

*The only thing to do with good
advice is pass it on.*

Oscar Wilde



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UNDERSTANDING
CONTRACTS AND NEGOTIATING SKILLS
FOR IRAQ

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Speech Prepared for GetEnergy for Iraq 09

Contracting and Negotiating Skills

Commercial Transactions, Politics and Long-Term Partnerships

Firstly I must thank the Ministry of Oil and Getenergy for the invitation to speak at this important event. It is a privilege to be here.

As an independent lawyer in the oil industry I have spent my whole career involved with the negotiation and implementation of upstream contracts. These are among the largest (in terms of value) and the longest-lasting of all commercial transactions, but there is a lot more than just money at stake. These transactions have a global economic and political significance. Ultimately the security of the world's energy supply and the health of the global economy depend upon them.

From the viewpoint of the Republic of Iraq, the owner of a very significant proportion of global oil reserves, the contracts that it signs with independent oil companies for the production of its reserves are of huge significance, not just economically but also in terms of politics and international relations. Iraq seeks to meet not only the immediate need for investment and income, but also to foster the long-term relationships and partnerships that will meet those needs into the future, for the long-term benefit of the Iraqi nation and its people.

Three Key Types of Upstream Transaction

I have been asked to introduce three of the key types of upstream transactions, and these are:

- 1. Agreements with Resource Holders**
- 2. Joint Operating Agreements**
- 3. Agreements with Suppliers and Contractors**

I am acutely aware that there are people here today who are experts in these upstream transactions, but for the benefit of those from other disciplines I must give a brief outline of each of these three key types of contract – who the parties are and what the contract is about.

I also want to mention briefly in each case how the contracts are let, where the balance of bargaining power lies and what affects it, and to give just a flavour of the general character of the negotiations.

1. Agreements with Resource Holders

Parties: In Iraq, as in most other nations, the petroleum resources belong to the State. These agreements with resource holders are the arrangements under which the State engages one or more independent oil companies (“IOCs”) to conduct petroleum operations in some part of its territory.

Outline: Lawyers refer to these agreements generically as the “grant of rights”, which accurately characterises the arrangement. These Agreements set out the petroleum operations that the IOCs are authorised to conduct and the rules governing those operations, and the remuneration of the IOCs in the event that petroleum is discovered and produced.

Form of agreement: Each State decides for itself the form which these agreements take: either a Licence, a Production Sharing Agreement or (as with Iraq) a Service Agreement. Each State adopts its own preferred terms, so there are literally hundreds of petroleum regimes round the world.

How the contracts are let: With a state that is not a proven petroleum province, the IOCs may be able to proceed by direct negotiation, which is always their preference. But a proven petroleum province is in a position to put these agreements out to tender (as Iraq is doing in its current Bidding Rounds) in order to maximise the competition and obtain the best possible terms.

Bargaining power: In these negotiations the balance of bargaining power is directly related to the available reserves. With a proven petroleum province such as Iraq the bargaining power lies firmly with the State; there will be many IOCs competing for the opportunities that are on offer.

Character of negotiation: Negotiations over grants of rights tend to be formal and civilised, however deep the differences between the parties may be. The individuals representing the State are senior officials from the Ministry or the National Oil Company, well aware of their privilege and responsibility to represent the people. The individuals representing the IOCs are senior executives, well aware of the need to distinguish their company from the competition. So in the negotiation of a grant of rights you are unlikely to hear angry exchanges or raised voices.

2. Joint Operating Agreements (“JOA”)

Most grants of rights are awarded not to a single company but to a consortium of two or more. For example in the first Iraqi Bidding Round earlier this year, the contract to operate the super-giant Rumaila oilfield was awarded to a consortium consisting of British Petroleum and China National Petroleum Corporation.

Parties: The Joint Operating Agreement is the agreement between the members of the consortium and provides for the conduct of joint operations.

Outline: The JOA sets out how the co-venturers will exercise their rights and meet their obligations under the grant of rights, and so the JOA is necessarily subsidiary to the grant of rights.

The JOA sets out the co-venturers’ shares of in the project (“participating interests”). All key decisions are made by an operating committee, on which all the co-venturers are represented, by a passmark vote. Each co-venturer is responsible only for its share of costs and is entitled to its share of petroleum produced.

One of the co-venturers will be appointed as the operator, with responsibility for the day-to-day conduct of petroleum operations in accordance with decisions made by the operating committee.

How the contracts are let: JOAs are always fully negotiated, with all the co-venturers represented. The tension is between the operator and the non-operators.

Bargaining power: Although the operator, who usually holds the largest participating interest, may try to dictate the terms of the JOA to the smaller interest holders, the terms of the JOA must be agreed unanimously by all of them. Without a JOA no operations can take place. So in a sense all the co-venturers are equal, even if their shares are different. No one co-venturer holds the bargaining power to dictate to the others.

Character of negotiation: These negotiations tend to be lively. Sometimes a JOA negotiation, or operations under a JOA, can become very heated indeed. Only once in my career have I seen a fist fight in a business meeting. This was in an operating committee meeting, when the negotiators came to blows over the location of an appraisal well.

The saving grace is that, regardless of who the operator is or what the co-venturers' shares are, the parties are in this project together. If it succeeds, all of them gain, and if it fails, all of them lose.

3. Agreements with Suppliers and Contractors

Our third key type of contract is agreements with suppliers and contractors, also variously called "supply contracts" or "procurement contracts".

Parties: These contracts are between the operator of the project and the suppliers and contractors providing the goods or services. The big operators have dedicated departments responsible for letting and overseeing them, usually called the "contracts" or "procurement" department.

Outline: These are the contracts for the supply of goods and services required in petroleum operations – contracts for drilling rigs, the construction of facilities and pipelines, and all the rest. Major oil and gas projects cost billions of dollars, and this is where the really big money is spent. With a major project there will be a very large number of these contracts.

How the contracts are let: We noted earlier the IOCs' preference to negotiate the grant of rights directly with the resource holder, rather than having to go through a bidding process. But when the operators are letting procurement contracts, they always put them out to tender if it is possible to do so, and this is actually a requirement under most JOAs.

In outline the tendering process involves sending each qualified and interested contractor an identical tender package. The tender package consists of the specification (a detailed technical description of the goods or services required) and the contract terms and conditions, complete in every respect but with the price left

blank. The idea is that the interested contractors bid their best price and the operator awards the contract to the lowest bidder.

To those who have never been involved in the process, this may sound like an elegant and effective way of obtaining the goods or services required at the lowest possible price. In practice however the tendering process is not so straightforward.

The contract terms and conditions in the tender package will be the operator's preferred terms, which will usually be very favourable to the operator. So the contractors who bid will usually also request some "contract exceptions" – changes to the contract terms to make them more favourable to the contractor.

Bargaining power: The balance of bargaining power in the negotiation of procurement contracts depends entirely on the state of the market, which in turn is driven directly by the oil price.

In times of low oil prices and low levels of activity, the contractors are keen for work and may have to put in a low bid and accept the unfavourable contract terms. In times of high oil prices and high levels of activity, the bargaining power is with the contractor. If there is only one contractor available who can do the work, it has the bargaining power to impose its own preferred terms on the operator and name its price.

Oil prices have been volatile throughout history, and the demand and supply for oilfield services is seldom in equilibrium for very long. Often there is a significant imbalance one way or the other.

Character of negotiation: These negotiations tend to be confrontational. The operator usually fiercely resists the contractors' contract exceptions, because if it allows changes to the contract terms the bids will no longer be directly comparable. I was involved in a tender for the construction of the processing module for an offshore production platform. One of the contractors requested more than 350 contract exceptions. In two days of negotiations, the operator refused to agree a single one of the contractor's proposed changes. You can imagine how heated this negotiation (or more accurately this refusal to negotiate) became.

Personal Nature of Upstream Agreements

The three key types of upstream agreement we have briefly considered are all important, but they are very different in terms of the ways they are let, the balance of bargaining power and the character of the negotiation.

These contracts involve states and some of the largest companies on earth. An outsider might therefore expect them to be among the most impersonal of commercial transactions. In fact the reverse is the case. These contracts always involve face-to-face negotiations between large and experienced negotiating teams, which may last for months or even years. The negotiators will get to know and understand each other very well. They are paradoxically the most personal of all commercial transactions.

The history of the upstream demonstrates very clearly that a one-sided contract is unstable and seldom results in a successful project. Taking short-term contractual advantage does not lead to good long-term business relationships.

A contract which provides a fair balance between the rights and obligations of the contract partners is a prerequisite to the success of the project, but does not in itself guarantee success. The success of the project will also require:

- favourable sub-surface conditions – a project cannot succeed if petroleum is not present in commercial quantities;
- technical skill in the conduct of operations; and
- co-operation, communication and goodwill between the contract partners to resolve the difficult technical and commercial issues which inevitably arise in an upstream project.

This is why in the negotiation and implementation of upstream agreements the premium is not on the technical skills, which are taken for granted, but on the personal skills, the ability to relate to people, to listen, to understand and to persuade.

Training in Contracting and Negotiating Skills

The training providers in the petroleum industry, several of which are represented at this event, provide a large number of excellent courses on the technical aspects of the industry – everything from horizontal drilling to high pressure gas completions, process module design to refinery upgrades.

Courses on commercial matters are rather less abundant, and most fall into one of the following categories:

- Comparative analysis of world-wide petroleum regimes;
- The economic evaluation of petroleum projects;
- Specialist contract areas such as gas sales and LNG projects.

Courses on contracting and negotiating skills in themselves seem to be rarer still which, to me at least, has always been something of a surprise. As I have tried to demonstrate, contracting and negotiating skills are not soft, secondary or “nice-to-have”. They are absolutely essential skills right at the heart of the strategy and business of every upstream company.

The relative scarcity of courses on contracting and negotiating skills is, to my mind, a reflection of the difficulties involved. No two negotiations are the same. Each has its own unique features. The balance of bargaining power is a unique equation in each. Each involves a strong personal element depending on the objectives of the parties and the personalities of the individuals involved.

How far can anyone give general instruction on this most complex subject? Is it even possible to develop two, five or ten “golden rules of negotiation” that apply to every upstream negotiation?

Two things are however clear, and these are the foundation stones of the courses on contracting and negotiating that we and our associates offer:

Firstly, anyone giving a course on upstream contracting and negotiating skills must have long exposure to real upstream negotiations. An academic knowledge of the world's petroleum regimes, though useful, is not in itself enough.

Secondly, any course on the subject must involve real examples and situations from actual negotiations. It is difficult to develop imaginary scenarios and role-plays that bear any resemblance to a real negotiation.

I would like to end by again thanking the Ministry of Oil for the invitation to speak, and to wish the Ministry and its representatives a successful outcome in the forthcoming Second and Third Bid Rounds in Iraq.

Chris Thorpe
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Chris Thorpe is a leading independent lawyer in the upstream oil and gas industry, and an established lecturer and author.

Chris has an MA and LLB in law from Magdalene College, Cambridge and trained as a barrister in London. Chris worked for eight years as an in-house lawyer for BP and Marathon.

Chris has also lectured at many UK and International conferences, both public and in-house.

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