

THE ROLE OF THE PRINCIPLES OF PUBLIC PARTICIPATION IN PETROLEUM DEVELOPMENT CONTRACTS IN DEVELOPING COUNTRIES*

Abstract

At the early stage of petroleum discovery in the developing countries, International Oil Companies (IOCs) played a dominant role of control, management and even ownership of the petroleum produced. As such, the host countries played nominal or no role at all in terms of participation in the search and production of petroleum. However, with the passage of time and with the growing of the activities of International Organization aimed at encouraging state participation and control of its natural resources. The awareness and consciences of the host country was aroused to participate actively in petroleum operations in its domain. This paper seeks to discuss critically the role of the principle of public participation in petroleum development contracts in developing countries. And by extension will recommend away forward.

Keywords: Public Participation, Petroleum Development Contracts, Developing Nations, Principles

1. Introduction

Public participation in natural resources management was the craze among petroleum producing countries from the 1960s. In recent times, though the concept is still being used by some producing countries in one form or the other; it is gradually reducing in other countries. The first half of the 20th century witnessed the tremendous influence and total dominion of multinational oil companies (MOC) in the petroleum industry all over the world.¹ These multinational oil companies (MOC) controlled almost all aspect of petroleum operations including the rate of exploration, the decision to develop new fields, the determination of production levels, the right to transport crude oil discovered, hiring of personnel and the setting of oil prices. As such the sphere of influence of producing countries in the exploitation of their petroleum was very limited.²

The traditional concession then in place consigned producing countries to the rather passive role of collectors of paltry sums taxes and royalties. With passage of time this traditional concession regime became unacceptable to the oil producing countries. However, these countries not only sought, but took active steps to secure greater involvement in the exploration of their petroleum. In the quest for greater government involvement in the exploration of their God's given oil, some countries took matters to extremes by nationalizing both their petroleum industry and the assets of the MOCS.³ Others took a middle ground by seeking an arrangement where the interest of the state and the MOCS could be accommodated. By the end of the 1970s major producing countries had affectively adopted state participation in one form or the other as the governing philosophy of their petroleum industry. This change was brought about through the declaration and resolutions of some international bodies such as United Nation Organization and Organization of Petroleum Exporting Countries (OPEC) on one hand and some national legislations, for instance, Nigerian local content Act on the other hand.

2. Definition of Terms

Public participation

The meaning of public participation will vary depending on the field or context in which is being considered. However, for the purposes of this paper, public participation refers to as a mechanism by which the government participates in many of the most important phases of the petroleum operation with the oil companies, especially in the sharing of risks, decisions and policy making, management, financial and other benefits arising from the industry.⁴

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¹ George S. Akpan, 'State Participation in Nigeria: Past, present and Future' Centre for Petroleum and Mineral Law and Policy University of Dundee.

² Ibid

³ As an example, Iran Nationalized its Petroleum Industry in 1951

⁴ Daintith & Willoughby, *Oil and Gas Law* (2nd edition) U.K (London Sweet and Maxwell, 1996) p. 1037

Petroleum

Petroleum has been defined by section s. 15 (1) of petroleum Act.⁵ as mineral oil or other related hydrocarbon or natural gas as it exists in its natural state in strata and does not include God or bituminous shale's or other stratified deposits from which oil can be extracted by destructive distillation.

Contract

An agreement between two or more parties creating obligations that are enforceable or otherwise recognizable at law.⁶

Principle

A basic rule, law or doctrine

3. Forms of State Participation⁷

Public participation may take many and varied forms. This paper will at this point discuss briefly various forms public participation may take. These forms include the follows:

Fixed participation

Fixed participation as the name implies, is an arrangement whereby the producing country or its national oil company is granted a stated percentage of production. This percentage may be fixed by agreement or statute. For instance in Nigeria, participating interest is fixed by agreement whereby the Nigerian National Petroleum Corporation has a fixed participation interest of 60 percent in the participation joint ventures while the MOCS have the percent.

Gradual participation

The gradual participation arrangement contemplates an increase of the government percentage of production over time in accordance with the level of production or pursuant to other parameters fixed by the participation agreement. In particular context of Nigeria, this form of participation is also applicable. The production sharing contract which is considered subsequently allows for increase in government percentage of production from a lower percentage to a higher one at certain production level.⁸

Optional participation

The optional participation gives the producing countries or its state oil company the freedom to decide its percentage of participation as and when it deems fit. This form is currently very rare in Nigeria. However, in the early 1970s the state company had the freedom to negotiate different participation percentages from 33 percent and this was later increased to 60 percent.⁹

Immediate or deferred participation

It is important to note that the distinction between immediate and deferred participation is that in the case of immediate participation the percentage of participation is determined from the beginning of the agreement while, deferred participation takes effect upon the decision of the producing state or its oil company to participate at any given moment, in most cases after commercial discovery. Furthermore, Gentry and Nzil have also divided government participation into three further forms, namely free equity, working interest and carried interest.

4. Various Forms of Petroleum Contracts vis-à-vis Public Participation in the Petroleum Contracts

It was quest for control and increased financial returns on the part of home countries that gave rise to new varieties of contractual arrangement under which oil rights could be acquired by the International Oil Companies. The

⁵ Cap A 350., LFN, 2004

⁶ *Black's law dictionary* 8th ed, s v 'contract'.

⁷ supra footnote No 1

⁸ G.S.Akpan, supra footnote 1

⁹ Ibid

common feature of these new forms of contractual arrangement is that they affirm the status of the home country (HC) as the undisputed owner of the natural resources to be developed.¹⁰ This paper will make reference to arrangement in practice in many countries including, Brazil, Nigeria, Indonesia etc. The contractual arrangements include:

Public Participation in Concession Regime

The concession regime was the first system adopted to regulate the petroleum industry and is still the most widely used system throughout the world. Basically, concession is an arrangement whereby the oil company is granted the right to explore and exploit oil and gas in exchange for the payment of all costs and also specific taxes related to the operation.¹¹ Under a concession arrangement the government grants the contract holders exclusive exploration rights, as well as exclusive development and production rights for each commercial discovery.¹² For example, in Brazil, the modern concession contract is based on the royalty/tax model. Companies interested in becoming a concessionaire must take part in a bidding round promoted by the National Agency of Petroleum (NAP). The bidding criteria are transparent and constitute a system where each bidder are given points subject to the proposed signature bonus, the minimum work programme and local content percentage. If a company wins the bid and is granted a concession contract, it assumes all costs and risk involved in the upstream activity. The concessionaire are entitled to 100% of the production at the wellhead and are given the right to export the crude oil or gas produced, subject to some obligation such as meeting national consumption and acquisition of local content.¹³ A concession comprises a contract in law, which protects the holder against unforeseen changes in case the petroleum legislation is altered. It gives the contracting company the status as the owner and the right to keep the hydrocarbons. This is the starting point to evaluate and identify the fundamental differences of this regime with others. In the concession regime the state is not the owner of the petroleum after it has been extracted. From a certain moment the home country started to interfere more directly in the form of contract, which can be seen in the clauses that were adopted in the modernized concession regime, such as:

- a) Small areas of concession
- b) Well defined time limits
- c) The ability for the state to intervene, through inspection, including the application of penalties and the right to cancel the concession
- d) A plan of development in the areas not utilized
- e) Local content, obligation to hire national companies for services and equipment
- f) Obligation to generate jobs for the national companies and invest in high education.¹⁴ Given the Brazilian concession backdrop, the ownership of the hydrocarbons generally belongs to the government until they are extracted from the subsoil, but once extracted it becomes the possession of the IOC. In relation to production installation, its ownership belongs to the IOC until the expiration of the contract term upon which it reverts to the state without compensation.¹⁵

Parties Responsibilities in Brazilian Concession

Under the concession regime, the National Petroleum Agency (NPA) is the main regulatory body for oil and gas activities in Brazil. NPA is in charge of granting the concession rights and is thus the party representing the Brazilian Federal Government. The other party is the concessionaire who may be the operating company possibly as a consortium of companies. There are some requirements that need to be met in order to be granted the contract under the concession regime. During the phase of exploitation, the IOC has to submit a plan that states its purpose

¹⁰ Ibid

¹¹ Lawrence Atsegbua, *Oil and Gas Law in Nigeria: Theory and Practice* 3rd ed. (Benin City, Edo State Nigeria, FIFRS Lane Publishers 2012); p. 125

¹² K.W Blinn, *International Petroleum Exploration and Exploitation: Legal, Economic and Policy Aspects*. (London, Euromoney Publishers 1986)

¹³ Candidate number: 5013, Erik Brannsten, 'production Sharing Contracts and Concessions in the Brazilian Subsalt Region: A Comparative Analysis', Accessed August 10, 2015, <https://www.duo.uio.no/bitstream/handle/10852/22787/Thesisfinal.pdf>.

¹⁴ Supra¹³

¹⁵ A Jemings, *Oil and Gas Exploration Contract*, (London) Sweet and Maxwell, 2008)

(Plano Exploration Minimum), PEM¹⁶ to be approved by the NPA. Furthermore, if it is approved, the IOC has to perform the work in accordance with this PEM. The state is responsible for inspecting the operations of the IOC. Additionally, the NPA determines the areas that are to be returned at the end of the exploitation.

During the production phase the IOC, in case of hydrocarbons discovery, has the obligation to deliver a statement of marketability to the NPA. Once this statement is approved, the IOC is obligated to fulfill the statement within 180 days after the statement was delivered to the NPA. During the auction process all auctioneers are required to submit a plan of development to the NPA. The NPA is then required to make sure that the IOC follows up with the plan of development during the auction process. The IOC has the obligation to communicate each step in the process to the NPA. Also the IOC has to make a plan, and act according to the minimum regulatory program. The concessionaire is liable to the NPA, the government and third parties for losses and damages deriving from their activities. It should also obtain appropriate insurance for the operations. The contract of concession thus determines what contributions the IOC has to pay, such as:

- a. Signature bonus
- b. Royalties
- c. Special participation and
- d. Payment of the occupation and retention of the area.¹⁷

It is important to note that concession regime had been practiced in countries such as Nigeria, Indonesia, Angola etc.

Public Participation in Production Sharing Contract (PSC)

The concept of production sharing contract originated in Indonesia where it was first used in agriculture. It was later adopted for petroleum in 1966. The concept is now used in Peru, Malaysia, Malta, Guatemala; Libya Egypt, Syria, Jordan, Angola, China Qatar Nigeria, Gabon, Bangladesh etc.¹⁸ A production sharing contract (PSC) is a contract between either a home country or its state oil company and an international oil company (IOC) by which the latter assumes all costs and risks associated with the exploration and production of oil and gas. In the event that a commercial discovery is made, the IOC is entitled to a share of the production in order to recover all costs as well as to have a return on the investment.¹⁹ Considering the strategic and economic importance of the activities involved with exploration and production of hydrocarbons in the vast majority of the oil producing countries, guarantying that a sufficient part of the produced hydrocarbons end up in the states hands is of vital importance. This is not only an economic aspect but also evident in the political activities involved with the exploration such as nationalism and to gain larger political control over the activities.²⁰

Terms and Features of Production Sharing Contract (PSC) vis-à-vis Public Participation

Under PSC the home country is the owner of the petroleum extracted, unlike the concession regime. As the contributions to the state are no longer through taxes and royalties, but the oil extracted is passed on to the state directly. Part of the petroleum is then given to the IOC as a compensation for its activities and the risks involved with the exploration.²¹ The PSC demands that the IOC be required to pay a specific amount to the Federal Government to get the licitation and the title of 'bonus de signature'. This is required in order to explore the areas of petroleum and gas. If petroleum is found in these areas, the company will be granted the right to keep a part of the outcome of the production. This part of the production is given to the IOC in order to pay all of the cost related to the exploration. The exceeding part is called profit oil. This part will be divided between the Federal

¹⁶ MEP is the Work Program (such as seismic 2p and 3D some Potential Methods and Exploration

¹⁷ See Article 45, Section IV Law of Oil 9, 478/97. This Article involves remuneration for the State in exchange for the right to a Concession to Engage in Oil and Natural Gas Exploration activities.

¹⁸ Oil and Gas Exploration and Production reserves, costs, contracts, Paris edition, 2004

¹⁹ K. Bindemann, *Production Sharing Agreements: An Economic Analysis* (Oxford, 1999)

²⁰ E.E Smith, *International Petroleum Transaction*, (Rocky Mountain Mineral Law Foundation, 2nd ed. 2004), p. 448

²¹ Ibid

Government and the companies in the contracts, according to the contract rules.²² Although the oil belongs to the state and the company takes the risks. However, the State can also take risks by allowing part of its profit to be used to develop the area. Nevertheless, the companies are entitled to recover their investment, operation and maintenance costs. In general, the investment costs are recovered along a certain number of years and the operation and maintenance costs in the same year they accrued. Another feature of the PSC, that has also resulted in a change in the activities of exploration and production of hydrocarbons; is a closer participation and control by the State in the segment of petroleum. Directly or through the National Oil Company the State obtains a more direct influence in the petroleum sector. In the case of Nigeria NNPC has up to 60 percent participation interest with IOCs in the country. As a matter of fact, the above features could be summarized as follows:

- a. The NOC chooses the IOC which is given a contract for a specific region and a determined duration of time.
- b. The IOC will operate at their own count and risks under supervision of the HC
- c. The IOC would supply all the materials, equipment, and necessary personnel for the condition of the operations, note at the end of the contract all the installations used revert to the federal government.²³
- d. The production will belong to the HC.
- e. The IOC has the right to recover their investments from the production in the contractually stipulated area,
- f. After the IOC has recovered all costs, the remainder of the production will be shared between the IOC and the HC, in properties previously agreed in the PSC.
- g. The revenue of the IOC is subject of taxation.

Responsibilities of International Oil Companies (IOCS) and the Government under Production Sharing Contract (PSC)

The National Oil Company (NOC) can either act as the organ that grants the rights of exploration and production to the IOCs, or as the organ that is granted the rights together with the IOCs are the investors and also the holders of the necessary expertise. The IOCs can either operate blocks completely on their own or have a less central role in the activities of exploitation and production.²⁴ Generally, under this kind of contractual structure the overall responsibility of the control and management of the operation is, in principle, in the hands of the NOC. The day-to-day and routine operations however, are the responsibility of the IOC. Under Brazilian law, the HC is not responsible for the risks imposed during exploration development, and production under the PSC. The IOC is also responsible for the investment costs. However, if the HC desires to do so, it can also assume risk risks by taking on a part of the investment costs. The PSC does not only impose obligation on the IOCs. There are also some responsibilities that the HC should exercise. The Brazilian government does so through the CNPE ANP and the Ministry of Mines and Energy.²⁵ The CNPE also has certain responsibilities. For instance, it needs to decide what blocks are to be explored under the PSC regime and for what blocks ‘petrobras’ will be contracted directly and what blocks are to be put out for auction. The CNPE also determines the technical and economical parts of the contracts and is also responsible for the HC’s part of the profit oil. It is the responsibility of the Ministry of Mines and Energy to propose a plan, submitted to CNPE, which includes aspects such as signature bonus, Minimum Participation of Petrobras.

An Examination of How Production Sharing Contract (PSC) is Utilized in Different Countries

Under this section this paper will take a closer look at two countries that use the PSC regime namely Angola and Indonesia. Under the Angolan law, the oil operation can only be exercised through a licence of prospection or

²² Ibid

²³ For instance See Articles 57 of the Law of Oil Activities (Law 10/2004, of 12 of November of 2004) of Angolan which State that, at the End of the Contract, all of the Equipment, Instruments, Material and any other Property acquired for the operations during the PSC, as well as all the information of economic and technical nature should be passed on to the nation (80 Sonangol), without any payment or reimbursement.

²⁴ supra, footnote 12

²⁵ In Nigeria case, is the Nigerian National Petroleum Corporation

concession according to Art. 6²⁶ However, the concession area is to be explored exclusively by sonagol²⁷ which under the terms of the law is the national concessionaire. The concession granted to the NOC is obtained through a law determined by the Minister. By analyzing the Angolan model, we find that the IOCs generally interpret the model utilized to be closer to the PSC,²⁸ because it is through these instruments that the relation between the IOC and the Angolan State are materialized. The law opens for the utilization of three regimes: concession, joint venture and PSC. Sonangol has utilized only the production sharing contract, however when interacting with the IOC.

The main characteristic of the Angolan PSC is that it has a specific taxation on the oil activities under the law. The law applies to all international and national companies which exercise oil activities in the Angolan territory. In Angola and Indonesia, royalties are not paid. However, the tax income is set to 50%. Angola has at present time, a specific taxation of the oil producing activities, governed by the law for the 'taxation of the oil producing activities. The limit of 'cost oil' in Angola is set in 50%, while in countries like Nigeria such limit does not exist. In other countries like Qatar, Gabon, and Ivory Coast it is far lower, representing about 30%. Even though the signature bonus needs to be paid in Angola, the simple fact that Angola is the only large oil producing country in Africa that utilizes the 'rate of return' as a basis of calculation of the 'profit oil', makes Angola a very attractive investment. Angola can be considered attractive also compared to other African countries where the royalties arrive at 20%, but where the profit oil is calculated based on the total volume produced.

On the other hand, in Indonesia for example, there exists a system called 'First Tranch Petroleum (FTP)²⁹ by which the first 20% of the production should be divided between the IOC and the NOC in percentages similar to that of the 'profit oil'. Even though there is no limit on how much of the production can be written off as investment and production costs in Indonesia, i.e, there is no limit on the 'cost oil' this recuperation can only be taken from 80% of the production. The remaining petroleum i.e the 'profit oil' is divided proportions between 65/35 and 55/43 for the NOC and IOC respectively. In addition, Indonesia in general requires the signature bonus and production bonus to be paid.³⁰

5. The Public Participation in Service Contracts (SCs)

The IOCs can also acquire oil rights by entering into SCs with the HC. The SCs first came into existence in the late 1960s between HCs and IOCs desiring to gain access to relatively assured supplies of crude oil.³¹ Under a service contracts, the HC hires the services of an IOC which assumes the legal status of a 'contractor'. Thus, the contractor is not a concession holder or partner, but merely a hired agent. Service contracts are similar to PSCs. The main difference lies in the mechanism for the recovery of costs and the remuneration of the contractor. The main features of SCs include:

- 1) The National Oil Company is the sole owner of the petroleum discoursed and the role of the IOC is limited to making available financial and technological resources.
- 2) All risks and investments are placed on the IOC, which provides the capital for exploration and exploitation. This means that, unless oil is found in commercial quantities, the IOC will not be reimbursed for the expense it has incurred in its unsuccessful search for oil.
- 3) Upon the completion of the development phase i.e; the beginning of commercial production, the HC's National Oil Company is authorized to take over the operations
- 4) The amount provided by the IOC for exploration and exploitation are reimbursed over a number of years;

²⁶ See Angolan Law of Oil 13/78, Article 6

²⁷ The Sociedade Nacional de Combustive is de Angola or so Anglo was created in 1976 as the national oil company of Angola. It is 100% owned by the state and serves as the business arm by the state and serves as the business arm of Angolan government, being responsible for coordinating and controlling all petroleum activities. The enactment of the petroleum law (law 13 of 1978) made sonangol the sole concessionaire for oil exploration and production in the country. (<http://www.mbendi.com/cosg.htm>, accessed 1/10/2010)

²⁸ see Angola Law of Oil and Gas 13/78, art 14

²⁹ FTP, works as a Cap on Cost recovery, furthermore, the third general contracts introduced improved Incentives for Marginal Fields

³⁰ Ibid, Footnote 12

³¹ L. Atsegbua, Supra, Note 10

- 5) The IOC is remunerated for its service in cash in accordance with a formula and
- 6) The IOC is authorized to buy and export a portion of the production at world price. However, in case of a national crisis this right may be curtailed.

6. Conclusion and Recommendations

In fact, there is no doubt, the decade of the 1970s witnessed a number of significant advances in government participation in the oil industry.³² yet this apparent evolution of oil contracts into the new forms of contractual joint ventures have not secured for the government the technological capacities, which would enable it to achieve its De facto control by oil producing countries over the industry calls into question the compatibility of the modes of acquisition over natural resources. De facto control of the oil industry can be achieved by the training and employment of oil producing countries nationals into the top management position in the IOCs. This approach to oil development contracts will enable the HC to be able to derive greater benefits by controlling its oil industry and thus, be able to serve its economic development purposes. However, the IOC will be allowed reasonable return on its investment under conditions of economic and legal security.

This paper recommends that to make for meaningful participation, there should be a provision that after an initial period the NOCs should take over the operations under the mining lease from the IOCs. Through this means the IOCs will expose the nationals of oil producing state to all the areas of operation so as not to endanger their investment. Furthermore, every participation arrangement irrespective of form should, apart from providing for joint management, also provide for joint executive committees at all levels of operation. Moreso, effective schemes should be put in place for the training of NOC's officials and other nationals so as to acquire the necessary expertise required in the industry.³³ Lastly, public education campaigns should be undertaken to ensure that the public is aware of their right to access information and participates in resources management processes. If there is a lack of knowledge and structures to demand and enforce rights, any legislation on natural resources control is in danger of being perceived as just another alien western concept promoted by donors and yet inadequate for developing countries.

³² L. Atsegbua Supra Note 31

³³ G.S. Akpan, Footnote 1