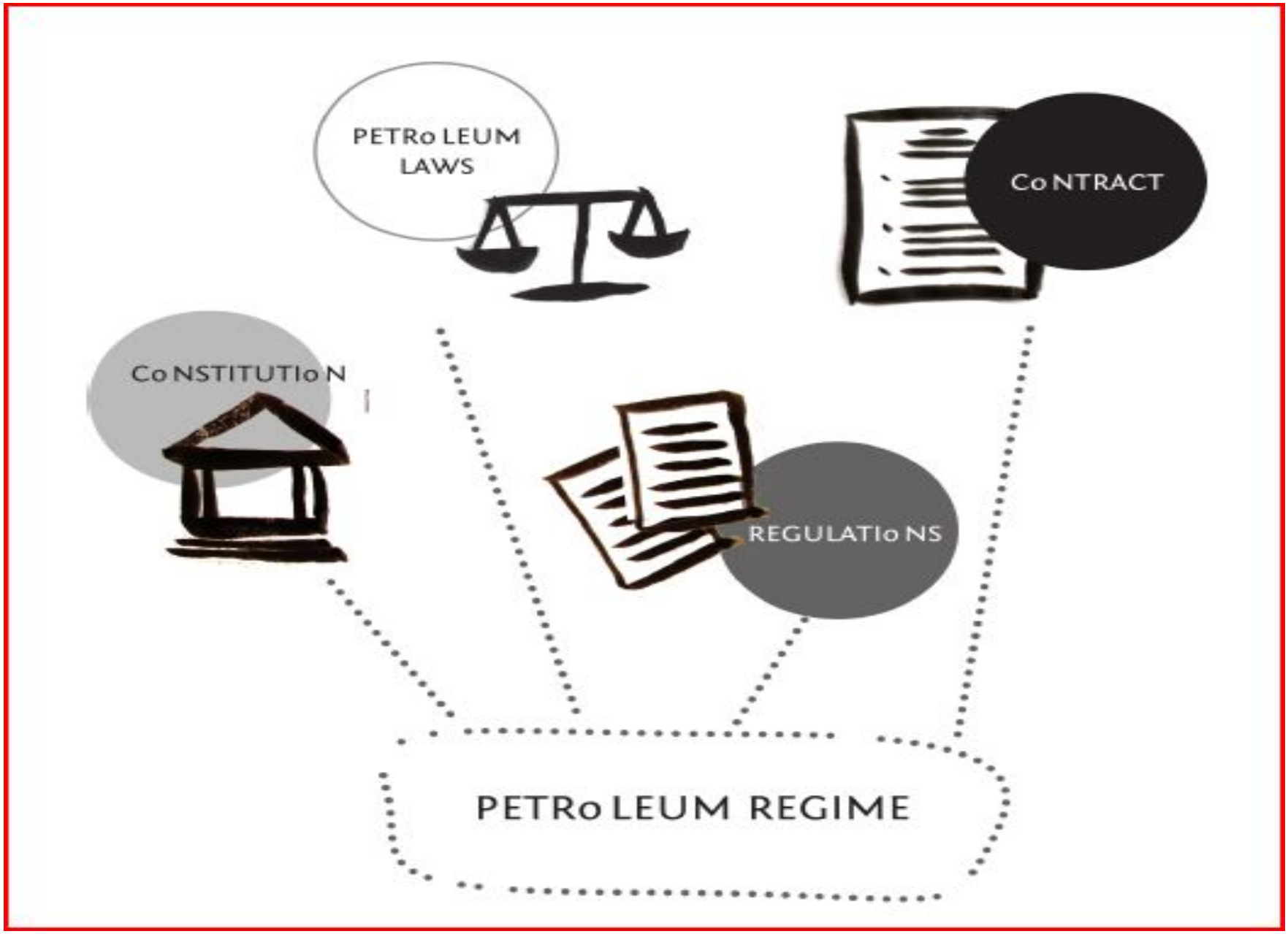
- governments and their national oil companies (NOCs), e.g. Gazprom, Petronas
- international oil companies (IOCs), e.g. BP, Exxon, Chevron, CNOOC
- private banks and public lenders, e.g. JP Morgan, World Bank
- engineering firms, drilling companies & rig operators, e.g. Halliburton,
- Schlumberger, Technip
- transportation, refining and trading companies, e.g. Hess, Glencore, Trafigura,
- Koch Industries
- ...and many more

Among these many contracts, the most important is the one between the

- government and the IOC. All of the other contracts must be consistent with and depend on this contract;
- these might be collectively referred to as "subsidiary", "auxillary" or "ancillary"
- contracts.
- This contract is most commonly referred to by the industry as a **"Host**
- **Government Contract"** because it is a contract between a Government (on the
- behalf of the nation and its people) and an oil company or companies (that are
- being hosted). It is through this contract that the host government legally grants
- rights to oil companies to conduct "petroleum operations". This contract appears in
- countries throughout the world under many names:
- Petroleum Contract
- Exploration & Producting Agreement (E&P)
- Exploration & Exploitation Contract
- Concession
- License Agreement
- Petroleum Sharing Agreement (PSA)
- Production Sharing Contract (PSA)

The petroleum regime

- petroleum contracts are one key feature, living in a constellation or web of other laws and regulations above it and many other subcontracts and other ancillary contracts are below it. These will be referred to by the contract but will not be explicitly described, explained or rewritten. This web of laws and regulations relating to petroleum within a particular country is known as a "petroleum regime". The petroleum regime can be best thought of as a hierarchy, starting with the constitution of the relevant country and ending with petroleum contract.


PETRoLEUM
LAWS
CoNTRACT
CoNSTITUTIoN
REGULATIoNS
PETRoLEUM REGIME

So, the petroleum contract is simply one part of the overall petroleum regime that governs petroleum resources. It is, however, the part that defines the particularities and rights that are essential to any company wanting to explore and extract within that country.

Awarding petroleum contracts

There are two main systems for awarding or winning contracts:

- **Competitive Bid**: Given the value of petroleum today, many countries award contracts by holding a 'bid round'. Here, companies compete against each other by offering the best terms with regards to one or more defined variables to win the contract.
- **Ad hoc negotiations**: Here an investor comes unsolicited and asks for a particular parcel of land and then negotiates a contract directly.
- **First come, first served**:

Alternatively, there might be an application system and the first company that applies and passes whatever regulatory hurdles the state may have, is then awarded the contract with some negotiations over the terms of the contract usually involved.

- **Negotiations**

A country is likely to have a model petroleum contract, in a standard format and with standard clauses that can be any of the types of Host Government Contracts listed in the next section. The extent to which the parties will negotiate or change these clauses and terms will depend upon such issues as; the country's petroleum law, market environment and current political situation. Through the negotiating process, the terms may be negotiated significantly from what was in the original model, or it may be only the numbers of one fiscal term on which the companies were bidding, such as a signature bonus that is filled in.

Following negotiations, what was a government model contract will become a signed contract with a particular company or several companies. With the signing of the contract, the company or companies are legally awarded the exclusive right to explore and produce oil in the contract area.

Types of petroleum contract

- Of these Host Government Contracts, there are three principal types which can be
- generally characterized as:
- **Concession**: contractor owns the oil in the ground
- **Production Sharing Contract**: contractor owns a share of oil once it is out the
- ground
- **Service Contract**: contractor receives a fee for getting the oil

- Concessions are the "original" or oldest form of petroleum contract. First developed
- during the oil boom in the United States in the 1800s, the idea was then exported to
- oil producing countries around the world by International Oil Companies (IOC).
- These contracts are based much more on a "land ownership" concept of oil that is
- based on the American system of land ownership. In the United States, the
- landowner, generally speaking, has legal ownership rights of the earth directly
- below it (subsurface)
- and the sky above it.
- This would include oil if it was found below a private property owners land.
- Due to this historical origin, the concession similarly grants an area of land to a
- company, though typically only the subsurface
- rights to the land, and therefore, if
- that company finds oil below the surface, the company owns that oil. Under the
- concession the contractor will also have the exclusive right to explore within the
- concession area.
- How then, you may ask, does a country benefits from this form of contract? This
- usually occurs through taxes and royalties, though a state may also hold shares in
- the concession through its NOC in a Joint Venture with the contractor.

Production Sharing Contracts or PSCs and Service Contracts are different from concessions, in that they do not give an ownership right to oil in the ground. This also means that the state, being the owner of the resource in the ground, must contract a company to explore on its behalf. Indonesia can be credited with the innovation of **Production Sharing Contracts** in 1966. The Indonesian government decided, as a 'nationalistic' move, to move away from concessioning to contracting. This was done so that the state retained ownership of the petroleum produced and only gave the international company the right to explore and take ownership (or legally speaking "title") to it once the petroleum was out of the ground. This innovation came about at the same time as many petroleum producing countries were gaining their independence and was part of the first wave of the socalled resource nationalism. Another key development during this time was the formation of OPEC (Organisation of Petroleum Exporting Countries) that led to further "rebalancing“ of government company relationships.

Under a **Service Contract**, title does not transfer at all. Unlike a PSC, where the oil company is entitled to a share of any petroleum produced, under a Service Contract, the oil company is just paid a fee.

- petroleum contract is the Joint Venture. This involves the state, through a national oil company, entering a partnership and working together with an oil company or companies. In this arrangement, it is the joint venture itself that is awarded rights to explore, develop, produce and sell petroleum. In reality it is rare to find any contract that fits entirely into one of the descriptions given above and is more likely to take elements from each.

the negotiation of a signed or executed contract, all are primarily driven by the executive branch of government. This will typically be the Ministry running the petroleum sector and perhaps some other ministries with relevant expertise such as the Ministry of Finance.

Those outside of this 'inner circle', even in other government departments, have historically found petroleum contracts shrouded in secrecy. As a result, the people that are interested, influenced, and affected by these industries, whether in producing or consuming countries often feel left out, in the dark, wondering where the money went or where the oil comes from and on what terms. And while a

country's constitution is public (we hope!) and the laws are too (if sometimes hard to find), petroleum contracts are likely to be not easily accessible even if by law they should be. The range of potential stakeholders is huge, and their concerns too numerous to list them here. While the majority of oil contracts today speak primarily about the financial and technical aspects of oil extraction, they are increasingly addressing concerns of stakeholders that are not directly parties to the contract but are deeply affected by it. This is further addressed in the section: Economic development.

Our great hope is that the rest of the book, which is devoted to the content of petroleum contracts, will help to empower people to read and understand these multibillion dollar contracts that fuel our world.

The anatomy of petroleum contracts

Generally speaking, contracts tend to follow the order in which things would happen in a petroleum project. After the introductions such as the list of terms to be used in the document they move onto exploration, followed by development and appraisal. Up until this point there is no pie to divvy up and so the clauses deal with operational management issues. Once commercial production begins, fiscal terms follow in the contract as in real life. After that come issues such as local content, dispute resolution and confidentiality, and other issues which may be more specific to each contract.

In the very back of the contract, it is common to see the Accounting Procedures for calculating cost oil in the annexes of a contract and various model forms of the ancillary contracts, like a Parent Company Guarantee or the Joint Operating Agreement. These are referred to as "Annexes", "Appendices" or "Addenda" which are all additional documents that are referred to in the contract but for some reason or another, the parties thought the contract would flow better with it as a separate document or the need for the document came after the parties had agreed to the contract.

Parties of the contract

The parties are usually the host government line ministry or its state/ national oil company (NOC) on the one hand, and an IOC or a group of IOCs, on the other. IOCs may be referred to as the contractor, the licensee or the concessionaire depending upon the type of the petroleum contract signed. Frequently more than one IOC is a party to the petroleum contract. Such group of IOCs is called a "consortium". Each of the companies are an individual party to the contract, but are treated as one entity and are collectively called the "contractor", the "licensee" or the "concessionaire". From the state's perspective, if

the IOCs together fail to fulfill their obligations then they are all at fault. In legal language the IOCs are said to have "joint and several liability" for the performance of the contractor's obligations under the contract.

- In addition to the NOC being party to the petroleum contract on behalf of the state, the script may require the NOC to play another role as well. The host country and the IOC may agree on some form of state participation in the project. In this event, the NOC will be a party to the petroleum contract as well as the representative of the state granting rights to the other parties. Sometimes an affiliate of the NOC is established for the purpose of representing the NOC in the direct operations of the project. Such state participation may be both one of the fiscal tools available to the state as discussed in the section: "'The Money'" and a means to promote broader national development goals as discussed in the section: "Economic Development". An IOC will often participate in a petroleum contract through an affiliate company rather than the ultimate parent company for various reasons such as tax optimization, project financing structuring, foreign investment protection regime structuring or local law requirements. This makes the IOC the "parent" company. Such an affiliate will be incorporated in another jurisdiction than the parent company or the country that is the party to the petroleum contract.

- Petroleum contracts will often set out a provision that captures the fundamental grant of rights to the parties as well as the assumption of obligations by the parties. This provision provides the key grant of rights that underlies the entire performance of the contract. An example is given below:

EXCERPT FROM THE AZERBAIJAN AGREEMENT:

2.1 Grant of Exclusive Right. SOCAR hereby grants to Contractor the sole and exclusive right to conduct Petroleum Operations within and with respect to the Contract Area in accordance with the terms of this Contract and during the term hereof. .....

This grant of right is the main purpose of the petroleum contract. All other rights and obligations are subordinate to it. The clause gives the contractor the right to conduct the components of Petroleum Operations, which are: exploration, appraisal, development, extraction, production, stabilisation, treatment,stimulation, injection, gathering, storage, building rail or roads for loading facilities, building connecting entry point to rail network or to existing pipelines,handling, lifting, transporting petroleum to the delivery point and marketing of petroleum from, and abandonment operations with respect to a contract area.

This grant of rights may be mirrored by a similar statement of obligations. An example is given below:

EXCERPT FROM THE BRAZIL MODEL AGREEMENT:

13.1 - "During the effective period of this Agreement and according to its terms

Historical background

- Historically, the principal contractual form in the extractive
- industry was the concession. A concession essentially grants a private
- company the exclusive right to explore, produce and market natural
- resources. This contractual form has survived to this day, albeit in a vastly
- different form.

- Companies paid small sums to the host government for the rights over its natural resources. Typically, the compensation was not tied to the value of the resource itself. It was, however, tied to volume produced. For example, the Oil Concession of 1934 between the State of Kuwait and the Kuwait Oil Company Limited (United Kingdom) states:

"(d) For the purpose of this Agreement and to define the exact product to which the Royalty stated above refers, it is agreed that the Royalty is payable on each English ton of 2.40 lb. of net crude petroleum won and saved by the Company from within the State of Kuwait-that is after deducting water sand and other foreign substances and the oil required for the customary operations of the Company's installations in the Sheikh's territories" (Oil Concession of 1934: Article 3(d)).

- Because companies determined the volume of production, this meant
- that the interests of governments and companies could and often did
- diverge. That is, it was not always in the interests of companies to exploit
- resources fully

In addition, the scope of the traditional concession was broad, particularly with respect to duration and geography. For example, a foreign company could be granted rights from 40 to 75 years. The Kuwait contract was to run for seventy-five years (Oil Concession of 1934: Article 1. At times, the company secured rights over large tracts of land. This control could extend to the entire country. The broad remit meant that the interests of companies in exploiting resources were not always congruent with those of the host government. For instance, a company might not always have a financial interest in comprehensive exploration. Thus, potential sources of revenue for the host government might not be identified and pursued. Moreover, since the contract granted exclusive rights to the foreign company for the period of the concession, the Government could not seek out a different "thirstier" company. Exploration was contractually tied up. At times, certain parameters for exploration were set.

This was the case in the Kuwait contract which stated:

“(a) Within nine months from the date of signature of this Agreement the Company shall commence geological exploration. (b) The Company shall drill for petroleum to the following total

aggregate depths and within the following periods of time at such and so many places as the Company may decide:·

4,000 feet prior to the 4th anniversary of the date of signature of this Agreement.

· 12,000 feet prior to the 10th anniversary of the date of signature of this Agreement.

· 30,000 feet prior to the 20th anniversary of the date o f signature of this Agreement.” (Oil Concession of 1934: Article 2(a) and (b)).

Importantly, these parameters allowed the company great freedom in determining the nature, scope and extent of exploration.