PARTIES TO OIL AND GAS CONTRACTS

The starting point of this note is to reiterate that in every country where crude oil is produced, the country create its own national body, the National oil company (NOC) which act as representative of the government in all oil and gas transactions with international oil companies. For example, in Nigeria, the NNPC serves such roles.

DETERMINANTS OF OIL AND GAS CONTRACTS

The type of contract used by a Host Country (HC) or its National Oil Company (NOI), and the terms agreed upon between the parties depends largely on the host government’s policies and objectives, and also its bargaining power in relation to the IOC, taking into account the external oil markets and the commercial viability of the acreage. However, pertinent to those considerations is the fiscal and non-fiscal policies, the former of which plays a more central role, since it comprises the instruments which enables the allocation of financial and economic benefits and risks between the NOC and the IOC.

TWO MAJOR TYPES OF PARTNERSHIP IN OIL AND GAS DEVELOPMENT

The two major types of oil and gas partnership usually signed by the international oil companies and the national governments are:

a) Production Sharing Contracts (PSC)
b) Risk Service Contract (RSC)
These two contract types share some common attributes such as, that they do not confer rights to title in the petroleum produced on the IOC. However, they are fundamentally different in their substantive provisions. In most circumstances, the Production Sharing Contract (PSC) is preferred.

SIMILARITIES BETWEEN THE TWO TYPES OF CONTRACTS

- Under both the PSC and RSC, the host country permits the foreign oil company to explore a specific area and evaluate the potential for oil discovery.

- Profit sharing is calculated in the same way. This means that the cost of production is always subtracted, then the net profit is shared in pre-agreed value (unitised value).

- Under both contract regimes there is no surrender of the host country’s sovereignty over its natural resources and title does not pass to the foreign oil company.

ORIGIN AND FEATURES OF THE TWO TYPES OF CONTRACTS

PRODUCTION SHARING CONTRACTS (PSCs)

The PSCs are more common in the present day oil and gas contracts, and are being used by at least 60 per cent of Oil Producing Countries. It was first used in 1966 by the Indonesia’s national oil company known as Pertamina.

The production sharing contracts have been defined as a contractual relationship between a state, a state authority, or an authorised state oil enterprise on the one part and one or more oil companies (collectively constituting the contractor) on the other, under the terms of which the contractor is authorised to conduct petroleum operations within the area as specifically described in an agreement and in accordance with its rules.
For example, under the Indonesia’s Production Sharing Contract, the International Oil Company is responsible for providing all the equipment, materials and foreign exchange that is needed for the operation, with the inclusion of skilled and technical foreign personnel.

In other words, under the Indonesian Production Sharing Contract, the recovery of capital costs of 40 per cent is reimbursed to the international oil company, this money refunded is called “cost oil”.

Cost Oil is a term used to refer to a fixed percentage of production revenue which is made available for recovery of capital costs, operating costs and exploration costs incurred by the contractor. In the event of non-commercial discovery under the PSC, the contractor who bears the risk of exploration is therefore not reimbursed by the host government.

In the early 1990s, when Nigeria sought to increase its petroleum production through the exploration and development of the offshore and inland basin, the Government adopted production sharing agreement as the appropriate upstream petroleum contract that would be suitable for the award of the acreages.¹

The reason for federal government decision was because, it would then have no financial burden on the government to enter into this type of agreement, the burden and risks of which were entirely that of the contractors.

**Advantages of Production Sharing Contracts**

- Moreover, equity participation also maximises the host government’s control and take in production and profits, and improves the acquisition of technological and managerial skills in the course of carrying out their day-to-

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day activities alongside the experts of the contractor who bears these skills, thereby benefitting from the participation.

- In the long term, the host state’s nationals will eventually be able to control and manage their natural resources through the acquisition of these technological and managerial skills. This could have been an unacceptable fact, as during colonialism, the transfer of technology and managerial skills would have been an unimaginable consequence.

- Participation will be beneficial to the host country as it has the potential to prevent the foreign contractor from pursuing policies that will be detrimental to the host country.

**Advantages of Production Sharing Contracts**

- The host country needs to carefully appraise its options on whether resorting to participation is a desired fiscal strategy. A crucial burden of host government participation is the fact that the state is vulnerable to the different risks inherent in the upstream petroleum operations. Thus, in the situation where an exploration is found to be commercially unviable to the host country, then the host country bear the risk to lose its revenue in the proportion of its participatory share in the partnership.

- Losses suffered by the host country as a result of participating in fruitless oil joint venture could affect the entire national budget and hinder infrastructural growth.

- There could also be a **conflict between the National oil company and the international oil company with regards to decision-making**. The government is usually the regulatory body that controls petroleum operations, and as a result should be responsible for making key decisions, particularly in managerial appointments. On the other hand, the foreign contractor should be responsible for strategic business decisions based on commercial realities,
managerial expertise in their given field, and strategic policy. Hence, there is a platform for conflict between the host state as an equity participant and the foreign oil company as contractor. In view of the state’s participation, a neutral regulatory body with adequate funding and personnel would need to be created in order to ensure transparency and probity in the discharge of its function, which is another drawback for the host government. Therefore, HC representatives who negotiate these agreements will need to identify the objectives sought by the host through participation and then make sure that these participatory arrangements are suitable for the attainment of the identified objectives.

- In the event of a successful venture, the resulting production is split between the parties according to participation formulas set forth in the contract. The benefit to the host country is that, it receives an actual amount of petroleum which is enough to be commercialised in huge monetary terms according to its socio-economic and development plans. Hence, the host government benefits in both fulfilling its domestic supply needs and also in building up the foreign exchange reserves by its exports to the international markets.

- The remaining oil produced after “cost oil” deductions is considered as “profit oil” and this is split between the host country and the international oil company, as contractor towards the venture according to the rules set forth in the contract.

- The Production Sharing Contract is a flexible instrument, in which improvement can, and indeed have been made, through the incorporation of additional mechanisms to deal with situations which are not adequately dealt with in concession licences.

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2 Ibid
3 Ibid.
• The Production Sharing Contracts also offer the home countries the advantage of limiting it from risks, hence the international oil companies bears the exploration and production risks coupled with the benefit of owning all petroleum installations and equipment at the end of the contract. Furthermore, the modern Production Sharing Contracts have an obligation provision to supply the domestic market with a certain quantity of products as agreed to within the rules of the contract.

Disadvantages of Production Sharing Contracts

• The international oil company being the operating partner could inflate the price of his cost oil once there is a commercial discovery, and if not proven otherwise by the HC, then the host could pay the inflated cost oil. This could particularly be the case if the contract area is a high prospectivity and low risk area.

• The international oil company being the operating partner could influence the market price of petroleum by selling his cost oil and his share of profit oil at low-cost, which could affect the pricing of the host country, thereby causing the national oil company to sell cheaply to the markets.

• The effect of stabilisation clauses could also affect the host country if it wants to change the terms of its tax policies.
In a Risk Service Contract, the host country allows the operating party which is the international oil company to perform exploration and development of petroleum in a specified area for a remuneration in cash for its risk capital and services after oil and gas are extracted.

| Risk Service Contract articulates that the oil and gas resource is owned and controlled by the host country, while the contractor bears all the risks and costs involved in the exploration and production, and if successful, the contractor will be allowed to share in the resource based on cost recovery and a percentage of profit oil. |

The risks and costs burden is on the international oil company during the exploration phase and if there is no commercial discovery, the contractor receives no payment or reimbursement.

| Under the Risk Service Contract, the foreign oil company is normally refunded in cash; whereas, under the Production sharing Contract, the foreign oil company receive their share in the barrels of the petroleum produced. |

Throughout the exploration phase of the contract, the international oil company solely invests all the capital outlay and therefore, bears all the risks as noted earlier, however, once there is a commercial discovery and production of petroleum starts, the international oil company has the right to be reimbursed and remunerated for the invested capital and services provided. The contract agreement spells out how and in what manner the payments should be made, which differs widely in different host countries.

**Advantages**

- An advantage to the host country is that reimbursement of capital invested by the international oil company in the exploration operations is with no interest. However, reimbursement of development funds for the commercial fields is reimbursed with interest at a rate agreed in the contract agreement.
• Once the international oil company is fully remunerated, the host country will have no further financial obligations to him, and will therefore enjoy all benefits from the production.

**Disadvantages**

• The host country bears the risk of **additional expenses** for being unable to maintain the installations and equipment after **petroleum development**, because of lack of expertise, and would therefore have to rely on the IOC who will have to be paid for the service, thereby costing the HC financially.
UNITISATION AND CROSS BORDER UNITISATION

The concept of unitisation is derived from the word ‘unit’. It is a mechanism devised by the combination of numerous oil wells to produce from a specified pool of reservoir. There are circumstances that arise which the unit operator (Oil Company) may find out that the crude oil reservoir which they intend to exploit stretches into that of another adjoining land not covered by the exploration and production contract. The Oil Company may thus seek legal protection to sustain its interest. This means that, of course, such foreseeable event should be covered by the license, lease or concession agreement with due care to accommodate the doctrine of capture where possible.

Unlike the rule of capture, the unitisation involved the joint development of crude oil from reservoirs that extends across individual boundaries. For example, if Crude oil is found in the lands of a small town called New Kingston and a neighbouring community called Ayayi Town both share a boundary. Where the reservoir of the crude oil spans across both communities and can be captured from a drilled well from either communities, the doctrine of unitisation can eliminate capture, if both communities agree to exploit the crude oil jointly from a single well irrespective of which town the well is drilled. The net gain to each community is calculated as a unit of the total production. Each community gets a unit of the profits known as unit interest or unit percentage. Both communities also share the costs.

In the early stages of crude oil field’s development, a reservoir that stretches beyond the licensed boundaries will not be properly delineated in that the stratigraphic trap that forms the entire reservoir may have been known solely by data obtained from the seismic activities. It is the mixture of the data from the wells that can be used to ascertain the degree of crude deposits. The Oil Company may thus, conduct further drilling to further explore and evaluate the wells to accurately assess the reservoir this is because, “the where? And how much? Questions are best answered by well data, the
location of that well and all subsequent appraisal and development wells will prove critical to the final assessment of each unit interests.\textsuperscript{4}

It is important to note that unitisation occurs within a national setting. Where the unitisation involves international boundaries of at least two nations, it is called \textit{cross border unitisation}.

\begin{quote}
*If countries share a common hydrocarbon reservoir across an established border, and are unable to agree on a definitive unitization agreement after making reasonable efforts to cooperate, international law does not require them to unitize the reservoir. Further, there is support among leading international scholars and practitioners for the proposition that a country may, if it is unable to reach a unitization agreement with a neighboring country, unilaterally exploit a cross-border reservoir, though it should be noted there is no international convention or court decisions directly upholding such proposition. Most countries, however, prefer a cooperative approach rather than unilateral approach for economic and political reasons, not necessarily legal reasons.*\textsuperscript{5}
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\begin{quote}
*A Delimitation Agreement Can Require Neighboring Countries to Cooperate toward Agreements to Exploit a Common Reservoir A hydrocarbon deposit may create complex legal issues if it underlies the territory of two different countries. At the time of discovery, three different factual scenarios may exist:

a) The countries have entered into a definitive agreement, such as a joint development or unitization agreement, that governs the manner in which they jointly develop a cross-border hydrocarbon deposit;

b) The countries have entered only a delimitation agreement with respect to the boundary that addresses the contingency of cross-border hydrocarbon deposits in a nondefinitive way; or
\end{quote}

\textsuperscript{4} Sean Rush (2010) Unitisation and Redetermination: Winning the End Game

www.memerycrystal.com accessed 20 February 2015

c) The countries have no delimitation agreement in place and/or dispute the boundary.\(^6\)

**General Assembly Resolution 3129 (XXVIII)** declares that: "it is necessary to ensure effective cooperation between states through the establishment of adequate international standards for the conservation and harmonious exploitation of natural resources common to two or more states in the context of the normal relations existing between them."

In this situation, the two countries enter into a contract to produce crude oil and gas rather than competing for extraction via capture mechanism. The inter-state agreements may take the form of voluntary joint development agreements or by compulsory\(^7\) means such as a constructive trust order of a court, an existing treaty which may be imposed by an international arbitrator or the international court of Justice.\(^8\) Joint development agreement can also be a viable tool for the exploitation of oil and gas on a temporary basis where there is a boundary dispute between two nations; the arrangement will enable oil and gas to be produced and profits to be shared pending the settlement of the boundary delimitation disputed between the countries concerned. However, in international law, **The United Nations Convention of the Law of the Sea 1982** gives countries, the absolute rights and control over mineral deposits in the seabed and subsoil of their territorial waters and Exclusive Economic Zones.\(^9\)

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6 ibid

7 Compulsory unitisation is easier to enforce where the crude oil reservoir lies within a national boundary. In that case, there may exist an enabling law under which the government may force the individual mineral owners to agree to a unitisation plan amongst themselves otherwise, the government can imposed such a plan on all parties. Examples of the legislation are the United Kingdom Petroleum Act 1998 and the Nigerian laws namely: Petroleum (Production) (Seaward Areas) Regulations (1988); Petroleum Act (1969) and the Petroleum (Drilling and Production) Regulations) (1969). The aforementioned legislation imposes obligatory statutory requirements on mineral interest owners and contractors to cooperate if and when a common reservoir must be developed in the national interest to secure maximum recovery of petroleum and to prevent time consuming competitive drilling.


9 See: Part V and Article 55 - 75 of the Convention
The UN Convention also authorises nations sharing common reservoir of mineral resources to be able to reach agreement regarding the peaceful settlement regarding continental shelves and exclusive economic zones, such efforts and arrangements should be in practical nature to develop the mineral deposits that are within the overlapping geographical boundaries without necessarily forgoing individual sovereign rights to the minerals. There are two methods of achieving cross border peaceful production of crude oil where the reservoir spans across two or more nations. The first is the cross border unitisation bilateral agreement and the second is the joint development zones bilateral agreement. Both methods share similar attributes, however, in the case of a joint development zone agreement, the development zone can be further split into separate contract areas, allowing each contracting nation to exercise some control over the zones within its boundary. This may occur where the parties prefer to independently handle their production affairs.

Cross border unitisation is straightforward, however, it can only work if both nations expressly agree to co-operate in the development of the common pool of crude oil reservoir. However, it is crucial for the parties to decide on the most suitable Unit Operator (Oil Company). Usually, the appointed Unit Operator will be able to guide where wells are to be drilled and other data collection processes that will be payable by the party that owns the unit interest. Also, the Oil Company will be responsible for the development of the reservoir simulation model (RSM) showing the Oil Company’s findings, including the “shape, flow rates, porosity, permeability, oil in place or STOOIP, and IGIP, and the distribution of both across the common reservoir, thus providing an early best estimate answer to the “how much?” and “where?” questions.”\(^1\) These services are very necessary and forms part of the Pre-Unitisation Agreement activities.

\(^1\) Sean Rush (2010) Unitisation and Redetermination: Winning the End Game
www.memerycrystal.com accessed 20 February 2015
The contracting nations can achieve the joint petroleum development area and the unitisation agreement for their common purpose in two ways: (a) By signing bilateral agreement or treaty to effect the transaction; (b) By an international unitisation agreement also known as unit operating agreement. This is usually done by permitting the relevant oil companies from both countries to engage in dialogue on the best possible development processes which would be of mutual interest to the countries and the corporations. These specifics can therefore be inserted into the bilateral treaty. The bilateral treaty sets out the rights and obligations of the contracting countries with respect to the oil field developments, profits sharing and decommissioning of facilities etc. To fully understand how the processes work, case studies will be presented herein.

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