OIL & GAS: VOLATILITY – ATTENTION TO DETAIL - THE KEY TO SUSTAINABILITY, PART I

In the following series of articles Alex Bakhshov will examine the challenges that come with negotiating key legal and contractual terms and managing legal risks across infrastructure operations comprising major oil and gas projects (Projects) in developing oil and gas markets and in turn a means through which to mitigate the impact of inflated barrel production costs (Barrel Price) by Independent Oil Companies (IOC), Oil Field Service Providers (OFP) and other market participants seeking to make strategic decisions relating to foreign direct investment (FDI).

Introduction:

Alex Bakhshov will seek to contrast the contractual challenges for both IOC's and OFP's delivering goods and services in those markets, providing examples where relevant of how savings were made in respect of Barrel Price.

In the first three of this series of introductory articles, Alex will seek to identify the key challenges faced by market participants seeking to invest in developing markets, focusing on the common barriers and determinants for FDI. Each Project and jurisdiction presents its own challenges and further guidance will be addressed in subsequent articles dealing separately with each of the key contractual terms and legal risks identified in the third article of this introductory series.

Having attained over ten years of experience of working on Projects in markets as diverse as Latin America, Middle East and North Africa (MENA), sub-Saharan Africa (SSA) and Asia Pacific during a period of oil price volatility, Alex hopes to demonstrate the benefits of giving careful consideration to legal as well as fiscal risks at the inception of a Project.

Need for Internal Controls & Corporate Governance

Controls for legal risk factors should also be implemented at the outset, adopting a collaborative approach with domestic policy makers (Regulators) and local content requirements (LCR) as it can contribute to ensuring effective crisis management in the event of dispute, political upheaval or environmental catastrophe. Additionally, for listed companies, a joined up approach should be adopted as part of the internal controls for the purposes of governance, reporting requirements and greater transparency for capital market participants – this should also ensure corporate level engagement and ownership and thus confidence for third party investors and other market participants.

The importance of having robust internal controls and a rigorous interface for corporate governance in developing countries cannot be stressed enough where the Project requires engagement with LCR's. Issues hampering development of the private sector of some developing countries frequently include the absence of a comprehensive credit reporting system, which "compromises banks' ability to distinguish good from poor performers and makes them reluctant to lend in the absence of collateral" per World Bank's biannual 'Mozambique Economic Update' report dated July 2017. The Report also states "Similarly, equity finance is constrained by a corporate governance regime that provides few incentives for firms to make financial information and audited reports of their activities available. As a result, investors are hesitant to invest because they cannot assess the viability of firms seeking finance."

Financial Controls:

For listed companies, financial controls in some developing countries are essential for compliance with anti-bribery legislation, which in many cases now imposes strict liability on corporations as well as partners, agents, suppliers and indeed throughout the supply chain irrespective of whether the company itself has fallen foul of the anti-bribery legislation. Under regulations, for example, large and EU-listed, UK-registered oil and gas companies must report their payments to governments worldwide annually for financial years starting from January 2015, country-by-country and Project by Project. At times of oil price volatility when profit margins are threatened, the pressure to cut capital expenditure can impact the risk of non- compliance with anti–bribery regulations – robust controls and governance can ensure that this risk is mitigated. Risks of anti-corruption non-compliance and exposure are a significant barrier to FDI.

Foreign Direct Investment (FDI):

FDI may include mergers and acquisitions, the building of new facilities and the expansion of existing production capacity. FDI usually involves control or participation in management, joint venture, management expertise and technology transfers. It excludes investment through purchase of securities or foreign portfolio investment, a passive investment in the securities of another country such as shares and bonds.

There are three main types of FDI contracts in the upstream oil and gas sector:

(1) concessions or licenses;
(2) production sharing contracts or agreements (PSCs or PSAs); and
(3) risk-service contracts.

Although legal risks are often addressed upfront through 'stabilization clauses', these, though advisable, provide limited comfort. Preference should be given to pursuing a collaborative strategy with Regulators to help support the roll out of infrastructure, as well as active pursuit of a joint strategy for transfer of knowledge and technology. This approach will not only mitigate Barrel Price and thus profitability but also promote an environment for sustainable business growth. Any meaningful engagement with the Regulator in this regard early in the assessment process can also help support a competitive bid.

Large proven reserves, relatively modest Barrel Prices and attractive concessions for FDI can mean that, in periods of oil price volatility, market participants can reap benefits by focusing their resources in developing markets.

FDI in the Oil Sector:

With high oil and gas dependent economies, many developing countries have historically provided opportunities for IOCs to spearhead oil exploration and production activities, and to acquire interests in fields with unexplored economic potential. As an example, the oil and gas sector has been the largest beneficiary of FDI in most oil exporting Arab countries. In Oman for instance, around 50 per cent of FDI is invested in the oil sector.

As manufacturing and service export bases remain limited in many of these countries, specialization and entrances in a specific segment of the global production chain could also benefit from FDI, while also improving export quality, sophistication and accelerating technology and knowledge transfers, specifically in the form of FDI. Improving the climate for FDI in non-oil industries may involve lowering entry requirements, creating investment promotion intermediaries, and streamlining tax structures. *See International Monetary Fund, Economic Diversification in Oil-Exporting Arab Countries (2016) 7-8 available* [here]().

The common determinants for FDI in oil and gas markets and by implication components of the Barrel Price are chiefly fiscal in nature, such as oil price volatility, infrastructure reliability, political uncertainty (e.g. risks of expropriation and ownership) and openness of the economy such as foreign exchange controls and tax laws; this can have an impact on expatriation of profits and transactional costs and in many cases the oil executive will typically be interested in the proven reserves and the fiscal terms as against the prevailing and forecast oil price as the basis for making a decision relating to FDI.

In the next article in this series, a particularly challenging jurisdiction, sub- Saharan Africa, shall be explored to illustrate some of the issues experienced by the international investment community and how they have responded to the barriers to FDI.

Alex Bakhshov is a commercial barrister that specializes in project and infrastructure work, having attained experience of major projects in Africa, Asia, the North Sea, South America and Australia. Alex has advised on mergers and acquisitions, joint ventures, construction, regulatory, contracting and procurement strategies, and possesses significant experience in construction, the marine sector, shipyard disputes, shipping (both wet and dry) and offshore Oil & Gas projects in the North Sea, West Africa and Brazil.

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For more information or assistance with a particular query please in the first instance contact the department paralegal Adam Mikula on 020 7947 5354 or by email on adm@prospectlaw.co.uk.