

Service agreements

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1. Introduction and background

This chapter considers the key characteristics and issues with the use of service contracts as the legal framework between a host government and an international oil company (IOC) for the exploration for and development of oil and gas resources within the host government's territorial jurisdiction.

The relationship between host governments and an IOC may broadly be categorised into either a concessionary regime or a contractual agreement. A concessionary regime involves the assignment of rights to resources to the IOC in exchange for the host government being granted a share of proceeds – typically through the payment of a royalty to the host government.

Under a contractual agreement, the host government (or its national oil company) retains the rights of ownership of the resources. Typically, the host government and IOC will enter into one of the following types of arrangements:

- production sharing contract;
- joint venture arrangement; or
- service contract.

The particular form of contract or arrangement between the host government and the IOC is influenced by the host government's legal framework, as well as the particular technical drivers of the project and the commercial drivers of the parties. Accordingly, the above distinctions, while useful, should not be regarded as definitive and an arrangement may be a hybrid of these contractual forms. We note that confidentiality obligations and the commercial sensitivity surrounding negotiations make it difficult to comment definitively on specific contracts.

This chapter will consider the specific characteristics of service contracts. Other features that are common across host government and IOC contractual or concessional relationships, including relinquishment, length of the exploration phase and local content provisions will not be considered in depth.

For the purposes of this chapter, a broad definition of service contract has been adopted, encompassing those contracts between a host government and an IOC under which the IOC explores for or develops oil and gas resources in return for the host government paying the IOC a pre-determined fee in cash or production.

2. General considerations for service contracts

2.1 Types of service contracts

A service contract, as compared to concessions and other host government contracts, generally allows the host government to retain greater control and indeed ownership over the project or resource.

Service contracts, as used in the international oil and gas industry, may further be categorised into either risk service contracts or pure service contracts.

(a) Risk service contracts

In certain jurisdictions, a risk service contract is typically used in the exploration phase. Under this arrangement, the IOC agrees to undertake the exploration and/or production activities according to an agreed scope of work, and is paid an agreed cost recovery fee and remuneration fee from the proceeds of production from the project.

In the exploration context, if no commercially exploitable reserves are discovered by the IOC, the IOC is typically not entitled to recover any of its costs. The IOC therefore bears all of the downside risk of exploration.

If commercially exploitable reserves are discovered within the relevant area, then the IOC may be remunerated for its exploration expenditure (either through cash payment or through a share of the production). The host government may also grant the IOC an option to participate in the subsequent production project.

In relation to petroleum service contracts, the IOC typically has no ownership or equity rights in the petroleum extracted. However there may be provisions allowing the IOC to 'buy back' petroleum at an agreed, typically discounted, price. This has historically been a common feature with service contracts promoted by the Islamic Republic of Iran (see section 4 below).

(b) 'Pure' service contracts

Under a pure service contract, the IOC is engaged to perform a particular service (as defined in the service contract) and is paid an agreed amount. Unlike a risk service contract, the host government takes on the overall risk of the project in ensuring the exploitation of the reserves. The IOC's scope of services is therefore quite narrowly defined.

The IOC is paid only for the services it provides. Costs of development and infrastructure that are incurred by the IOC are reimbursed on an agreed basis and the host government would typically maintain some form of cost oversight through the approval of work programmes and budgets.

The use of a pure service contract is considered to be more appropriate where a project is in the production phase or where the likelihood of production is very high. For example, an IOC may be engaged because of its technical expertise and experience in enhancing recovery from an existing field under a pure service contract, whereas a pure service contract may not be preferred in engaging an IOC to identify the location and facilitate the development of a new field.

A service contract that does not include any provision for the IOC to acquire an interest in the resource is sometimes referred to as a technical assistance contract.

2.2 Drivers for the use of service contracts

Host governments will enter into an arrangement with an IOC to achieve one or all of the following objectives:

- to access the IOC's skills and resources to explore for and/or develop petroleum resources;
- to acquire the IOC's skills and expertise for its national oil company (NOCs) and domestic workforce, with a view to transferring those skills over time;
- to shift all or part of the risks of exploring and developing petroleum resources to the IOC; and
- to facilitate the efficient exploitation of the petroleum resource.

The primary motivation for an IOC is to maximise the returns for its shareholders through efficiently exploiting oil and gas fields and obtaining the greatest possible access to such resources.

(a) *Host government legal requirements*

In entering into any form of contract with a host government entity, an IOC should consider the authority under which that entity enters into the contract and its capacity to grant the rights and assume the obligations provided under that contract. In considering whether a service contract is legally enforceable, let alone commercially appropriate, the constitution of the host government, as well as relevant legislation, including foreign investment laws, must be considered.

In some jurisdictions, the constitution and legislation enshrine ownership in petroleum resources in the people and either expressly or impliedly prohibit the host government from granting an ownership interest in the hydrocarbons to a privately held or foreign company. In this scenario, a concession arrangement is impossible. A contractual arrangement however, may be legally compliant.

By way of example, article 111 of the constitution of Iraq provides that "oil and gas is owned by all of the people of Iraq in all regions and governorates". Similarly, article 81 of the Iran constitution provides that "[t]he granting of concessions to foreigners or the formation of companies or institutions dealing with commerce, industry, service or mineral extraction, is absolutely forbidden". In the Iranian context, the prohibition has been interpreted to exclude even the use of production sharing contracts, as typically under those contracts, the IOC is granted proportionately greater control in the decision-making and day-to-day management of the project.

Typically, the broader powers and prohibitions set out in a host country's constitution are implemented in the laws of the host government. Therefore, it is also necessary to consider whether the host government and IOC contracting relationship is legally consistent with the oil and gas law and other applicable laws of the host country.

Any contract entered into by a host government will need to be consistent with such issues in order to avoid being invalidated by the courts of the host country. If a project is being financed by international banks, the lenders will typically require a legal opinion as to the enforceability of the service contract from suitably qualified legal counsel.

(b) Resource sovereignty

A primary driver for host governments insisting on the use of service contracts with IOCs stems from political concerns over natural resource sovereignty (which as noted above may also be the subject of legal compulsion under the constitution of the host government). It is, particularly in developing countries, considered to be in the interests of the host government to retain title to the petroleum resources and the contract will often expressly provide for this (or expressly provide in the negative that the IOC does not have any claim to the petroleum resources). However, the host government needs to balance resource sovereignty concerns with the efficient and effective exploitation of its petroleum resources. Service contracts are generally less attractive to IOCs than concessions and production sharing contracts and hence their use may reduce levels of foreign investment, and production, in the host country.

In the absence of legal compulsion, a host government may have compelling drivers to maintain control over oil and gas reserves when contracting with IOCs. The primary motivation for this is to ensure that the future economic benefits are retained as far as possible by the host government under the contractual arrangements as opposed to the contractual arrangements acting as a value transfer to the IOC.

This informs the underlying tension in negotiations between host governments and IOCs in that host governments need to provide an economic incentive to IOCs whilst at the same time seeking to ensure that the host government (or its national oil company) maximises its participation in the economic benefits.

Depending on the accounting standards applicable to the IOC, a claim or right directly over the petroleum resources may yield significant benefits to the IOC in it being able to book the value of the petroleum reserves on its balance sheet and improve its overall financial position. The nature of a service contract may not afford the IOC this measure of control over the resources and therefore it is not always the case that the IOC would be able to book the value of the petroleum reserves in this manner. Levels of booked reserves are important when considering the performance of IOCs, and uncertainty over reserves booking in the context of service contracts is therefore another disincentive for IOC investment.

(c) Balancing expertise

IOCs typically have specialised skills and experience in exploiting oil and gas fields and this expertise is sought-after by host governments. In entering into a service contract with an IOC, host governments obtain the benefit of the IOC's experience and expertise but, unlike other forms of host government–IOC relationships, such as concessions or production sharing contracts, the host government retains a greater degree of control over the project and the resource.

Therefore, whilst the IOC's skills are sought by the host government, it is also necessary for the host government's national oil company to have sufficient technical and commercial expertise in order efficiently to manage the IOC's provision of services under the service contract.

3. Key terms and provisions

3.1 Management of the project

In a similar manner to a production sharing contract or a joint operating agreement governing a petroleum joint venture, a service contract will usually involve the formation of an operating committee with oversight over the particular services that the IOC will be providing in respect of the project. These provisions would typically provide that:

- the IOC is appointed as the operator for the operations/services under the services contract;
- the host government (or its national oil company) is represented on the operating committee; and
- certain decisions ('reserved decisions') cannot be made by the operating committee without the agreement of the host government party.

Examples of the key reserved decisions would include approval of the work programme and budget, and any deviations and the removal or appointment of the auditor of the project accounts.

In a production sharing contract, the IOC will typically take on a greater role in determining the operations of the project and making the 'reserved decisions'. In a risk service contract context, the scope of the IOC's authority as the operator of the project will generally be broader than it would be under a pure service contract.

However, since the scope of a service contract is generally more limited when compared to a production sharing contract, the host government will necessarily exercise greater control over the project and arguably the host government's retention of a veto right for operating committee voting is not as critical.

3.2 IOC remuneration

The provisions of a service contract that determine the amount and rate at which an IOC is paid for its services will typically be heavily negotiated. In a long-term service contract, accurate financial modelling is critical and the underlying assumptions of the model should be extensively tested.

The IOC will typically be paid the following fees:

- a cost-recovery fee for the capital and non-capital costs incurred by the IOC in undertaking the operations that are the subject of the service contract; and
- a remuneration fee that is essentially the IOC's profit margin for undertaking the services.

The cost-recovery fee and the remuneration fee may be paid in cash or production.

The service contract should also provide the timing for the payment of such fees and the extent (if any) to which such amounts may be capped for a given invoicing period.

(a) Cost-recovery fee

For service contracts that involve the undertaking of capital expenditure, such as the construction or upgrading of infrastructure or the undertaking of other expenses of a capital nature (such as seismic studies), the period over which the IOC may amortise such costs is an important consideration. The IOC's preference will be to amortise these costs over a shorter period and recover them as quickly as possible from production to reduce its exposure in the event that the service contract is terminated for any reason.

From a host government perspective the recovery of the IOC's costs should be structured to ensure that the host government is able to extract a viable economic benefit throughout the term of the contract and that the production is not disproportionately allocated during a given payment cycle to pay down the IOC's costs.

The determination of the IOC's costs will be subject to the agreed accounting procedure which should provide the types of costs that are recoverable by the IOC. Such costs might include:

- the costs of materials and equipment;
- labour costs, in terms of both wages and salaries and other employment-related benefits;
- costs of engaging third-party service providers, including the provision of technical and administrative services required for the performance of the service contract; and
- insurance premiums for policy coverage in relation to the services performed.

(b) Remuneration fee

The remuneration fee represents the effective profit margin of the IOC. It may be expressed in the service contract as a lump sum amount (payable in instalments), or calculated on an agreed basis in association with the production of the project. In both cases, the fee (or the basis on which the fee is calculated) is pre-determined and based on assumptions regarding the level of production and the commodity price at the time the service contract is entered into. Accordingly, this means that the service contract, particularly those of longer duration, may result in sub-optimal outcomes for either or both parties if these underlying assumptions change.

For example, in setting the remuneration fee, the IOC may be given an incentive to maintain production at or above certain levels. This may become problematic in market conditions of lower commodity prices and higher production costs, in which case the production targets effectively incentivise the IOC not to pursue the efficient outcome of reducing overall production.

IOCs will also seek to ensure that if the host government enforces a right to curtail production under the service contract or otherwise imposes an obligation to reduce production, it will continue to be able to receive a minimum remuneration fee, notwithstanding reduced production levels.

(c) Interaction of cost recovery fee and remuneration fee

The cost-recovery fee and remuneration fee will also typically be subject to caps on

the total amount that can be paid in a billing cycle. Amounts owed to the IOC above the cap may be carried over to the next billing cycle. The cap on the payment of fees is linked to overall production of the project.

Generally, the service contract will also provide that the cost-recovery fee is to be paid in priority to the remuneration fee.

3.3 Sharing of studies

In addition to any reporting obligations placed upon the IOC with respect to operations under the service contract, a host government may require that the IOC share any technical studies (including seismic studies) regarding exploration activities or potentially obtain such studies for the joint benefit of the IOC and the host government.

3.4 Confidentiality and technology ownership

Generally, the provisions dealing with confidentiality and technology will be directed at protecting the IOC's proprietary technical expertise and technology. The IOC will typically seek express recognition that its expertise and technology remain its property under the service contract and that the host government is bound by strict confidentiality obligations to prevent disclosure of such information, expertise and know-how to third parties.

Conversely, the host government may require some form of technology transfer in the form of licensing or technical assistance agreements to be provided by the IOC as part of the IOC's general local training and employment obligations.

Where the IOC's technology is applied in the form of the construction of facilities and implementation of processes, it may also be necessary for the IOC and the host government to enter into licensing agreements to protect the IOC's intellectual property if the IOC is, for whatever reason, no longer the operator of those assets.

3.5 Tax and host government take

Whilst the nature of a service contract focuses primarily on the services that the IOC provides and its remuneration, both the host government and the IOC as part of the commercial considerations will generally seek to have a clear view on the overall host government take under the service contract.

The host government will usually be entitled to receive the entire production of the project, less the IOC's agreed cost recovery and remuneration fees. In addition, consideration needs to be given to the tax regime of the host country as this will affect the IOC's overall remuneration as part of providing the services.

For example, a service contract may provide that an IOC is exempt from the payment of customs and stamp duties, as such taxes would primarily add to the quantum of the IOC's costs of providing the services and therefore increase the cost recovery fee that is ultimately reimbursed to the IOC from the production of the project. Host governments may wish to minimise the administrative burden of such taxes in these instances.

Conversely, the application of the corporate income tax regime of the host