Non-fiscal Clauses in Host Government Contracts that are Disincentives to Investment – Can the Value Loss be Quantified?

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Agenda

- ***Overview of Data Base***
- ***State Participation***
- ***Performance Bonds, Parent Company Guarantees, Penalties***
- ***Local Content***
- ***Natural Gas Rights***
- ***Stabilisation***
- ***Assignment and Change of Control***
- ***Renewals and Extensions***
- ***Abandonment***
- ***Governance***
- ***Cost Recovery and Tax Deductibility***

Overview of Database

- ***Concentrate on Top 50 Oil Producers***
  - ***54 in total (duplicates in Brazil, Mexico, Pakistan, Trinidad)***
  - ***28 (52%) Production Sharing Contracts***
  - ***22 (41%) licences/leases/concessions/contracts with royalty/tax***
    - ***41 (76%) "contractual" royalty/tax or PSC***
  - ***4 (7%) Risk Service Contracts***
- ***Southeast Asia***
  - ***Brunei (42) Block L PSA***
  - ***Indonesia (21) 1992 Model PSC***
  - ***Malaysia (26) 1998 Model R/C PSC***
  - ***Thailand (30) Thai III Concession***
  - ***Vietnam (32) 2005 Model PSC***
    - ***Thai PSCs and Indonesian Gross Revenue PSCs not yet included***
- ***PSCs still dominate if expand to Asia-Pacific***
  - ***Australia (31), China (5), India (22), Pakistan (47)***
  - ***Only Southeast Asia for this presentation***

State Participation

- ***State Take v Country Take***
  - ***Confusing and why?***
- ***Two significant Value Impacts***
  - ***Risk Capacity – break-even chance of success***
  - ***Risk Aversion – dominated by PVf*(1-Ps)***
- ***Globally 23/50 (46%) of which in 18/50 (36%) State is carried***
  - ***18 through sanction, 6 through production, 4 throughout***
  - ***Range 5% to 51% WI, median 20%***
- ***Southeast Asia fairly benign***
  - ***Brunei 15%***
  - ***Indonesia 10%***
  - ***Malaysia 15-30%***
  - ***Thailand 0%-15%***
  - ***Vietnam 7%***
- ***Why not more pushback?***

Performance Bonds, Parent Company Guarantees, Penalties

- ***Minimum Work Programme Definition (92% have MWP)***
  - ***Work or Work & Estimated Cost (77%)***
  - ***Work Units (10%)***
  - ***Cash Only (4%)***
- ***Surety***
  - ***None (39%)***
  - ***PCG (14%)***
  - ***Bank LOC (23%)***
  - ***PCG or Bank LOC (11%)***
  - ***PCG and Bank LOC (14%)***
- ***Penalty***
  - ***Cost of Work not carried out (43%, including 30% drawable on LOC)***
  - ***Liquidated damages which may be lower (23%)***
  - ***Contract termination (6%)***
  - ***Not prescribed (28%)***

Local Content

- ***Not new (1949 Getty Saudi Concession)***
- ***Usually benign***
  - ***"Contractor shall make priority use of suitable services, goods and materials from Vietnamese companies in the conduct of Petroleum Operations provided they are competitive in terms of price, quality, delivery time and availability" (globally typical)***
- ***Rarely extremely onerous with high specific quotas***
  - ***Brazil, Mexico***

Natural Gas Rights

- ***Different approaches to fiscal terms***
  - ***No rights (2% - Angola)***
  - ***Defined – same as liquids (30%)***
  - ***Defined – different from liquids (48%)***
  - ***To be determined (20%)***
- ***But what about the price?***
- ***Where is the midstream/downstream?***
  - ***Inside the ring fence – Indonesia***
  - ***Outside the ring fence – Australasia***
- ***Southeast Asia is mature, sophisticated***
  - ***Same terms – Thailand***
  - ***Different terms – Brunei, Indonesia, Malaysia, Vietnam***

Stabilisation

- ***Different approaches, some duplication, exclusively contractual***
  - ***None (9/37)***
  - ***Tax paid (12/37)***
  - ***Freezing (10/37)***
  - ***Equilibrium (22/37)***
  - ***Force of Law (4/37)***
- ***Problems with equilibrium clauses***
- ***Progressive v regressive terms***
- ***Why is stabilisation not highly valued, or lack of stabilization not a significant value reducer?***
- ***Check the precise wording; dispute resolution has hung on meaning of individual words***

Assignment and Change of Control

- ***Wording of assignment clause***
- ***Tax consequences***
- ***Host government leverage***
- ***Host government ROFR or pre-emptive right***
- ***Southeast Asia practice***
  - ***Indonesia – Pertamina & Govt Approval, not to be unreasonably withheld***
  - ***Malaysia – Petronas approval***
  - ***Thailand – Minister's approval only to technically competent company***
  - ***Vietnam – subject to Petrovietnam pre-emptive right and tax on any profit***
  - ***Brunei – subject to PetroleumBrunei's approval with reason if not; if change of control unacceptable, right to purchase at FMV***

Renewals and Extensions

- ***Three approaches***
  - ***Explicit or implied continuance of contract terms (50%)***
  - ***Explicit or implied renegotiated terms (25%)***
  - ***Language lacking, i.e. silent on renewals/extensions (25%)***
- ***Incentive to offer renewals to encourage late-life investment***
- ***Often in state's interest even if language lacking***
  - ***Indonesia ONWJ (twice) with new terms***

Abandonment

- ***Not addressed (34%) particularly in older HGIs***
- ***Whose liability since state or NOC owns facilities?***
- ***Cost recoverable or tax deductible provision***
  - ***CC UOP most common but not ubiquitous***
- ***Actual deposits into escrow account now usually required***
- ***Present Value impact significantly different with and without provisions, with and without escrow account***

Governance (PSCs)

- ***Management Clauses – NOC retains responsibility – one or more of***
  - ***Express language (as in Indonesia)***
  - ***E&P rights (HGI) held by NOC***
  - ***Management Committee of State/NOC and Contractor***
  - ***State/NOC approval of development plans and annual WP&Bs***
- ***Management Committees in 23/28 (notably not Indonesia)***
- ***Unanimity required in 20/23 (notably Brunei forum for discussion not decision making)***
- ***Surprisingly, lack of agreement is not often contemplated***
  - ***Sometimes expert determination (even for strategic questions!)***
  - ***Arbitration is the "nuclear option"***

Governance Issues

- ***Consequences of failure to agree in MC***
- ***Status of approved Development Plan***
- ***Status of approved WP&B***
- ***Treatment of cost increases (over-runs/changes in scope)***
- ***Audit rights and resolution process for exceptions***
- ***Scope of Cost Recovery (e.g. financing costs)***
- ***Contractor compliance***

Checklist for HGI Negotiations and Transaction Due Diligence

- *State Participation*
- *Performance Bonds, Parent Company Guarantees, Penalties*
- *Local Content*
- *Natural Gas Rights*
- *Stabilisation*
- *Assignment and Change of Control*
- *Renewals and Extensions*
- *Abandonment*
- *Governance*
- *Cost Recovery and Tax Deductibility*
- *Compliance (for ongoing operations)*