TYPES AND FEATURES OF INTERNATIONAL PETROLEUM CONTRACTS

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ABSTRACT

All over the world, the oil producing countries sought to extend their control over natural resources and attempted to regulate this lucrative sector by contractual documents or by legislation. The petroleum operation involved high risk, big expenses and investment and cannot be run by one party. By entering into an appropriate contract, the parties can reduce the risk and share the costs which are required for exploration, development and production activities. Understanding the contracts and being able to analyze the contracts are important to estimate and mitigate risks in the petroleum business. Example of common contracts which had been developed and used by the host state (HS) and international oil companies (IOCs) in the petroleum industry are the concession contract, production sharing contract, service contract and joint venture contract.
This article discuss the features and types of the four common international petroleum contracts and highlight the importance of the contract in balancing interest of the host state (HS) and international oil companies (IOCs)

Key word: Petroleum Industry, Concession Contract, Production Sharing Contract, Service Contract, Joint Venture Contract.

INTRODUCTION

The petroleum industry and its contracts with foreign companies have followed a number of different structures. Though, there are controversies about the types of petroleum contracts, researchers have figured out that in the exploration and exploitation of petroleum resources mainly four common types of contracts have been experienced (Hossain, 1979), (Wäelde & Beredjick, Petroleum Investment Policies In Development Countries, 1988), (Johnston, International Petroleum Fiscal Systems and Productio n-Sharing Contracts, 1994), (Machmud, The Indonesian Production Sharing Contract: An Investor’s Perspective, 2000), (Taverne, 2008). (1) The Concession Contract. (2) The Production Sharing Contract. (3) The Service Contract; and (4) the Joint Venture Contract. This chapter will analyze the types, concepts of these contracts and tries to reveal their main features and structures of these contracts, too.

TYPES OF PETROLEUM CONTRACTS

(I) CONCESSION CONTRACTS

The history of the concession petroleum agreements began when the international oil companies entered the Middle East, starting with the famous D’Arcy concession granted on May 28, 1901 by the Persian government (Iran) to an English man, William Knox D’Arcy (Gao, 1994). The D’Arcy arrangement opened the era of concessions and was shortly followed by a number of other Concession Agreements (Gao, 1994). In the wake of this concession there was a fast-following proliferation of Concession Agreements between producing states and foreign oil companies all over the world; for instance, the concession from Iraq in 1925, concession from Saudi Arabia in 1933, and a concession from Kuwait in 1934 (Gao, 1994).

The term of concession gives a number of concepts. It is used to be relevant to both the privileges and rights approved by a government to carry out the operation. It is difficult to define the word” concession”, in its legal sense as it is mostly in relation to the phenomenon of foreign participation, which deals with permits or licenses, especially exclusive ones from the authority (Gao, 1994).

A variety of definitions was given for petroleum concession agreement, for example, Denis Guirauden (Guirauden, 2004) stated that under the concession agreements the state grants the contract holder exclusive exploration rights (exploration license), as well as an exclusive development and production right (lease or concession) for each commercial discovery whilst Cotula, Lorenzo (Cotula, 2010) contended that concessions are contracts when the government grants the investor the exclusive right to exploit natural resources in a given area for a specified period of time, in exchange for payment of royalties, taxation and fees.

FEATURES AND LEGAL FRAMEWORK OF A PETROLEUM CONCESSION CONTRACT

The concession agreement established the relative rights and obligations between the foreign concessionaire company and the host state, whereby the individual or the concessionaire company received a right called mineral or mining right, in exchange for its payment of all costs and specific taxes to explore for petroleum, in case the production had begun (Barrows, June, 1983). The company pays a royalty and income tax in addition to costs.

Under the Concession Contracts, the mining right of the concessionaire will be transposed into a mere authorization to explore and produce; the minerals remain the property of the state until produced (Blinn, et al., 2009). The counterpart of the rights so granted to the holder of the concession consists in an obligation for the latter to "pay" the granting authority i.e. a royalty which is an agreed upon percentage of production (Blinn, et al., 2009).

The common features of Concession Contracts are:

1. The HS grants the IOC an exclusive right to carry out exploration, development and production operations in a restricted area for a specified period of time;
2. The IOC obtains the titles of equipment and petroleum and natural gas;
3. The IOC guarantees the financial and commercial risks; and
4. The IOC agrees to pay bonuses, surface taxes, royalties, etc… at the exploration and exploitation phases (Parra, 2004).

TRADITIONAL CONCESSION CONTRACTS (TCC)

In a TCC, the HS granted the concession and guaranteed the stability of its rights and obligations for the duration of the concession (Nations, Main Features and Trends in Petroleum and Mining Agreements, 1983). The non-existent standard form for a Traditional Concessions' regime makes Traditional Concession Contracts seemingly differ from one country to another. In spite of that, they all follow the same general arrangement and adopt similar conditions (Gao, 1994). Common issues that occurred in tradition concessions are:

i. The area of the concession: The area involved in the contract is normally large and in some cases covering the entire national territory or at least the most important parts of a territory without the relinquishment provision of any part of the area (Blinn, et al., 2009).
ii. The time frame: The period of the contract is an important provision of the contract, for example in the case of Kuwait, the duration of the concession contract is approximately 90 years.
iii. The ownership of equipment and installations: The equipment and installations which have been used for the petroleum operations shall be transfered to the HS upon the expiry of the concession (Blinn, et al., 2009).
iv. Royalty: The IOC pays a royalty to the host state (HS), as per oil production volume (Gao, 1994).
v. Petroleum reserves: The ownership of petroleum reserved found in the area covered by the concession belongs exclusively to the IOC.
vi. Assets and funds: Required assets and fund for exploration and development of the concession contract would be provided by the IOC as a direct investment (Nations, Alternative Arrangements for Petroleum Development: A Guide Government Policy-makers and Negotiators, 1982).

Generally, the traditional concession contracts do not have any provision to renegotiate the terms and conditions of the contract and there is no provision to oblige the HS to join in the exploration and development operations.

It is observed that the traditional concession contracts failed to achieve a balance, continual stability and mutual interests between the host state and the international petroleum company. This is one of the reasons that in the second half of the 20th century, the usage of traditional concession agreements declined and a new generation of concession contracts emerged.

THE MODERN CONCESSION CONTRACT

Due to the dramatic political and economic evolutions which occurred in relationships between the countries, the second half of the 20th century witnessed the emergence of the Modern Concession Contract (MCC). Due to the dramatic political and economic evolutions which occurred in relationships between the countries, the second half of the 20th century witnessed the emergence of the Modern Concession Contract (MCC). Due to the dramatic political and economic evolutions which occurred in relationships between the countries, the second half of the 20th century witnessed the emergence of the Modern Concession Contract (MCC). However, the MCC is an agreement which maintains the basic legal structure of the Traditional Concession Contract (TCC) which has a significant inconvenient impact on the host state, but (MCCs) have gradually excluded those features, disadvantageous to the host state (Blinn, et al., 2009).

MAIN FEATURES OF MODERN CONCESSION CONTRACTS

A MCC generally has these characteristics:

i. The Modern Concession Contract addresses the issue of large jurisdiction. the national territory has been divided into a limited number of blocks;
ii. The time frame of a Modern Concession Contract is limited, with the possibility of extension if the oil still being produced in commercial quantities at the end of the period, but if no oil is found, then the Concession Contract will be terminated within twelve years;
iii. The Modern Concession Contracts secure the employment of the host state e.g. the IOC is required to employ nationals of the HS, and the HS exercises some measures of control over the workers brought to the country;
iv. Financial benefits accruing to the HS include payments based on production, in the form of a royalty as per the value of production.

v. Some Concession Contracts also include bonus payable on signature of the contract, on failed discovery of petroleum, or on reaching certain levels of production.
vi. Host states (HSs) are better informed than under the Traditional Concession contracts on the IOCs' operations and decisions;
vii. The host states (HSs) are given authority to exercise some review of, control over the IOCs' decisions, for example, by requiring a minimum exploration work program, participation in the decision-making process and the approval of the exploration's costs and expenses;
viii. Most Modern Concessions included a provision for the relinquishment obligation (Cattan, 1967).
ix. Form the HS's point of view; relinquishment provisions create two favorable points:
x. They prevent the tying up of the area which is available for exploration by the government or third party;
xi. They encourage a speedy exploration and development of the concession area (Wells & Smith, (winter 1976)).

Generally, MCC authorizes the IOC to explore for and exploit the host state's reserves and transfer considerable discretion over most facets of the development to the company (Gao, 1994). In practice, Modern concession contract also provides more active role for the HS including its authority to exercise some review of and control over the concessionaire's decision, for example, by requiring minimum exploration work programs, approval of the exploration costs and expenses and of field development plans, and by providing for government's option to participate in the venture (Suleiman, 1988).

(II) PRODUCTION SHARING CONTRACTS (PSC)

The Production Sharing Contract is a new type of petroleum agreement which initiated a new era of contracts in the history of the petroleum industry (Machmud, The Production Sharing Contract in Indonesia, 1994). The Production Sharing Contract is a contract that establishes cooperation between a national oil company (NOC) and a foreign or international oil company. This means under a PSC that the host state manages the petroleum operations through the national oil company (Machmud, The Indonesian Production Sharing Contract: An Investor's Perspective, 2000). Zhigou Gao (1994) brought the most comprehensive definition of the PSC (Gao, 1994) when he stated "*the production sharing contract is an agreement under which a foreign company, serving as a contractor to the host state/its national oil company, recovers its costs each year from production and is further entitled to receive a certain share of the remaining productions as payment in kind for the exploration risks assumed and the development service performed if there is commercial discovery*."

In a PSC, a foreign or international oil company conducts the exploration and production operations as a contractor for the state's enterprise such as the Ministry of oil or the National Oil Company (NOC), within a certain area (contract area) in accordance with the rules of a contract (David, November 1996). Today, PSC is considered as a common arrangement for petroleum exploration and development.

CONCEPT AND NATURE OF THE PSCS

In the last quarter of the twenty first century, the majority of petroleum producing countries nationalized the mineral resources, however, in certain the door for exploration and production was not closed for foreign oil companies. Under a PSC the host state as the owner of the petroleum resources engages an international oil company to provide technical and financial services for the exploration and development operations (Bindemann, October 1999). All costs and risks of exploration and production will burden by the contractor, in case the exploration and production were successful and a commercial discovery had been achieved, the contractor (IOC) is entitled to be repaid out of a proportion of the oil produced known as (cost recovery) and further, as a reimbursement for the development achieved, the contractor is entitled to a share in the remaining oil known as (profit oil) (Hossain, 1979).

A PSC is based on contractual principles for the relationship between the parties (HS & IOC) with regards to exploration and production. The rights and obligations of the parties are determined under the contract itself, so that the relationship would legally be equal and any sort of breach raises the issue of contractual and legal liability. It is noteworthy that, PSC operates in a way that the host state keeps its internal authorities and obligation simultaneously and fulfilling its obligations towards the foreign investor (IOC). Therefore, the legal nature of PSCs can be summarized as a risk with the right to share the production (Gao, 1994).

In its most basic form of PSC, the royalty would be paid by the IOC to the government on revenue production. After paying the royalty, the IOC is entitled to a pre- determined share of production for a cost recovery. The profit oil is shared between the host state and the IOC at a stipulated share. Then the income tax should be paid by the contractor (IOC) on its share of profit oil (Bindemann, October 1999). According to Kristen Bindemenn (1999), the entire exploration risk under PSC is borne by the contractor (IOC) whilst the host state owns both the resources and equipment and manages the whole operations through its enterprises: the National Oil Company or the Ministry of Oil. In other words, the role of an IOC and the NOCs' involvement are clearly identified in the PSC compared to other petroleum contracts.

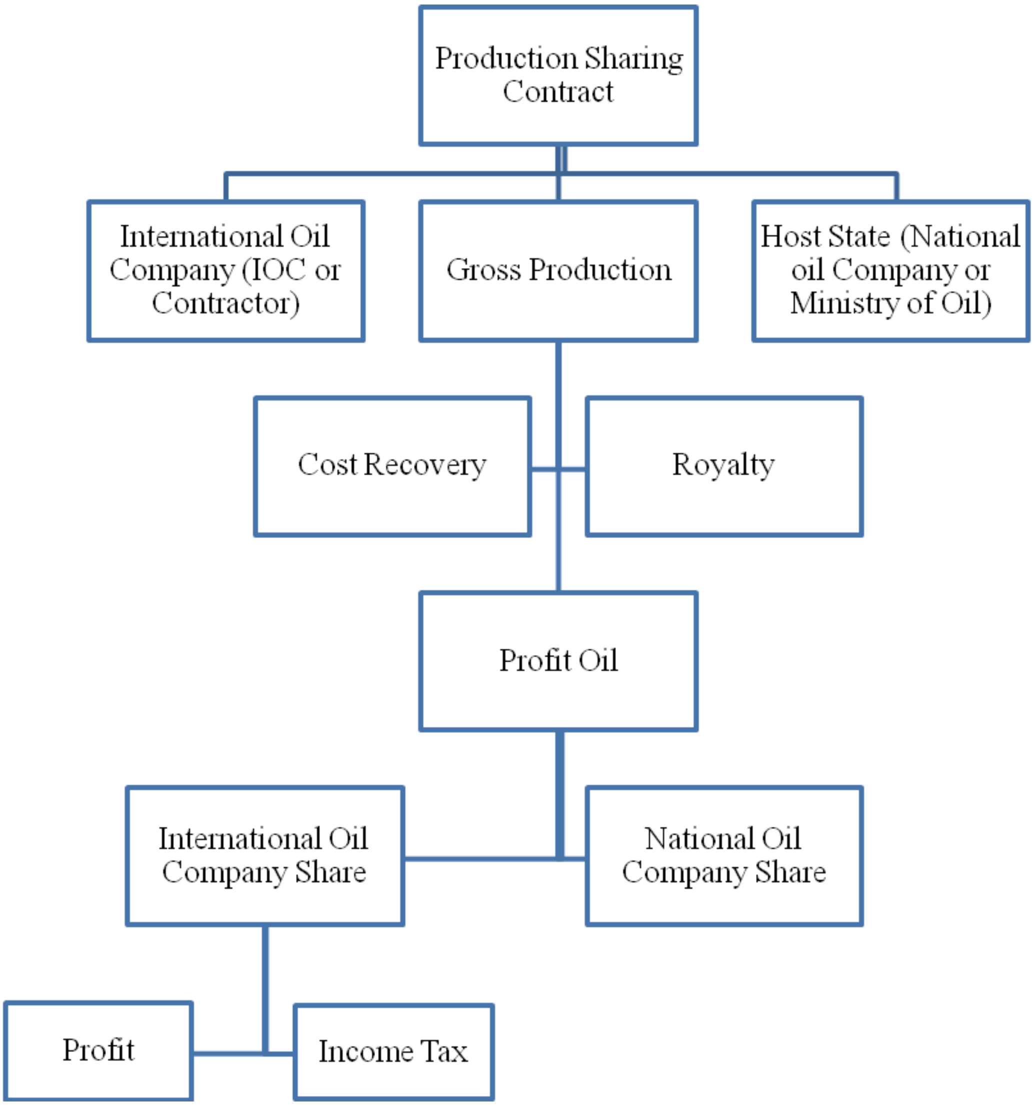
FEATURES OF PRODUCTION SHARING CONTRACTS

The "Contractual structure" of a Production Sharing Contract rises a few features depicted as follows:

1. The host state signs up an IOC as a contractor through its enterprises (the National Oil Company or Ministry of Oil);
2. The contractor (IOC) runs the exploration and production operations at its own risks and expenses;
3. The host state is entitled to the amount of petroleum if produced;
4. The IOC has the right to get a portion of the production from the contractual area as a payment to recover its costs (cost recovery);
5. Both of the host state and the international oil company are sharing in quantum of production on a pre-determined ratio;
6. The PSC contains a taxation provision; under this provision the IOC would be liable to income tax;
7. All equipment and installations required to the exploration and production process belong to the HS (Blinn, et al., 2009).

The PSC recognizes prevailing trends for both parties in the contract, that the notion of production sharing is a clear endorsement and manifestation of the principle of the mutuality of interest in relationship (Gao, 1994). The PSC offers a stable contractual relationship between the two parties. The ownership and management of the natural resources belong to the host state and simultaneously the PSC acknowledges the essential role of the foreign oil company.

Figure 1- Main Features of PSCs (Bindemann, October 1999)



(III) THE SERVICE CONTRACTS

Some oil producing countries attempted to improve the contractual relationship with the IOC in order to get a better position of national control over both the petroleum resources and operations, at the same time having a minimum level of foreign involvement. Thus, in spite of the Concession Contract and Production Sharing Contract, in the second half of the 20th century, Service Contracts emerged.

The appearance of the Service Contract reflects the general dissatisfaction of the host states with the relationship with the governmental companies under the Concession and Production Sharing Contracts (Gao, 1994). Furthermore, the oil producing countries were mostly developing countries incapable financially and technically to launch an exploration and production operations; that is why they devised an instrument under which the costs and risks were carried out by international contractors in return for a fee or a certain amount of the production (Gao, 1994). Denis Guirauden (Guirauden, 2004) described a service contract as "a contract by which a contractor (IOC) undertakes to explore for hydrocarbons at his own risk and expense on behalf of a national oil company (NOC), and by which he is reimbursed and remunerated in cash depending on the success of the exploration".

Types of the Service Contract

A Service contract has several equivalent names, such as "Agency Agreement", "Operation Contract" and "Association Contract" (Blinn, et al., 2009). Service contracts could be classified into two general categories:

(i) THE RISK SERVICE CONTRACT (RSC)*

Under this category the contractor (IOC), also referred to as the investor agrees to afford all capital and services' risk for the exploration and development. In case the oil is produced the IOC repays for its cost and investment and remunerates for its services in cash or buy-back oil or both (Gao, 1994).

(ii) THE NON-RISK SERVICE CONTRACT

This type service contract is also known as "Pure Service Contract". In this contract, the IOC executes a specific task for a host states in return it would be paid a flat fee; as the name of this category reveals the IOC does not carry any sort of exploration risk. Inconsistently, all the risks and costs will be borne by the host state (Gao, 1994).

CONCEPT AND LEGAL NATURE OF THE SERVICE CONTRACT

The principles and structures of Service Contracts are comparable if not identical to the Production Sharing Contracts. The major dissimilarity between them rises in the mechanism of the recovery of costs and the remuneration of the contractor (IOC) (Blinn, et al., 2009). The main distinction between a Service Contract with a Production Sharing Contract is that, the Service Contract reimburses the contractor in cash, not in crude oil (Wäelde & Beredjick, Petroleum Investment Policies In Development Countries, 1988). The contractor will be paid a cash payment for carrying out the service of producing the petroleum resources. While all production vests to the host state, the contractor (IOC) is required to provide all capital that is necessary for the exploration and development (Johnston, Production Sharing Contract, 1994a). If the exploration efforts were successful, then the contractor recovers the costs through a fee that is based on a percentage of the produced oil (Johnston, Production Sharing Contract, 1994a). It must be pointed out that a Service Contract guarantees the legal status to the host state as an owner of the resources and the international oil company acts as a contractor for a National Oil Company. As a result, the contractor (IOC) would be defined neither as a concessionaire nor as a partner (Hossain, 1979). Thus, the legal nature of a Service Contract is risk without title to oil (Gao, 1994).

THE MAIN FEATURES OF A SERVICE CONTRACT

Although a Service Contract has common objectives with a Concession Contract and Production Sharing Contract, but it has own features namely:

i. A Service Contract ensures the host state total ownership of the petroleum resources and all assets (Nations, Main Features and Trends in Petroleum and Mining Agreements, 1983). In other words, a Service Contract guarantees the maximum national control over the petroleum development whilst securing the cooperation of the foreign contractor;
ii. Economically a Service Contract causes higher income than other petroleum contracts because the host state has exclusive power over production;
iii. Due to the Service Contract's structure, the fiscal system is less complex than other petroleum contracts, especially in terms of tax and royalty provisions, which are a traditional area of dispute;
iv. Technically a Service Contract is simpler and clearer to manage. In this regard, it is probably right to say that the supervisory process and administrative mechanisms have been reduced in order to avoid bureaucracy in the course of executing the contract (Gao, 1994).

* The term "Risk Service Contract" has several synonyms specifically "risk-bearing service contract", "risk contract", "risk clause contract", or "service contract", in this study the researcher used the "risk service contract" when referring to all of these names.

In short, a Service Contract is a device that can be arranged for the requirements of some oil producing countries in the sense of finance, technology and experts. At the same time the foreign oil companies get access to the oil operations.

(IV) THE JOINT VENTURE CONTRACTS (JVC).

The Joint Venture Contract comes in as a common mode of doing international oil business. The Joint Venture Contract (JVC) has an additional combination structure that makes the partnership more effective and creates a more balanced atmosphere between the parties; which we will approach as balance of interests between the parties and its mechanism specifically in this academic work in later chapters. Moreover, it has been claimed that in comparison with a Concession Contract and Production Sharing Contract, the Joint Venture Contract provides the host state greater control over the petroleum projects (Cotula, 2010). Although the financial and technical aspects are necessities in a petroleum project, spreading and minimizing the various risks (geological, technical, development, environmental, and political risk) attached to a petroleum operation are also reasonable motives to adopt Join Venture Contracts (Taverne, 2008).

CONCEPT OF A JOINT VENTURE CONTRACT

A Joint Venture Contract is considered to be a favorable option for the host state. Under this type of contract the host state or (its National Oil Company) and the international oil company share the equity and installments in joint operations to explore, develop and produce petroleum resources (Nations, Alternative Arrangements for Petroleum Development: A Guide Government Policy-makers and Negotiators, 1982). The parties are sharing the risks, costs, production and profits, in pursuant to the terms specified in the Joint venture contract (Nations, Alternative Arrangements for Petroleum Development: A Guide Government Policy-makers and Negotiators, 1982). A Joint Venture Contract creates a partnership arrangement, in which both parties interests somehow are balanced by jointly bearing the rights and obligations in the petroleum operations. The host state must be able to participate in the petroleum operations and bear the costs and risks, in case the commercial discovery fails the host state becomes subject to losses, which is not the case under the Concession and Production Sharing Contracts (Cotula, 2010).

TYPES OF JOINT VENTURE CONTRACTS

There are two models of JVC:
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1. The Incorporated Joint Venture: Identified by the formation of a separate legal entity, whereby the jointly owned company is set up and would be run by a board where both parties are represented. The profits are shared according to each party's participation in the joined company (Nations, Alternative Arrangements for Petroleum Development: A Guide Government Policy-makers and Negotiators, 1982).
2. The Unincorporated Joint Venture: The joint venture might also be run through contractual arrangement, without the creation of the separate legal entity (Cotula, 2010).

The JVC reflects real partnership between the host state and oil the company, which involves the host state and oil company in the common undertaking of petroleum management (Hossain, 1979). Its legal nature is often: risk with a title to share management and production (Gao, 1994).

THE LEGAL NATURE OF INTERNATIONAL PETROLEUM CONTRACTS

In the area of international law the nature of international petroleum contracts is a controversial issue. Clarifying the positions of the international petroleum contracts strongly relies on their legal descriptions. From judicial verdicts and scholarly opinions there is no unanimity towards the nature of international petroleum contracts. Some jurists, mainly those from western countries, believe that petroleum contracts have an international agreement's status; consequently they are subject to international legal principles (Jenning, 1961). Other scholars claim that these types of contracts should be run by domestic law of the host state, under the principles of the private international law (Gao, 1994). During the analysis of the four presented contracts in this research it was obvious that petroleum contracts contain both private and public law elements, such as government control, domestic needs, state participation (public law elements) and the consequences of the contractual and commercial nature of transactions (private law elements). Thus, we might say a petroleum contract has a dual legal character which is a mixture of public and private law. According to jurists, although a Concession Contract does not have public law elements, it still retains a contractual nature. It is considered as a private project; as it is generally governed by principles of the private law of contracts (Libyan American Oil Co. (Liamo) vs. Government of Libyan Arabic Republic, 1981), (Gao, 1994).
The question is whether a petroleum contract is similar to a treaty? According to Daniel Patrick O'Connell, since one of the parties is a foreign private company a contract is not analogous to a treaty (O'Connell, 1955). It seems, like a treaty which is noticeably between two sovereign states; one state cannot use its own municipal law to vary its treaty obligations towards another state. Therefore, a contract between the host state and a private entity is anything but an international treaty and cannot be even considered as analogous to an international treaty (Bowett, 1988).

2.7 OBSERVATIONS

It is observed that the various types of petroleum contracts are a real manifestation of the political, economic even social development that happened across 20th century. However, all petroleum contracts designed to achieve same common goals, but they differently approach the ownership of oil and gas resources, the extent of control over operations, the size of the national oil company's participation and the assumption of risk by each party of the contract.

Most contracts which were introduced in the second half of the last century give an essential role to the host state through its National Oil Company. A close analysis of a Production Sharing, Service and Joint Venture Contracts approves the fact that national oil companies are in a position to controlling oil and gas operations (Wäelde, International Energy Investment, 1996). A Concession Contract has been used to encourage foreign investment in countries where the petroleum industry is in poor level of development and the Service and Production Sharing Contracts have been relied on to achieve a more active participation. Meanwhile, A Join Venture Contract is adopted in order to spread risk and cover for the capitals and equipment shortage. Flexibility and balance between the parties are the most important factors to determinate the success or appropriateness of the contract.

Based on these findings, it is observed that the host state and the international oil company are in a contractual partner relationship. Under the Concession Contract a concessionaire works essentially for itself. Under Service and Production Sharing Contracts an international oil company works as a contractor for the government. Under the Joint Venture Contract a foreign oil company works in association with the state oil company (Gao, 1994).

In this respect, we may conclude that, the PSC is the most attractive contract of the possible agreements, simply because it is able to reconcile the primary aspiration and objectives of both parties to the maximum extent possible. The system offers the necessary adaptability and flexibility for both parties in petroleum operation. Under this arrangement, HS legally retains overall management, but in practice, the IOC exercise day-to-day control. Its flexibility enables the state to structure the division of the production on the basis of a theoretical model that incorporate fair rate of return for the contractor and a fair share of increased revenue from rising prices for the state. Most importantly, both parties to the relationship have certain access to crude oil. PSC is an excellent means of having a shared relationship between the HS and OC. Both sides are can find advantages and satisfaction in this arrangement. It is predicted by experts in the oil industry that "PSC will continue to be more popular, because it satisfies the needs of both host government and the contractor" (Gao, 1994).

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