EGYPTIAN GAS ASSOCIATION - ANDREWS KURTH: Introducing Legal Training for Oil&Gas Companies

By Gamal Shaban and Salma Essam

The Egyptian Gas Association in collaboration with Andrews Kurth LLP Middle East, and Open Chance & Associates organized a two day training program International Oil and Gas Law and Contracts, held at the Intercontinental City Stars Hotel on the 1st and 2nd June, 2016.

The training program provided an opportunity for engineers, in-house lawyers, finance managers, commercial managers, insurance and risk managers to further expand their knowledge about key legal issues shaping the oil and gas industry. The sessions tackled a variety of themes from the impact of geopolitics and technology on legal and contractual issues to managing commercial and legal risks, claims, and disputes to different government contracts with international oil companies (IOCs).

The legal training was delivered by Hugh Fraser, Mark J. Thurber, and Vera A. Rechsteiner – Partners at Andrews Kurth LLP; Dr. Helal Farghaly, Managing Partner, and Hadir Helal, Partner at Open Chance.

Geopolitics and Technology

In the first session, Hugh Fraser outlined major geopolitical concerns impacting on the oil and gas industry such as rapidly rising long term energy demand in the developing world with respective impact on prices and investment, projected diversification of petro-economies, phasing out of coal-fired power plants under the related structures of climate control, and energy efficiency requirements. In this global context, some key patterns emerge that will likely shape the industry trends towards internationalization of national oil companies (NOCs) as clients, whereas IOCs are predicted to take over a role as technical partners in competition with independent E&P companies.

Reserves, Production, Consumption

The future of oil and gas geopolitics is undoubtedly intertwined with global distribution of natural reserves and consumption patterns that indicate imbalances of world demand and supply. Examining the statistics of oil and gas reserves, production percentages, and consumption levels, Fraser elaborated on some vital statistics.

He noted that "in terms of reserves, the Middle East has, for a long time, dominated these figures [of total percentage of global oil and gas reserves], actually, it has been coming down, it was over 50% not so long ago, but it slipped back below 48% for oil and 43% for gas reserves." The Former Soviet Union comes second with 8.3% of global oil reserves and 29.2% of global gas reserves. Third is Venezuela, which despite its struggles still has 17.5% and 3% of global oil reserves and global gas reserves, respectively. Conversely, "the US, China, and the EU, their percentage of reserves is relatively small, but remember that they are the big consumers. There is a mismatch where the demand is and where the supply is, and this is to continue for some time."

The consumption variable thus demonstrates major global disparities. Fraser explained that "the overall picture is that the supply and demand are irrelatively in the wrong places." On a global scale, the Middle East and Russia produce 31.7% and 12.7% of oil respectively, while consuming as little as 9.3% and 3.5%. In terms of the gas, the Middle East produces 16.7% and Russia 17.3% of global supplies, while consuming merely 12% and 13.7%, respectively.

However, as Fraser pointed out, "not so long ago, China has overtaken the US as the world's largest consumer of energy with 23% of the world's total energy, while the US has slipped back to just under 18% and the EU coming in third with a 12.5% figure." Their production of oil is recorded on the levels of 12.3% for the US, 5% for China, and merely 3.3% for the EU, and similarly, gas production figures show that the US produces slightly higher 21.4%, thanks to its shale gas revival, nonetheless China and the EU contribute to global gas production with some 3.9% and 6.9%, respectively.

Rise of Renewables

According to the presented analysis, future trends will further be defined by recent revolutions in liquefied natural gas (LNG) and shale gas, depend on enhanced oil recovery (EOR) advancements, keep reviving nuclear power, and most importantly witness rise of renewables.

The International Energy Agency (IEA) is currently executing a five-point plan to maintain global warming at the 2% figure, or better to reduce it to the new 1.5% stretch target by 2030. These efforts will revolve around calls for increased energy efficiency, phasing out of inefficient coal-operated power plants and fossil fuel subsidies, reducing methane emissions of oil and gas production, and increasing investments in renewable technologies. "We can all see, in the last two-three years, the renewables energy really take-off in a way that have not been witnessed in the past," stressed Fraser. He further expressed his belief that Egypt is a leader when it comes to investing in renewables and targets to get 20% of its production mix from renewables by 2022.

One of the attendants at the training program, Mahmoud Shawkat, Sales & Marketing Director at Baker Hughes, posed a vital question on how the dropping price of oil and gas may lead to halting renewable projects. Mark Thurber said that renewables are increasingly accelerating their position into a full-fledged partner in the energy mix. "Renewables are in the game to stay, they have political support and emotional support from most people who like the fact of being able to generate electricity from the sun," thus, for the foreseeable future, there will be

balanced mix between depending on renewables and fossil fuels to generate electricity, as "renewables are poised to completely take over," according to Thurber.

Geopolitics' Impact on Oil&Gas Contracts

These factors will considerably influence both the regulatory processes and the contract procedures in the oil and gas industry. Fraser drew his trainees' attention towards the importance of becoming aware that contracts, law, court-system, policy issues, power issues, currency risks and politics, all come mixed together in this industry globally. He added that one should first consider managing the international dimensions of a contract before proceeding with finalizing it. Various aspects like the intellectual property rights that the technology brings in, the courses of legislation followed, the ways disputes are solved, and the governing laws of the contract, need to be carefully studied and discussed before reaching an international agreement.

Taxation as an Incentive

Session two discussed as series of critical issues that define the relation between local governments and IOCs pertaining to the question of sovereignty and ownership of oil and gas, legal systems and the rule of law, taxation and customs duties, as well as transfer of technology with involved intellectual property rights.

The focus was on how governments regulate their oil and gas industries and control the players operating within them. "The application of currency rules, exchange controls, and the ability to repatriate profits as well has a major impact on the attractiveness of a country to investments," emphasized Fraser.

Further, he made it clear that an oil and gas company does not necessarily need to be present within a country to abide by its rules and regulations. For example, an external supplier that provides a specific service or product in a foreign country and in return takes money out of the country will have to deal with customs and import duties. The supplier might also be subject to withholding taxes. Fraser explained that "taxation can be a burden, but also in some limited occasions, may be deployed as an incentive."

Local Legal Environments

When IOCs want to expand their businesses and get into agreements with foreign countries and their local companies, they will end up dealing with governmental entities on an extensive level. Therefore, it is important to be aware of relations dynamics, when "governments can be clients, can be contactors, can be licensees, they can be tax collectors, they can be enforcement agencies, and they can be playing a major role in dispute resolution processes," as Fraser explained.

Similarly, every single employer that wants to come in a new territory will have to go through the employment and the immigration laws that the targeted country imposes Fraser stressed that these expert expat and local workforce hiring dynamics need to addressed upfront and properly in order to avoid possible serious mistakes that can rise up between governments and IOCs as a consequence of failing to understand how relevant local laws function.

The Principal Contracts

Fraser also provided an overview of the principal types of contracts that are existent in the Oil and Gas industry, elaborating on their function that shapes the relation of the involved parties. Drafting legal contracts between two or more parties is crucial for validating the agreed upon deal as a legitimate, official, and binding agreement, as he noted.

The principal contracts in the oil and gas industry revolve around the industry's three major sectors - the upstream, midstream and downstream. "By and large, you can probably segment contracts, which governments place in the industry into three different types," said Fraser. The Exploration and Production (E&P) Licenses, the oldest form of contract that the industry has applied, tends to be more of a "laissez-faire" type of contract as it gives the most freehand and the most attractive commercial terms to operate the licenses, which are commonly known as concession agreements, further explained Fraser.

The Exploration and Production Sharing Agreements (EPSAs / PSCs / PSAs) that were first introduced by Indonesia in the early 1960s and laid foundation for "a new mechanism for contracting within the oil and gas industry, said Fraser. This type of contracts tends to "rebalance the commercial situation more in favor of the producing nations" rather than IOCs, he pointed out. PSCs mechanisms often tend to come in the form of JV agreements as the contracting entities usually share their costs, risks, and profits. Fraser believes that this type of contracts is more common in the Middle East, than in the North Sea, US, and Australia where typically there are more E&P licenses.

The Enhanced Technical Services Agreements (ETSAs) are very appealing for governments, according to Fraser, as they want to move away from the interests of IOCs, JV agreements, and profit sharing arrangements. "Effectively, instead of a profit-sharing mechanism, here [in ETSAs] it is a fees-for-services mechanism; sometimes on a peer basis, sometimes on a risk-reward basis for the fees are enhanced performance."

Contracts Negotiations

In addition to the terminology of the principal contracts, Mark J. Thurber at Andrews Kurth LLP, elaborated on Licenses/Concessions, PSAs, ETSAs, and joint operational agreements (JOAs) in another session that examined the processes of drafting and negotiating agreements between governments and IOCs.

Licenses/Concessions grant exclusive rights to IOC to explore, develop, and produce hydrocarbons, while management, control of operation, and facilities rest in the hands of IOCs. In addition, title to hydrocarbons is vested in IOCs, while state financial interest is constrained to a signature bonus, or royalties and taxation of profits, which depends on the clauses concluded in this type of a contract.

"Production sharing contracts started out 60 - 70 years ago with extremely generous rates to the oil companies to the extent that they owned and controlled large reservoirs of oil with no particular obligations to ever return

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it or develop it; very favorable royalty provisions," noted Thurber. "Today, we do not have any of those types of contracts left, but we still do have different degrees of ownership," he added. Currently, PSAs are formed through Joint Ventures between governments and IOCs to explore, develop and produce hydrocarbons, whereas title to hydrocarbons remains with state. Thurber stressed that this issue should be analyzed carefully by companies in order not to end up in contracts where it controls reserves, but it is not allowed to report them for financial accounting purposes.

On the other hand, technical services contracts (ETSAs) are designed on the scheme where technology / know-how are the key driver and title to hydrocarbons remains with state. Under this type of agreements, IOC receives fees based on production revenues, while state financial interest is production revenues and taxation of IOC fees.

As Thurber pointed out, all contracts have minimum commitments that partners are bound to undertake including geological works, drilling of exploration wells, letters of credit, that governments consider as a guarantee for contractors to fulfill their operational, financial, and other contractual obligations.

Additionally, he highlighted the importance of termination/expiry contracts especially when the operation fails to bring production, and the contractor seeks compensation for the high cost of the investment he had made. "As a contractor you want to make sure that you are in a position to have established your economics by the time you get to that point," stated Thurber. Further, an exit from a concession in the form of relinquishment can be thought of as a partial termination of a contract, when "most of the acreage in the original exploration block that is won through a bid round goes back to the sovereign after the contractor decided which parts it wants to keep," as he explained.

In the discussion on JOAs, Country Manager of Beach Energy, Samir Abdel-Moaty, addressed a major issue "if one party at default did not pay cash calls during the exploration phase, which has a minimum work program commitment with better guarantees to the EGPC." He described this scenario saying that "it is not in favor of other parties in default as it would lead to distributing working interest to other parties, and that means that other parties have to pay more and get more cash calls." The question remains if JOAs can handle these cases to avoid these scenarios from occurring. In this case, Fraser stressed on the importance of cash backing and extra guarantees, including the need to resort to bonding from banks.

Joint Ventures

The rationale and processes behind the formation of JVs was further discussed and Partners enlightened the audience as to the types of joint ventures, the players, joint operating agreements, and other types of deals, as well as commercial logic for contracts.

Hugh Fraser shed lights on joint ventures companies (JVs) dividing them into three types including co-operation / collaboration agreements / alliances; consortium & agreements; and standard joint venture companies. As he explained, "the collaboration agreements do not involve necessarily a single project or do not involve necessarily setting up a new JV company to put some shape and legal substance as in [standard] JVs; they can be relatively short-term or short-term collaboration arrangements, usually purely contractual signed up between parties for whatever scope or duration."

In addition, there are three major categories of deals between governments, NOCs and IOCs: farm-in/farm-out; acquisition and disposal of assets; and corporate takeovers. "Farm-ins and farm-outs typically apply when there is a partial change of the ownership of the venture," said Hugh. In asset deals "there are no corporate structures involved [instead] the assets are being acquired," he elaborated. And the third type is with corporate structures and groups where assets are being acquired and corporate entities and corporate groups" are coming in, concluded Fraser.

Types of agreements to pull joint ventures together, as Fraser elaborated, revolve around study and bid agreements, memoranda of understanding, joint operating agreements, accounting procedure schedule, lifting agreements, and balancing agreements.

Managing Risks, Settling Disputes

The training also covered the issues of managing and solving legal risks and claims that can be easily transformed to greater disputes if they are not handled properly. Hugh Fraser discussed a variety of subjects from dangerous and risky businesses to commercial risks to liability and indemnities to limitations and exclusions. The partners proposed an approach according to which the risks are to be mapped in line with a so called 'grid system.'

When it comes to settling controversies, there are five options to choose from: litigation, the ultimate legal method for resolving disputes that is publicly done through a state opened process; arbitration, a private process that is usually less expensive than litigation; expert decision, "particularly in regions where arbitration and litigation can be very time consuming, very costly, and producing results which are uncertain;" mediation, a non-binding process that does not involve brining in a third party; and finally, negotiation, "the best of all, no need to involve third parties [as] it is private, informal; the timeline is entirely driven by the parties and there is no or limited external costs involved," as Fraser concluded.

At the end of the session, Fraser pointed out some advice for the audience to keep in mind for coming up with an effective problem solving process. The top five tips that the attendants were advised to follow suggested to conduct proper cost-benefit economic assessments of how to handle a dispute, prepare a professional analysis on the substantive and procedural matters from a legal point of view, review all the evidence independently and objectively, tell 'the whole story' to the officials involved with the case, and finally, to de-personalize the process.

Service Contracts

The last session disclosed the interface between oil companies and the service sector. It mainly addressed the oil and gas upstream service agreements with specific reference to rig hire and drilling services contracts and engineering, procurement, and construction contracts (EPC).

EPC contracts involve often understudied, yet inevitably present elements such as planning, design, engineering, land rights, procurement, construction, installation, pre-commissioning, inspection, testing, and commissioning. In addition, according to Fraser, EPCs are "very dangerous animals to deal with, because the scale of the contract of EPC is very likely to [have] a whole raft for subcontractors," which "is one of the major pivot points of the industry" as some operators try to simplify their interfaces with supply chains and large number of involved service companies, noted Andrews Kurth Partner Fraser.

The training program concluded with the collaborative partners from Open Chance - Dr. Helal Farghaly and Hadir Helal - taking an active part in responding to participants' questions and issues they raised in particular with regard to the practical conundrums that the Egyptian oil and gas companies are facing in the existing environment. They provided a plethora of solutions that unveiled some useful tips to navigate through the Egyptian legal framework.

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