

The Uproar Surrounding Petroleum Contract Renegotiations

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In recent years, complaints of unfairness on the part of host states in the renegotiation of international petroleum contracts have become commonplace at conferences and seminars in both the United States and Europe. Not so often discussed are the legal issues underlying the particular cases – simply repeating the mantra of *pacta sunt servanda* is not a discussion. Even less attention is paid to the facts, a point which is the focus of this article. Without an understanding of the facts underlying a renegotiation, one can easily jump to the wrong conclusions, and that is precisely what seems to have been happening with alarming frequency on the conference/seminar circuit, where conclusions are too often drawn from incomplete information derived from press releases or press reports.

Background

This recent period is not the first time that the petroleum industry has provided the setting for political, economic and legal struggle. The same was true in the 1970s, when the principle of Permanent Sovereignty Over Natural Resources¹ was trumpeted as loudly as *pacta sunt servanda*. A wave of nationalisations gave rise to a series of arbitral decisions that would be cited throughout the coming decades, even to this day.² When circumstances changed radically, the industry again became the incubator for what has been dubbed a new wave of ‘resource nationalism’.

What is it about the petroleum industry that seems to always place it in the eye of the storm? Here are some contributing factors.

First, upstream licences or agreements tend to be long-term in nature. It was not uncommon for concessions granted in the 1950s to have a term of 50 years or longer.³ Production sharing agreements, the next generation of upstream contracts that became popular in many oil-producing countries when concessions fell into disrepute, were anywhere from 25 to 40 years in length.⁴ Agreements of such duration tend to undergo fundamental changes at least once in the course of their life.

Second is the volatility of the price of the resource. In the 1970s, the oil shock sparked by the Arab oil embargo was followed by another extraordinary price rise at the end of the decade. The 1980s saw the market flooded with oil as Saudi Arabia increased production and market share with netback pricing. The price of oil plummeted to less than \$10 a barrel, and stayed relatively low throughout the 1990s, averaging around \$18 per barrel for the entire decade. In March 1999, the cover story of *The Economist* argued that the price could hover around \$5 for some time.

Starting in 2004, the price environment again changed dramatically, averaging around \$40 per barrel that year. The seemingly endless upward spiral continued in the succeeding four years, with the price shooting right through the \$100 per barrel barrier and reaching a peak of almost \$150 per

barrel in July 2008. Given this kind of structural change in the petroleum markets, it is not unusual to see adjustments in contractual terms or fiscal regimes to take account of the changed circumstances.

Third, the economic importance of the petroleum industry to host countries cannot be overstated. With the stakes that high, a mistake in petroleum policy can have devastating consequences for the host state concerned. That is why matters relating to the petroleum industry tend to be considered matters of public policy in those countries.

Fourth, the best-known renegotiations and industry restructurings of the last five years have involved upstream contracts entered into in the 1990s, when the price of oil was a fraction of what it was to become and when privatisation was in vogue. The Soviet Union had just collapsed and the prevailing attitude was that everyone would flourish from private ownership and exploitation of natural resources. In that environment, many long-term agreements that were very unfavourable from the host country’s standpoint were concluded, agreements that invariably led to trouble as circumstances changed and the anticipated benefits of privatisation did not materialise.

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Finally, many of those contracts were not only economically indefensible, but they also purported to cede control over petroleum operations to private parties, often in a manner that raised serious legal issues going to the heart of the contracts. Ownership of petroleum in the subsurface typically is conferred upon the state by constitutional mandate in host countries, and in some cases the political sensitivity of control over the hydrocarbon sector is at least as important as the legal issues raised by such constitutional provisions. This explains the propensity to create new forms of contracts that pass constitutional muster and can withstand the political heat that often accompanies long-term contracts involving foreign, or any private, participation in the oil industry. The proliferation of ‘service’ contracts, in which the service contractor never acquires title to the oil produced, is attributable mainly to the perceived need to reconcile the desire to attract private investment with the legal and political constraints standing in the way of achieving that objective.

All this has led to contract renegotiations, and in some cases complete national industry restructurings, in the last few years. In many countries, this has involved fundamental issues of structure and governance; all cases involved adjustments in government take.

Host countries that have taken measures in this direction include Algeria, Bolivia, Canada, China, Ecuador, Kazakhstan and Venezuela, all of which imposed new taxes and royalties on production, exports or windfall profits. Bolivia and Venezuela also mandated structural changes for all contracts in their hydrocarbons industries. In Alberta, Canada, the provincial government announced a 20 percent increase in oil and gas royalties. The US Government provided Congress with a report in May 2007 on the question of increasing oil and gas royalties, including a comparison of royalty rates under fiscal regimes around the world, in response to concerns that government take was not keeping pace with record oil company profits. Oil executives were called before Congress to defend windfall profits, and Sarah Palin's Alaska collected billions in additional revenue from a new windfall profits tax. The attitude of many governments is reflected in the following statement of US Secretary of the Interior Salazar to an oil industry audience last year:

Just as your shareholders expect you to get a fair rate of return on your investments and to be wise stewards of your balance sheets, the American people are asking the same of us as we manage their resources. . . .

That means we are going to take another look at royalty rates. It means that tax breaks that are no longer needed, and which the American people can't afford, will disappear.⁵

Three Case Studies

Three of the best-known renegotiations or industry restructurings of the last few years involved the operating service agreements (*convenios operativos*) in Venezuela, the gas production contracts in Bolivia, and the renegotiation of the world's largest production sharing agreement, the one covering the Kashagan field in Kazakhstan.

In Venezuela, approximately 500,000 barrels per day were being produced under the operating service agreements, which were supposed to be pure service contracts. The 1975 Law Regulating the Industry and Trade of Hydrocarbons did not allow, except in certain cases approved by Congress, any private participation in production. Service contracts were allowed for basic services, such as drilling and seismic survey, but these were supposed to be pure service contracts, not contracts mimicking production sharing agreements that effectively granted the contractors a participation in the business.

The Venezuelan operating service agreements, although structured as service contracts, were in substance anything but pure service contracts. They ceded control over petroleum operations in huge areas for 20 years, and compensation was based on the volume and value of production. Many of the service providers were in effect senior partners in the business, on average taking more than half the value of production. In some cases, the state company actually lost money for each barrel of oil produced, after accounting for the royalty owed to the State. Making matters worse, the contractors, claiming to be only service providers, argued that

they were subject to the non-oil income tax rate of 34 percent rather than the rate applicable to oil producers, 50 percent.

In April 2005, the Venezuelan Government intervened to require migration of the operating service agreements to the new structure of mixed company (*empresa mixta*) under the 2001 Organic Hydrocarbons Law, and 30 out of 32 contracts were successfully migrated over a one-year period. The other two resulted in negotiated settlements. The new mixed companies emerging from the migration of the operating service agreements are all subject to combined royalties and special advantages (*ventajas especiales*) of 33 1/3 percent, as well as the 50 percent oil income tax rate. A special assessment for extraordinary prices also applies when the price of crude oil exceeds \$70 per barrel. Apart from the fiscal regime, a state company is by law the owner of at least 60 percent of the shares of each of the new mixed companies. Basic minority protections are included in the by-laws, but the legal issue of control has been resolved.

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Turning to Bolivia, we again hear a lot of talk about resource nationalism, but little about the facts of the old agreements. Prior to 2005, contractors were taking 82 percent of production from Bolivia's giant gas fields, paying only an 18 percent royalty. This was after all investment that had long ago been recovered. The contracts had never been approved by Congress, as appeared to have been required by the Constitution.

By 2005, the situation had become untenable. A new Hydrocarbons Law was enacted in May of that year, imposing a 32 percent tax on the gross value of hydrocarbons (*Impuesto Directo a los Hidrocarburos*) in addition to the 18 percent royalty, thereby reducing the private party's share to 50 percent. The Hydrocarbons Law also provided a six-month period for migration of all existing contracts to one of the new legally-sanctioned forms of contract. That six-month period expired with no progress on the migration.

On May 1, 2006, the new administration again nationalised the industry, granting another six-month period for the conversion of the old contracts. While the new operating contracts were being negotiated, the state company was given a provisional 32 percent share, reversing the old 18/82 split to 82/18. Six months later, all of the contractors executed the operating contracts, which are structured as service contracts with the service providers receiving remuneration in cash, not oil.

The third case study is the renegotiation of the PSA covering the world's largest discovery in three decades: Kashagan in Kazakhstan. There the heart of the problem was the concept of cost recovery, under which a large percentage of production, known as ‘Cost Oil,’ is allocated off the top to the contractors to recover their costs. In the case of

Kashagan, that percentage was 80 percent. After allocation of that 80 percent to the contractor, the remaining production, known as 'Profit Oil,' was allocated initially 90 percent to the contractor and 10 percent to the State, a ratio that was eventually supposed to change in favour of the State based on a set of complicated triggers set forth in the agreement. Until then, the contractor would continue to receive 80 percent of the Cost Oil and 90 percent of the Profit Oil, or 98 percent of total production.

Despite what many feel is a textbook alignment of interests in a contract including such cost recovery provisions, experience shows that this structure is often a recipe for disaster, and that is exactly what happened in Kashagan. Overall costs of the project increased by more than 100 billion dollars, and production, originally scheduled to start in 2005 or 2006, now is scheduled for 2012. The net result was that in the world's largest discovery in recent times, which is expected eventually to produce 1.5 million barrels per day, the state would have received a grand total of only 2 percent of the oil produced for at least the first decade of production, not including the relatively small participation of a subsidiary of the national oil company in the contractor consortium. That was obviously an unacceptable situation, which most people with knowledge of the facts fully recognised. In the renegotiation, the national oil company's subsidiary doubled its stake in the project, a new 'priority share' was allotted to the Government off the top, and new cost and schedule control mechanisms were introduced to help guard against future cost increases and delays.

What lessons can be drawn from these experiences?

First, bad deals spell trouble. The worse the deal, or the more imbalanced the deal, the more likely it is to be renegotiated. That goes for both sides. One might say that the best form of stabilisation is an equitable deal.

Second, don't believe everything you read in the papers. Most of the renegotiations or industry transformations have ended in success, which says something about the reasonableness of the processes. The objective has not been to exclude private participation from the petroleum industry or to make it economically non-viable, but rather to put it on a sound legal and economic footing.

Third, most renegotiations take place without adversarial proceedings, another indication that reason tends to prevail on both sides. There is a school of thought that favours adversarial proceedings, mainly arbitration, as a negotiating

tactic, but the wisdom of using that tactic would not appear to be borne out by experience.

Finally, terms such as 'resource nationalism' are an oversimplification of what has been happening on the ground and are no substitute for informed analysis of both the facts and the legal issues underlying the major renegotiations of the last five years.

Notes

- 1 *Declaration on the Establishment of a New International Economic Order*, G.A. Res. 3201(S-VI) U.N. Doc. A/RES/S-6/3201 (1974); *Charter of Economic Rights and Duties of States*, G.A. Res. 3281 (XXIX), U.N. Doc. A/RES/29/3281.
- 2 *Libyan American Oil Company (LIAMCO) v. The Government of the Libyan Arab Republic*, Award dated April 12, 1977, 20 INTERNATIONAL LEGAL MATERIALS 1 (1981); *B.P. Exploration Company (Libya) Limited v. Government of the Libyan Arab Republic*, Award (Merits) dated August 1, 1974, 53 INTERNATIONAL LAW REPORTS 331 (1979); *Texaco Overseas Petroleum Co. and California Asiatic Oil Co. v. Government of the Libyan Arab Republic*, Award on the Merits dated January 19, 1977, 17 INTERNATIONAL LEGAL MATERIALS 1 (1978); *In the Matter of an Arbitration between the Government of the State of Kuwait and The American Independent Oil Company (Aminoil)*, Award dated March 24, 1982, 21 INTERNATIONAL LEGAL MATERIALS 976 (1982).
- 3 See, e.g., *Libyan Petroleum Law of 1955*, Article 9(4) ("Concessions shall be granted for the period of time requested by the applicant permitted provided that such period shall not exceed fifty (50) years. A concession may be renewed for any period such that the total of the two periods does not exceed sixty (60) years."). Thomas W. Walde, *Revision of Transnational Investment Agreements: Contractual Flexibility in Natural Resources Development*, 10 LAWYER OF THE AMERICAS 265 (1978), pp. 265, 279 ("Traditional petroleum concessions in the Middle East often had a duration of up to 99 years.").
- 4 Concessions fell into disfavour not merely for economic reasons, but because they appeared fundamentally inconsistent with notions of sovereignty. They granted international oil companies control over petroleum operations, title to production, and control of the marketing of crude oil. Production sharing agreements did not have the stigma associated with concessions because the national oil company was usually a party, receiving a share of production and exercising at least nominal control over operations through approval processes for work programs and budgets. The reality did not always conform to the theory, as became evident from some well-publicized cases.
- 5 Department of the Interior News Release, March 19, 2009, "Salazar Addresses the American Petroleum Institute's Board of Directors" (http://www.doi.gov/archive/news/09_News_Releases/031909.html).