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THE RECENT EVOLUTION OF PETROLEUM LAW ABROAD

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INTRODUCTION

You will excuse the writer if he looks at the world of petroleum law from both practical and philosophic viewpoints. Forty years in the industry brings to one certain trends of thought; the French have a term for it - the deformation professional. One of my gray-headed friends advised me against entering the service of this extraordinary industry because, he said, it was certain that we would run out of our raw material, and coal would then be the main fuel and source of power. It is now 40 years later, and the world's oil resources seem immensely larger than in those days. We have, it is true, thoroughly explored most of the U.S. on land, but we are just somewhat timidly venturing to sea. Elsewhere we have just begun.

Forty years ago the amazing story of the Mexican fields was coming to its climacteric. Revolution was imposing slowly its paralyzing theories on the industry which in the end resulted in nationalization and slow decline. But despite the shortage that was supposed to loom in the U.S., there were few in those days who had the courage to face the political hazards of the times and go abroad. Unless one could divide the risk one could scarcely afford the huge investment necessary to develop production only to have it snatched away on the basis of some political theory. In Russia the industry had been confiscated. The legislation with reference to oil in many countries was written by soldiers who could see it only as a source of military power upon which they must lay their paralyzing nationalistic hands. They forgot that the bomber made refineries the unsafest of plants to have in one's own country. The last great war finally drove home that lesson.

So it was that in the history of the industry in the two decades following 1918 we find foreign exploration operations confined mainly to companies with extensive marketing organizations in foreign countries or to a few bold wildcatters who attempted to supplement production at home with fields abroad. Few indeed were those who had the money to risk on these ventures. It came about, therefore, that early endeavors were largely on great concessions usually based on acts of parliamentary bodies such as, for instance, the DeMares and Barco concessions in Colombia, the Valadares concessions in Venezuela, the D'Arcy concession in Iran and the various Iraq Petroleum concessions in Iraq and the smaller Persian Gulf states.

The courageous discoverers of petroleum on these great concessions found the habit in which it occurred - built ports, towns, hospitals, schools, pipelines - the thousand and one things

so necessary to make a viable industry. They extended the cycle of their operations around the world - built tankers and refineries and all the special paraphernalia necessary to bring their product into trade so that a specialized product standard in quality could be sold to the very ends of the earth. But many of them lost everything they had invested. We hear only of the Aramco's, the IPC's, the Anglo-Iranians and the Creoles. No one is interested in the failures - and the writer can assure you that in the lottery of foreign operations there are more blank numbers than prizes. But once oil has been discovered and the way made easy, newcomers must expect to pay more when they enter the game. In the meantime, with the energies generated in the exploratory effort at home by an increasing number of operators competing for a decreasing number of prospects, pressure has developed to abroad. This in turn has increased the pressures to pass laws which will permit the entry of more wildcatters into the foreign scene. From this develop many of the competitive phenomena we are witnessing abroad - such as larger bonuses, higher taxes and royalties and the invasion by governments of those fields of action usually considered the prerogatives of management. Some of these developments are in themselves innocuous, others are dark harbingers of future trouble.

CONCESSION LAW

It can no longer be said that possession of crude oil is the key to the industry. Reserves have grown so rapidly abroad of late and avails have also increased rapidly so that price is inevitably weakened and the struggle for markets intensified.

But this is supposed to be a paper by a layman on the evolution of oil law, and there are at the moment two frontiers in that esoteric science upon which the writer would comment more fully: first, the trend away from the granting of great concessions followed by the passing of specific general laws on petroleum concessions administered by government bureaus and, second, the gradual evolution of the laws of the sea as applied to oil.

The evolution of concession law over the last years has been marked by new legislation in Guatamala, Turkey and Iran. The pattern follows in general that started by Venezuela in the legislation of 1919 and its subsequent modifications. The Leasing Act of the U.S. and the various petroleum enactments in Colombia and Peru are all of this same pattern - a general law administered by the proper bureau and rendering unnecessary the direct parliamentary sanction of each separate concession. Subsurface rights still are attached to surface ownership in the U.S. when the titles are of a certain age or possibly in the strict sense, when not specifically reserved by the state. In Colombia, proofs of title to the subsoil were made so rigorous that joint title to the surface and subsurface has been proved in only a few cases.

It is to be noted that in northern South America, production was first discovered on large concessions - the Barco and DeMares in Colombia, the great concessions in the states of Zulia and Monagas in Venezuela, the Berea and Parinas concessions [originally a grant to a religious order] in Peru. But the changes in concession status in Latin America, as noted above, started with passage of the Venezuelan Oil Law of 1919. It appears that at present we stand possibly on the threshold of a similar development in the Middle East and North Africa. The great virtue of the large concessions was that they attracted capital to engage in risky business - the exploration for oil in untested territory. These explorers on large concessions discovered the habit in which oil occurred, developed the ports, pipelines and towns upon which depend so greatly the viability of the new industry. It was only then that new conditions arose, which on a political basis justified a change in base of petroleum legislation.

There is a curious fact not often noted in passing that the finding of oil depends largely upon differences of opinion among operators themselves and even among the technicians. If you do not believe this, you have only to look at the present situation in Lake Maracaibo or, for that matter, in Saudi Arabia. The writer strongly suspects that this is the vital spring which drives the industry. Oil discovery is often like horse racing, which only arises because of men's difference of opinion regarding the speed of their horses.

This problem of competition between prospectors and technicians is also brought sharply to the fore by the experience of countries that have limited exploration to national companies. Here we might place Brazil and the Argentine and Soviet Russia. Of late, neither Brazil nor Argentina has permitted prospecting by any except their national petroleum monopolies; and the net result is that, with excellent prospects, they still remain net importers of oil with disastrous effects on their international balance of payments. There may be a way they can circumvent this disadvantage as a government, but the writer does not know how it can be done. Russia, with a complete monopoly and probably the greatest petroleum possibilities in the world, has limped along in a secondary place as a world producer. The competitive stimulation for exploration is lacking.

In the Iranian law and the Turkish law, allowance has been made for the relatively great difficulties of operating under unfavorable conditions by provision for concessions over

relatively large blocks with a requirement that part of the block be returned to the government after a period of years. There are also stringent provisions to assure the continuance of the prospectors' effort. The bidding for concessions in Iran has led to the belief that the basis of profit-sharing built up over the last few years has been undermined by such agreements as those between the National Iranian Oil Co. and the AGIP [Italian interests] but this is doubtful.

The Guatamalan law has attracted numerous prospectors and we shall see in the next year or so whether the great area of northern Guatamala is to be a petroleum province.

SEAWAY LAW

Aside from these areas the most critical area of new legislation is likely to be in the seaway. We have in the U.S. only begun to approach this problem. The first step, taken more than 10 years ago, was the Truman Proclamation of 1945 relating to the Continental Shelf. Since that time much argument has plagued the courts of the U.S., and we have seen at the same time such poorly drafted legislation as that of California passed, designed more to stifle development than to encourage it. In the meantime, it becomes more apparent that we shall have at sea immensely complicated boundary problems coupled with technical problems of jurisdiction that will keep both lawyers and statesmen fully employed for years to come. Further, it is now clear that we can drill wells in water well over 100 fathoms deep and by proclamation or other means dominion over the sea bottom will most probably be extended much beyond the 100-fathom line. There is, we might remark, almost as much area prospective for oil offshore as there is on the continents, so the prospecting for minerals in the sea areas has just begun. Means of developing secure titles must be evolved before the large investments necessary to operate in the sea areas can be attracted. The conference on the law of the sea at Geneva beginning in February will do much to explore the problems on an international basis, but the writer must warn the lawyers - should he say, sea lawyers? - that technical development has already outrun the law for the so-named Cuss Boat has already made hole in ground underneath 1,500 ft of water. Principles in such matters are being established gradually by decisions of international tribunals, such as the Norwegian Fisheries case which sets precedents as to the establishment of boundaries with the high sea across the mouth of bays. It is to be noted that questions of both fisheries and customs jurisdiction have been, up to the present, the basis of most such law, but in the future questions of mineral resources will beget a large part of future jurisprudence dealing with lands under the sea.

MIDDLE EAST CONTRACTS

Now as to specific questions, there have been recently let two new contracts in the Middle East which have caused much comment. One of them is the contract between the Italian oil monopoly and the nationalized Iranian oil company. This contract is a good example of bad draftmanship and it is not clear what is actually intended by the two parties. It does appear clear, however, that the intention is to create a partnership between the Italian company and the National Iranian Oil Co. in which the Italian company pays the exploration expenses up to such time as oil is discovered. There has been much dispute as to whether the contract calls for 50 per cent of the net profits to each party or whether some other ratio is indicated. The contract covers a small portion of the seaway in the northern part of the Persian Gulf, a tract in central Iran and one along the southern coast. For the present, it is merely a piece of paper and will remain so until financing of the venture is arranged.

The Japanese contract with the Saudi Arab government for a concession over the Saudi Arab share of the offshore area of the Kuwait Neutral Zone beyond the 6-mile limit is of a different kind and exhibits many new phases. The exploration license runs for two years, but may be extended for an additional two years if the government is satisfied that the drilling obligations have been carried out. If commercial oil is discovered, the government agrees to grant a concession for 40 years. One of the interesting phases about the description of the area of the concession is that it extends to the median line in the Gulf between Iran and the Neutral Zone. There is a provision too for the relinquishment of 20 per cent of the unexploited concession area after three years, and 20 per cent of the remainder at the end of each five-year period thereafter. The company must operate two drilling rigs continuously and must drill to a depth of 10,000 ft unless commercial oil is found at a lesser depth. The annual rental is 1-1/2 million dollars until commercial discovery when an additional payment is required. There is a royalty of 20 per cent which may be paid in kind or cash, and the minimum royalty must equal 2-1/2 million dollars per annum. Income tax is payable on the basis of the royal decree applicable to other corporations and the sum of the income tax and royalties must equal 56 per cent of the company's net profits, but taxes paid to governments other than Saudi Arabia are chargeable to expense, except in the case of tanker operations. All payments must be in U.S. dollars or other currencies stipulated by the Saudi Arab government. The company also agrees to build a refinery when production reaches 30,000 B/D and must refine 30 per cent of the company's requirements in Saudi Arabia when production reaches 75,000 B/D. The company in agreement with the Saudi Arab government will post prices. The refinery must produce

all products of high value, including lubricating oils and aviation gasoline. The company must also construct a petro-chemical plant. The government may use or dispose of such gas as the company fails to use or sell. Ten per cent of the stock must be offered at par to the Saudi Arab government which has the right to nominate one-third of the members of the Board. A committee is provided which will supervise all buying and other expenditures of the company to be sure they are reasonable, and half of the members of this committee must be nominees of the Saudi Arab government. Saudi Arabs must comprise a minimum of 70 per cent of the company's employees in Saudi Arabia. The contract also provides that 30 per cent of the personnel of the company employed abroad shall be Saudi Arab, if and when available. A board representative with broad powers must reside in Saudi Arabia, but board meetings and annual meetings of shareholders may be held in Japan. The company renounces any right to diplomatic recourse on matters involving the agreement.

There are many phases of this contract that call for explicit comment. They begin with those things which a government should not do because they involve excursions into the political jurisdiction of another government. In the first place, no government should attempt to dictate the percentage of their own nationals who should be employed in another country. This is likely to invoke an immediate clash with the local authorities and to be in opposition to the general interest of all nations. For instance, it could be interpreted as applicable to Japanese interests that 30 per cent of the filling station operators in Japan would be Saudis.

In the second place, the provision regarding the prohibition of appeal to diplomatic intercession, the Calvo doctrine, is by its own text null. No citizen can bind his own country not to intercede on his behalf if it cares to do so. The appearance of this clause in a Saudi contract is reminiscent of similar clauses which appeared in Latin American contracts, but no government has ever surrendered its right to protect its citizens diplomatically.

The third notable thing about this contract is the attempt to invade areas of taxation which belong to other nations. I might add that other governments have not been altogether guiltless in this respect. Profits should be taxed where they are made and no country has the right to attempt to tax profits made in other jurisdictions. This kind of an extension of the right of taxation brings up a number of grave questions which have been at the heart of some of the discussions about the oil situation in Europe, for instance, the famous ECE paper. The sword cuts both ways. Perhaps nations should agree as to the fields which their own taxation should occupy.

Another group of questions which arises in the case of this contract is the attempt on the part of the Saudi Arab Government to take some of the managerial prerogatives from the operator as, for instance, in the provision for a committee to approve or disapprove expenditures by the company in the development of its concession. As the development, in the writer's mind, should be confined entirely to Saudi Arabia, there can be no reason for such provision providing the books of the company are examined from time to time by competent tax authorities to see that there is no error in accounting practices. The government has also attempted to invade the prerogative of management in insisting that the government approve field production rates and in obligating the company to refine 30 per cent of its production in Saudi Arabia to provide for a wide range of products and to operate two rigs. The question as to whether the company should agree to abide by such regulations seems to the writer to be a matter of judgment. These regulations would be objectionable to most operators.

CONTRACTS RESTRICT ENTERPRISE

The writer's final comment is that this is poor contract, both for the Government of Saudi Arabia and the Japanese concessionaire. Nevertheless, should the Safaniya field extend into the Neutral Zone and the Japanese corporation start off by getting a well in that area, it may yet be successful, providing the Saudi Arab government itself by regulation does not make it impossible to operate. It is, however, an example of the tendency which is appearing to restrict freedom of enterprise unnecessarily and by this same token to restrict the development of the mineral resources of the world so necessary to general progress.

The writer would have little to say if he believed that these restrictions resulted in better operations, but his fear is that they will do exactly the opposite. There is only one way to increase the world's standard of living and that is to increase production so that people can have more. It is the writer's belief that we have just begun to explore the world's mineral resources, the resources so vital to world progress. Governments should encourage - not obstruct - the process of their discovery and development.