

Legal Hierarchy/Contract Forms and Terms

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Yogyakarta, Indonesia
Patrick Heller

Presentation Outline

1. Legal Structure and Hierarchy
2. Overview of common types of Petroleum and Mineral Contract/Fiscal Systems
3. License/contract allocation processes
4. Contracts: Key Concepts and Using Contract Terms for Advocacy

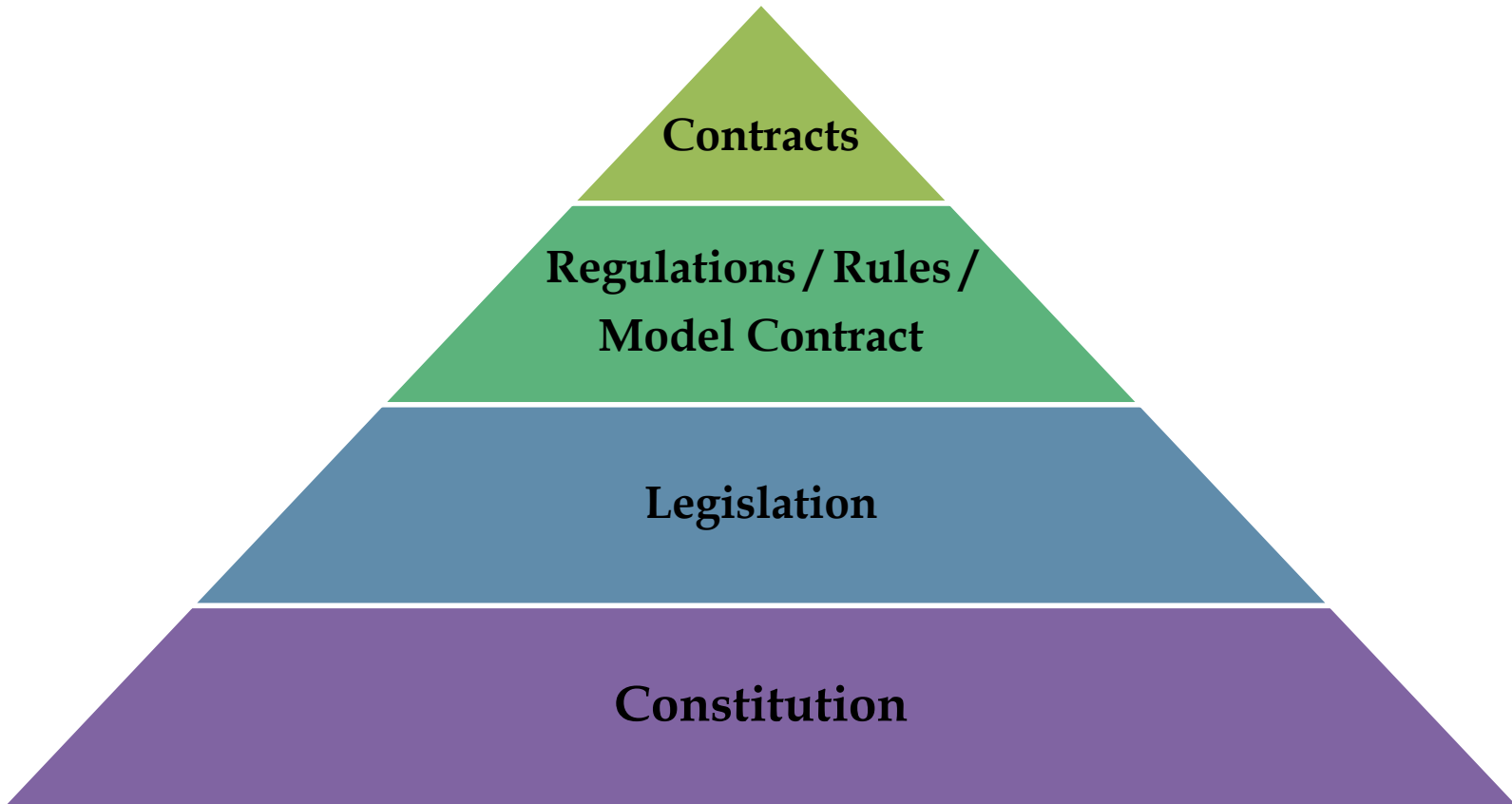
1. Legal Structure and Hierarchy

Why does the legal framework governing the oil or mining sector matter?

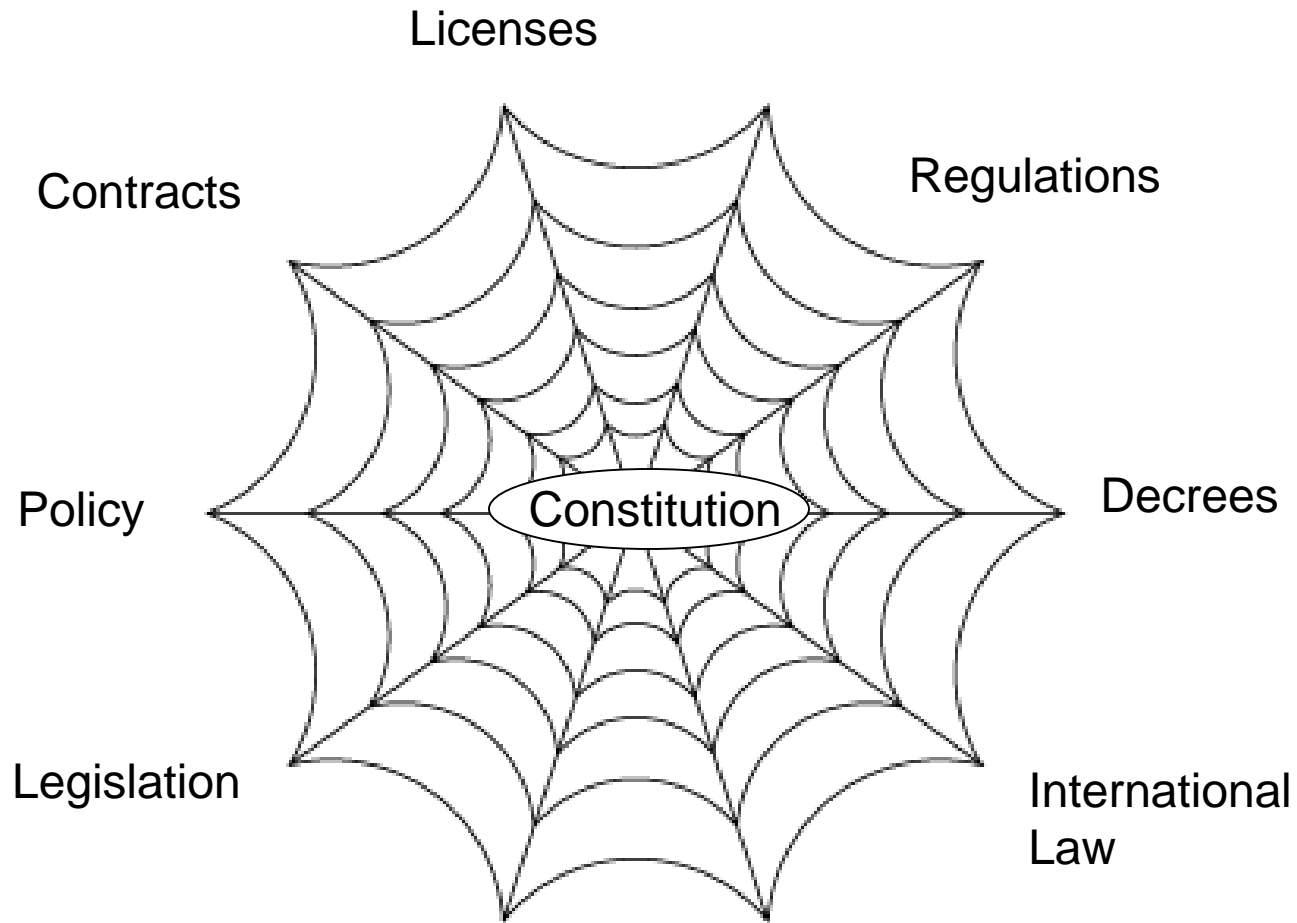
Three areas of focus today:

1. Sets the institutional structure for the state.
2. Sets the relationships between government and companies.
3. Sets checks and balances between the state, companies and citizens.

Legal Structure and Hierarchy



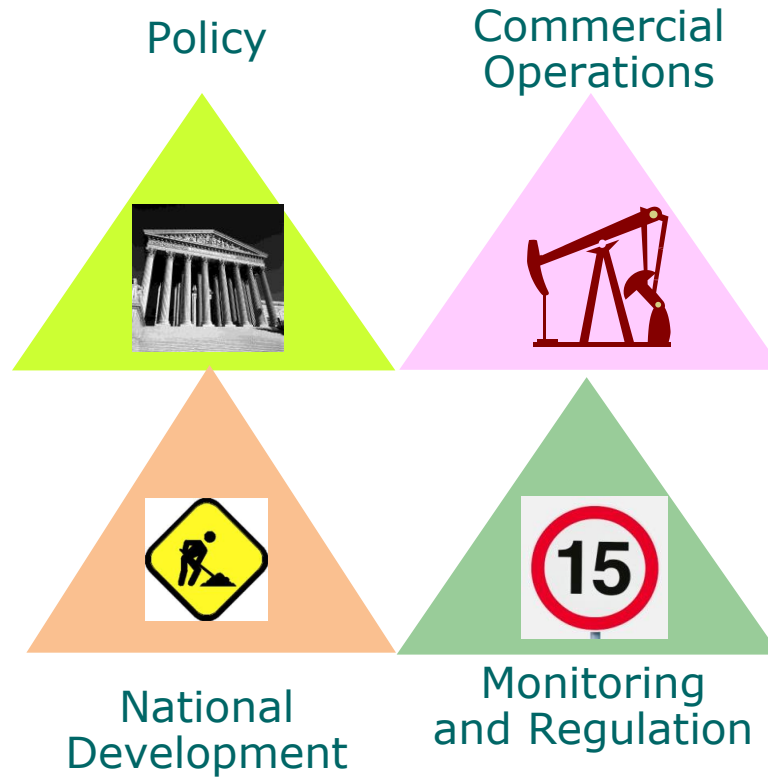
Reality can be messier



Institutional structure: where are rules established?

Type of text	Issues covered	Specific documents
Constitution	Role of legislature, freedom of information, state ownership, basic institutional responsibilities	
Legislation	Roles, responsibilities, oversight of state institutions	Petroleum Act, Minerals Act, State-Owned Enterprises Act, Extractive Industries Transparency Act
Regulation	Specific powers of state agencies, modes of implementation	Petroleum Regulations, Minerals Regulations, Operational Regulations
Contracts	Roles of ministries or SOEs vis-à-vis specific projects	PSAs, concession agreements, Offtake agreements

Institutional Structure – four key roles to allocate



Archetype 1: Norway



Policy



Commercial
Operations



National
Development



Monitoring
and Regulation

Archetype 2: Malaysia

Commercial
Operations

Policy

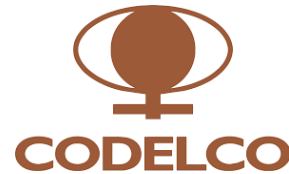


Monitoring
and Regulation

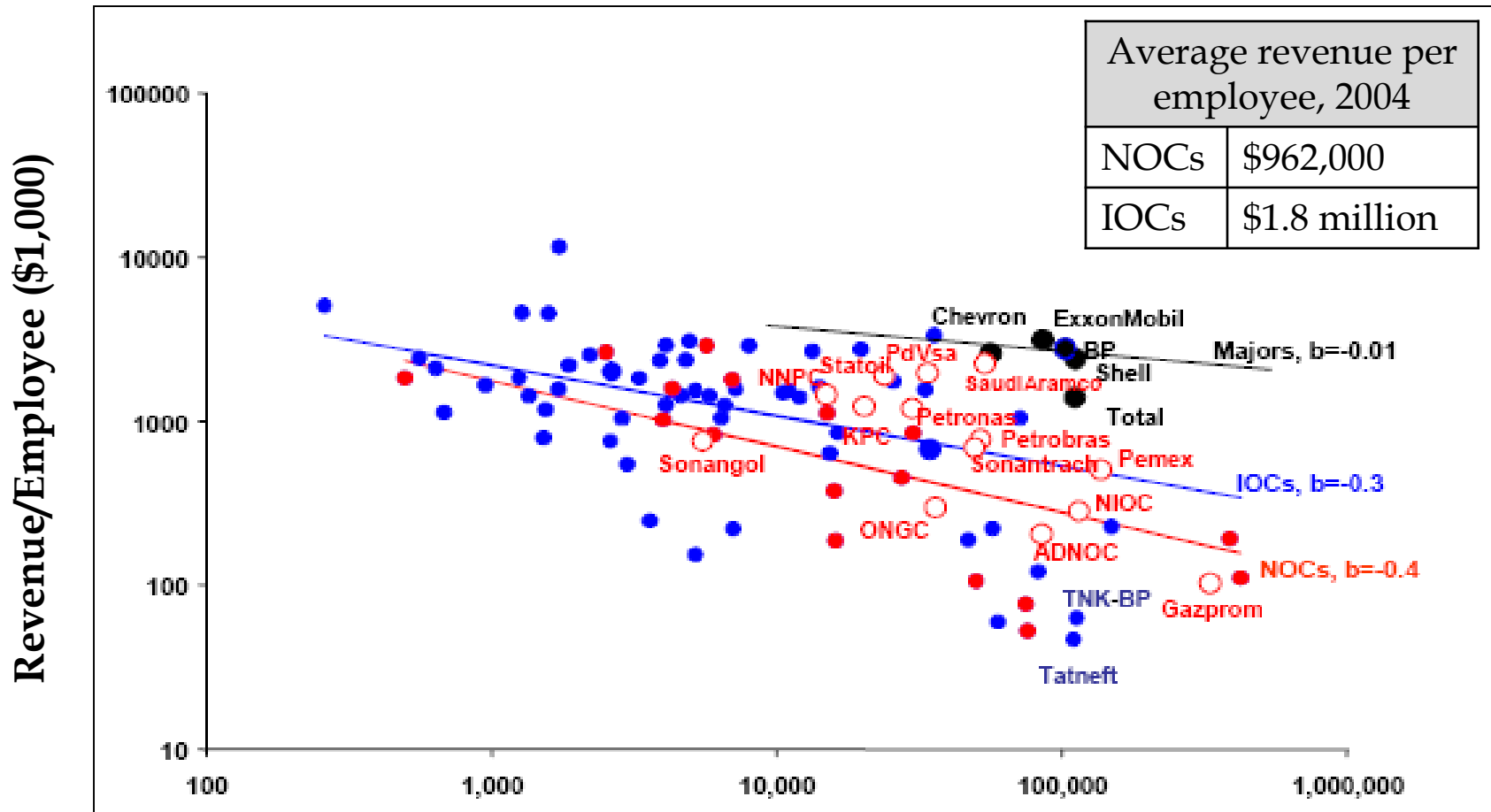
National
Development

SOEs: Benefits and success stories

- Development of national skills
- Long-term economic control and financial returns
- More effective state control over the pace and development of the industry
- Stimulator of local content and positive economic spillovers



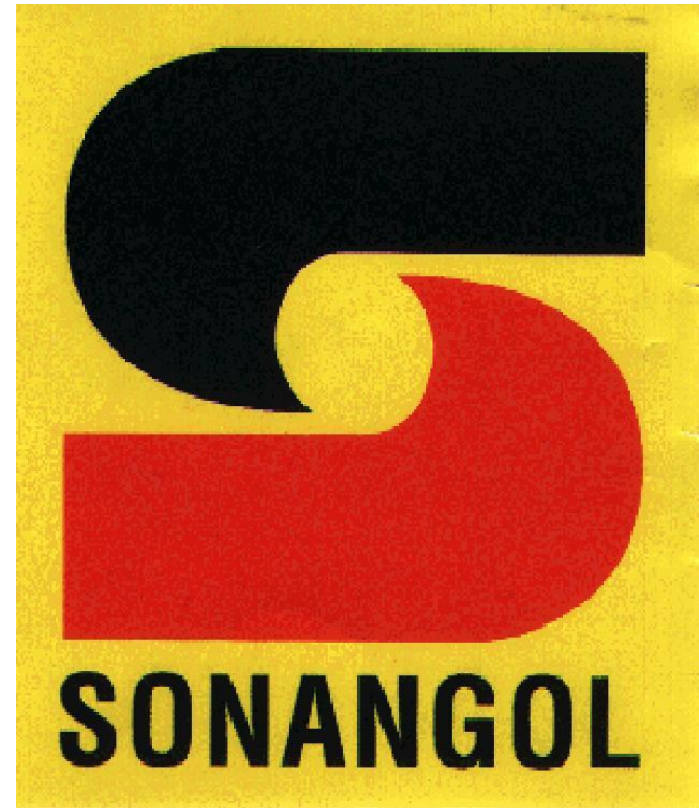
Risks from SOEs: Inefficient project development and revenue collection



■ NOCs
 ■ IOCs
 ■ Majors

Risks from SOEs: Extra-budgetary expenditure

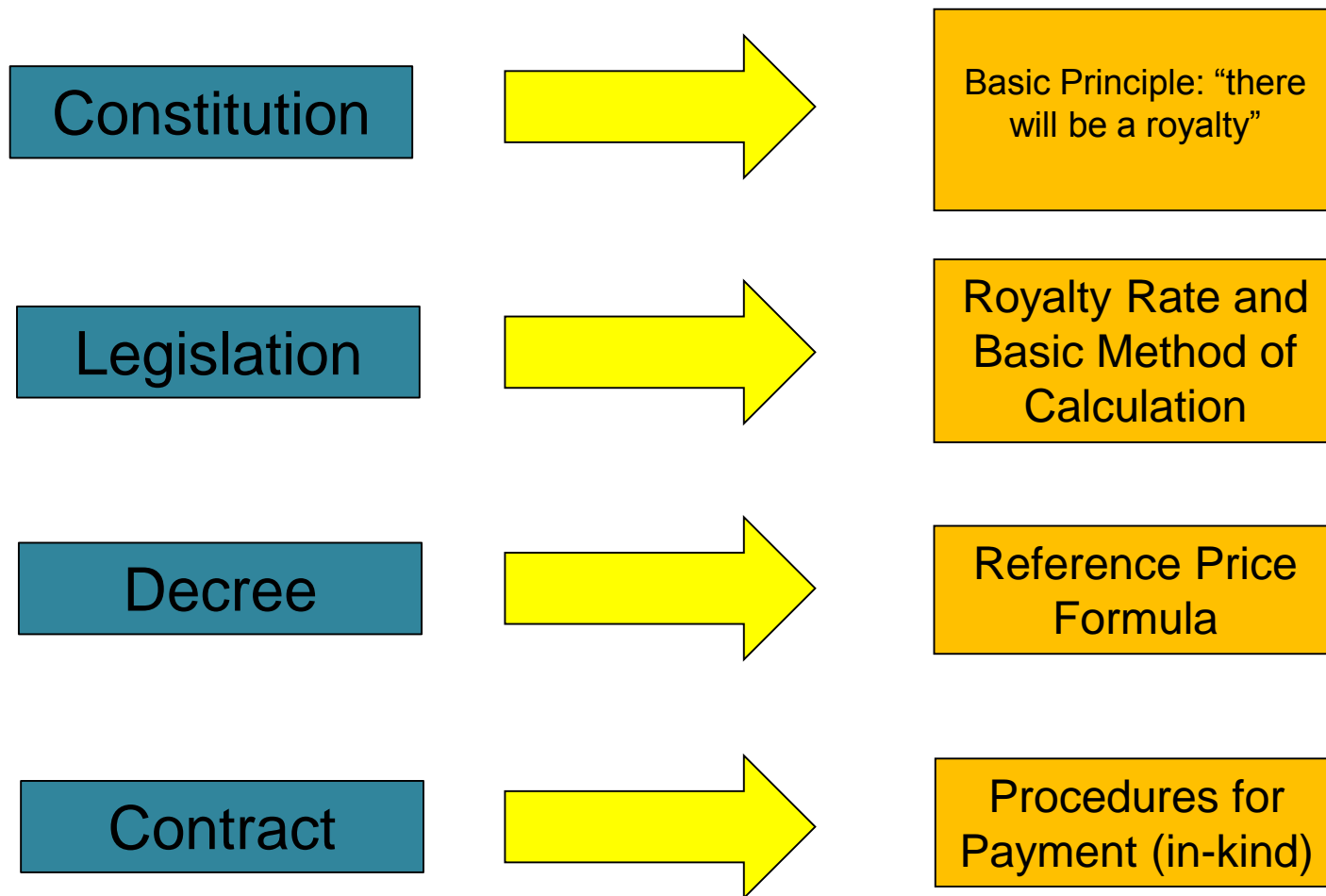
**\$31
Billion**



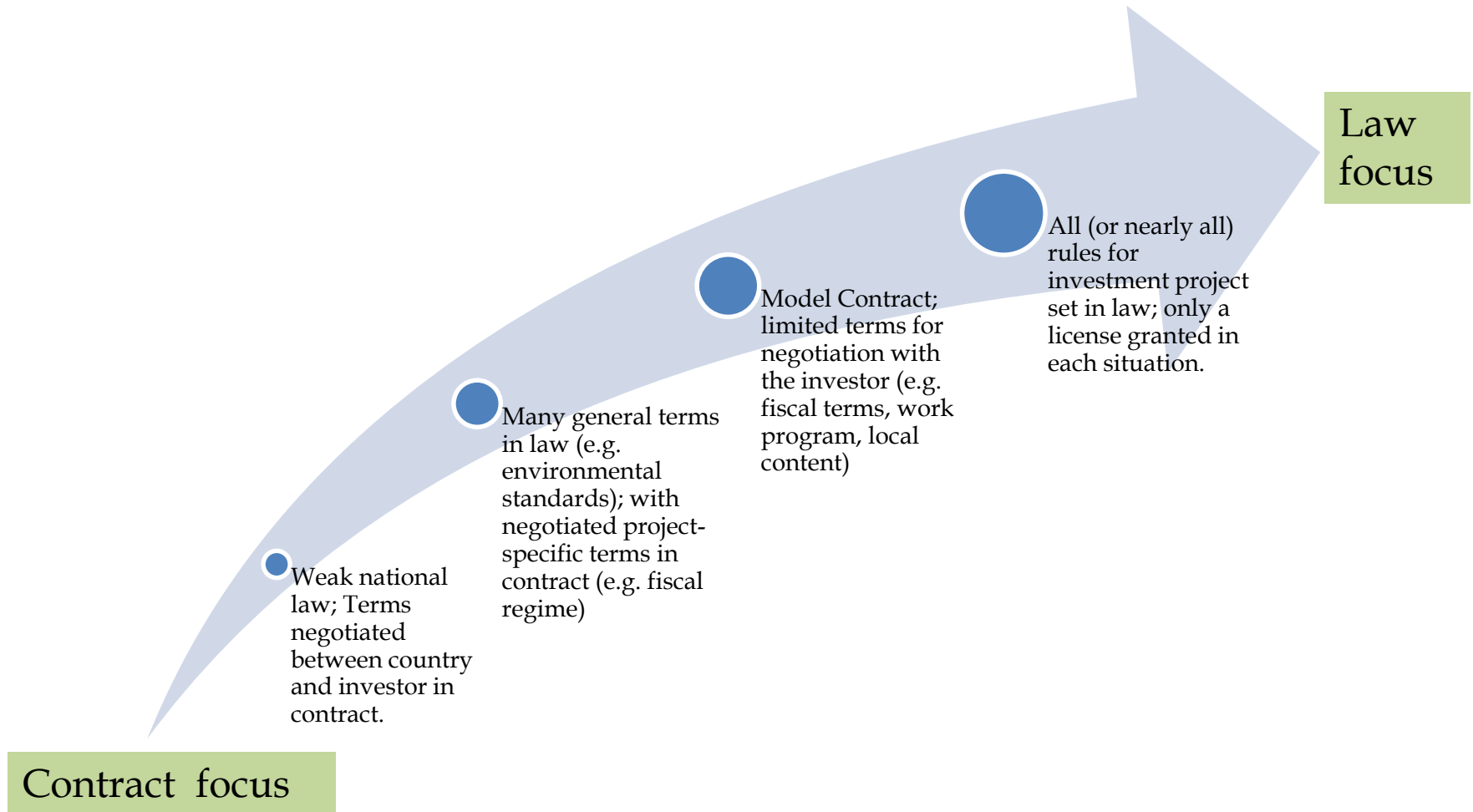
Accountability mechanisms are critical for effective institutions

1. Clear roles and responsibilities
2. Technocratic boards of directors
3. Meritocratic hiring and promotion
4. Extensive (and effectively-tailored) investment in skills development
5. Transparent reporting on activities and results

Rules for companies: Mining Royalties in Colombia



Relationship between contracts and laws



Natural Resource Charter – Precept 2



“As far as possible, terms should be written into legislation that can be more clearly scrutinized; any remaining concessions which depart from standard legislated terms should be submitted to and approved by the legislature.”

Licenses and Agreements

License:

Official document, according to a standard form, whereby the government grants a time-limited right to explore and/or exploit petroleum to a company.

Some countries include most or all of the relevant terms in the license itself: Norway, United Kingdom, United States, Peru

Related term: Permit

Licenses and Agreements

Agreement:

The formalization of a mutually-accepted set of terms between government and company establishing the rights the responsibilities. Can follow a standard form, but is subject to negotiation. Usually significantly more detailed than a license.

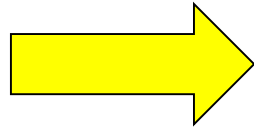
Most petroleum and mineral producing countries utilize agreements, often supplementing a license.

Related term: Contract

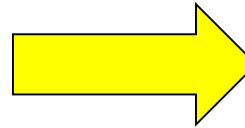
In petroleum....



Agreement



Exploration/
Development



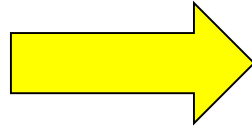
Production

Split license system

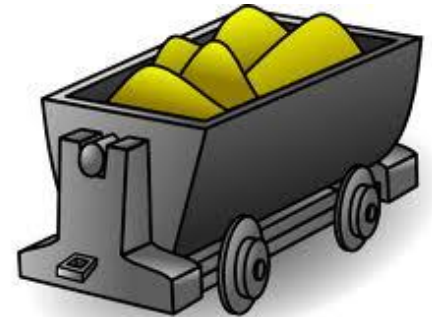
In mining, frequently....



Exploration



Agreement



Production

Content of Agreements – Key Elements vary depending on local laws and regulations

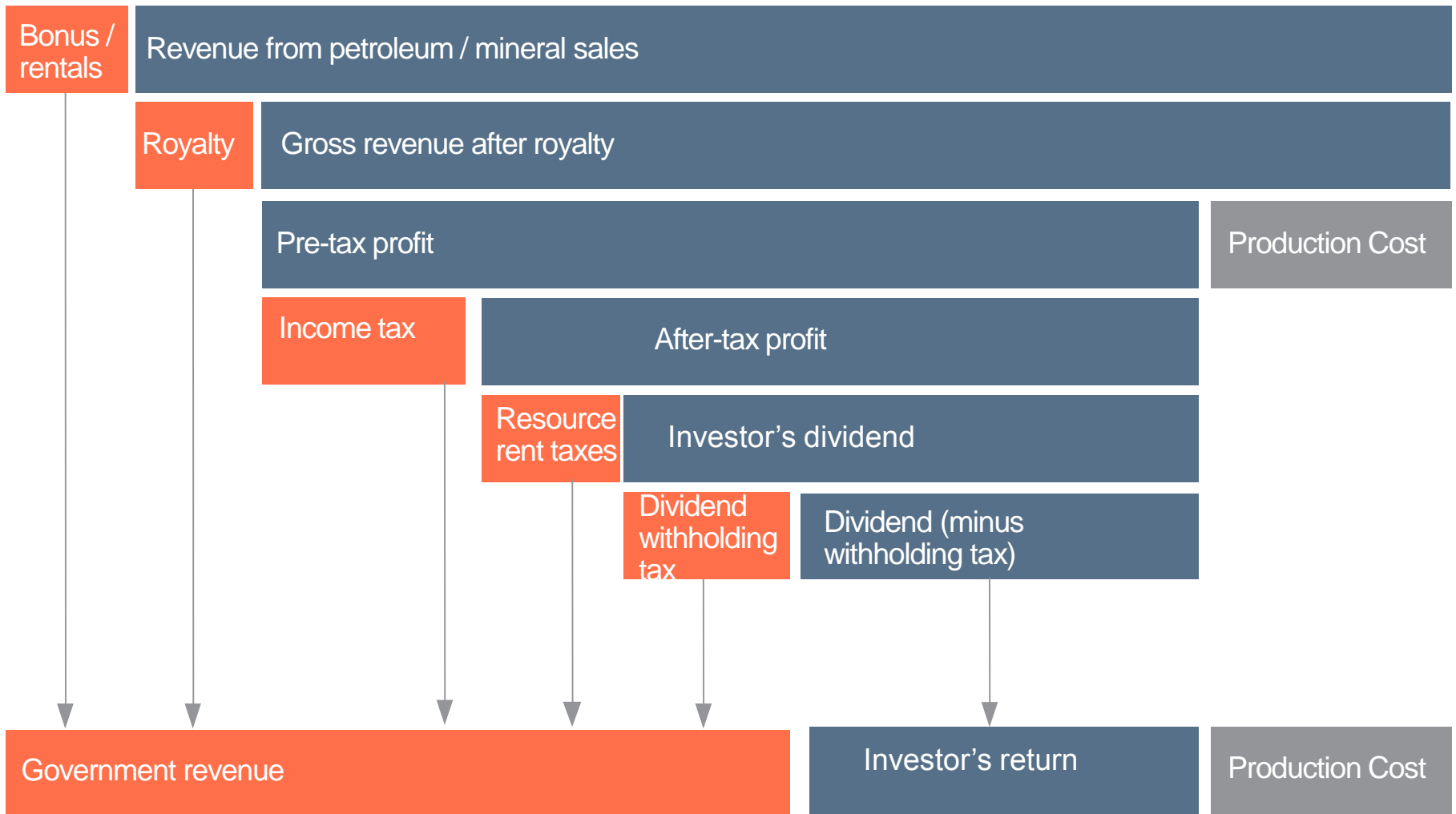
- Duration and extensions
- Work programme obligations
- Contract area and relinquishments
- Contractor rights, obligations and liabilities
- Discovery and appraisal
- Development and production
- Cost recovery, Fiscal terms/production sharing
- Measurement and valuation of petroleum
- Natural gas
- Management of Operations
- Approval of work programmes
- Confidentiality
- Change of ownership
- Environmental protection and safety
- Training
- Local content
- Bonus payments
- Abandonment of wells and installations
- Accounting procedures
- Company Guarantees
- Termination
- Governing law and arbitration
- Stabilisation

Best practice is to include as much as possible in statutory regulation that apply across all licenses

2. Types of Petroleum and Mineral Agreements

Agreement Type	Key Features	Examples
Concession (Royalty/Tax)	Company owns 100% of the produced resource	UK, US, Colombia, Brazil
Production Sharing	Produced resource is split among government and company, company gets entitlement to recover costs plus some share of profit	Indonesia, Azerbaijan, Angola
Service Contract	Government retains ownership, companies are paid a fee	Iran, Iraq, Mexico, Bolivia

Concession Regime



Concessions: Key Issues

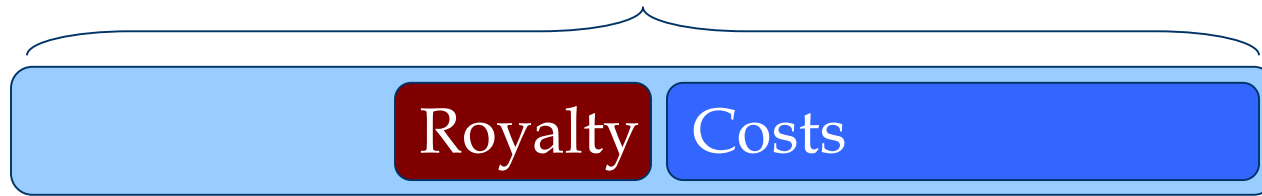
Subject	Concession Features
Direction of Payments	Contractor pays government
Distinguishing Government Revenue Streams	Royalties and Income Taxes
Other Possible Revenue Streams	Bonus, Dividends from State Equity, Dividend Withholding Tax, Windfall Profits Tax, Fees
Key Issues in System Design	<ul style="list-style-type: none">• Setting appropriate royalty• Tax rates and rules on deductions• Providing some measure of progressivity
Advantages	Simplicity
Disadvantages	No built-in progressivity, alignment of incentives

Royalties

- **Economic Function**
 - A payment to the owner of reserves for the right to extract (and to purchase) those reserves on a per-unit basis
- **Types of Royalties**
 - Ad Valorem: A percentage of the value of output
 - Unit based: A fixed monetary amount per ton of ore extracted (less common)
- **The definition of the royalty *Base* is as important as the *Rate***
 - A 10% royalty in Country A may not be the same as a 10% royalty in Country B.
 - There are advantages to defining the base, where possible, by reference to transparent price indices.

Income Tax

Gross Income (base for Royalty calculation)

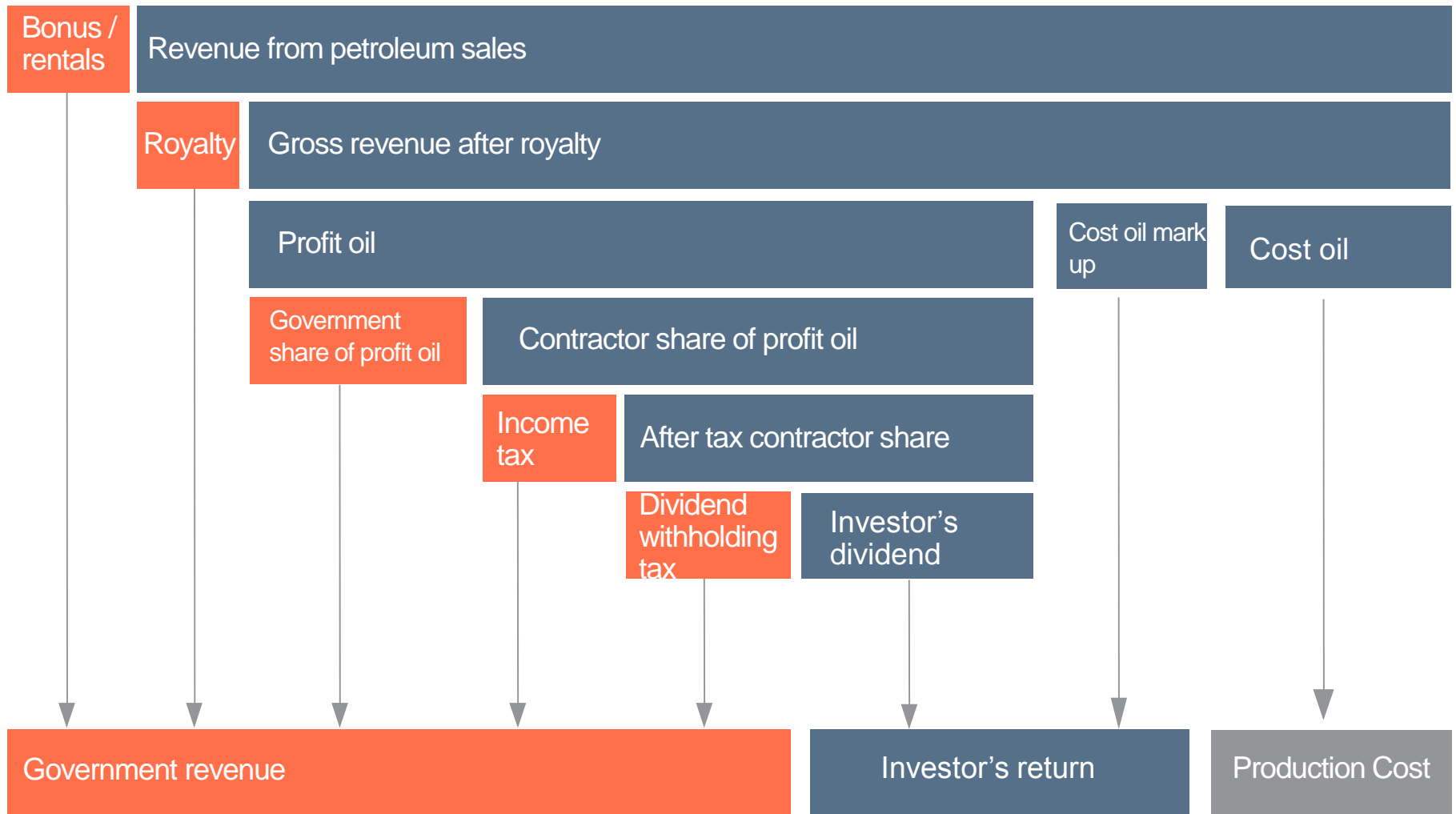


Net Income (base for Profit Tax calculation)

While Royalties are generally imposed on Gross Income, Profits Taxes are imposed on Net Income.

- Thus, royalties are generally treated the same as a cost in calculating profits taxes.

Production Sharing Contracts (PSCs)



PSAs: Key Issues

Subject	PSA Features
Direction of Payments	Contractor pays government taxes and (sometimes) royalties; Government sells share of petroleum
Distinguishing Government Revenue Streams	Production share
Other Possible Revenue Streams	Royalties, Income Tax, Bonus, Dividends from State Equity, Dividend Withholding Tax, Windfall Profits Tax, Fees
Key Issues in System Design	<ul style="list-style-type: none">• Cost Recovery Rules• System for Production Split• Oversight of National Oil Company
Advantages	Direct government role in oil sales, alignment of incentives, easy to build in progressivity
Disadvantages	Increased potential for conflict of interest

PSA Examples: Profit-oil split

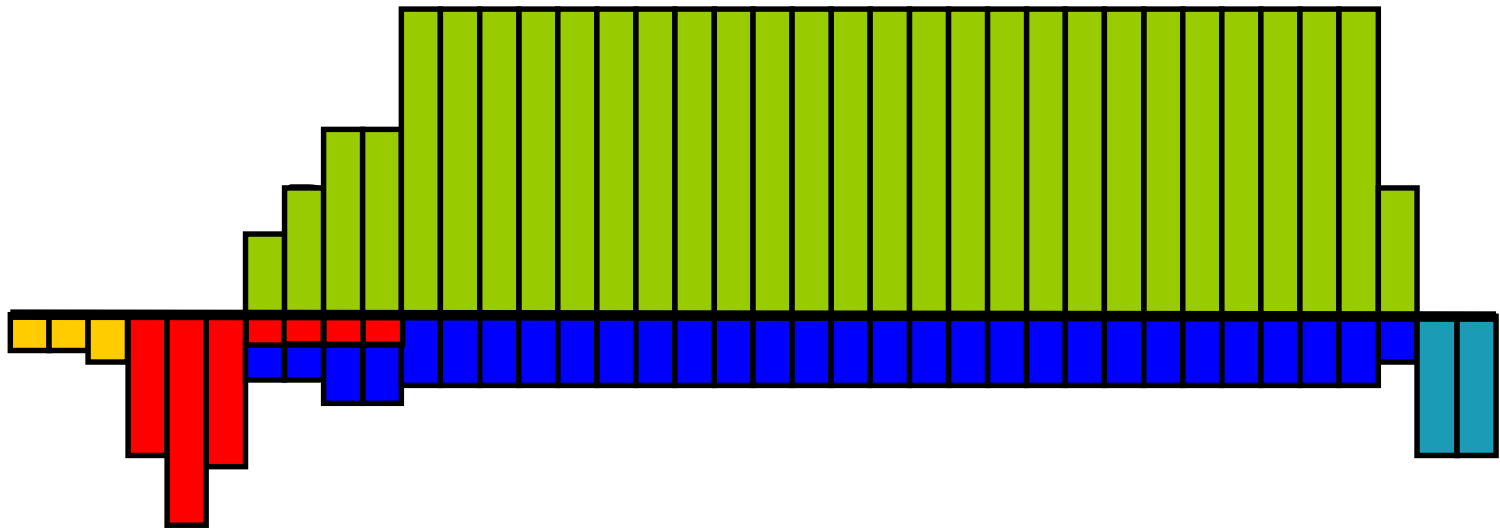
Production-based: Nigeria (Bonga deepwater)

Cumulative Production	Profit-oil split
< 350 mb	20% state / 80% contractor
351 – 750 mb	35% state / 65% contractor
751 – 1000 mb	45% state / 55% contractor
1001 – 1500 mb	50% state / 50% contractor
1501 – 2000 mb	60% state / 40% contractor

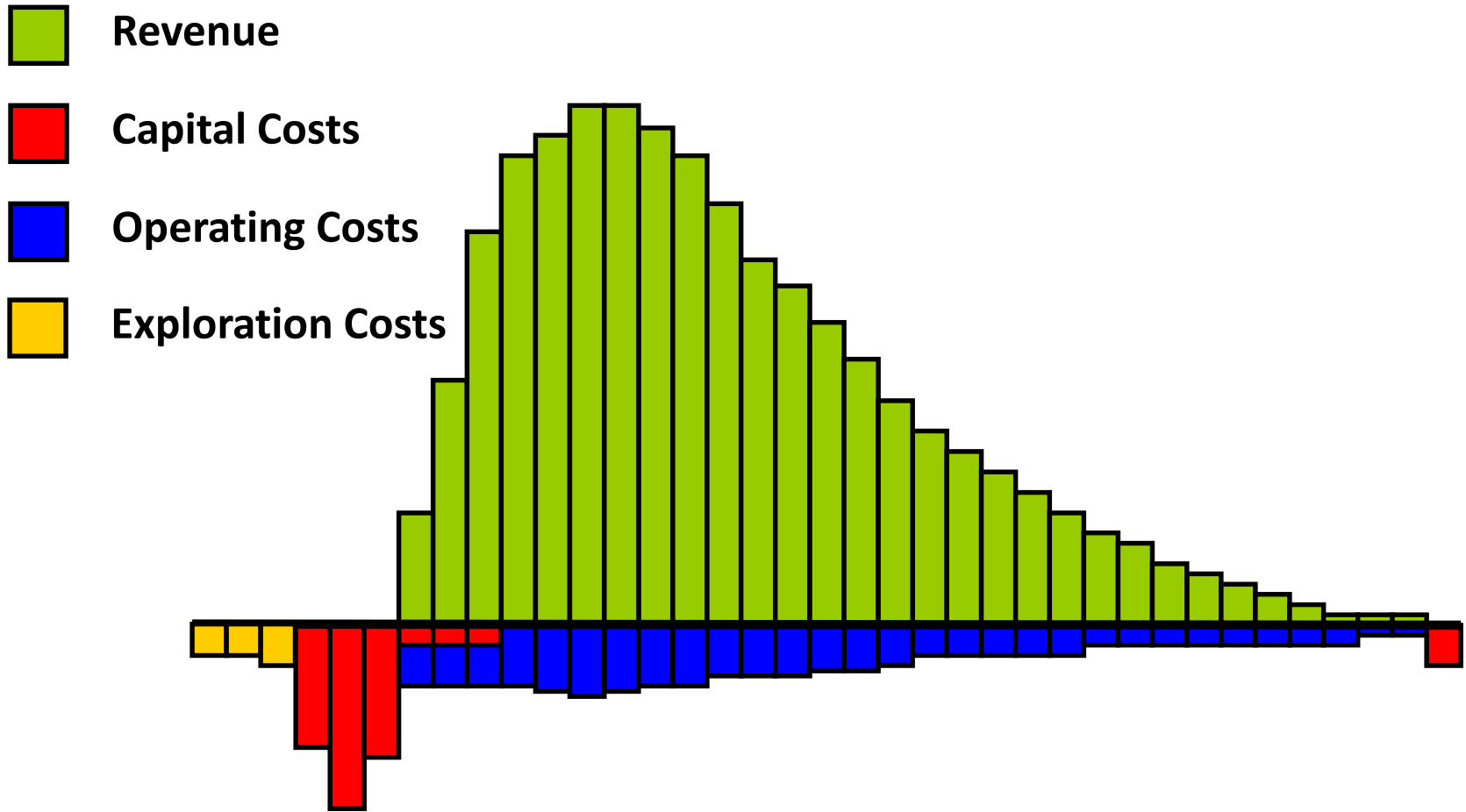
IRR-based: Azerbaijan (ACG)

Internal Rate of Return	Profit-oil split
RROR < 16.75%	30% state / 70% contractor
16.75% < RROR < 22.75%	55% state / 45% contractor
RROR > 22.75%	80% state / 20% contractor

Risk 1: Project Timeline (mining)



Risk 1: Project Timeline (oil and gas)



Risk 2: exploration

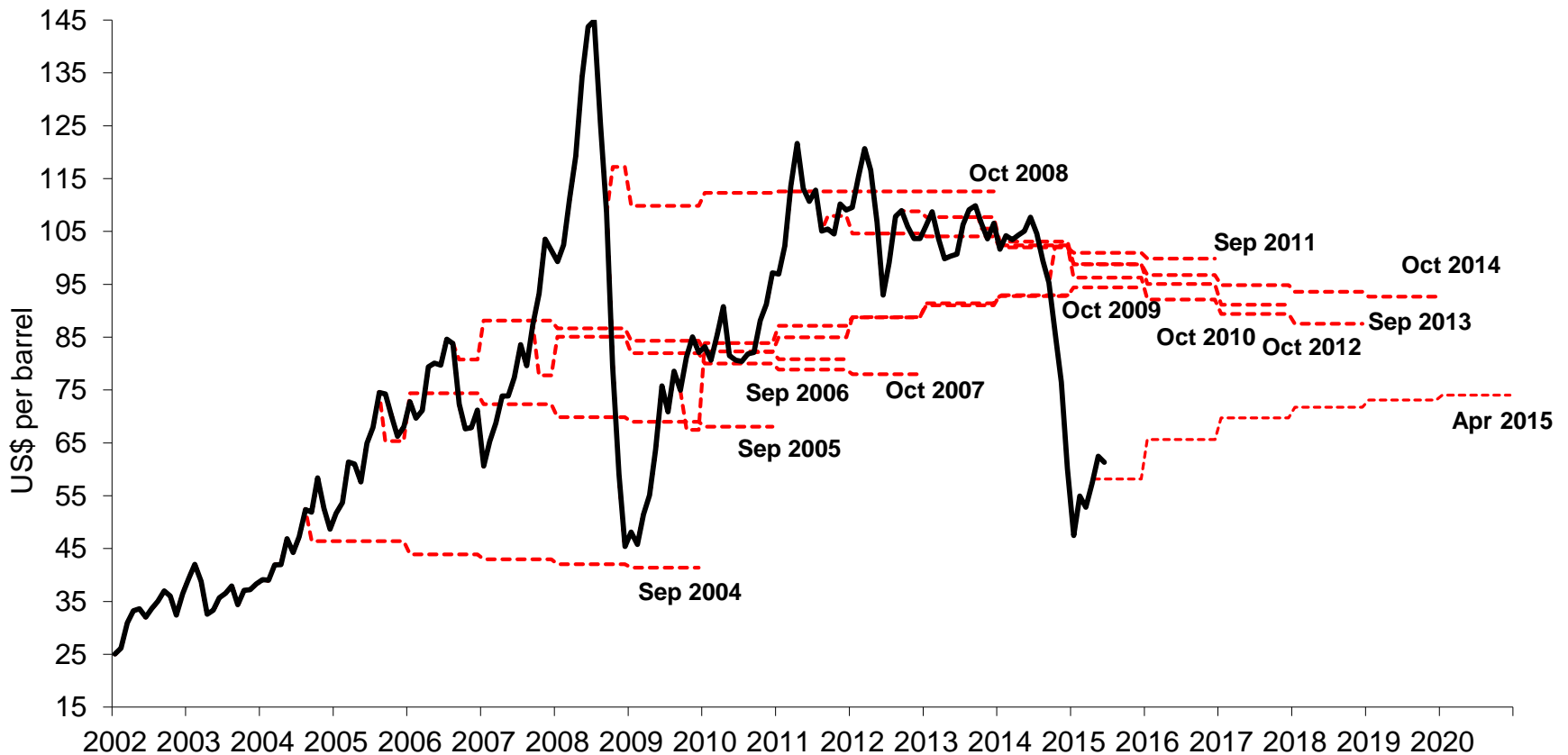
Drilling success rates and discovery sizes 2010-2014

	Frontier	Emerging	Maturing	Mature
Commercial Success Rate	8%	47%	30%	36%
Average Discovery Size mmboe	352	353	74	30
Drilling Cost \$/boe	3.0	0.4	2.0	2.4

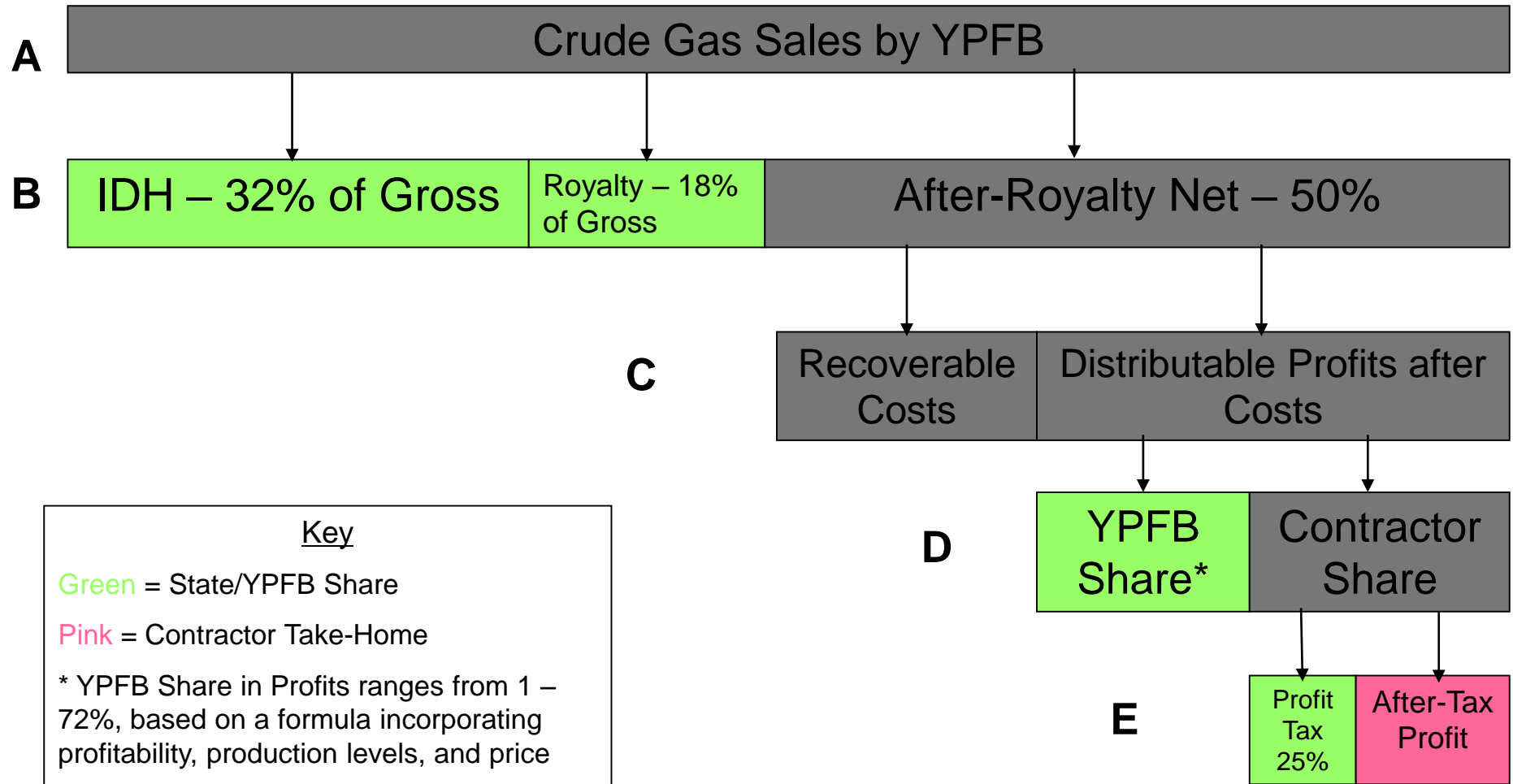
Based on drilling results of 40 mid and large cap E&P companies, does not include Appraisal costs of pre-drilling seismic and studies. Approximate full finding cost is 3x drilling cost

Risk 3: market volatility

WEO Oil Price Forecasts 2002-2020
(Monthly prices, 2015 U.S. Dollar per Barrel)



Service Contract Financial Flows: Bolivia



Service Contracts: Key Issues

Subject	Service Contract Features
Direction of Payments	Government sells all petroleum, pays fee to contractor
Distinguishing Government Revenue Streams	Sale of production
Other Possible Revenue Streams	Royalties, Income Tax, Bonus, Dividends from State Equity, Dividend Withholding Tax, Windfall Profits Tax, Fees
Key Issues in System Design	<ul style="list-style-type: none">• Determination of Fee• Oversight of National Oil Company
Advantages	High levels of government control over operations and petroleum
Disadvantages	Incentives for contractors may be inadequate (particularly upside); Increased potential for conflict of interest

3. License/contract allocation processes

Key Goals:

1. Pick the “right” company
2. Get the best terms for the State
3. Limit / eliminate corruption
4. Reflect broader sector goals

...important for system to be consistent with legal framework.

Competitive bidding vs. open door

Generally, competitive bidding allows country to:

- choose best among pool of bidders
- have a stronger negotiating position to get best terms
- increase transparency and minimize discretion / discrimination

Competitive bidding - challenges

- Need to have competition – where geology not known, risk of few companies being involved
- “Winner’s curse” – risk of overbidding -> renegotiation
- Capacity / political will – government needs to have (or acquire) capacity to carry out process and political will to implement

License allocation in the mining sector



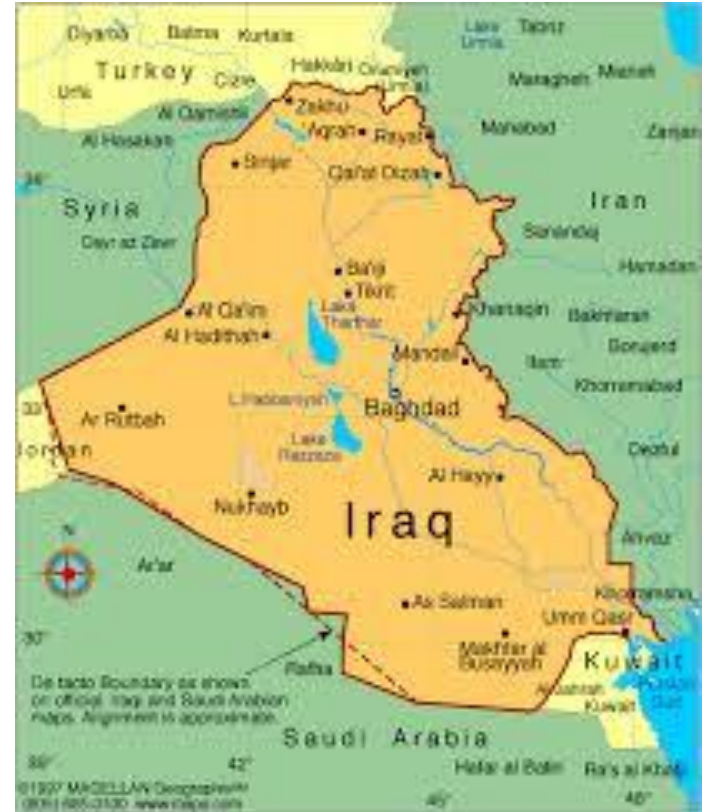
Auctions in Iraq - 2009

\$2.80/barrel:

Difference between fee bid by Exxon & the winning bid of CNPC/BP for Rumaila oil field.

\$750m:

Extra accruing to Iraq per year from 1 m barrels per day (bpd) production of the Rumaila field.



Risk of post-bid negotiation



SOEs in the license allocation process

Rule for SOE access to upstream projects	Example(s)
SOE has monopoly over all E&P	Saudi Arabia, Mexico (up to 2013)
SOE has guaranteed role/option	Algeria, Malaysia, Brazil (deepwater “pre-salt” fields)
Application with favor	Kazakhstan, Mexico (now)
Full competition	Norway, Colombia

Good practices

Competitive processes	All processes
Limited number of biddable variables	Maximize geological information before process
Make ranking and relative weight of variables clear	Limit variance from standardized legal rules
Build (or contract) sufficient expertise to run the process	Publish the reasons for selection, identity of the winner and the licenses/contracts
Competitive but realistic fiscal conditions	Require strong technical/financial qualifications

4. Contracts: Key Concepts

A. Stabilization Clauses

B. Dispute Resolution and International Arbitration

C. Confidentiality Clauses and Contract Transparency

Tool for analysis: www.resourcecontracts.org

RESOURCE CONTRACTS

A directory of
Petroleum &
Mineral Contracts

Search 1335 contracts and associated documents **Search**

[Advanced search](#)

1335 Documents | 89 Countries | 36 Resources

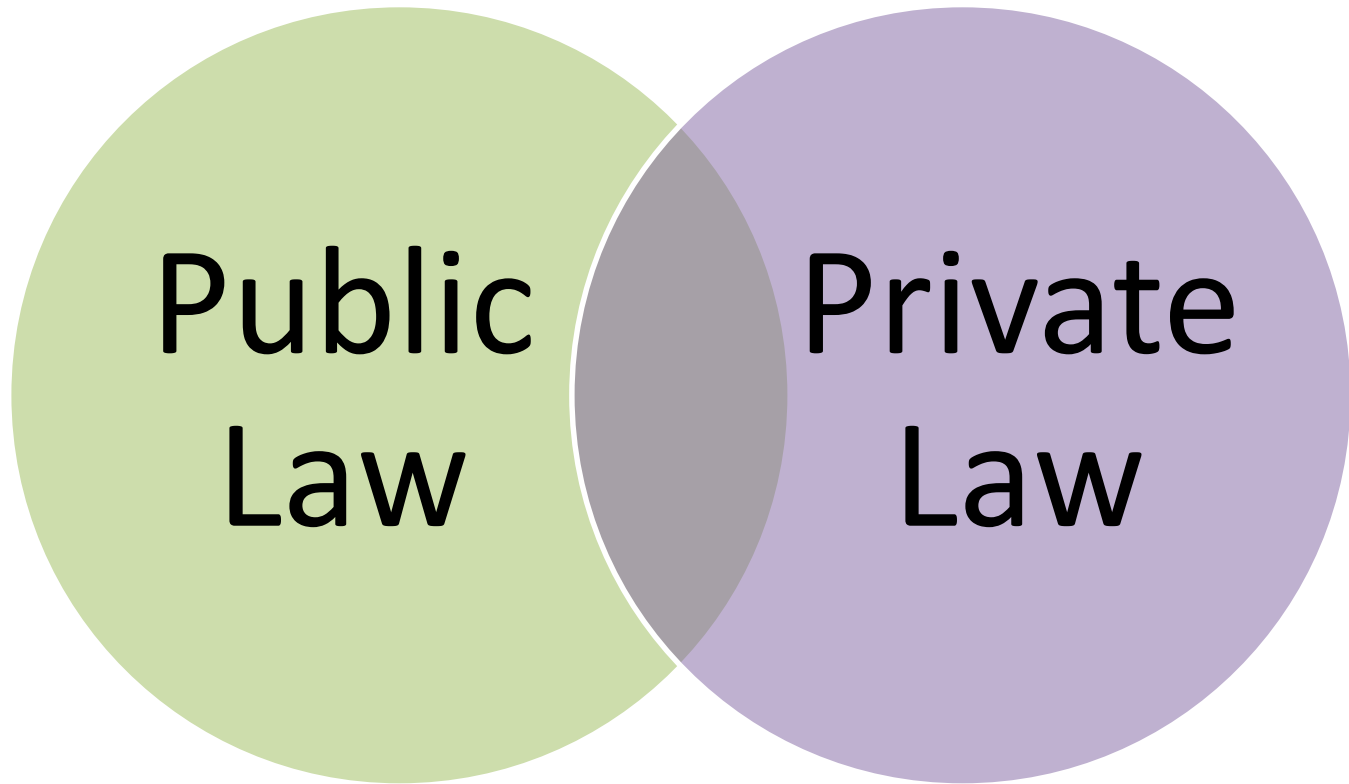
Explore contract terms:

- Environmental impact assessment >
- Income tax: exemptions >
- Local employment >

A. Stabilization Clauses

What are these clauses?

What is their purpose? For the company and for the government?



**Public
Law**

**Private
Law**

Stabilization clauses – things to look out for

Read the excerpts from the Azerbaijan and Mongolia Stabilization clauses. What are the differences between them?

B. Dispute Resolution and International Arbitration

1. What is international arbitration?
2. Why would arbitration be agreed to by:
 - a. The Company?
 - b. The Government?

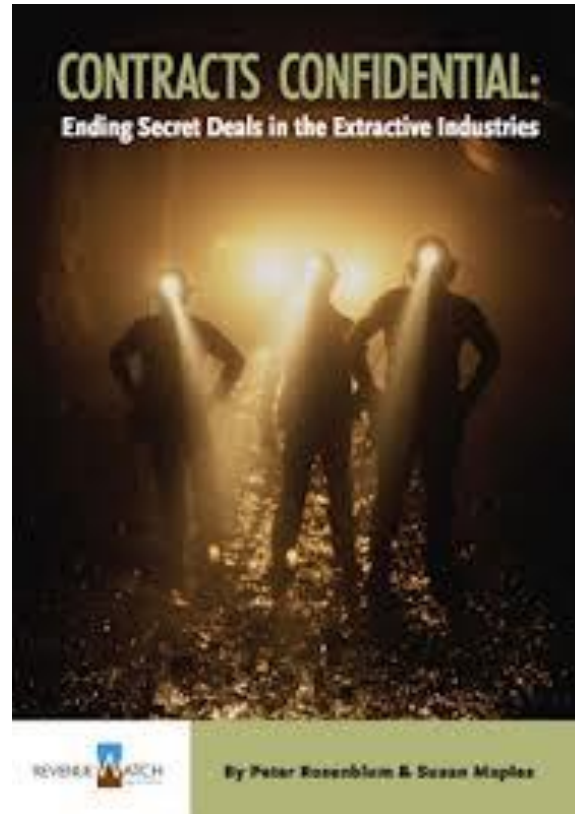
Dispute Resolution and International Arbitration- Timor Leste Contract S-06-01

Read the excerpt
from the Contract.

What does this tell
you about
arbitration in this
contract?



C. Confidentiality Clauses and Contract Transparency



<http://www.revenuewatch.org/publications/contracts-confidential-ending-secret-deals-extractive-industries>

Confidentiality: Cambodia Model Production Sharing Contract (2009)

- What information is confidential?
- What obligations does the confidentiality obligation impose on various parties
- What are the limits to confidentiality?

Confidentiality clauses almost always contain important exceptions

1. Information already in the public domain
2. Information that a party has to divulge by virtue of applicable laws
3. Mutual agreement of the parties

Disclosure of contacts—dispelling the myths

Specific terms	Likely to cause competitive harm if disclosed	In a primary contract?
References to future transactions	Yes	Unlikely
Trade secrets	Yes	Unlikely
Work obligations	Unlikely	Likely
Local Content	Unlikely	Likely
Employment and training	Unlikely	Likely
Financial terms of the deal (terms and payment rates)	Unlikely	Almost always
Parties to the contract	Unlikely	Almost always

Contract transparency—growing, but still an exception



<http://resourcegovernance.org/sites/default/files/documents/paris-declaration-briefing-transparency-and-open-contracts-in-the-natural-resource-sector-web.pdf>

Countries

Filter by country ...

Filter by Resources



Afghanistan
7 contracts



Albania
12 contracts



Algeria
1 contract



Angola
4 contracts



Argentina
1 contract



Australia
1 contract



Azerbaijan
6 contracts



Belize
21 contracts



Benin
2 contracts



Bolivia
34 contracts



Brunei Darussalam
1 contract



Burkina Faso
6 contracts



EITI and Contract Disclosure

- The EITI Report should provide an **overview of any contracts and licenses that are already publicly available**, and include a reference or link to the location where these are published. (§3.12(b))
- The EITI Report must document the **government's policy on disclosure of contracts and licenses** related to both exploration and exploitation, including relevant legal provisions, actual disclosure practices and any reforms that are planned or underway. (§3.12(b))
- EITI implementing countries are *encouraged* to **publicly disclose any contracts and licenses** that provide the terms attached to the exploitation of oil, gas and minerals. (§3.12(a))

Thank you.

pheller@resourcegovernance.org



@prpheller