# Ownership of petroleum and rights of exploitation

## 1. Legal theories of ownership of oil and gas in situ

In an industry worth multiple trillions of dollars and essential to the modern economy, it is perhaps surprising that there is not more academic and judicial discussion about the ownership of substances that occur naturally and without any human enterprise. Marketability of good title is clearly of paramount importance to commercial companies. However, in academic discussion and legal practice, the point is most likely to arise in a financing context where, in order to create a legally robust security package, lenders will analyse the ownership of assets over which they take security. Financing of UK continental shelf exploration and production has been structured around the inability of a borrower (unlike its US counterpart) to claim an ownership interest in petroleum *in situ* – in other words, in its unexploited natural environment.[1] Despite being granted the necessary government licence, a borrower has no ownership claim to petroleum until it is produced or (to use the legal term common in this area) 'captured', and therefore cannot offer a lender security in petroleum until after the exploration phase (exploration being the non-income-generating phase when external funding is most needed). To the limited extent that underlying legal ownership has been judicially examined, it has often been in an onshore real estate context relating to land conveyances pre-dating modern petroleum law.[2] These cases are reproduced later in this chapter. Despite their age and context, they remain of value to modern onshore practice.

In order to put UK law in its international context, this section provides a brief analysis of how other jurisdictions determine ownership of petroleum and the commercial arrangements then put in place to exploit it. Section 1.2 then examines the same question under English law. Once it has been determined that a UK oil and gas licence conveys limited ownership rights over petroleum, the next topic could be

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1 In addition to this legal inability to grant security in a chattel in which, until it is produced, the borrower has no property interest, lenders to the UK continental shelf will also require government consent before the licence is assigned or before they take any action that would be prohibited without an exploration or production licence. However, this is more a practical and regulatory than a legal issue.

2 See, for example, *Mitchell v Mosley* (pp32-33); *Lonsdale v Attorney-General* (pp3 4-60) is an example of historic land conveyances being litigated in 1982; *Bocardo v Star* (pp61-100) is a real estate dispute decided shortly prior to publication of this book. The Privy Council's advice in *Barnard Argue Roth Stearns Oil & Gas Co Ltd v Farquharson* [1912] AC 864 that natural gas was not included within a leasehold exception and reservation of "minerals, and springs of oil" looks awkward in the modern context; were the case decided today, it might be limited to its facts, and particularly the finding that at the time of granting the lease, natural gas had no commercial value and was not, therefore, within the contemplation of the parties.



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the law (or rule) of capture – that is, the law determining ownership of petroleum once it has been produced (or 'captured'). This is the next question in determining title. However, in order to separate the discussion on ownership of petroleum *in situ* and the ownership of petroleum once produced, the law of capture is discussed in Chapter 5.

The principle of ownership of oil and gas *in situ*[3] depends, in most jurisdictions,[4] on an assumption of state sovereignty over petroleum reserves, an exclusive (although often sub-licensable) right of the state to extract those reserves or both. The more commonly discussed issue is not who owns the petroleum, but rather how the state allows companies to exploit petroleum. This is as much a political as a legal issue.

Typically, as in the United Kingdom (a country with historically centralised government), sovereignty over petroleum *in situ* is assumed by the national administration. However, there are several international examples where, often because of regional conflicts (where the ownership challenge can be both legal and physical), sovereignty can be exercised by a sub-division of central government. Devolvement of jurisdiction in this area is the current policy of the Scottish Parliament and, because of its topicality, it is worth briefly considering how this point has been resolved in other Commonwealth countries.

Sovereignty rights between national and state governments were an issue in New *South Wales v The Commonwealth*,[5] where the court held that the purpose of the Australian Constitution is to vest proprietary rights and legislative powers in relation to the territorial sea, seabed and continental shelf in central government. The Australian High Court, citing a decision of the Canadian Supreme Court,[6] was influenced by the need of a central government to control its territorial sea, seabed and continental shelf in order to assert independent nationhood and to be recognised by other nations. Notwithstanding the favourable outcome for the central government, the outcome of this case was subsequently legislatively modified by the Coastal Waters (State Title) Act, which vested title to each state in its coastal waters, being the state's internal waters and territorial sea up to a limit of three nautical miles. Rights in relation to waters outside this limit were vested in central government.[7]

The language by which sovereignty and exclusive extraction rights are asserted

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3 It was held in *NV de Battaafsche Petroleum Maatschappij v War Damages Commission* (1956) 22 MLJ 155 (Singapore Court of Appeal, applying English law) that the doctrine of specification (ie, the acquisition of ownership of a chattel belonging to another as a result of its manufacture into a new product) was not recognised by English law and ownership of refined products will follow the ownership of the source crude oil or natural gas.

4 The United States and Canada are notable exceptions. In these jurisdictions the real estate owner (which can, for onshore exploration, include government entities acting as real estate owners) has the unrestricted right to exploit petroleum underneath its property. This is based on the common law principle, which also forms the starting point for English law, of *cujus est solum, ejus est usque ad coelum ad infernos* (ie, the landowner also owns the corresponding space up to the sun and down to the earth's core) – see *Mitchell v Mosely* at p32; but also see the criticism of this principle by the Court of Appeal in *Star Energy v Bocardo* (p85 (at paragraph 85) and the Supreme Court's response at pp99-100 (at paragraphs 10 and 14). This common law principle is qualified by different versions of the law of capture (see Chapter 5), which recognises that petroleum will migrate naturally from underneath the land of one owner to another.

5 (1975) 135 CLR 337.

6 *Reference re Ownership of Offshore Mineral Rights* (1967) SCR 792; 1967 65 DLR (2d) 353.

7 Elsewhere, *United States v California*, 332 US 19 (1947) was decided, and the Submerged Lands Act 1973 (43 USC §§1301-1315) was passed, on an analogous set of facts and legislative compromise.

will differ between jurisdictions. However, whenever ownership or the rights of extraction are reserved by the state, the government is free to decide the manner in which it will exploit petroleum, if at all. There are broadly three different international commercial models for exploiting reserves: exclusive licensing, production sharing contracts (PSCs) and risk service contracts. Each is a type of agreement (although in Chapter 2 we test the strength of this assertion in the UK context, where it may also be viewed as regulation), and can broadly be described as a concession which governs the relationship between the government (as sovereign owner of petroleum) and company (or, more typically, companies) to which the government will transfer its sovereign rights.

In PSC and risk sharing systems, the ownership of petroleum is often legislatively stated to be the property of the federal or state government.[8] Having granted itself the legal ownership of petroleum, pursuant to a PSC the state will allow one or more international oil companies (named collectively as the 'contractor' – although this term understates its interests in production) to undertake exploration and production in return for a share of resulting petroleum – with the balance going to the national oil company.

A risk service contract is a form of agreement where a commercial company assists the state in exploiting reserves while not taking or, for political reasons, appearing to take any equity ownership in resulting production – but with an option to purchase the same. As the first word of the name suggests, the international oil company assumes the exploration and production risks. The second word emphasises that it does this pursuant to a contract of services (rather than equity participation). These types of agreement are common in South America and other countries which, often as a result of nationalism following previous foreign domination of their oil and gas industries, prohibit foreign ownership of production. More recently, they have been used in regions of Iraq as part of the politically sensitive reconstruction of the oil industry by international oil companies.

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PSCs and risk services contracts are common in developing world countries, where the state wants to reserve for itself a high degree of control over its natural resources in order to manage the development of (often nascent) industry dependent on stable supply and pricing of petroleum.[9]

The PSC may oblige the contractor to deliver a percentage of production (particularly of natural gas) to the domestic market at favourable rates. The PSC is likely to include local content provisions requiring the use of, and knowledge

8 For example, Indonesia, which was the first country to adopt a production sharing system, passed Law 22/2001, which states: "(1) Petroleum and natural gas as non-renewable strategic natural resources contained in the Indonesian mining jurisdictions shall constitute national assets controlled by the state. (2) The control by the state as meant in paragraph (1) shall be executed by the government as the holder of the mining concession." The 1999 Constitution of the Federal Republic of Nigeria (an example of a country that has moved from other forms of oil and gas concessions to a PSC regime) states at Article 44(3) that: "the entire property and control of all mineral oils and natural gas in and under or upon any land in Nigeria or in, under or upon the territorial waters and the Exclusive Economic Zone of Nigeria shall vest in the Government of the Federation and shall be managed in such manner as may be prescribed by the National Assembly."

9 The obligation on governments to exploit natural resources for the benefit of national development and the benefit of the population of the state is an obligation of Article 1 of UN General Assembly Resolution 1803 of 1962.

transfer to, indigenous workers and companies. Perhaps most importantly, the state's (or its national oil company's) costs of exploration and production are carried (ie, deferred) until the production phase and then paid out of its share of production. This has obvious cash-flow advantages for the state. More significantly, it effectively passes exploration risk[10] to the international oil companies: if there is no commercial discovery, there will be no production for the state to pay back its share of exploration costs. In such circumstances, contractually, these costs are borne by the international oil companies. Collectively, domestic supply obligations, local content requirements, carried exploration costs and passing of exploration risk are considered excellent benefits for developing-world economies able to demand these terms by offering international oil companies attractive exploration opportunities. [11]

The foregoing discussion does not, however, reflect the system adopted in the United Kingdom. As we shall see in the chapters that follow, UK law and policy are now based on a free market model that excludes state participation and minimises state involvement. The rationale of the exclusive licence is that commercial companies are commercially, technically and financially better qualified to exploit petroleum reserves than governments or their national oil companies. The government's role, therefore, is to license exploration acreage using an orderly system, regulate the industry[12] and collect resulting tax and other forms of revenue – such as royalties (a contractual rather than fiscal payment) and licence fees – from exploration and production activity.

The sovereignty of nations over their natural resources is explicitly recognised (albeit in differing language) in the international materials set out later in this chapter. General Assembly Resolution 1803 refers to the resolutions being based on "the inalienable right of all States freely to dispose of their natural wealth and resources in accordance with their natural interests". Article 2 of General Assembly Resolution 3281 states that every "State has and shall freely exercise full permanent sovereignty, including possession use and disposal, over all its wealth, natural resources and economic activity". Finally, the Energy Charter Treaty recognises "state sovereignty and sovereign rights over energy resources".

In the United Kingdom, sovereign ownership of petroleum was recognised in the Petroleum (Production) Act 1934[13] (without any compensation to a landowner under whose land the deposits were extracted, on the basis that it had no rights in the petroleum), but was not expressly repeated (other than in the non-binding heading of Section 2) in the Petroleum Act 1998. However, the savings provisions of the 1934 act make this a largely academic point.

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10 One of the distinguishing features of the upstream oil and gas industry is the significant investment required at the exploration phase, during which there is a high degree of uncertainty over the economic feasibility of the investment.

11 For an analysis of the benefits to host governments of using PSCs, see Hammerson M, "Production Sharing Contracts: An Analysis of Certain African Jurisdictions", *Petroleum Africa* (October 2007).

12 The role of government in promoting unitisation (Chapter 5), access to infrastructure (Chapter 7) and decommissioning of disused installations and pipelines (Chapter 8) is a recurring theme in the subject areas discussed in this book.

13 "The property in petroleum existing in its natural condition in strata in Great Britain is hereby vested in His Majesty, and His Majesty shall have the exclusive right of searching and boring for and getting such petroleum" (Section 1(1)).

The brief discussion of PSCs and risk sharing contracts (particularly, the day-to-day commercial influence they provide to the host government or its national oil company, compared to that currently[14] exercised by the UK government) provides a comparison for an analysis of the exclusive licensing system in the United Kingdom. Other than the foregoing, this book does not discuss petroleum exploitation models used outside the United Kingdom. Although English law may be chosen as international parties' governing law,[15] PSCs and risk service contracts are not part of onshore or UK continental shelf exploration and production. The system used in the United Kingdom, and elsewhere in Europe, is the exclusive licensing model. This is analysed in the following chapter.

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14 The position now differs from the first development of the UK continental shelf in the late 1960s and 1970s – due mainly to the adoption of free market reforms on the 1980s (applied equally to the oil and gas industry starting with the Oil and Gas Enterprise Act 1982), but also reflecting a desire of recent governments to make the UK continental shelf, in its declining years, an attractive investment opportunity. For a historic analysis of previous UK government participation in the oil and gas industry, see appendix A in Daintith, Willoughby and Hill (eds), UK *Oil and Gas Law*.

15 More typically, English law may be chosen as the governing law for the inter-party arrangements of a joint operating agreement, rather than the concession agreement granted by the government (or its national oil company) to the commercial parties.