Security of Investment Considerations Under PSCs and Other Government Petroleum Contracts

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INTRODUCTION

Recent events in Venezuela, Ecuador, Bolivia, Argentina, and Kazakstan, as well as Alberta and Newfoundland, have caused sophisticated international oil companies ("IOCs") to structure their petroleum projects with security of investment in mind.

Under a GPC the IOC typically bears 100% of the risk of failure.

In a "perfect world", from the IOC's perspective, under an applicable UPR the IOC would have each of the following "three pillars" of security of investment[1]:

1. "right to monetize": the IOC's "right" to appraise, develop, produce, transport and market (including export) any discovery of petroleum that the IOC might be fortunate enough to make, on the most profitable basis available to the IOC, provided that the engineering, health, safety, and environmental aspects of the IOC's proposed development plan are in accordance with international petroleum practices – and thereby "monetize" such discovery;

2. "stability": the "right" to stable terms and conditions (some UPRs offer "full contractual stabilization" - both fiscal and non-fiscal) that are agreed upon and stipulated before the IOC risks capital on exploration and that are not subject to unilateral revision by the host country; and

3. "enforceable international arbitration": the IOC "right" to fair, impartial dispute resolution via international arbitration, with an effective means of enforcement of any resulting arbitral award.

In the "real world", do UPRs provide IOCs with all of these three "pillars"? The answer: almost never.[2]

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[1] Substantial portions of this Introduction are based (although on an updated basis) from Alexander, Frank, "The Three Pillars of Security of Investment Under PSCs and Other host country Contracts", *Fifty-Forth Annual Institute on Oil and Gas Law*, Publication 640, Release 54, August 2003, Chapter 7.
[2] The author has performed an extensive comparative analysis of GPCs in connection with preparation of the AIPN's *host country Contract Handbook (For The International Petroleum Industry) – Volume No.1*(1999), as well as *Vol. No. 2* (scheduled for publication in 2009), and also in connection with the preparation of "A Proposal for Annotated Upstream Petroleum Regime Model Form Provisions," *A SLA/OAS – CIDA Project commissioned by the Organization of American States (OAS), International Business Transactions in the Americas: Legal Harmonization and Bijuralism* (2002).

Professionals who are routinely involved in disputes between IOCs and host countries are aware[3] that:

- the degree to which there is an "alignment of interests" between the IOC and the host country, in that they both benefit if the IOC is permitted to appraise, develop, produce, transport and market (including export) a discovery by the IOC – is sometimes insufficient for the purpose of avoiding serious disputes between the IOC and the host country over the IOC's "right to monetize";

- there have been many such disputes (often unreported) over the IOC's "right to monetize" – particularly in the context of the host country demanding that the IOC revise its proposed development plan in a way that would be beneficial to overall Government objectives but costly in terms of the individual IOC project – and UPRs are often unclear regarding the degree to which the IOC has any such "right to monetize";

- there have also been many disputes over "stability" and, again, UPRs are often unclear regarding the nature of any such IOC "right" to stability; and

- even in the case of GPC's that provide for international arbitration: (i) the selected place of arbitration may, on a comparative basis, provide for a comparatively high degree of exposure to interference by the national court system of the place of arbitration; and (ii) even if the IOC is successful and "wins" an arbitral award, it may find it impossible to "execute" an arbitral award (turn it into money) against the host country within the host country itself (or elsewhere) – due to "flaws" (from the IOC's perspective) in the arbitration provision contained in the GPC, or because of the absence of an applicable enforcement treaty.

A review of the international marketplace of UPR terms and conditions confirms that where geologic prospectivity is high enough IOCs have been generally willing to risk capital on exploration according to terms that afford them a much lesser degree of security of investment than is demanded by, for example, the community of international financial institutions.

At the same time, competition among the 150 or so host countries that compete for IOC risk capital is intense. Few host countries are obtaining the level of foreign investment by the IOCs that they would like to have. As a result, host countries are involved in continuing efforts to make their respective UPRs more attractive to foreign investment by the IOCs – on a basis that will continue to permit the host countries to protect what they consider to be their critical interests in the development of their petroleum resources. A relatively high percentage of host countries, particularly some of those perceived to have high geologic risk and/or high political risk, have decided that in addition to offering attractive fiscal terms, it is in their overall interest to offer the

[3] The author often serves as an expert witness on international petroleum contracts, and has been asked to serve as an arbitrator in regard to disputes between host countries and IOCs.