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THE ROLE OF HOST GOVERNMENTS IN INTERNATIONAL PETROLEUM OPERATIONS

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INTRODUCTION

The international oil industry is the scene of some of the most important economic conflict in the world. Goals sought by the nations and the companies that are involved vary widely. Those nations that are net fuel importers seek low-priced supplies. Conversely, the nations that are net exporters want to maximize income from their natural resources. Oil companies, both public and private, seek to implement either impartial commercial decisions or the aims of their national government or an amalgamation of the two.

Petroleum exports are a key source of foreign exchange and government income for the major oil-exporting states. For those countries that are economically underdeveloped, the importance of this revenue is magnified. Consequently, these nations have begun to seek an expanded role in the operation of their domestic oil industry.

The host governments have begun to enhance the role of the producer state through new agreements with both the established international majors and with smaller companies. State-sponsored oil companies have been formed in the host nations, and these have begun to work both independently and with the foreign oil firms. Efforts have met with certain successes, and one may expect that the host governments will make future attempts to improve their position.

The rapid increase in activity by the host governments of the major developing, oil-exporting nations makes an evaluation of their present and potential economic role timely. This paper will touch upon avenues of host government participation, and will suggest some forms for such participation.

NEW ADVANTAGES FOR HOST GOVERNMENTS

The period since the establishment of the "fifty-fifty" profit-sharing agreements has seen the formation of a new series of oil exploration and production agreements that offer the producer governments a larger share of the profits and management of the oil industry.

The more prominent new advantages include the following:

1. The government receives a larger share of the gross production profits through an increased rate of taxation.
2. The government receives a carried interest in the enterprise, such that the government does not bear a risk during the exploration stage, but is entitled to a partnership participation if the venture succeeds in discovering commercially recoverable quantities of crude oil.

References at end of paper.

3. The government receives the right to purchase a predetermined share of the venture at a predefined price after the discovery of commercial amounts of oil.
4. The government receives some share of the vertically integrated profits.
5. The host country enjoys substantial representation on any executive committees.
6. Portions of the concession are relinquished at preset periodic intervals.
7. Newer agreements are of shorter duration than the older concessions.
8. The concessionaire is obligated to give preference to national flag vessels of the host government when chartering tankers.
9. The concessionaire is obligated to construct local refining capacity.

Although not all of these features are incorporated in any one agreement, the host nations have a spectrum of alternatives open to them. Most commonly, in melding the foregoing changes into new agreements, the host government has formed a state oil company to act as a vehicle for government entry.

ALTERNATIVE ROLES OF STATE OIL COMPANIES

There are several basic reasons for establishing a national oil company. Of some importance is the political decision to create a prestige symbol. A corporation with such a purpose rarely enjoys economic success, although some political elements are in the backgrounds of all state oil companies.

Four levels of achievement may be reached by a government-owned oil company. These are, in order of increasing complexity:

1. government negotiating device
2. domestic marketing agent
3. domestic crude oil producer
4. partially or fully integrated company

All state oil companies are levers during negotiations with outside oil companies. Even those state oil companies that are inoperative prestige devices may threaten independent action in oil affairs.

A more common role for a state oil company is that of domestic marketing agent. Petroleum products are often obtained at cost from the concessionaire in the producing country. Government-controlled marketing conserves foreign exchange by keeping profits from domestic petroleum sales within the nation. When gasoline and other products are sold at state-decreed, depressed prices, the foreign oil companies do not resist the loss of marketing responsibilities.

Refining of state-produced oil or royalty oil taken in kind is a possible next step for the state oil company. Petroleum products obtained from these refining operations may be sold through the state marketing agency.

Crude oil production requires ample proven reserves. The costs involved in establishing separate state-owned oil production makes this a significant step toward maturity by any host government oil company.

State oil companies that achieve partial or complete integration at home may extend operations abroad. Partial ownership of an overseas refinery or controlling interest in flag tankers are two methods of operating beyond national boundaries.

RANGE OF STATE OIL COMPANY OPERATIONS

State oil companies have been established by most leading oil-exporting countries. Objectives and activities of these firms vary, as does the degree of organization and the capital provided by the central government. State involvement in oil operations is not a function of overall oil output.

In Venezuela, Corporacion Venezolano del Petroleo [CVP] was created in 1960 to handle further development of petroleum reserves outside of current concessions. This situation has arisen from government refusal to grant new concessions to foreign oil companies. CVP is presently responsible for supplying a portion of Venezuelan markets, and produced 1.2 million barrels of crude oil in 1963.[14]

In Indonesia, there are three separate state oil companies. Each has its own market area, which is shared with international majors. Under a 1960 law, the framework of the Indonesian oil industry was altered, and the foreign oil companies became contractors as the concession agreements were replaced. According to contract, production is shared between the foreign company and the state firm. Recent contracts have also been signed with several smaller foreign oil operators from North America and Japan.[10]

Within the Middle East, the four leading oil-exporting countries are, in order, Kuwait, Saudi Arabia, Iran and Iraq. These states have quite dissimilar national oil enterprises.

The Iraqi state oil company is merely in the planning stages. A law has been passed, setting up the Iraq National Oil Co. [INOC]. Specific investment objectives for the company have not yet been announced and its future is unclear.[5]

The Saudi Arabian state oil company, known as the General Petroleum and Minerals Organization, is an internal marketing agency. It is emerging from the planning stage.[11] Neither Iraq or Saudi Arabia has yet emphasized state oil efforts, and their state oil companies are of only passing interest.

The Kuwait National Petroleum Co. is operative. It has total control of internal marketing. KNPC has a five per cent interest in a refinery being completed in Southern Rhodesia. It may purchase twenty per cent of the venture that is now exploring offshore Kuwait, and it expected to receive the concession rights to over one-half of the nation.

KNPC has firm plans for a domestic refinery and may in time become much more active since surplus Kuwaiti investment capital gives it the potential for considerable expansion.[12] It should be noted that 40 per cent of KNPC is held by Kuwaiti private citizens. This is unique among state oil companies.

The Iranian state oil company is well developed, with broad powers. National Iranian Oil Co. [NIOC] is the most advanced of all such organizations in the developing, producer nations. It is the sole domestic marketer and has made major investments to expand its production, transportation and treatment of crude oil and natural gas on behalf of the Iranian government. Additionally, NIOC has made several partnerships with international oil companies. Consideration of its operations may show paths for future work by other state oil companies.

THE IRANIAN PETROLEUM LAW OF 1957

Prior to the 1951 nationalization, the Iranian petroleum industry was operated by the Anglo-Iranian Oil Co. [AIOC], with majority control of AIOC held by the British government. In the consortium of international oil companies that followed, this share was reduced to 40 per cent.

Besides lowering the concentration of British control, Iran sought state participation in new petroleum developments. Legislation passed in July, 1957 allows Iran to act in the development of its own oil without hindrance to foreign capital and technical skills. The Petroleum Law of 1957 provides for various arrangements under which the National Iranian Oil Co., which is wholly state-owned, may be a partner in the development of Iranian oil with either foreign groups or non-government Iranian interests. NIOC may also operate separately it if so chooses.[4]

PROVISIONS OF THE IRANIAN PETROLEUM LAW

The basic purpose of the Petroleum Law is to provide a framework for Iranian state operation in the oil industry. National interests are represented by NIOC, which is an administrative body able to negotiate concession terms with its partners or with other operators. In cases where NIOC is a minority partner or has no operating participation, it can negotiate the cash bonus and the rental payments. In partnerships, NIOC may waive rental payments if the partner pays all or part of the agreed exploration expenses within a set period of time or until oil is found in commercial quantities.

Areas controlled by the consortium are exempt from the Petroleum Law. In all cases covered by the Law, the operation is subject to the conventional "fifty-fifty" division of profits with the Iranian government. For purposes of taxation, posted prices are assumed to be equivalent to realized prices.

Rights may only be granted to nationals of those states which would permit Iranians to engage in similar activities. Such reciprocity is not uncommon, but it is interesting in this case as it bars Soviet entry.

NIOC may make three general types of concession agreements. These are: a] NIOC participation of 50 per cent or more, b] NIOC participation of from 30 to 50 per cent and c] operations independent of NIOC. The duration in all cases is 25 years from the date of the beginning of commercial oil production, to be calculated separately for each producing area. The agreement may be renewed for not more than three additional terms of five years each. When NIOC is a partner, the terms of the agreement provide more acreage and less strict drilling obligations.

NIOC may divide the national territory into districts of not more than 80,000 square kilometers each. These areas are selectively opened for oil operations. However, at least one-third of the national territory must be conserved as national reserves. Only NIOC may be active in more than five districts at once.[4]

A partnership with an NIOC interest of at least fifty per cent may hold up to 16,000 square kilometers in one district. The total net interest that one partner may hold in a single district is 8,000 square kilometers.[4]

When the NIOC share is between thirty and fifty per cent, the partnership may not hold more than 9,000 square kilometers in any one district and the total net interest of any one party may not exceed 6,500 square kilometers. When NIOC has no interest in the operation, the maximum area is 6,500 square kilometers per district.[4]

Drilling limitations and acreage relinquishment requirements have been tailored to promote NIOC participation. An organization with at least fifty per cent NIOC interest must begin drilling within four years, continue with reasonable speed and return the area to full NIOC control if no commercial oil production is forthcoming within twelve years of the agreement. In any case, one-half of the concession area is to be relinquished within ten years. These provisions allow ample time for exploration but minimize procrastination.[4]

An organization with less than one-half NIOC participation must meet more stringent drilling and relinquishment standards. It may divide its concession area into not more than ten segments within five years of the agreement date. Within this period, it must begin drilling one well on the total area or, if divided, on one section. In the latter case, one well must be drilled within eight years on each of the sections. After twelve years, all sections without commercial production are relinquished. One-half of the total area or one-half of each section must be returned within 10 years, but in no case may the area or section at the operator's disposal exceed 1,000 square kilometers.[4]

These controls give operators the option of subdividing the area while increasing the drilling obligations in order to retain more territory, or minimizing drilling obligations at the expense of ultimately surrendering a greater portion of the acreage after ten years. The Petroleum Law thus covers exploration in areas of varying potential.

Independent concerns or those with minority NIOC participation are also liable to pay a lump sum cash bonus, in addition to the rental payments. Annual rental fees are payable by all who make agreements with NIOC, are determined by considering the possibilities of the discovery of oil and the potential ease of exports. When rental payments are waived in lieu of a stipulated level of exploration expenses, expenditure might fall short of the designated amount. NIOC may then request the difference be spent on further operations or may have half of the difference paid to the government. That payment would represent the equivalent investment made on behalf of NIOC by the operator.

Taxation under the "fifty-fifty" provisions also applies to the NIOC share of profits, so that the increase in revenue gained by the state exceeds the percentage received from consortium operations by one-half of the NIOC participation fraction.

Although the Petroleum Law and the statutes of NIOC give autonomy to the state oil company, agreements must be individually approved by the Parliament and the Shah.

The broad range of the Petroleum Law allows both independent operation and state participation of from 30 to 100 per cent, thereby providing a framework for continued entry of foreign capital and skills into the Iranian petroleum industry.

CONCLUSIONS AND RECOMMENDATIONS

Many paths are open to producer governments that seek to extend control over oil operations. To summarize the most economic and stable routes, three questions will be answered.

1. What are the types of agreements that are currently being formed between the host governments and the oil companies?

New agreements are emphasizing and enlarged administrative role for the host government, as well as an increased share of gross profits for the producer country.

Administrative gains have included such specific provisions as precise definition of the employment opportunities for nationals and provision for host government representation on executive committees.

More importantly, the host nation has been given some financial control through partial ownership of the producing company, commonly by purchase of equity in the producing operations after the discovery of commercial amounts of crude oil.

Iran has established precedents in pursuing its ambitions for government participation under the umbrella of the comprehensive Petroleum Law of 1957. The National Iranian Oil Co. has formed equal partnerships with foreign oil companies. The foreign partner shoulders the costs of preliminary exploration and production, but NIOC provides half of the development capital after the discovery of commercial crude oil.

New agreements have not emphasized government participation in downstream operations outside of the producing country. The host governments recognize that the rates of return on integrated downstream operations do not justify the diversion of capital from more vital internal development projects.

Host governments have begun to market petroleum products and natural gas domestically. Local refineries have been erected, sometimes as part of an obligation assumed by the concessionaire. As a result, the host nation has achieved local partial downstream integration.

The final form of any given agreement is determined in part by the negotiating skills of the bargaining agents. Such factors are intangible and account for the variations between the different agreements.

2. What role are state oil companies playing in the host countries?

The state oil companies are the mechanism for government implementation of petroleum policies, and their importance has been increasing at an accelerating pace. Although some host nations have shown relatively little interest in such bodies, these countries are now exceptions.

State oil companies are presently hampered by many bottlenecks that hinder complex commercial operations by developing countries. Among these are the shortage of trained personnel and investment capital. In some cases, there has been little analysis of national development needs, and investment plans are nebulous.

State oil companies are the simplest and most flexible way for the host nations to channel their resources into petroleum operations. Additionally, they fit into the philosophy of planned economic development espoused by many developing countries. Continued use of the national oil company as a vehicle for government action is to be expected.

3. Which features of the current scene offer host governments the most practical opportunities for more responsibility and income?

There are opportunities for profitable state participation in oil operations, but producer governments must recognize those parts of the integrated oil industry for which their resources are best suited, and avoid unattractive commitments that require resources in short supply within the host country.

In light of limited investment capital and the massive internal needs, most host states would be wise to confine investments to producing operations and abstain from downstream operations.

An exception might be made for government investment in domestic marketing. Administration of internal marketing, and the auxiliary functions of petroleum operations, are good training grounds. They are in themselves, however, cul de sacs and are not pathways to extensive government activity.

Formation of an active, autonomous state oil company is vital before entering any phase of the industry. Local marketing operations may be assumed by this company prior to entering more complex affairs. Independence of action is a desirable trait. In the same way that international oil companies try to avoid political entanglements, the state oil companies should also try to avoid partiality in their commercial dealings.

Host states should arrange all future concessions to permit a minority partnership for the state oil company. It may not be possible to make this adjustment in older concession agreements. Simulation of the practices of the Iranian government are worth consideration. The state firm would provide development capital in proportion to its equity interest after crude oil deposits have been discovered.

To host nations, stability of income is quite important. Therefore, the maintenance of the posted price system might seem in their best interest since artificially high posted prices insulate the governments from the discounting prevalent in world oil markets.

Despite the benefits of prices that do not reflect true market transactions, all host nations should consider choosing income calculations based upon actually realized prices, as Venezuela and Indonesia have done. If host countries are to become active partners, they must accept commercial realities.

Mutual understanding by all parties is a fundamental prerequisite for effective host government participation in petroleum production operations. Coupled with a recognition of the problems of the integrated, international industry, both government and oil company may benefit from joint operation of the industry.

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