

OPINION

What a Century

Robert Pritchard

As the twentieth century draws to a close, we can reflect on some of the heady events which had such an extraordinary effect on how the oil and gas industry is organised, financed and regulated.

Oil Becomes Political

The headiest event of all was the 1973 Arab oil embargo. I remember then being consulted by a major oil company about a contractual difficulty which today would be unthinkable: the oil company had sold forward at a fixed price on the assumption that its supply was secure and that the producer price was predictable. My client was not alone; it was the way most oil business was done before the Arab countries acted in concert to drive home to the West the point that oil was not just another commodity.

Western access to oil supplies, especially those of the Middle East, was one of the premier foreign policy interests during the Cold War years. Western and Eastern Europe were then worlds apart—so far in fact that Western oil economists tended only to talk of the “non-communist world”. Since then, the major ideological and political barriers between the communist and non-communist systems have come down. The big surprise is that this has exposed a complex, stubborn web of institutional barriers which have required dismantling, restructuring and replacement.

But I am running ahead of myself. As a small child in the immediate post-World War II years in Australia, one of my earliest memories is of queuing with my family at the local gasoline outlet to buy our weekly ration of gasoline for the car. I never really thought much about this because other essential commodities, like tea, flour and sugar, were rationed as well. Soon, all rationing ceased in Australia and I forgot about it.

By the 1950s, the industrial economies of the world were well on the way to rebuilding themselves, beginning an era of increasing prosperity in the West which was to last more than two decades. To a large degree, this era was financed by a plentiful supply of oil at static, sometimes even falling, prices. And, increasingly, the oil came from the Middle East. At the time, I never really thought much about that either.

In the mid-1950s, the world’s largest oil consumer, the United States, became a net importer of oil as its demand exceeded its supply. The Middle East had by then become the main source of supply for the industrialised nations. By 1973, it accounted for 55 per cent of the world’s proved reserves. More significantly, it accounted for 66 per cent of international trade in oil. Sagging oil prices in the late 1950s gave rise to the formation of OPEC by 1960. For years, however, OPEC members could never agree on the reductions in production which would have brought about increases in price. Competition amongst them ensured that prices remained low.

Everything seemed to change in the 1970s. In 1971, after Iran occupied three Arab islands in the Arabian Gulf with British acquiescence, Libya retaliated by nationalising BP’s interests in Libya.¹ This drastic action became the forerunner of many other unilateral actions by the Gulf members of OPEC, including price fixing, production cutbacks, tax increases, creeping confiscation under so-called “participation” agreements and the notorious 1973 embargo.

Oil had become a political weapon.

The Impact of International Treaties

Attempts to control the oil and gas industry were the direct or indirect purpose of an increasing number of international treaties since World War

¹ As the Libyan representative stated to the UN Security Council on December 9, 1971: “My Government, an Arab Government replied in the only way understood by the imperialists by nationalising the oil interests of Great Britain in the Libyan Arab Republic and withdrawing our deposits from British banks.”

II. These included the UN Declaration on Permanent Sovereignty over Natural Resources, the Declaration for the New International Economic Order, the Law of the Sea Convention and the Framework Convention on Climate Change.

The 1991 Energy Charter Treaty ("ECT") is of special interest because its purpose was not just to secure energy for Western Europe. It was also aimed at assisting the countries of Eastern Europe in making the transition to market economies as well as addressing environmental problems associated with energy supply which extended beyond national boundaries. What had started as a European initiative evolved into a multi-lateral investment, trade and environmental treaty with implications well beyond Europe.

Thomas Waelde's 1996 volume on the ECT became an essential reference for practitioners as well as students of oil and gas law.² It explained in detail how and why energy markets became hostage to issues of energy security, energy politics and energy diplomacy. In Waelde's book, I especially recall Mehmet Ogutcu's prediction that, despite new discoveries in other regions, Western dependence on the Middle East would grow stronger. Ogutcu also predicted that the Eurasian region around the Caspian Sea would become an energy exporting super-power if (but only if) a secure network of pipelines could be developed to transport oil and gas to deep water ports for sale on world markets.

Economic Liberalisation

Remember the "mixed economy"? With economic liberalisation, the term has almost disappeared from contemporary use. The popularity of liberalisation as the fundamental driver of economic policy stands in marked contrast to the 1970s. In those years, Western Europe witnessed a stream of nationalisation in petroleum, chemicals, pharmaceuticals, telecommunications, pulp and paper, electronics and other sectors. European governments had a direct ownership stake in over half of Europe's 50 largest companies.

The proposition that a market economy which fosters private entrepreneurial initiative is more likely to advance the living standards of people than one which does not has now become dominant:

... the argument is that individuals freely pursuing their interests and interacting in the market place together provide a more efficient, dynamic and creative economy than one based on centralised commands. The centralised command economy may suffer more severely from political manipulation, corruption, the arbitrary exercise of power, poor information, cumbersome systems and perverse incentives. While it is recognised that there are many respects in which markets may fail, and that there are circumstances (such as war or natural disaster) where command systems may be required, the dominant view now is that, on balance, a market-based system has overwhelming advantages over central planning.³

It was Britain's Margaret Thatcher who seemed to do more than anyone to reverse the thinking about the perceived benefits of government ownership.

The upstream development of primary energy sources, such as oil and gas, had always been mainly a private sector activity. Not so, however, with the downstream conversion of primary energy into electricity—the supply of electricity was seen as an essential responsibility of government.

As the century draws to a close, the public ownership philosophy seems to have almost run its course. The traditional view that government themselves have to own, operate and finance the assets of the electricity sector is now seen as misguided. The belated realisation is that governments just need to regulate electricity supply. The private sector can be left to own, operate and finance the assets because the private sector is better equipped to manage the commercial risks of doing so. Increasingly the parameters for commercial supply of essential services are set by professional, independent regulatory agencies and not by politicians.

² Thomas Waelde (ed.), *The Energy Charter Treaty—An East-West Gateway for Investment and Trade*, Kluwer Law International, London, 1996.

³ European Bank for Reconstruction and Development, "Transition Report", London, October 1994, p. 3.

The Globalisation of Markets

The wave of economic liberalisation in the 1980s and 1990s occurred in the midst of the phenomenon of globalisation of markets and was in large measure an outcome of it. The successful conclusion of the GATT Uruguay Round opened up new export opportunities and improved market access. At the same time, it diminished national autonomy in setting industrial policies. Countries now have less scope for anti-competitive trade policies, such as imposition of tariff protection and the subsidisation of exports, and are required to enforce more rigorously intellectual property rights. The global capital markets and the rating agencies are now quick to remind both governments and corporations if their revenue streams are faltering.

Oil, almost from the beginning of production, has been a global commodity. Gas is now also evolving into a global commodity, with more and more pipelines linking production to markets in adjacent countries and the expansion of LNG trade. Factors of international supply and demand are making for increasingly complicated cross-border contracting and financing arrangements and providing great challenges for the legal profession and their clients.⁴

The Acceleration of Foreign Direct Investment (FDI)

The most prominent manifestation of liberalisation has been in the field of FDI, especially in the developing countries.⁵ Host countries almost everywhere are opting for more FDI and are adopting more liberal policies in relation to its treatment: it is now almost a standard phenomenon for foreign investors to be greeted by the equivalent of China's long-standing "open door" policy.⁶ Recently, Kuwait and, if it can be credited, Libya have been soliciting more FDI in their oil and gas sectors.

In the 1960s, world FDI was dominated by the U.S. multinationals. In the 1980s, the major Japanese corporations also became prominent. At the end of the end of the twentieth century, most countries are now both host and home countries—most have become "takers" as well as "makers" of FDI. The "Asian economic crisis" underscored the great advantages that FDI offers a host country over any form of portfolio investment, especially borrowing by governments themselves. FDI normally brings technology and operating and marketing know-how. Much more importantly, FDI reduces vulnerability to downturns in world economic conditions by tying foreign repayments to ability to pay. FDI is locked in to a host country's fortunes, whereas any form of portfolio investment has the disadvantage to the host country of instability. Also, FDI is more easily taxed.

The Internationalisation of Environmental Law

Until the 1990s, environmental issues were still largely treated as side-issues. By the end of the century they had moved to centre stage and the term "sustainable development" was on everyone's lips.

Despite early radical calls for punitive carbon taxes, the international community responded to the risk of climate change in a measured way with the 1992 UN Framework Convention on Climate Change (FCCC). By December 1997, the Kyoto Protocol succeeded in specifying individual emission reduction commitments for the developed countries. Although doubt still remained whether the Kyoto Protocol would be ratified by sufficient countries and actually enter into force, it already had a profound effect on thinking in the energy industry.

The Urge to Merge and Converge

At the end of the twentieth century, we witnessed company mergers on an unprecedented scale, led by the BP and Amoco deal.

The University of Dundee's Paul Stevens recently suggested there was a large element of herd instinct in the urge to merge and that the arguments for large mergers by upstream producers were unconvincing.

4 See the article in this issue by Susan Farmer, "LNG in the Twenty-First Century" [1999] O.G.L.T.R. 102.

5 About which much was said in Robert Pritchard (ed.), *Economic Development, Foreign Investment and the Law*, International Bar Association and Kluwer Law International, London, 1996.

6 Until recently, I would not have labelled any post-Mao policy reform in China as longstanding, but that is surely how the open door policy now must be described. When I led an international delegation of business lawyers to China in 1985, it was all very novel—it was only one year since the 14 coastal cities had been opened to foreign investors. Since 1982, however, foreign investors have been encouraged to invest in China with the constitutional assurance that their legitimate rights and interests will be protected. In China's case, liberalisation of the economic system is being pursued without liberalisation of the political system. See Flint, Pritchard and Chiu, "Constitutional and Legislative Safeguards for FDI: A Comparative Review Utilizing Australia and China," in chapter 5 of Pritchard, n. 5 above.

Since the early 1970s, supply had been distorted by low-cost reserves acting as the marginal suppliers to the market. A more competitive oil market would be reinforced by raising production from low-cost reserves, restoring a normal supply curve where the low-cost reserves are produced first and the high-cost reserves last. According to Stevens, if producer governments could survive the consequent economic deprivation, competition "would restore a dominant position for the Gulf producers in global supply as high cost areas such as the Caspian are pushed out of business."⁷

The urge to merge has not been confined to the upstream sector. Downstream, as well as in the increasingly closely-related electricity supply industry, gas marketing companies have been pooling their resources to make themselves stronger in increasingly competitive wholesale and retail markets. Gas and electricity utilities have been converging to provide consumers with all of their energy-related needs. Some utilities have even begun to offer telecommunications, insurance and Internet services, putting a whole new spin on the strategies that companies in the energy business need to pursue if they are to retain and build a profitable customer base.

Finally, Markets Overtake Politics?

As we are about to enter the twenty-first century, market forces again appear to be having their way despite what any government wants to say. Nonetheless, the vulnerability of individual businesses to sudden shocks, especially political interference, remains acute.

After a century which has been characterised by far-reaching, sometimes rampant change, traditional organisational structures appear no longer adequate. Companies must be vigilant against attack by a range of external threats but be ready to take positive action when opportunities for building their businesses emerge. This entails staying very well-informed and having reliable networks of allies external to the company in the various jurisdictions in which the company operates.

International networks do not develop by happenstance but by careful contrivance of explicit understandings amongst trusted parties who have a stake in each other's welfare. These allies may include a mixture of government agencies, regulatory authorities, public utilities, private companies, investment banks and professional advisers. Strange bed-fellows perhaps but, in an increasingly interdependent world, they cannot live without each other. And lawyers still seem to play an essential part.

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⁷ Paul Stevens, "A Low Oil Price World, Oil Company Mergers and Oil Market Implications", *On-Line Journal*, Centre for Energy Petroleum and Mineral Law and Policy (CEPMLP), University of Dundee, Scotland, <http://www.dundee.ac.uk/cepmlp/html>.

* Robert Pritchard has been a member of the O.G.L.T.R. Editorial Board since its inception.