Initiative for Policy Dialogue Working Paper Series

September 2006

How to Negotiate an Oil Agreement
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Resource Curse

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Chapter 4: How to Negotiate An Oil Agreement?

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Abstract

Discoveries of oil and gas generate much excitement, and both governments and companies put great effort into understanding technical and commercial aspects of field development. In fact, however, the first challenges for governments are negotiation challenges. This chapter identifies the key areas on which governments should focus during their negotiations and provides guidance regarding: who should be negotiating, over what issues, with what informational environment, and with what time horizon. Features such as contract structure are also examined and a set of especially tricky issues are discussed, including accounting standards; the role of social projects; health and environment concerns; stabilization clauses; and contract termination provisions.

I Introduction

The mere mention of a natural resource discovery, especially of oil and increasingly of gas, ignites personal and national dreams of riches and hopes of prosperous times, fueled more than ever by recent dramatic increases in oil prices. Bolivia, Kazakhstan, Mexico and other developing nations view their natural resources as an asset not belonging to any private party. Irrespective of who may own the surface land and rights, the nation owns the assets, and this position is often enshrined in a state's most fundamental law, its constitution (see also Chapter 7). The "emerging" players, such as Mauritania, Equatorial Guinea and Azerbaijan, optimistically view such a valuable treasure as a fast track to development. Their vision of tomorrow is the oil rich nations of Kuwait and the United Arab Emirates of today. But the emotional euphoria of a beautiful tomorrow often runs into reality -- namely, the financial, commercial and political challenge of transforming locked underground assets into a useable liquid asset -- cash. And dashed emotions can turn to anger; witness the recent popular protests in Bolivia, Ecuador and Venezuela. Ruined dreams pose significant political and economic risks for the energy industry, for the consuming nations, as well as for the producing nations. Hence the hurdle: how can the challenge of rising expectations, desires and demands be satisfied.[1]

It is commonly accepted that these challenges involve overcoming technical engineering and related commercial hurdles in exploration and development. Indeed, from the viewpoint of many producing nations, the key hurdles center on management issues, as evidenced by the renewed desire to establish state owned energy companies. In fact, however, the *first* challenges are typically negotiation challenges.

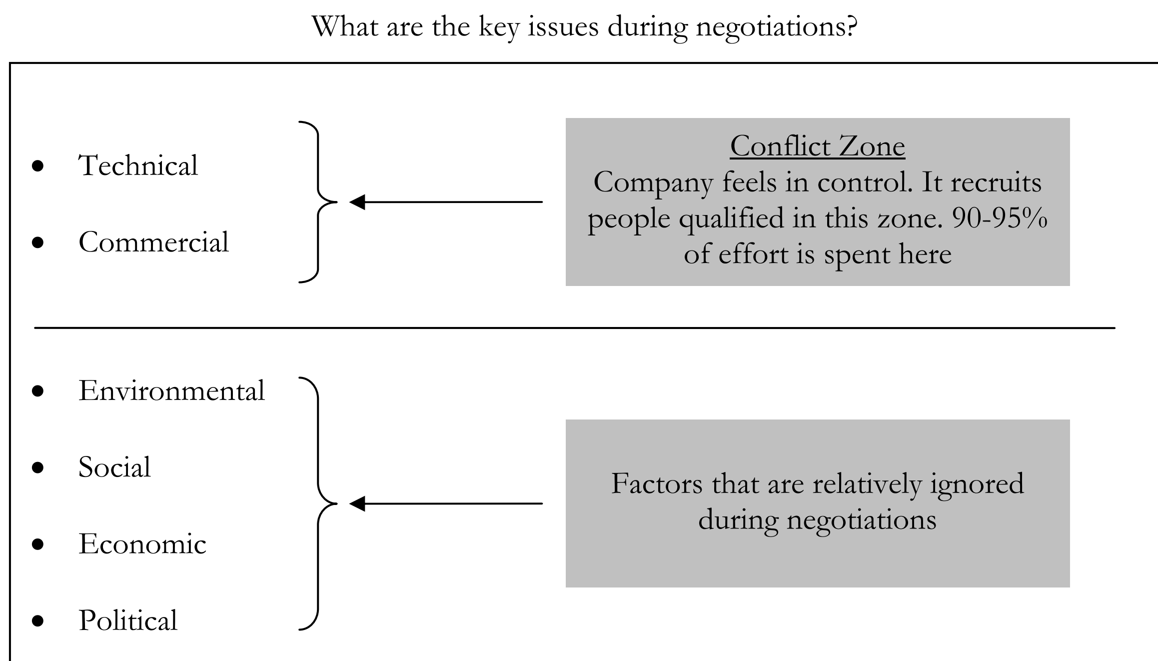
In most cases, resource rich nations will seek to attract the participation of international companies with the resources and expertise to help them exploit and market their energy resources. Yet, once they start negotiating, they find that major oil and gas companies often possess greater financial resources, superior knowledge of the oil or mining fields, and more experience in negotiating contracts. Indeed, most countries where oil companies operate have far fewer resources than the oil companies themselves; for example, Exxon Mobil's

income of $371 billion far outstripped even oil-rich Saudi Arabia's entire GDP of $281 billion.[2] Negotiations can thus become heated affairs.

Oil companies are highly motivated during negotiations. They resent the costly and speculative exploration investments and the number of dry wells encountered, and will seek to recover rapidly such out-of-pocket costs in any negotiations. They also lament that they have to deal in extremely difficult and corrupt situations, which admittedly require international institutions and the home government -- where oil companies are domiciled -- at times provide "political" support" (Radon 2005). Or as the president of an independent oil company told me: "We have to deal in chaos… but [then smiling] we make money in chaos." Oil companies often tailor their negotiation style to their interpretations of the political environments in which they operate. Accustomed to dealing with authoritarian regimes or in countries plagued by civil strife, oil companies often bring a self-protective, uncompromising and feisty attitude towards negotiation.

Figure 4.1

What are the key issues during negotiations?



TSource: Based on figure provided by Donal O'Neill, Lansdowne Consulting.

This approach takes on a life of its own. As emphasized by one former international oil company executive, Donal O'Neill (see Figure 4.1), too little time and effort gets spent on the "people" side of the oil development process, with the result that many of the most important risks of the negotiations and the consequent agreements are ignored.

Negotiating a fair distribution of wealth with these companies is a major challenge and requires a significant investment of time and money in assembling a team of experts to conduct negotiations. This paper will discuss these considerations and highlight contractual issues and options of which government negotiators need to be aware.

II Setting the Parameters

II.1 The Setting

Many eyes are on oil negotiations, not just those of the two principal parties. Affected landowners -- often indigenous communities—demand compensation for the use and disturbance of their property. This will have to be taken into account, even if such groups are not part of the formal negotiation process. Local communities which, until recently, were on no one's checklist of factors to take into consideration, now often demand their part of the spoils in the form of jobs and compensation payments. These demands will have to be handled, and ideally resolved, through the domestic political process, and, preferably, as part of the overall oil contract negotiations. Oil companies will thus often make specific commitments to train and engage domestic labor, as well as to support community development and cohesion -- the ultimate in so-called soft (or social) issues. More broadly, political discussions on how to spend the not-yet-realized fortunes will quickly monopolize a nation's airwaves and the public discourse, bringing its own unrealistic momentum and pressure for fast action to bring the oil on-stream. Political pressures in particular tend to undermine prospective negotiations with international oil companies by subtly establishing an artificial time schedule, namely a fast one. Negotiations will, however -- if history is a guide -- be intense and invariably time consuming. They are also likely to be heated, if not

acrimonious, as the differences of opinion, goals and objectives among the many participants and affected actors are typically quite significant.

Despite the keen interests and the size of the stakes, the negotiation process itself is nonetheless all too often given insufficient attention by government parties. Since negotiation is generally accepted as a routine experience, it is often not viewed as a real skill, but rather as something that anyone can do. Even when, for complex matters, parties engage an expert -- such as a lawyer, for their legal knowledge, or an engineer, for his technical knowledge -- the negotiation itself is frequently handled by the government, which will still tend to regard negotiating as a straightforward activity not deserving of much preparation or focus. Moreover, too often there is a refusal or reluctance to engage the necessary expertise, let alone pay for it. With oil contracts, however, too much is at stake -- especially for the producer nation -- to permit such a simplistic and narrow approach (see Chapter 2)

Oil contracts are a direct result of negotiations. This is true even in bidding situations, which are often wrongly perceived as "negotiation neutral." The issues in an oil contract are many, varied and complex. There is no model result that can or should be achieved. The result is the inevitable give-and-take as each line is negotiated.

Negotiations assume, and can be said to thrive on *uncertainty*, whether stemming from a lack of knowledge of the potential of the oil find, the break-point of the negotiating partner, or the obvious inability to predict the future. Good negotiators know that, in every situation, there is an element of poker -- a weak hand, if played well, can win, and even win big. But oil negotiations do not have the simplicity of poker, even if steadfastness, focus and other lessons can be applied. There are too many issues to consider: the cost of exploration and development; the ever changing market conditions; the possible field size, including the possibility of dry holes; and the difficulty of recovery. The list goes on. Judgment is required to determine the importance and priority of each issue and, ultimately, to strike an ever changing balance among them, with the result that no two contracts are identical. Moreover, there is the element of time, a powerful tool. There is a time to be patient and a time to rush. Time is an element to use and to control in order to achieve the desired end:

maximization of returns for a country with the lowest economic and societal cost, including minimization of the potential for environmental damage. Overall, this means withstanding political, corporate and other pressures.

II.2 Who does it?

The first issue a government faces is selecting who will be on a negotiating team. Selecting the right team requires recognizing the demands of the job. Negotiation is an art that weaves a host of elements into a coherent strategy. It demands the creation of a plan, well-conceived tactics, and the separation of negotiable factors (such as compensation) from non-negotiable factors (such as regulatory matters), all the while taking into consideration and addressing the valid concerns of the investor -- the oil company.

Investors everywhere want and require legal and institutional stability, and seek to avoid instability from political, institutional, and societal inexperience in handling resource wealth. They also aim to avoid the conflict and development challenges that tend to prevail in many nations where natural resources are located.

It is not surprising that oil companies, focused only on profits and operating world-wide in conflict zones and difficult–to-access terrain, are better prepared, skilled and financed in their negotiations with officials from natural resource nations.

In contrast, emerging nations normally do not have sufficient domestic know-how or expertise, whether technical, financial or legal, for development, implementation and management. These shortcomings are compounded by private-public sector competition for skilled negotiators; the best educated and ambitious often turn to the more lucrative and professionally challenging private sector.

A solution for national counterparts is to treat the negotiation phase as an investment and seek to hire skilled, dedicated and independent negotiators in order to counter the vastly superior experience and funds that oil companies bring to bear. In short, the negotiation process and the engagement of expert negotiators are the unheralded and often overlooked

means for a developing country to successfully, profitably and at relatively low cost, exploit its natural resources for national advancement.

Unfortunately, however, from the point of view of these governments, the value of outside negotiation experts is not obvious, the skills not appreciated, and the advice suspect, especially if it comes from foreign advisors. In general, outside advice can be inadequate, poor and even counter-productive. Nevertheless, oil contract negotiations demand expert advice as oil agreements cover a wide range of complex factors, from technical construction standards to equipment depreciation schedules, not to mention commercial and legal matters. In the end, a reasonable and mutually acceptable balance between the interests and concerns of an investor and those of a nation, as represented by its government, must be achieved. Simply put, expert advisors are the motor of successful negotiations.

Beyond the complexity of the issues and the asymmetry of negotiating skills, there is another often overlooked reason for engaging external independent negotiators: the problem of conflicts of interest. On one hand, a government is expected to use its regulatory power to protect the public interest.[3] Moreover, a government is increasingly called upon to create and foster a positive investment climate and provide economic freedom in order to attract investors, thereby promoting economic growth, increasing employment and creating opportunities. On the other hand, as a signatory -- a contractual party to a commercial oil development contract -- a government assumes, often unwittingly, the role of a businessperson seeking to maximize its profits. In other words, the government seeks to maximize its income from oil wealth while simultaneously finding itself an object of its own regulations. It should be noted that this employment-regulation-profit maximization conflict is also inherent in state owned energy companies. In addition, a government is also obligated to regulate its partners, namely the oil companies, in the conduct of their activities while still working with them on a day-to-day basis. This public-private conflict of interest may be manageable in a developed nation -- such as Canada or Norway, with their well-established rule of law practices -- but in a developing or an emerging nation, it is a daunting challenge at best and an unmanageable at worse. Nigeria is a poster-child example of such a challenge. Notwithstanding its considerable oil wealth and its inherited British established institutions and legal system, Nigeria has been bedeviled by the natural resource curse and has witnessed

a significant decrease in living standards, unfathomable corruption and societal strife, and remains undeveloped.

II.3 With what time horizon?

In the case of oil contract negotiations, it should never be forgotten -- though it frequently is -- that these negotiations are dependent on time sensitive factors, notably on current market conditions (especially the price of oil); the host country's current political and economic situation; and on present expectations of how these factors will change in the future. These expectations need to find expression in a contract that can withstand the challenge of time by anticipating and providing for foreseeable and unforeseeable changes or demands.

For example, Norway, the model of stability, initially had to entice oil companies with a favorable tax regime of ordinary or standard taxes (i.e. no higher or super profits tax), and only a 10% royalty and license fee, so that they would invest in the geologically challenging and still uncertain North Sea oil development. Yet, Norway did not mortgage its future by making an initial introductory concession a permanent life-time one; indeed it was able nearly to double the maximum royalty rate to 18% just three years after the discovery (see also Chapter 2). Bolivia, with its enactment in the 1990s of a low energy tax rate, appeared not to have learned from the Norwegian experience. As a result, the Bolivian political storm of 2006, which led to the nationalization of Bolivian oil fields, was, if not inevitable, largely predictable.

Of course, in hindsight, such initial terms can look like give-aways if market conditions have changed. Current energy history, with its record high prices, is illustrative. Any agreement or tax regime that did not contemplate and provide for producing nations to receive a (greater) share in higher prices through a special profits tax is, in retrospect, found wanting (see Figure 3.2 in Chapter 3). The solution to the problem of inadequate arrangements under changing conditions is simple: make sure that contracts are more responsive to changing conditions. In particular, as prices rise, the proportionate gains to a government should also rise, in order to meet the certain political challenges of tomorrow, judged by the standards of tomorrow.

There is another way in which time matters. As prices change over time, so too do domestic conditions. Since most developing nations do not yet have established practices and stability in the rule of law and its application, oil companies seek to create a stable working environment through contractual means. In the process, they also try to eliminate contractually the normal dynamic changes that take place within a society, especially in regulatory matters, by insisting on so-called *stability clauses*. These provisions effectively freeze the "chaotic" present, not for a few short years (e.g. 5 - 7 years) to permit recovery of an oil company's investment, but for the life of the contract. They do so by making tax, financial and commercial concessions, environmental regulations, as well as other contractual provisions, permanent for a 20, if not a 40 to 60 year period.

Stability clauses require a government to compensate an oil company for any change in a nation's laws, rules or regulations that adversely affect a company or its operations. If, for example, a new environmental law -- even if it is of general applicability to all companies and is adopted to bring the country into compliance with international treaty obligations -- would increase the cost of oil development or operations, then the oil companies would automatically be exempt from complying with such a law. Or, a government would have to compensate the oil companies for the cost of compliance. Through stability clauses, oil companies limit the normal prerogatives of any legislature and government, such as their right to enact and issue protective environmental, labor and other regulatory laws. These clauses are immune even to judicial challenge by the host country's domestic courts. In fact, a nation's domestic courts are often disempowered in an oil contract.

This type of contractual permanency should be examined very carefully by host governments since it restricts a country's freedoms in the future and implies great future costs. They can also be a source of distraction during negotiations, with the result that the size and scope of the government's Take, whether in the form of taxes, license fees, royalties or other rents, is relegated in negotiations to simply being "a" factor rather than "the" factor. A government finds itself in the position of having to bargain with the oil companies for the right to modernize its legal system with the enactment of new safety standards, to maintain national fiscal stability by increasing its tax rates, and to adopt international treaties in the future.

There is no equivalent to such clauses in states such as Canada or Norway, despite their extensive oil resources and similar need to strike deals with foreign actors. Stability clauses are too often "contractual colonialism," the modern world's legal answer to a discredited system.

The more unstable the legal environment is, the more likely companies are to make such demands. Their ability to make such demands, however, depends in part on their relative bargaining power, a power that may be waning. With rising energy security stemming from a feared energy shortage as the new mantra of China and India, as well as of the United States, producing nations are competitively in the driver's seat in any current negotiations. The contracts of yesterday (as recently as 2000), negotiated in periods of assumed energy surplus, are again found wanting.

A fair question is how this private-public conflict can be reconciled in an oil contract, especially the need of the oil companies for rule-of-law stability, the government's need to be compensated well for its national asset, and the government's need to develop a dynamic, time-responsive legal system. There is no silver bullet answer, especially as the negotiated result, the oil contract, requires acceptance. Acceptance is not a momentary concept but one that must withstand the force of time. Oil companies and their host nations are in reality long term partners bound together in the same geographical space. That imposes a premium on the necessity of achieving a sustainable long term acceptance.

II.4 What is the information environment?

Transparency is the key to achieving public acceptance of a contract. Transparency is a necessary condition to allow civil society to provide an informal mechanism of checks and balances where formal mechanisms do not operate; it is the motor for an institutionalized system, even a weak one. Transparency, defined here as disclosure of the terms of an oil contract and the payments to be made thereunder, is a *sine qua non,* notwithstanding that certain contractual matters may need to remain confidential for a specified period of time (notably company business information, such as exploration data derived and paid for by the oil company). Moreover, transparency is the only way to dispel the ever concerns of greed

and corruption so often associated with oil contracts. Furthermore, transparency is no longer a revolutionary, and therefore risky, concept, with the steady and widening acceptance of the principles embodied in the Extractive Industry Transparency Initiative (EITI), publicly launched by Tony Blair at the September 2002 World Summit on Sustainable Development in Johannesburg.[4]

Transparency prevents government officials from agreeing to terms that the citizenry can not politically accept and will be wont to criticize, if not attack. Open public forums permit buy-in on the part of a public that firmly believes the oil is an asset that belongs to the nation. Transparency is long-term risk management for both the government and the oil companies, which are under increasing pressure to focus on long-term risk by such investors as pension funds, mutual funds and hedge funds (an ironic switch for financial investors accustomed to analyzing and reacting to company quarterly reports). Publish What You Pay, a movement spearheaded by an international coalition of NGOs by the same name, serves not only to lessen corruption but also to provide resolve to government negotiators who know that they will need to publicly justify, explain and defend the contractual terms.[5] In this way, a transparency requirement can in fact strengthen the hand of a negotiator.

The oil companies have a need and an obligation to their shareholders to secure their significant investment through time, including against possible future negative public reaction that can take the form of violence, disruptive civil disobedience, and calls for nationalization. In fact, openness or public disclosure, notwithstanding that it lengthens the period of negotiation, benefits the oil companies with increased long-term stability as the public becomes a stakeholder, an integral part of the negotiation process. Transparency thus provides a useful public participatory mechanism, one often only achieved by pursuing a more flexible negotiation process than is normally favored by oil companies.

Reasonable people may nonetheless differ over what constitutes transparency. Full disclosure of an agreement, including all of its exhibits, would invariably include proprietary technical data and business know-how that ought to remain secret. Thus, complete disclosure is an illusion. Nevertheless, oil companies in their thrust for stability are effectively requiring and permitting fuller disclosure of oil agreements by demanding that the host

countries parliaments enact oil contracts, such as production sharing agreements, into law. Each contract thereby becomes a law unto itself. The *ad hoc* nature of this tendency, however, prevents a country from developing a coherent functioning legal system. It also does not necessarily withstand the test of time as there will always be the suspicion about such one-off tailor-made laws, with the public sooner or later demanding adjustment or "renegotiation" of such a law. In short, one-off disclosures, by not being embedded in a comprehensive legal system, are not sufficient.

Moreover, the terms of a published agreement will become, for better or worse, the psychological, as well as the practical starting point, if not the model, for future negotiations and agreements. Existing agreements are precedents and therefore, color the future. If a government should, for whatever reason, determine to give more liberal terms in the future, there will invariably be public criticism or questioning. Additionally, companies that have already signed agreements will demand equal treatment on the basis of non-discrimination, arguing that the more favorable terms granted to other companies in the future also be granted automatically to them.

In short, transparency is a necessity, but as reasonable people can differ on what should be published, a debate is unavoidable in order to establish a consensus.

II.5 Using which contractual form?

A critical decision for a government is to select the type of contractual system it will use in particular a concession or license agreement, a production sharing agreement (PSA), a joint venture (JV) or a service agreement. Although each type of contract has traditional advantages and disadvantages, as discussed in Chapter 3, the provisions of concessionary systems and PSAs have converged and have come to resemble each other in substance.

License Agreements. Concession or license agreements (see the discussion of "Royalty/Tax systems" in Chapter 3) grant an oil company a right to explore, develop, sell and export the oil extracted in a specified area for which the company has received exclusive

development and production rights for a prescribed period of time. The degree of professional support and expertise required is not (necessarily) as extensive or as encompassing as in the case of JVs and PSAs (but only if an acceptable and reliable legal infrastructure is in place, which is often in reality a major "if"). Financial or economic advisers, not to mention lawyers, are of course needed to structure the bidding system. The financial and other terms of a license are drafted by a host government in compliance with applicable law. In a bidding situation, these terms are published and opened to bid. The successful party, selected by the host government, pays the asking price (i.e. a license fee and/or signing bonus) which is retained by the host government irrespective of whether production takes place. If commercial production occurs, the host government will earn additional compensation through royalties on gross revenues as well as from the income tax. All risks of exploration and development are borne by the successful party in the bid. The license is a relatively risk free form for a government and the only serious shortcoming is the expense and loss of time if a bidding round does not attract an acceptable, financially strong, and technically competent bidder. There are commercial disadvantages of licenses, particularly if there is a reliance on up-front payments. If there is a lack of sufficient knowledge about the concession area, companies will have to take calculated risks about the price to bid; taking into account risk, they will be conservative in the amount they offer.

PSA. The production sharing agreement (PSA) was originally conceived as a nationalistic response to the colonial originated license-concession method.[6] The virtue of the PSA for oil producing nations, is that it forthrightly recognizes that ownership of the oil rests with the citizens of that country and not with private parties (see Chapter 3). But like the license agreement, oil companies manage and operate the development of an oil field and bear the financial and operational risks. Despite the philosophical differences, the financial terms of the PSAs are in concept comparable to those of the license, although the structure may, at times, lead to different commercial results. The host government can earn a signing bonus, although this is often waived -- or preferably traded -- for a greater share of any future profits, the determination of which is a matter of negotiation. The oil company will first be entitled to cost recovery for both operating expenses and capital investment, but the agreed depreciation period for the latter is always a matter of hard negotiation. Simply put, the longer the period of depreciation, the better for the host government; not only because the

government earns a greater share of oil proceeds early but also because it creates incentives for an oil company to keep producing until it recovers its investment. The balance after deducting expenses (i.e. the net profits) is then shared with the host government according to agreed percentages, with the oil company obligated to pay taxes on its share. The taxes are often waived and included in the agreed percentage profit split, however. Although PSAs follow a historical structure, today the details of PSAs can be so different and varied that the commonality of PSAs has basically been reduced to the concept of sharing. This flexibility is not surprising, as PSAs result from intense line-by-line negotiations. Also, the provisions of the PSAs are inversely related to the solidity and reliability of a nation's legal infrastructure. The less reliable the legal system, the more issues need to be addressed in the PSA, as this contract effectively becomes a self-contained law unto itself. The flexibility of the PSA masks many challenges. It demands skilled negotiators. It requires expertise in technical, environmental, financial, commercial and legal areas, all of which are taken for granted in a licensing regime even if in practice they are absent. It demands judgment in balancing these conflicting matters. These are daunting challenges for a host government, which, as already mentioned, has considerably less data and information -- as well as less technical and commercial knowledge and expertise -- than oil companies.

Most important, as the host government earns a share of the profits, the PSA puts the government in direct and immediate conflict with itself as it is confronted with determining whether to offset profit making with the enforcement of environment and other regulations. As the PSA structure does not have the institutional checks and balances normally associated with a licensing regime, the PSA finds the government directly negotiating with itself, causing a conflict of interest. Moreover, as mentioned earlier, the PSA has given the oil companies a voice, if not a modified veto, over regulatory enforcement by the inclusion of regulations as contractual provisions. Contract terms can be more easily contested by the oil companies than statutes, with the further result that administrative prerogatives of the government have in part been transferred to the oil companies. Accordingly, the PSA provides a host government with a ready excuse for regulatory inaction.

Joint Ventures. Joint ventures (JVs) defy ready explanation because there is no commonly accepted definition anywhere in the world. A JV arises if two or more parties wish to pursue

a joint undertaking. Typically, a JV gives rise to a series of unending questions: What is its purpose, e.g. exploration, development and/or operation? What is each side's contribution and responsibility? How long is the venture to remain in existence? How are profits to be shared? How and by whom are decisions to be made? The JV is a double-edged sword as it is based on partnership. Therefore, it requires an allocation of operation, management and financial risks and responsibilities, which means that the government is an interested and involved participant in the natural resource exploitation. As the question remains over where to draw the line in respect to these issues, and, as everything is accordingly subject to negotiation, JVs are a negotiator's dream (or nightmare) because they take notoriously long to negotiate. Furthermore, in a JV, it is necessary to focus from the outset on termination. Unless there are clear, specific, and complementary (i.e. non-competing or non-duplicative) contributions by the partners, JVs generally end in divorce (Radon 1989). Moreover, the negotiation is even more intense if the host nation lacks adequate laws. In short, JVs have little intrinsic merit, notwithstanding that there is or can be a transfer of technology, skills and expertise to a host country.

Service Agreements. In addition to these arrangements, service agreements can be employed, which in essence provide payments for specified tasks or services (also see Chapter 3). In this case the contractor may receive a fixed payment independent of the discoveries or the price of oil. Key management decisions tend to stay within the hands of government. This type of agreement will likely gain increasing currency as Bolivia and other nations take direct control over their natural resources and increasingly rely on their state owned energy companies. The major companies, such as Exxon, however, have no incentive to enter into such agreements (at least, not unless their compensation schemes are dramatically changed, so that in effect they resemble licenses or PSAs). Since, in the short run, the impact of this option will be limited, the merits of this arrangement have received relatively little attention.

II.6 Over what issues?

As negotiation is an integral part of the process in all oil agreements, the major issue -- from a national or public perspective -- is to separate the negotiable from the non-negotiable

issues: what should and should not be the subject-matter of a contract. In the latter category, there should be traditional regulatory matters, such as environment, heath and safety, which are embedded in and governed by applicable domestic law, rules and regulations. If such laws are inadequate or ambiguous, reference can be made in the contract for guidance -- or even for determination -- to a settled body of law, such as that of an EU member state. These domestic laws should be universal in application, without discrimination or favoritism, and not amenable to self-interest adjustment as the result of lobbying by or pressure from oil companies. They should not be the subject of negotiation with individual oil companies.

In the former category—the negotiable items—there are commercial or compensation matters, namely what a nation receives as rents. The question of Government Take, however it is measured, should always be at the heart of the negotiations. As discussed in the next section, compensation can be structured in diverse and multiple ways: in the form of income taxes; royalties or licensee fees; and bonus payments or profit sharing arrangements, which can be recast as taxes. Of course, compensation parameters or principles can be set forth in a law, as they often are. If overly detailed, however, the required flexibility necessary in the negotiation process—especially where there geological data is still speculative—will be severely hampered.

Without such a division of issues into the negotiable and the non-negotiable, there will be the invariable horse-trading, with oil companies seeking to lower the amount of compensation to be paid to a state in return for having to comply with and maintain, for example, "expensive" state-of-the-art environmental standards set forth in a contract. And there is only one tried route to achieving such separation: the establishment of a rule of law system. Moreover, a contract should be flexible enough to foresee the development of such a system, but, in any event, a contract should not hinder a legal system's development through a stability clause or other cast-in-stone provisions.

II.7 How to structure payments?

In creating an oil compensation system in a developing nation, certain fundamental concepts are, at times, overlooked. Of central importance is the fact that income taxes *per se* are in and

of themselves not sufficient for the host government. Every company, including an oil company, is subject to a corporate income tax at established (normally progressive) rates. This tax, however, does not take account of the fact that the state, as distinguished from a private party, is in many nations the owner of the oil.[7] A profits tax is, effectively, only a tax on the profits earned from the services and equipment utilized in converting the oil into a liquid or cash asset. Therefore, the state still needs to be compensated for the "transfer" of the oil from the state to a private party, which obviously occurs over an extended period of time as oil fields are developed. Moreover, to the extent that a profits tax system is used, a "windfall" profits tax, in which the rate increases when company profits exceed a certain threshold, is a reasonable mechanism. The price of the asset (oil) changes over time; without such a tax, the state would not receive its equitable share of any increased price for its asset while the costs to the oil company remain more or less constant. In short, the state, without such a tax, would have "sold" its asset at an initially-set contractually low price and would not reap any benefit from a substantial increase in the price of the oil, which would instead inure solely to the oil companies. Nevertheless, a windfall profits tax should not be suddenly sprung, it is a mechanism that must be embedded in a legal system or contractually foreseen in order to underscore the goal of stability.

Mongolia has recognized this and recently enacted a novel statute by imposing a super profits tax in the event the market price of the natural resource in question (gold) exceeds a predetermined specified amount.[8] Even in such a case, a host government has to ensure through the agreement that production levels are maintained by the companies. Especially since, under some conditions, it may well be in their interest to decrease production and preserve the asset for future production, on the hope that the market price drops and the super profits tax is no longer applicable (discussed more Section III.3, on development plans, below).

Royalties are normally levied on the value of the oil production, although they can also be based on quantities produced. Royalties have the virtue that they are simple to administer and can be levied with the very first production. As they are not affected by profit, however, corporations dislike them as they are a direct and immediate expense that (at a minimum) slows the recovery of capital expenditure and accordingly increases the uncertainty and risk

of a project. It may even make the development of otherwise profitable fields unprofitable. Nevertheless, from the public perspective, royalties can be viewed as a (partial) payment to the government for the transfer of its asset to the oil companies, or even as a sales or excise tax. Yet, given the sharply different public-private perspectives, there is considerable room to negotiate, including: the amount of royalties, the timing of payments; the degree of progressive structuring; and the tax structure and treatment, whether as an expense or a credit.

Bonuses, especially signing bonuses, are one way for the government to secure for itself some minimum compensation, even if, for example, the exploration does not result in sufficient recoverable oil. Without a signing bonus, a government has no assured means to secure any earnings, let alone cover its administrative expenses or the costs of its advisors. Bonuses can also be charged on discovery and during the course of production as different levels of production are reached. Bonuses are usually a fixed amount and do not take into account the profitability of a project. From the oil company's point of view, they are another expense that increases the uncertainty and risks of a project and therefore adversely affects the profitability of a project. Again, bonuses with their flexible structuring are another negotiable item.

The use of profit-sharing arrangements is conceptually similar to a progressive income profits tax combined with a windfall profits tax. In fact, it is often structured as a tax by a host country in order for oil companies to be able to preserve their benefits under double taxation treaties. Such an arrangement is quite complex as agreement has to be reached on what constitutes an expense, reasonable depreciation schedules, and related or inter-company transfer pricing (among other matters). In addition, agreement has to be reached on the calculus of how different levels, as expressed in a percentage, of profit sharing are reached. Normally as increased profits are made the government share increases. In sum, a profit sharing mechanism offers many issues for negotiation and sufficient flexibility to withstand the pressures of time, but puts a premium on getting it right initially.

One question remains unanswered: What should the compensation rates be? It is clearly a matter of negotiation and there is no silver bullet answer. What companies pay under other

agreements is not readily available, although one can examine public bidding situations for guidance. One can research the partner splits inserted in those production sharing agreements that have been enacted into law as they then become public information. Yet, as discussed in Chapter 3 different tracts, different locations, and other different factors complicate the comparability of such analyses, even if the data is available. One can take a working approach, however -- namely viewing the oil companies as regulated utilities -- by starting with the normal proposition that profits are oil sales less expenses and that all profits belong to the state, other than an agreed rate of return for the oil companies. This approach is akin to the approach underpinning a service contract. This admittedly simplistic method has the virtue that the oil companies have the burden of justifying and proving their demand for compensation, namely by disclosing their internal rate of return (a jealously guarded secret), rather than making the government shoulder the burden of justifying its claim to a higher share.

II.8 What constitutes a fair outcome?

Oil contracts are by business custom, necessity and tradition, private documents. Even oil contracts with governments are traditionally not public instruments, except in the unusual cases where the contracts have been enacted into law (this has as its own complications, not the least being that it hinders the development of a national rule of law system). In the absence of contract transparency and availability, any analysis to determine whether a nation is receiving contractually a "fair" (a term on which reasonable people can differ), or competitive, return can not be determined comparatively or objectively. The consequence of this lack of information is that any negotiator will have to rely almost exclusively on his judgment, experience and analysis, which by definition will be based on incomplete information. Economists, however, could provide benchmark studies and analyses that support a nation's negotiator's position, especially as data on national oil production and corresponding export data is readily available.

Notwithstanding that Norway, with its state owned oil company, Statoil, can be dismissed as an ideal national case, the Norwegian situation can provide data on the practical maximum return for a state from oil development. Norwegian data, and that from comparable nations

or areas, can be used as a benchmark to extrapolate what a nation can presumably earn, what normal or standard operational expenses are, and what adjustments have to be made over time as an oil area matures. From this so-called ideal situation, adjustments need to be made for perceived and actual risks in any producing nation, whether political, exploratory, technical or other, all of which would have to be quantified. The objective would be to develop data that provides state negotiators (and the public) with an ambitious target rate of return on oil development, deviations from which would have to be explained and justified, preferably publicly. This data could make it possible to switch the burden of proof to oil companies to justify their commercial positions and agree contractually to a "reasonable" maximum rate of return, with excess rate of returns accruing to the state. Such data could also support publish-what-you-pay efforts as it would establish upper limits of what a government or nation is presumably earning from its oil production.

III. The Devil in the Details: Sample Contractual Provisions

No matter what contractual form is selected, the number of provisions that must be negotiated and the number of exhibits that must be agreed upon is extensive (also see Chapter 3). Moreover, the truism that the devil is in the details is never more apposite than in oil and gas negotiations. The heart of the contract is the provision setting forth the compensation to be received by the government, and the factors that need to be considered have already been analyzed. Other contract clauses also have a direct impact on compensation -- including oil price, details of the tax regime, development plans, cost and expenses, and stabilization -- and are therefore critical. Further contract sections, such as those affecting health and environment, have an indirect but significant impact on compensation and can not be overlooked. Social project commitments, often set forth in separate agreements or public pronouncements, actually can have a hidden negative impact. And the status of the contractual partner is critical to ensure that the contract is binding on a real party, with assets and technical competence, and does not simply morally oblige an oil company. A termination provision for non-compliance of the oil contract, especially for repeated violations, is a necessary enforcement tool. The list can, and does, go on.

III.1 Oil Price

Host government compensation, whether in the form of taxes, royalties or profit sharing arrangements, and irrespective of the contractual form of an agreement, is directly determined by the oil company's selling price for oil. But the challenge is to apply an objective, independent and verifiable price. Governments should, for example, never accept the price paid between related or affiliated companies because that price is determined internally by a company's managers and will not reflect market rates (Chapter 2, p.[24]), except by accident. The only objective method to calculate the selling price of oil is by reference to, for example, the applicable spot market price for the region, notwithstanding its volatility and the need for constant monitoring. This calculation method should be specified in the contract.

III.2 Taxation, Costs and Expenses

Irrespective of the percentage of compensation a host government is to receive, its compensation, other than off-the-top royalties, is decreased by the expenses incurred by the oil company.

The administration of a tax system requires skilled accountants and other personnel, which are often lacking in an emerging nation, certainly in adequate numbers. A tax system also demands agreement on applicable accounting standards. Monitoring an oil company's tax payments requires sophistication and a proper understanding of what constitutes a project expense. This is a fact that is frequently overlooked: countries should not rely heavily on self-reporting by companies but should instead invest in engaging sophisticated accounting services—the returns for doing so could be significant. For example, one particularly difficult area to monitor is payments made between affiliate companies having a common ownership. In these cases, it is difficult to determine the reasonability or accuracy of such transfers.

Determining what constitutes an expense is an unavoidable challenge. It starts with choosing the applicable accounting principles, whether derived from the internationally acceptable

accounting systems of countries such as the United States or the United Kingdom. But such principles will not help in deciding whether certain types of costs -- ranging from first class air tickets to five-star hotels for company employees to so-called hardship bonus payments for foreign workers posted in a developing country to fines for violating the law -- are properly to be treated as business expenses with the consequent effect of decreasing profits, all the while countering the refrain of oil companies that such expenses are standard industry practice. And a particular area of contention is payment for services of affiliate oil companies, the fairness and accuracy of which are almost impossible to determine. In addition, what constitutes an appropriate depreciation period for capital investments can produce reasonable disagreements. Micro-financial management is therefore an unavoidable necessity for a government. Accordingly, a list of items that are not to count as expenses must be agreed upon and set forth in the contract.

Simplicity in the creation and administration of a compensation system can be a benefit in an emerging nation. It permits easier verification, lessens disagreements, creates transparency and reduces public transaction costs. Yet, achieving simplicity is not easy, particularly as companies have an understandable interest in recapturing their substantial capital costs as quickly as possible, as well as covering the ongoing costs of extraction and operation and, of course, making a profit. Hence, companies will prefer a detailed tax regime. If there is no reasonable perspective for a company to recapture its capital costs from early oil or otherwise within a reasonable period of time, a company may well not undertake an investment, particularly in light of the uncertainty of the size of a prospective field. Even with the recent high market price of oil, investment is still of great concern because more costly exploration and development investments are being undertaken in traditionally unprofitable fields.

Consequently, sophisticated accounting and financial expertise will be required to determine, among other things, the total or full cost of capital investments and the appropriate recovery or depreciation periods, the latter especially being subject to differing reasonable opinions and, therefore, intense negotiation. From a state's perspective, the longer the depreciation period the better, as a state will receive more compensation early. A company, of course, takes the opposite viewpoint.

III.3 Development Plans

The challenge for any government is to balance the need to maximize rents with the need to incentivize a company to invest in exploration and development of a field, which in turn will provide future earnings for the government as well as the company. If the Government Take is too high, an oil company may well determine not to continue to develop or slow the development of a particular tract. This is especially true since oil companies have "competitive" fields or projects throughout the world, which are operated as a group for maximum return for an oil company, although each project is a separate profit center. A well structured agreement, however, can provide for the loss or termination of development rights if a field is not exploited in accordance with a detailed development plan. This requires the government to approve the plan and, accordingly, the government must have the expertise to negotiate the plan, monitor it, and supervise its implementation.

III.4 Health and Environment

Oil development is a "dirty" business. It affects the health of the workers themselves as well as the people and the communities living close to a field, even if a direct casual relationship between any particular activity -- such as flaring -- and health are still disputed by the oil industry. It also affects the environment, whether through flaring, escaped gases, explosions or spills. To the extent that externalities or hidden costs -- in particular health and environment costs, including the restoration of a development area to its original condition --are not fully borne by the oil companies, the oil company effectively receives public subsidies. The extent to which there should be such a subsidy is a matter of public concern that needs to be discussed, debated and addressed in the legislature as well as in open public forums, but it clearly should not be relegated to a negotiable contractual issue. In the absence of adequate domestic legislation, a host government should consider incorporating by reference the applicable laws of a nation experienced in legislating such matters, such as Norway or the U.K. Even these nations, however, have still not fully addressed the issue of mandating the corporatization of public external costs caused by a company, leaving many matters to be resolved by the vagaries of tort laws. Although it is common practice to apply

the laws of England as the governing law of an oil agreement, there is a reluctance in many countries to incorporate directly the laws of another nation on such matters as health and environment on the grounds that this is a violation of national sovereignty. In essence, however, this means simply that the oil companies -- in the absence of good local legislation -- do not bear the true cost of compliance.

III.5 Stabilization

Oil companies, as already noted, require rule of law stability, which offers predictability and certainty for planning and commitment of significant investment. The possibility of annual or periodic changes in the tax rate increases uncertainty and risk -- still an acute problem in developing nations where legislative and institutional systems are not well established. Also, the risk of creeping nationalization of an investor's assets (and therefore its future stream of revenue) through confiscatory tax rates is an additional risk that oil companies have confronted. Such concerns do validate the oil companies' need for a limited stability provision for a commercially justifiable period of time, such as five to seven years, and a clause negating nationalization in all its forms.

III.6 Social Projects

Often oil companies, during the course of negotiations, will be asked to -- or will offer to -- underwrite social projects to demonstrate that they are good corporate citizens. These projects may include building schools, playgrounds, hospitals or sponsoring scholars and students. Supporting such projects is honorable and public-spirited. The building of a school, moreover, certainly provides favorable press, a good image, and cements community relations for a company. It also recognizes the government official negotiating an oil contract as a doer, a leader who can deliver public benefits. Too often, however, these visible and immediate charitable contributions become at best a distraction that deflects a government from vigorously negotiating the hard issues, in particular compensation, and at worst an expensive "trade" for the payment of lower compensation by the oil company. The government's goal should be to maximize receiving "real" compensation and not

charity, and this can only be attained if social projects are not tied to contractual negotiations, whether in the oil contract or in simultaneously executed agreements.

III.7 Oil Contract Parties

Oil companies normally operate through special purpose and country specific subsidiaries, which have limited capitalization and no separate technical expertise. Money and skills reside with parent companies and other affiliate entities on which these subsidiaries rely. Furthermore, the structure is designed to minimize taxes—with a subsidiary frequently established in a tax haven -- and to protect the parent company against potential liability from the actions of its subsidiary, including environmental pollution. Thus, if an oil contract is not guaranteed by a subsidiary's ultimate parent, a host government has literally no protection, no assurance of performance, and is subject to the "good will" of an oil company. The only appropriate and rightful contractual partner is the ultimate parent, and therefore a parent company guarantee (without any qualifications) of the performance and payment of all the obligations of its direct or indirect subsidiary is a *sine qua non*. In fact, such a requirement is no more than bank and other lenders regularly receive and secure from oil companies, and host governments should be treated no differently.

III.8 Termination

A termination provision that does not provide for the possibility of the loss of all exploration and development rights is a contract with no teeth. Although reasonable people can differ on what constitutes grounds for the permanent loss of such rights -- including, for example, the use of substandard construction material in violation of agreed specifications, the failure (or repeated failure) to pay the amounts due a government or the abandonment of development for a period of time -- the lack of an effective and encompassing termination provision denies a government a valuable tool in policing and ensuring compliance of the oil contract.

IV Conclusion

With the ever increasing global competition for the acquisition and control of energy resources -- particularly from state oil companies, which readily offer state aid as an inducement for securing an oil supply agreement and therefore oil supplies -- and with the heightened concern for energy security, especially in Europe and the United States, it is more critical than ever for emerging oil producing nations to have the professional know-how to negotiate oil contracts with multinational oil companies that will be accepted and honored over time by the future governments of such nations. Counter-intuitively, this new competitive environment will also require more, rather than less, openness from the multinationals in the negotiation process. Otherwise, oil producing nations will have no way to determine whether they are being treated fairly. Delivering a sense of fair treatment, and fair return -- which builds trust, the foundation of a long term partnership -- can therefore prove to be a competitive advantage for a multinational oil company in the ever more competitive game of securing new exploration and development rights and, therefore, reserves. So let the "great game" not continue to be a modern version of colonialism but become the "great fair game."

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[1] Oil companies do need to be concerned about how the compensation paid to host governments pursuant to an energy agreement is in fact spent; or they may well (unwittingly) be accused of complicity in the actions of the host government and will, accordingly, not only have failed to manage future rising expectations but may well have been complicit in a human rights violation (see Radon 2005).

[2] "At Exxon Mobil, a record profit but no fanfare," *The New York Times*, 31 January 2006.

[3] Such principles are laid out in documents approved by the United Nations General Assembly, like the International Covenant on Economic, Social and Cultural Rights (available at http://www.publishwhatyoupay.org/english/) and the Declaration on the Right to Development. (available at http://www.unhchr.ch/html/menu3/b/74.htm).

[4] For more on this initiative, visit the EITI homepage at http://www.eitransparency.org/.

[5] http://www.publishwhatyoupay.org/english/.

[6] See Chapter 2 for a discussion of the relation between production sharing contracts (PSCs) and production sharing agreements (PSAs).

[7] The United States, where assets are owned privately, is an important exception to this rule.

[8] For background, see "Mongolian tax on copper and gold likely to 'kill exploration efforts'" *Financial Times (London, UK)*. 17 May 2006.

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