STATE PARTICIPATION IN INTERNATIONAL PETROLEUM ARRANGEMENTS

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Content

Introduction

International petroleum arrangements are the result of interplay of states, often represented by their national companies, and private oil entities, within the oil industry. While the former are interested in economic development of their petroleum resources, the latter offer financial and technical capacities to serve this purpose. Management of resources requires advanced technology and investments, which may be challenging for states who, therefore, seek assistance from professionals. This cooperation takes its legal form through international petroleum agreements.

The thesis intends to identify legal mechanisms used by states to improve their legal position in the framework of international legal arrangements concluded with oil and gas companies for the exploitation of their national resources . The question will be raised on how state's interests and strategies materialize in petroleum agreements.

The cornerstone of state participation in petroleum arrangements is its own strategy for management of resources. The process of policy-making is of high relevance, as it forms the background for future contracts. Thorough evaluation of objectives and priorities at this stage fosters state's position in relations with companies. Therefore, the first part of the paper deals with elements of state's strategies towards petroleum development, as they have direct impact on the choice of petroleum legislation, type of an agreement or concrete provisions. Furthermore, the most crucial aspects of state's petroleum development will be analyzed in light of international law.

Secondly, the paper deals with the different types of standard petroleum contracts, currently used in the oil industry. The petroleum arrangements are the implementation and realization of state's objectives. Thus, the assessment of state's legal position in four most common models of petroleum arrangements is presented, with emphasis on evaluation of advantages and disadvantages of these solutions from the state perspective.

Finally, the analysis of concrete contractual and legislative provisions is made, with special focus on those provisions which particularly foster state's legal position. The concrete legal mechanisms presented are common to all kinds of petroleum arrangements, and may be implemented through different legal forms, like petroleum legislation or contract provisions. In order to give a broader overview of various forms of implementation of these mechanisms, comparative case study of two different systems is provided: the Norwegian concessionary system and the Timor Production Sharing Model Contract.

1 Chapter 1 Legal aspects of state participation in petroleum development

1.1 Historical background and types of international petroleum arrangements

Formation of modern international petroleum arrangement for oil development is a continuous and ongoing process. In order to understand the rationale of the modern petroleum contracts and legislations it is necessary to draw the background of their evolution.

The origins of modern petroleum agreements date back to the second part of the 20th century and are the result of states opposition towards extensive domination of multinational oil companies under the old concessionary system. Increasing dissatisfaction with the status quo made host states look for alternative legal arrangements for management of their resources. Despite ongoing evolution and various modifications, agreements between states and companies usually have taken form of one of the four typical contract models.

Initially, the Soviet Union and the United States dominated the industry. At the same time, international oil companies, particularly British and Dutch, started market expansion and grounded their dominant position in the industry. The former state is said to launch modern petroleum era with the first concession signed in Persia in 1901.[1] Historical events, such as the First World War confirmed oil as a strategic material [2]. The growing need for petroleum contributed substantially to the expansion of American economy, making the USA world's major oil exporter and most influential licensee in the Middle East (for instance in Bahrain and Saudi Arabia). Concurrently, other international companies continued their expansion, forming the group of the so-called 'majors', that is large private petroleum enterprises which dominated the oil industry. The majors controlled almost the entire industry – they imposed the conditions on which petroleum resources were

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[1] 'Alternative arrangements for petroleum development. A guide for government policy-makers and negotiators', United Nations, New York, 1982, p.3.
[2] 'Law and policy in petroleum development. Changing relations between transnationals and governments' Kamal Hossain, Nichols Publishing Company, New York, 1979, p.2

developed, they controlled marketing, production, explorations, export - basically all aspects of operations [3]. In return, governments received royalties , sometimes additional returns and bonuses. Majors' dominant position was the result of many factors giving them advantageous position and bargaining power in the industry. Particularly, companies offered significant financial resources, technical and managerial expertise and access to marketing outlets.

The Second World War and the post-war period increased need for oil supplies which was followed by expansion of the majors and extensive exploration (especially in the 70s, after stability in 60). Due to steadily growing oil consumption and prices, new private and public 'independents' came to the oil market. The competition for the licenses increased, which was also stimulated by growing position of the Soviet exports. Increased competition for licenses caused by growing demand led to decline of prices and pushed several oil-producing countries to form OPEC. [4]

Dissatisfaction with companies' revenues policies pushed states to take over control over oil developments. However, it was not only low financial returns that was a disadvantage but also limitation of states involvement and influence on management of deposits. Among the major shortcomings was for instance lack of relinquishment obligations, hence, companies didn't develop areas and kept them only to avoid taking over by other companies. Among other disadvantages were long duration of concessions (50-60 years [5]), lack of permanent control of the state or companies' high discretion oil in oil pricing.[6]

[3] The only two exceptions were former the Soviet industry, fully nationalized after the revolution of 1917 and Mexico which created PEMEX in 1938

[4] Joint Venture Contracts (JVCs) among Current Negotiated Petroleum Contracts: A Literature Overview of JVCs Development, Concept and Elements' Talal Al-Emadi, p. 5 http://gjil.org/wp-content/1_1_al_emadi.pdf

[5] 'Alternative arrangements for petroleum development. A guide for government policy-makers and negotiators', United Nations, New York, 1982, p.3

[6] Many concessions of this type were granted to American companies in the Middle East before 1945. They covered large areas (Bahrain, Saudi Arabia) or even entire countries (Kuwait) and were granted for long periods, for instance in Bahrain (55 increased to 90 years, Qatar (75 years), Saudi Arabia (approx. 66 years)

The evolution of the concept of resource nationalism changed states' way of governing petroleum resources, so that their national interests are safeguarded and protected.[7] States were encouraged to demand higher financial returns and guarantees of wider control over production and management of deposits. New forms of international petroleum arrangements were supposed to replace the old system. These new tendencies had a spillover effect on the whole industry, causing developed and non-OPEC states to reevaluate their own policies in order to meet demands of the changing situation.

The shift of control over petroleum development resulted in three main changes. Firstly, new types of arrangements were introduced and old ones renegotiated. An example can be Indonesia, which was the precursor of traditional production sharing agreements and introduced new legislation allowing only state enterprises to undertake petroleum operations.[8]

Secondly, national oil companies were gradually established and their position was strengthened by favoring legislation, granting them special rights in the local industry.[9] This was backed by the UN policy, which supported nationalist policies on revenues management. The new approach was reflected in the UN Resolution NO. 1803 in 1960 and was subsequently called the doctrine of 'Permanent Sovereignty over Natural Resources'[10]. NOCs' basic objective was to increase governments' take, through such means as enhanced control, direct participation in petroleum production , cooperating or competing with other oil companies.

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[7] Resource nationalism as opposed to resource privatism
http://www.iied.org/pubs/pdfs/G02507.pdf

[8] Outlines of the Presentation of Dr. Irina Paliashvili, the President of the Russian-Ukrainian Legal Group ,at the Seminar on the Legislation on Production Sharing Agreements, September 14,1998
http://www.rulg.com/documents/The_Concept_of_Production_Sharing.htm

[9] First NOCs were established in the Latin America, with the process of anti-majors tendencies such companies as PEMEX (Mexico, 1938), NIOC (Iran, 1957), ENI (Italy, 1953).

10 'The right of peoples and nations to permanent sovereignty over their natural wealth and resources must be exercised in the interest of their national development and of the well-being of the people of the State concerned.' (1)The exploration, development and disposition of such resources, as well as the import of the foreign capital required for these purposes, should be in conformity with the rules and conditions which the peoples and nations freely consider to be necessary or desirable with regard to the authorization, restriction or prohibition of such activities.'(2)

Thirdly, the establishment of OPEC launched a new period of states domination over prices and production. Through the organization states could reach agreements which enabled them to collectively agree on their energy policies in opposition to and independently from international oil companies.

To sum up the shift from the old concessionary system to era of new petroleum arrangements was caused by emergence of nationalist movements against excessive control and domination of large international oil companies. The need for control and participation in oil development pushed states to reevaluate their policies and design new legislations. The aftermath of this process was the emergence of new models of petroleum contracts.[11]

1.2 Commencement of petroleum operations by the state

1.2.1 Basic elements of state's strategy for petroleum development

1.2.1.1 Identifying state's objectives

The choice of petroleum strategy and subsequent legal framework for petroleum development is a form of realizing states' objectives in the industry. Despite varying interests and strategies of host governments one may distinguish essential and fundamental principles of petroleum policies. The latter form the framework for further legislations and contracts, which are a legal reflection of states' expectations and policies. Hence, it is necessary to illustrate the background for legal provisions used by states in domestic legislations and contracts by identifying the basic states' objectives in oil development.

Maximization of government revenues

Basic objective of a state is to obtain the biggest financial return possible. The goal is to make oil production profitable for a state either by negotiating most favorable terms or by implementing them into general legislation, at the same time not

11 See Chapter II

discouraging an investor. State's share of rent make take different forms. Under traditional concessions, states generally obtained royalties. Under contemporary agreements states may obtain their share through different ways, depending on a type of agreement and negotiated terms (royalties, rents, taxes, shares in profits as well as combinations of these[12]).

Meeting domestic petroleum demand

Depending on domestic needs, a state may be interested in obtaining share in production at its own disposal or obligating a company to supply it with certain amount of production (eg.the concessionary system as opposed to the production sharing contract, joint venture system). For many states, the main objective of oil production would be replacement of imports, while others may only be interested in financial returns if their domestic needs are low or already supplied. For some states it might be more convenient to import while exporting oil produced in the country (for instance when costs of transportation are too high). Additionally, not all companies must be interested in petroleum, but may seek only financial benefits from operations (service contracts[13]).

Development of national capacities

States involved in the oil industry, especially developing ones, usually lack sufficient expertise and qualified, experienced nationals. International firms and organizations may assist or provide a state with sufficient know-how, train their personnel or give some funds for this purpose in order to strengthen their position.[14] For this reason, modern petroleum agreements have integrated provisions obligating foreign investors to train nationals in technical and managerial skills, hire nationals or organize trainings etc. From state's point of view acquiring good conditions for development of national technology is a big investment for future. Another way of increasing technological capabilities and better commercial

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[12] 'Law and policy in petroleum development. Changing relations between transnationals and governments' Kamal Hossain, Nichols Publishing Company, New York, 1979, p.53

[13] See Chapter II 1.4.

[14] Companies prepare advanced strategies for technological development, for instance Norwegian Statoil or Shell have strategies is to carry out research and development projects through technology and research centers, located near their production sites and markets

position is to impose obligations on companies to submit data and information obtained from the fields or to ensure direct participation and get experience on a daily basis (joint venture system[15]).

Rapid exploration and maximizing recovery

State's policy on oil development is designed in a long-term perspective, which may not be in line with company's market strategies. Therefore, governments may impose various obligations on oil companies to maximize production and ensure recovery . These are for instance minimum exploration obligations , specific work programs. production schedules to ensure intensive exploration, time limits, minimum work programs, relinquishment requirements etc.

It is in state's interest to ensure that sufficient level of control is maintained at every stage of oil development. States may be particularly interested in controlling speed and conditions of production. In arrangements giving host governments share in petroleum a key issue will be a decision on start of petroleum activities, that is whether it is economically profitable to commence production or not.

Protection of environment

A growing concern, especially in developed oil states is protection of environment and other sectors of economy, such as fishing industry, navigation and tourism.[16] Hence, many current legislations and contracts include provisions requiring oil companies to pay special attention to environment protection, for instance by impact assessments in development plans approved by the governments. Special attention has also been paid to liability regimes in case pollution, damage or decommissioning.

Ensuring government's control

The need for more extensive control and sovereignty over resources is a distinct feature of modern international petroleum arrangements. Control should be laid down by legislative framework and/or detailed agreements with provisions clearly setting boundaries for company's discretion. On the other hand, states' policies

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[15] See Chapter II 1.3.

[16] 'Alternative arrangements for petroleum development. A guide for government policy-makers and negotiators', United Nations, New York, 1982, p.7

must be shaped in the way that good investment climate is ensured with regard to 'the global environment'[17].

One of the forms of increasing state's control is through National oil Companies. These undertakings function both as contractors and representatives of a government and may serve many purposes - from single-purpose entities to international big oil enterprises.[18] Practice shows that NOCs from well-developed countries have as their main goal to supply their own states with crude and are more focused on supply security than profits, whereas state companies from developing countries tend to be more focused on technological development than profits. [19]

1.2.1.2 Economic and political development

State's energy policy and strategy for oil development are determined in the first place by the level of development which affects its bargaining position towards oil companies. Only a few states have sufficient revenues to develop their resources. Since petroleum development is very expensive and requires high investment rate, many governments, especially developing ones are more likely to depend on oil companies. The combination of political and economic factors increases or decreases state's chances to negotiate better conditions with international oil companies or impose favorable conditions for access to the operations. This refers to the extent of many conditions exploration rights, share in production, financial returns etc. The developed countries have a naturally better starting point,

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[17] 'Global environment' is an interplay of oil producers, exporters and importers, private and national companies as well as organizations in a broader context. Of highest relevance are relations between states and oil companies, which are the basis for international petroleum arrangements as they reflect economic and political interactions of parties.
'Law and policy in petroleum development. Changing relations between transnationals and governments' Kamal Hossain, Nichols Publishing Company, New York, 1979, p.12

[18] 'World Petroleum Arrangements 1985', The Barrow Company, INC, New York, 1985, p.523
[19] 'Alternative arrangements for petroleum development. A guide for government policy-makers and negotiators', United Nations, New York, 1982, p.10

their bargaining positing is improved due to political stability or independence from financial capabilities of oil companies. Additionally, developed states can afford to make preliminary investments that strengthen their position in the industry. They have a wider scope of flexibility in terms of buying expertise, investing in infrastructure, hiring and qualifying nationals etc. They may also offer political predictability and a better financial situation, which may encourage investors as a sign of reliability, economic stability and good investment climate. [20]
However, a state may take some steps to reduce this risk and improve its starting position and obtain better position in the industry. Possible solutions are internal reforms (both legislative and economic) with twofold benefits– they create a better investment climate and give a state more confidence in the industry. Hosting states may improve their economic situation through different means. These may be for example loans and credits from banks, international financial institutions or other organizations (for example the World Bank or OPEC), which are capable of supporting investments and improvements in states' petroleum sectors. Obtaining assistance from the United Nations Development Programme is also an option, since the United Nations arrange special programs with a goal to support states in their petroleum development process.[21]

1.2.1.3 Domestic legislations for petroleum development

Forming a legislative framework for petroleum development is part of an overall state's petroleum policy. Frameworks for petroleum operations make take the form of detailed legislations or systems based on open bidding, in which regulation of relations and obligations between contractors (state and a foreign oil company) is covered by the agreement. Some states have introduced medium forms, where

[20] 'World Petroleum Arrangements 1985', The Barrow Company, INC, New York, 1985, p.520
[21] *Ibidem*, p.74

only part of the regulatory framework is regulated by law, while the rest is subject to negotiations.

All aforementioned systems have both advantages and disadvantages, and they differ mostly with regard to degree of state's flexibility, being an advantage but also a burden at the same time. If a state enters into a contract with an oil company in a fixed framework, it offers a good investment climate with predictability and equal treatment for oil companies, at the same time limiting state's ability to negotiate better terms of an agreement. Fixed systems which stipulate terms of a future contract in domestic legislation and are used for instance in the United States and Canada.

The flexible system is exactly opposite and additionally makes it difficult for a state to change terms of the contract after the agreement has been signed. [22] To overcome possible deadlocks, there is a need for clauses allowing for change of certain provisions if circumstances change significantly or the need to adapt agreement to changing conditions arises. Examples of the individually negotiated agreements may be found in early concessions in Iraq, Iran, Saudi Arabia. A recent example exists in the Indonesian legislation – 'The Bangladesh Petroleum Act' from 1974, which leaves it for state authorities to negotiate terms of agreements with oil companies. Under this legislation one may find very general, unspecific and broad provisions concerning conditions for petroleum cooperation with companies, leaving the state a wide margin of discretion. For instance, article 4 (1) simply states that : 'The Government may enter into a petroleum agreement with any person for the purpose of any operation' or article 8 : 'The Government may, by order in writing, delegate to the Bangladesh Oil and Gas Corporation, that is, Petrobangla, or to any other Government agency, subject to such conditions, if any, as may be specified therein, such of rights and powers under this Act…'.

The mixed system allows for supplementing fixed provisions with additional negotiated terms and thus, allowing adjusting of an agreement to changing

[22] 'Alternative arrangements for petroleum development. A guide for government policy-makers and negotiators', United Nations, New York, 1982, p.59

circumstances. [23] In other word, such systems legislation provides for minimum regulation leaving a margin of flexibility for states to decide on certain issues. This system exists for instance in Norway, India, the Netherlands, the UK. Under the Norwegian Petroleum Act many terms are defined in the legislation, for instance: duration of concessions, obligation of submission of work programs, development plans, (s. 4-2) production schedules (s. 4-4) etc. On the other hand, the Petroleum Act gives the state opportunity to require submission of a work program (s. 3-8) without defining its content in the general legislation or allows for state participation in petroleum activities if the King so decides, without defying the extent of state's involvement (s. 3-6). In case of such provisions, the terms and conditions of operations are subject to negotiations between Norwegian authorities and licensees.

Negotiated systems usually meet opposition of oil companies insisting on general legislation to be fixed. Having a certain degree of predictability is of particular relevance in developing countries, where political and legal instability may discourage foreign investors. The need for having a certain level of security both for a state and foreign investor speaks in favor of regulating basic terms of such agreements in legislation, especially financial terms which are usually involve most intensive negotiations.[24]

1.2.2 Commencement of petroleum development under international law

1.2.2.1 Ownership of petroleum resources and delimitation of deposits and collection of geological data

[23] 'Alternative arrangements for petroleum development. A guide for government policy-makers and negotiators', United Nations, New York, 1982, p.58.
[24] 'Law and policy in petroleum development. Changing relations between transnationals and governments' Kamal Hossain, Nichols Publishing Company, New York, 1979, p.106.

Delimitation of deposits is of high importance – they should not be neither too small, nor too big, so that optional and competitive development is ensured. [25]
However, before allocation, assessment of territory and deposits subject to future disposition should be made.
The very first step is delimitation of area for exploration on states' continental shelves according to states' rights to exploration under international public law.[26]
The prerequisite for state's exploitation of natural resources is article 2 of the United Nations Convention on the Law of the Sea, extending state's sovereignty rights to its own natural resources (article 2[27]).
Rights to exploration and use of marine resources is a core principle of an exclusive economic zone under the law of the sea, recognized as a principle in the United Nations Convention on the Law of the Sea, stipulating that '*the exclusive economic zone, the coastal State has sovereign rights for the purpose of exploring and exploiting, conserving and managing the natural resources'* (article 56 (a)).
Additionally, public international law gives states sovereignty rights to the resources on their continental shelf (Article 77 of the Convention on the Law of the Sea), at the same time providing for the limits thereof (article 76). Hence, the document states that : '*The coastal State exercises over the continental shelf sovereign rights for the purpose of exploring it and exploiting its natural resources'* (Article 77 (1)).
In some cases it might be difficult to establish clear dividing lines between areas subject to state's rights. By way of example, due to uncertainties concerning the Norwegian territory , the UN Commission on the limits of the Continental Shelf

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[25] 'Alternative arrangements for petroleum development. A guide for government policy-makers and negotiators', United Nations, New York, 1982, p.59
[26] Article 2 of the Convention on the Continental Shelf of 1958, Article 77 of the United Nations Convention of the Law of the Sea

[27] '*The sovereignty of a coastal State extends, beyond its land territory and internal waters and, in the case of an archipelagic State, its archipelagic waters, to an adjacent belt of sea, described as the territorial sea'*

issued a recommendation in 2009. It specified the limits of the Norwegian continental shelf to the north and hence, clarified the extent of area subject to state's sovereign rights to resources.

Furthermore, uncertainties regarding territorial aspects of resource management may be solved by bilateral international agreements between states. Recent examples of such agreements are agreement between Norway and the UK from 2009, setting out the boundary between states' economic zones. Another example is a recent agreement between Russia and Norway on maritime delimitation[28], clarifying the maritime boundary between the two states and thus, the limits to state's right to petroleum and fisheries activities.

Collecting geological and geophysical data is an important step towards creating a comprehensive strategy towards oil companies. After assessing capacities, a government may evaluate its bargaining position and introduce respective development strategy. Collecting data may be undertaken by states themselves, which is however expensive and requires both highly-developed technology and expenses. Therefore, states may hire oil companies or specialists with large experience and expertise in the field. Ordering such activities is usually carried out through contracts of work, which differ from typical petroleum agreements [29]. Under such contracts a state enters into an agreement with a private contractor, for instance an international oil company and requires it to carry out agreed projects and activities in a particular area. The subject in such a contract would not only be geological and geophysical data, but often also professional interpretation.

The process of demarcation of areas to be granted for exploration is an element a comprehensive petroleum policy. Well-designed, it may increase state's returns and facilitate long-term management of deposits. For instance, a state may decide

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28 'Treaty between the Kingdom of Norway and the Russian Federation concerning Maritime Delimitation and Cooperation in the Barents Sea and the Arctic Ocean'

29 See Chapter III 1.5.

to assign better quality blocks to a national oil company or to assign more smaller blocks to different contractors and thus increase competition among them. [30] There are different systems for demarcation of territory, such as a block system, applied in Norway and Britain or district system, applied in Iran. In Norway, the amount and size of blocks on the part of the Continental Shelf belonging to the Norwegian state are laid down in the Norwegian Petroleum Act. Hence, as a rule the territory is divided into blocks of 15 latitude and 20 longitude minutes in size, whereas production license generally covers one, several or parts of blocks (section 3-2 and 3-3 of the PA).

1.2.2.2 Awarding areas for petroleum operations

1.2.2.2.1 Systems for awarding areas for petroleum operations

Procedure of allocating an area to a contractor for a state is an important preliminary step in terms of state's position in the awarding process. Some states introduced the system of auction or open bidding, in which a license is granted to a company which presents a better offer.[31] Such an offer may take the form of a royalty, net profit interest, cash bonuses, work commitments, guaranteed state participation and /or combinations.[32] In the auction system, the main advantage is that a government may obtain high returns in the form of bonuses choose most efficient company. On the other hand, auction entails a risk of allocation of area to a company interested merely in purchasing rights to such an area, without guarantee that its policy will ensure efficient exploitation of deposits, as it is based

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[30] 'Law and policy in petroleum development. Changing relations between transnationals and governments' Kamal Hossain, Nichols Publishing Company, New York, 1979, p. 80.

[31] 'Law and policy in petroleum development. Changing relations between transnationals and governments' Kamal Hossain, Nichols Publishing Company, New York, 1979, p.83.

[32] 'World Petroleum Arrangements 1985', The Barrow Company, INC, New York, 1985, p.525.

on purely economic selection criteria. [33] The auction system is applied in the United States and the UK in a changed form.
Some states may opt for the discretionary system, in which certain minimum information concerning elimination criteria are provided but the states are left with the choice of a company upon submission of applications. The discretionary system may also include elements of auction of bidding. [34] The discretionary system is applied in Norway and Nigeria, where the procedure for granting a license is extensively laid down in the domestic legislation. The Norwegian Petroleum Act (section 3-5) provides for the procedure in which companies are free to apply for concessions upon official announcement in public journals (both the Norwegian Gazette and the Official Journal of the European Communities since Norway is a member of the common market). The application must be sent within a certain time limit and is then subject to evaluation based on non-discriminatory and objective criteria. However, the procedure allows for exceptions when the King decides to grant a concession without announcement or decides not to grant any basing on applications submitted to the Norwegian Ministry of Petroleum and Energy. Another example is The Nigerian Petroleum Act which vests the Authority - ‘the Minister’ - with power to grant exploration or prospecting license or a mining lease (section 2 of The Nigerian Petroleum Act). ‘The Minister’ ‘shall exercise general supervision over all operations carried on under licences and leases granted under this Act (section 8 (a)).

1.2.2.2.2 Negotiations and conclusion of petroleum contracts under international law

International petroleum agreements are the form of investment contracts between states and foreign investors. As they often entail high risk, the need for protective measures arises for both parties. States secure their positions through domestic

[33] 'Law and policy in petroleum development. Changing relations between transnationals and governments' Kamal Hossain, Nichols Publishing Company, New York, 1979, p.85.
[34] Ibidem, p.87.

legislations or on the bilateral basis. Both parties may include certain protective provisions in the contract or conclude separate, bilateral agreements regulating such issues as stability of terms.[35] Stability clauses are often applied in contracts with high investment risk, for instance in states with unstable economy or political system. An example is the so-called 'consistency clause'[36] which does not allow for adverse interpretation of the contract in light of national legislation.[37] Stability clauses contribute to reduction of risks, as they entail legal consequences under international law – private party is entitled compensation for the breach by the state.[38] While states are often secured by their domestic regulations[39], foreign investors may protect their interests through stability and 'umbrella'[40] clauses.

International law also covers to a certain extent issues of negotiations and conclusions of petroleum agreements. Especially, they aim at ensuring transparency and public scrutiny. [41] Example of legal acts regulating these issues is article 10 of the Rio Declaration on Environment and Development from 1992, saying that : '*Environmental issues are best handled with participation of all concerned citizens, at the relevant level. At the national level, each individual shall have appropriate access to information concerning the environment that is held by public authorities, including information on hazardous materials and activities'.* Another example are provisions of the Aarhus Convention on Access to Information, Public Participation in Decision-making and Access to Justice in Environmental Matters.

The 1983 Draft United Nations Code of Conduct on Transnational Corporations requires governments and transnational corporations to negotiate and implement

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35 Chapter III 4.4
36 Example: 1998 COTCO Cameroon pipeline project and obligation 'not to modify conditions so that they adversely affect the rights and obligations of COTCO'
37 'Foreign Investment Contracts, L.Cotula, Strengthening Citizen's oversight of Foreign investment: Investment Law and Suitable Development, Sustainable Markets Investment Briefings, Briefing 4, International Institute for Environment and Development, 2007
38 Ibidem
39 See point 3
40 Additional clauses protecting investors in international investment contracts; Interpretation of the Umbrella Clause in Investment Agreements, Working Papers on International Investment Agreements, Number 2006/3/ OECD, 2006
41 'Foreign Investment Contracts, L.Cotula, Strengthening Citizen's oversight of Foreign investment: Investment Law and Suitable Development, Sustainable Markets Investment Briefings, Briefing 4, International Institute for Environment and Development, 2007

contracts in good faith (paragraph 11). Additionally, the Draft extends the requirement to renegotiation of contract in god faith, even if the contract does not include such a provision. Such review should be subject to national and international legal principles.[42]

1.3 The Legal status of petroleum contracts

Petroleum contracts between host countries and oil companies have certain special features, due to the legal status and position of parties involved. As state contracts, they are concluded between a state or its institution on one hand and a private party on the other. Private parties are entities established according to national private law. State is usually represented in agreements by its national institutions, established within the state, under its control and subject to a special regulatory system. [43]

Oil companies are in the position of a foreign investor, entering agreements with a state usually represented by its institution. [44] The legal framework for state contracts is based on both national and international legal systems.

Firstly, state's domestic legislation determines the legal status of petroleum contracts. Most of domestic legislations differentiate between public and private contracts, for which special rules apply. States tend to create special regulatory regimes for contracts involving state , its entities or public interest. This refers to various aspects of petroleum agreements, including special procedures for negotiations, funding, conclusions or termination. Contrary to typical commercial contracts, public agreements cover not only business aspects, but also public

[42] 'Never adopted, but attempted to provide either *mandatory* requirements or *voluntary* guideline for transnational corporations (TNCs) to follow, by encouraging contribution to the development goals and objectives of the countries in which they operated. The Code also attempted to facilitate co-operation with and among States on issues relating to TNCs; and to alleviate difficulties derived from the international character of such corporations and the resulting diversity of laws and cultures.'
http://www1.umn.edu/humanrts/ataglance/compdftun.html, 2010-24-11

[43] 'State Contracts. UNCTAD series on international investment agreements', United Nations Conference on Trade and Development, United Nations, New York and Geneva, 2004

[44] Ibidem

constraints and needs. Thus, through domestic legislations states secure their interests and place themselves on privileged position.[45]

Secondly, petroleum contracts exist within the framework of international law. The framework for petroleum contracts is completed by international investment law derived from multilateral (e.g. The Agreement Establishing the World Trade Organization and its Annexes), regional (North American Trade Agreement) and bilateral agreements (e.g. the U.S. Bilateral Investment Treaties) . Additionally, customary international investment law is binding upon states (e.g. the principle of fair and equitable treatment).

2 Chapter II Commencement of petroleum development by the state

2.1 Types of petroleum arrangements – State's legal position in international petroleum arrangements

2.1.1 Concessions

2.1.1.1 Traditional concessionary system

Under the traditional systems for petroleum development, states granted concessions which gave extensive control over operations to oil companies. Not only didn't state have influence on the operations but also marketing of oil produced; companies' strategies often ran contrary to states' interests.

[45] 'State Contracts. UNCTAD series on international investment agreements', United Nations Conference on Trade and Development, United Nations, New York and Geneva, 2004

Characteristic features of the old concessionary system were extensive control of oil companies and their dominant positions in contracts. Areas for development were usually large (sometimes even whole state's territory) and concessions were usually granted for very long periods, usually between 60 to 75 years[46].
Additionally, it was up for an oil company how it would manage the area under concession, a host government could not influence relinquishment or recovery of the area. With changing global environment, the traditional concessionary system evolved strengthening state's position.

2.1.1.2 Objective and basic principles

Initially, states interested in developing their petroleum deposits entered into contractual relationships with international companies which had enough capabilities and experience to perform petroleum operations.
Currently, a number of states still use the modernized concessionary system. Generally, in the concessionary system state receives payment of costs, taxes and other fees. In return, a company is granted the right to explore and/or produce, market and usually transport produced oil or gas.

2.1.1.3 Ownership of petroleum

The basic feature of the concessionary system that distinguishes it from other petroleum arrangements is that under concessions a state doesn't acquire right to share in production – produced petroleum is owned by the oil company. In the concessionary system ownership rights are transferred automatically to the company, at the moment when petroleum is produced. On the contrary, in the joint venture system and production sharing state remains the owner of petroleum, the ownership rights are however later transferred according to conditions in the

[46] 'Alternative arrangements for petroleum development. A guide for government policy-makers and negotiators', United Nations, New York, 1982, p. 46

contract. However, in such systems many additional obligations are imposed on companies, which increase government's influence and control over operations.

2.1.1.4 Costs and risk bearing

Concession is an agreement which gives the company right to use of assigned area for a fixed period of time, at its own risk and expense. The state is entitled to financial revenues from the contractor. In this regard, the contract is similar to a lease contract.[47]

2.1.1.5 The legal position of the state

As a rule, in the concessionary system state position is that of an administrative authority, which provides legal framework for operations carried out by a company.[48] Participation in operations is limited, which is compensated with high financial government take.

2.1.1.6 Evaluation

Traditional concessionary systems were highly disadvantageous for states. Modern versions of concessions may be beneficial for those states which do not intend to participate in petroleum operations and thus, transfer all the risks and liability to the oil companies. Instead, states may receive higher financial benefits, at the same time without getting directly involved in petroleum activities.

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[47] Outlines of the Presentation of Dr. Irina Paliashvili, the President of the Russian-Ukrainian Legal Group ,at the Seminar on the Legislation on Production Sharing Agreements, September 14,1998 http://www.rulg.com/documents/The_Concept_of_Production_Sharing.htm
[48] *Ibidem*

Generally, under the concessionary system states do not receive shares in production, which makes it a good solution for these governments, which do not have need for domestic supplies or have a limited domestic market.

2.1.1.7 Case study

Currently, oil operations are to the large extent dominated by states. Norway applies the system based on concessions, which is characterized by state control and participation. The Norwegian Petroleum Act and subsequent Regulations are the framework for management of petroleum operations. The licenses are granted by the state to oil companies in license rounds, which may be however revoked by the state in certain situations. Usually several companies are granted the production license for one or several deposits, for which the operator is appointed. The control over operations is applied throughout the petroleum operations - state may decide to participate in petroleum activities, interfere with operations and exercise control at every stage of petroleum development. The ownership rights to petroleum, stay in hands of the state, however, they are directly transferred to licensees producing petroleum. Additionally, the state may decide that it will receive its share in production if necessity arises.

2.2 Production sharing

2.2.1 Traditional production sharing agreement

The first production sharing contract was introduced in Bolivia in 1950s, it took its modern form in Indonesia in 1967 and was then followed by other states.[49]. Under the traditional Indonesian contract between the national company Pertamina and a foreign contractor, the company was entitled to 40 % of share each year until it

[49] Outlines of the Presentation of Dr. Irina Paliashvili, the President of the Russian-Ukrainian Legal Group, at the Seminar on the Legislation on Production Sharing Agreements, September 14,1998 http://www.rulg.com/documents/The_Concept_of_Production_Sharing.htm

was fully reimbursed. After the reimbursement, the proportions of share amounted to 65:35 in favor of state.

2.2.2 Objective and basic principles

The objective of the production sharing contract was to increase state's participation and ensure its share in production through nationalization. The underlying principle of the production sharing contract is that state gets its share in production which distinguishes it from the concessionary system.
Another option, although uncommon, is the combination of a production-sharing contract and joint venture system.[50] The production sharing system is based on three basic elements: cost recovery, split in production and state's income tax. All three will be elaborated upon. Similarly to the joint venture system, the moment of commercial discovery opens the phase in which production begins and the foreign contractor is usually entitled to recovery of costs incurred by the company. From this moment also the state is entitled to its share in production on the other. By the time commercial discovery is made, the state is 'carried' by a company, similarly to the joint venture system.

2.2.3 Ownership of petroleum

In the production sharing agreement state remains the owner of petroleum. It is only the ownership over certain part of production that is transferred to the company according to terms in the agreement. The control over subsoil remains in the hands of the state .At the point of measurement the state automatically becomes the owner of the petroleum produced and transfers company's share.

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[50] 'World Petroleum Arrangements 1985', The Barrow Company, INC, New York, 1985, p.554

Production split

Basic principle of the production sharing is division of production between the foreign company and the state (or its national company). Shares differ among states, they may be set in advance or may be dependent on the level production.[51] In the first production sharing contracts, there were no clauses obligating companies to supply the domestic markets, which were however introduced in later contracts, according to stipulated volume.[52]

2.2.4 Costs and risk bearing

Characteristic for the production-sharing contract is division of costs to 'cost oil' and 'profit oil'

In PSCs the production starts when the discovery is considered economically profitable. The principle of cost recovery assumes that certain amount of the first production will be devoted to cost recovery for the oil company, sometimes up to a certain limit agreed between contractors (the so-called 'cost oil'). The size of volume is proportional and different in different states. The other option is also cost recovery by increased company's share in production. After the commercial discovery and production started a company divides the production obtained at the 'point of measurement' into shares proportionally to agreed volumes. After the costs have been reimbursed to the company, the share in production called 'profit oil', is split between the company and the state or its NOCs.

Income tax

In systems where tax is completely replaced by benefits in kind, tax is paid regardless of share in production. However, in many PCSs a contractor is exempt from taxes. In the former case, tax is paid by a company directly or through the NOC, while in the latter, company's share is free of tax and usually the company is

[51]*Ibidem*, p.555

[52] 'Law and policy in petroleum development. Changing relations between transnationals and governments' Kamal Hossain, Nichols Publishing Company, New York, 1979, p.143

obligated to pay income tax to their national authorities. Partial replacement of tax is beneficial for companies, since it makes it independent from changes and reforms of the host state's tax law system.

2.2.5 The legal position of the state

A twofold position of a state in the production sharing agreement means that a state is a contractor – a party to the agreement with the same rights and liability as the company. At the same time, it plays an administrative role by regulating the operations, controlling and approving taken by the company.

In the production sharing system contractual relations between the parties based on the equality principles - each carries legal liability in case of violation of the contractual clause. [53]

Under the production-sharing agreement it is usually a national company that enters into the agreement with a foreign contractor and conducts operations. There is a shift of the duty of management from the company to the state - the operations are conducted by the state, while they are executed by the oil company. Next, it is the contractor that carries all the risks and costs before the commercial discovery is made. The state and its national company stay in charge of operations despite the foreign contractor being appointed as an operator. The contractor acts under state's or NOC's supervision and is responsible before the host state. [54] Contrary to the joint venture system, under the production sharing contract there is a full state control over operations. Thus, private contractor's plans, working programs or periodic reporting are subject to state's or NOC's approval at all stages of petroleum operations.[55]

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[53] Outlines of the Presentation of Dr. Irina Paliashvili, the President of the Russian-Ukrainian Legal Group ,at the Seminar on the Legislation on Production Sharing Agreements, September 14,1998 http://www.rulg.com/documents/The_Concept_of_Production_Sharing.htm
[54] 'Law and policy in petroleum development. Changing relations between transnationals and governments' Kamal Hossain, Nichols Publishing Company, New York, 1979, p.139
[55] *Ibidem*, p.140

2.2.6 Evaluation

From the state's point of view a production sharing system may be beneficial for many reasons. Firstly, it exempts the state from making big expenditures for exploration and exploitation of their revenues – a state participates only in production and does not bear the risk or costs of exploration (a company's responsibility). Currently, approximately 40 states are using the PSC contract form, including Russia, Azerbaijan, Libya, Vietnam, Egypt, Malaysia and Kazakhstan.[56]
Secondly, even though the state is in charge of operations and controls company's performance at all stages of operations, it does not have to get directly involved. These two arguments make the psc contract particularly attractive for developing states, which cannot afford or have no experience or capabilities to execute petroleum operations.

Thirdly, by participation in production, the state guarantees its energy security by ensuring supply and direct access to petroleum when needed.

Conversely, the basic weaknesses from state's perspective is that it doesn't participate directly in management of operations. Not only does it block direct involvement, but also makes it difficult for the hosting states (especially developing ones) to improve their capabilities and prospects for future. This can be however overcome by additional provisions obligating companies to get involved in trainings and transfer of technology.

Additionally, apart from financial benefits a company gets its share in kind, which means that it is free to dispose its share in the market. This entails the risk of uncontrolled marketing and pricing by companies, for which no tax is paid to the host state. However, modern production sharing agreements contain clauses providing for states' control over pricing [57]

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[56] Outlines of the Presentation of Dr. Irina Paliashvili, the President of the Russian-Ukrainian Legal Group ,at the Seminar on the Legislation on Production Sharing Agreements, September 14,1998 http://www.rulg.com/documents/The_Concept_of_Production_Sharing.htm

[57] 'Law and policy in petroleum development. Changing relations between transnationals and governments' Kamal Hossain, Nichols Publishing Company, New York, 1979, p.157

As in previous agreements, states may foster their position by introducing additional provisions, for instance on training obligations, clauses obligating a company to purchase a part of state's share of production, etc.

2.2.7 Case study

Currently, the production sharing agreement is a common framework for development of subsoil revenues, especially in the Middle East and Asia. Among states using production sharing agreements are Angola, Vietnam, Libya, Egypt, Malaysia, Peru, Syria, the Philippines, Equatorial Guinea Russia, Azerbaijan, Kazakhstan and others.

Recently, Russia started using the production sharing agreement as a form of contract. In 1995 the Russian Duma introduced law 'On Agreements about Production Sharing'. The Law is however not widely applied due to lack of subsequent legislation. [58] For instance, the Russian Federation enters into agreements with Sakhalin Energy[59] under which the Russian Federation remains the owner of petroleum, receives its share in production as well as financial revenues. The state is entitled to its share, which increases proportionally to oil produced. In case of excessive production, state's share increases too up to the limit of 70 % of extra oil produced. Regarding financial revenues, state is entitled to bonuses at certain points of oil development, royalty of 6% of oil produced throughout operations and tax on company's profit. The Sakhalin covers the costs of deposits development and is entitled to reimbursement for exploration costs from production at early stages of petroleum development.[60]

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[58] Outlines of the Presentation of Dr. Irina Paliashvili, the President of the Russian-Ukrainian Legal Group ,at the Seminar on the Legislation on Production Sharing Agreements, September 14,1998 http://www.rulg.com/documents/The_Concept_of_Production_Sharing.htm

[59] A consortium for production and export of oil and liquefied natural gas, with shareholders: Gazprom, Shell, Mitsui Sakhalin Holdings B.V, Diamond Gas Sakhalin

[60] http://www.sakhalinenergy.ru

There have been many variations of the traditional production sharing agreement. Two examples may be given. Firstly, under the contract between Libya and Mobil from 1974, the company was not reimbursed for any exploration costs, regardless of the commerciality of the discovery.[61] Secondly, the Malaysian production sharing agreement with Shell 1976 provided for increased government's share and take on the account of Shell, by reducing company's reimbursement to 20%.[62]

2.3 Joint venture system

2.3.1 Traditional joint venture system

The joint venture was built on the same concept as the production sharing agreement and was a reaction to extensive domination of oil companies in the industry. However,
in addition to share in production states gained access to management of petroleum operations. In the traditional Middle East agreements parties' participation was variable with time – the longer the operations lasted, the more interest in production a state obtained. [63]

2.3.2 Objective and basic principles of an arrangement

In contrast with the concessionary system, both joint venture and production sharing system allow for ownership of petroleum produced by a state and put a

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[61] 'Petroleum Geology of Libya', Don Hallet, Elsevier B.V, Amsterdam, 2002, p. 32
[62] Overview Of Exploration For Petroleum In Malaysia Under The Production Sharing Contracts', Abstract; Said, Ahmad, Petronas, Malaysia, Offshore South East Asia Show, 9-12 February 1982, Singapore

[63] 'Law and policy in petroleum development. Changing relations between transnationals and governments' Kamal Hossain, Nichols Publishing Company, New York, 1979, p.108

state in a position of a partner to the oil company. The objective of the joint venture system is that petroleum is jointly shared by state or its national company on one hand and oil company on the other.

Joint venture, being a form of partnership arrangement, not petroleum agreement [64], is a way of balancing state's and company's interests by jointly bearing the rights and obligations in petroleum operations. State's basic benefit is that a state receives ownership in production. This can be obtained either with equity (equity joint ventures with 50/50 share) or proportionally to its interest agreed between the parties to the agreement or in a concession.

The concept of joint venture is not a legally defined term and attempts to clarify the definition have been made by courts and scholars, as a form of partnership with mutual objectives : expectation of profit and limitation of risks.[65] Additionally, there are different legal forms for functioning of joint ventures. Firstly, in the incorporated model (point c) the relationship between the parties are generally based on the contract and subsequent Joint operating Agreement (complementary to the joint venture agreement). Secondly, in the non-incorporated model, where a separate entity is created, relationship between the parties is governed by the corporation law of the relevant state.[66]

2.3.3 Ownership

Joint ventures give a state not only share in production, at the same time to participate in operations. It is possible to include a provision allowing for increase of state's share in case of change in production up to the limit of maximum participation, in exchange for compensation either in cash or in kind. Usually,

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[64] 'World Petroleum Arrangements 1985', The Barrow Company, INC, New York, 1985, p.574
[65] Joint Venture Contracts (JVCs) among Current Negotiated Petroleum Contracts: A Literature Overview of JVCs Development, Concept and Elements' Talal Al-Emadi, p.
[66] *Ibidem*, p. 20

participation in production varies according to level of production, is however limited to certain percentage agreed by the contractors.

The ownership rules differ according to the type of joint venture. Two typical forms are the incorporated and non-incorporated model, from which the non-incorporated model is considered as more beneficial for the state.[67] The non-incorporated model is based on the undivided direct interest principle, which means that neither state nor oil company jointly participate in production and management. The produced petroleum isn't jointly owned either. Each party directly participates in production and is entitled to its share in production, and the petroleum produced remains at their disposal, pursuant to provisions in the contract or concession.

The incorporated model is considered as less beneficial for the state due to lack of flexibility. In this model a separate management company – an independent legal entity- is created on a non-profit making basis. The oil produced is sold by a joint company and the revenues are then split according to shares. Subsequently, the participants obtain their benefits in dividends set beforehand in the contract or concession. To overcome this problem, often additional agreements are made between participants which allow for direct access to produced oil.

2.3.4 Costs and risk bearing

The case of cost-sharing and cost reimbursement is a one of the key issues for the joint venture system. Of particular importance is the exploration phase, where the risk is high -at this stage little information on commerciality of the discovery is known. Also at this stage a state may participate in costs of exploration in equal basis, proportionally or non-reimbursable. More often the so-called 'carried-interest system' is applied, which is more beneficial to a host state, as it transfers the exploration risks to the oil company. In the joint venture state's financial input is dependent on whether production commences, that is whether the discovery is

[67] Outlines of the Presentation of Dr. Irina Paliashvili, the President of the Russian-Ukrainian Legal Group ,at the Seminar on the Legislation on Production Sharing Agreements, September 14,1998 http://www.rulg.com/documents/The_Concept_of_Production_Sharing.htm

considered as commercial. A state 'is carried through exploration' [68] but only through the exploration phase. As soon as discovery is made its commerciality is evaluated and decision on production made and state begins to participate in costs. At this point it is relevant to establish clear criteria for commerciality of the discovery, in order to avoid a deadlock. Duration of the carried interest phase is relevant for state's future share in joint venture or production – the longer a company bears the costs of operations, the lower state's share becomes.[69] In this context, it is practical for a state to consider bearing costs in the development phase, where the risk is lower and it may be advantageous to share the costs in order to obtain better participation in the production phase.[70]

Before the production phase begins a decision on commerciality must be taken – in state's interest is to determine clearly criteria for evaluation to avoid a situation when a deposit remains passive. Clear description is necessary for a state not only to ensure development of deposits but also to highlight the point from which it will participate in costs. Participation in costs requires substantial resources which may not be available especially for developing states, hence the outside financing system is usually applied. If no commercial discovery is made, it is in general company's loss and a state is not required to compensate. However, a company is reimbursed from the profits if the discovery is considered commercial.

The question of commerciality may be a source of dispute between participants. As was previously mentioned, the criteria for evaluating a discovery should be clearly set or agreed between the parties. A state may also introduce provisions that will allow it to develop the field even if the company is unwilling to do so and maintain efficiency of petroleum development. 'The sole risk clause' provides a possibility for a state to produce oil at its own cost and risk. [71]

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[68] 'World Petroleum Arrangements 1985', The Barrow Company, INC, New York, 1985,p.575
[69] *Ibidem*
[70] 'Alternative arrangements for petroleum development. A guide for government policy-makers and negotiators', United Nations, New York, 1982, p.51
[71] 'Law and policy in petroleum development. Changing relations between transnationals and governments' Kamal Hossain, Nichols Publishing Company, New York, 1979, p.126

During the production phase a state participates jointly with the foreign company in operating costs and, if the contract or concession so decides, the oil company is reimbursed the costs borne in the exploration phase. Obtaining benefits from produced oil is solved differently in different forms of joint ventures. A state may secure its interests by adding provisions that would enable or require a company to buy or sell its share of production.
Regimes for liability differ depend on the type of joint venture. In the non-incorporated type both the state and the company are jointly and severally liable for obligations and their liability is unlimited. The advantage of unlimited liability is larger influence and control over operations, as opposed to limited partnerships. [72]

2.3.5 The legal position of the state

In the petroleum joint venture the state is both an authority regulating petroleum operations and participates through the joint committee – an entity created as a forum for cooperation between the state and foreign contractor. In the joint venture both state and a company take control, monitor and participate in operations thought the Joint Management Committee.
A joint management committee usually consists of representatives of all parties involved and is in charge of making key decisions on operations through voting. In practice management rests in the hand of international companies, as they have technical and technological capabilities.[73] Both parties are represented in the committee, which has the board of directors and the chief executive is to be appointed by the foreign company. It is also possible in non-incorporated agreements to establish a separate non-profit-making company in charge of managing operations or to entrust management to the national oil company.[74] The

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[72] Joint Venture Contracts (JVCs) among Current Negotiated Petroleum Contracts: A Literature Overview of JVCs Development, Concept and Elements' Talal Al-Emadi, p. 22
[73] 'Law and policy in petroleum development. Changing relations between transnationals and governments' Kamal Hossain, Nichols Publishing Company, New York, 1979, p.122
[74] 'World Petroleum Arrangements 1985', The Barrow Company, INC, New York, 1985, p.577

biggest disadvantage of such non- profit making organizational structure is that has no financial flexibility.[75]

2.3.6 Evaluation

The basic objective for entering into joint ventures with international oil companies by government is to ensure share in production and control over petroleum operations through participation in operations . There are several benefits from the joint venture mode. Firstly, as was already mentioned, despite financial benefits from taxes and other payments, a state receives its share in production. Ownership of petroleum (non-corporate model) or financial benefits (corporate model) increase substantially state's take and leave it up to a state how it will manage produced oil. Furthermore, very often state's participation grows parallel with the increase of the production level.

Secondly, direct participation enables control over operations - a state may either directly or indirectly control operations . In the corporate form a state takes part in the decision-making process and may limit company's flexibility.

Thirdly, through participation a state gets insight into 'know-how' and capabilities of the company. This can be done either through direct obligations to train and qualify nationals of the host state or through participation in the management committee or board of directors.

On the contrary, practice shows that the lack of expertise of the representatives is visible and leads to factual control and privileged position of foreign companies in managing bodies, which impedes state's effective control.[76]

2.3.7 Case study

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[75] 'Law and policy in petroleum development. Changing relations between transnationals and governments' Kamal Hossain, Nichols Publishing Company, New York, 1979, p.128
[76] *Ibidem*, p.137

Joint ventures are widely applied in Saudi Arabia, Quatar, India, Australia, New Zealand. Saudi Arabian Aramco or Quatar Petroleum are examples of state-owned companies involved in joint ventures on behalf of the state. In India, the state-owned company Hindustan Petroleum Corporation Limited enters into equity joint ventures into joint ventures with multinationals. Among biggest projects nowadays are HPCL-Mittal Energy Ltd.(HMEL), where it has 49 % equity interest with Mittal Energy Investment and 2% for international financial institutions or Prize Petroleum where Hindustan Petroleum Corporation Ltd holds 50% Equity Stake[77] .

2.4 Service contracts

2.4.1 Traditional service contracts

First service contracts were introduced in Argentina, Iraq, Iran as a reaction to the old concessionary system, providing for more control and influence from the state. The main objective for introducing service contracts was to abandon the traditional concessionary system and to move control over operations to states, at the same time by sharing risks of oil development with companies.

2.4.2 Objective and basic principles

Under service contracts company's position is that of an agent, which means that the company does not own oil produced, is not granted any concession, is not a partner for a state. It merely provides services, 'know how', technical capabilities and funds, while bearing the exploration risks at the early stage.[78] The company may be remunerated from the petroleum produced, the payment may be either in cash or in kind.

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[77] Other partners are the ICICI Bank Limited with 35% equity stake, ICICI Venture Funds Ltd with 10% Equity stake and M/s. HDFC Limited with 5% equity stake

[78] Law and policy in petroleum development. Changing relations between transnationals and governments Kamal Hossain, Nichols Publishing Company, New York, 1979, p.159

2.4.3 Ownership of petroleum

The ownership over petroleum remains in hands of the state, whereas operating and developing if the oil and gas field remains company's obligation.[79] Under the service contract the company does not obtain any share in production, although in some cases remuneration to the company may be in kind.

2.4.4 Costs and risk bearing

The service contract may take one of two forms : the risk service contract or pure service contract. This distinction entails legal consequences for the company with regard to risk bearing and compensation of costs.
In terms of risks, the service contract is similar to the standard psc - the company takes all the exploration risks and may be compensated only if production starts (discovery is economically profitable). However, in contrast with the psc, under the service contract company is not entitled to share in production.
Under the pure service contract, all risks are borne by the state and all the costs are reimbursed to the company, regardless of commerciality of discovery.

2.4.5 The legal position of the state

The service contract for petroleum development creates a civil law relationship between the state and the company in which the company has a position of an agent. The ownership as well as full control over petroleum and management of resources rests in the hands of the state. Apart from being a party to the service

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[79] Joint Venture Contracts (JVCs) among Current Negotiated Petroleum Contracts: A Literature Overview of JVCs Development, Concept and Elements' Talal Al-Emadi, p. 8

contract, the state is also an administrative authority in charge of control over company's activities.

2.4.6 Evaluation

The service contracts were reaction to companies' domination in petroleum development. However, states usually lack expertise and technologies or don't have access to outlet markets which companies have. Through service contracts states get access to such capabilities, while keeping control over operations. Benefits for a host government are full control and full control and management of resources and ownership of produced oil . The contractor does not benefit from the price of marketed oil, it merely acts as an agent acting on behalf of the state (however companies may negotiate premium – share in profits, which depends on the bargaining strength of a company).

2.4.7 Case study

In Iran the constitution does not allow for any form of foreign company's control over petroleum development - The Petroleum Act of 1974 allows only the national oil company to conduct petroleum activities or enter into agreements with foreign companies for this purpose.[80] Due to full nationalization, foreign investors are not entitled to shares in production. Thus, the 1974 Act excluded possibility of entering production sharing or joint ventures by the state. The form of contract used by the Iranian National Oil Company is a service contract with elements of the production sharing agreement.[81] Oil company undertakes management and development of petroleum, provides services while using its capabilities and takes all exploration risks. The company does not receive ownership rights to petroleum produced, but

[80] Article 2 of the Iranian Petroleum Act of 1974
[81] 'The Contractual Form of Iran's Buy-back Contracts in Comparison with Production Sharing and Service Contract', S.N. Ebrahimi, A. Shiroui Khouzani, National Iranian Oil Co., PEDEC Middle East Oil Show, 9-12 June 2003, Bahrain 2003. Society of Petroleum Engineers

is entitled to compensation for costs of operations and agrees to buy certain portion of produced petroleum from the state.[82]

2.5 Contracts of work

Contracts of work between states and oil companies are civil law institutions – contracts which provide for performance of specific petroleum services in a particular place, for a certain price. Such services may be also provided by companies involved in one of the petroleum agreements, but contracts of work cover limited services and are related to specific cases. By way of example, a state may enter into the contract of work with a company for submission of geological surveys or preparing documentation about a deposit.

3 Chapter III Standard provisions and contract clauses of international petroleum arrangements as legal means of strengthening state's position towards international oil companies

3.1 Standard provisions and contract clauses of international petroleum arrangements

Contemporary international petroleum arrangements differ both with regard to scope and contents. There is however a clear tendency for states to ensure that a high level of control and influence on petroleum activities is maintained. Some provisions and contract clauses are particularly significant with regard to state's

[82] *Ibidem*

legal position in relations with foreign investors, regardless of type of the agreement applied. These mechanisms, common to all petroleum arrangements, will be elaborated upon and presented in the context of two different legal systems for petroleum development : the concessionary system under the Norwegian Petroleum Act[83] and Regulations and the production sharing system under The Timor Model Contract [84].

3.1.1 Duration of a contract

of petroleum contracts or concessions varies among states, however, under current agreements they are much shorter than in the traditional concessionary systems. Additionally, each particular phase of petroleum development varies in length, this refers to exploration, and exploitation phases. [85] The first one is usually the shortest in duration and encompasses collecting data without permission to drill, except for shallow drilling necessary to obtain geological or geophysical data.[86] The exploration and exploitation phases are longer and cover permission for drilling and should be proportional to the seize and kind of a deposit.
In states' interest is to introduce such a period of a license to ensure balance between time necessary for operations in a field and the risk of area remaining passive. [87] Hence, states stipulate provisions which make duration of a license dependent on information about an area and make it subject to possible renewals. According to the EU law and the article 4 (b) of the EC Directive 94/22/EC[88], the period of may be extended if the initial one didn't suffice despite good performance of operations. This is why exploration licenses are usually short – a

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[83] Act 29 November 1996 No. 72 relating to petroleum activities
[84] 'Model Production Sharing Contract under the Petroleum Act', http://www.laohamutuk.org/Oil/PetRegime/PSC%20model%20270805.pdf; 27-10-2010
[85] 'World Petroleum Arrangements 1985', The Barrow Company, INC, New York, 1985, p.533
[86] *Ibidem*
[87] 'Alternative arrangements for petroleum development. A guide for government policy-makers and negotiators', United Nations, New York, 1982, p.10
[88] Directive 94/22/EC of *The European Parliament and of the Council of 30 May 1994 on the conditions for granting and using authorizations for the prospection, exploration and production of hydrocarbons*; *Official Journal L 164 , 30/06/1994 P. 0003 - 0008*

couple of years long. Additionally, the Directive requires the Member States to grant authorization for exploration or production only for periods necessary for performance of operations. Thus, in the European legislation the requirement of efficiency was formalized and enforced in all Member States as well as EEA states like Norway through the EEA Agreement. Other states apply solutions which they find most profitable.. Usually exploration licenses are granted for approximately three to four years, total licenses (both exploration and production) for about 30-40 years. [89]

The Norwegian legislation system provides detailed rules on duration of the production license, which is limited to up to 10 years with possible extension within the 10 years limit if it was first awarded for less than 10 years. Additionally, the Petroleum Act grants a right to demand extension of a license if a state fulfilled a work program imposed on it by the state. In such cases the concessions would be generally extended up to 30 and maximum 50 years (section 3-9 of the Petroleum Act).

The Timor Production Sharing Model Contract lays down the list of conditions for a contract to terminate. Hence, the agreement terminates upon relinquishment of areas or if the parties (The Ministry – Leste and The Contractor) so agree (article 2.3 of the Timor Production Sharing Model Contract). Additionally, the agreement gives a right to the State to unilaterally terminate the contract if one of the grounds on the Contractor’s side occur.

3.1.2 Ownership o petroleum and title to assets

Ownership of petroleum is one of the basic issues subject to regulation or negotiation under petroleum agreements. As was already mentioned, the need for participation in production is one of the elements of state’s petroleum strategy. The

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[89] 'Petroleum, Industry and Governments. An introduction to petroleum regulation, economics and government policies' Bernard Taverne, Kluwer Law International, UK, 1999, p.147

ownership clauses and provisions are a legal exemplification thereof. In typical modern international arrangements state participates in production under production sharing and service contracts as well as in the joint venture system. Under the concessionary system in Norway, 'the licensee becomes the owner of petroleum produced' (the Petroleum Act, section 3-3) – the ownership rights are directly transferred from the Norwegian state to the licensee holding the production licensee at the moment when petroleum is produced.

With regard to title to assets used for production of petroleum. Normally an oil company is allowed to use facilities imported for production and after the expiration of operations title to assets passes to the state, unless they're leased by a company.[90] Furthermore, in many contracts there are provisions concerning ownership of production facilities in case a deposit is not depleted before the end of a license. In such cases, it is usually a state that takes over ownership of such facilities. However, if a deposit is depleted before the end of a license, it is in state's interest to guarantee removal of such facilities on a company's cost or take them over. The Norwegian system allows the state to take over fixed facilities in several situations, that is upon expiry, surrender, revocation or termination of use of such facility. The take-over shall be additionally subject to compensation if the king so decides. (section 5-6 of the Petroleum Act).

In the production sharing agreement oil production is split between the state or its NOC and the foreign contractor.[91] The model production sharing contract of Timor, contains detailed provisions on split of production between the Ministry 'Leste' and the contractor, stating that in general 5 % will be owned by the Ministry and 95% by the contractor. (Article 7 of the Model Contract)

3.1.3 State participation

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[90] 'World Petroleum Arrangements 1985', The Barrow Company, INC, New York, 1985, p. 536
[91] See Chapter II 1.2.2.

The degree to which a state is allowed to participate in petroleum activities differs substantially in under petroleum agreements. The Norwegian concessionary system[92] is an example of a very state-oriented approach, where the legislation allows the state to interfere at every stage of operations. A very general provision stipulating that the King may decide that the State would get involved in petroleum activities is not further specified, leaving the state a very wide discretion with regard to conditions and criteria for participation (the PA, s. 3-6)
By contrast, provisions on state participation under The Model Production Sharing contract are very detailed, giving the state (the Ministry) a possibility to decide within 60 days after the declaration of commercial discovery on participation in the Development of petroleum, which is however limited up to 20 % (Article 8.1 (a) and (b) of the Model Contract). The decision on participation entails the obligation to participate in expenditures provided for in the minimum work and expenditure program and to join the Joint Operating Agreement (Article 8.2 (a) and (b) of the Model Contract).

3.1.4 Petroleum revenues and payments to the state

Obtaining financial profits is a primary objective of states involved in oil development. Payments may take various forms, like for instance royalties, bonuses[93], taxes, fees.
Oil revenues may be used to repay expenditures a company made before production started [94], while the rest of oil produced is then shared between the company and the government, in proportions agreed in the contract. Often estimation of returns will depend on whether commercial discovery has been

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[92] Chapter II 1.1.7.
[93] At the early stage of operations, states may impose bonuses in addition to investments companies must make at their own risk. State may require different bonuses to be paid : signature bonuses (upon signing of the agreement), discovery bonus (when a commercial discovery is made) , production bonuses (proportional to discoveries made), bid bonuses (payable at bidding)
[94] Production sharing agreements, joint ventures, Chapter II 1.2. and 1.3.

made. [95] Companies expectations will normally grow with the risk of exploration. Conversely, a state may expect higher returns guaranteed, when the risk of no commercial discovery is small.[96]

States obtain financial profits either directly or indirectly. The former usually take form of fees and taxes, while the latter may be acquired through dividends from assets in oil companies. This is the case with the Norwegian system, in which the state obtains indirect financial revenues through ownership of interests in the SDFI (State’s Direct Financial Interest) and dividends from Statoil. Participation in the SDFI gives the state interests in production licenses. Section 11of the Petroleum Agreement deals with management of the SDFI. Additionally, the state owns 67 % of the shares in Statoil, for which dividends are obtain ed.

With regard to direct petroleum revenues, taxes for petroleum are covered by the standard general Norwegian tax legislation and the Petroleum Taxation Act[97]. Under the Norwegian legislation the tax system is the combination of the general income tax (28% tax) and the special tax imposed on profits from petroleum activities (Section 5 of the Petroleum Taxation Act) (50%), complemented by additional environmental taxes[98] and the area fee contributing to efficiency of operations (section 4 of the Petroleum Taxation Act).

Under the production sharing model for Timor, the state is entitled to both benefits in kind (share in production, article 7 of the Contract) and cash (article 11of the Contract). The Contract refers to the Timor-Leste Petroleum Taxation Act, which provides for the value-added tax and income tax as the basic form of petroleum taxation (Articles 5 and 6 of the Contract).

[95] This refers to production sharing contracts, petroleum joint ventures

[96] 'Alternative arrangements for petroleum development. A guide for government policy-makers and negotiators', United Nations, New York, 1982, p.15

[97] Act of 13 June 1975 No. 35 relating to the Taxation of Subsea Petroleum Deposits, etc. (the Petroleum Taxation Act). Last amended by Act of 29 June 2007 No. 51.

[98] Carbon dioxide tax introduced in 1991

3.1.5 Mechanisms accelerating production of petroleum

3.1.5.1 Production schedule and field recovery

Provisions obligating a company to submit production schedules give a state opportunity to control the production rate so that maximum potential of deposits is used. States may have different approach to expected production - sometimes it would be optional to ensure rapid production in a contract or concession and thus obtain substantial and quick revenues. On the other hand, many governments opt for stable and gradual production which contributes to better recovery of deposits and therefore a long-term strategy . [99] In state's interest is to ensure maximum control over production, production schedules and state participation provisions serve this purpose.

Norway applies a procedure for acceptance of a production scheme submitted by a company in advance, which allows for control over production rates and ensures optimal production rate for the assigned area. The Norwegian Petroleum Act guarantees maximum production through the requirement of prudent operations (s. 4-1, PA) which should be read along with the provisions for control over production (s. 4-4, PA). State's control starts before commencement of production and is continued throughout the operations. Firstly, production schedule is subject to Ministry's approval where the requirement of prudent production checked. Secondly, it is the Ministry that decides on quantities to be produced basing on the submitted production schedule. Thirdly, the state has a right to intervene in the fixed schedule if it is 'required due to important interests of the society .

State's control under the Norwegian system is maintained throughout operations – at every stage of field development the state may interfere with the process of

[99] 'Alternative arrangements for petroleum development. A guide for government policy-makers and negotiatiors', United Nations, New York, 1982, p.34

production. Section 4-6 of the Petroleum Act allows for such interference and gives a right to the Ministry to order preparation, commencement or continuation of production, provided that it is justified by reasons enumerated in this section, for example when it is ‘economically beneficial to society’.

The model of the Timor production sharing contract the contractor is obligated to include production profiles in the Development Plan, together with detailed levels and rates of production (Article 4.11 (d(iii) of the Contract). This information forms the basis for the start of the Commercial Production (petroleum activities following the Declaration of Commerciality) Additionally, the state may refuse to approve the Development Plan (Article 4.11 (f) of the Contract) provided that it justifies its decision.

Furthermore, the Contractor in the abovementioned agreement is required to submit annually Development Work programs and Budgets to the Ministry for approval. The Development Work programs must document Contractors compliance with the Development Plan, including production level and rates (Article 4.12 of the Contract).

3.1.5.2 Relinquishment obligation/ relinquishment schedule

Relinquishment obligations are part of long-term strategies for petroleum development, as they allow for exploitation of deposits in intervals, often in several licenses. Setting time limits for relinquishment is profitable for a government, as it may turn out that the first license reveals information about the deposit that may increase its value for future, which can be useful knowledge for a state when granting next license. Hence, it is in state’s interest to introduce a relinquishment obligation into a contract. In practice, states with developed oil production apply stricter provisions on relinquishment compared to those with less-developed oil industry.[100] Increasingly, there is currently a tendency that productive areas do not have to be relinquished.[101]

According to the Norwegian Petroleum Act, relinquishment of areas covered by the production license shall be conducted with a 3-month notice or at the end of a year. A licensee relinquishes the area if it does not intend to produce oil from the area or at the end of the exploration phase.

The Timor Model Contract contains more detailed and specific rules regarding relinquishment, compared with the Norwegian legislation, also with regard to consequences of non-compliance. Firstly, the contract lays down basic relinquishment obligations: periodic relinquishment (Article 3.1 of the Contract) and final relinquishment (Article 3.2). The former refers to relinquishment at the end of the third (not less than 25% of the area) and the fifth Contract year (not less than further 25% of the area). The latter obligation requires the contractor to relinquish the whole Contract Area at the end of the seventh Contract Year. The contracts terminates in respect of part of the Contract Area which is relinquished (Article 3.4 (a) of the Contract)

3.1.5.3 Conservation

Conservation requirement is a set of provisions or clauses which aims at increasing technical efficiency of production[102] and may encompass such principles as anti-pollution measures or flaring of associated gas.

In Norway, legislation provides for several measures in the form of legal obligations concerning conservation. The Petroleum Act contains a general obligation for prudent production of petroleum (section 4-1, PA), saying that production should be carried out in compliance with respect to economic and technical principles, so

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[100] 'Alternative arrangements for petroleum development. A guide for government policy-makers and negotiators', United Nations, New York, 1982, p.31
[101] 'World Petroleum Arrangements 1985', The Barrow Company, INC, New York, 1985, p.535
[102] *Ibidem*

that unexpected wastes are avoided. Additionally, it imposes a duty on the licensee to monitor compliance with the general obligation. Detailed requirements are set in subsequent regulations. For instance, Petroleum Regulations[103], section 27 obligates a licensee to monitor a deposit during the process of production in order to achieve 'optimal operation'. Another example is the provision concerning flaring of petroleum (the Petroleum Act, s. 4-4, l.2) , which does not allow for excessive and disproportionate burning of unnecessary gas without Ministry's consent.
In the Timor Model Contract one may found several examples for conservation obligation. For instance, Article 5.3 of stipulates that the Contractor shall have several obligations regarding maintaining security of employees, protection of marine environment, to introduce procedures and methods and practices for developing petroleum in Timor. Additionally, the Article 5.5 prohibits flaring of natural gas, except for emergency situations or upon Ministry's consent.

3.1.5.4 Minimum work programme

Minimum work program is a means of ensuring by a government that deposit does not remain passive. Some companies may manage deposits in accordance with their interests, sometimes delaying petroleum operations. In order to prevent such situations, a state may impose a minimum work program obligation which obligates a company to perform minimum exploratory work (e.g. minimum number of wells, seismic programs), minimum expenditure commitment, or both.[104]

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[103] '*Regulations relating to health, environment and safety in the petroleum activities'* (The Framework Regulations)

[104] 'Alternative arrangements for petroleum development. A guide for government policy-makers and negotiators', United Nations, New York, 1982, p.29

According to the Norwegian Petroleum Act, a state may impose a work program on a licensee. The commitment (s.4.2 of the PA) may include for example exploration drillings on a certain number of wells (Petroleum Regulations, s. 13). The work program is not mandatory and petroleum legislation leaves a margin of discretion for a state to decide in each individual case on the necessity and scope of work obligation. Fulfillment of the work program additionally entitles a licensee to apply for extension of the production license (s. 3-9 of the Petroleum Act).
While the Norwegian Petroleum Act contains a general provision on possible work program leaving for the Ministry to and the licensee to decide on the scope of it, the Timor model contract provides a very detailed obligation regarding necessary work and expenditures to be performed by the contractor. Hence, the contractor is obligated to three types of programs : in the initial period (Article 4.1 of the Contract), in the second period (Article 4.2 of the Contract) and in the third period (Article 4.3 of the Contract). For each period the contract provides for a detailed plan of obligatory data evaluation, conduct of surveys and wells to be drilled. Moreover, Article 4.7 enumerates the expenditure obligations for the contractor. A distinguishing feature of the Contract is a very detailed provision on consequences of non-performance of the minimum work program, including possible payment to the Ministry, termination of the contract or both (Article 4.5 of the Contract).

3.1.5.5 Development plan

States take control over production through requirement of a development plan, which provides a framework for production rates or recovery and is subject to state's approval. Often a separate production schedule is issued prior or concurrently to the development plan (for example in the Norwegian system). Through a development program, a state gets influence not only on production rates but also other elements of petroleum activities. The Norwegian example best illustrates the scope of a development plan, required in majority of states involved in petroleum operations.

The Norwegian Petroleum Act requires licensees to submit a development plan prior to commencement of operations, unless the Ministry decides otherwise. The Petroleum Act enumerates the aspects of prospective operations that must be included in the plan, these are: economic, resource, technical, commercial and environmental, transport and decommissioning aspects of operations. No operations in the field may be started before the plan is approved by the state authority (s. 4-3 of the PA).

In the Norwegian system it is the Petroleum act and Regulations that impose and specify the duty of submission of the Development Plan, whereas the Timor Model Contract itself stipulates in details the scope and procedure for submission of the Development Plan (Article 4.11 of the Contract). Differently from the Norwegian system, the obligation for submission of the Development of the Contract is executed after the Declaration of Development (within 12 months). The Contract gives very specific requirements on the contents of the Development Plan, including decommissioning plan, evaluation of environmental issues, details of transport and production facilities, production profiles etc. The Contract as well as possible amendments are subject to Ministry's approval.

In some cases a state may impose an obligation on a company to build up refineries or other plants to process produced petroleum or, alternatively, establish plants in other oil-related industries in a host country. However, such an obligation is difficult to enforce since refineries are usually large in seize and expensive and not all companies have enough capabilities to build them. Moreover, before the production starts, it is usually hard to estimate future discoveries, which makes it hard for a government to require companies to build refining plants beforehand. [105]

By way of example, the Timor Contract stipulates that production, processing, transportation and making petroleum ready for sale shall be made at the

[105] 'World Petroleum Arrangements 1985', The Barrow Company, INC, New York, 1985, p.538

processing plant called ‘Field Export Point’, agreed and approved in the Development Plan (article 1.1 of the Contract)

3.1.5.6 Obligation of joint exploitation of reservoirs

Joint exploration of reservoirs clause is used by states to ensure efficiency and better coordination of petroleum operations. The obligation refers to situations when management of petroleum development would be more efficient if several contractors or licensees cooperated with regard to eg. production or transport of petroleum. By way of example, the Norwegian Petroleum Act obligates licensees with assigned blocks to make efforts to reach agreements on cooperation for better coordination of petroleum activities and subsequently submit them to the Ministry for approval. The area of cooperation may cover exploration, production, transportation, utilization and cessation of operations. In case no agreement is reached, the Ministry may determine the scope of activities under cooperation (s.4-7 of the PA).

The Timor Model Contract provides for a strict requirement for the Joint Operating Agreement to be concluded if there is more than one contractor (Article 2.2 (ii of the Contract) . The consequences of non compliance is termination of the contract – its legal force is conditional upon the fulfillment of the obligation before the sixtieth day after the Agreement was signed (Article 2.2 (b) of the Contract).

3.2 Technological and technical aspects of petroleum development

3.2.1 Supply of data and information

Collecting information and data concerning oil operations from oil companies may serve several purposes. First, it is a means of checking company’s compliance with obligations through regular submissions of data or information of different kind.

Secondly, data collected from oil companies has certain commercial value. Not only do states often require companies to submit relevant information, but also impose confidentiality obligation on data collected throughout operations (usually except for situation when disclosure is necessary for carrying out petroleum activities.[106]). This helps to avoid data trading among oil companies and leaves the disposal of information within state's competence. Additionally, state's retention rights can be guaranteed either in a contract or domestic petroleum legislation. Upon termination of a license, collected data has certain commercial value and may be sold to other companies investing in a host country. It may also reveal new information on commerciality of deposits which in turn helps a state to estimate the value of a field for future.

Thirdly, collection of data contributes to general technological capabilities of the industry and domestic market by.

Information may be collected through participation in joint bodies –often established by companies and states involved in petroleum contracts. Appointed persons have access and control over activities of an oil company and access to information through boards of directors. In the joint venture system states' representatives take direct participation in daily management of production and hence get access to first-hand information.

The Norwegian legislation requires licensees so submit a vast category of information concerning petroleum activities. The Petroleum Act s. 10-4 lays down general criteria for data and information – it must be available in Norway and submitted free of charge if required by the Ministry or designated persons. The Petroleum Regulations specify the general obligation in the PA, indicating what kind of information is to be provided by companies. These are for instance annual status reports (s. 47), information on petroleum produced (s.48), information on

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[106] 'Alternative arrangements for petroleum development. A guide for government policy-makers and negotiators', United Nations, New York, 1982, p.32

sale of petroleum (s.49), information on plans and budgets (s.50). Additionally, the licensee is required to retain collected material so that a Ministry can verify company's compliance with obligations. Apart from material mentioned in the Petroleum Act and Regulations, the state may require additional documents to be submitted or surveys or analyses to be carried out. (s. 10-4 l.1 of the Petroleum Act).

One can also find requirements for data collection and submission in specific regulations related to petroleum operations. By way of example, The Framework Regulations on Health, Environment and Safety requires the licensee to retain and collect data or relevant information available for authorities in order to document compliance with safety requirements (Chapter V of the Framework Regulations). The Timor Model Contract explicitly gives ownership rights over data and information acquired throughout operations to the Ministry (Article 15.1 (a) of the Contract) and requires the Contractor to keep respective material and documentation and make it available to the Ministry (Article 15.2 of the Contract) as well as to not to take out of the territory of the state without Ministry's consent (Article 15.4 of the Contract). The confidentiality obligation refers to both Parties – that is to the Ministry and the Contractor for a specific period of time (Article 15.6 of the Contract). The same refers to trade secrets acquired by the parties throughout operations (Article 15.7 of the Contract).

3.2.2 Training programs

A substantial contribution to the development of state's oil industry is a training obligation, which gives a hosting state a possibility to benefit from companies' experience, technical and managerial skills. It is advisable to make such provisions as specific as possible and include both theoretical and practical issues[107], for

[107] 'Alternative arrangements for petroleum development. A guide for government policy-makers and negotiators', United Nations, New York, 1982, p.36

instance, obligation to organize a training center or provisions regulating amount of nationals to be employed by the company.

Training programs may encompass not only nationals of a hosting state but also state’s NOC. Furthermore, many legislations or contract terms impose obligations to train host governments or authorities as well as governmental agencies in charge of petroleum development. [108]

A possibility for training obligation is provided under section 10-11 of the Norwegian Petroleum Act and specified in the corresponding section 84 of the Petroleum Regulations, which says that the obligation may be imposed on a licensee to organize training of the personnel of Norwegian authorities involved in petroleum management, that is the Ministry of Petroleum and Energy, the Norwegian Petroleum Directorate and other. However, it leaves it to the Ministry and a licensee to enter into a separate agreement regulating details of training obligations.

Among several provision on transfer of technology in the Timor Model Agreement, one can mention the obligation of the Contractor to include proposals for such contribution into the Development Plan, which is subject to Ministry’s approval. Article 4.11 (vii) mentions proposals for training and employment of Timor-Leste nationals amd processing Petroleum- Leste.

3.2.3 Preference for using of domestic goods services , employing nationals

Through the preference clause a state gains possibility to increase economic benefits from oil operations by obligating the oil company to procure goods and order services from the domestic market. An additional requirement to employ nationals of a hosting state contributes to state’s economic development and increases potential of the industry, especially in less-developed oil countries.

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[108] ‘How Can Governments Best Achieve Its Objectives for Petroleum Development: Taxation, Regulation or State Participation?’, A. Ogunlade, Oil, Gas and Energy Law Intelligence,1875-418X, Vol.8 –issue 4, p. 10

States may establish authorities in charge of control and management of supplies for international oil companies operating in hosting states. Requirement for employing nationals of a hosting state can provide a substantial contribution to the industry, especially in countries with less developed oil industry.

Practice shows that oil companies often have economic and political interest in establishing links with hosting states, hence facilitating inclusion of domestic labor and goods market into the industry.[109] Nonetheless, it is generally advisory for a state to introduce monitoring systems to control whether company's policy does not coincide with state's interests.[110]

Under the Timor Model Contract, proposal for employment of nationals or the use of domestic goods and services is part of the Contractor's development Plan (article 4.11 vii of the Contract). The same regards the employment of nationals. Additionally, Article 12.1 requires the Contractor to 'draw attention of supplies based in Timor-Leste' with regard to goods and services used in petroleum activities.

3.3 Domestic supply

3.3.1 Meeting domestic petroleum needs/ supply for the domestic market

A common requirement included in petroleum agreements between states and international oil companies is obligation to meet the need for crude in a hosting state, that is to devote certain portion of produced oil to a state for a said price. This will usually be the market price, however in certain cases payment may replace tax imposed on a company. [111] The requirement for oil refining may go hand in hand with obligation for domestic supply – if there is a high need for crude

[109] 'How Can Governments Best Achieve Its Objectives for Petroleum Development: Taxation, Regulation or State Participation?', A. Ogunlade, Oil, Gas and Energy Law Intelligence,1875-418X, Vol.8 –issue 4, p.10

[110] 'World Petroleum Arrangements 1985', The Barrow Company, INC, New York, 1985, p.538

[111] 'Alternative arrangements for petroleum development. A guide for government policy-makers and negotiators', United Nations, New York, 1982, p.38

in a hosting state, the government has more arguments to impose the refining obligation on a company. [112]

The Norwegian legislation gives the ownership rights over petroleum produced to the licensee. However, the Petroleum Act gives the State the King the right to decide on certain amount of petroleum to be delivered to cover domestic needs for the price according to rules laid down in section 4-12 of the PA.

The production sharing system is an agreement guaranteeing share in production to the state, this is why it is often concluded by states with need for domestic supplies. The Timor Model Contract allows the state to require the Contractors to meet the needs if the occur, upon 30 days advance written notice (article 9.1 of the Contract). The obligation is additionally followed by clear and detailed rules for calculation and prices of Contractor's contribution.

3.3.2 Marketing of state's crude oil

A state may require an oil company to market its share of production either on a regular basis or in case of surplus. Marketing obligation gives the state access to company's selling capacities and marketing outlets.

The Timor Model Contract states that the Contractor shall 'take and receive and dispose of , in common stream with their own share and on terms no less favorable to the Ministry than the Contractors receives from their own share all of Timor-Laste's share of Petroleum' (article 7.2 (a)). However, the subsequent provision (article 7.2 (b) of the Contract) gives the state a right to dispose of its share separately. Thus, in this case the Contractor's duty to market state's share in production is permanent and may be lifted if so decided by the Ministry.

[112] 'World Petroleum Arrangements 1985', The Barrow Company, INC, New York, 1985, p.537

3.4 Guaranteeing performance of obligations

Availability of guaranteeing provisions is beneficial both for a hosting state and international oil companies. From a state's perspective such rules are necessary to ensure company's performance of obligations. In case of non-fulfillment or damage, for example pollution damage, such provisions or clauses would compensate state's losses.. [113]

3.4.1 Settlement of disputes

Both petroleum agreement and concessions entail a risk of dispute between the parties. The most effective and practical way of solving disputes between parties to the agreement is arbitration. It is in state's interest to ensure that such a clause is included in a contract, as it usually causes many problems to establish a court in charge of dispute resolution in a particular case. When reference to arbitration is made, it is advisory to refer a possible case to an established institution which has much experience in dealing with dispute settlement. Otherwise, there may be merely a clause stating that such tribunal will be established in case of dispute, such provisions however require many details to be agreed upon by the parties. Legal disputes arising from petroleum activities on the Norwegian Continental Shelf are covered by the Norwegian domestic legislation. The Petroleum Act and Regulations provide for additional procedures for dispute resolution in specific cases, for instance in case of damage caused to Norwegian fishermen by a licensee. In such cases a special commission deals with claims from fishermen. The solution takes form of an administrative decision, from which a party may appeal. Only after the procedure has been exhausted, may the case be brought before the district court (Chapter 8, s.8-6 of the Petroleum Act).

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[113] 'World Petroleum Arrangements 1985', The Barrow Company, INC, New York, 1985, p.537

By contrast, the Model PSC makes clear reference to the International Centre for the Settlement of Investment Disputes in case of a dispute between the Contractor and the Ministry. Reference to arbitration shall be however preceded by mandatory negotiation (Article 14.1 of the Contract)

3.4.2 Liability rules

Liability rules for petroleum activities may be based on different legal sources - they might take a form of a special separate legislation or regulation, they may be incorporated into a separate petroleum agreement or may be derived from the civil law of a hosting state.

In case of damages which entail a risk for a government being held liable (such risk is relatively high for example in the production sharing contract [114]), it is in state's interest to make sure that it will be an oil company that will bear responsibility for damages caused during petroleum operations. A risk of state's liability for contractor's performance increases when a contractor performs operations on behalf of state's NOC.[115]

In Norway, petroleum legislation provides for special framework for liability related exclusively to petroleum activities. Hence, The Petroleum Act contains provisions on the following types of damages: liability for pollution damage (Chapter 7 of the PA), liability in the abandonment phase (Chapter 5, s. 5-4), compensation to Norwegian fishermen (Chapter 8, s.8-1, PA) and finally a regime for damage caused to third persons by licensees or 'anyone undertaking tasks for a licensee' (Chapter 10,s. 10-9, PA).

Under the Timor Model Contract liability shall be borne by the Contractors joint and severally, the State-Owned Contractor is exempt from this liability (article 1.5 of the Contract). Additionally, the Contract contains an indemnity clause, stipulating that

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[114] Chapter II 1.2.4.

[115] 'Alternative arrangements for petroleum development. A guide for government policy-makers and negotiators', United Nations, New York, 1982, p.40

the Contractor ‘shall indemnify and hold harmless the Ministry from all claims of whatsoever nature which are brought against the Ministry’(article 19.1 of the Contract). Complementing provision is one requiring the Contractor to take out and maintain insurance on strict liability (article 19.2 of the Contract) which is a condition for the Agreement to stay in force (article 2.2 of the Contract).

3.4.3 Good oil field practice obligation

The requirement of good oil practice is a broad obligation for a company to carry out operations in a prudent manner, with respect to general practices rules of the industry based on experience and practice of oil companies.
An example from the Norwegian legislative framework is a general efficiency requirement (Chapter 4, s. 4-1 and Chapter 10, s.10-1 of the Petroleum Act) setting criteria for prudent petroleum activities of licensees. The standards for production are to make it compatible with technical and ‘sound economic principles’, with respect to safety and environmental issues, avoiding unnecessary damage or impediment to other activities, preventing damage or pollution. Next, the PA stipulates that the licensee shall have a duty to make all efforts to ensure compliance with prudency standards and take all necessary precautions to avoid violations. If, however, the licensee fails to fulfill this obligation, the state is allowed to stop the activities for so long as it’s necessary to ensure compliance.
Similarly, the Timor Model Contract requires the Contractor to carry on operations on a ‘workmanlike manner’ (article 5.1 of the Contract), to ‘provide all human, financial and technical resources’ in their work. The Contract mentions directly the ‘good oil field practice’ as the point of reference for the Parties when they conclude agreements on potential agreements on lifting of their shares of petroleum (article 7.3 (b) of the Contract).

3.4.4 Stability of terms guarantees

general rule says that original agreements should not be changed ('pacta sunt servanda'), nonetheless states often introduce provisions allowing them to change conditions of agreements or concessions in case of substantial changes of circumstances. provision can be beneficial for both parties.

International oil companies may demand that special provisions guaranteeing non-changeability of terms are applied, especially in the field of tax law.[116] This refers especially to developing countries, where political situation is not stable and risk of terms being changed by governments is high.

Under the Norwegian petroleum legislation the state is left with a large margin of discretion with regard to changing and influencing petroleum operations. Licensee's activities are subject to extensive control and many terms may be altered by the state if the necessity or change of circumstances so require. For instance, the Ministry may demand a change of a development plan if significant deviations or alterations of preconditions occur (Chapter 4, s. 4-2, l.7 of the PA). Other example is a possibility for change of levels of production. In case necessity arises, the state may deviate from agreed production rates and stipulate new production schedules (Chapter 4, s. 4-4, l.4 of the PA).

The Timor Model Contract contains very detailed provision on force majeure, exempting the Party from liability, at the same time enumerating situations which cannot be considered as force majeure (for instance strikes, lockouts or industrial disturbances) and providing special procedure in case of force majeure situations (article 20 of the Contract).

[116] How Can Governments Best Achieve Its Objectives for Petroleum Development: Taxation, Regulation or State Participation?', A. Ogunlade, Oil, Gas and Energy Law Intelligence,1875-418X, Vol.8 –issue 4, p.13

4 Conclusion

State’s perspective and objectives are dependent on many factors that state’s must pay due regard to. International petroleum agreements are the result of an interplay between states and international oil companies, which cooperate in a constantly changing environment, being influenced by many objective factors. A well-designed strategy allows the state to lead a realistic petroleum policy in the industry, which is then reflected in subsequent legislation and petroleum contracts. State participation in international petroleum agreements is the form of exercising their rights granted by international law. However, due to mainly economic considerations, states decide to enter into contracts with foreign investors. It has been shown that states create their petroleum policy, which materializes in the form of petroleum contracts. However, these contracts must be read in a broader context. State’s legal position in petroleum agreements is not only defined by contractual provisions but also by domestic legislations and international law in general. Petroleum agreements directly regulate relations between the parties, but they function in a broader legal framework of different sources of law.

To sum up, the creation of state’s position towards oil companies starts at early stages of policy-making and is influenced by different sources of law. Nonetheless, in the end it’s the contract clauses that directly regulate relationships of the parties. States have different approach and policies behind petroleum agreements. Those interests are implemented by policy-makers and parties through relevant contract provisions and domestic legislations, and this is something states should be well aware of when entering the contracts with oil companies.

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