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Smaller Exploration Companies on the International Frontier

ABSTRACT

The increasing interest in foreign oil and gas exploration presents unique challenges for domestic oil and gas lawyers. The familiar world of title examination is completely absent where oil and gas is owned by governments, and knowledge of oil and gas lease terms is unavailing where rights are granted under concessions, production sharing contracts, risk service contracts and hybrid agreements. Knowledge of foreign tax laws, direct investment laws, and specialized international arbitration methods is necessary, together with knowledge of domestic laws with extraterritorial impact. Ultimately, international oil and gas law is as much international as oil and gas law.

I. INTRODUCTION

The domestic oil and gas industry is not dead, or even dying. Daily oil and gas production in the United States is currently greater than any other producing country in the world and natural gas production is second only to the Russian Federation. An even more convincing sign of the industry's health is its continuing ability to sustain fads and follies, like the recent Lodgepole play in North Dakota, the current offshore interest in deep Gulf of Mexico waters, and the seemingly irresistible temptation to drill new coalbed methane wells even where past wells have performed dismally. Greater operating efficiencies, improved technologies, and a willingness to expend very substantial amounts for exploration and development have each contributed to the strong growth in the domestic oil and gas industry over the past several years.

For a number of reasons, however, smaller independents are not fully participating in this resurgence. These independents traditionally impact the industry through their willingness to participate in grass roots exploration. But, the number and relative attractiveness of domestic exploration opportunities are diminishing for these companies. To a lesser extent, land use and environmental protection constraints are gradually tightening on smaller companies, especially as they seek to develop fee

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lands near expanding urban centers or federal lands in national forests or other environmentally sensitive areas. Finally, those areas that are open and accessible often require exploration and exploitation technologies that are quite expensive, well beyond the financial means of smaller companies.

Consequently, many smaller independents are beginning to look overseas, applying their relish for risk and the nimbleness which comes from their small size to undertake preliminary exploration, with a view to discovering a prospect which either may be proven on a shoestring or farmed out to a larger company. Some of this interest in overseas activity may simply be a fad, the willingness to follow the lead of others when faced with limited information, but the entire movement should not be dismissed as a fad.

The driving force behind this movement is the tremendous imbalance between the extensive exploration that has occurred in the United States and the relative lack of exploration in many other countries. This leads to the inescapable conclusion that the vast majority of reserves remaining to be discovered will be discovered outside the United States. The current interest in international exploration is not motivated primarily by negative characteristics within the United States legal or economic environment, but by the much more positive geological environment abroad. This geological fact is not something that will change.

Geologists, geophysicists and other technical personnel already have the skills necessary to undertake exploration overseas. The geology may be different, but the methods used to identify and evaluate that geology are the same as in the United States. For lawyers, however, the movement abroad is a sea change. If, as Bruce Kramer suggests the skeletal structure of oil and gas law is property law,[1] that entire structure is lost when a company undertakes foreign operations. Oil and gas in place in most countries outside the United States is, with only the most rare and isolated exceptions, owned by the government. Consequently, all of the knowledge held by competent oil and gas lawyers relating to title examination, correlative rights, implied covenants, and similar matters becomes wholly irrelevant in dealing in an environment where the mineral ownership is clear, uniform, and unchanging.

What does become relevant is a myriad of unfamiliar international law matters. Moreover, the countries most likely to be of interest to small exploration companies are precisely the ones where these legal issues may be the least developed, least accessible, and least stable. The entry price for stable areas like the United Kingdom, Norway, France and Indonesia often is too high for small companies, since competitive bids in such locations

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1. Bruce M. Kramer, *Property and Oil and Gas Law Don't Mix: The Mangling of Common Law Property Concepts*, 33 WASHBURN L.J. 540, 541 (1994).

fully reflect available knowledge, established infrastructure, and political stability. Small exploration companies are therefore drawn to what may be bypassed or overlooked portions of developed areas or, with increasing frequency, to frontier areas which previously have been avoided by larger companies because of legal uncertainties or perceived political risk. Indeed, without having enjoyed a great deal of exploration attention in the past, these frontier countries themselves may be unsure of the fiscal regime and legal requirements which should be applicable to oil and gas exploration and development.

Providing legal assurance in such an unfamiliar and uncertain environment is a formidable undertaking. Experienced oil and gas lawyers do, however, bring an understanding of the industry, its exploration and development techniques, its economics, and the way it does business. In addition, the major integrated oil companies have been operating abroad for nearly a century, resulting in a wealth of available literature and a number of specialized journals, services, and organizations which may guide the negotiating and drafting process and provide the information necessary to understand key concepts. Although these resources are available, it remains true that, just as domestic oil and gas law is a type of advanced property law, so too is international oil and gas law a type of advanced international law. It requires at least as much knowledge of public and private international law as knowledge of the oil and gas industry.

II. THE HOST COUNTRY LEGAL FRAMEWORK

Most analyses of international oil and gas contracting begin with the proposition that reviewing applicable provisions of the host country constitution and its law governing petroleum activities, together with applicable regulations, are the first and most important steps in counseling a company. However, a close review of the model contract often provides a clearer and more concise vision of the organizing principles of the country's contracting system. For that reason, I often prefer to begin with a review of the country's model form contract. Whichever comes first, a review of the host country law must be conducted at an early date to identify the contracting system, award procedures, the provisions which lawfully may be changed by negotiation and, perhaps most importantly, to ensure that negotiations are conducted with the properly authorized governmental department. In some countries, like Cameroon,[2] negotiating

2. Alexander Ekollo Moundi, *Petroleum Exploration and Exploitation in Cameroon: Some Legal, Economic and Policy Aspects*, 12 OIL & GAS L. & TAX'N REV. 181, 182 (1994); George K. Ndi, *The Contractual and Legal Framework for Petroleum Exploration and Production in Cameroon*, 10 J. ENERGY & NAT. RES. L. 267, 270 (1992).

power may have been delegated by the government to its national oil company, a corporate enterprise wholly or partially owned by the government. In other countries, like the former Soviet Union during its turbulent transition years,[3] there may be considerable uncertainty as various state companies and governmental departments maneuver for authority to negotiate such contracts.

The host country's constitution and petroleum laws establish the framework of the negotiations because neither a ministry nor national oil company may disregard the governing law or grant exploration rights contrary to its legal authority.[4] Nevertheless, in many deep frontier countries it is possible to negotiate a contract containing provisions contrary to the law, and then have the contract itself obtain the force of law. This may be done through enactment by the legislature or, if the law permits, through governmental approval of the contract and subsequent publication in the official gazette. Such changes can sometimes be approved and adopted in frontier countries with surprising ease, although the time required to secure all necessary action may stretch from months to years.

Curiously, while the legal framework underpinning a particular transaction may sometimes be changed, it is usually very difficult to change the basic structure of a model contract. This is another reason why I prefer to examine model contracts even before the law itself. The model contract was likely developed by the country in cooperation with an outside consultant such as the World Bank, Commonwealth Advisory Service or some other public or private entity. In any event, the consultant likely was highly respected by the country, worked hard on the model form, and produced a document which will not lightly be discarded.[5] Substantial provisions of that contract may be added, modified or even vitiated in the negotiation process, but is exceedingly difficult to move entirely away from a model form and begin life anew with an entirely different contract structure.

A company usually generates its first interest in a particular country by a visit of its technical personnel to an international conference, trade show or the country itself. Accordingly, technical people should request as much legal information as possible, in English if available, as soon as they identify a serious interest in the country. Copies of the

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3. Dirab Doeh & Annie Williams, *Oil and Gas: Doing Business in the USSR*, 8 OIL & GAS L. & TAX'N REV. 374, 376 (1990). This uncertainty continued for years following the independence of the various Republics. *See, e.g*, Martin Friedrich, *Petroleum Investment in Kazakhstan*, in INTERNATIONAL OIL AND GAS INVESTMENT (Thomas W. Wälde & George K. Ndi, eds., 1994).

4. MICHAEL P. DARDEN, LEGAL RESEARCH CHECKLIST FOR INTERNATIONAL PETROLEUM OPERATIONS 21 (ABA SONREEL Monograph Series No. 20 1994).

5. Gerald Padmore, *Tax Negotiations in Mining Ventures: A Government Perspective*, in THE TAXATION OF MINERAL ENTERPRISES 195 (James M. Otto ed., 1995).

petroleum, tax, and foreign investment laws, as well as any applicable regulations, the model contract form, and any promotional summaries concerning investment in the country should be sought. These materials may also be obtained by direct inquiry to the concerned government, but the typically written nature of such queries, possible language barriers, and other bureaucratic complications may substantially slow the process. A personal request at a conference or trade fair, together with a subsequent confirmation letter, almost always brings satisfactory results. Of course, such materials may be obtained by retaining a local agent or legal counsel in the host country, but this in turn raises the difficulties of locating a suitable person and incurring premature expenses.

A company should obtain these full text documents directly from the host country to ensure that it is working with the most current and accurate information possible. As an interim measure, reliable summary information may be secured from World Petroleum Arrangements published biannually by Barrows Company Inc. in New York, or from World Petroleum Laws published annually (and supplemented quarterly) by Petroconsultants, S.A., in Geneva. A number of journals, including the Journal of Energy and Natural Resources Law, Oil & Gas Law and Taxation Review, Petroleum Economist, and others may have country-specific information which can be located through periodical indices, but such publications may lack the depth of full text and may not be current. Full text laws are available through Barrows' Basic Oil Laws & Contracts, but even this very useful service lacks applicable regulations and suffers the possibility that its version of the law may not be current. Although they ultimately lack the certainty and comprehensiveness of primary source materials obtained directly from the host country, each of these secondary sources can provide a sound initial orientation, as well as very useful descriptions of recently negotiated contract terms.

III. CONTRACT FORMS

Most contracts between host countries and companies granting exploration and development rights fall into one of three basic categories: concessions, production sharing contracts, or risk service contracts.[6] There certainly are other arrangements in use, but virtually all petroleum con-

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6. A fourth category, participation agreements, is suggested in ERNEST E. SMITH ET AL., INTERNATIONAL PETROLEUM TRANSACTIONS 349-58 (1993). These agreements employ a joint venture or joint operating agreement structure to place the host country and company on a very nearly equal footing. While they are very commonly used after a commercial discovery has been made, they are relatively infrequent as a method of granting initial exploration rights.

tracts may be understood by reference to one of these three principal classifications. Indeed, the differences among these three principal types of contracts are, upon close examination, largely differences of appearance, process and style, which have come about for historical, rather than commercial, reasons. Every agreement, regardless of classification, shares a common intent to afford a company the ability to explore and develop and to afford the host country with appropriate compensation for the rights granted.

A. Concessions

The defining moment for international petroleum concessions was the grant at the beginning of this century to William Knox D'Arcy of the exclusive right to conduct oil exploration in much of Persia for a 60-year period.[7] As compensation for this breathtaking privilege, Mr. D'Arcy paid a modest signature bonus in cash and stock and agreed to pay 16% of the net profits which might be realized from the concession. Considering the cumulative production from this area and the proven reserves that remain intact, such consideration now appears ridiculously small. At the time, however, Mr. D'Arcy was conducting the deepest of deep frontier exploration in an area of great political risk. While the potential for commercial oil deposits in Persia was well known, two previous concessions had ended without obtaining success. He and the backers of his syndicate took substantial risks and came perilously close to absolute failure before unlocking the vast petroleum of the Middle East.

Substantial concessions were granted during the first part of the twentieth century by Mexico[8] and Venezuela[9] and, after delays occasioned by the First World War and the intricate maneuvering of investors and their governments, elsewhere in the Middle East.[10] These concessions typically called for very long durations, exceedingly low returns to the host country, and substantial grants of acreage. Starting in the early 1950's, these agreements began gradually to unravel, as host country governments

7. Note, *From Concession to Participation: Restructuring the Middle East Oil Industry*, 48 N.Y.U. L. REV. 774, 776 n.5 (1973). The D'Arcy concession was not the first oil concession—earlier concessions had, for example, been granted in the Dutch East Indies and even in Persia itself. However, it is the one generally viewed as the model for subsequent concession structures.

8. Jonathan C. Brown, *The Structure of the Foreign-Owned Petroleum Industry in Mexico, 1880-1938* in THE MEXICAN PETROLEUM INDUSTRY IN THE TWENTIETH CENTURY 6 (Jonathan C. Brown & Alan Knight eds., 1992).

9. JORGE SALAZAR-CARRILLO, OIL AND DEVELOPMENT IN VENEZUELA DURING THE TWENTIETH CENTURY 36-37 (1994).

10. HENRY CATTAN, THE EVOLUTION OF OIL CONCESSIONS IN THE MIDDLE EAST AND NORTH AFRICA 1-3 (1967).

argued for a greater share of production, for recognition of their sovereign rights, and for ownership of important facilities and equipment.[11] As the decades passed, these original concessions were progressively renegotiated under pressure from the host country governments to provide greater governmental control over operations and increased revenues. Indeed, several concessions were ultimately expropriated by the concerned governments. Consequently, commentators began to speak of the end of the concession system as a contracting mechanism.

The term "concession" does not have a clear meaning in international law. To the extent that it is understood as necessarily involving the outright grant of exclusive exploration and production rights for a very extended period of time, with very small compensation to the host country, and without any control by the government over operations, the concession system is now dead. However, if an oil concession is more broadly defined as an exclusive grant of exploration and production rights in exchange for payments to the government based upon production, then concessions are in fact the most prevalent form of agreement in the world today.[12]

To avoid the negative connotation of the term "concession," these agreements are now referred to as licenses, tax/royalty arrangements, or modern concessions. They differ notably from the earliest concessions by covering much smaller areas (although these areas are still quite large by United States standards). They also require timely performance of specific exploration work and relinquishment of lands not proven by a discovery; provide much larger payments from production to the host country government; allowing the government some participation in exploration and development decisions; and often provide the national oil company a right to back-in for a direct ownership interest, usually a carried interest, after discovery.[13] Many variations exist with respect to the foregoing items, but the crux of these agreements still grant exclusive exploration and production rights against payments, in cash or in kind, based on success.

It is important not to minimize the enormous protections afforded host country governments in these agreements, all of which are vastly greater than in the original 1901 concession granted to Mr. D'Arcy. However, the fundamental commercial structure of these modern concessions—exploration and production rights granted against payments from production—remains just as it was in the Persian concession.

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11. KEITH BLINN ET AL., INTERNATIONAL PETROLEUM & EXPLOITATION AGREEMENTS 46-48 (1986).

12. BARROWS COMPANY INC., 1 WORLD PETROLEUM ARRANGEMENTS 1 (1995).

13. ZHIGUO GAO, INTERNATIONAL PETROLEUM CONTRACTS 52-57 (1994)(using Thailand's contracts as an illustrative example of these changes).

B. Production Sharing Contracts

The widespread reporting of the death of concessions was likely due to Indonesia's introduction in 1966 of the production sharing contract, a new form of host country agreement which quickly gained popularity in many countries throughout the world.[14] Production sharing contracts are now the second most common form of contracting arrangement in the world and are used in many of the most important producing countries.[15]

Production sharing contracts begin with a premise of equality between the host country as owner of the minerals and the company as the contractor responsible for operations. Such exploration and development occurs at the contractor's sole risk and expense (often subject to back-in rights held by the national oil company after discovery). As compensation for the contractor's efforts, the contractor is allowed to recover its costs from a specified percentage of total production ("cost oil"), while the remaining production ("profit oil") is divided between the contractor and the host country. Royalties are occasionally imposed under production sharing contracts as well, although it is difficult to find any theoretical justification for using both production sharing and royalties in the same agreement.

The amounts allocated to cost and profit oil under various production sharing contracts, even contracts granted by the same country, can vary tremendously based upon the prospectivity and anticipated difficulty of a given area. In addition, the share of profit oil attributable to each may sometimes be adjusted by the size of the reserves, the amount of production, or a cost recovery factor tied to the profitability measured against investment.[16] Cost recovery from cost oil can also be adjusted by ring fencing, a system whereby exploration and other costs may be recovered only from production in the related discovery area.[17]

C. Risk Service Contracts.

Introduced by Venezuela, and used mostly in South America, risk service contracts are commercially similar to production sharing contracts. However, they carry the underlying philosophical basis an important additional step. In a risk service agreement, the contractor acts as the provider of a service to the host country by exploring and developing that

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14. Gordon Barrows, *Production Sharing in Indonesia, 1966 to 1993: Evolution and Trends*, 11 OIL & GAS L. & TAX'N REV. 3 (1993); BLINN, *supra* note 11, at 69-81 (1986).

15. BARROWS COMPANY INC., 1 WORLD PETROLEUM ARRANGEMENTS 1 (1995).

16. BLINN, *supra* note 11, at 75-76.

17. GAO, *supra* note 13, at 78.

country's resources. In return, the contractor is authorized to receive as payment for its services a share of production that is often divided between production which may be used for recovery of costs and additional production which may be used for a reasonable profit.[18] The risk in risk service contracts is that the contractor must fund all exploration, but receives its fee only out of production actually obtained. If there is no production, there is no fee to the contractor and no reimbursement of incurred costs.[19] Risk service contracts are consequently very closely akin to production sharing contracts, but justify the production share due to the company on a wholly different philosophical basis.

IV. HOST COUNTRY TAXATION

The host country's revenue from petroleum production includes not only its royalties or share of production under the terms of the contract, but also the amounts that it receives through taxation. Such taxation may include income taxes, windfall taxes, or additional profit taxes. As with any evaluation of tax impact, the important question is the effective tax rate after consideration of the tax base, available deductions, credits, and other matters. These inquiries closely involve the lawyer in a detailed consideration of the host country's internal tax regime.

While income taxes may be the most readily apparent form of host country taxation, small exploration companies must also give careful attention to customs duties, withholding taxes, turnover and value added taxes, excise taxes, and other fees. Import duties, for example, may be imposed with crippling effect upon the full value of a drilling rig when that rig is brought into the country. Such duties, however, often may be avoided at the time of initial contract negotiation if production equipment ultimately will become the property of the government.[20] Even if this is not the case, by pointing to the host country's strong interest in having the newest, most technologically advanced, and most valuable equipment used in operations the duties may be avoided. The importance of export fees is amply demonstrated by the Russian Federation's unexpected imposition of export fees of between $4 and $5 per barrel. This move virtually eliminated the profit of many producing companies in that country, and continues to

18. Johnnie W. Hoffman, Jr., *The Service Contract as a Vehicle for International Petroleum Exploration and Production*, in INTERNATIONAL OIL, GAS, AND MINING DEVELOPMENT IN LATIN AMERICA 14-1 (ROCKY MTN. MIN. L. FDN. 1994). The company may also be paid in cash, frequently with an option to purchase production.

19. There are also pure service contracts, by which a host country or a national oil company retains a company to perform development or other services in exchange for payment. SMITH, *supra* note 6, at 371-73 (1993).

20. GAO, *supra* note 13, at 48.

concern both companies and lenders.[21] These tax impacts sometimes may be avoided or ameliorated at the time of initial contract negotiation, but they are much more difficult to change after contract execution. This is a matter of obvious importance to a small exploration company that hopes later to interest a larger company in participation in the contract area.

To protect against increased taxation following contract execution, it is quite common to include a stabilization clause in the contract fixing the income tax rate for the life of the contract. Such clauses prohibit increases in the effective tax rate prevailing at the time of contract execution and provide that any subsequent changes in the taxation level will be non-discriminatory, imposed by the host country equally upon all industries, or determined in consultation with the company, with a view to preserving the anticipated return on capital.[22] These are difficult negotiations, since the host country has a legitimate interest in preserving its sovereign powers, maintaining its flexibility in revenue generation, and avoiding the possibility that the company will later reap and expatriate enormous profits without comparable rewards to the host country.[23] Conversely, companies contemplating enormous development expenditures, including expenditures for equipment that likely will be transferred to the host country at the end of the contract term, require assurance that their expectations of economic return will be realized. Simply put, a company needs assurance that if the host country government later finds itself in a liquidity crisis, the company alone will not be asked to fund the shortfall.

Some exploration companies seek to obtain a temporary tax holiday or permanent exemption from income taxation, but this must be carefully weighed against other contract terms. United States companies are taxed upon worldwide income. Income taxes paid in other countries generally may be credited against income taxes due in the United States, subject to certain limitations which are designed principally to preserve the effectiveness of the alternative minimum tax and to ensure that credits are not used to shelter United States income.[24] Amounts paid to host countries which are not income taxes or which do not meet the stringent requirements

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21. *See Russia: Export Routes Need Expanding,* PETROLEUM ECONOMIST, Apr. 1996 at 51.

22. Samuel K. B. Asante, *Stability of Contractual Relations in the Transnational Investment Process,* 28 INT'L & COMP. L. Q. 401 (1979)

23. Gerald Padmore, *Constitutional Versus Contractual Commitments by Government* in INTERNATIONAL RESOURCES LAW II 5-1 (ROCKY MTN. MIN. L. FDN. 1995).

24. I.R.C. § 901(a) (1988). *See* Richard A. Westin, *Taxation of United States Corporations Involved in Overseas Natural Resources Operations,* in THE TAXATION OF MINERAL ENTERPRISES 352-367 (James M. Otto ed., 1995). Bilateral tax treaties may also help to avoid double taxation. *See* John E. Osborn, *Treaties and Other Bilateral Agreements for the Protection of International Development,* in INTERNATIONAL RESOURCES LAW: BLUEPRINT FOR MINERAL DEVELOPMENT 3-10 (ROCKY MTN. MIN. L. FDN. 1991).

for classification as a tax in lieu of an income tax may not be credited. Consequently, increasing royalties and other amounts in exchange for the elimination of host country income taxes often may be counterproductive. Similarly, sophisticated income tax negotiations strategies which turn upon securing rapid depreciation of capital investment and immediate expensing of exploration costs may prove too clever if the host country subsequently decides to create new taxes which are not based on income or profit.

V. CURRENCY AND EXCHANGE CONTROLS

After determining the share of production and production proceeds to which an exploration company is entitled under the contract, and the effect of income and other taxes, a company must ensure that its profits may be repatriated in a freely convertible form of currency. Many countries have historically enacted restrictive exchange and repatriation measures to assist in macroeconomic management, to avoid capital flight, and to encourage reinvestment. While the increasing globalization of the world's economy has substantially reduced these restrictions, they have not been entirely eliminated, especially in frontier areas.[25] Careful consideration consequently must be given to all aspects of the host country's foreign investment laws.

The clearest and easiest way of avoiding convertibility and repatriation risks lies in securing appropriate host country guarantees that oil and, if appropriate, natural gas may be freely exported to a country with convertible currency, great depth in foreign exchange and relatively transparent fiscal controls. Even then, such export arrangements may be foiled by host country requirements. For example, the host country may require foreign currency earnings first be repatriated to the host country and converted to domestic currency. The host country may impose export taxes, or contract provisions requiring that a share of production be sold into the local market for domestic use, sometimes at prices well below those available on the world market.[26]

Some countries still regulate the timing and extent of repatriation of capital investment, and different and more restrictive controls may apply in these and other countries to the repatriation of profits.[27] Foreign direct investment often must be registered with the host country government. Such registration occasionally guarantees or provides favorable treatment in respect of the ability subsequently to repatriate capital investment amounts, but often is required simply for statistical purposes. In addition,

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25. Blinn, *supra* note 11, at 168-176; PHILIP R. WOOD, COMPARATIVE FINANCIAL LAW 174-190 (1995).

26. Blinn, *supra* note 11, at 176-77.

27. ZOUHAIR A. KRONFOL, PROTECTION OF FOREIGN INVESTMENT 50-51 (1972).

repatriation of profits may be subject to additional taxes or may actually be limited to a specific percentage of profits or capital. Conversion of local currency also may be limited by law, both as to amount and as to the permissible site of such conversion, or simply by the availability of foreign currency. Even if currency convertibility is possible, it may occur at unfavorable rates.

Subject to compliance with International Monetary Fund policies,[28] the best protection lies in carefully drawn contract provisions by which matters of concern to the company are expressly guaranteed by the host country government. This is especially true where such host country guaranties are supported by the terms of a bilateral investment treaty between the United States and the host country.[29]

VI. CONTRACT NEGOTIATION

A. Government Take

The combination of a host country's share of production under the contract, whether as royalties, a share of profit oil, or the amount which remains after payment of fees under a risk service contract, together with income, windfall, additional profit, and other taxes, plus signature, discovery and production bonuses, is collectively referred to as "government take."[30] Without a complete analysis of both the contract terms and the effective tax rate, it is simply not possible to determine the attractiveness of a prospective opportunity. Several consulting services provide helpful reports describing the relative attractiveness of the fiscal regimes in various countries,[31] but the increasing competitiveness among countries seeking exploration and production investment requires specific consideration of applicable tax laws at the time each contract is negotiated.

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28. Section 2(b) of Article VIII of the Articles of Agreement of the International Monetary Fund, Dec. 17, 1945, 60 Stat. 1401, T.I.A.S. No. 1501 (1947), provides that exchange contracts entered into in violation of foreign exchange regulations are unenforceable.

29. Bilateral investment treaties, where they exist, provide substantial comfort not only in matters of foreign exchange, but also in respect of compensation for expropriation, dispute resolution, and waivers of sovereign immunity. *See* M. SORNARAJAH, THE INTERNATIONAL LAW ON FOREIGN INVESTMENT 225-76 (1994).

30. Carried participation by the national oil company may have a significant impact upon contractor take and consequently should be analyzed as a part of government take. D. Johnston, *Contractor/Government Take: Old Concept-New Terminology*, 14 OIL & GAS LAW & TAX'N REV. 143, 145-46 (1996).

31. Petroconsultants, S.A., for example, publishes the REVIEW OF FISCAL REGIMES, updated semi-annually; Barrows Company Inc. includes a World Fiscal Systems for Oil-Comparison of Favorability in its WORLD PETROLEUM ARRANGEMENTS (1995).

The expropriation and contract renegotiation experiences in South America and the Middle East remain so vivid that most commentators insist that negotiations be carefully conducted to ensure final contracts that will withstand subsequent political objection in the host country. This advice is underscored by the recent announcement by Ecuador that one of its modern risk service contracts is to be unilaterally terminated and replaced with a new joint action contract providing a greater return to the government.[32] Announcements of this type, whether they ultimately lead to contract termination or renegotiation, are chilling to companies contemplating foreign investment. Surely the best deal for an exploration company is a deal which will yield appropriate compensation to both the host country and the company itself and, most importantly, which will continue without unanticipated upheavals in contract terms.

Exploration companies who hope later to interest larger companies in purchasing their operations should remember that contracts are more easily renegotiated to provide a greater, rather than a lesser, government take. Although it is never possible to predict the final project size, cost and revenue if a discovery is made, it is clear that the mandatory contract terms concerning government take will define which discoveries will be commercially viable and which will not. Consequently, while there is every reason to encourage fairness in all negotiations, there is also very good reason not completely to lose sight of a certain measure of self interest and self protection. For example, the currently applicable terms in many important Colombian contracts afford the government such a large share of production after considering tax impacts that the commercial viability of even the largest fields is threatened.[33] Renegotiating these contracts to reduce the government take will involve obviously difficult, time consuming and politically charged discussions, and may ultimately prove impossible.

B. Foreign Corrupt Practices Act

Among the applicable United States laws new to domestic exploration companies is the Foreign Corrupt Practices Act [HEREINAFTER FCPA]. The FCPA is a simple piece of legislation whose brevity belies the great difficulty of its application. The law is structured in two parts, including various accounting procedures applicable to publicly traded companies,[34] and more fundamental anti-bribery requirements applicable

32. WALL ST. J., Aug. 22, 1996, at A2.
33. LATIN AMERICAN ENERGY ALERT, July 15, 1996.
34. 15 U.S.C. § 78dd-1 (1994).

to all United States companies and all natural persons who are citizens, nationals or residents of the United States.[35]

The anti-bribery provisions generally prohibit any person from directly or indirectly offering, giving or paying anything of value to any officer or employee of a foreign government for the purpose of corruptly influencing any act or decision by such foreign official or corruptly inducing such foreign official to use his influence to affect any decision or action of the government in order to obtain or retain business. The FCPA contains a specific exception for routine governmental action, as well as further exceptions in the nature of affirmative defenses. These exceptions include payments legal under the written laws or regulations of the host country, and reasonable and bona fide expenses associated with the promotion, demonstration or explanation of products and services and expenditures relating to the performance and execution of a contract with a host country government. Similar prohibitions and exceptions are applicable to contributions, gifts and payments to political parties and candidates.

The foregoing summary is neither comprehensive nor complete, but it does provide a reasonable initial outline of the FCPA's proscribed conduct.[36] The propriety of specific conduct turns upon careful consideration of the exact language of the full statute, which is slightly illuminated by a number of reported judicial decisions and a much smaller number of review procedure releases issued by the Department of Justice.[37] The statutory language is perhaps more fully illuminated by an internal moral sense. There are no regulations providing guidance under the anti-bribery provisions of the FCPA.

Like other legal regulations that arguably are grounded on a moral plane, the anti-bribery provisions regulate behavior which ranges in gradation from clearly illegal to clearly legal. There is no accessible bright line demarcation distinguishing permissible from impermissible conduct. The FCPA conveys an intuitive sense that the outright delivery of a cash payment to a government official in exchange for a contract award is wrong. Indeed, even in those jurisdictions where such payments are anecdotally reported as commonplace, it is impossible to locate written permission for such payments under local law. Thus, the affirmative defense accorded to written local law is largely illusory. This is true because

35. 15 U.S.C. § 77dd-2 (1994).

36. *See generally* DONALD R. CRUVER, COMPLYING WITH THE FOREIGN CORRUPT PRACTICES ACT (1994).

37. The judicial decisions are reported and the releases summarized in BUSINESS LAWS, INC., FOREIGN CORRUPT PRACTICES ACT REP., a three volume service which also provides useful articles and commentary relating to the Act.

most countries decry such payments on a public policy level, even if these payments are widely understood to occur on an everyday basis.

The FCPA also prohibits the use of an agent to effect a prohibited payment. By extension, a company's recognition of the high probability that a prohibited payment will be made to a foreign official. For example, an agent's request for an excessive fee for its services or explanation that an additional fee is necessary to complete all necessary arrangements often is an indication that such payment will be improperly applied and therefore unlawful.[38] A responsible company may avoid these problems by establishing through appropriate representations, warranties and covenants, its insistence that such improper payments not occur. Such a corporate policy may be made meaningful by continuing inquiry and vigilance.

The prohibition upon payments through an agent also extends to payments to an agent or other conduit for a foreign official. One common indication of this illegal purpose is an insistence that a contract will be awarded only if a specific entity, other than a recognized national oil company, is included as a local partner. Foreign investment laws sometimes require that a percentage of the license interest be owned by a domestic entity, but a demand that such interest be owned by a specific entity is a tip-off that the interest may be intended for a foreign official.

Importantly, the FCPA in no way prohibits the hiring of a local agent, even a local agent with great private influence upon the government.[39] The desirability of a particular local agent is entirely dependent upon that agent's knowledge of local procedures and his access to important decision makers. As the agent's level of knowledge and access increase, so too does the likelihood that the agent may be related a foreign official subject to the FCPA. There is, of course, no express prohibition upon retaining and paying a member of the official's family, so long as it is certain that amounts paid to him will not be channeled to the government official. The prohibition against payment to officials, however, certainly extends to officials with responsibilities outside the natural resources licensing area if they are retained to influence government action. The former is difficult to discern, and the latter difficult to uncover, except through express and well communicated representations and warranties.

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38. *See* 1 BUSINESS LAWS, INC., FOREIGN CORRUPT PRACTICES ACT REP. at 103.024, et seq. (1996)(list of red flags derived from Department of Justice and Securities and Exchange Commission releases).

39. Lucinda A. Low, *The Extraterritorial Reach of U.S. Laws to the Interests in Natural Resource Projects in Latin America*, in INTERNATIONAL OIL, GAS AND MINING DEVELOPMENT IN LATIN AMERICA 3-13 (ROCKY MTN. MIN. L. FDN. 1994).

The two exceptions that exist in the nature of affirmative defenses raise similar problems. Paying the expenses of a foreign official while on a due diligence trip to the United States to verify the company's operations on behalf of his country is, even if a modest per diem is paid for everyday expenses, quite appropriate under the reasonable and bona fide business expense defense.[40] As per diem expense reimbursement, type of lodging, and entertainment quality escalates, however, the company may be caught between the foreign official's insistence that such treatment is commensurate with his status and a quite natural hesitation that the resulting extravagance is exceeding reasonable reimbursement. In such circumstances, the amounts ordinarily afforded as similar expense reimbursement by a company to its employees and outside contractors may provide a guide.

In those cultures where gift giving is an important social practice, written local law may expressly authorize the relatively low monetary value gifts which are employed on these occasions. Even without specific written authorization, comfort may be obtained from the commonplace nature of the exchange, since the FCPA bars only transfers which are made with a corrupt intent or purpose. Although the FCPA has no threshold amounts (it covers anything of value), the same logic covering de minimis gifts in United States corporate practice should apply with equal force internationally since gift exchanges which are culturally routinized are not done with any corrupt intent, but rather to conform with local custom.[41]

Finally, the FCPA precludes transfers to foreign officials, not governments. In certain cases, a governmental agency will request computers, fax machines, vehicles, or technical training in the course of its relationship with an exploration company. In dealing with such requests, the important thing is truly to believe that the item will be received and retained by the government, and not diverted for personal use. Transfers made to the government itself before contract execution are not materially different from a signature bonus paid to the government upon contract execution.

The foregoing discussion provides only general guidance, since the law itself has so few clear demarcations between legal and illegal conduct. Like so many other elements of international practice, the FCPA is not within the normal scope of a domestic oil and gas lawyer's practice and requires a certain amount of study and understanding before the question arises.

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40. FCPA Review Procedure Release 85-1 (July 16, 1985); FCPA Review Procedure Release 83-2 (July 26, 1983); FCPA Review Procedure Release 83-3 (July 26, 1983).

41. Barry A. Sanders, *Foreign Corrupt Practices Act-Antibribery Provision*, in 1B THE LAW OF TRANSNATIONAL BUSINESS TRANSACTIONS §18.04[1][a][i] (Ved P. Nanda, ed. 1996).

VII. DISPUTE RESOLUTION

Many United States exploration companies fear having contract disputes judicially resolved in the host country. These fears stem from concerns that the judicial and executive functions are not sufficiently separated in the host country or that the local courts may be unduly influenced by the government. Indeed, even if there is a clear separation of powers and a truly independent judiciary, the potential impact of a decision adverse to the host country may be so devastating to the national economy as to create an impression of possible bias against the exploration company. There are also concerns over publicity, due process, the absence of knowledge of other countries' local judicial procedures, and an inherent uncertainty as to the possible future direction of the local judicial system. Finally, whatever the source of concern, there is something to be said for making dispute resolution equally inconvenient, uncertain, and expensive for all of the parties concerned. This not only creates a level playing field, but also creates a strong incentive amicably to resolve differences. This often can best be accomplished by selecting arbitration in a distant, neutral jurisdiction.

Host country governments prefer dispute resolution through their own courts for reasons of public policy and national pride. Even so, arbitration in a neutral country is increasingly accepted as a compromise means of formal dispute resolution. In South America, for example, the historical impact of the Calvo Doctrine, while certainly not dead, appears to be receding as more and more South American countries are willing to participate in foreign arbitration.[42] Certainly, no country lightly undertakes a decision to have matters pertaining to its natural resources decided in a final and binding fashion by outsiders, but most countries do understand the hesitation of exploration companies to subject themselves to local courts in matters of contract interpretation. With appropriate assurances of fundamental fairness, neutrality and impartiality, many more countries are

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42. The Calvo Doctrine, formulated by Carlos Calvo in the nineteenth century, provides that foreign nationals doing business in a country should be treated in the same fashion as the citizens of that country, and consequently that disputes should be resolved locally and without foreign involvement. The wide acceptance of this doctrine in Latin America required the use of local courts, or sometimes local arbitration, for more than a century, and continues in some countries to this day. *See* Horacio A. Grigera Naon, *Arbitration in Latin America: Overcoming Traditional Hostility*, 5 ARB. INT'L. 137 (1989). In countries where the doctrine lingers, like Bolivia, it may be possible to use neutral arbitration within the host country itself. *See* R. Blain Andrus, *The Use of Arbitration Provisions in Latin American Agreements*, 12 OIL & GAS L. & TAX'N REV. 139, 141 (1994).

now agreeing to include arbitration clauses in their exploration and production contracts.

The increasing emphasis in the United States on alternative dispute resolution has made more domestic oil and gas lawyers aware of the nature and structure of arbitration clauses than was true just a few years ago. Nonetheless, international dispute resolution has some very important differences from the arbitration procedures generally used in a domestic context.

A. Sovereign Immunity

The historical right of a sovereign state to be immune to proceedings or execution against it arises under principles of comity, by which countries refuse to permit their courts to entertain actions against foreign governments. While these principles of comity would not appear to bar arbitration proceedings, the better practice is to include a specific waiver of sovereign immunity in connection with arbitration proceedings, as well as judicial efforts to enforce any arbitration award.

In the absence of an express contractual waiver, two theories are often advanced to establish a government's waiver of its immunity: first, that the inclusion of an explicit arbitration clause in a contract negotiated and executed by a government reflects such government's consent to both the concerned arbitration and, by extension, enforcement of a resulting award;[43] and second, that sovereign immunity generally is not applicable under the increasingly more common restrictive view of immunity, by which proceedings or execution against sovereign states are prohibited only where the activity is of a governmental, rather than a commercial, nature.[44] In addition to these theories, the United States is a party to many bilateral investment treaties with specific countries which recognize arbitration as a proper dispute resolution mechanism and which expressly waive assertion of sovereign immunity defense.[45] The U.S. is also party to the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards,[46] by which ratifying countries may be found impliedly to have waived sovereign immunity as a defense to enforcement.

Since explicit waivers of sovereign immunity are universally recognized, it seems a needless risk to rely upon implied waivers when the

43. PAUL H. VISHNY, 2 GUIDE TO INTERNATIONAL COMMERCIAL LAW §12.06 (1995).

44. ESA PAASIVIRTA, PARTICIPATION OF STATES IN INTERNATIONAL CONTRACTS at 182-191 (1990) (considering the special problems associated with the concept of permanent sovereignty over natural resources).

45. *See* Sornarajah, *supra* note 29, at 225-76.

46. *Done* June 10, 1958, 21 U.S.T. 2517.

entire risk of a sovereign immunity defense may be extirpated by a few sentences.[47] The validity of such waiver must, of course, be checked against applicable local law. In the rare case where the waiver is contrary to law, it should be approved by necessary legislative or other governmental action.[48] Ensuring that the persons or entities executing the contract have the power to bind the host country to the waiver may require appropriate inquiry at the very highest levels of the government.

B. Applicable Treaties

There are a variety of treaties and other international agreements which may bear upon the use of international arbitration. This is true not only in connection with sovereign immunity defenses, but also in connection with the availability of various arbitration procedures and judicial enforcement of resulting awards. These treaties include bilateral investment treaties between the United States and the concerned host country,[49] the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards ("New York Convention"),[50] the Inter-American Convention on International Commercial Arbitration ("Panama Convention"),[51] and the Convention on the Settlement of Investment Disputes Between States and Nationals of Other States "World Bank Convention".[52] The World Bank Convention established the International Centre for the Settlement of Investment Disputes ("ICSID") for conciliation of arbitration of disputes between foreign investors and governments or government entities.

C. Arbitration Procedures

After reviewing applicable treaties and determining that sovereign immunity has been waived by express or implied consent, the issue of

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47. Georges Rene Delaume, *Contractual Waivers of Sovereign Immunity: Some Practical Considerations*, 5 ICSID REV. 232 (1990).

48. There is substantial authority for disregarding technical objections concerning compliance with local law procedures if the contracting party was led to believe that the waiver would be effective by the host country. *See* KLAUS PETER BERTER, INTERNATIONAL ECONOMIC ARBITRATION 185-87 (1993).

49. Gudgeon, *Arbitration Provisions of U.S. Bilateral Investment Treaties*, in INTERNATIONAL INVESTMENT DISPUTES: AVOIDANCE AND SETTLEMENT 41 (Seymour J. Rubin & Richard W. Nelson, eds., 1985).

50. *Done* June 10, 1958, 21 U.S.T. 2517.

51. *Done* Jan. 30, 1975, 104 Stat. 448 (1990).

52. *Opened for signature* Aug. 27, 1965, 17 U.S.T. 1270; *see generally* MOSHE HIRSCH, THE ARBITRATION MECHANISM OF THE INTERNATIONAL CENTRE FOR THE SETTLEMENT OF INVESTMENT DISPUTES (1993).

specific dispute resolution procedures becomes paramount. In this regard, the first issue is determining whether to employ ad hoc or institutional arbitration.[53] This unfamiliar concept relates to the use of rules adopted by an international arbitration organization, usually the UNCITRAL Arbitration Rules,[54] but with administrative procedures handled by the parties themselves (ad hoc arbitration) or by the use of an international organization's arbitration rules, together with its full appointment, support, and interpretative facilities (institutional arbitration). All such institutions, including ICSID, the American Arbitration Association, the International Chamber of Commerce, and others have published clauses that they believe appropriate in conferring jurisdiction. The most difficult decision faced by a United States exploration company is balancing the high costs associated with institutional arbitration against the greater complexities and uncertainties associated with ad hoc arbitration. Ad hoc arbitration can be equally effective and much less expensive than institutional arbitration, but there are many more drafting traps for the unwary in arranging ad hoc arbitration. For example, it is vitally important that ad hoc arbitration clauses specifically identify an appointing authority like the International Chamber of Commerce or London Court of International Arbitration, which can formally appoint the arbitrations and resolve challenges to proposed arbitrators.

Use of a recommended submission clause does not end a lawyer's responsibility, since several more aspects must also be considered. For example, many companies will decide their preference for arbitration based upon the perceived confidentiality of arbitration procedures, even though there is nothing in any of the recommended submission clauses requiring confidentiality. If confidentiality is important, it must be explicitly added to the concerned contract. Specific provision as to the location of the arbitration proceedings is also important, both to ensure that the arbitration is held in a country which is a party to the New York Convention or has a similar agreement allowing enforcement of the award and to ensure that the country has an arbitration law which minimizes the possibility of judicial interference with the arbitration proceedings. Explicit language is often included in international agreements prohibiting judicial review of the arbitral award in all or only very narrow circumstances. However, such provisions are useless if the parties have selected a country that does not recognize such clauses as the situs of their arbitration.

53. William K. Slate, II, *International Arbitration: Do Institutions Make a Difference*, 31 WAKE FOREST L. REV. 41 (1996).

54. 31 U.N. GAOR SUPP. (No. 17) at 35, U.N. Doc. A/31/17 (1976); *see generally* ISAAK I DORE, THE UNCRITICAL FRAMEWORK FOR ARBITRATION IN CONTEMPORARY PERSPECTIVE (1993).

Finally, consideration is often given to procedures relating to language, expense of the arbitration, number of arbitrators, pre-hearing discovery, and, perhaps most importantly, governing law.

D. Governing Law

Whether disputes are resolved judicially or through arbitration, one critical concern is the applicable substantive law. The use of local law is sometimes required by host country law and cannot be changed by negotiation. If the governing law may be changed, many exploration companies seek to do so because of the perceived bias in favor of the host country government or the relative thinness of the law concerning petroleum exploration and production issues. Where possible, companies may attempt to avoid these concerns by using the law of another country with greater experience in oil and gas issues or by internationalizing the agreements through use of applicable laws widely used in petroleum producing countries. Both approaches are helpful, but both may suffer substantial drawbacks.

Many domestic oil and gas lawyers are aware of the United States principle of conflict of laws that governing laws may not be selected which have no relation to the parties or the concerned transaction. Oklahoma law, for example, may not easily be selected to govern the relationship of Texas and Colorado companies drilling for oil and gas in New Mexico. The rules governing the choice of law in international agreements are much more forgiving on this point, allowing the selection of an unrelated third country's laws to govern the parties' relationship in situations where the host country has little experience adjudicating such issues. These choice of law rules require that there be a reasonable basis for the selection of the concerned law, most commonly where the country whose law is chosen has a substantial relationship with the parties or transaction, but may also be encountered where a party is "contracting in countries whose legal systems are strange to them as well as relatively immature."[55] Nonetheless, a selected governing law may still be avoided if it contravenes an important public policy of the host country.[56] Selecting the law of a third country as the governing law is relatively easy where arbitration, rather than litigation, is employed in a litigation setting.[57]

In situations where host country law need not be used as the governing law and where the parties cannot reach agreement on another

55. Restatement (Second) of Conflict of Laws §187, Comment f (1971).

56. Restatement (Second) of Conflict of Laws §187(b) (1971).

57. Note, *General Principles of Law in International Commercial Arbitration*, 101 HARV. L. REV. 1816, 1817-18 (1988).

country's laws, it may be possible to internationalize the contract by agreeing to apply applicable laws widely used in petroleum producing countries.[58] Such provisions are not without drawbacks, since they consider not only laws used in developed countries, but also the laws of many developing countries. Moreover, the practical effect of sorting through these laws and determining which provisions are commonly shared or widely applicable is an obviously difficult and expensive task requiring substantial expert assistance.

VIII. CONCLUSION

It appears certain, given the potential rewards associated with the vast unexplored areas of the world, that the future course of oil and gas activity for smaller exploration companies will increasingly be directed overseas. As a necessary corollary, the future course of oil and gas law will increasingly involve international oil and gas law which, paradoxically, is neither oil and gas law as most practitioners now know it nor as most law schools now teach it.

This article merely scratches the surface of the complex interplay among United States, foreign and international law, omitting some important topics, such as the impact of United States antitrust and export control laws and of local training, employment and technology transfer laws, while addressing other topics only briefly. Even this brief introduction to international oil and gas practice amply demonstrates, however, the need for broadening our understanding of the nature and scope of oil and gas law. Happily, the long experience of major international companies provides a rich source of knowledge that is accessible through available publications. The transmission of that experience and knowledge to a new generation of practitioners and students will be an increasingly important task in the coming years.

58. Stephen Hancock, *Dispute Resolution in International Investment Agreements*, 8 OIL & GAS L. & TAX'N REV. 399, 402-04 (1990).