



International law expert **Colin Roberts** continues his series of articles on the legal aspects of mining in foreign lands

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Resource regulatory systems

Any resource regulatory system is based either on licences directly obtained from a government or on contracts for work to be entered into with a designated state enterprise.

The licence or concession system is applied and practised in industrialised countries, whereas the system of work contracts is exclusively used in developing countries.

The adoption by developing countries of work contracts in lieu of licences has made it possible for foreign direct investors to become involved and engaged in petroleum and mining operations in those countries.

Licence or Concession Contracts

The most common form of agreement for ongoing exploration and development rights is the concession. This was the principal instrument for leasing acreage through the mid-1950s.

In the concession-type of agreement the host government assigns the right to the resource company to explore and develop surface defined areas for petroleum or mineral resources in return for a share of the proceeds (royalty) and taxes. The resource companies compete for concession rights in a number of ways, including bonus (front end payment), royalties and tax arrangements. The reliance placed on a given approach to granting the award varies among countries.

Originally a concession area might include a whole country or province. Since the latter part of the 1950s host countries reduced these rights from the original very large areas to blocks of much smaller size. Agreements of this type were in effect in some 120 countries. Most countries in Europe and America still utilise the concession methods, including the US, Canada, Norway, the Netherlands, West Germany, Trinidad and the UK. The individual concession areas are limited in size, averaging perhaps, in the case of petroleum, 2,000ha to thousands of square kilometres each. Companies may be permitted to as many areas as they wish to obligate themselves to undertake.

In the concession-type agreement, the foreign direct investor has a simple equity interest in the project. Such agreement stipulates that the Domestic or Foreign Direct Investor will pay all of the exploration, development and operating expenses. The investor also pays royalties on the value of the production, and income taxes on net earnings. The royalties taken from gross revenue (or production) are commonly within the range of zero to 20%, although Canada's province of Alberta has extracted royalties as high as 43%. The royalty arrangement forms a floor under the government's take. Royalties can usually be taken in cash or kind (oil or minerals) at the

host government's option.

Under the terms of a petroleum licence the licensee becomes the owner of the petroleum at the moment the petroleum flows into the well – i.e. at the moment the petroleum is "Caught" by the licensee, in accordance with the ancient "rule of capture".

A licence is not only a simple transfer of title to petroleum. The elaborate conditions and the list of rights and obligations lend a strong contractual aspect of the transfer and thus to the licence. It should be added that under some legislations a contract has to be approved by the body of people's representatives and thereby achieves the status of a formal law.

Production Sharing Contracts/Agreements (PSC/PSA)

In a PSC agreement, the investor becomes a contractor. PSC agreements normally provide that the costs and risks through development for production are to be borne by the contractor and recovered from a negotiated fraction of production. The remaining production is shared, or divided according to an agreed formula, and income taxes are levied on the contracting company's profits.

As in a concession contract, the company is granted the right to explore for oil, gas or minerals and develop any commercial discoveries. Unlike the basic type of concession agreement, however, the production is split between the host government, usually through its national resource company (NOC or NMC), and the contractor.

Using petroleum as an example, this shared fraction of production from the project is designated as "profit oil". The profit oil is the residual of the production after first reimbursing the contractor for his operating costs, carried portion of the host government's obligations, operators capital investment, allowed exploration expenditures, interest and other allowances not previously covered from what is termed "cost oil".

Some of the items chargeable to cost oil have agreed annual maximums, with the surplus carried forward to the next year. In the author's experience, the definition and quantum of cost recovery has been a major dispute area.

Under the terms of a work contract, the contractor is compensated for his efforts in cash or kind (oil or minerals). If being compensated in kind, part of the production is delivered to the contractor at an agreed point of delivery, usually the point of export. At such, the contractor becomes the owner of the resource, similarly as any other buyer of the resource would become an owner of that resource. Up to that point the ownership of the

resource rests either with the State or, after being caught in the borehole or mined, with the state enterprise concerned in its capacity as the only authorised petroleum or mineral agency.

It is this difference in allocating ownership that persuaded developing countries not to grant licences to Western oil or mining companies but instead to engage such companies as contractors on the basis of a contract for work.

The work contract originated in the colonial past of Indonesia and has been applied in that country since 1996. Outside Indonesia the work contract in the form of a production-sharing contract (PSC) was adopted in Peru (1971), in Libya, Egypt, Syria (1974) and in Malaysia (1976). Nowadays any developing country, in which petroleum operations are started, will apply a work contract in the form of some type of production sharing contract, except if resource operations are confined to special development work.

The manner in which the production is shared between the State and the parties and amongst the parties themselves depends on the type of contract. However, within the same type of contract the actual sharing, as far as absolute numbers and percentage figures are concerned, will also differ between particular contracts, depending on the individual circumstances of the contract. This is subject to negotiation.

Again using petroleum as an example, with only a few exceptions the production is divided into three unequal portions:

- The first portion is destined for the State and is referred to as a **Royalty Petroleum**.
- The second portion is called **Cost Recovery Petroleum** or **Cost Petroleum** and is assigned to the contractor for the purpose of the reimbursement or recovery of the costs incurred by him. The procedure of the cost recovery (which costs may be recovered and in which manner) is spelt out in the contract.

- The third portion is referred to as **Remaining or Profit Petroleum** and is shared in certain proportions between the contractor and the state enterprise. It will be clear that there is only one portion of production that is being shared. It is the sharing of this portion that lends its name to the contracts.

The three portions of the sharing of the profit petroleum are expressed as percentages of the volumes concerned.

In the next issue, we will discuss Legislation and the different types of Fiscal Systems, their functions and effects.