Negotiating exploration contracts with foreign government representatives is a dynamic experience. Government personnel find the experience equally fascinating but the dynamics are different. Unfortunately some of the dynamics are adverse and created by personnel with what they consider to be innocent statements. Usually the statements are based on the false notion that most government personnel are a bunch of fools. Typically though, the government folks are extremely well educated and have substantial experience. Often too, they have worked for both oil companies and their own government agencies so they have seen “both sides”. It is less common to find oil company personnel who have actually worked both sides. Sometimes because of the statements made by oil company personnel the government folks think they are dealing with a bunch of fools.

The following statements are heard so often that many government folks have lost count. They really have no useful place in the discussions between government and oil company negotiators yet they surface regularly. Apparently the temptation to make these statements is irresistible. Many government folks have learned over the years to be graceful and pretend they have never heard such wisdom before.

(1) “What you have to understand is that we are the ones taking all the risk!”

This statement can be close to the truth but there are various circumstances where it is not entirely true. Nevertheless, even in those cases where perhaps it is true it need never be mentioned. If there is anything about negotiating exploration licenses, it is the fact that taking on the lion’s share of the risk is one of the key services that oil companies provide. This is why there are negotiations in the first place. This is so obvious to government representatives that it is an insult to point it out.

Companies are in the business of taking on certain risks but they try to avoid those situations where the potential rewards are outweighed by the perceived risks. Sometimes company folks are able to communicate this graciously if they must. However, the lore among many government officials is sprinkled with stories of huge discoveries that followed such explanations or relinquishment of acreage.
As it happens, governments struggle to ensure that oil companies shoulder as much of the exploration risk as possible. Oil companies are better positioned to take on these risks. They have the technology and they are better able to diversify-out some exploration risk. But it is nearly impossible for a government to avoid all risk and place the entire exploration risk burden on the oil companies. An example is shown in Figure 1 where a company makes a discovery after having drilled a few dry holes. Ordinarily profits from the discovery would be taxed partly on the basis of deductions from and/or recovery of the dry holes that preceded the discovery. Therefore, the government was at-risk to a certain extent. It paid for a portion of the dry holes.
In this example an oil company makes a discovery with the last well in a 4-well program in its license area – Block A. Because the government allows the company to use costs from the 3 dry holes as tax deductions (and/or for cost recovery purposes) associated with the discovery the government ultimately “pays” for a portion of the unsuccessful drilling. With this common scenario in mind it is difficult to claim the government is entirely risk free.

![Diagram of Exploration License Area (Block A)](#)

Dry hole

Discovery well (Oil and Gas)

Oil field

Figure 1
There was another problem with this statement—the way it is usually delivered. To preface a statement this way invites trouble. The two most common examples are discussed below.

(2) “What you have to understand is . . . . . “
   “What you have to realize is . . . . . . . “

Starting a statement with these words is rude. Most of the time the government negotiators have already heard these things before many times anyway—they already understand or realize. Even if they don’t understand, they know an insult when they hear one. Positions should be presented plainly and directly. Arrogance is counterproductive.

(3) “What you have to realize is we are the ones putting up all the money!”

Most governments understand what the oil company folks are talking about here, but they see things differently. Certainly in most situations oil companies fund the initial exploration, and development costs. But under almost all fiscal regimes there are direct mechanisms to ensure the companies will get their money back and a share of the profits (if sufficient revenues are generated).

Under nearly every fiscal arrangement, when hydrocarbons are produced, oil companies recover costs through either deductions or cost recovery. Thus, from the government viewpoint, it is they who ultimately pay (if hydrocarbons are found, and if they are found in sufficient quantities). However, they know that by having the oil companies pay up-front and recover costs later the national oil company (NOC) benefits by not having to pay directly the cost of rounding up capital (discussed below). Thus, the governments consider development costs, in particular, as an interest-free loan - one of the main reasons for bringing in oil companies.

(4) “What you have to understand is money costs money! Money has a time value!”

Duh! While there are perhaps a few politicians who have not heard of this concept, government negotiators understand the “time-value” of money. Furthermore they do not like hearing this for the millionth time. The collective wisdom of most government agencies is extremely high. There are certainly a few, technical or political folks who may not be intimate with present value theory, but unless they ask for training on the subject it is best to assume they understand the concept.

(5) “40% of something is better than 100% of nothing.”

OK, now you’ve really made them mad! Statements like these are often made in regard to marginal or sub-marginal discoveries where there is a significant chance the field will not get developed (or at least any time soon), unless the government is willing to renegotiate the commercial terms. However, many governments would rather see a field go undeveloped if it cannot get an appropriate share of revenues and/or profits. Past costs associated with a discovery can have a huge influence on field development feasibility. Past costs (also called “sunk costs”) at the time a development plan is being considered are often particularly significant with marginal and sub-marginal discoveries. If the field is developed and produced the sunk costs will be cost recovered and/or used as tax deductions. They behave then like a tax-loss-carry-forward (TLCF). A TLCF
position can be a wonderful thing for an oil company but it can be painful for a government faced with a marginal discovery.

(6) “You will never get anybody to agree to those terms!”

This is a perfect no-win statement. If the terms really are too onerous, the government will find out soon enough and then change their terms. Then when the company personnel who made this prophesy want to go back it may not be such friendly territory. If the government does get somebody to agree to those terms, they laugh at those who made such statements. This kind of statement from company representatives inspired Figure 2. This cartoon, enlarged and framed, was hanging on the conference room wall at the offices of the Petroleum Authority of Mongolia in Ulaanbatar in 1998 when I was there. This was a country with only two producing oil wells at the time. By-the-way, in 1998 they had 14 production sharing contracts in force!
(7) “We need to talk about how we can reduce the tax rate.”

This statement is rarely appropriate. And too often it is made to the wrong person anyway. Taxes are rarely negotiable and where they are, like typically the Middle East, they are a known negotiable item. In most other countries taxes are levied by an authority other than the national oil company. In any country, there are elements that are simply not subject to negotiation. It is a golden rule that only those elements that are negotiable are negotiated with the appropriate authority. Unfortunately this golden rule is often broken and when it is it always destroys credibility.

(8) “I grew up on a pig farm in Iowa!”

There is always a cultural element that must be considered. This statement was supposedly made by an American oil company executive in a friendly attempt to make casual conversation. Unfortunately, as the story goes, it was made in a Moslem country—not China.
(9) "We do it this way in the U.S."

That is great, but why are you here? It is tiring hearing about the wonders and virtue of doing business in the United States. Government folks know that there are a few things common in the U.S. that would not be appreciated in other countries including:

**Signature bonus bidding**

The US has the highest signature bonuses in the world in terms of dollars per acre. No other country has collected as much with bonuses alone. The US has collected well over $60 Billion in bonuses since the early 1950s. Western companies, particularly American companies detest signature bonuses.

**Dispute resolution – Litigation vs Arbitration**

Western companies are constantly trying to promote binding international arbitration as the means by which disputes are resolved. But a natural question might be, “How are disputes resolved in the US?”. The US is famous for being one of the most litigious societies in the world—rivaled only by India.

**Abandonment and environmental liabilities**

Unfortunately this issue was not addressed as carefully in the past as it is now. But if other countries evolve to the point that we have in the US there could be problems. Most of the US offshore is off-limits. Some refer to this as the “Not in our back yard!” syndrome. If other countries adopted similar attitudes and legislation there would likely be dramatic shortages of oil and gas in this world.

Furthermore, the concept of a Potentially Responsible Party (PRP) is fairly unique to the US. This is where any company who has had ownership in a field or facility is potentially responsible, forever, even if they have sold their interests. Certainly there is some logic to this but it would not be popular if it was adopted by other countries and became a part of their petroleum legislation.

(10) “My, this is a lovely restaurant. What a great place to discuss business.”

Oh dear! Dinner time is usually not the appropriate place to discuss business directly or even indirectly, especially if the government representatives do not initiate such discussions. Westerners especially should watch out for this as we appear to have developed a reputation for only caring about business and not about the real people across the table. This is the place for small talk (See #8) and the opportunity to get to know the other side on a more personal level.

(11) “Our objective is to create a win-win situation.”

This statement is not such a great sin. And usually, when people make this statement their heart is in the right place. However, from the government point of view it is a bit of a joke although it must not be too much of a joke because government folks use this win-win rhetoric too. The point
is though that most contracts simply are not win-win in the long run. For example, assume a situation where an oil company needs some particular goods and services and three service companies submit bids as follows:

<table>
<thead>
<tr>
<th>Service Company</th>
<th>Bid</th>
</tr>
</thead>
<tbody>
<tr>
<td>Company A</td>
<td>$10 MM</td>
</tr>
<tr>
<td>Company B</td>
<td>$13 MM</td>
</tr>
<tr>
<td>Company C</td>
<td>$ 8 MM</td>
</tr>
</tbody>
</table>

Assuming all the companies are technically competent and capable of fulfilling the obligation the choice is easy—Company C. Governments require international tendering for goods and services in this fashion to ensure they (and the oil company) get the best price possible because ultimately they will both share these costs in proportion to the savings index. [The “savings index” concept discussed in earlier columns (PAFMJ Summer 1998 Vol.) captures the essence of this “cost”.] Does the oil company care if Company C makes a profit? No. Does the government care? No. But what about “win–win”? Humbug.

How much difference is there between this and where a government launches a tender for the rights to explore in their country? Not much – governments usually grant the rights to the highest bidder—simple as that. If win-win was their objective they might justify granting the rights to the lowest bidder or the average bidder.

(12) Persian Gulf vs Arabian Gulf

In Matt Simmons’ book “Twilight in the Desert” he discusses whether or not the Saudis really do have the reserves they say and the capacity to deliver. He is not a popular person in Saudi Arabia – they think he is a petroleum engineer “wanna-be”. Furthermore, throughout the book Simmons refers to the “Gulf” as the “Persian Gulf”. This has to be a bit galling to the Arabians.

Commentary

There are no examples of anyone actually getting killed for making statements like these. However, there are numerous situations where company personnel feel the chemistry of a meeting or a relationship is not good but they cannot understand why. Statements like these are often part of the beginning of an unhealthy relationship. There is room for more understanding and trust on both sides and the result will be healthier business relationships.