PROSPECT LAW

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

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:

In the first part of this series Alex Bakhshov considered the common determinants and barriers for Independent Oil Companies (IOC), Oil Field Service Providers (OFP) and other market participants seeking to make strategic decisions relating to Foreign Direct Investment (FDI) in developing markets. In this second article Alex will focus on the barriers faced by IOC's in sub – Saharan Africa (SSA), which presents its own unique set of challenges amongst developing markets. Alex will hope to demonstrate that by collaborating with domestic policy makers (Regulators), barriers to FDI can be overcome and sustainable business can be built through periods of oil price volatility.

Unfavourable Fiscal Terms

A frequent source of frustration for oil executives seeking to invest in developing markets and in particular in SSA are the unfavorable fiscal terms frequently encountered during periods of low oil prices; this coupled with inflated barrel production costs (Barrel Price) is often the primary barrier to FDI. Paul McDade, chief executive of Africa focused Tullow oil told the Africa Oil Week Conference in Cape Town (2017) that exploration license terms must be competitive to attract new investors to the region's upstream.

"*This means governments and regulators being bold and flexible and allowing companies to make final investment decisions more quickly by improving fiscal terms that were in many cases initially agreed at greater than $100 per barrel*," he said. "*At the end of the day capital goes where it's welcome and that's especially the case at $50 oil. If we like the play and we like the basin, but the terms don't work, then we won't be investing.*"

The reality is that resource rich dependent and developing economies are impacted negatively during low oil prices, triggering aggressive fiscal terms for investors; however this should serve as an impetus and incentive for collaboration for diversification of the economy and liberalization of the legal framework to allow full ownership of enterprises by foreigners and the proper protection of their property rights – which would have the added benefit of encouraging expatriates to save and invest locally. SSA remains behind the GCC states in diversification of economic initiatives (see further "Could low oil prices be an opportunity for the Middle East?", World Economic Forum). So even where fiscal terms are unfavourable, there are opportunities for IOC's to include the meaningful transfer of knowledge and technology as part of FDI by, amongst other initiatives, engaging with Local Content Requirements (LCR's).

As was shown in Part 1 of this series, in considering FDI, frequently overlooked by the investment community and oil executives are the inherent legal risks in the misalignment between international contracts and those mandated under LCR's; especially where the initial fiscal terms look attractive. Often these risks do not materialize until a contractual dispute, political upheaval including policy and legislative change or environmental crisis arises, which will often be long after significant capital has already been committed, further inflating Barrel Prices. Whilst developing markets are prone to these risks, these factors are rarely factored into the Barrel Price and therefore proactive procurement, contracting, governance and project management strategies must be implemented early on and revisited throughout the lifetime of the oil and gas project (Project), to minimize the impact on business disruption, health and safety or financial loss.

Varying Production Costs:

Investment in high oil and gas dependent developing countries, as has been indicated in relation to SSA, does not consistently attract FDI, as the components of Barrel Price can be inflated through higher capital costs, taxes, transportation costs, infrastructure unreliability and security costs. Risks of expropriation during periods of political instability and the imposition by some countries of a requirement of majority domestic ownership can be a significant deterrent to FDI (*see further 'On the Determinants of Foreign Direct Investment to Developing Countries: Is Africa Different?' World Development Vol. 30, No. 1, pp. 107 to 119, 2002*).

Oil and gas barrel production Cost, March 2016

Country	Gross taxes	Capital spending	Production costs	Admin transport	Total
UK	$0	$22.67	$17.36	$4.30	$44.33
Brazil	$6.66	$16.09	$9.45	$2.80	$34.99
Nigeria	$4.11	$13.10	$8.81	$2.97	$28.99
Venezuela	$10.48	$6.66	$7.94	$2.54	$27.62
Canada	$2.48	$9.69	$11.56	$2.92	$26.64
U.S. Shale	$6.42	$7.56	$5.85	$3.52	$23.35
Norway	$0.19	$13.76	$4.24	$3.12	$21.31
U.S. non-shale	$5.03	$7.70	$5.15	$3.11	$20.99

Prospect Law Ltd
23 Berkeley Square, London W1J 6HE
T +44 (0)20 7947 5354

Regus House, Pegasus Business Park, Castle Donington, Derbyshire DE74 2TZ
T +44 (0)1332 818 785

@prospectupdate
E info@prospectlaw.co.uk
www.prospectlaw.co.uk

Oil and gas barrel production Cost, March 2016

Country	Gross taxes	Capital spending	Production costs	Admin transport	Total
Indonesia	$1.55	$7.65	$6.87	$3.63	$19.71
Russia	$8.44	$5.10	$2.98	$2.69	$19.21
Iraq	$0.91	$5.03	$2.16	$2.47	$10.57
Iran	$0	$4.48	$1.94	$2.67	$9.08
Saudi Arabia	$0	$3.50	$3.00	$2.49	$8.98

Source: "Barrel Breakdown" Wall Street Journal, April 15, 2016.

Increased Costs: Nigeria & Angola

It is evident that in Nigeria, the total Barrel Price is significantly higher than most of the emerging markets largely due to higher capital and production costs. In times of low oil prices, Nigeria therefore does not attract FDI. These increased costs are due in part to lack of confidence in infrastructure and security concerns - most of the exploration activities now occur offshore, which attracts significant capital spending. Indeed, as indicated above the trend is that SSA countries attract less FDI than MENA or indeed other developing regions. This is troubling not only because of the significant oil reserves (Nigeria and Angola have amongst the highest proven reserves in the world) but because FDI is crucial to the region to help accelerate growth through technology, knowledge transfers, employment and infrastructure.

Pade Durotoye, chief executive of Nigerian independent Oando Energy Resources, has expressed frustration at the delay the company faced in exploration and production on its acreage because of unattractive terms.

"*One of the things we are trying to make the government understand and appreciate is that a higher government take of nothing is nothing*," he said at the Africa Oil Week conference in Cape Town (2017).

Future Reform:

These messages come at a critical time for the industry in the region, as governments rethink their hydrocarbons strategies at $50-60 oil. The continent's two largest oil producers, Nigeria and Angola, are revamping their investment and legal frameworks for the oil and gas sector, and a plethora of other African states are keen to emulate the recent success of Senegal, Mauritania and Mozambique in kick-starting exploration and converting successful finds into concrete development plans.

Cote d'Ivoire, having just settled a protracted maritime border dispute with Ghana, has re-launched its efforts to encourage new exploration, offering redrawn blocks through direct negotiation with oil companies. Elsewhere on the continent, Namibia, Sierra Leone, Liberia and the Gambia are also promoting frontier offshore acreage. Onshore, Mali is also offering up blocks, hoping that investors will overlook the security risks posed by Islamist terrorism.

They will be keen to emulate countries such as Ghana, Mozambique and Senegal, which have managed to maintain exploration momentum during the industry downturn since Brent crude futures began to tumble in mid-2014.

In Part 3 of this series Alex Bakhshov will take a closer look at Mozambique, which has consistently attracted FDI, thus bucking the trend amongst SSA countries. Alex will take a close look at Mozambican Regulators' approach to working in collaboration with IOC's to develop its infrastructure and implement legal and social reform by working towards an innovative legal framework and diversification of its markets.

Alex Bakhshov is a commercial lawyer specialising 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.

Prospect Law is a multi-disciplinary practice with specialist expertise in the energy and environmental sectors with particular experience in the low carbon energy sector. The firm is made up of lawyers, engineers, surveyors and finance experts.

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.