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Nature of Petroleum Arrangement in View of Licensing Agreement: Contractual or Regulatory

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Abstract:

Countries endowed with oil and gas resources may enter into concession or licensing, production sharing agreement (PSA) or service contract for the purposes of raising fund and for the social and economic development of the country.

In licensing agreement, the host government (HG) gives to the international oil company (IOC) exclusive rights to explore, develop, sell and export oil or minerals extracted from a specific area for a fixed period of time. Companies compete by presenting bids which may be accompanied with signing of bonuses for the license of such right. Countries such as Kuwait, Sudan, Angola, Ecuador operates this kind of petroleum arrangement.

Under the PSA, the HG permits the IOC to manage and operate the development of the oil field while ownership of such still vests with the HG. Under a PSA, the IOC bears most of the financial risks of exploration and development, even though the HG faces some risks too. Often times, the national oil company (NOC) joins the consortium as an interest holder in a PSA, contributing to some of its profit as "shared capital" in developing the area granted under a PSA.

Most times, the HG has the cost of its initial contribution "carried" by the IOC. The carried cost will then be paid to the IOC from the HG future profits under the PSA.

Countries such as Azerbaijan, Norway operate this kind of petroleum arrangement.

Under a service contract on the other hand is a long term arrangement used by the HG to acquire expertise and capital from the IOC without handing over the field and production rights to the IOC.

These petroleum arrangements however have their advantages and disadvantages but will not form part of this paper as this work will review the nature of petroleum arrangement between the HG and the IOC for the purposes of determining if such arrangement is contractual or regulatory.

In recent times there has been a controversy as to the nature of petroleum arrangement between the HG and the IOC, However this work will review a number of literatures on the subject matter using the licensing regime as a case study for the purpose of determining the nature of such petroleum arrangement. It will do so by examining the characteristics of a contract and a regulation; it will consider the regulatory nature of a licensing agreement in view of what is obtainable in the United Kingdom (UK).

The review of this paper suggests that during petroleum arrangements, the relationship between the IOC and the HG is rather regulatory than contractual in view of the fact that the conditions of a license are embedded in a legislation in most practicing states. The substance of a license the substance of a license remains regulatory in nature in the sense that considerable degree of discretion remains with the state with respect to the execution of certain projects by the IOC, the fact that it is a government grant from the state and could be unilaterally amended by the state without prior consent of the licensee, the administrative function of the state to checkmate the activities of the licensee throughout the duration of the license and more as discussed in this paper.

Keywords: *production sharing agreement (PSA), Licensing, Service contract, International oil company (IOC), Host government (HG), Oil and Gas, Exploration and development, consortium, oil field, United Kingdom (UK), Department of Energy and Climate Change (DECC)*

1. Introduction

Most exploration and production of oil and gas resources are conducted today in almost all countries pursuant to agreements entered into between international oil companies and the government of the countries.¹ The petroleum arrangements between the state or its National Oil Company (NOC) and the International Oil Company (IOC) varies and may take the form of a license (concession), production sharing contract or agreement (PSC/PSA), service contract (SC), Joint venture agreement (JVA) to mention but a few.²

¹ King and Splading LLP, "An introduction to upstream government petroleum contracts: their evolution and current use", (2005) OGEL, Vol.3, Issue 1, available @><http://www.ogel.org/article.asp?key=1730>>accessed on 12th December 2016

² Geoffrey Picton-tubervill et al, "Oil and gas, a practical hand book", (Globe Business Publishing Ltd, 2009) p.27

Government of any country in developing its natural resources can create state companies for exploration, development and production as in Saudi Arabia, Mexico, Venezuela, Iran and Oman;³ they can invite private investors to develop their natural resources as in the United States, United Kingdom, Russia and Canada, or they can use a combination of the two afore mentioned systems as in Indonesia, Nigeria, Azerbaijan, Kazakhstan and more.⁴

However, over the years, the relationship that exists between the state and the IOC during an oil and gas operation has been subjected to various speculations as to whether such an arrangement is contractual or regulatory in nature considering the different arrangements.⁵

Hence this work will review the characteristics of a contract and a regulation for the purposes of determining whether a licensing type of petroleum agreement is regulatory or contractual in nature.

In which case, it will discuss the regulatory nature of a licensing agreement in view of what is obtainable in the UK.

2. Characteristics of a Contract and Regulation

A regulation is a rule of order having the force of law, prescribed by a superior or competent authority which relates to the actions of those under the authority's control.⁶ When an act is regulatory in nature, the arrangement between the parties are governed by the principles of administrative law, but when it is a contract, the ordinary rules of contract apply as relates to any issue arising between the parties to the contract.⁷

Contractual agreements on the other hand are more rigid and stipulate essentially an agreement with specific terms between the contracting parties in which there is a promise to do something in turn for a consideration.⁸

Also, for there to be valid contract, there must be offer and acceptance for which a valid consideration is given, there must be certainty of terms and duration.⁹

3. Overview of a Licencing Petroleum Arrangement

3.1. Nature of a Licence

Licensing is a system by which the host government (HG) grants to the IOC the exclusive right to explore for and produce hydrocarbons at its own risk and expense in a given area of land for a certain period of time in exchange for payment o royalties and taxes.¹⁰ Licensing regime is the first and oldest form of petroleum agreement adopted for the world industry during the oil boom in US in 19800's, and presently, it is widely used by different countries in regulating their oil and gas industry.¹¹ UK, Russia, Norway to mention a few are some of the countries that make use of the licensing system to grant access to their hydrocarbon resources.¹²

Under a licensing regime, the IOC owns the produced hydrocarbon. Secondly, licensing agreement consists of sets of tax system as profit and risk distribution mechanism.¹³

Under a licensing regime also, the licensor merely grants to the licensee proprietary right to explore and produce hydrocarbons but not ownership right over the unproduced hydrocarbons.¹⁴

Licensing agreements are straight forward and the less-requirement of professional support and expertise makes it less complex. Also in a licensing regime, it is material for oil to be found and commercial production to take place as the HG depends on taxes.¹⁵ All

³ Omon Anenih, "The UK Petroleum Production Licence-is it a contract or regulation and does it matter?> available @><http://www.dundee.ac.uk/cepmplp/gateway/?news=27980>>19th December 2016

⁴ King and Spalding LLP(n1)

⁵ Ibid

⁶ Ibid

⁷ Charles R.Blitzer, Panos E, Cavoulacos and James L. Paddock, Risk-bearing and contract design: Are Stable Contracts feasible? In: Kameal I.F.Khan (ed), Petroleum resources and development (Belhaven press, London and New York, 1987) p.173-181

⁸ The law teacher, "Production sharing contract and licensing systems", available at><http://www.lawteacher.net/english-legal-system/essays/psc-licensing-systems.php>> accessed 15th December 2016

⁹ Humphries Associates, "Essential features of a valid contract", available at>http://www.knoc.co.kr/servlet/ownload?num=6&bid=DATA1&callback=/sub05_1.jsp&ses=USERSESSION>accessed 12th December 2016

¹⁰ Blinn, K .W, "International petroleum exploration and exploration agreements: Legal economic and policy aspects" (London Euromoney Publication 1986)

¹¹ King and Splading LLP, supra (n1)

¹² Eduardo G. Pereira and Kim Talus , "Upstream law and regulation: a globe guide (Globe Business Publishing Ltd 2013)

¹³ Ibid (n12)

¹⁴ Yi Junseog, "Merits and demerits of the different types of petroleum agreement">available at>http://www.knoc.co.kr/servlet/Download?num=6&fno=6&bid=DATA1&callback=/sub05_51.jsp&ses=USERSESSION>accessed 12th December, 2016

¹⁵ Raymond Mikesell, "Petroleum company operations & agreements in the developing countries resources for the future" (Washington D.C, 1984)

financial risks of development including the costs of exploration are absorbed by the licensee.¹⁶ In a licensing regime, companies bidding for a license tend to be more cautious in their bids since there is no guarantee that the license will cover their cost and return profit.¹⁷ Also, if oil and gas reserves are not proven, then there is no guarantee that a company's cost will be covered and as such, the HG may not maximize its potential return.¹⁸

Furthermore, licensing may discourage investors since the terms of the agreements are already stipulated in the petroleum laws and regulations of the HG; hence, the IOC's are bound to obey those laws and regulations regulating the license for their license not to be revoked.¹⁹ In the UK for example, the model clauses as contained in some of the UK secondary legislations,²⁰ pursuant to the UK Petroleum Act of 1988 which governs the relationship between the state and the licensee sets out the terms and conditions which the licensee is bound to comply with; such as assignment of a license which must be with the approval of the Department of Energy and Climate Change (DECC), failure of which the license will be revoked.²¹

3.2. General Provisions of a License

Every license has some common provisions contained in it which helps to regulate the relationship between the state and the IOC. Some of such provisions will be discussed below.

3.2.1. Licensed Area

Every license contains an area which the IOC is expected to cover upon the grant of a license.²² In the UK for instance, model clause 1, 5, 6 and 10 provides for the area which a license covers for a certain period of time. In the North Sea, the size of a license area is around 200 to 250 square kilometres.²³ However, article 4(a) of the hydrocarbons licensing directive stipulates that the block must not be larger than the size allowed under the licensing activity.

3.2.2. Fiscal Instruments

Some fiscal instruments which serve as a source of revenue to the government which the IOC is expected to pay to the state upon grant of a license are contained in every license such as rentals, bonuses, royalties, corporate income tax to mention but a few.²⁴ Rentals are annual charges which a licensee pays for each year upon the issuance of a license.²⁵ In the UK for example, under model clause 12, licensees pay rentals on each anniversary of the license depending on the amount of the acreage the licensee holds.

3.2.3. Terms or Duration

Every license contains an exploration period called terms, and at the expiration of that term, the license determines depending on the type of license issued, unless the licensee has made enough progress to earn a chance into the next term.²⁶ In the UK for example, the initial term of a seaward production license which is a type of license in the UK is 4years, but for petroleum, exploration and development license, the term is 6years.²⁷

3.2.4. Surrender

Every license is entitled to determine at the end of the term or life cycle of the license.²⁸ In the UK for example, under model clause 11, a licensee is required to relinquish the license or any part of the acreage covered by the license or unilaterally surrender the license at a certain period, except where the licensee is still on the initial term of the license and work program has not yet been completed.

¹⁶ Jenik Radon, "The ABCs of petroleum contracts: license-concession agreements, joint venture agreement and production sharing agreement" in Tsalik and Schiffrin (Eds), *Covering Oil: A Reporters Guide to Energy Development*, (New York: Open Society, Institute, 2005)

¹⁷ Ibid (n16)

¹⁸ Geoffrey Picton-Tubervil et al, "Oil and gas, a practical hand book" (Globe business publishing Ltd 2009)p.29

¹⁹ The law teacher, *supra* (n8)

²⁰ Model Clauses applicable to older licenses are set in the Petroleum (Current Model Clauses) Order of 1999, model clauses applicable to the current licenses are set out in Petroleum Licensing (Exploration and Production) (Seaward and Landward Areas) Regulations 2004. Licenses issued after April 2008 are guided by model clauses as set out in the Schedule to the Petroleum licensing (Production) Seaward Areas Regulations 2008

²¹ United Kingdom Model Clause 40

²² Marc Hammerson , "Upstream oil and gas: cases, materials and commentary" (Globe business publishing Ltd 2011)

²³ Ibid (n22)

²⁴ Mac Hammerson (n22)

²⁵ Leuch H L, " Contractual flexibility in new petroleum investment in N Beredjick and TW Walde: Petroleum investment policies in developing countries" (Graham and Trot Man Ltd, London, 1998)

²⁶ Ibid (n25)

²⁷ Mac Hammerson *supra* (n22)

²⁸ Eduardo G. Pereira and Kim Talus (n12)

However, at the end of the production period of a license, the license is determined and the acreage returns back to DECC who may or may not re-assign it.²⁹

3.2.5. Assignment

Licenses usually prohibits assignment of the license because licensees under a license have an individual character and cannot be transferred to other entities.³⁰ In the UK for instance, under model 40, it prohibits assignment of a license except with the approval of DECC.

3.3. The Regulatory Nature of a Licence Vis -a-Vis Uk Licensing Regime

The relationship between an IOC and the HG during oil and gas agreement is regulatory in nature in view of the licensing arrangement for the following reasons:

3.3.1. Conditions of a License Are Reflected in State Legislations

Conditions regulating the grant of a license are usually incorporated into various laws of a HG.

Thus, the fact that the conditions of a license are reflected in the various laws and legislations of the HG shows that a license is regulatory in nature.³¹ In the UK for instance, the Secretary of States (Minister) under the Petroleum Act of 1998 may grant to any person as he deems fit a license to search, bore and get petroleum based on the conditions as set out in the model clauses. The model clauses are however set out in the secondary legislations,³² made pursuant to the Petroleum Act of 1998 which governs the relationship between the IOC and the state. Failure to comply with these conditions such as that relating to assignment of the license as contained in the model clauses may lead to the revocation of the license by DECC.³³

3.3.2. Substance of a License

A license has the form of a commercial contract from the operative provisions which grants to the licensee the exclusive license and liberty to search and bore for and get petroleum. This shows a temporal transfer of right to the IOC in return for consideration of payments from the licensee for the performance of the license terms.³⁴ Also, the conditions contained in the model clauses such as prohibition against assignment as contained in model clause 40, are terms that are commercially negotiated in a contract.³⁵ The fact that a license is usually signed under English law indicates that a license has the form of a contract.³⁶

However, notwithstanding the contractual form of a license, the substance of a license remains regulatory in nature in the sense that considerable degree of discretion remains with the state with respect to the execution of certain projects by the IOC.³⁷ For example, the minister in the UK has to consent to and approve projects like minimum working obligation under model clause 16, field development plans under model clause 17, commencement, abandonment and plugging of wells under model clause 19, to mention a few, before they are executed.

According to Prof Omon Anenih, the language used in a license is not sufficient evidence to assert that a license is an enforceable contract, as what is paramount in establishing if a license is regulatory or contractual is the substance and not the form of a license.³⁸

In the same view, Justice Harmans in the case of *Inland Revenue Commissioners V Mobil North Sea Ltd*,³⁹ inter alia stated that the fact that an agreement between the state and the international private company contains some contractual obligations does not make it a contract, for it is wrong for all intent and purposes to assume a license to be a contract since petroleum license is not ordinarily described as a contract. He further asserted that it is more strained use of language to describe a grant made by a crown as a contract.

3.3.3. Unilateral Amendment of a License

Under the general rules of a contract, any change to the terms of the contract requires mutual consent of each of the parties to a contract, but a regulation may from time to time be changed by the government on reasonable grounds and in good faith.⁴⁰ From the

²⁹ DECC, "Licensing: Overview", available at <http://www.og.decc.gov.uk/upstream/licensing/overview.htm> accessed 17th December 2016

³⁰ Ibid (n29)

³¹ Omon Anenih supra (n3)

³² Model Clauses applicable to older licenses are set in the Petroleum (Current Model Clauses) Order of 1999, model clauses applicable to the current licenses are set out in Petroleum Licensing (Exploration and Production) (Seaward and Landward Areas) Regulations 2004. Licenses issued after April 2008 are guided by model clauses as set out in the Schedule to the Petroleum licensing (Production) Seaward Areas Regulations 2008

³³ United Kingdom, Model Clause 40

³⁴ Mac Hammerson supra (n22) p.61-63

³⁵ United Kingdom, Model Clause 40

³⁶ T. Dainith, " The petroleum production license in the United Kingdom", in Dainith, T, (Ed), " The legal character of petroleum licenses: a comparative study" (1981)

³⁷ Ibid (n36)

³⁸ Omon Anenih supra (n3)

³⁹ *Inland Revenue Commissioners V Mobil North Sea Ltd* (1986) 1 WLR,296 at p.138-140

⁴⁰ Charles R.Blitzer et al, (n7)

foregoing, the principle of mutual consent before altering the terms of the contract by one of the parties to the contract appears to have no application in relation to the relationship between the HG and the IOC during an oil and gas agreement from a licensing perspective, since the government may in fact make such unilateral alterations of the license without the consent of the licensee.⁴¹ Thus, the power of state to solely change the terms of a license is the most important factor that strips a license of its contractual character, thereby reducing the security of the licensee that would otherwise be available under a contract. In the UK for instance, pursuant to S.4 (1)(e) of the Petroleum Act of 1998, which gives the minister the discretion to modify or exclude the model clauses under a license as he deems fit in the circumstance, the UK government has made three unilateral amendments to the existing licenses, giving them retroactive effects,⁴² such as the abolition of royalty payments under the license.⁴³ It has been opined that although the amended license remains contractual in form, they cannot be so in substance, since they lack the essential features of a contract-consensus as to terms.⁴⁴ Prof. Bowett on the same note stated that "if there is a general principle to be applied, it is not the absolute sanctity of contracts, for no such principle exists under the arrangement between the state and the IOC, but rather the principle of state party's exceptional prerogative powers in relation to the agreement".⁴⁵ It is worthy of note that even though the state can unilaterally amend the provisions of a license, it must do so in good faith and for public good.⁴⁶

Further, under the principle of contract, when there is a change in the terms of a contract, it must be communicated to the parties by way of the written amendment agreement, but since the relationship between the state and the IOC during oil and gas agreement is one of regulation, the UK government simply implemented the change in its model clause by way of a press release.⁴⁷

3.3.4. Remedies Available in a Contract

Remedies available in a contract are not the same as that available under a regulation when there is an alteration or amendment. Different rules apply for rescission of a contract and the termination of government granted licences. In the UK for instance, where there is a breach of the terms of the license, such as assignment of a license without the approval of DECC under Model contract 40, DECC can unilaterally revoke the license.⁴⁸

However, if a license were to be a contract, the general principle of contract been that where there is a serious breach of the terms of the contract which goes to the root of the contract, that the party may treat the agreement as discharged and refuse to perform his/her own part or accept his/her counterparts further performance of the contract would have applied where there is a breach of the terms and conditions in the model clause against assignment.⁴⁹ Also, it is argued in this light that if a license is considered to be a contract, that the parties will rely simply on the ordinary principles of contractual interpretation in relation to the powers and discretion exercised by the minister,⁵⁰ but since the license is a regulation, that the principles of administrative law provides that the law and regulations should control the exercise of the discretionary power of the minister and the court is always eager to strike down the actions of the government whenever it perceives misuse, arbitrary use of power or that the government acted ultra vires its powers.⁵¹

3.3.5. The Administrative Nature of the State Regulation of a License

License is regulatory in nature considering the administrative powers of the state and other regulatory bodies who checkmates the activities of the IOC, in order to ensure that there is compliance with the terms and conditions of the license.⁵² In the UK, DECC controls and oversees licensing system or administration.⁵³

4. Conclusion

In view of the reasons above, ranging from the fact that the conditions of a license is imbedded in a legislation in most practicing states; looking at the substance of the license, the fact that it is a grant from the state(UK-Crown) and not an agreement and could be unilaterally amended by the state without prior consent of the licensee, the administrative function of the state to checkmate the activities of IOC's throughout the duration of the license and more shows that the licensing petroleum agreement is regulatory in nature.

This view however is against the backdrop that some other petroleum arrangements can be seen as contractual like the production sharing contract or agreement (PSC/PSA) and service contract (SC) considering the fact that the state and the IOC's enter into a

⁴¹ Omon Anenih supra (n3)

⁴² The Petroleum and Submarine Pipelines Act 1975, Oil and Gas (Enterprise) Act 1982 and the Petroleum Act 1987

⁴³ Mac Hammerson supra (n22)

⁴⁴ J. Armstrong, "UK Petroleum Licensing-An Introduction" (Unpublished) paper presented at the University of Dundee CEPMLP Summer Course 1994

⁴⁵ D.W. Bowett, "Claims between States and Private Entities: The Twilight Zone of International Law, 35 Catholic Univ. L. Rev. (Summer 1986, No.4) p935

⁴⁶ Ibid (n45)

⁴⁷ J. Armstrong supra (n44)

⁴⁸ DECC supra (n29)

⁴⁹ Humphries Associates supra (n9)

⁵⁰ Omon Anenih supra (n3)

⁵¹ Mac Hammerson supra (n22)

⁵² LLP, K.S, " An introduction to upstream government petroleum contracts: Their evolution and current use", (2005) OGEL 3, 1

⁵³ DECC supra (n29)

contract by negotiating the terms and signing to it, which such is not obtainable in a license because the HG have different licenses to offer and the IOC's just pick the one suitable for them which is in turn granted to them.

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