A Comparison of International Upstream Petroleum Regimes

Frank C. Alexander Jr.

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9. A Comparison of International Upstream Petroleum Regimes

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1. Introduction

Association of International Petroleum Negotiators Host Government Contract Handbook: The "HGC Handbook" provides an analysis of selected articles found in host government contracts ("HGCs" - the full range of contracts between a foreign investor international petroleum company and a host government, inclusive of production sharing agreements, tax royalty contracts ["concessions"] and service contracts). The purpose of the HGC Handbook is to provide an academic review of selected articles found in HGCs.

2. Conceptual Review of the Relationship

Host Countries invite International Oil Companies to perform petroleum operations in the Host Country because the Host Country does not wish to risk its own capital.

International Oil Companies also have technology often not available to the host country.

3. Key Host Country Considerations

International Oil Company performance.

not just production, revenue, and reserves – also information generation for host country.

Host Country share of revenue, and share of profit.

Host Country overall management of petroleum resources.

Host Country discretion to withhold approval of International Oil Company assignments to third parties that might be dangerous to the Host Country.

Host Country discretion to withhold approval of International Oil Company cross-border pipelines.

Reasonable information disclosure rights (regarding new discoveries).

Training and transfer of technology.

Local content.

HSE - Health, Safety and Environment.

Including International Oil Company environmental indemnities/insurance (or parent guarantees).
4. **Key International Oil Company Considerations**

- International Oil Company share of revenue (for “pay-out”).
- International Oil Company share of profit.
- Management and control – operations approval mechanisms – ability to monetize discoveries.
- Export.
- Right to produce at MER – Maximum Efficient Rate.
- Currency exchange and transfer rights.
- No mandatory conversion.
- Right to maintain accounts in hard currency.
- Reasonable assignment and encumbering rights.
- Reasonable confidentiality of International Oil Company generated information.
- Gas terms.
- Right to hold non-associated gas discoveries past the end of the exploration period.
- Security of investment.

5. **HGCs**

Definitions and the three general types of HGCs.

- **“Host Country”** (or **“HC”**)
  
  Means a country, a subdivision of a country, or an agent or instrumentality of a host government (such as a “national oil company” or “NOC”) which signs an HGC with an International Oil Company.

- **“IOC”**
  
  Means a foreign investor international oil company.

- **“Upstream Petroleum Regime”** (or **“UPR”**)
  
  Means the HGC, the applicable Host Country legislation, and applicable Host Country treaties which, taken together, describe the relationship between the International Oil Company and the Host Country.

- **“HGC”**
  
  Means the full range of the contracts between the International Oil Company and the Host Country, inclusive of production sharing agreements, royalty/tax contracts (“concessions”) and service contracts.

- **“JOA”**
  
  Means an international operating agreement entered into by International Oil Companies – where there are two or more of them signing an HGC.
HGC — Host Government Contract
This is the primary international petroleum contract. It is the source of the money which drives the international petroleum industry.

Parties
Host Country and one or more International Oil Companies. A national oil company" ("NOC") controlled by the Host Country, or a domestic private company, might also sign an HGC with an Host Country.

6. JOA Not Applicable to Relationship Between Contractor and Host Country

7. JOA Applicable to Relationship between Contractor and Host Country

8. HGC — Key Distinguishing Factor
Disposition of production.

9. Production Sharing Contact ("PSC")
Divides production between the Host Country and the International Oil Company.
Used by approximately 60% of Host Countries.

10. Royalty and Tax Agreement ("R/T") (also called "Concession")
Basically provides for the International Oil Company to receive all production (excepting royalty).
Used by approximately 40% of Host Countries.

11. **Service Contracts**

*Risk Service Contract* - provides for the International Oil Company to receive none of the production; International Oil Company receives cash only. International Oil Company share of revenue generally calculated on same basis as International Oil Company share of production calculated under PSA. International Oil Company may, or may not, have the right to buy a certain amount of the production.

*Pure Service Contract* - International Oil Company has no risk. International Oil Company renders services to Host Country for a fixed fee, regardless of results. Again, no production.

Has been used by only a limited number of Host Countries (e.g. Iran, Venezuela, Ecuador, Brazil).

12. **HGC Types**

Some Host Countries use more than one HGC format (e.g. Kazakhstan, Pakistan, Russia, Trinidad & Tobago).

13. **“Cost Petroleum”**

The purpose, under a PSA, is to provide the International Oil Company with a higher percentage of revenue early in the project — this accelerates International Oil Company “pay-out”.

Use of an R Factor can also achieve a similar result.

A PSA with no “cost petroleum limit” (i.e. previous Indonesia PSAs) is, essentially, an R/T!

14. **Myths about PSAs**

That “cost recovery” permits International Oil Company to recover costs faster under a PSA than under an R/T.

That the “cost petroleum limit” describes a limit regarding the % of costs that may be recovered — as opposed to timing of the recovery of costs.

That only PSAs limit the speed at which an International Oil Company may recover costs — and then only by way of the “cost petroleum limit.”

That Host Country has greater management and control over International Oil Company by way of “joint review committee.”

15. **HGC Types – How Different Are They?**

PSAs, R/Ts, and Risk Service Contracts are very much alike.

“Government Take” (profit split).

Effective Royalty Rate.

Management and control.
### Summary Calculation of Profit Split and Lifting Entitlement for Royalty/Tax Contract

**Assumptions:**

1. Full cycle, "life of field", cost/revenue ratio of @35%;
2. Royalty @ 10%;
3. Income Tax @ 35%; and
4. "Government Participation" of 10%.

**Gross Revenue:** $100.00

<table>
<thead>
<tr>
<th>IGC Share</th>
<th>Host Country Share</th>
</tr>
</thead>
<tbody>
<tr>
<td>Royalty</td>
<td>$10.00</td>
</tr>
<tr>
<td>10%</td>
<td>$90.00</td>
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<tr>
<td>$35.00</td>
<td></td>
</tr>
<tr>
<td>Full Cycle Costs (CAPEX and OPEX)</td>
<td>$55.00 (Taxable Income)</td>
</tr>
<tr>
<td>$55.00</td>
<td>Federal Income Tax @35%</td>
</tr>
<tr>
<td>$35.75</td>
<td>$10.25</td>
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<tr>
<td>Government Participation</td>
<td>$3.58</td>
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<tr>
<td>$32.18</td>
<td>Division of Profits</td>
</tr>
<tr>
<td>50%</td>
<td>Profit Split (&quot;Government Take&quot;)</td>
</tr>
<tr>
<td>90%</td>
<td>Lifting Entitlement</td>
</tr>
</tbody>
</table>

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**17. Summary Calculation of Profit Split and Lifting Entitlement for PSA**

Assumptions:
1. Full cycle, “life of field”, cost/revenue ratio of @35%;
2. Income Tax @ 35%;
3. Profit Petroleum Split 49%/51%;
4. “Government Participation” of 10%.

<table>
<thead>
<tr>
<th>Contractor Share</th>
<th>Government Share</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Revenue</td>
<td>$100.00</td>
</tr>
<tr>
<td>Cost Recovery (full cycle CAPEX and OPEX)</td>
<td>35%</td>
</tr>
<tr>
<td>$35.00</td>
<td></td>
</tr>
<tr>
<td>Profit Oil Split</td>
<td></td>
</tr>
<tr>
<td>@49%/51%</td>
<td>$33.15</td>
</tr>
<tr>
<td>($11.15)</td>
<td>$11.15</td>
</tr>
<tr>
<td>Income Tax @35%</td>
<td>$20.70</td>
</tr>
<tr>
<td>Government Participation @10%</td>
<td>$2.07</td>
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<tr>
<td>($2.07)</td>
<td></td>
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<tr>
<td>Division of Profit</td>
<td></td>
</tr>
<tr>
<td>$18.63</td>
<td>$46.37</td>
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<tr>
<td>37%</td>
<td>71%</td>
</tr>
<tr>
<td>65%</td>
<td>35%</td>
</tr>
</tbody>
</table>

**18. Summary Calculation of Profit Split and Lifting Entitlement for PSA**

Assumptions:
1. Full cycle, “life of field”, cost/revenue ratio of @35%;
2. Income Tax @ 35%;
3. Profit Petroleum Split 49%/51%;
4. “Government Participation” of 10%.
Gross Revenue
$100.00

Country Share

Royalty
@10%

Host
$10.00

$90.00

Federal Income Tax

@35%

$0.00

Government Participation

@10%

$9.00

Division of Gross Revenue

Effective Royalty Rate
19%

(in “worst case” accounting period for host government)

81%

Company Access to Gross Revenue

(in order for IOC to recover costs in “best case” accounting period for IOC – indicative of how fast IOC can recoup risk capital – i.e. achieve “pay-out”)

19. Summary Calculation of Effective Royalty Rate Under PSA

Assumptions (worst case accounting period for host country):
1. Full cycle, “life of field”, cost/revenue ratio of @35%;
2. Income Tax @ 35%, but tax deductions offsetting all revenue;
3. Cost Petroleum Limit @ 50%;
4. Profit Petroleum Split 49%/51%;
5. “Government Participation” of 10%.

Gross Revenue
$100.00

Con.actor Share

Cost Recovery Petroleum
@50%

$50.00 (Total Profit Oil)

Profit Oil Split
@49%/51%

$25.00

($0.00)

Income Tax
@35% (but with offsetting deductions)

$0.00

Government Participation

@10%

$2.50

Division of Gross Revenue

Effective Royalty Rate

$72.50

28%

(in “worst case” accounting period for host country)

72%

Company Access to Gross Revenue

(in order for IOC to recover costs in “best case” accounting period for IOC – indicative of how fast the IOC can recoup its risk capital – i.e. achieve “pay-out”)

20. Fiscal Elements and Mechanisms

Royalty.
"Cost petroleum" (under PSAs).
Amortization rates for CAPEX.
"Profit petroleum" (under PSAs).
Profit taxes.
Tax rate.
Tax base (amortization rates for CAPEX).
"Government participation".
"Ring-fencing" (for both cost rec. and taxes).

21. Fiscal Elements – world averages

Royalty – 7%.
Profit taxes.
Tax rate – 35%.
Tax base (amortization rate of CAPEX - 20%).
"Cost petroleum limit" – 65%.
No amortization for cost recovery (PSAs) – 50%.
"Government participation" – 49%.
Approx. one half require NOC reimb. of exploration costs.
"Ring-fencing" (cost recovery and/or taxes) – 55%.
"Government Take" – 65%.
"Effective Royalty Rate" – 17%.
Above from Daniel Johnston & Co. (2001)

22. Fiscal Elements and Mechanisms

Flexible v. inflexible.
Sliding scales based upon production.
Sliding scales based upon price.
Sliding scales based upon profitability.
R Factors (e.g. Venezuela, Qatar, Azerbaijan).
Additional Profits Tax (e.g. Kaz and PNG.)
Letting the marketplace determine.
Trinidad & Tobago.

23. PSAs – Better Than the Other HGCs?

More complicated.
Reserve booking problem.
Politics.

24. Legislation v. HGC

How much of the relationship should be described in the legislation, and how much in the HGC?
Some Host Countries (e.g. Bahrain) do not have a petroleum law at all.
How much of the relationship should be negotiable? How does this work in the context of a bid round?

25. Licenses
Are they necessary?
Does every country use them?
   Bahrain, Brunei, Qatar and Trinidad & Tobago have not
What are the potential problems where there is both an HGC and a license?

26. Area, Term, and Relinquishments
   Contract Area.
   Contract term for exploration (if applicable) and development/production.
   Relinquishments.
      International Oil Company right to retain a non-associated gas discovery past the end of the exploration period?

27. International Oil Company Work Program Commitments
   Seismic.
   Drilling.
      - What constitutes performance by International Oil Company? Depth? Geologic horizon?
      - Does an appraisal well count toward the International Oil Company commitment?
      - What happens if International Oil Company has to terminate well before reaching required depth?

28. Financial Security Instruments
   Bank guarantees.
   Parent guarantees.

29. Bid Rounds and Direct Negotiation
   Bid elements.
      WP and fiscal.
   Transparency:
   Competition.
   When direct negotiations might be attractive alternative to tendering.
Key is how elements are weighted – Host Country can, for example, emphasize WP over fiscal elements, or even production bonuses over signature bonuses.

30. *IOC Security of Investment*

Expropriation – how is the amount of applicable damages determined?

Stabilisation (including fiscal and HSE).

“Freezing”.

“Government/NOC pays”.

“Economic balancing”.

31. *IOC Security of Investment*

Force majeure.

Termination and suspension.

Governing law.

Hardship doctrine problems under civil code jurisdictions.

Waiver of sovereign immunity.

International arbitration outside of Host Country.

ICSID - International Centre for Settlement of Investment Disputes.

32. *IOC Security of Investment*

Bilateral investment treaties.

Energy Charter Treaty.

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