Strategy of Oil Contract Negotiation

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Abstract

Contract negotiation is a key feature of petroleum business transactions between governments and oil companies. Negotiation is not a simple process of giving and taking, it involves various steps and complexities. At each step in the value chain, variety of contracts has to negotiate and bring to closure. This paper identifies the chain of negotiation steps and explores the significant areas on which governments should focus on during the negotiation process. It also highlights the key provisions and clauses which are commonly used in oil contracts. It provides valuable information regarding the negotiation of oil contracts for governments in transactions with oil companies.

Keywords: Negotiation, Oil contracts, Government, Oil companies, Clauses

1. Introduction

In order to explore for and develop their natural resources, many governments rely on international oil companies. Usually, the relationship between the governments of countries with natural resources and foreign companies is determined by negotiated contracts. However, the first challenge the governments face is negotiating oil contracts with foreign companies.[1] Host governments typically attempt to obtain the participation of international companies because of their expertise in exploiting and marketing oil and gas. Governments are aware that most oil companies have greater financial resources, better knowledge of the oil fields as well as further experience in negotiating contracts.[2] Since petroleum contracts play a vital role in the revenue of governments, they need to carefully and effectively manage their contracts. There are many sensitive issues concerned with petroleum contracts, such as environmental issues: governments should not disregard these issues. This paper describes the negotiation procedure for oil contracts and highlights the important issues and points that government negotiators need be aware of. The key provisions and clauses which are commonly used in the contracts are explained and for the sake of clarity, the paper refers to international arbitration cases for some of the clauses.

2. Negotiation of Oil Contracts

2.1 General Consideration

In general, negotiation is a procedure by which parties discuss or bargain to reach a mutual agreement. Marsh states: "A modern definition of negotiation is two or more parties with common (and conflicting) interests who enter into a process of interaction with the goal of reaching an agreement (preferably of mutual benefit)". [3]
Planning for a negotiation is a necessary and important step at the beginning of the negotiation. In order to prepare a negotiating plan, a three stages process should be undertaken: [4]

1- Creating an explicit statement by management of the target objective.
2- The target objective which management wants to achieve needs to be assessed by the negotiating team.
3- Consent between management and the negotiating team on any adjustments to the target objective.

[1] J Radon, ' How to Negotiate an Oil Agreement ' in M Humphreys, J D. Sachs & J E. Stiglitz (eds), *Escaping the Resource Curse*, Columbia University Press, New York, 2007, p. 90
[2] Ibid.
[3] D W. Hendon, R A. Hendon & P A. Herbiq, *Cross-Cultural Business Negotiations* (Greenwood Press, Westport, 1996), p.1
[4] P. D. V. Marsh, *Contract Negotiation Handbook (* 2nd edn, Gower Publishing Ltd, Aldershot, 1984), p. 52.

2.2 Negotiation in the Context of Oil Contract

Oil contract negotiations are delicate and important affairs for both of natural resource countries and foreign oil companies. Radon noted that: "Oil companies are highly motivated during negotiation. 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 ".[5] In the contract, governments usually determine how much they will obtain from their natural resources and whether a government can enforce standards such as: environmental and health standards that apply to the companies. Essentially two main issues must be determined in all contracts: The method of the division of profits between the government and the companies, and the way of paying for or recovering their costs.[6] The main objective of oil contract negotiations is to reach a reasonable and adequate balance between the interests of an oil company and a government[7]. However Radon argues that: There are no objectives or universal standards in determining the terms that balance the interests of a company to minimize its financial risk when pursuing exploration and development activities and those of a host country that wants to receive competitive compensation for its natural resources without sacrificing its environment. [8]

2.3 Significant Areas for Governments in Negotiations

a) Determining the Main Objectives of Entering into the Contract

The government needs to determine its objective to negotiate with the oil company. According to Johnston: The objective of a host government is to maximize wealth from its natural resources by encouraging appropriate levels of exploration and development activity. In order to accomplish this, governments must design fiscal systems that:

- Provide a fair return to the state and to the industry
- Avoid undue speculation
- Limit undue administrative burden
- Provide flexibility
- Create healthy competition market efficiency

The design of an efficient fiscal system must take into consideration the political and geological risks as well as the potential rewards.[9] After identifying their objectives, governments should know and consider the objectives of the companies which are usually as follows:

- To obtain return consistent with the company's objectives;
- To recover the investment costs as rapidly as possible;
- To gain access to oil and gas reserves;
- To ensure that reserves are replaced;
- To limit risk by diversifying their portfolio of exploration and production acreage.[10]

Obviously, the objectives of the government and the company are not always completely constant. Therefore in order to achieve a 'win-win' situation for the two parties, a legal, fiscal and contractual framework should be considered. [11]

b) Selecting the Type of Contracts

After determining the main objectives, one of the most important decisions that governments need to make is selecting the type of contractual system to use with the company. It could be a concession agreement, a production sharing agreement or a service contract.

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[5] J Radon, loc., cit.

[6] J Radon, How to Negotiate the Right Petroleum Contract, UNDP Discussion Paper No.6, p. 46, http://www.un.org.kh/undp/images/stories/special-pages/extractiveindustries/docs/negotiating_contracts_eng.pdf ,accessed 10 September 2014

[7] ibid

[8] Ibid

[9] D Johnston, International Petroleum Fiscal Systems and Production Sharing Contracts (PennWell Books, Tulsa, 1994),p. 17.

[10] D Guirauden & B Franlab, ' Legal, fiscal and contractual framework ' in Institut Français du Pétrole Publications, Centre for Economics and Management, (ed), Oil and Gas Exploration and Production: Reserves, Costs, Contracts, (Editions Technip, Paris, 2004),p. 177.

[11] ibid

The heart of negotiations about any international petroleum contract is the type of contract, which in the case of commercial exploration determines the division of profits and revenues between the state and foreign oil company.[12] It should be noted that there is no consensus on which type of contract is the best option to serve a government's interests, because each contract has advantages and disadvantages.

c) Who does the Negotiation?

The first issue a government faces in the negotiation procedure is selecting who will be in the negotiating team. The successful team needs to identify the demands of the job. For negotiating, governments need to prepare a plan, tactics, and separate negotiable points (such as compensation) from non-negotiable points (such as regulatory matters), as well as managing the valid concern of the oil company. [13] The companies do not desire to enter into oil contracts with countries which have conflicts and/or development challenges regarding their natural resources. When oil companies operate in conflict areas, they need to be better prepared, skilled, and financed for negotiating with host governments. [14] Therefore in such cases, governments should handle the negotiation stage as an investment and try to employ skilled, appropriate, and independent negotiators to stand against the greater experience and funds that oil companies bring. Radon states that: "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".[15] Briefly governments should pay attention to expert advisers in their negotiations, because they play an important role in successful negotiations.

2.4 The General Structure of a Contract

An oil exploration and production contract commonly contains three main sections: The preamble, the main text and appendices which are an integral part of the contract; The preamble expresses a set of general statements and its aim is to arrange the specific provisions of the contract in their broader framework, both legal (for instance references to existing legislation) and political (for instance the role of the country, national policy on the exploration and production oil and gas). [16] The main text comprises a series of articles and sub articles which are numbered sequentially and regularly organized in chapters. It identifies the parties and the purpose of the contract as well as the terms of validity. The main text also determines the rights and obligations of the parties and contains the provisions of the contract.[17] Commonly, the appendices describe the contract zone in terms of its geographical coordinates, the accounting process and the work commitments. [18]

2.5 The Main Contractual Provisions/ Clauses

After choosing the form of contract, the government must negotiate a number of provisions with oil companies. Provisions play a vital role in the contract; they vary from one country to another. Provisions depend on country factors such as legal and regulatory systems. Briefly and concisely the most common and significant provisions for oil contracts are as follows:

a) Parties

Usually host governments enter into agreements in two ways: either the government enters as a contractual party, in which it takes direct responsibility and has unlimited liability or the government employs a state-owned enterprise and by this it will limit its own responsibility and liability to only those assets which are held by the enterprise. [19] The other party in the agreement is the oil company which usually makes or uses a subsidiary to be a party to the agreement. Mostly this type of subsidiary is a special purpose subsidiary, which is established only for oil exploration in a particular country and it has only limited assets.

[12] P D. Cameron, Stabilisation in Investment Contracts and changes of Rules in Host Countries: Tools for Oil & Gas Investors, p. 27 (AIPN, Final Report, 5 July 2006)
[13] Radon, How to Negotiate an Oil Agreement ,op. cit., p.93
[14] Ibid
[15] Ibid
[16] Guirauden & Franlab , op, cit., p. 182
[17] Ibid
[18] Ibid
[19] Radon, How to Negotiate the Right Petroleum Contract, op, cit., p. 47

Since the process of oil exploration and production is subject to accidents or damages resulting from environmental pollution, host governments in their negotiations should require a guarantee from the parent company of the subsidiary for any breach of the agreement or accident.[20]

b) Oil Price

The compensation for the host government (taxes, royalties, or profit-sharing arrangements) is based on the method of determining the market price of oil. But the oil price needs to be objective and verifiable.[21] "The only objective method to calculate the selling price of oil is to use, as a starting point, the price as established by the spot market in a particular region. Normally, a contract would specify what price would serve as a benchmark ". [22] Governments should be careful to never accept the price paid between affiliated companies as an objective price of oil, because that price is determined internally by a company's manager and it is not objective or verified. [23]

c) Taxation or Compensation

Tax regimes can play a significant role in attracting foreign companies to invest in a country. Therefore host governments should provide a balance between their own and the companies' interests. There are various types of taxation a host government can use: The first is a profit tax that a host government can apply on the income which is obtained by the company. But the administration of a profit tax regime needs expertise and skilled accountants. Information about the volume of production and sales must be collected and monitored by tax inspectors. In addition, in many countries, the nation is the' landlord' of the oil and profit taxes do not take that into account. This tax is, in reality, only a tax on the profits gained from the services and equipment used in converting the oil into a liquid or cash asset.[24] The royalty, or excise tax, is another regime of tax which host governments often impose on oil companies in the exploration and production process of natural resources. This tax is frequently applied by the host government in addition to other taxes. It is easier to administer than a profit tax. In addition, the collection of this tax does not need to wait until the project becomes profitable. [25] Host governments have another option, which is to require bonuses from oil companies. This is also easy to administer. A host government can require a 'signature bonus' when the company starts the exploration or a 'production bonus' once production reaches a certain level.[26]

d) Settlement of Disputes and International Arbitration

Clauses providing for dispute settlement are found in all oil production contracts. Dispute settlement clauses can be in different forms. In some contracts the parties agree to submit their dispute to the domestic courts. Sometimes, according to the laws of the host states, parties settle their dispute through international *ad hoc* arbitration. Moreover, in some agreements, parties may agree to both state settlement and *ad hoc* international arbitration.[27]

e) Health and Environment

Almost all oil contracts contain a section on the environmental standards or domestic environmental legislation to be applied to the project. Tienhaara states that:

''In this regard, there are five general forms that contracts appear to follow:

(i) Reference to domestic environmental law only;
(ii) Reference to international industry standards only;
(iii) Reference to both domestic law and international industry standards;
(iv) Reference to domestic law and/or industry standards and international environmental agreements; or

[20] ibid
[21] Radon, How to Negotiate an Oil Agreement ,op. cit., p. 107
[22] Radon, How to Negotiate the Right Petroleum Contract, op, cit., p.51
[23] Radon, How to Negotiate an Oil Agreement, loc., cit.
[24] Radon, How to Negotiate the Right Petroleum Contract, op, cit., p.48
[25] Ibid,p.49
[26] ibid
[27] Y Omorogbe, The Oil and Gas Industry: Exploration and Production contracts (Malthouse Press Limited, 1997, Lagos), pp.10-112

(v) Development of project-specific environmental standards''. [28]

Reference to both domestic environmental legislation and international industry standards is more acceptable; therefore host governments in their negotiations should not ignore international environmental standards because of domestic legislations but give importance to both of them.

f) Stabilization

Stabilization clauses are usually required by oil companies in an international oil contract to guarantee that the contract concluded between a host government and the international oil company will not be changed and will remain stable. Stabilization clauses minimize risks for international oil companies, especially political risks. These types of clauses are extremely disadvantageous for the government because they freeze the law and regulatory situation for the government as it stood at the time the agreement was signed between the government and the international oil company.[29] An example of such a clause is the clause contained in the Concession Agreement of 1933 between the State of Iran and the Anglo Iranian Oil Company.[30] It provided as follows: Concession shall not be annulled by the Government and the terms therein contained shall not be altered either by general or special legislation in the future, or by administrative measures or any other acts whatever of the executive authorities.[31]

The legal effect of stabilization clauses can be observed in the important case of ***Saudi Arabia v. Arabian American Oil Company (Aramco)***[32]**.** In 1945, Saudi Arabia entered into an agreement with Saudi Arabian Maritime Tankers, Ltd and its Greek owner, Aristotle Onassis.[33] Under this agreement the company obtained a thirty year right of priority to transport Saudi Arabian oil. However the agreement caused a conflict with the concession of the Arabia American Oil Company (Aramco).[34] In 1933, Saudi Arabia granted an oil concession to Aramco, so that it obtained the exclusive right to transport the oil it extracted from its concession area in Saudi Arabia.[35] Aramco claimed that because of the agreement between the Saudi Arabian government and Aristotle Onassis's company, its right to transport oil from its concession area had been contravened.[36] To settle this dispute, The Saudi Arabian government and Aramco agreed to refer the dispute to an ad hoc tribunal of three arbitrators sitting in Geneva.[37] The Aramco concession agreement had a stabilization clause, therefore Aramco won the case. The importance of this case is that, because of it, the validity of stabilization clauses was recognized under international law.[38]

g) Governing Law

In any contract, parties have to choose a law to govern the interpretation of the contract and a jurisdiction, in the event of the existence of disputes between them. Al-Qurashi argues that: "The applicable law also determines the legal consequences of failed negotiations or if failed negotiations are attributed to the conduct of one of the parties. " [39] The parties can choose whether national law or international law will apply to the contract.

[28] K Tienhaara, ' Foreign Investment Contracts in the Oil & Gas Sector: A Survey Of Environmentally Relevant Clauses ' (2011) 11[3] Sustainable Development Law & Policy 16 – 40

[29] Radon, How to Negotiate the Right Petroleum Contract, op, cit., p. 51

[30] A Nwokolo, Oil and Gas Law: Is There a Legal and Functional Value for the Stabilisation Clause in International Petroleum Agreements? http://www.dundee.ac.uk/cepmlp/car/html/car8_article27.pdf, accessed 20 Oct 2012

[31] A Nwokolo, cited in E Passivirta, *Participation of States in International Contracts and Arbitral Settlement of Disputes,* p.162 (Helsinki: Lakimiesluton Kustannus, 1990).

[32] *Saudia Arabia v. Arabian American Company (Aramco)* (1963) 27 International Law Report 117

[33] A Redfern & M Hunter, Law and Practice of International Commercial Arbitration (3rd edn, Sweet &Maxwell Limited, London,1999),p.373

[34] M T. B. Coale, ' Stabilization Clauses in International Petroleum Transactions ' (2002) 30 Denver Journal of International Law and Policy 217- 237

[35] Ibid, p. 229

[36] Redfern & Hunter, loc, cit

[37] Ibid

[38] Coale, op., cit. 229

[39] Z A. Al-Qurashi, ' Renegotiation of International Petroleum Agreements ' (2005) 24 Journal of International Arbitration 261 - 300

There are two basic legal systems: Common Law systems (e.g. England and the United states) and Civil Law systems (e.g. Germany, France, and most of Middle East countries).[40] Usually the law of the host nation is the applicable law for the contract. However the parties can choose international law to govern their contract. Moreover, occasionally parties combine laws when they choose international law, national law, and general principles of law. [41] An early a case of international arbitration that involved a choice of law clause was ***Lena Goldfields v. USSR***[42]**.** In 1930, Lena Goldfields, Ltd., English Company began arbitration proceedings against the Soviet Government.[43] The company conducted this arbitration under an ad hoc arbitration clause contained in a written concession agreement between itself and the Soviet Government.[44] Because of a long dispute between the Soviet Government and Lena Goldfields and after failing in all efforts to negotiate a settlement, Lena Goldfields referred the dispute to arbitration under the arbitration clause in the agreement.[45] In this case, for the first time, arbitration involved a choice of law clause as well as a stabilization clause. There was a choice of law provision and a stabilization clause in the agreement.[46] The tribunal's decision was that the agreement between Lena Goldfields and the Soviet Government, although governed by Russian law in respect to ordinary matters, was subject to the general principles of law.[47] The significance of this case is that for the first time it had been established that law other than domestic law, could govern the agreement between a foreign company and a sovereign state. [48]

h) Force Majeure

The force majeure clause in a contract excuses a party from its contractual obligations due to unpredictable events beyond its control.[49]They often include specific examples of events which excuse liability, because of the clause. Three basic groups of these kinds of events are:[50]

- Natural disasters (i.e., Floods, hurricanes, and fires).
- Human events (i.e., wars and riots).
- Performance failures outside the control of the contracting party (i.e., labor disputes other than those of the contractual parties, e.g. disruptions in telephone service attributable to the telephone company).

i) Work program

A work program detailing the company's exploration and development plan will be included. Commonly it is hidden behind technical and financial details, such as how to drill in deep water or earthquake areas.[51] With regard to this, the protection of the natural environment is an important issue. The company should show how to best protect the environment in its plan of work. Radon argues that: "the host government should insist on a work plan that specifies clearly the circumstances under which a project could be delayed or even discontinued and the circumstances under which it may not ".[52]

j) Termination

In any oil contract, the parties must identify circumstances under which the contract can be terminated. For example, in the event of repeated environmental damage, agreements can be terminated.

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[40] Radon, How to Negotiate the Right Petroleum Contract, loc. cit.
[41] Al-Qurashi, op, cit,p.269.
[42] Lena Goldfield Arbitration, Annual Digest of Public International Law Cases (H. Lauterpacht ed. 1929-1930)
[43] A Nussbaum, ' The Arbitration Between the Lena Goldfields, LTD. And the Soviet Government ' (1950-51) 36 Cornell Law Quarterly 31- 53
[44] V. V. Veeder, ' The Lena Goldfields Arbitration: The Historical Roots of Three Ideas ' (1998) 47 International and Comparative Law Quarterly 747- 792
[45] Ibid,pp.762-763
[46] Coale, op., cit., p.227
[47] Ibid
[48] Ibid
[49] AllBusiness, What is a Force Majeure Clause?, http://smallbusiness.yahoo.com/advisor/force-majeure-clause-210000718.html, accessed 27 Oct 2012
[50] Ibid
[51] Radon, How to Negotiate the Right Petroleum Contract, op., cit.p.50
[52] J Radon, ' The ABCs of Petroleum Contracts: License-Concession Agreements, Joint Ventures, and Production Sharing Agreements ' , in S Tsalik & A Schiffrin (eds), *Covering Oil: A Reporter's Guide To Energy and Development*, Open Society Institute, New York, 2005

Parties should terminate their agreement if companies are no longer developing the field. In this case, the host government could transfer the agreement to another oil company that is willing to develop the field.[53]

k) Date of Entry into Force of Oil Contracts

How oil agreements enter into force depends on the country. There are several methods that oil agreements can enter into force:[54]

- Immediately after signing an agreement, when the agreement is signed by the head of the country or a minister.
- After the publication in an official journal of the signing of the contract.
- After the agreement has been approved by a law.

3. Conclusion

Oil contracts are complex and detailed. They are difficult to negotiate and manage. The government of oil producing countries needs professional and experienced negotiators to negotiate with international oil companies in order to enter into an oil contract. The method of the division of profits between the government and companies, and the way of paying for or recovering their costs are two important issues which need to be determined in any oil contract. The Government should determine its objectives in negotiating with a foreign company and also consider the company's objectives. The Provisions and clauses play an important role in oil contracts, such as taxation, stabilizations, governing law, and work program, therefore the government needs to be aware of these clauses.

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[53] Radon, How to Negotiate the Right Petroleum Contract, op, cit., p.51

[54] Guirauden & Franlab, op, cit., p.192

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