

“Toward Enrichment of the Petroleum Contract Types”

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Abstract

The oil producing countries, all over the world, sought to extend their control over natural resources and attempted to regulate this lucrative sector by contractual documents or by legislation. The petroleum operation involved high risk, big expenses and investment and cannot be run by one party. By entering into an appropriate contract, the parties can reduce the risk and may share the costs which are required for exploration, development and production activities. There are common contracts which had been developed and used by the host state and international oil companies in the petroleum industry such as the concession contract, production sharing contract, service's contract and joint venture contract. This paper explains the types of some common petroleum contracts with the view of proposing an additional type of a contract based on the concept of unilateral intention.

Keywords: Contracts - Concession - Joint Venture – Petroleum - Production

1. Introduction

The petroleum industry, also known as the oil industry, includes the global processes of exploration, extraction, production. Petroleum is vital to many industries, and is necessary for the maintenance of industrial civilization in its current configuration, making it a critical concern for many nations. Oil accounts for a large percentage of the world's [energy consumption](#). The oil including gas industry is one of the largest sectors in the world in terms of value generating revenue. Oil is crucial to the global economic framework, especially for its largest producers such as the United States, Saudi Arabia, Russia, Iran, and others. Investors looking to enter the oil and gas industry can quickly be overwhelmed by the complex jargon and unique metrics used throughout the sector. The oil and gas industry is broken down into three main segments: upstream, midstream and downstream ([Rebecca 2020](#)). Upstream businesses consist of companies involved in the exploration and production of oil and gas. These are the firms that search the world for reservoirs of the raw materials and then drill to extract that material. These companies are often concerned with exploration and production. The upstream segment is characterized by high risks, high investment capital, extended duration as it takes time to locate and drill, as well as being technologically intensive. Virtually all cash flow and income statement line items of the companies are directly related to oil and gas production. [Midstream](#) businesses are those that are focused on transportation. They are the ones responsible for moving the extracted raw materials to refineries to process the oil and gas. Midstream companies are characterized by shipping, trucking, pipelines, and storing of the raw materials. The midstream segment is also marked by high regulation, particularly on pipeline transmission, and low capital risk ([Rebecca, 2020](#)). The segment is also naturally dependent on the success of upstream firms. [Downstream](#) businesses are the refineries these are the companies responsible for removing impurities and converting the oil and gas to products for the general public, such as gasoline, jet fuel, heating oil, and asphalt. The petroleum industry and its contracts with local or foreign companies have followed a number of different structures. Though, there are controversies about the types of petroleum contracts and its sufficiency to meet the need, practitioners have figured out that in the exploration and exploitation of petroleum resources mainly four common types of contracts have been experienced. This paper is divided into two parts: the first presents the types of contracts which are currently in practice while the second part presents the proposed new type of contract.

2. Types of Contracts

In business agreements, the intention to create legal relations is so readily assumed that a heavy burden would lie upon the party challenging it to refute the presumption. The mere fact of an agreement does not of itself create a binding legal contract. The law requires evidence that the parties to an agreement intend that it be legally enforceable, such intention may be either express or implied from the circumstances ([Beatrix 1999](#)). In oil field many governments enter into contracts with foreign companies to develop and sell their oil or gas. Negotiating the right contract is vital to a government's efforts to reap the benefits of its natural resources. They can create state companies for exploration, development, and production, as in Saudi Arabia, Mexico, Iran, and Oman. They can invite private investors to develop the natural resources, as in the United States, United Kingdom, Russia, and Canada. Or they can use a combination of these two systems, as in Indonesia, and Nigeria. Contract terms determine how much a producing nation earns from its natural resources ([Jenik, 2013](#)).

Yet a host government is also expected to create a positive investment climate that promotes economic and job growth while establishing investment laws and penalties for their violation. Host governments need to learn how to balance these competing needs. Further complicating matters is the fact that as a signatory to any contract, the government acts like a normal business seeking to maximize its revenues. This places the government in the awkward situation of having to

regulate itself. Governments of resource-rich developing countries also face the challenge of negotiating with major oil companies, which have the advantage of employing hundreds of well-skilled legal representatives. Though contracts can vary widely in their details all must establish two key issues: how profits are divided between the government and participating companies and how costs are to be treated. What complicates negotiations is the high level of uncertainty caused by incomplete or even faulty information. Typically, neither the oil company nor the host government knows with certainty at the time of signing the contract how much it will cost to explore and develop a field, whether future oil or gas prices will justify that cost, or how much oil or gas there is in a field. Contract negotiation requires skillful bargaining to find a reasonable and mutually acceptable balance between the interests of an investor and a government. Often, host governments turn to international financial and legal experts to advise them during these negotiations. One of the first decisions that governments must make is to select the type of contractual system it will use to establish the terms of the development process: a concession or license agreement, a joint venture or a production-sharing agreement. Each form of contract has its advantages and disadvantages, especially from a commercial point of view. The details of the contract can vary greatly even between similar types of contracts. To add to the confusion, the provisions of license-concession agreements and profit-sharing agreement have also come to resemble each other. Governments and investors should release the terms of their agreements. As far as the petroleum contracts are concerned, the law of contract is found in several statutes of the countries. Therefore it is an appropriate to explain the various types of the petroleum contract in an organized sequence (Jenik, 2013).

2.1 Concession

Concession or license agreements have evolved considerably since their introduction in the early 1900s as one-sided contracts when many of the resource-rich nations of today were dependencies, colonies, or protectorates of other states or empires. The modern form of such agreements often grants an oil company exclusive rights to explore, develop, sell, and export oil or minerals extracted from a specified area for a fixed period of time. Companies compete by offering bids, often coupled with signing bonuses, for the license to such rights. This type of agreement is quite common throughout the world and is used in nations as diverse as Kuwait, and Sudan (Jenik, 2013). **Advantages:** The advantages from a developing country's point of view are substantial. First, licenses or concessions are more straightforward than other types of agreements, especially if a public bidding system is used to set basic terms. The degree of professional support and expertise required is often less complex than that needed to negotiate joint ventures or production-sharing agreements. Yet sound financial advisers are still needed to structure the concession bidding system. An acceptable and reliable legal infrastructure, including a judiciary capable of interpreting complex agreements, is also necessary. With a well-developed legal system, as in most industrialized or license agreement, a joint venture (JV), or a production-sharing agreement (PSA). Each form of contract has its advantages and disadvantages, especially from a commercial point of view. The details of the contract can vary greatly even between similar types of contracts. To add to the confusion, the provisions of license-concession agreements and PSAs have also come to resemble each other. Governments and investors should release the terms of their agreements. If they decline to do so, questions need to be raised about the need for confidentiality since there is no intrinsic reason why such agreements should be kept from the public. Concession or license agreements Concession or license agreements have evolved considerably since their introduction in the early 1900s as one-sided contracts when many of the resource-rich nations of today were dependencies, colonies, or protectorates of other states or empires (Jenik, 2013).

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Disadvantages: The main disadvantage from a developing country's point of view, as well as from a bidder's perspective, is commercial. There is normally a lack of adequate knowledge about the potential of a concession area because seismic exploration has not been fully undertaken. The result is that the bidding system is often simply an auction. Oil companies have no choice but to take calculated risks about what price to bid for a license. A company will be cautious in the amount it is prepared to bid since there is no guarantee the concession will cover the company's costs and return a profit. Where knowledge and facts are inadequate, the host government will not maximize its potential return from an auction system. Since the bidding documents specify a minimum work program as prescribed period of time within which to make the corresponding investments or run the risk of forfeiting the license potential bidders will naturally be more judicious and conservative in their offers (Jenik, 2013).

2.2 Production-sharing agreements

Production Sharing Agreement ("PSA") is a form of an agreement under which the state retains ownership of the resources but permits foreign corporations to manage and operate the development of the oil field, thereby negotiating a profit-sharing system. Under a PSA, an oil company carries most financial risks of exploration and development, with the state also facing some risk. Often the national oil company joins the consortium as an interest holder in the PSA, contributing some of its profits as share capital to the consortium that is developing the area granted under the PSA. Often the host government has the cost of its initial contribution "carried" by the other companies. This carried cost is repaid to the companies from the host government's future profits under the PSA. If the government refuses to contribute to the share capital, then the oil companies try to negotiate a greater share. The exact split is a result of hard bargaining since there are no scientific determinants of what a reasonable split should be (United Advocates, 2016).

The financial terms of the PSAs are similar to those of the license agreement, although the differing structures may lead to different commercial results. The host government often earns a signing bonus, although this is regularly waived or traded for a greater share of future profits. The oil company is first entitled to cost recovery for both current operating expenses, expenses for materials consumed or used in the year in which they were acquired, and capital investment expenditures for assets such as buildings, equipment, and computers, which have a longer shelf life. Cost recovery for current expenditures is immediate, in the year in which the expenditure is incurred, and cost recovery for capital investment is spread over a number of years. There are grey areas where accountants can reasonably reach different conclusions as to whether certain items, such as books and tools, should constitute an operating expense or a capital cost. The remainder of the annual earnings after repaying for company's operating expenses and capital investment, as depreciated in that year, is then shared according to the agreed percentage division with the host government (United Advocates, 2016).

The foreign company is required to pay taxes on its share, but these are often waived by the host government and included in the company's portion of the agreed percentage split. PSAs have developed in a way that today there are many different versions resembling each other only in the basic concept of sharing. This variation is not surprising as they are a product of intense negotiations and the interests of each party naturally differ with the circumstances. The complexity of a PSA depends on the soundness of the legal infrastructure of a state. Less reliable and/or predictable a state's legal system is, the more issues must be covered and specified within a PSA. However, the hybrid variations of a PSA with regards to distribution of financial revenues are also possible. It could be a sharing scheme where (a) if commercially valuable oil reserves were discovered, the investors costs (for exploration, development and exploitation) shall be refunded by the so-called compensation oil; (b) the remaining part of the extracted oil shall be distributed between the investor and the state (proportions differ from country to country); (c) the share obtained by the investor shall become the object of the income-taxation; and (d) royalties based on the value of production shall also be included. PSAs were largely criticized by the foreign companies, considering that such precedent would affect their concessions elsewhere. However, independent companies entered into PSAs and the majors had no choice but to follow. PSAs are now spread globally and are a common form of doing business, especially in Central Asia. (United Advocates, 2016).

2.3 Joint Venture

Joint venture (“JV”) typically implies a commercial arrangement between two or more parties willing to pursue a joint undertaking in some still to be clarified form. A joint venture requires the parties to know and understand each other’s goals, interests and ways of doing business. Given the open-ended nature of the JV structure, it is not surprising that JVs are less commonly used as the underlying agreement between an oil company and a host government. Nigeria was an exception: The national oil company favored this format until it could no longer meet its share of the JV’s financial commitments. Now, new agreements in Nigeria are mostly PSAs. Since a JV demands parties do execute business goals jointly, by not resolving material issues prior to entering into a JV, the parties only postpone a potential disagreement or a stalemate, especially if a JV is of equal shares. JVs require a wide range of negotiations over an extended period of time to ensure that all issues are thoughtfully addressed (United Advocates, 2016).

The joint-ventures may be created either between the recipient country and the foreign oil company or between several investors. Popularly, international oil companies often form a JV to bear the risk and share the reward for large scale or high risk ventures. As opposed to the traditional concessions and PSAs, JVs allows host country partner to exert greater control over the project. Besides sharing high financial costs of the international petroleum project, JVs is also very helpful in minimization of possible risks, such as the geological risk of not discovering oil reserve subsequent to the exploration procedures; the technical risk to perform in difficult or even extreme conditions (including terrain, weather and temperature); the development risk that the found petroleum reservoir will have such characteristics as to hamper the extraction activities; and the political risk that riots or uprisings affect the petroleum project. State participation in the joint venture helps developing nations to obtain new petroleum technologies, and professional training from a more developed foreign investor (United Advocates, 2016).

. Collaboration with the state-owned petroleum enterprise can increase the chances for an investor to win the tender for a petroleum project. Also, if a state enterprise already has an existing license to undertake petroleum activities, the creation of a JV will allow a foreign investor to benefit from the same. Alongside the advantages, JVs also have potential flipside such as, in the event, the project fails, the host country partner may incur substantial losses, unlike under concessions, leases and PSAs. JVs can be broadly classified into two categories, incorporated and unincorporated. Under the incorporated JVs, the parties set up a jointly owned company incorporated in the host state and managed by a board which is jointly represented by both the parties. The unincorporated JVs run on the basis of contractual agreement alone, without the creation of a separate legal entity. Under the modern concession contract, the concessionaire works essentially for itself. Under the production-sharing contract and the risks service contract, the contractors work primarily for the government. Under the hybrid contract or a joint venture contract, the foreign company works in association with the state oil companies (United Advocates, 2016).

2.4 Risk Service Contract

Risk service agreements are the least-used agreement type among the three mentioned here. They have been used by states that take a nationalistic approach, or by countries like Venezuela, Iran or Iraq which have long-established petroleum production. Under this type of agreement, the host state merely hires the service of a petroleum company or consortium to benefit from its financial and technical expertise. The company or consortium assumes the risk and liability and is reimbursed by a service fee, usually paid in cash. An example of this type of agreement is Iran’s now defunct buy-back agreements, which eventually proved too onerous for any private sector investor to take up (Extractive Hub, 2020). The Iranian Buy Back Agreement is a short term Risk Service Contract struck between the National Iranian Oil Company and an International Oil Company, IOC, and is for petroleum Exploration and/or Production rights. The IOC is a Contractor to NIOC and never gains Equity Rights in Crude Oil being reimbursed in cash after completing an agreed Scope of Work. The Reimbursement includes Cost Recovery and an agreed Rate of Return. Some authors have doubted whether the Agreement is licit under Sharia law (Bunter, 2009).

Since the Constitution of the Islamic Republic of Iran (1979) does not allow foreign companies to own equity stakes in hydrocarbon projects, Iran has developed a new mechanism in line with the Constitution to facilitate the engagement of foreign oil companies in development of oil/gas fields. Such a mechanism resembles a typical buy-back arrangement, under which a foreign company provides the funding for, and necessary equipment and services for the establishment, development or updating a project and agrees to purchase back a portion of the production such as those goods or services

produced in that project. This mechanism, however, is a hybrid of a service contract and a production sharing agreement, although it is much closer to the former (Ebrahimi, 2003).

Under this mechanism a foreign oil company provides the fund for, expertise, equipment and machinery for the development of a gas/oil field. In return, the petroleum costs, constituting Capital Costs, Non-Capital Costs, Operating Costs, Bank Charges (interests), and Remuneration Fee, will be recovered through the revenues generated from the filed as the result of the development operations carried out by the foreign oil company as contractor. Alternatively, the oil/gas produced as the result of the development operations may be sold to the oil company under the Crude Oil Sales Agreement at the prevailing market price against the expenses and costs charged to the Project Account by the contractor. The development operations are carried out under the control, supervision, inspection and audit of Iranian National Oil Company (a state oil company). Although this provides a degree of control over operations of the private contractor, development operations are carried out under the management of the risk-taking foreign oil company. Thus, for instance, the risk of any shortage of revenue shall be borne by such company (Ebrahimi, 2003).

3. Reward Based Contract

This type of a new proposed contract is classified under the concept of unilateral intention to contract. It designed for countries that do not interested in sharing economic risks. The state or the owner of a land or an oil and gas working interest agrees to assign an interest in a reward or Ju'alah basis to another party in consideration for a share in the profit generated provided it is in the percentage form (Qudamah, 1959). The party may be required to do more than drill a well, including performing geological, seismic studies, exploration, extraction, production and paying a cash consideration for all costs. Contracting in reward basis is held permissible even though it contains the element of uncertainty (Shathri, 2013). The agreement shall be accomplished in a form of letter agreement that typically contains provisions relating to the following:

- (1) Names of the parties and the effective date of the agreement
- (2) Description of the performance and lands to be farmed out
- (3) The location, well objective depth, commencement date, and geological requirements of the farm out wells are to be determined by the investing company.
- (4) Negotiation and setting out of the contract terms and conditions.
- (5) Obligations of the parties and payments in the event of production
- (6) Liabilities of the parties.
- (7) General clauses related to notices and information furnished to the parties, audits, marketing of production, access to the wells, and gas processing

The legal framework which may help in implementing the new contract is found in Islamic jurisprudence specifically the Islamic law of contract, as such this type of contract is more suitable for countries such as Saudi Arabia, Iran, Sudan and others.

A brief description of the common features of reward concept which may help in its implementation are arranged as follows (Ansari, 1967):

- (1) The reward signifies the consideration offered to a person known in return for specific performance, work or deed.
- (2) Reward is invalid, where the performance, work or the deed required do not contain the element of hardship that incurred by the performing party.
- (3) There shall be permissible and legal benefit or a real interest for the performing party on the subject-matter, otherwise the contract is deemed invalid.

- (4) The fixed reward which is offered as the consideration shall be specified and fixed in advance with certainty whether in form of specified amount of money, percentage or any other form.
- (5) The fixed reward becomes lawful and binding upon the completion of the performance required or upon the commencement of the performance.
- (6) The performing party shall incur the expense needed for the required performance, unless there is an agreement to the contrary.
- (7) The hand of the performing party over the property provided to facilitate the performance is the hand of a trustee, no guarantee of such property can be given unless upon default, negligence or transgression.
- (8) The fixed reward is negotiable before the commencement of the performance unless the parties agreed otherwise.
- (9) Reward is also considered valid where it was made or offered by the performing party to the landlord and the latter accepted it.
- (10) The parties who entered into a contract on reward basis may rescind it before the commencement of the performance.
- (11) Where the contract is held invalid for any reason, no fixed reward shall be deserved, alternatively an equivalent amount of money or a hire that commensurate with the exact hardship incurred shall be paid to the performing party.
- (12) The contract is terminated upon completion of the performance or it shall be terminated subject to the general rules of the contract of reward.

4. Conclusion and Recommendation

Petroleum is vital to many industries, and is necessary for the maintenance of industrial civilization in its current configuration, making it a critical concern for many nations. Oil accounts for a large percentage of the world's [energy consumption](#). The oil including gas industry is one of the largest sectors in the world in terms of value generating revenue. The petroleum industry and its contracts with local or foreign companies have followed a number of different structures. Though, there are controversies about the types of petroleum contracts and its sufficiency to meet the need, practitioners have figured out that in the exploration and exploitation of petroleum resources mainly five common types of contracts have been experienced. In oil field many governments enter into contracts with foreign companies to develop and sell their oil or gas. Negotiating the right contract is vital to a government's efforts to reap the benefits of its natural resources. They can create state companies for exploration, development, and production. The modern form of concession agreements often grants an oil company exclusive rights to explore, develop, sell, and export oil or minerals extracted from a specified area for a fixed period of time. agreements often grants an oil company exclusive rights to explore, develop, sell, and export oil or minerals extracted from a specified area for a fixed period of time. Production Sharing Agreement is also a form of an agreement under which the state retains ownership of the resources but permits foreign corporations to manage and operate the development of the oil field, thereby negotiating a profit-sharing system. Joint venture typically implies a commercial arrangement between two or more parties willing to pursue a joint undertaking with the view of sharing profits.

It is recommended that a new type of a contract shall be introduced beside the current ones. The new contract is designed for countries that do not interested in sharing economic risks. The state or the owner of a land or an oil and gas working interest agrees to assign an interest in a reward basis to another party in consideration for a share in the profit generated in a percentage form.

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