OpenOil Online Curriculum: Governance: Contracts

Source: Covering Oil, Chapter 5 – The ABCs of Petroleum Contracts: License-Concession Agreements, Joint Ventures, and Production-sharing Agreements, by Jenik Radon

This chapter takes a more detailed look at the differences and similarities between different types of contracts that the governments of resource-rich countries can make with international, and national, oil companies. Political and economic situations can vary greatly between resource-rich countries, and as such, there are varying models of contracts that are used in each. For those wanting to obtain a deeper knowledge of how exactly these contracts function, this article serves as a good basis, allowing journalists to understand more about the contracts that their particular governments have signed.

5. The ABCs of Petroleum Contracts: License-Concession Agreements, Joint Ventures, and Production-sharing Agreements

Jenik Radon

It is in the interest of natural resource–rich countries to use their resources to obtain funds for social and economic development. To do so, 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.

This chapter will focus on the different types of contracts that are standard in the industry while also addressing the important public interest concerns that are too often neglected in contract negotiations. By reporting on these issues, the media can help inform public debate about what kind of contracts are best for their country.

Governments have three options to develop their natural resources: They can create state companies for exploration, development, and production, as in Saudi Arabia, Mexico, Venezuela, 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, Nigeria, Azerbaijan, and Kazakhstan.

Contract terms determine how much a producing nation earns from its natural resources, and often, whether a government will have the regulatory authority to enforce environmental, health, and other standards that apply to the contractors.

A government is expected to use its regulatory power to protect the public interest—to ensure, for example, that oil spills don't damage public drinking water. 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.

Another reason to focus on contracts is the opportunities for corruption that exist in the huge investment costs and vast profits involved in most energy deals. Because normally so little information is made public about negotiations and contract terms, there is potential for abuse on both sides of the table. Companies bidding for potentially lucrative deals have sometimes made illegal payments, often disguised, to government officials or their representatives to curry favor. It is difficult to determine whether a particular company was chosen for its competitive bid or competence, or its close relationship with a government official. If the government official is also the regulator, the opportunity for corruption is even greater. Criminal investigations involving this kind of corruption have been pursued in Angola, Congo-Brazzaville, Kazakhstan, and elsewhere.[1]

Oil Contracts

Though contracts can vary widely in their details, all must establish two key issues: how profits (often called "rents") 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. Nine out of ten exploration efforts result in a loss.[2]

Companies will seek to protect themselves against possible losses, which drive up investors' internal costs. 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 (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.

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, Sudan, Angola, and Ecuador.

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 countries such as the UK, Norway, and Canada, a license or concession agreement can focus on the commercial terms without the burden of devising contractual provisions to fill in gaps in the legal system of the host country.

The financial and other terms of the license are set forth in an agreement draft-

Questions about License or Concession Agreements

If your government has entered into a license or concession agreement, there are a number of questions you can pose to better understand the situation. Some of these same questions are also applicable to JVs and PSAs.

- If the tender terms have not been made public, ask government officials for this information and also ask why the terms were kept secret.

- How long is the concession valid? How many companies bid? What has the successful bidder agreed to pay? Which outside experts advised the government in designing the concession license?

- How long is the work program and how much has the bidder agreed to invest? What environmental standards will be adhered to and what agency will police compliance with these standards? Will any residents be relocated to make way for the natural resource development?

- How will the proceeds be shared between the central government and the local governments?

Questions for Companies

- How much will be paid for the concession and to whom? Will the terms of the concession agreement be made public? Will company officials publicly confirm that they have not paid, in cash or in kind, any government official or his family or friends for the concession? What are the criteria for choosing local subcontractors?

ed by the host government which should then be published and opened to a bidding process by competing companies. The successful bidder pays the bidding price—usually the license fee and/or signing bonus—and these fees are kept by the host government regardless of whether oil is found and commercial production takes place.

If commercial production occurs, the host government also earns royalties based on gross revenue and/or a profit tax based on net income, both of which are based on the quantity of production and the price at which the production is sold. All financial risks of development, including the costs of exploration, are absorbed by the successful bidder. In short, there are few serious financial or other drawbacks for the host government, other than the loss of opportunity or the loss of time if the bidding system does not attract an acceptable, financially strong, and technically competent bidder.

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—a 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.

For more information about concessions, refer to Box 1 at the end of this chapter.

Joint ventures

Joint ventures (JVs) defy ready explanation and definition because there is no commonly accepted definition or meaning. A JV simply implies that two or more parties wish to pursue a joint undertaking in some still to be clarified form. A "joint venture can be best understood by comparing it to a modern-day marriage. . . . There is a courtship period. . . . Parties to a joint venture need to know and understand each other's goals, interests and ways of doing business. Without such understanding, it is impossible to draft a workable prenuptial agreement (i.e., the joint venture agreements). . . . The low success rate of modern-day marriage applies equally to corporate joint ventures."[3]

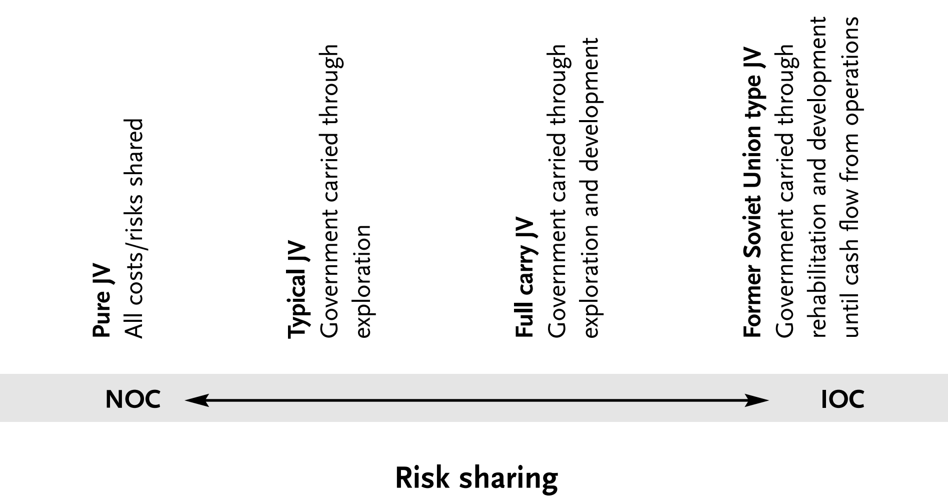
Given the open-ended nature of this type of structure, it is not surprising that JVs are less commonly used as the basic agreement between an oil company and a host government. Nigeria was an exception: The national oil company favored this format until it could no longer meet its share of the JV's financial commitments. Now, new agreements in Nigeria are mostly PSAs.

It is in the nature of the JV that the list of issues to resolve is long. Because a JV demands that the parties do things 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 a 50–50 deal. JVs require painstaking negotiations over an extended period of time to ensure that all matters are thoughtfully addressed and that the parties agree on how to work with each other.

Advantages: The only advantage of a JV for a government is that it is not alone in the decision-making and responsibility for a project. It can count on the expertise of a major oil company. It will also share the profits, on top of any other remuneration like taxes or royalties.

Joint Venture Characteristics

- Partnership between NOC (National Oil Company) and IOC (International Oil Company)
- Risks and costs are shared between NOC and IOC
- Examples: Nigeria, North West Shelf (Australia), Russia



Disadvantages: Sharing has a downside. Risks and costs must also be shared, making the host government a direct and responsible participant in the natural resource extraction. Responsibility also brings with it potential liability, including for environmental damage.

TIP SHEET

Questions about Joint Ventures

The mere introduction of the term "JV" should provoke journalists to question government and oil company officials.

- What is the exact purpose of the JV? Is it for exploration, development, and/or operation?
- What will each party contribute, e.g., cash, know-how, and/or management? What will each party receive? What is the responsibility of each party, e.g., operation, sales, and/or government coordination?
- How long is the JV to remain in existence? What are the agreements that constitute the JV—e.g., establishment agreement, which sets forth the JV governance provisions; operating agreement which sets forth, among other things, how the oil field operations are to be managed?
- How is the JV to be terminated or dissolved? Can one party take over the rights of the other party, and under what circumstances?
- Why was a joint venture format chosen? The decision to use a JV demands an explanation, if not a justification, of why the host government has agreed to assume and accept the sharing of risks, and the consequent financial liabilities. Every term of a JV is freshly drafted and negotiated; full scrutiny is required of almost every single provision.
- What is the government receiving in exchange for taking on these extra risks and liabilities?

The main disadvantage is that the JV format is inherently ambiguous. It can complicate and intensify negotiations. A JV offers no natural advantage over any other form of agreement and will probably require more extended negotiations. In short, a JV will require much more legal advice from experts in petroleum contracts, which will cost the government and companies more. In addition, JVs take a long time to negotiate.

Production-sharing agreements

The production-sharing agreement (PSA) was first used in 1966 in Indonesia. Even though Indonesia had proclaimed its independence in 1945, foreign oil companies' activities were still based on the Indische Mijnwet, the mining law of the Dutch colonial period.[4] As nationalist sentiment grew, this license concession method was discredited as a legacy of imperialistic and colonial periods. The government refused to grant new concessions and introduced the "Indonesian formula," now widely known as the PSA, in which the state would retain ownership of the resources and negotiate a profit-sharing system. At first, foreign companies firmly resisted this change, afraid it would create a precedent that would affect their concessions elsewhere. However, independent companies entered into PSAs and the majors had no choice but to follow.[5] PSAs spread globally and are now a common form of doing business, especially in Central Asia and the Caucasus.[6]

The PSA recognizes that the ownership of the natural resources rests in the state but at the same time permits foreign corporations to manage and operate the development of the oil field.[7]

Under a PSA, an oil company carries most financial risks of exploration and development. The state also faces 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 will be repaid to the companies from the host government's future profits under the PSA.

If the government does not agree to contribute to the share capital, then the oil companies will try to negotiate a greater share. The exact split is a result of hard bargaining since there are no scientific determinants of what an appropriate or reasonable split should be.

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,

PSA Characteristics

- Started in Indonesia in 1960
- Work commitment
- Bonus payment
- Royalties
- Recovery of production costs (Cost Oil)

Profits – Cost Oil = Profit Oil

- Profit oil split between company and host country
- Overall share of the host country depends on bargaining
- Developing countries now prefer PSAs

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 gray 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.

What remains after companies have used annual earnings to repay themselves for their operating expenses and their capital investment, as depreciated in that year, is then shared according to the agreed percentage division with the host government.[8] 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 such 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 concerns and 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. For example, if a country does not possess basic rules governing petroleum operations, the issues normally covered by such a law will have to be addressed in the PSA. In short, the less reliable and/or predictable a state's legal system the more issues must be covered and specified within a PSA.

Advantages for a host government: All financial and operational risk rests with the international oil companies. The host government does not risk losses other than the

Bonuses

- **Signature bonus**
  Paid upon contract signing
- **Discovery bonus**
  Paid upon first discovery
- **Production bonus**
  Paid when production reaches a specified level
  - Unpopular with oil companies
  - Oil companies prefer higher income taxes

cost of the negotiations (mainly fees paid to advisers). At most, the host government loses an opportunity but suffers no material loss if an exploration or development project fails. Should a project not be pursued in accordance with the terms of an exploration or development program, a government can still, if the PSA is drafted well, cancel or terminate the deal or bring in another oil company. A host government has the added advantage that it shares any potential profits without having to make an investment, unless it agreed to do so.

If the PSA is enacted into law, it provides legal security for international oil companies—a novel approach used by Azerbaijan and other former Soviet republics. But from the point of view of a government, such an approach turns a contract, which is a flexible instrument that can be changed simply by the parties, into an "inflexible" law, which can only be amended with the approval of parliament. In many cases, the PSA is superior to, or trumps, all other present and future laws with respect to the matter addressed in it. The result is that the government effectively surrenders its right to adopt new laws and regulations in the public interest if such laws or regulations should adversely impact any rights of the oil company under the PSA.

Disadvantages for a host government: The theoretical flexibility of the PSA as an all-in-one document is also a disadvantage. It puts a premium on very professional negotiations and the government having access to technical, environmental, financial, commercial, and legal expertise. In structuring the financial provisions, the government must undertake to assess the reserve potential of the oil fields, even though accurate information may not be readily available. In fact, a host government often has considerably less data and technical and commercial knowledge than the oil companies.

Most importantly, if the host government will obtain a significant portion of its share or compensation directly through profits, the PSA puts the government in conflict with itself. It has to balance the desire for higher profits with the enforcement of environmental and other regulations. The cost of environmental compliance cuts into profits. Also, the lower the amount of a company's profits, the less taxes it will pay to the government. However, through the terms of the PSA, the host government is at least passively a decision maker in the development of the oil fields.

At the same time, a host government has granted oil companies, through the PSA, a say in the enforcement of environmental and other standards, when these standards have been incorporated as contractual provisions. A contractual provision can be more easily contested, and even violated, than a statute or regulation. The reason is simple. Breaching the provisions of the PSA, even an environmental provision, is only a contractual violation. The violating party will normally be required only to rectify the breach, perhaps even pay damages. Only if a serious or material breach has occurred is termination of the agreement a possibility.

Moreover, a breaching party could argue that its breach came as a direct result of the action or inaction of the other party. A breach of a contractual provision is an extension of the contract negotiation process, a renegotiation, albeit more acrimonious. By contrast, the violation of a legal statute is an offense, subject to legislatively approved sanctions and penalties and even pubic condemnation. A contractual breach is a private affair.

In addition, if a PSA has been enacted into law by a country's parliament, it limits the flexibility of both parties and any changes require parliamentary approval. As the PSA is also a contract, ambiguities will have to be mutually settled by the government and the oil companies. By making the PSA a law, as well as a contract, the government has in part transferred some of its responsibilities to the oil companies and surrendered considerable flexibility.

Furthermore, making contracts into law creates a legal infrastructure of one-off, exceptional situations; the investment climate of a nation suffers accordingly. By adopting PSAs into law, Azerbaijan has little possibility of developing a coherent and comprehensive legal system because the PSAs will remain exceptions to any more general or principled laws. In short, the PSA is a form of positive legal discrimination or favoritism for the oil companies. Other investors, whether in tourism, banking or large-scale agriculture, will invariably lobby the host government and parliament for similar special treatment. The net result is legal confusion and a general disrespect for the law.

The government's take

Many contracts require companies to pay the host government a signing bonus. Subsequent bonuses may be contingent on reaching certain stages of exploration or development.

Local investment provisions in a contract may actually be quite costly for a host country because oil companies will request concessions in the PSA for this form of pri-

Government Take in Onshore and Deep Water Conditions[9]

(expressed in percentages)

Country	*Onshore*	*Deep water*
Portugal	43.2	39.7
State of Louisiana	69.3	47.2
Thailand	67.0	57.5
Nigeria	84.8	64.2
Malaysia	89.4	68.1
Indonesia	89.8	81.1

vate subsidization of local industry. Most of the time, it is simpler and more transparent for a government to use part of its proceeds to train workers or provide commercial credit for local entrepreneurs.

Since the government is typically the owner of the resource, it is legitimately entitled to keep the major share of the rents. This portion that the government keeps, or the "government take," depends on a number of factors, including how risky—financially, commercially, politically, and environmentally—the investment is for the companies; the availability of alternative projects for those companies on a world-wide basis; and the prevailing oil market price at the time of negotiations.

The level of government take can increase with a project's profitability. Thus, where the investment is successful, government revenues can increase without negatively impacting incentives to explore and to produce. In practice however, it appears difficult to design a tax system that adjusts perfectly to the rate of return actually achieved on investment in a project.

The rents from a petroleum deposit cannot be determined in advance so a company will be concerned not only about the overall impact of the tax regime, but also by the way in which the tax burden will be imposed at different points in the field's life (the tax structure).[10]

In order to understand why the level of government take is what it is, the characteristics of each field must be taken into account: Onshore or offshore? Shallow or deepwater? The country's geological history is also important: Large and relatively mature oil sectors as in Norway? Smaller or newer oil fields as in Azerbaijan? The riskier the investment, the greater the share of profit demanded by companies.

Questions about Production-sharing Agreements

In addition to some of the questions asked about license agreements, journalists should ask government officials how the investors were identified and chosen.

- Was there a competitive bid?

- What types of payments will the government receive? Will there be bonuses? When will the bonuses be paid and for what amount?

- What other types of payments will companies make? What are the conditions? Will the companies be paying taxes, and if so at what rate? Will they pay royalties once production begins?

- Are the companies obliged to invest in local communities where they operate, for example, by building schools or hospitals? Will local laborers be engaged? Will they be trained? And if the answer is yes, will the government give tax or other financial concessions for such a commitment? Is this commitment an expense to be deducted from profit or a one-to-one credit against tax obligations?

- How will profits between a host government and the oil companies be shared?

- How will the costs of environmental damage be treated? Are they a deductible expense? Are they deductible under all circumstances, including negligent conduct by the oil companies? Will the oil companies alone be responsible for such costs? (If the government shares the cost of environmental damage, and its portion of the profit is accordingly reduced, lax enforcement of environmental regulation is often the result.)

- Ask the government, as well as oil company representatives, to detail local content contractual requirements. (PSAs often contain provisions requiring a specified share of materials and supplies be procured from domestic suppliers. The selection criteria for domestic suppliers should be transparent to ensure that the system is not vulnerable to bribery or nepotism.)

- How will income and costs be calculated and shared between the companies and the government? (What companies include as expenses can have great consequences on how much the host government earns. In Alaska, legal challenges against the companies' accounting practices brought the state an additional $6 billion in revenue.[11])

- What are the rates of depreciation, and how do these compare to depreciation practices in other countries? How is the price of oil calculated?

If the PSAs in your country are not public documents, ask the government and company representatives why they refuse to share this information with the public. (Some countries, like Azerbaijan, make PSAs publicly available, but only because those PSAs have been enacted into law and therefore must be published.[12] However, most countries keep these contracts confidential.)

- If the PSA has been adopted as a law by parliament, does it take precedence over existing and/or future environmental and safety regulations? What are the consequences if the country later adopts stricter regulations concerning oil and gas operations? Are the added costs of compliance for the companies deductible as expenses or does the government have to compensate the oil companies?

- Does the contract require companies to pay a penalty for damage to the environment? (Some natural gas contracts require companies to pay a price for gas flaring, which contributes to greenhouse gas emissions.)

Certain Contractual Provisions

The concession or license agreement and the PSA have certain provisions in common as they focus on the same subject matter albeit from a different perspective. The following sections examine some of the more common provisions.

Parties. The choice of parties to any agreement should be examined carefully, especially when the parties are from different nations and when one of the parties is a government or a public institution. To the extent that a host government is a direct party to an agreement, it accepts direct responsibility and unlimited liability. But it may limit its liability by engaging one of its own enterprises as a contractual party. There is often confusion between those two related—but separate—legal entities where the state-owned enterprise is perceived as the executive arm of the government.

For example, a host government may agree to provide sufficient electrical power for a project and if it fails to do so, it can be held liable. But if the national electric company, even if wholly owned by the government, agrees to provide the power, then only the electric company will be liable for failure to perfom, and only its assets can be seized to cover compensation costs. In general, it is advisable for the government to never serve as a direct contractual partner in a commercial agreement, although this is not always possible. In oil deals, national oil companies often serve as intermediaries for the government.

For these and other reasons, a government should separate its commercial activities from its governmental or regulatory functions. It should not assume contractual liability for exercising regulatory functions.

The oil company partners in any deal with a host government will usually create a subsidiary to serve as party to the agreement. This type of subsidiary will have limited or no assets of its own, and it will not be able to rely on the financial resources of the parent company to stand behind its commitments, especially in regard to damages resulting from environmental pollution. Host governments should require a guarantee from the ultimate parent company of the subsidiary so that the host government has a reliable contractual counterparty with the resources to cover potential liabilities.

Accounting Methods. In order to determine profits, there must be a decision on accounting methodology. The United States, UK, and France each have their own national accounting standards, and the International Accounting Standards Board is in the process of drawing up international accounting principles. Accounting standards leave room for discretion and interpretation, and can lead to serious disputes.[13]

Moreover, accounting standards do not have provisions prohibiting any particular type of expenses. Consequently how certain expenses are to be treated should be clarified in the contract.

Intercompany pricing—what firms with a common owner or common control charge each other for services and goods—is a particularly difficult issue for which accounting standards provide only guidance and no definitive resolution. Intercompany pricing can inflate costs and decrease government compensation.

Recovery of Costs. Companies' costs are important for host government revenues because the taxes that companies pay and the royalties they share with the government are based on the companies' profits. How companies account for their costs determines what profits they report.

There are two types of costs: current operating costs and capital investment costs. Current costs are expensed in the year in which they are incurred and represent an immediate deduction from gross income and an immediate reduction in profits. Capital investment costs are long term and can be depreciated over a set period of time. From a government's perspective, the longer the rate of depreciation, the higher its share of the profits during the time period. A company, on the other hand, will seek to recover its costs as quickly as possible through a more accelerated depreciation. Thus, the terms that the companies use for depreciating assets can have a significant impact on government revenues.

Whether every expense is valid is a different matter. For example, are bonuses paid to expatriate employees as compensation for working in the host country a valid expense? Is the import of a foreign wine for expatriate employees a necessary expense? Should air travel be limited to economy class? A detailed expense policy is necessary.

Capital investment, whether for drilling rigs and other longer-life or "permanent" investments, is significant. Since they are useable over an extended period of time, they should be depreciated or expensed over time. The oil companies prefer to recover these costs immediately and expense them fully in the year in which they are incurred in order to lower profits for that year and pay less tax and less profit to the host government. If the government allows a rapid depreciation of capital investment, an oil company has less to lose should it decide to discontinue operations. After all, the company will already have recovered the majority of its costs.

Taxation or Compensation. The question of how to tax production is an extremely important issue as income earned from the production and sale of a natural resource often accounts for the biggest portion of the government budget. But if the government taxes too much, it runs the danger of pushing companies out of the country to areas that offer better terms.

There are several different types of taxes the government can apply. The first is a profit tax that can come in the form of a corporate income tax or can be subsumed as part of the amount the government agrees to take from any profits. Tax inspectors collect data on production and sales volume data and the price at which the product is sold, and the inspectors audit company expenses. Oil sold to a company's subsidiary in another country may be priced lower or higher than prevailing market prices. In countries where tax administration is weak, this kind of transfer pricing can create opportunities for tax evasion.

Another tax often imposed on oil companies is a royalty, or excise tax, which is normally a percentage of the value of the production, although it can be a set fee based on volume or quantity. This tax is often imposed on top of other taxes. Governments like these taxes because they are easy to administer, in contrast to the corporate income tax, and their collection does not have to wait until the project becomes profitable. On the other hand, these taxes can be inefficient because they tax production without any regard to profit. When the project is marginal or not competitively profitable, the royalty or excise tax may discourage further investment.

Bonuses are another source of revenue that are easy to administer. A host country can require a one-time payment before the company starts exploration (signature bonus), or continued fixed payments once production reaches certain levels (production bonus). Bonuses are fixed payments and do not take into account the success of the project or its profitability; they are usually tax deductible.

Norway designed a sophisticated system that adapts relatively well to the stage of development of a project, and awards the government a significant share of the oil rents. The tax rules are based on the ordinary corporation tax (28 percent) and the addition of a special petroleum tax (50 percent). Both taxes are based on the companies' net profits, and all expenses relevant for the activities on the Norwegian continental shelf are tax deductible. Investments are favored by a high depreciation rate. In addition, an uplift allowance lets a company deduct 30 percent more than it invests against the special tax. For example, if capital expenditure is $100 million, the company can recover $130 million. Thus, the Norwegian petroleum tax system is favorable for marginally profitable projects because the uplift allowance will shelter profits from the full effect of the special petroleum tax.[14] But it should be noted that Norway has extensive experience in managing a natural resource tax system.

Environment. Each government has an obligation to protect its environment. However, where environmental standards are covered by PSAs and license-concession agreements, environmental rules and regulations can be ambiguous, giving oil companies the right to interpret, negotiate, or even veto, albeit indirectly, environmental standards. For example, the PSA for Azerbaijan's major oil development project allows the contracting companies to discharge air emissions "in accordance with generally accepted international petroleum industry standards and practices." The problem is that there are none!

Moreover, if an environmental standard is simply a contractual provision, then companies, together with the government, are also interpreters of that provision and effectively can exercise a veto. It is standard for an agreement to provide that parties shall mutually interpret or agree on the meaning of unclear terms, which means the consent of both parties is required.

Developing countries, if they are lax on environmental standards and their enforcement, indirectly subsidize the cost of a commercial commodity by permitting their environment to be despoiled.

Environmental standards are generally higher in Western countries, but there is no rational reason why they should be, especially in the oil and gas industry, where the commodities are in such demand. The problem arises when oil companies, avoiding the stringent environmental standards in one state, take advantage of more lenient legislation in other countries to discharge, for example, their toxic drilling mud.

Oil companies prefer to pay a relatively low penalty for noncompliance with environmental standards rather than invest in costly pollution monitoring and control. Fines should be high enough to act as a deterrent. Companies usually have an obligation to restore the area upon completion of a project. While some countries like Germany strictly enforce this, other nations employ less stringent requirements.

Work Program. A work program detailing a company's exploration or development plan can be murky, often hiding behind technical and financial considerations, including how to drill in deep water or earthquake areas. In that regard, questions concerning how to best protect the natural environment also become an issue, partially because of the cost of installing the necessary protective equipment.

Often an oil company will slow down certain projects it deems too expensive, especially in comparison to other projects that it may be developing in another part of the world. As such, the host government should insist on a work plan that specifies clearly the circumstances under which a project could be delayed or even discontinued and the circumstances under which it may not.

Stabilization. Stabilization provisions protect oil companies from governmental or legislative changes affecting any contract term and grant them compensation from the host government for any added costs due to future legislative changes, unless otherwise agreed.

Originally, stabilization clauses addressed specific political risks that could affect the contract. In developing countries, the greatest worry was that the host government would nationalize the investors' assets or terminate the contract by unilateral decision.

In the 1970s, there were several disputes between foreign investors and Libya following the nationalization of the oil companies' interests and properties in that country. The arbitrating court decided that Libya's unilateral decision to nationalize the oil companies' interests was a breach of contract that gave rise to liabilities and required remedy.

A stabilization clause is extremely disadvantageous for the government which "agrees" to it because it freezes the legal and regulatory situation of the country for an extended period of time and requires the government to pay compensation if changes affect an investor.

The stabilization clause must be closely analyzed from a time perspective: what does it mean today and what will it mean tomorrow?

Price. How the market price of oil is determined is critical as it directly impacts the compensation of the host government, whether in the form of taxes or profit sharing. The only objective method to calculate the selling price of oil is to start with the price established by the spot market in the particular region. Platts, an oil pricing service owned by McGraw Hill, publishes a comprehensive list of commonly traded crude oils and their daily market prices. Normally, a contract would specify what prices would serve as a benchmark.

What should never be accepted without question as an acceptable contract price is the price paid between related companies because that price is determined internally and will not necessarily reflect market rates.

A related company is not just a company that is partially or wholly owned by the same company. It can also be a company that has contractual or other ties with the selling party, relationships that are not necessarily public or obvious. The danger for governments that tax companies based on what the companies report as the price of oil sold to subsidiaries is that this price may be well below market rates. Even a marginal difference in price per barrel, can make a considerable difference overall.

Termination. A contract needs to address under what circumstances an agreement can be terminated. Agreements can be terminated, for example, for repeated environmental violations. Termination should also result if companies are no longer developing the field. At that point the host government could transfer the contract to another company that is still willing to develop the field.

Outside Experts. In negotiating contracts, developing countries usually must rely on foreign experts, including, ironically, some from the international energy companies. Relying on oil and gas companies for their expertise is inevitable as no number of government officials, even if they had the expertise, can oversee every aspect of natural resource development. Outside experts must be evaluated, selected, then managed and directed. A nation's experts need to be truly independent so they can be true advisers and advocates.

Conclusion

As oil contracts are necessarily complex and can be subject to abuse and corruption, these contracts, as well as any subcontracts and any regulatory terms, should be fully disclosed and made public. Only then can the public effectively judge the efficacy and soundness of these agreements and the decision-making of public servants and government officials.