The Governance of International Oil: The Changing Rules of the Game

Bernard Mommer

Oxford Institute for Energy Studies

WPM 26

2000

The contents of this paper are the author's sole responsibility.
They do not necessarily represent the views of the
Oxford Institute for Energy Studies
or any of its Members.

ISBN 1 901795 16 0

CONTENTS

EXECUTIVE SUMMARY

This paper deals with upstream oil where it is conventionally assumed that the game is about rent capturing involving two parties: the governments owning the natural resource, and the international companies. There is, however, a third party to the game: the governments of consuming countries. The issues, therefore, are not only about rent; they also relate to prices. As a matter of fact, the game strategically is about prices, and only tactically about the capturing of rent. It is at the strategic level that the governance structure of oil has to be analysed. This structure defines the rules determining the oil price level in the long term, to which the tactical rules of rent capturing are subordinated.

Governance structures have a history; they are set up at a time when a dominant player can exercise power in favourable circumstances. The author argues that the private oil companies, which constituted the International Petroleum Cartel, set up the first governance structure in the inter-war period. The second structure emerged when the oil-exporting countries, after the Second World War, formed their own cartel, OPEC. The first governance structure collapsed definitively when the 'OPEC revolution' took place in the early 1970s. This provoked the intervention of the governments of consuming countries, which established the International Energy Agency (IEA), to create a third governance structure to deliver lower prices.

Setting up a governance structure is the putting in place of a set of rules. Hence, the strategic game aims at changing the rules, as each player will be always looking for ways that improve them in its favour. The relevant set of rules consists basically of the following elements: (1) the licensing regime; (2) the fiscal regime; (3) issues of sovereign taxation, and (4) methods of dispute settlement. The paper summarises the evolution of these rules through the first and second governance structure, and goes into greater details regarding the third one. It thus provides an account of the IEA, of the new role of the national oil companies (NOCs) of exporting countries when entering into upstream contracts with private investors, the development of bilateral investment treaties regarding upstream oil, mentions shortly the WTO and, last but not least, analyses the Energy Charter Treaty (ECT).

The paper concludes that out of the first governance structure, characterised by the fifty-fifty profit sharing principle – the ultimate compromise – two extreme structures have developed. The first is nationalisation by oil countries as a result of ground-rent maximising objectives. The second is the consuming countries' reaction, which denies the legitimacy of natural resource ownership claiming for ground-rent. In this context, the oil-exporting

countries claimed for their right to manage oil in relation to economic development and social objectives; today, the consuming countries ignore the relevance of this argument.

Over the last fifteen years or so, the trend has been in favour of the consuming countries, in the sense that their governance structure has made significant inroads even into some OPEC countries and, of course, into the former Soviet Union. But there has been no trend converging towards a new governance structure all parties could live with. Hence, the conflict-laden history of international oil in the twentieth century is bound to continue well into the twenty-first century.

INTRODUCTION

Most people still believe that the big international oil companies dominate the governance of world oil. This is not surprising since these companies continue to be amongst the largest in the world and through most of the twentieth century their power has been unchallenged. Their eclipse inside the exporting countries by the national oil companies has been only partial since they have not lost their supremacy in the development and application of new technologies; and outside the exporting countries they have ceded none of their powers. In short, it is clear that the international oil companies are not preparing to retire from the stage they have dominated for so long.

Of course, they have always had to share it to some extent with the oil consumers. When the companies' power was at its height there was great concern in the consuming countries about integration and the question of cartelisation vs competition. The companies were accused of imposing an unacceptable burden on consumers through their International Petroleum Cartel and had to endure attacks such as the famous investigation in the early 1950s by the US Senate's Select Committee on Small Business. This debate seemed like the main plot in the drama of world oil.

Waiting in the wings, however, was a third group of actors which for a long time remained invisible and ignored. The governments of the producing countries had granted big concessions to the oil companies and the power of the Cartel depended on these. The significance of these governments was not understood even after they had joined together to form OPEC. And so their entry into the drama of governance came as a complete and very costly surprise to the governments of the consuming countries.

What had looked like a simple couple consisting of companies and consumers was revealed to be a *ménage à trois* of companies, consumers, and the concession granting governments. The more active, even dominant role which these countries started to play stimulated a reaction from the governments of the developed consuming countries which formed the International Energy Agency (IEA). This attempt to redress the loss of consumer power amounted to a recognition that the companies could no longer guarantee a secure supply at a reasonable price since they had lost an essential part of their power, based on the concession system, a system which ultimately depended on the colonial and semi-colonial supremacy of consuming countries over producing countries.

The drama of oil governance had turned out to be more complex than most observers had believed. There was the larger cast of characters; not only companies, consumers, and

their governments but also the previously ignored characters, the governments of the producing countries which controlled the access to the natural resource. They always had a hidden importance and had finally become the defining characteristic of the governance structure. Not to take this into account is to assume, in contradiction to the clear facts, that these governments do not play an active role in the drama.

A governance structure – a set of political and legal rules based on power relations – delivers a price, an economic variable; different governance structures therefore deliver different prices. This is obvious to social scientists, historians and politicians, but not to economists. Economists tend to look at the problem the other way round: price is the outcome of demand and supply conditions in the market and the governance structure has simply to adapt to changes in these competitive market forces. They insist on this view even when natural resources are privately owned.

Private Mineral Ownership[1]

The fact is, however, that landlords demand a minimum or reservation ground-rent just as tenants demand a minimum level of profit, and workers demand a minimum wage. These three reservation levels are included as costs in the price paid by consumers, who accept them all as the outcome of competition and not of conspiracy or monopoly behaviour. Landlords and tenants partake in the strategic struggle about what the reservation ground-rent should be. Once the strategic reservation ground-rent has been established – consisting basically of a normal royalty rate to be paid even on marginal lands or on marginal barrels – the negotiation of any new lease involves a more tactical struggle over economic rents, specifically Ricardian rents, over and above the reservation ground-rent and profit.

It is useful to see the process as a two-stage one. In the first stage a reservation ground-rent is determined (assuming that the reservation profit has been determined previously). The status of different kinds of land is established in relation to this level: there are lands too poor to be exploited, marginal lands, and better lands with sufficient productivity to generate Ricardian rents. In the second period new leases are taken and old ones renewed or abandoned. These leases, however, are entered into within an already established legal and political framework. The reservation ground-rent does not change even with extreme variations of prices. Only the status of different kinds of land will change, and

[1] Bernard Mommer (1997): *Private Landlord-tenant Relationship in British Coal and American Oil: A Theory of Mineral Leases*, OIES Paper EE20, Oxford Institute for Energy Studies.

the equilibrium in the market is maintained by changes in supply from existing leases, and also by bringing in new, or abandoning old, leases.

At the heart of this governance structure is the reservation ground-rent. Its stability comes from the fact that it is embedded in numerous contracts which form a complex social, political, and legal structure. This structure works as a shock absorber: it evolves and change but can only be destroyed by really exceptional events. When that happened the game reverts to its strategic phase of defining a new reservation ground-rent.

Public Ownership

The costs imposed by private landed property, however, are not limited to ground-rent. They also include transaction costs, surveillance costs and, most importantly, obstructions to the development of productivity. These costs can be high and have a direct influence on prices. That is why almost everywhere in the world mineral resources, especially those found at greater depths, are publicly owned regardless of the political regime. Here the issue is not socialism vs capitalism, or even left vs right, but above vs below. Conventions about the property rights differ as a result of differing uses of the surface and the subsurface.

Public ownership, however, does not settle the question of ground-rent. In cases where the state regards the natural resource as a free gift of nature or common property, licensees or concessionaires will be considered ordinary taxpayers and fiscal policy will aim for production efficiency, high volumes and low prices. On the other hand, if the state regards the natural resource as a national (or regional) property, a potential source of an international (or interregional) ground-rent, then it will still aim for production efficiency but not for low prices. It is possible for the state to hold an amalgam of these positions pursuing low prices for domestic consumption but high prices for exports.

The first case corresponds to the liberal ideal of modern economics: the state grants concessions or licences under proper political control from investors and consumers. Reservation ground-rent is set at zero, and only economic rents are targeted by the fiscal regime.[2] But when the state treats the resource as national property and acts as landlord it will demand a reservation ground-rent just as in the case of private ownership. As a sovereign monopolist it can even impose a higher level of ground-rent than private landlords, a fact which has been decisively demonstrated by Third World oil-exporting countries.

---

[2] Bernard Mommer (1999): *Oil Prices and Fiscal Regimes*, OIES Paper WPM 24, Oxford Institute for Energy Studies.

Tenants, Landlords, and Consumers in International Oil

The most important conclusion from this discussion is that landlord-tenant relationships are determined as part of a broader economic, political and social system. Under capitalism, new governance structures were designed to replace the old dominant form of surplus value, ground-rent, with the new one, profit. The tenants negotiate and attempt to limit the power of landlords; and governance structures normally support them. Consumers are only present indirectly, through whatever role they play in the politics of these structures and through competition. This results in guaranteed supplies at reasonable prices, though it does not eliminate ground-rent. Reservation ground-rents, however, are normally constants either in amount per unit of production or percentage of the price. Consumers' needs are generally met and the conflict between landlords and tenants is restricted to Ricardian rent.

This was basically the situation which existed in international oil up to the 1950s. The dominant players were the big international tenant companies, backed by the European powers and the USA, which became known as the International Petroleum Cartel.[3] After the Second World War, however, the power of the imperial countries over the Third World began to weaken and, as part of the process, the Cartel lost its control over the oil-exporting countries. The landlord states emerged as the new dominant players. It was their turn to form a cartel, OPEC, and then to dismantle the old governance structure which finally collapsed in the so-called 'OPEC revolution' of the early 1970s. The international tenant companies were nationalised and a new governance structure, dominated by OPEC and the successor national oil companies, was established. To begin with oil consumers and their governments were surprised by these events which according to economic theory should not have been possible and they reacted with confusion.[4] They quickly realised, however, that they would have to take a much more active role if security of supply and reasonable prices were to be assured. They undertook the task of creating a third governance structure of international oil. And so they, too, cartelised by forming the IEA.

---

[3] U.S. Senate, Select Committee on Small Business (1952): *The International Petroleum Cartel*, Staff Report to the Federal Trade Commission, 82nd Congress, 2nd Session, Publication of the Committee No.6, 22 August.
[4] Bernard Mommer (1983): *Die Ölfrage*, Institut für Internationale Angelegenheiten der Universität Hamburg, Nomos Verlagsgesellschaft Baden-Baden; Chapter 7: 'Zum Verständnis, Unverständnis und Selbstverständnis der OPEC'.

Conclusion

The governance of international oil in the twentieth century can be divided into three periods each characterised by the dominance of one of the three fundamental actors: international tenant companies, landlord states, and consuming countries. In each of these periods the dominant players altered the rules to their advantage. But they have all played the game at two levels: tactically they try to make the best of the existing rules while strategically they try to stretch and ultimately replace those rules with new ones. The main concern of this paper is with this strategic part of the game, especially in the last period, emphasising the single most important event of the new, still developing governance structure, the Energy Charter Treaty (ECT). Before considering that, however, the next two chapters briefly examine the first two periods.

1 THE INTERNATIONAL TENANT COMPANIES[5]

The invention of the internal combustion engine turned oil into a strategic good for industrialised economies and an indispensable ingredient for modern warfare. Yet among the most powerful countries only the United States possessed abundant domestic resources. The European powers had to look for concessions elsewhere, in Rumania, Russia, their colonies, or other dependent territories. Thus, the Netherlands and Royal Dutch-Shell were predominant in Indonesia, Britain and the Anglo-Persian Oil Co. (APOC)[6] in Persia. And all of them, including the USA, were competing for Mexican oil.

On the eve of the First World War the supply of oil had become such an important issue to the then dominant European power, Great Britain, that the government decided to become a majority stockholder of APOC. After the war the other European powers followed suit founding their national oil companies.[7] Oil was only to be found at great distances, in politically and economically difficult environments and, therefore, its supply could not be guaranteed by private enterprise alone.

1.1 The Eastern Hemisphere

With the loss of Russian oil to the Bolsheviks and a shortage in domestic supplies in the United States, the struggle amongst the victorious powers came to centre on the potential oil riches of the Middle East. Neither Turkey whose empire had collapsed nor Germany, crushed after Versailles, were any longer protagonists. But the manoeuvrings of the other powers led to the formation of the Turkish Petroleum Company (TPC),[8] an association of British, Dutch, French, and American interests, to the famous 'Red Line Agreement', and to the establishment of the International Petroleum Cartel.

The European powers and the United States were heavily involved in this first international governance structure, either directly as shareholders, or indirectly through the strong support they gave to their private companies. The apportioning of the potential oil wealth was based on the joint ownership of huge, nation-wide concessions. The governments of the major powers concerned themselves mainly with the strategic issue of security of

[5] Mommer, *Die Ölfrage, passim.*
[6] The company was renamed Anglo-Iranian Oil Co. (AIOC) in 1935, and finally British Petroleum (BP) in 1954.
[7] During the Second World War even the American government seriously considered becoming a majority shareholder of the Standard Oil of California-concession in Saudi Arabia.
[8] Renamed Iraq Petroleum Co. (IPC) in 1929.

supply, and to a lesser extent with prices. But, for the most part, the business of oil, including the details of the landlord-tenant relationship, were left to the companies.

The 'Red Line Agreement' of 1928 was an arrangement between the companies to hold down ground-rent by not competing for concessions. Despite the agreement competition sometimes occurred (in Iraq and Saudi Arabia, for instance), resulting in contracts which were more favourable to the landlord states than in those cases (such as Kuwait and Qatar) where the tenant companies applied jointly for concessions.

The principal form of ground-rent in the earliest concessions was a percentage of net profits. In Iran it was 16 per cent, and in Indonesia 20 per cent. A similar system was originally planned for the TPC concession in Iraq but, after US pressure, was replaced by a tonnage royalty of four shillings, which became the new reference in the region.[9] Iran also adopted this royalty in its earlier concession, though not without a major confrontation with APOC and the British government.

The tenant companies insisted that the contracts not only should encompass ground-rent but also sovereign taxation. In this respect the exceptional case of Iraq is of particular interest. The original concession contract of 1925 – negotiated in the midst of competition and confusion between the future associates – recognised the right of the government to impose the same taxes upon the company as "those ordinarily imposed from time to time upon other industrial undertakings".[10] Six years later, however, the companies put aside their differences and together succeeded in renegotiating the contract. In return for "complete fiscal exemption"[11] an additional but contractually fixed levy was agreed.[12]

The tenant companies also insisted that the contracts should be subject to international law and arbitration rather than national law and jurisdiction. Consequently, during the life of the contracts (between fifty-five to seventy-five years) payments were fixed, or could only vary according to narrowly defined contractual rules. The embryonic landlord states were thus deprived of their sovereign rights.

---

[9] Although the *nominal* tonnage royalty in the Middle East was everywhere quite close to four shillings, in real terms there were significant differences. Only Iraq, Saudi Arabia and Iran got a guarantee in gold. But even in these cases, the fact is that at the time Iran signed the new concession contract in 1933, the shilling had already lost 30 per cent of its value in gold.

[10] Quoted by George W. Stocking (1970): *Middle East Oil*, Vanderbilt University Press; p.132.

[11] Zuhayr Mikdashi (1966): *A Financial Analysis of Middle Eastern Oil Concessions: 1901–1965*, Praeger, New York; p.304.

[12] For an interesting account on the case of Iraq see Francisco Parra (1999): "Oil in the Twentieth Century: The Way We Weren't", *Oxford Energy Forum*, No. 40, Oxford Institute for Energy Studies, Oxford; p.2.

1.2 Western Hemisphere

The situation in the Western Hemisphere was very different. There the companies had to deal with sovereign countries, which could look back on a long tradition of mineral laws. Nation-wide colonial-style concessions were out of the question. More important, as reaction to the gunboat policy of the nineteenth century, these countries refused to accept international arbitration. Foreign investors were subject to the 'Calvo clause',[13] which was incorporated into mining laws and concession contracts all over Latin America. Foreign and national investors alike were subject to national law and courts. These general principles can be seen in the two important cases of Mexico and Venezuela.

1.2.1 Mexico

By 1920, Mexico was producing about 24 per cent of the world's total oil supply, and practically all of it was exported. It was then by far the biggest oil-exporting country of the world. After 1884, private landed property in Mexico extended, as in the United States, to hydrocarbons. Hence the industry was based on private leases, on private lands, and on concessions on public lands. Mexico's revolutionaries, however, opposed private mineral ownership in oil and it was abolished by the 1917 Constitution. Those foreign oil companies who had bought land rather than leasing it, joined the counterrevolutionary front of Mexican landlords who were the real target of that agrarian revolution. Their entanglement with private mineral property unleashed a conflict which was to prove fatal to the industry. For years they questioned the government's sovereign right to tax and resisted the jurisdiction of national courts. In 1938 their refusal to abide by a Supreme Court ruling favourable to the unions became the event which triggered their nationalisation. Mexico's diminished importance in world petroleum markets at that time and the proximity of the Second World War made possible a unique arrangement whereby nationalisation of the industry was accepted – subject, of course, to payment of indemnities – by the United States and Great Britain. From then on and until the 1970s, Mexican oil was a world apart.

1.2.2 Venezuela

Public mineral ownership was never seriously questioned in Venezuela. From the outset, the oil industry was based on a relatively modern concession system. Venezuela overtook Mexico as the world's biggest oil-exporting country in 1928, a position the country was able to

[13] Carlos Calvo (1885): *Manuel de droit international public et privé*, Berlin.

maintain until 1970. And Venezuela was the great beneficiary of the Mexican debacle. In 1943 the international oil companies agreed to a radical reform. Not only had the companies learnt their lesson but also, most importantly, in the middle of the Second World War the American government was keen to avoid confrontation. Washington was in fact heavily involved in the reform process and in drafting a new Hydrocarbon Law.

The Venezuelan reform can be summarised in a few words. The legal and economic status of the sovereign, the landlord state, and the tenant companies, followed the patterns established by the United States. The foreign companies had to acknowledge once more their submission to sovereign national law, jurisdiction, and taxation. Following the example of federal lands in the United States, the usual royalty rate was set at one-sixth.

1.3 Peak and Demise of the First Governance Structure

Over the next five years, government oil revenues in Venezuela rose considerably, due to the combined effect of an increased royalty rate, increasing volumes, prices, and income tax rates, which followed the upward evolution of corporation income tax rates in the United States.[14] The rise of the Venezuelan income tax rate from 12 per cent in 1943 to 28.5 per cent in 1946 had no net effect on the American companies since they were able to credit every dollar they paid in Venezuela against their income tax liabilities in the United States; so the bill was footed by US taxpayers.

What concerned the companies was not the tax rate as such but the precedents which might be set by Venezuela's successful assertion of national sovereignty. They devised an ingenious response in the form of a pre-emptive offer. Through sheer coincidence, after the war, royalties and income taxes gave Venezuela slightly less than 50 per cent of the profits. The tenant companies offered to pay an 'additional tax', to be enacted within the Income Tax Law, to round up the split to fifty-fifty, a figure which was meant to become emblematic of fairness. In 1948, the government accepted and the companies launched a national and international pubic relations campaign the theme of which was that an ideal fifty-fifty 'agreement' had been reached in Venezuela representing fairness and justice to both the landlord state and its international tenants.

In 1943 the level of ground-rent in Venezuela was still comparable to that prevailing in the Eastern Hemisphere; by 1948 it was more than twice as high. This imbalance could not last and, indeed, over the next few years, the other oil-exporting countries also got their fifty-

fifty, albeit with one very important difference: income taxation was included in the contractual relationship.[15] Once more in Iran this only happened after a serious, international confrontation. The AIOC (BP) and its majority shareholder, the British government, were not willing to agree to a massive transfer of taxes from London to Teheran. Great Britain, ruined by the war effort and short of foreign exchange, still believed itself to be powerful enough to impose its own patterns against the USA. The British government had miscalculated for a second time, provoking nationalisation by Mosadeq, an international boycott of Iranian oil, a CIA-promoted coup d'état, and finally a new concession along with a fifty-fifty profit-sharing agreement.[16]

The first governance structure had reached its peak. Its uniformity and psychological appeal, so the companies hoped, would endow it with the desired stability. Yet from the late 1940s the oil-exporting countries got increasingly favourable deals as new leases were negotiated. In reality 'fifty-fifty' was nothing but a formalisation of an accidental outcome paying royalties and income taxes at the usual US rates on marginal lands. In the USA itself, however, the stability of the governance structure was based, ultimately, on the private character of lease contracts and the clearly liberal character of its government. It was a system controlled by producing and consuming interests, where maximising ground-rent had never been on the agenda. In the oil-exporting countries, however, the companies and the consumers were foreign, but ground-rent was not; hence the tenacious efforts to deny these countries their sovereign rights by contractual fetters. Politically this structure could not survive the collapse of colonial power after the Second World War; economically it could not survive either, because it was far too favourable to the tenants.

---

[14] In upstream oil and taking into account depletion allowance, federal corporation income tax rates were increased from a maximum of 13.8 per cent in 1938 to 37.7 per cent in 1952.
[15] Moreover, elsewhere the royalty rate was one-eighth.
[16] The international solidarity was not for free. BP had to hand over a 60 per cent share of its Iranian ventures to American, British, Dutch and French interests.

2 THE LANDLORD STATES

As soon as the oil-exporting countries became aware of the potential riches of their lands, all of them adopted the viewpoint that the landlord-tenant relationship in oil must be subordinated to the supreme goal of national development. They could not accept a contractual relationship which put them on an equal footing with a Texan rancher. They claimed their sovereign rights, not unsuccessfully, even before the Second World War. Neither in Iran, nor in Mexico, nor in Venezuela, could the tenants enforce their contracts as they would have liked to; they had to agree to renegotiations – or even worse, to suffer nationalisation.

2.1 Reservation Ground-Rent

Following the Second World War, the entire Third World bid successfully for independence, nationhood, and sovereignty; and the oil-exporting countries were no exception. Moreover, since all of them were subject to a similar scheme of profit sharing with the same international tenant companies, collective action was relatively easy to achieve. Oil-exporting countries had been in touch with each other ever since a Venezuelan diplomatic commission visited the Middle East in 1949, promoting fifty-fifty profit sharing. The Venezuelan government was convinced that it would only be able to maintain its higher fiscal take if the oil-exporting countries of the Middle East followed it. The same situation was to repeat itself ten years later. In December 1958 the Venezuelan government put an end to fifty-fifty by sovereign legislation, increasing income tax rates from about 30 per cent to 47.5 per cent. The result was a profit split of around 65:35 in favour of the government. Once more a Venezuelan diplomatic commission rushed to the Middle East to promote its latest advance. Very conveniently, Venezuela, along with Iran, had already been invited to attend the First Arab Petroleum Congress to be held in Cairo, in April 1959. Seizing this opportunity, high-level representatives of the oil-exporting countries secretly reached a 'Gentlemen's Agreement' to suggest to their respective governments the creation of a 'Consultative Petroleum Commission'. Amongst other things, they also agreed to increase their profit shares to a minimum of 60 per cent. OPEC was founded the following year.

The oil-exporting countries benefited greatly not only from the exceptional international political environment but also from geological and economic circumstances. About 75 per cent of the world's proven reserves were to be found in the OPEC countries, and demand was growing fast. Nevertheless, by 1960 oil prices were falling and, under the 'fifty-

fifty' principle, the same would happen to ground-rents per barrel. Yet OPEC immediately froze posted prices, converting them into tax reference prices, on which their 50 per cent profit share would be based. The tenant companies tacitly agreed. Consequently, although market prices continued to fall during the 1960s, ground-rents per barrel did not. In fact they actually increased as OPEC continued to set a 60 per cent profit share (also based on tax reference prices) as a minimum. This was basically achieved – after protracted negotiations and with a phase-in period lasting several years – through a fifty-fifty profit split on top of royalty. At the end of the 1960s the governments' take in the Middle East was about 75 per cent of (real) profits.

To sum up, OPEC in the 1960s increased reservation ground-rent in the face of falling prices; it converted a percentage into a fixed rent per barrel,[17] and it developed a system of fiscal reference prices. This was to be a most effective device in raising the fiscal floor to prices once there was an upturn in world petroleum markets.

2.2 Ricardian Rent

What about Ricardian rents? In the case of the old nation-wide concessions, the exporting countries insisted successfully on the gradual relinquishment of idle areas. These areas, when leased or granted again, always fetched significantly higher rents in an increasingly competitive environment. The same applied, of course, to new areas. In any case, whatever the age of the contracts, by 1968 OPEC was already determined to collect all Ricardian rent. Its *Declaratory Statement of Petroleum Policy in Member Countries*[18] left no doubt about it:

> Notwithstanding any guarantee of fiscal stability that may have been granted to the operator, the operator shall not have the right to obtain excessively high net earnings after tax. The financial provisions of contracts which actually result in such excessively high net earnings shall be open to renegotiations...
>
> In the present context, 'excessively high net earnings' means net profits after taxes which are significantly in excess, during any twelve-month period, of the level of net earnings the reasonable expectation of which would have been sufficient to induce the operator to take the entrepreneurial risks necessary.

The international tenant companies would be reduced to simple 'operators' and fobbed off with a 'reasonable' profit. In other words, OPEC was on the verge of adopting a strategy of nationalisation. Already in the 1959 Gentlemen's Agreement the exporting countries had been urged to set up National Oil Companies (NOCs). In the 1960s, participation of these

[17] Prices fell in the Persian Gulf, from an average of US$ 1.80 per barrel at the beginning of the decade to US$ 1.25 at the end. However, fiscal revenues per barrel in the old concessions increased from US¢ 80 to US¢ 85.
[18] OPEC Resolution XVI.90 (1968).

companies in new leases or concessions became the rule. This would now also apply to the older concessions:

> Where provision for Governmental participation in the ownership of the concession-holding company under any of the present petroleum contracts has not been made, the Government may acquire a reasonable participation, on the grounds of the principle of changing circumstances.

But this was only a first step:

> Member Governments shall endeavour, as far as feasible, to explore and develop their hydrocarbon resources directly.

Last but not least, the legal framework had to be adjusted to these 'changing circumstances'. OPEC claimed 'permanent sovereignty':

> the inalienable right of all countries to exercise permanent sovereignty over their natural resources, in the interest of national development.

This was a reference to the UN General Assembly Resolution on 'Permanent Sovereignty over Natural Resources',[19] approved by the majority of Third World countries. Sovereignty was to be strengthened by terminating the role of international law and arbitration:

> Except as otherwise provided for in the legal system of a Member Country, all disputes arising between the Government and operators shall fall exclusively within the jurisdiction of the competent national courts or the specialised regional courts, as and when established.[20]

By the end of the 1960s there was nothing to prevent OPEC from taking over completely. De-colonisation had already proved to be unstoppable, and OPEC oil was becoming more important to the world economy almost by the day. The old governance structure, completely corroded, was to collapse, inevitably, with the next upturn in world petroleum markets.

2.3 Nationalisation

This is what happened in the early 1970s. The governments took over the foreign tenant companies by establishing equity participations of 50 per cent, 60 per cent or, in most cases, of 100 per cent. Thus, the foreign companies were converted into nothing more than operating companies. The landlord states were now free from any fetter to the fixing of volumes, prices, royalties, and income taxes. The Arab Gulf countries, for example, in 1974 set royalty at 20 per cent and income taxes at 85 per cent. And prices soared to hitherto unknown levels.

---

[19] UN General Assembly Resolution 1803 (1962).

[20] OPEC Res. XVI.90.

3 THE CONSUMING COUNTRIES

The international tenant companies were no longer able to guarantee either security of supply or reasonable prices. The governments of the relevant consuming countries (basically the OECD countries) had to intervene directly. Yet in the short term there was very little they could effectively do. The defeat of the international tenant companies was also a defeat for them. The last act of the 'OPEC revolution' had taken place in the midst of an Arab oil embargo. Prices rose out of control as the cartel of landlord states pursued the maximum price the market could bear. The surprise element had caught the consuming countries completely unaware and OPEC was to enjoy and fully exploit its power advantage for a further decade. The world of oil became polarised between ground-rent maximising sovereign landlord states, on the one hand, and the governments of the consuming countries, on the other.

3.1 The International Energy Agency[21]

Not surprisingly, the developed consuming countries took the lead in confronting OPEC. In December 1973 the American government announced the forthcoming foundation of an International Energy Agency (IEA). After a preparatory meeting in February 1974, the IEA was established by the OECD in November of that year.[22] It immediately adopted an International Energy Programme (with the status of an international treaty, like the OPEC Charter) to deal with emergencies. Member countries had to hold stocks equivalent to sixty (later ninety) days of consumption and prepare a programme of contingent demand restraint measures. An Emergency Sharing System was put in place, and the whole arrangement was supposed to operate in close liaison with the international oil companies.

In 1976 a Long-Term Programme was adopted to reduce dependency on imported oil. This goal was to be achieved by reducing demand – or, at least, the growth of demand – through improved efficiency in consumption, conservation, new technologies and, last but not least, through higher taxes on petroleum products. The use of alternative sources of energy (domestic oil, coal, natural gas, nuclear, etc) was to be increased and the consumption of petroleum products restricted to those uses such as transportation, where it was irreplaceable. In power generation, coal was regarded as the most obvious alternative to fuel oil.[23]

---

[21] Richard Scott: *IEA The First 20 Years*. Vol. 1: *Origins and Structure* (1994); Vol. 2: *Major Policies and Actions* (1995); Vol. 3: *Principal Documents* (1995). Published by the OECD/IEA.

[22] However, the membership of OECD and IEA is not identical. France joined IEA as late as 1992. Norway is only a conditional member. Mexico joined OECD in 1994, but not the IEA.

[23] In 1979 "Ministerial Principles for IEA action on coal" were approved. According to these principles:

3.1.1 Licensing and Fiscal Regimes

Maximising output from domestic sources entailed, among other things, revising the licensing and fiscal regimes for oil and gas "so as to encourage [their] timely development".[24] Member countries were also encouraged "to exploit all economically... appropriate opportunities to minimise declines in their own indigenous oil production".[25] In plain English, all potential oil lands were to be opened up for exploration and production as soon as possible. The need to pay royalties, however, still restricted production. In the North Sea, for example, the typical American royalty rate of one-eighth applied. In 1983, therefore, the British government scrapped royalties for new developments, and Norway followed suit three years later. In this way new acreage was brought into exploration, and some previously non-commercial discoveries became commercially viable. Scrapping or reducing royalties also postponed the abandonment and definitive closure of ageing oil fields. In other words, reservation ground-rent fell towards zero, and the scope of fiscal regimes was increasingly limited to Ricardian rents. This kind of reform met with a very modest success in North America, where (private and public) royalties are widespread and deeply rooted, but it is progressing everywhere else.[26]

3.1.2 Conclusions

Although the OECD includes the most advanced countries of the world, it could only restrain but not eliminate dependency on OPEC oil despite the high prices. OPEC production peaked in the early seventies at about 31 million b/d and by 1985 had fallen to half of that level. But then, in spite of continued efforts of IEA, the growth of demand for OPEC oil resumed with the growth of the world economy, albeit at lower prices and today, OPEC production is back to over 29 million b/d.

In 1991 the OECD countries imported 58 per cent of their oil needs (38 million b/d), but by 2010, due both to increasing demand (45 million b/d) and declining domestic production, this might rise to 70 per cent. By that date imports are expected to increase by about nine million b/d, and demand in the 'rest of the world' is expected to grow even faster.

> the use of oil for electricity generation is minimised by national energy policy planning which... precludes new or replacement base load oil-fired capacity; progressively confines oil to middle and peak loads; and makes maximum use of fuels other than oil in dual-fired capacity. Scott, op.cit., vol.3, p.224.

[24] Scott, op.cit., vol.2, p.169.

[25] Scott, op.cit., vol.2, p.169.

[26] The same observations apply to coal mining. According to the 1979 "Ministerial Principles for IEA action on coal" already quoted, member countries had to ensure "that fiscal regimes, e.g., government royalties and severance taxes, ...do not adversely affect the viability of coal mining developments". Scott, op.cit., vol.3, p.227.

This increase is likely "to be met primarily by the major Middle East producers and Venezuela. Production in these countries will have to double over the next... seventeen years to meet expected world oil demand",[27] despite the widespread consumption of coal and, more recently, natural gas in power generation.

3.2 Opening up New Areas to Private Investors and National Oil Companies

The IEA came to see the problem of getting secure supplies at reasonable prices as a global one, especially since more than half of world energy consumption now comes from non-OECD countries. Member countries were urged "to promote diversified investments in world-wide production".[28] Of special interests were the "developing countries with significant potential for future hydrocarbon supply", where the IEA would "support activities of international organisations to help improve investment regimes".[29] Hence, the campaign against royalties as a rent-collecting device and in favour of excess profit taxation became a world-wide one.

The search for unexploited production potential in Third World consuming countries, however, has not altered a stark fact: 76 per cent of the world's crude oil reserves are located within OPEC, with another 6 per cent in the former Soviet Union (a net oil-exporting area). At the same time, nuclear energy has not lived up to expectations. Natural gas – an energy source of similar importance to crude oil with world-wide reserves equivalent to about one trillion (10^{12}) barrels – is also distributed unfavourably from the point of view of OECD countries: OPEC holds 42 per cent of world reserves, and another 39 per cent is to be found in the former Soviet Union. Within OECD and other non-OPEC countries coal is the only abundant fuel source, but in a more and more environmentally conscious world it is stigmatised as the dirtiest source of energy.

So there was no easy way out and OPEC countries have remained the ultimate targets. They had to be convinced to produce more, and hence cheaper, oil. In this respect, the collapse of OPEC quotas in 1986 was a major success for the consumers. Though OPEC quotas – first introduced in 1983 – were soon restored, prices fell back about 40 per cent. After this date, however, the demand for OPEC oil began to grow once again and OPEC

---

[27] Scott, op.cit., vol.2, p.64.
[28] Scott, op.cit., vol.2, p.169.
[29] Scott, op.cit., vol.2, p.347.

showed signs of recovery. But OPEC countries had severe weaknesses. In addition to wars between some member countries, military and civil unrest in others, and foreign indebtedness in most of them, no single OPEC member was actually delivering the political and economic development which one might have been expected given their financial resources. By 1989, some of them were internally very weak and divided, and they began to cede to the mounting pressure to re-open upstream oil to private, foreign investment.

At that time, the Soviet Union was the second most important oil-exporting country. And then came the surprise of the century, the fall of the Berlin Wall and the collapse and disintegration of the Soviet Union. With this victory of capitalism over communism and the end of the Cold War, new territories rich in hydrocarbons were suddenly and unexpectedly opening up to foreign investors.

This new political context provided a unique opportunity for the consuming countries to advance their agenda on a truly global scale. The nascent governance structure of international oil was suddenly upgraded to become a model of what the new world of global capitalism should look like.

3.3 National Oil Companies

3.3.1 The Consuming Countries

Developed consuming countries set up the first NOCs early in the twentieth century as part of the hunt for concessions in the Third World. In Latin American consuming countries the main aim of NOCs, most of them set up between the two World Wars, was to explore, to produce, and to refine domestically. The final wave of NOCs in relatively resource-rich consuming countries was triggered by the OPEC revolution. Concerned about security of supply and the economic threat of high prices, Canada and the United Kingdom, for example, set up PetroCanada and British National Oil Company (BNOC).

This last wave of NOCs was short-lived. The issue of security of supply at reasonable prices was soon taken up collectively by IEA/OECD within the context of a strong liberal political environment. The new liberalism centred in the USA and UK, was partly a reaction to OPEC countries' nationalisation of some of the biggest private companies of the world. In this environment the new NOCs came to be seen as an inappropriate answer and they were dismantled and privatised during the 1980s.

The Latin American NOCs suffered a similar fate. The old accusation that the international oil companies ignored the development of national reservoirs in favour of

importing from their highly profitable concessions elsewhere, was no longer justified. The general model of protectionist, import-substituting economic development in Latin American countries, was in deep crisis and under increasing external pressure, they turned in the 1990s to privatisation and liberalisation. Argentine, for example, privatised Yacimientos Petrolíferos Fiscales (YPF), the oldest Latin American NOC, and in Brazil Petrobras lost its monopoly and had to coexist with private investors.[30]

Finally, the wheel came full circle. The original NOCs, which were related to the old concession system, lost their most important function once they were nationalised in the OPEC countries. So they, too, were privatised in the late 1980s and early 1990s, the UK taking the lead privatising BP. In the United States there was, of course, nothing to privatise.

3.3.2 The Exporting Countries

The consuming countries, developing or developed, had differences about the details of the governance structure in place, but fundamentally they agreed on one crucial issue: that the prices determined by OPEC were too high. In the oil-exporting countries, however, high prices, always the most important single determinant of national revenue, after nationalisation became even more important. In developing a strategy for this new situation, the consuming countries and international oil companies had to accept as given that in OPEC countries the oil industry was definitively in national hands. It was neither politically feasible nor appropriate to call for privatisation, necessarily back into foreign hands, since no strong entrepreneurial class existed. Yet, while in the past these NOCs had been the ground-rent collecting agents of the landlord states, their role had expanded enormously with nationalisation and, inevitably, principal-agent problems had begun to arise. The question arose as to whether these companies were outgrowing their role as mere operators and becoming fully-fledged producing companies and, therefore, ground-rent paying tenants interested in minimising their tax bill.[31]

That possibility meant that these NOCs might become potential allies of the consuming countries and international oil companies. They had already played an ambiguous role in the 1960s. At that time the prevailing fiscal regime in Eastern Hemisphere exporting

---

[30] For details on the development of the relevant petroleum legislation and contracts see Barrows' monthly publications.

[31] Bernard Mommer (1994): "Rôle Politique des compagnies pétrolières nationales dans les grands pays exportateurs: Le cas du Venezuela", *Économies et Sociétés*, Série Économie de l'énergie, EN, n° 6, 9/1994, p.111–35.

countries, still included a 'freezing clause',[32] whereby the concession granting governments waived (to be less euphemistic were denied) their sovereign rights to tax and accepted that contracts were subject to international law and arbitration. Such conditions were never accepted by concession granting governments in developed countries where the only guarantee available to concessionaires and taxpayers generally, was the general political system of checks and balances. Such a system could not work in undeveloped economies, principally because of the unbalanced economic and political structure resulting from the overwhelming dominance of successful foreign mining ventures. Political independence of the Eastern Hemisphere countries, however, led to increasing dissatisfaction with the 'freezing clause', already long superseded in Latin America.

During the 1960s a new, intermediate, approach to the question of fiscal stability developed, involving the newly founded NOCs. Indonesia took the lead in abolishing the concession system and moving to production sharing agreements (PSAs) in which the foreign investors usually shoulder the commercial risk, exploration included, and the NOCs the 'sovereign risk'. These agreements were subject to sovereign taxation but the NOCs paid all relevant taxes on behalf of their foreign partners who would not, therefore, be affected by new taxes or rate increases. The NOCs thus acted as intermediaries and shock absorbers between the concession granting sovereigns and the private foreign investors.

After the OPEC revolution and the nationalisations of the 1970s, this kind of regime so clearly at variance with 'permanent sovereignty over natural resources', was officially consigned to the past. Yet it never disappeared completely: it survived in less important Third World oil producing and exporting countries, and has since reappeared in those deeply weakened OPEC member countries which have reopened the upstream to private investment. Moreover, the NOCs being always a partner in the new contracts, they include additionally a renegotiation clause under which the NOCs are committed to renegotiate the contracts whenever new or higher taxes, or any other governmental measures, disturbed what private investors considered the original intended equilibrium. These contracts were also subject to international arbitration, though not to 'international law of civilised nations' (a concept now disappeared from official discourse, probably because it would be politically unacceptable to argue that the majority of UN member countries are not civilised).

---

[32] Thomas Wälde (1994): *Stabilising International Investment Commitments: International Law versus Contract Interpretation*, Professional Paper PP13, Centre for Petroleum and Mineral Law and Policy, Dundee, Scotland, UK.

This new contractual framework was also introduced, immediately, into the oil-rich Newly Independent Republics of the former USSR. More surprisingly, it became now acceptable in Latin American oil-exporting countries such as Ecuador and Venezuela, although there are some differences, for example, regarding the applicable law: in Azerbaijan contracts it may be English Law and the Common Law of Alberta (Canada), whereas in Venezuela it is always national law.[33]

What matters is not such details but the fact that some NOCs in oil-exporting countries assumed direct charge of, or became involved in, the design of upstream contracts and so of the applicable fiscal regime and its administration, while foreign investors remained discreetly in the background. Ultimately, these NOCs were taking over the administration of the natural resource from the Ministries. They were no longer, therefore, mere rent-collecting agents of the landlord states. Their role became one of protecting the profits of private investors, and transforming the landlord states into simple shareholders.[34] According to the present trends privatisation would be the logical conclusion. During this transition they play a role, albeit as minority partners in private ventures: economically, they function as hostages, guaranteeing profitability; politically, they give the appearance of continued government involvement even though access to the natural resource is actually granted under liberal conditions. These roles will persist until the nascent national and international governance structure is strong enough to be enforced directly and explicitly.

---

[33] For Azerbaijan, see Barrows: *Petroleum Legislation*, Supplement 140, April 1999. In the case of Venezuela, see Bernard Mommer: *The New Governance of Venezuelan Oil* (1998), OIES Paper WPM 23, Oxford Institute for Energy Studies, 1998.

[34] For a detailed study of the Venezuelan case of agency capturing see Mommer: *The New Governance...*, op.cit.

4 INTERNATIONAL LAW AND TREATIES

After the winning of independence, Third World countries pursued its logical corollary, 'permanent sovereignty', meaning the dismantling of the cobweb of concessions and other contracts which controlled the use of their own natural resources, all based on the 'international law of civilised nations'. No countries undertook this task more radically or successfully than the oil-exporting countries.

After the 'OPEC revolution' its members faced the challenge of building a new governance structure. Their response, however, consisted more of high-sounding declarations or resolutions about a New International Economic Order than of anything economically, politically, or legally significant. A new governance structure, a working relationship with the international companies and consuming countries, was of necessity a complex task of political compromise, which proved far beyond the political capacity of the landlord states. The polarisation between consuming countries and the international oil companies, on the one hand, and the landlord states, on the other, became entrenched.

As a result, consuming countries engaged in a policy of containment, and moved on leaving OPEC and the world economy as two worlds apart. In order to confront the concept of 'permanent sovereignty' in the 'rest of the world' (given the majority of Third World countries in the UN), the consuming countries – first the Europeans, then the United States and other members of OECD – started to negotiate a series of Bilateral Investment Treaties (BITs), usually between one developed and one underdeveloped country. Since the flow of investment was virtually all in one direction, the rules agreed upon were essentially those of the capital-exporting developed countries. Traditional international law was thus revitalised as it was endorsed, one by one, by many Third World countries, whatever their public discourse.

One bilateral international treaty between two developed countries deserves to be mentioned: the 1989 US-Canada Free Trade Agreement (USCFTA). In spite of its name, it actually also covers investment,[35] making it unique at that time and it significantly applies to upstream oil.

After the collapse of the Soviet Union, the trickle of BITs turned into a torrent. A majority of them were signed, of course, between OECD member countries and Russia, the Newly Independent Republics and the Eastern European countries.[36] The European Union

---

[35] *US-Canada Free Trade Agreement*, Chap. XVI: Investment. (http://wehner.tamu.edu/mgmt.www/nafta/fta/index.htm).

[36] A complete list can be found at http://www.worldbank.org/icsid/treaties/treaties.htm.

(EU) with its eyes on the hydrocarbon riches of the former Soviet Union, initiated multilateral negotiations between both sides, rendering hundreds of individual BITs unnecessary. The first result was, in December 1991, a non-binding European Energy Charter, the starting point for the subsequent negotiation of a binding Energy Charter Treaty (ECT) which was concluded in December 1994.

The negotiation of other multilateral international agreements also acquired a new momentum with the collapse of the USSR. The North American Free Trade Agreement (NAFTA) between the USA, Canada, and Mexico, which followed the USCFTA in 1993, covers trade and investment, though it does not include Mexican oil.[37] GATT's languishing Uruguay Round was also given a new boost leading to its successful conclusion in 1994 and the foundation of the World Trade Organisation (WTO).

In the five years from 1989 to 1994 the consuming countries achieved very significant advances in establishing a new governance structure for international oil. Its core set of rules was spread quickly through the world by these international treaties which ultimately constituted new international law.

4.1 Defining 'Investment'

There is no place for landlords or for natural resource ownership in the liberal ideal. They disappeared long ago from economic textbooks. Nor do they appear in BITs or in the ECT, which are generally regarded only as investment treaties. The term 'investment' in these treaties is typically defined in an all-inclusive way to include "contractual rights, such as ... production or revenue-sharing contracts, concessions, or other similar contracts", as well as "rights conferred pursuant to law, such as licences and permits". Upstream contracts thus become simply "investment agreements".[38] The ECT defines 'investment' as, amongst other things, "contractual rights, such as under turnkey, construction or management contracts, production or revenue-sharing contracts, concessions, or other similar contracts", as well as "any right conferred by law or contract or by virtue of any licences and permits granted pursuant to law to undertake any Economic Activity in the Energy Sector", or simply "returns".[39]

---

[37] *North American Free Trade Agreement*, Chapter VI: Energy. (http://www-tech.mit.edu/Bulletins/nafta.html)
[38] *Treaty Between the Government of the United States of America and the Government of the Republic of Azerbaijan for the Encouragement and Reciprocal Protection of Investment*, Art. I.
[39] *The Energy Charter Treaty and Related Documents*, http://www.encharter.org/English/FullText/index.html; Art.1.6.

Hence, all types of upstream contracts are defined simply as 'investments', and the treaties only deal with the rights of 'investors'. Natural resource owners do not appear in them.

4.2 Making an Investment

Nevertheless, upstream investment depends on some kind of permit from the natural resource owner. Hence, the owner may 'discriminate' and concede permits to selected investors, for example to national companies, private or public. Similarly, when privatising a NOC, the state may favour national private companies or buyers. This was specifically outlawed in the US-Azerbaijan BIT which serves here as a typical example:

> With respect to the establishment, acquisition, expansion, management, conduct, operation and sale or other disposition of covered [i.e. covered by the Treaty] investments, each Party [i.e. the US or Azerbaijan government] shall accord treatment no less favourable than that it accords, in like situations, to investments in its territory of its own nationals or companies... or to investments in its territory of nationals or companies of a third country... whichever is most favourable...[40]

In the more complex multilateral ECT negotiations, which included countries less desperate than Azerbaijan to attract foreign investment, agreement on such an unambiguous wording was impossible. Non-discrimination was more a hope than an obligation:

> Each Contracting Party shall endeavour to accord to Investors of other Contracting Parties, as regards the Making of Investments in its Area, ... [a] treatment no less favourable than that which it accords to its own Investors or to Investors of any other Contracting Party or any third state, whichever is the most favourable.[41]

Further pressure, however, was put on the reluctant signatories of the ECT to agree to a firmer commitment, through a "Supplementary Treaty". This would "oblige each party thereto to accord to Investors of other parties, as regards the Making of Investments", a treatment "which is no less favourable than that which it accords to its own Investors or to Investors of any other Contracting Party or any third state, whichever is the most favourable".[42] This obligation would be subject to conditions still to be negotiated.

4.3 Trade Related Investment Measures

The US-Azerbaijan BIT also outlawed trade related investment measures (TRIMs) in accordance with GATT/WTO. In addition, NOCs were forbidden to favour national suppliers of goods and services:

---

[40] *Treaty US-Azerbaijan*, Art.II.1, Art.VI.
[41] *ECT and Related Documents*, Art.10.2, 3.
[42] *ECT and Related Documents*, Art.10.3, 4.

> Each Party shall ensure that its state enterprises, in the provision of their goods or services, accord national and most favoured nation treatment to covered investments.
>
> Neither Party shall mandate or enforce, as a condition for the establishment, acquisition, expansion, management, conduct or operation of a covered investment, any requirement (including any commitment or undertaking in connection with the receipt of a governmental permission or authorisation):
>
> (a) to achieve a particular level or percentage of local content, or to purchase, use or otherwise give a preference to products or services of domestic origin or from any domestic source...
>
> (e) to transfer technology, a production process or other proprietary knowledge to a national or company in the Party's territory...
>
> (f) to carry out a particular type, level or percentage of research and development in the Party's territory.[43]

Similarly, the ECT followed the patterns already established by GATT/WTO, stipulating that "a Contracting Party shall not apply any trade-related investment measure that is inconsistent with... GATT". But then, with its typical ambiguity, it adds exceptions and clauses allowing signatories to opt out, and others designed to maintain the pressure on reluctant signatories to keep moving in the desired direction.[44]

4.4 Dispute Settlement

In the US-Azerbaijan BIT the private investor is given the following menu of choices for the settlement of an 'investment dispute':

> 2. ...[to] submit the dispute for resolution under one of the following alternatives:
>
> (a) to the courts or administrative tribunals of the Party that is a party to the dispute; or
>
> (b) in accordance with any applicable, previously agreed dispute-settlement procedures; or
>
> (c) in accordance with the terms of paragraph 3.

And Paragraph 3 states:

> 3. Provided that the national or company concerned has not submitted the dispute for resolution under paragraph 2 (a) or (b), and that three months have elapsed from the date on which the dispute arose, the national or company concerned may submit the dispute for settlement by binding arbitration:
>
> (i) to the Centre [ICSID]... or...
>
> (iii) in accordance with the UNCITRAL Arbitration Rules; or...
>
> (iv) if agreed by both parties to the dispute, to any other arbitration institution or in accordance with any other arbitration rules.[45]

---

[43] *Treaty US-Azerbaijan*, Art.II.1, Art.VI.
[44] *ECT and Related Documents*, Art.10.
[45] *Treaty US-Azerbaijan*, Art.IX.3.

In other words, whatever may have been written in an 'investment agreement', or into a foreign investment law, the private investor can *always*, by waiting three months, directly initiate international arbitration against the state, without having to go first to national courts or to ask their home governments to take up the case.

The dispute settlement provisions in the ECT, heavily influenced by the USA and the precedents created by the USCFTA and NAFTA, were worded almost identically with the addition of the characteristic ambiguities of this Treaty.[46] This was certainly the most important achievement of the ECT.

4.5 Sovereign Taxation

The important question of sovereign taxation is a tricky one. In the US-Azerbaijan BIT, taxation was referred to in the area of expropriation:

> Neither Party shall expropriate or nationalise a covered investment either directly or indirectly through measures tantamount to expropriation or nationalisation (hereinafter referred to as "expropriation") except for a public purpose; in a non-discriminatory manner; upon payment of prompt, adequate and effective compensation.[47]

The word 'indirectly' here alludes to taxation. In the same indirect manner, it is stated that "no provision of this Treaty shall impose obligations with respect to tax matters". This is followed by the exceptions, the most important of which refers to 'investment disputes' based on "an investment agreement or an investment authorisation".[48] The latter, in plain English, are concessions or licences while the former means:

> a written agreement between the national authorities of a Party and covered investment or a national or company of the other Party that (i) grants rights with respect to resources or other assets controlled by the national authorities and (ii) the investment, national or company relies upon in establishing or acquiring a covered investment.[49]

It should be remembered that 'investment' is defined in this treaty as, among other things, simply 'returns'. In other words, 'investment disputes' about upstream oil are, properly speaking, landlord-tenant disputes. The treaty adds that:

> A national or company, that asserts in an investment dispute that a tax matter involves an expropriation, may submit that dispute to arbitration... if:

---

[46] *ECT and Related Documents*, Art.26.
[47] *Treaty US-Azerbaijan*, Art.III.1.
[48] *Treaty US-Azerbaijan*, Art.XIII.
[49] *Treaty US-Azerbaijan*, Art.I.

> (a) the national or company concerned has first referred to the competent tax authorities of both Parties the issue of whether the tax matter involves an expropriation; and
>
> (b) the competent tax authorities have not both determined, within nine months from the time the national or company referred the issue, that the matter does not involve an expropriation.[50]

This gives full legal backing not only to 'stabilisation clauses' in upstream contracts but also to concessions or licences which do not actually contain such clauses. In fact even investors without any contractual relationship were offered the option of international arbitration in tax matters as long as one of the parties – the US or Azerbaijan government – had not ruled, within nine months, that a new tax or increase 'does not involve an expropriation'.

The ECT, while including its usual diplomatic caveats, generally adopted the same procedure.

4.6 'Sovereignty over Energy Resources'[51]

Several oil exporters were among the countries which negotiated the ECT, most importantly the only developed oil-exporting country, Norway. That country's presence probably explains why the question of sovereignty was taken up although it was treated under the heading 'Sovereignty over Energy Resources' and no longer 'Permanent Sovereignty over Natural Resources' (as in the 1962 UN Resolution).

State sovereignty and sovereign rights over energy resources were recognised, though only if they were "exercised in accordance with and subject to the rules of international law". In the same way, "the rules in Contracting Parties governing the system of property ownership of energy resources" were not at stake, but they should not affect "the objectives of promoting access to energy resources, and exploration and development thereof on a commercial basis". It was also agreed that "Contracting Parties undertake to facilitate access to energy resources, *inter alia*, by allocating in a non-discriminatory manner on the basis of published criteria authorisations, licences, concessions and contracts to prospect and explore for or to exploit or extract energy resources". All this suggests that the next step could be to *oblige* the sovereign power, in one way or other, to put those 'energy resources' on the market. Remarkably enough, this possibility was formally denied:

> Each state continues to hold... the rights to decide the geographical areas within its Area to be made available for exploration and development of its energy resources, the optimalization of their recovery and the rate at which they may be depleted or

---

[50] *Treaty US-Azerbaijan*, Art.XIII.2.
[51] *ECT and Related Documents*, Art.18.

> otherwise exploited, to specify and enjoy any taxes, royalties or other financial payments payable by virtue of such exploration and exploitation, and to regulate the environmental and safety aspects of such exploration, development and reclamation within its Area, and to participate in such exploration and exploitation, *inter alia*, through direct participation by the government or through state enterprises.

In this paragraph the desperate effort to avoid any suggestion of a link between energy and natural resources, especially non-renewable ones, is particularly striking. While the language may sound odd, there is nonetheless a recognition of the states' property rights: rights to deny investors access to particular 'areas', to get compensation for its natural resource, to set production levels, and to participate with its NOCs in exploration and production. This could hardly be more contrary to the spirit, and even the letter, of the rest of this Treaty. Its essential purpose, so systematically and carefully expressed, was to hammer into the head of resource-rich signatories the idea that there was no such thing as a landlord-tenant business relationship, only a state-taxpayer one. Yet the political realities of these complex multilateral negotiations meant that if this alien Article had not been grafted onto the Charter, there would have been no Treaty.

4.7 Conclusions

The governance structure of international oil which the developed consuming countries have been building since the early 1970s, has been conceived as an integral part of a great historic design for capitalism: one global economy, united by free trade as well as free investment. The latter requires, of course, also the mobility of some 'Key Personnel', as granted by the ECT.[52] Regarding mineral resources, free investment means free access including the freedom of international transit.[53]

Multilateral international treaties such as ECT and NAFTA also promulgate new rules between the developed countries. In both treaties the arbitration rules were innovations and went far beyond whatever the EU or the OECD had agreed to before. In the euphoria following the success of the ECT and the fact that all the former socialist countries were signatories, the OECD launched the idea of a general Multilateral Agreement on Investment (MAI). But this attempt failed; and ECT or WTO stopped moving at the same breathtaking velocity as they had immediately after the collapse of communism.

The provision of the ECT relating to international arbitration became effective as soon as it was signed, although this was also one of the possible opt-outs. The Treaty itself would

---

[52] *ECT and Related Documents*, Art.11.
[53] *ECT and Related Documents*, Art.7.

only become effective after its ratification by thirty signatories, a target that was reached in 1998.[54]

Yet not everything went smoothly. The USA, which had pressed hard to be part of these negotiations so as to prevent the ECT from becoming a 'European' treaty as originally intended, refused to sign. It regarded the approach to the pre-investment phase as too soft compared with the standards already established in BITs; and it would not swallow the article on sovereignty. It believed that these defects would have created negative precedents for potential BITs (for instance with Russia) and later multilateral treaties (for instance with Latin America).[55] It was nonetheless largely the American presence in these negotiations which produced, among other things, the far-reaching arbitration clauses.

Russia signed but has so far not ratified the ECT. Russia's importance is evident: it contains 74 per cent of the former USSR's proven crude oil reserves and 85 per cent of its proven natural gas reserves. One of the reasons for its failure to ratify is that the "negotiations have been largely led, on the Russian side, by the reformist groups, and the negotiations and their results have been a strategy of the reformers aimed at imposing the Treaty's market economy model on the internal policy debate".[56] Yet back home, various national interest groups retain a great deal of power. Not least amongst these is the oil and gas sector in which over 60 per cent of Russian exports and fiscal revenues originate. From their perspective the ECT was difficult if not impossible to accept. From the Newly Independent Republics things looked somewhat different, as illustrated by the words of the Kazakh President, Nursultan Nazarbayev: "I do not think that in today's world weapons can do anything to protect a country. Our main security guarantee (against Russia) will be a powerful Western business presence in Kazakhstan."[57]

In practice, private foreign investors have not been very successful in getting into Russian oil. By 1998, cumulative spending in the projects involving Arco, BP, ENI, and

---

[54] The only institutions created under the ECT are the Charter Conference and the Secretariat.

[55] On the other hand, in December 1994, at the same time the ECT was signed in Lisbon, in Miami the Summit of the Americas was held, the largest ever meeting of Heads of States in the Western Hemisphere. The Summit agreed to create a 'Free Trade Area of the Americas', extending NAFTA all over the Americas. An integral part of this design is the 'Energy Initiative of the Americas' with its annual ministerial meetings. For further details see http://www.summit-americas.org.

[56] Thomas W. Wälde (1996): "International Investment under the 1994 Energy Charter Treaty", in Thomas W. Wälde (ed.): *The Energy Charter Treaty – An East West Gateway for Investment and Trade*, Kluwer Law International, London; p.316.

[57] Mehmet Ögütçü (1996): "Eurasian Energy Prospects and Politics: Need for Longer-Term Western Strategy", in Wälde (ed.), *The Energy Charter Treaty...*, op.cit.

Shell, still amounted to very little and the outlook was not very exciting.[58] Yet the Russian government is under continuous pressure to ratify the Treaty. Thus, for example, at the G8 Energy Ministerial in Moscow, in April 1998, the Energy Charter Secretariat and the International Energy Agency presented a joint paper on 'Energy Investment', largely based on "valuable studies carried out by or under the auspices of the World Bank and the European Bank for Reconstruction and Development".[59] Its Executive Summary, having stressed the well-known requirements to attract private foreign energy investment, concludes that:

> in countries where appropriate legal and/or fiscal regimes are still being developed or have not long been in place, government will need to take positive action to create investor confidence through strong and stable legal guarantees. International treaties can provide a broadly-based, secure and stable foundation... Examples are the... ECT and its future extensions, a Multilateral Agreement on Investment being negotiated under the OECD, bilateral investment treaties and production sharing agreements...[60]

The importance of PSA was to involve the NOCs in their new political role as hostages:

> Investors... have a need for a national legal regime that meets basic criteria for reduced political risk. In this context they have raised questions as to whether legislation in the transition economies does in fact provide appropriate assurances. In the case of Russia, major studies have noted that the existing Joint Venture licensing arrangements are based on an administrative system that views the Subsoil Licence as the supreme document, while the agreement among parties to the Joint Venture is only secondary. This exposes the investor to several significant risks. The terms of the licence to use the subsoil are subject to unilateral change by new legislation and are terminable by the governments on various grounds. It is subject to all applicable taxes at all levels of government, and no protection is provided against adverse changes in tax laws or other laws... Disputes are not subject to impartial adjudication because there is no contractual relationship between the Joint Venture partners and the government.[61]

As already noted, all developed countries grant concessions or licences, in exactly the same way as intended by Russia, even if these countries have, or had, NOCs (for example, Norway, and until recently Canada and Great Britain). In the case of undeveloped countries the involvement of NOCs was, for the time being, deemed unavoidable. Ultimately they should be privatised, but only after their transformation into liberal licensing agencies. The interim solution was PSAs and Azerbaijan's PSAs were quoted as a positive example. All this is premised on the investors' right to pursue binding international arbitration.

---

[58] *Energy Investment*, joint paper by the Energy Charter Secretariat and the International Energy Agency presented to the G8 Energy Ministerial in Moscow, 1 April 1998; p.5.
[59] *Energy Investment...*, p.1.
[60] *Energy Investment...*, p.ii.
[61] *Energy Investment...*, p.20.

Regarding fiscal regimes, the joint paper strongly argues that royalties should be scrapped:

> The viability of an energy investment will depend crucially on the relevant tax regime. Experience has shown that an unstable or unbalanced tax system can be the single most important factor in deterring investors. This has been particularly true where taxation is based on gross revenues rather than on profits, with allowance for incurred costs...[62]

The last part of this quote is quite curious, as it alleges that royalties contribute to the instability of fiscal regimes. This point is further developed elsewhere:

> Frequent tax changes are due in part to the nature of gross-revenue based regimes where governments need to make adjustments to benefit from changes in prices or costs. Profit-based systems are more self-adjusting and give a better basis for investors to assess the fiscal impact over the life of their investment project... Finding the right tax structure is of particular importance to Russia where the oil industry accounted for 70 per cent of federal government revenues in 1997.[63]

The truth is, however, that the adjustments to royalties made over the last fifteen years or so, have basically been the results of the deliberate international campaign to scrap them. The adjustments were certainly not related to countries' attempts to 'benefit' from changes in costs or prices. In any case, the homeland of royalty-based fiscal regimes is the USA. Yet this country, is also the birth and homeland of the largest, most prosperous and successful private petroleum industry in the world; and nowhere else have fiscal regimes been more stable.

The joint paper ends with some 'Recommendations'. On the issue of equal pre-investment opportunities it asserts that "national economic benefits arising from a... investment will not be determined by the nationality of the investing company". Privatisation opportunities, it says, should, "except in very limited cases", "be open to companies without discrimination on grounds of nationality. There should be no constraints on the subsequent resale and purchase of shareholdings or other assets after privatisation". Once more, the PSA is seen as important, but only as a transitional arrangement in "countries where the legal framework... and the relevant taxation rules do not yet provide sufficient confidence to investors". On energy trade, the paper predictably recommends that WTO rules should be followed as closely as possible. Last but not least, the joint paper concludes that Russia

---

[62] *Energy Investment...*, p.ii.
[63] *Energy Investment...*, p.21–2.

"should continue to pursue, as a matter of priority, ratification of the 1994 Energy Charter Treaty".[64]

[64] *Energy Investment...*, p.25–6.

5 CONCLUSIONS

During the first part of the twentieth century the governance of international oil evolved in the direction of the kind of compromise between the main actors which had developed in American oil in the nineteenth century. But in recent decades it has swung between two extremes, one pursued by the landlord states, the other by the consuming countries. There has been no trend towards a new compromise and so the question at the start of the twenty-first century is whether on a global scale consuming states will prevail over the landlord states.

For a century oil-exporting countries – and mineral-exporting countries more generally – have claimed the right to use their mineral wealth according to the needs of their economic development. The consuming countries categorically reject this claim. All that oil-exporting countries should expect, according to them, is the investment necessary to produce and export oil.

To speculate about who will win this confrontation it is necessary to look at the historical experience of developed countries and their handling of ownership of natural resources generally. All in all, this experience seems to suggest that in the case of the *surface* (the most significant natural resource), while everywhere the importance of private landed property has relatively declined, nowhere has it been eliminated. This may be obscured by the fact that landlords, as a political class, have vanished, and private landed property has been absorbed by modern economic life. Curiously enough, its existence is even acknowledged by the joint paper of the IEA and ECT Secretariat: "Private land and property ownership is a fundamental ingredient in the formation of private capital,"[65] which incidentally provokes the question of why this should not also be true of the subsurface.

In the case of the *subsurface*, i.e. minerals, things look very different. There are many places where landlords have disappeared completely, or where they were never allowed to exist in the first place. Private landlords in oil only survive in the USA, and even there they are steadily losing importance due to the exhaustion of on-shore oil and the increasing importance of offshore oil. Yet it may be wrong to conclude that the same will happen in the global economy. Oil, precisely because of its exceptional economic importance, inevitably has an impact on the community on the surface – or, in offshore oil, on the community on-shore – which is likely to react, be it on environmental, political, economical, or social grounds. This is true even in the USA, the homeland of the oil industry. In the 1980s it was

[65] *Energy Investment...*, p.27.

community resistance, combined with the federal structure of the country, that largely foiled the American government's radical liberal plan for the leasing of public lands and waters.[66]

The fact that some oil countries have accepted deals involving uncompromisingly liberal criteria, does not mean that they will continue to do so tomorrow. If they recover a reasonable degree of governability, they will have a closer look at the treaties and deals they have signed, often with very little understanding of their contents. By then, the architects of this governance structure hope, it will be too late for the exporting countries to do anything about it. In some cases this may be true, especially where a relatively significant non-oil economy exists. Yet even there it may require a lot of arm-twisting. Foreign indebtedness is one thing which may be used as a lever to force a country to open up continuously new tracts of land to foreign investment. But there are chances that this strategy will backfire.

The political and diplomatic bureaucracy of consuming countries, the employees of international oil companies, and independent consultants constantly insist that oil-exporting countries have to compete to attract foreign investment. They rarely admit that competition may also work in reverse, with foreign investors competing for access to scarce reserves. Yet this is so obvious that, inadvertently yet unavoidably, it is admitted from time to time. The already quoted joint paper recognises that recently "companies have been forced to drill in deeper waters and in more technically difficult environments".[67] This, of course, is because they have nowhere else to go. Even so there *are* places where drilling would be much cheaper:

> High cost energy resources have been and are developed world wide, while cheaper resources are left in the ground. This is an unfortunate consequence of the geographical concentration of resources and monopolistic behaviour coupled with large political uncertainties. This waste of resources can be reduced through closer economic and political co-operation, underpinned by international treaties.[68]

Very significant amounts of money could be saved both by the investors and by consumers through lower prices. But the natural resource owners are simply urged to adopt profit-based fiscal regimes with the necessary downward-elasticity, regarding prices, and upward-elasticity regarding costs. Under such regimes there is no question that they would all lose out.

Michael Klein, chief economist of Royal Dutch-Shell in London, recently suggested a scenario of this kind for the new century:

---

[66] Robert Gramling (1996): *Oil on the Edge – Offshore Development, Conflict, Gridlock*, State University of New York Press, Albany.
[67] *Energy Investment...*, p.3.
[68] *Energy Investment...*, p.18.

> With declining real oil prices the fight over upstream rents continues to intensify. Many oil-exporting countries crucially depend on oil revenues... As population grows and the price of oil declines, producer countries open up all parts of the oil and gas business for foreign investors. They revise tax regimes to attract investors. In particular, countries with marginal fields abolish royalties... To provide relief to the fiscal authorities more and more countries are privatising their national oil companies... while... ownership of the natural resource itself remains in government hands. The public authorities realise that they get the best deal as owners of oil and gas when several oil companies compete for acreage... Over time, auction design is streamlined and many contracts are awarded to the bidder of the highest marginal tax rate rather than an up-front signature bonus. Bidding on the tax rate improves risk sharing... by 2040 all national oil companies are privatised and tax systems for upstream operations converge to regular corporate tax regimes as upstream rents diminish.[69]

This is hardly a scenario that oil-exporting countries will feel comfortable with. Especially so when the gross-revenue based taxation of petroleum products, so condemned in the oil-producing countries are heavily and systematically used by the consuming countries to restrain demand, raising the price of petrol at the service station to several times its refinery-gate price.

The oil-exporting countries and landlord states are certainly bound to lose much of their relative importance over the next few decades, and liberal governance structures have already made significant inroads into some oil-exporting countries. Still it seems highly unlikely to this author that the landlord states will relinquish their ground-rents only to embrace the dogma of economic liberalism. They may be forced to accept it today for both domestic and international reasons. They may also be very much confused about the nature of the treaties and contracts they are signing. But in the long run they are bound to become aware of what they are losing, especially when they start to take a close look at the accounts of their tenants.

Although international oil companies, especially the big European ones, now support liberal fiscal regimes and are antagonistic to royalties and bonuses, this may well change once they recover a significant share of production in the exporting countries. If alliance with consumers weakens and they will have to deal, once again, with the landlord states and their peoples, they may well re-discover the virtue of royalty, or gross-value, based fiscal regimes. To produce oil without paying ground-rent may turn out to be the more costly alternative.

Since nationalisation the landlord states have managed from time to time to reach agreements on prices and volumes and little else. One should not expect much more from this heterogeneous *mélange* of countries united only by a quirk of nature. The role of the oil-

---

[69] Michael Klein: "Energy Taxation in the 21st Century", *Oxford Energy Forum*, Issue 40, Oxford Institute for

exporting countries to the future of the international governance structure is more likely to be the passive one of rejecting one proposition but allowing another to go ahead. A new compromise, if there ever is one, is likely to originate in the ranks of the producing companies, who remain after all the intermediaries between consumers and landlords. But this is very unlikely to happen in the foreseeable future. The conflict-ridden history of oil in the twentieth century will extend almost certainly well into the twenty-first.

Energy Studies, Oxford, December 1999; p.13–4.

BIBLIOGRAPHY

Adelman, Morris A. (1964): "The World Oil Outlook", in Marion Clawson (ed.), *Natural Resources and International Development*, Baltimore.

Barrows: *Petroleum Legislation*, monthly publication.

Calvo, Carlos (1885): *Manuel de Droit international public et privé*, Berlin.

Energy Charter Secretariat and the International Energy Agency (1998): *Energy Investment*, joint paper presented to the G8 Energy Ministerial in Moscow, 1 April 1998.

Energy Charter Treaty and Related Documents, http://www.encharter.org/English/FullText/index.html.

Energy Initiative of the Americas, http://www.summit-americas.org.

Gramling, Robert (1996): *Oil on the Edge – Offshore Development, Conflict, Gridlock*, State University of New York Press, Albany.

Klein, Michael (1999): "Energy Taxation in the 21st Century", *Oxford Energy Forum*, Issue 40, Oxford.

Mikdashi, Zuhayr (1966): *A Financial Analysis of Middle Eastern Oil Concessions: 1901–1965*, Praeger, New York.

Mommer, Bernard (1999): *Oil Prices and Fiscal Regimes*, OIES Paper WPM 24, Oxford Institute for Energy Studies.

Mommer, Bernard (1999): "Propiedad mineral y nacionalización de la industria petrolera mexicana", Banco Central de Venezuela: *Venezuela en Oxford – 25 años de la Cátedra Andrés Bello en el St. Antony's College de la Universidad de Oxford*, Caracas.

Mommer, Bernard (1998): *The New Governance of Venezuelan Oil* (1998), OIES Paper WPM 23, Oxford Institute for Energy Studies.

Mommer, Bernard (1997): *Private Landlord-tenant Relationship in British Coal and American Oil: A Theory of Mineral Leases*, OIES Paper EE20, Oxford Institute for Energy Studies.

Mommer, Bernard (1994): "Rôle Politique des compagnies pétrolières nationales dans les grands pays exportateurs: Le cas du Venezuela", *Économies et Sociétés*, Série Économie de l'énergie, EN, N° 6, 9/1994.

Mommer, Bernard (1983): *Die Ölfrage*, Institut für Internationale Angelegenheiten der Universität Hamburg, Nomos Verlagsgesellschaft Baden-Baden; Chapter 7: 'Zum Verständnis, Unverständnis und Selbstverständnis der OPEC'.

North American Free Trada Agreement, http://www-tech.mit.edu/Bulletins/nafta.html.

Ögütçü, Mehmet (1996): "Eurasian Energy Prospects and Politics: Need for Longer-Term Western Strategy", in Wälde (ed.), *The Energy Charter Treaty*...

OPEC Resolution XVI.90 (1968).

Parra, Francisco (1999): "Oil in the Twentieth Century: The Way We Weren't", *Oxford Energy Forum*, Oxford Institute for Energy Studies, Oxford.

US Senate, Select Committee on Small Business (1952): *The International Petroleum Cartel*, Staff Report to the Federal Trade Commission, 82nd. Congress, 2nd. Session, Publication of the Committee No.6, 22 August.

Scott, Richard (1994/5): *IEA The First 20 Years*. Vol. 1: *Origins and Structure* (1994); Vol. 2: *Mayor Policies and Actions* (1995); Vol. 3: *Principal Documents* (1995). Published by the OECD/IEA.

Stocking, George W. (1970): *Middle East Oil*, Vanderbilt University Press.

The New Palgrave – A Dictionary of Economics (1998), London, Macmillan.

Treaty Between the Government of the United States of America and the Government of the Republic of Azerbaijan for the Encouragement and Reciprocal Protection of Investment, http://www.state.gov/www/issues/economic/7treaty.html.

UN General Assembly Resolution 1803 (1962).

US-Canada Free Trade Agreement, http://wehner.tamu.edu/mgmt.www/nafta/fta/index.htm.

Wälde, Thomas W. (ed.) (1996): *The Energy Charter Treaty – An East West Gateway for Investment and Trade*, Kluwer Law International, London.

Wälde, Thomas W. (1996): "International Investment under the 1994 Energy Charter Treaty", in Thomas W. Wälde (ed.): *The Energy Charter Treaty...*

Wälde, Thomas (1994): *Stabilising International Investment Commitments: International Law versus Contract Interpretation*, Professional Paper PP13, Centre for Petroleum and Mineral Law and Policy, Dundee, Scotland, UK.

OXFORD INSTITUTE FOR ENERGY STUDIES
57 WOODSTOCK ROAD, OXFORD OX2 6FA ENGLAND
TELEPHONE (01865) 311377
FAX (01865) 310527
E-mail: publications@oxfordenergy.org
http://www.oxfordenergy.org