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The Venezuelan Operating Service Agreements: Trying To Fit A Square Peg In A Round Hole

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In 1975, Venezuela nationalized its oil industry through the Law that Reserves to the State the Industry and Trade of Hydrocarbons (the '1975 Nationalization Law'). Article 1 of the 1975 Nationalization Law set forth the reserved activities in broad terms:

> Everything related to the exploration of national territory in search of oil, asphalt and other hydrocarbons; the exploitation of fields of the same, the manufacture or refining, transportation through special means and storage; domestic and foreign trade of the exploited and refined substances, and all of the works required for the management thereof, in the terms set forth by this law, are reserved to the State....

The activities comprising the oil industry were to be carried out by the state company, Petróleos de Venezuela, SA (PDVSA), and its subsidiaries. With one exception for associations that might be entered into under special circumstances with the approval of both houses of the Venezuelan Congress, no private participation in production was permitted. Like any other oil company, PDVSA and its subsidiaries were permitted to engage service contractors "for the better performance of its functions," provided that in no case would such contracting "affect the essence of the reserved activities." Both the exception for associations approved by Congress and the provision allowing "operating agreements" were set forth in Article 5 of the 1975 Nationalization Law, which provided as follows:

> The State shall carry out the activities indicated in Article 1 of this Law directly through the National Executive or through state-owned entities, being able to enter into operating agreements necessary for the better performance of their functions, but in no case shall such transactions affect the essence of the reserved activities.
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> In special cases and if convenient for the public interest, the National Executive or such entities may, in the exercise of any of the indicated activities, enter into association agreements with private entities, with a participation that guarantees control on the part of the State and with a specified duration. The execution of such agreements shall require the prior authorization of the [Congressional] Chambers in joint session, within the conditions that they establish, once they have been duly informed by the National Executive of all the pertinent circumstances.

From 1975 until the 1990s, private parties in fact did not participate in upstream activities in the Venezuelan oil industry, except as pure service contractors. However, that state of affairs was to change with the advent of the *Apertura Petrolera* (Oil Opening) spearheaded by PDVSA.

Much has been written about the *Apertura Petrolera* by both its proponents and opponents. It is not the point of this article to debate further the wisdom of opening a national oil industry to private investment or the relative merits of nationalization and privatization. Rather, this article focuses on one aspect of the *Apertura Petrolera*, the more than 30 Operating Service Agreements (OSAs) entered into by PDVSA subsidiaries with international oil companies (IOCs) posing as service contractors in the 1990s, and explores the problems that arose, and tend to arise generally, in trying to fit 'a square peg in a round hole'.

The 'Service Contract' Controversy In The International Oil Industry

Before turning to the details of the OSAs, it is worth noting that the controversy surrounding service contracts is not unique to Venezuela. On the contrary, the legal and political problems associated with service contracts lie at the core of the most fundamental issues of structure and control over the exploitation of hydrocarbon resources in many countries.

It is no surprise that such issues are of the utmost political sensitivity, particularly in countries whose economies are heavily dependent upon hydrocarbon production. The experience of many producing states under the concession system that dominated the international industry until the 1970s did little to allay fears that opening the door to private investment would be tantamount to handing the national wealth over to foreigners.

The declining popularity of concessions was partially responsible for the invention of the more politically palatable production sharing agreement (PSA) form of upstream contract, under which production is shared between the state or state company and one or more IOCs, with an IOC acting as operator of the fields. From the host country standpoint, the PSA experience has been mixed, with disastrous consequences in some cases making PSAs almost as unpopular as concessions and providing further impetus for the development of other forms of contracting.

Service contracts have always been an intriguing option because of their name and their association with traditional oilfield services. Despite the strong political and ideological opposition in many countries to private participation in the oil sector, virtually all concede the value of service contractors in assisting national oil companies (NOCs) in the development of their respective hydrocarbon resources. Even in Mexico, where any form of private participation in the upstream was a subject off limits – at least until the 2008 Energy Reform – the Law Regulating Article 27 of the Constitution in Matters Relating to Petroleum always allowed Petróleos Mexicanos to hire service contractors, provided that they received their compensation in cash and did not participate in the success of the project. In other words, the political sensitivity, and the consequent legal impediment to private participation, were geared to the equity or ownership interest in the business, not the physical activity itself. Hiring a pure service contractor did not entail ceding control over the development of the natural resource; nor did it grant the service contractor a participation in the business as an equity holder or partner. It was no more controversial than a homeowner hiring a painter to paint his house. No one confuses the painter with the owner. The owner remains the 100% owner, while the painter collects his fee and goes home to his own house.

This was the general understanding of the 1975 Nationalization Law in Venezuela until the 1990s. A key passage of the legislative history of Article 5 of the 1975 Nationalization Law made clear that the "operating agreements" permitted under Article 5 "must not, under any circumstances, affect the core essence of the attributed activities," and that the provision was intended to allow the state companies to contract oilfield services under "simple" service contracts, without giving away a substantial portion of the production. The only exception to that principle was that set forth in the second paragraph of Article 5 of the 1975 Nationalization Law for associations in which, in special circumstances, a private party could participate with the approval of both houses of Congress after being duly informed of "all the pertinent circumstances."

The term "simple service contract" is not generally used in English, but it can fairly be said to refer to a "pure service contract," a concept well understood in the international oil industry. According to one glossary:

> A pure service contract is an agreement between a contractor and a host government that typically covers a defined technical service to be provided or completed during a specific period of time. The service company investment is typically limited to the value of equipment, tools, and personnel used to perform the service. In most cases, the service contractor's reimbursement is fixed by the terms of the contract with little exposure to either project performance or market factors. Payment for services is normally based on daily or hourly rates, a fixed turnkey rate, or some other specified amount. Payments may be made at specified intervals or at the completion of the service. Payments, in some cases, may be tied to the field performance, operating cost reductions, or other important metrics. Risks of the service company under this type of contract are usually limited to non-recoverable costs overruns, losses owing to client breach of contract, default, or contract dispute. These agreements generally do not have exposure to production volume or market price; consequently, reserves are not usually recognized under this type of agreement. ('Glossary of Terms Used', University of Houston, http://www.uh.edu/).

In short, a pure service contractor performs an oilfield service, such as drilling a well or performing a seismic survey, for a fee that is payable irrespective of the success in finding oil and irrespective of the value of production resulting from the service. The pure or simple service contract is to be distinguished from the risk service contract, in which the contractor performs the service at its own cost and expense, looking exclusively to success in production to achieve its reward.

Despite the relative clarity of the concept and the historical context of the legal provisions permitting service contracts in nationalized industries, those same provisions left the door open to theories that were the equivalent of driving a truck through a loophole. Focusing exclusively on the word 'service,' proponents of privatization began to argue that as long as the contractor was performing a service and never acquired title to the oil produced, the contract could pass legal muster as a 'service contract.' Hence the development of the 'risk service contract.'

Under the typical risk service contract, the service contractor's role and the economic substance of its remuneration can hardly be distinguished from those of an IOC under a PSA. As anyone experienced in international petroleum contracts knows, one can easily draft a service contract to mimic a PSA in all important respects, including the scope of work, the extent of the contract area, the duration of the contract and, most importantly, its basic economic structure. All that is necessary is to make sure that the contractor is identified as a 'service contractor' performing services, and that it gets paid in cash, not acquiring title to the crude oil produced. If access to crude is important for the service contractor, provision can always be made for a right to 'purchase' the crude oil produced from the state or state company. A service contract that so completely mimics a PSA – or even a concession – in a country with a strong legal and political tradition against private participation in the upstream oil business is bound to run into trouble sooner or later, and that is exactly what happened in Venezuela.

The Venezuelan OSAs

Thirty-two OSAs were signed by PDVSA subsidiaries in three bidding rounds (and one direct award) between 1992 and 1997. With each new round, the OSAs moved further away from the notion of a pure service contract and closer to the structure of a conventional PSA. By the third round, the two forms were virtually indistinguishable, with the exception that the contractor in the OSAs never acquired title to the oil produced. None of the OSAs was approved by Congress.

In the first round, the OSAs ceded the operatorship to the contractor in large areas for a period of 20 years. Work programs and budgets were subject to the state company's approval, but that formality did little to diminish the contractor's effective control over petroleum operations. The contractor bore all costs of operations and was compensated based on production.

The form contracts provided for two types of fees. The first, a per barrel fee called the Opfee, was the bidding variable. It was supposed to cover operating costs and the contractor's profit. The Opfee was indexed, not to the price of crude oil directly, but to the energy component of the consumer price index. The second fee, called a Capfee, was to allow the contractor to recover its capital costs over a 10-year period, with interest. The sum of the Opfee, Capfee and interest in any quarter could not exceed a Maximum Total Fee (MTF), which was indexed to a basket of crude oil prices. Fees unrecovered in any quarter due to the MTF could be carried forward to future quarters, although contractors assumed the risk of losing amounts not recovered by the end of the contract term.

From the standpoint of size of area, conduct of petroleum operations and allocation of risks and costs, the contract looked very much like a PSA. The contractor's remuneration was also linked to production, but more to the volume of production than its value. The more the contractor produced, the greater its income from the per barrel fee, but the indexing to the consumer price index rather than the price of crude oil meant that the contractor did not benefit as much as a PSA contractor would from oil price increases.

In case anyone had any doubt as to the intention of the parties to characterize the OSA as a service contract, the first round OSAs included self-serving statements reciting that the activities were being carried out by the contractors "on behalf of" the PDVSA subsidiary, a declaration seemingly without purpose other than to stress that the contractor was not an owner in the business. The OSAs also expressly confirmed that the contractor's remuneration "will not include direct property rights on the Petroleum found or produced in the Contract Area, which rests exclusively in the [PDVSA subsidiary]," and "the rights of the Contractor arising from the Contract do not include rights over the economic benefits resulting from the sale or disposition by the [PDVSA subsidiary] of the Petroleum extracted from the Contract Area, but only those economic interests that under this Contract may be allocated to the Contractor for its operational activities."

Nevertheless, the combination of fees in the first round of Venezuelan OSAs meant that the contractor received a very significant share of the economic benefit of production, thereby raising serious questions as to the essential nature of the contract. Could it really be said that a contractor receiving half or more of the value of production was not a partner in the business? The reality was that not only were the service contractors effectively partners in the business, but they were in many respects the senior partners, despite the language labeling them as mere service providers.

The structure of the contracts as service contracts had two additional anomalous consequences. Since the PDVSA subsidiary was deemed to be the "producer," it remained responsible for payment of the royalty. This meant that in some cases the PDVSA subsidiary, after paying the royalty, would actually be losing money for each barrel of oil it produced, not the kind of result an owner expects from a simple service contract.

The second consequence of characterizing the contractor as a mere service provider had to do with income taxes. Under the Income Tax Law prevailing in the 1990s, the general rate applicable to companies dedicated to the production of oil was 67.7%, which was lowered in 2002 to 50%. Both the 67.7% and 50% rates were higher than the general corporate tax rate of 34%. The contractors took the position that they were eligible for the lower rate because they were not producers.

The second round of OSAs improved upon the first from the contractors' standpoint. The compensation structure was similar to that of the first round, except that an additional fee (other than the Opfee and Capfee) was introduced. The additional fee, called an *incentivo*, was payable on a per barrel basis when specified levels of cumulative production were reached. Most significantly, the *incentivos* were paid irrespective of the ceiling on quarterly payments provided by the MTF. The *incentivos* were also directly linked to the price of oil, as they were indexed to a basket of crude oils. When the *incentivos* kicked in, the service fees in certain cases could exceed the entire value of the production.

The third round of OSAs moved even further toward a conventional PSA. The bidding variable was an upfront payment (*factor de valorizacion*), not the Opfee. Whereas the scope of operations in the first two rounds did not include exploration of new areas, the third round covered the full range of petroleum operations. Contractor remuneration was a fixed fee per barrel for what was defined as base production, but for incremental production, the contractor would receive a payment based on its modified internal rate of return in real terms (MIRR). When the MIRR was less than zero, 100% of the value of incremental production after the royalty was allocated to the contractor. For positive MIRRs, the contractor was paid costs plus the value of a share of the incremental production, which decreased to 30% only when the MIRR exceeded 60% per annum.

Migration To Mixed Companies

In 2005, the Venezuelan Government took a series of actions to bring the OSAs concluded during the *Apertura Petrolera* to an end. The Minister of Energy and Petroleum declared that the OSAs were illegal inasmuch as they awarded a significant share of the business to the service contractor. The minister issued a formal *Instructivo* requiring the OSAs to migrate, in a six-month period, to the mixed company structure under the 2001 Organic Hydrocarbons Law. Under that Law, the only legal form of participation in the Venezuelan oil industry was as a minority shareholder in an *empresa mixta* (mixed company) formed with the approval of the National Assembly and having a state company as majority shareholder. As a transitional measure, the minister ordered that the total remuneration to the contractor under the existing OSAs could not exceed two-thirds of the production value, a requirement which itself spoke volumes as to the nature of the OSAs. The measure allowed the state company to pay the 30% royalty and have some room to pay administrative expenses, not a satisfactory situation but one that at least avoided the embarrassment of a state company losing money on its own production.

Apart from the requirement to migrate to the mixed company structure under the 2001 Organic Hydrocarbons Law, the Venezuelan tax authorities reviewed the tax status of the service contractors and came to the conclusion that they were companies "dedicated to the exploitation of hydrocarbons and related activities" within the meaning of Article 11 of the Income Tax Law. The consequence of such a conclusion was that the contractors were not eligible for the 34% general corporate tax rate.

Exacerbating the controversy regarding tax rates was the finding that in fact the tax rate in some cases had made virtually no difference in tax collection. It was possible for contractors to structure their activities through highly leveraged subsidiaries that took deductions effectively wiping out taxable income. If taxable income is zero, the tax rate, whether 34% or 50%, becomes irrelevant.

The migration process was extended into 2006 and concluded in a nationally televised ceremony presided over by President Chávez on the evening of 31 March 2006. Thirty out of the 32 contracts were successfully resolved in the migration process, with the remaining two settled by agreement afterwards. The new mixed companies were all subject to the following conditions: (i) a PDVSA subsidiary, Corporación Venezolana del Petróleo SA, held a minimum of 60% of the shares of each mixed company; (ii) the oil tax rate of 50% applied; (iii) the mixed companies were also subject to a combined royalty and extraction tax of 33⅓% assessed on the gross value of hydrocarbon production (deductible for income tax purposes); and (iv) an additional royalty – to avoid the prior experience of deductions wiping out taxable income – equal to the positive difference, if any, between 50% of the gross value of production and the sum of taxes and royalties otherwise paid, was also assessed under the Transfer Decrees creating the new mixed companies.

Unlike under the OSAs, the new mixed companies are the operators of the fields. They are permitted to hire service contractors, but this time the governing documents addressed the issue of operatorship explicitly, making crystal clear that the service contractors may not assume the role of operator. The authorizations of the National Assembly provide, as an express condition to approval of the formation of each mixed company, that:

> the mixed company will be the operator in the Designated Area for purposes of the primary activities indicated, it being able, in accordance with what is provided in Article 25 of the Organic Hydrocarbons Law, to contract specific oil services which may be necessary to assist in the performance of its activities, such as for example, seismic services, drilling and maintenance, on the understanding that the mixed company may not enter into any contract or group of contracts by which, directly or indirectly, it transfers its function as operator.

Likewise, Article 25 of the standard charter and by-laws of the mixed companies provides that in no case may a contract "affect the position and authority of the corporation as operator in the Designated Area."

Lessons

The Venezuelan experience demonstrates at once why service contracts became so popular in the international oil industry and why they are now the subject of much criticism. They became popular because a lot of people thought they were a convenient way to open the door to a nationalized industry. As long as the contractor was willing to forego taking title to the molecules, virtually anything could be negotiated. The contractor could even book the reserves.

The problem, of course, is that such innovative thinking sooner or later stretches the concept of service provider to the breaking point. In many cases, the contractor effectively takes over the business, with the host state or NOC assuming the role of a passive collector of a decreasing share of the revenue from the resource. In Venezuela, where the national company was at times in a loss position for every barrel of oil produced, this situation became legally and politically untenable, particularly as the price of oil commenced its extraordinary rise in 2004.

The main lesson of the Venezuelan experience is not that service contracts are all bad. Just as anyone experienced in international petroleum contracts knows how to make a service contract effectively the same as a PSA, an experienced person also knows that there are good and bad PSAs and good and bad service contracts. To fall into the good category, the contract must be both reasonable from an economic standpoint and legal according to the applicable law. Failing on either count is likely to prove problematic at some point during the life of the contract. Failing on both is a recipe for a short-lived relationship.

From a legal perspective, the lesson to be learned from the Venezuelan OSAs is that there are limits to the ability to play with legal forms, especially if one takes a long term view. The scope of the reserve to the State of the hydrocarbon sector was enough to raise questions about the way that the loophole in Article 5 of the 1975 Nationalization Law was used during the *Apertura Petrolera*. The legislative history of the provision also should have been a red flag. But the drive toward opening the oil industry outweighed the legal constraints. The opening proceeded in spite of the fact that the political will to effect the legal changes that would have supported it did not exist.

For many in the industry, service contracts such as the OSAs have acquired a bad name precisely because they are increasingly seen as legal maneuvers designed to circumvent laws. Especially in an industry that touches on sensitive nerves of national sovereignty, such creativity has to be tempered. One basic test is whether the features of the service contract can be explained to the public without embarrassment. If not, the chances are it is illegal. That is no substitute for a more serious analysis of the contract's validity under the applicable legal framework, but it is a good place to start.