OIL EXPLORATION CONTRACTS UNDER P.D. 87

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INTRODUCTION

The preamble of the Philippine Constitution calls for the establishment of a government which will, among others, conserve and develop the national patrimony.

Our natural resources are part of the national patrimony, and in line with the policy of conservation, our constitution follows the Regalian Doctrine. Under this principle, all natural resources found within the territorial jurisdiction of a state belong to the State.[1]

Against the policy of conservation, however, is the policy of development. The exploitation and utilization of our natural resources is necessary if the government's policies and programs for economic development are to be implemented. This is particularly true of petroleum.

The energy which petroleum provides is necessary to the society of today. Without it, industries would cease to be productive and technology developed by man would be rendered useless. To a developing country such as the Philippines, intent on gaining an international position equal to that of the nations of the West, a continuing supply of petroleum is crucial. Also important is the development of its own sources of energy. In 1977, the Philippines spent $3,953 million for oil imports alone.[2] This accounted for 21.3% of total imports.[3] This is a large burden to an economy continually faced with the problem of maintaining its dollar reserves.

In recognition of the need to develop our natural resources, the Constitution provides for their use, development and exploitation, under the control of, and on conditions prescribed by, the state. Thus Section 9 of Article XIV provides that the disposition, exploration, development, exploitation and utilization of any of the

[1] 1 FERNANDEZ & SISON, PHILIPPINE POLITICAL LAW 1581 (1st ed., 1975).
[2] Ministry of Energy, Ten Year Energy Development Program 1978-1987, p. 19 (1978).
[3] *Ibid.*

natural resources of the Philippines shall be limited to citizens of the Philippines, or to corporations or associations at least sixty per centum of the capital of which is owned by such citizens. The aim of the constitutional provision is to ensure that the enjoyment of the natural resources be limited to citizens of the Philippines so that the national patrimony may benefit the nation.

The process of discovering, exploiting and refining petroleum and other natural resources, however, requires a very high degree of technological know-how and vast amounts of capital. Both of these canot be provided by Filipino citizens on their own. Section 9 therefore further provides that citizens who have been given the right to exploit and explore our natural resources may be allowed to "enter into service contracts for financial, technical, management or other forms of assistance with any foreign firm or entity for the exploration, development, exploitation or utilization of any of our natural resources."

On December 31, 1972 President Marcos issued Presidential Decree No. 87. This decree promulgated an ". . . Act to Promote the Discovery and Production of Indigenous Petroleum..." It puts in practical terms the policy under the Constitution of entering into service contracts for the exploitation of petroleum resources. Section 2 of this decree sets forth the avowed policy of the state: to hasten the discovery and production of indigenous petroleum. This policy it seeks to achieve through the utilization of government and/or private resources, local and foreign.[4] These resources are to be harnessed under certain agreements and arrangements "which are calculated to yield the maximum benefit to the Filipino people and the revenue to the Philippine government for use in the furtherance of national economic development."[5] At the same time such agreements are designed to "assure just returns to participating private enterprises, *particularly* those that will provide the necessary services, financing and technology and fully assume all exploration risks."[6]

There is, therefore, an interplay of the interests involved. On the one hand, there is the policy of the Philippines to conserve its natural resources for the benefit of its nationals. This is a reaction to its long experience of colonial rule, under which its natural riches redounded to the benefit of others—not of its own citizens. On the other hand, there is the need to develop what resources we do have. This requires the technology and financing of the very foreigners we are determined to exclude. They in turn will definitely not be

[4] Pres. Decree No. 87 (1972), sec. 2.
[5] *Ibid.*
[6] *Ibid.*

willing to provide us with the requisite technology and capital without an assurance that they will earn the commensurate profit from it.

The interplay of interests may be seen in Presidential Decree No. 87, the basic law which governs the petroleum service contract system which the martial law authority has deemed to be the best way of protecting Filipino interests, at the same time providing incentives for the aliens to come in.

The paper attempts to study Presidential Decree No. 87 and its effectiveness in achieving the goals set by the government. The researchers of this paper had originally intended to study the actual implementation of the decree through a study of the service contracts entered into by the government under its provisions. Upon inquiry with the Bureau of Energy Development, however, the researchers were informed that data and information regarding executed service contracts are confidential and may not be looked into. The practice of keeping the actual provisions of service contracts confidential is not unique to the Philippines, however. Other researchers have met the same phenomenon in other countries.[7] The present work is therefore limited to an analysis of Presidential Decree No. 87 as amended and an evaluation of whether it is sufficient and effective in carrying out the mandate embodied in the Constitution.

I. THE SERVICE CONTRACT

The government is given the sole prerogative to undertake the exploration and production of petroleum resources in the Philippines.[8] However, it may enter into service contracts in the prosecution of its effort to discover and exploit indigenous petroleum, subject to the condition that the contractor is financially capable and technically competent to undertake the operations required under the contract.[9] The Bureau of Energy Development (BED) is responsible for determining the financial capability and technical competence of the prospective contractor.

The law lays down the general guideline for every service contract: service and technology are to be furnished by the contractor and, in return, the contractor is entitled to a service fee.

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[7] See: Smith & Wells, *Mineral Contracts in Developing Countries*, 69 AM. J. INT'L. L. 578 (1975), and Fabrikant, *Production Sharing Contracts in the Indonesian Petroleum Industry*, 16 HARVARD INT'L. L. J. 303 (1975).

[8] Pres. Decree No. 87 (1972), sec. 4.

[9] *Ibid.*

As a rule, the government is under obligation to finance the whole venture.[10] This is corollary to the basic tenet in the law that the government is the entity primarily responsible for the exploration and production of indigenous petroleum.[11]

Recognizing the contingency, however, that the government might not have enough funds to finance the undertaking, the law allows the government to stipulate that the contractor shall furnish not only service and technology but also financing. This is done also in order "to induce the contractor to exert maximum efforts to discover and produce petroleum as soon as possible."[12] In this case, the source of the funds for the payment of the service fee and operating expenses of the contractor shall be the proceeds of the sale of the petroleum produced.

The service contract is not unique to the Philippines. Other nations have adopted similar forms of agreements. In Indonesia, there are production sharing contracts (PSC's); in Bolivia there are operating contracts.[13] There are also agreements termed management contracts and work contracts. These agreements seem to have been entered into by the different countries with one common goal: the development of their natural resources without necessarily sacrificing their economic and political independence to the great conglomerates that provide the necessary expertise and capital.

The service contract adopted in the Philippines is very similar to the production sharing contract which originated in Indonesia. This form of contract has since then been used in other places, including Peru, Malaysia and Egypt.[14] The outstanding characteristic of the production sharing contract (PSC) is that sovereignty and management capacity remain with the host country. Meanwhile, the foreign contractors explore and extract minerals on contract terms contemplating payments out of a percentage of total production from the enterprise, rather than a splitting of profits or a grant of ownership to the company accompanied by a royalty to the host country.[15] The PSC therefore implicity recognizes the inevitability of host-country ownership and eventual takeover of the industry.

There are two ways by which a service contract may be concluded. One is after due public notice, pre-qualification and public

[10] Pres. Decree No. 87 (1972), sec. 6.
[11] *Ibid.*, sec. 4.
[12] *Ibid.*, sec. 7.
[13] Smith & Well, *op. cit., supra*, note 7 at 583, 585.
[14] Griff, *International Business: Oil and Gas (Indonesia)*, 19 HARV. INT'L. L.J. 396 (1978).
[15] *Ibid.*

bidding. Another is by way of negotiation. A contract is negotiated only if bids are requested and none are submitted or the ones submitted are found to be disadvantageous to the government.

Subject to the approval of the President, the BED has certain alternatives in opening contract areas: it may select an area or areas and offer it for bidding; it may open large areas for bidding and bidders many select integral areas therein; or it may allow an interested party to select an area and negotiate with the Board for the terms and conditions of the contract.[16]

II. Obligations of the Contractor and Statutory Conditions Under the Contract

Under Section 8 of Presidential Decree No. 87, the Government shall oversee the management of the operations contemplated in the contract.

The contractor is under the obligation of furnishing services and technology. The contractor also assumes all exploration risks, such that if no petroleum in commercial quantity is discovered and produced, it will not be entitled to reimbursement.[17]

Geological Data and Information

The contractor is also under obligation to furnish the BED promptly with geological and other information which it may require. As a corollary to this and in order to ensure that the BED has at least an opportunity to check the accuracy of these data and reports, the contractor is required to maintain detailed technical records and accounts of its operation and must allow access to exploration and production sites and operation to BED-authorized inspectors.

Annual Work Obligation

The contractor is required to spend in direct prosecution of (a) exploration work and (b) after the discovery of oil in commercial quantity in delineation and development, certain minimum amounts of labor and capital per hectare of area covered by the contract.[18] This obligation, however, is subject to certain provisions and exceptions, namely:

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16 Pres. Decree No. 87 (1972), sec. 5.
17 *Ibid.*, sec. 8(e).
18 *Ibid.*, sec. 9(a).

(1) if the contractor, during any contract year, spends more than what is required for that year, he is allowed to credit the excess against his work obligations for the succeeding year;

(2) if the contractor holds two or more areas under different contracts, the total amount of work obligations for the initial term of all the contracts may be spent on any one or more of the areas as if they were covered by a single service contract; and

(3) if the contractor renounces or abandons wholly or partly the area covered by the contract within 2 years from the effective date, it shall, with respect to the area abandoned, pay the government the money value of its work obligations for the two-year period as regards the abandoned area. In relation to this, the contractor must be able to drill a certain minimum footage of the wells within certain periods to be agreed upon in the contract in order to qualify the contractor to an extension of the exploration period.

Failure of the contractor to perform these annual obligations will result in his paying, as a penalty, the money value of the deficiency to the government.

Compulsory relinquishment

The contractor is obliged to relinquish to the government a certain portion of the contract area after certain periods. Thus, five (5) years from the effectivity of the contract, the contractor is obliged to forfeit 25% of the area originally awarded. Again, at the end of seven (7) years from the date of effectivity of the contract, he must relinquish another 25% of the original award if he is to be granted an extension of another 3 years for further exploration. Effectively, the contractor gives up one-half (50%) of the area originally covered after the expiration of 7 years. If he is not granted an extension of 3 years for further exploration, he must relinquish the whole area by virtue of the expiration of the contract.[19]

From this computation is excluded the area delineated as a production area upon the discovery of oil in commercial quantities. Furthermore, any area renounced or abandoned by the contractor within 2 years from the effective date of the contract is credited to the area which he must relinquish at the end of 5 years.

[19] *Ibid.*, sec. (c).

Exploration Period

The original exploration period is 7 years. It is extendible for three years if the contractor has not been in default in its exploration work and other obligations.

If oil is discovered on the tenth year, the contractor may request for a one-year extension to determine whether it is in commercial quantity. If the oil discovered is in commercial quantity, the contractor may retain the delineated production area plus 12½% of the original area awarded. The contractor shall pay not less than ₱10/ha. for on-shore areas and not less than ₱20/ha. for off-shore areas as rentals for 12½% area retained. Rentals may be offset against exploration expenditures actually spent on the retained area.[20]

If discovery is made during the exploration period, the contract with respect to the production area shall remain in force for the 10-year exploration period and for an additional period of 25 years; thereafter it shall be renewable for another 15 years under the terms and conditions agreed upon by the parties upon renewal.

Transfer and Assignment

The rights and obligations under a service contract may not be assigned or transferred without BED approval.[21] However, transfer to an affiliate shall have automatic approval by the Bureau, provided that the affiliate relationship be maintained during the existence of the contract.[22]

Other Obligations

The contractor is further required to post a bond to guarantee compliance with the obligations of the contractor.[23] Section 31, also provides that preference should be given to qualified local personnel in the municipality or province where exploration or production operations are being undertaken.

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[20] *Ibid.*, sec. 9(e).

[21] *Ibid.*, sec. 11.

[22] An affiliate, under sec. 3(o) is a company which holds directly or indirectly at least 50% of outstanding share entitled, or in which a contractor holds at least 50% of the outstanding entitled to vote; or a company in which at least 50% of its shares outstanding and entitled to vote are owned by a company which owns directly or indirectly at least 50% of the shares outstanding and entitled to vote.

[23] Pres. Decree No. 87 (1972), sec. 16.

III. OBLIGATIONS OF THE GOVERNMENT

Reimbursement of operating expenses of the contractor

Section 8 provides that the contractor is allowed operating expenses not to exceed 70% of the gross proceeds from production in any year. Furthermore, operating expenses which exceed 70% of the gross proceeds from production in any year shall be allowed to be recovered from operations in succeeding years.

Contractor's service fee

The contractor is entitled to a service fee of an amount not exceeding 40% of what remains from the gross proceeds from production after deducting the operating expenses and the 15% Filipino participation incentive, if allowable.[24]

The BED is authorized to enter into contracts authorized under Presidential Decree No. 87 with such terms and conditions as may be appropriate under the circumstances. Thus, the form and manner of payment is subject to agreement. Moreover, special allowances may be granted by the BED.[25]

IV. PRIVILEGES OF THE CONTRACTOR

The contractor is exempt from all taxes except income tax.[26] It is also exempt from tariff duties on importation of machinery, equipment, and spare parts provided they are not manufactured domesticaly, and are actually and directly needed for operations.[27] The contractor may construct and operate a power plant even though a local enterprise can supply within a reasonable period and at reasonable cost the power needed, and may export machinery and equipment it no longer needs.[28]

The contractor need not meet publication requirements under Republic Act No. 5435 and Republic Act No. 6173 concerning the exploration, production, exportation or disposition of Philippine crude oil.

Exportation of Petroleum

The contractor may export petroleum subject to prior filling of domestic needs of the Philippines on a pro-rata basis.[29]

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24 *Ibid.*, sec. 8.
25 *Ibid.*, sec. 18(b).
26 *Ibid.*, sec. 12(a).
27 *Ibid.*, sec. 29(b).
28 *Ibid.*,sec. 12(c).
29 *Ibid.*, sec. 12(e).

Alien technical men

Under Section 12 of Presidential Decree No. 87, entry of alien technical men shall be allowed upon approval by the BED, which approval shall not be unreasonably withheld. However, Filipinos should be given preference to positions for which they have adequate training.

Repatriation of capital and retention of profits abroad

The contractor is allowed to repatriate capital investment actually brought into the country in foreign exchange or other assets and are registered with the Central Bank, and to retain abroad all foreign exchange representing proceeds from exports accruing to the contractor over and above amounts necessary for local costs of administration and operations of exported crude oil and revenue due to the Government.[30] The contractor is also allowed to convert into foreign exchange any excess balance of their peso earnings from petroleum productions and sale over and above the current working balances they require.

Equity/Interest in Contractor

A domestic mining or petroleum firm may be allowed to hold interest in the contractor to any extent, provided there is full disclosure to BED, and approval thereof.

Filipino participation incentive

The contractor is allowed a 7½ allowance to be deducted from the selling price of the crude oil sold either domestically or abroad. To qualify for this allowance, the contractor must allow Philippine citizens or corporations to have a minimum participating interest of 15% in the contract area.[31]

A "Philippine corporation" is defined as a corporation organized under Philippine laws at least 60% of the capital of which is owned and held by citizens of the Philippines.[32]

V. TAX PROVISIONS

The contractor shall be liable each taxable year for Philippine income tax on income derived from petroleum operaitons.[33]

[30] *Ibid.*, sec. 13.
[31] *Ibid.*, sec. 28.
[32] *Ibid.*, sec. 2(n).
[33] *Ibid.*, sec. 35.

Out of a total one hundred per cent (100%) of expenditures made, seventy per cent (70%) goes to the contractor as reimbursement of operating expenses. Thirty per cent (30%) is to be shared by the government and the contractor, on a 60%-40% proportion.[34]

The 40% of 30% would in effect be the income or service fee of the contractor. Section 21 of Presidential Decree No. 87 provides that in computing the taxable net income, there shall be allowed as deductions the Filipino participation incentive and the operating expenses reimbursed.

Intangible exploration assets may be deductible in full, all tangible exploration costs such as capital expenditures and other recoverable capital assets are to be depreciated over a ten-year period.[35]

Gross income is determined, under Section 20, in the following manner: if the crude oil is exported, gross proceeds shall be the sale at posted price; in case of crude oil sold for domestic consumption, gross income shall consist of gross proceeds from sale at market price. Where natural gas and/or casinghead petroleum gas are concerned, the gross income shall consist of the total quantity sold at the prevailing market price thereof.[36]

VI. THE SERVICE CONTRACT UNDER PRESIDENTIAL DECREE NO. 87

Comments and Analysis

The foregoing has been an attempt to put in capsule form the basic provisions of Presidential Decree No. 87, in order to give the reader an overview. We will now attempt to analyze its provisions in relation to the policy considerations discussed in the first part of the paper: conservation for the benefit of the Filipino people, as against the need to develop these resources.

In our analysis, we will sometimes refer to similar features of production sharing contracts in Indonesia. We feel it appropriate to advert to the Indonesian experience for two reasons: the many similarities between our service contracts and their PSC's, and the fact that Indonesia, like the Philippines, is a developing country in Southeast Asia.

The transnational corporation as service contractor

According to the report of the Ministry of Energy for the year 1977 to 1978, a total of twenty-one (21) exploration contracts have

[34] *Ibid.*, sec. 8(1).
[35] *Ibid.*, sec. 22.
[36] *Ibid.*, sec. 30.

already been executed. Of these, twelve were with Filipino companies, and nine (9) were concluded with multinational corporations.[37]

A multinational (or transnational, as we will refer to it in this paper), is an enterprise which controls assets—factories, mines, sales offices, and the like—in two or more countries, exercising significant market controls in some sectors of the economy, with a home base from which control or direction emanates and which derives a significant proportion of its total activities from its overseas operation.[38]

Transnationals are feared by many nations because they render ineffective many traditional policy instruments, the capacity to tax, to plan investment, etc. because of their great international flexibility. In addition, transnationals act as a vehicle for the intrusion of the policies of one country into another with the ultimate effect of lessening the power of both.[39] International business weaves a tangled web and it is often beyond the power of the developing country (dependent upon it for capital and technology) to control.

Many developing countries share the view that transnationals undermine their sovereignty. Thus, they have adopted statutes which will serve to control the activities of these entities, at the same time maintaining them in business in the countries concerned. This a reflection of the ambivalent attitude toward transnationls: the need for them on the one hand, and the fear of their control, on the other.

In the case of service contracts for the exploration and exploitation of petroleum resources, the justification for the entry of transnationals is that they are the only ones with the requisite capacity to finance these projects as well as the technological knowhow for the actual operations.

Teehnology and its transfer

Unless the developing country is to be forever dependent on the service contractor (and therefore maintain its status of "developing"), technology must be transferred to the host country.

Certain provisions on Presidential Decree No. 87 provides for the transfer of technology. Section 12(f) provides for the entry of

[37] Ministry of Energy, Energy Resources Development in the Philippines: A Report of Activities During 1977-1978, p. 9 (1978).

[38] Espiritu, *A Filipino Looks at Multinational Corporations*, LAW AND DEVELOPMENT 2 (1977).

[39] Hymer & Rowthorn, *Multinational Corporation and International Oligopoly: The Non-American Challenge*, in THE INTERNATIONAL CORPORATION, A SYMPOSIUM (KINDLEBERGER, ED.) 88 (1970).

alien technical and specialized personnel, provided the contractor shall adopt and implement a training program for Filipinos along technical or specialized lines, which shall be reported to the BED. Section 8(f) requires the maintenance of detailed technical records and and other information, data and reports which it may require. Section 8(g) requires the maintenance of detailed technical records and accounts of its operations.

The obligation to furnish data seems to be very encouraging on the surface. A deeper examination, however, may reveal some difficulties and complications. First, the cost in administering an inspection and verification system would be very high. The government coffers would be greatly diminished by the maintenance of such system. Neither does the law provide for any mechanism whereby the costs of inspection would be shouldered by the contractor. On the other hand, if an inspection of verification system is not maintained, there can be no assurance that the data being furnished by the contractor is true and accurate. One cannot be expected to open the doors to the future possibility that one will lose an opportunity for profit due to one's own acts. The data being sought are intended for the use of the government when the contractor eventually leaves the area. As the provision stands, however, the geological data may seem as strange to the government as it was before the contractor commenced operations.

Secondly, these data, granting them to be true and accurate, are useless to persons who do not have the necessary expertise in field. The data would therefore be meaningless unless and until we have our own technological and technical experts who can interpret and make use of the data in the particular field of petroleum exploration and production. The provision for training Filipinos does not carry with it a specified program of implementation. Nor are there specific sanctions for its non-fulfillment. As it is, the Philippine government is undertaking its own program for the training of Filipinos in this field.[40]

In the case of Indonesia, there is a state enterprise (Pertamina) which has the management of, and is responsible for, the operations contemplated in the contract.[41] The contractor is responsible to Pertamina for the execution of such contracts, and Pertamina assists and consults with the Contractor with a view to the fact that the contractor is responsible for the work program. The management clause institutionalizes dialogue between Pertamina and

[40] Ministry of Energy, *op. cit., supra*, note 39 at 31.
[41] Fabrikant, *op. cit., supra*, note 7 at 312.

the contractor, triggering an educational process which lays the groundwork for the eventual transfer of the industry from foreigners to Indonesians.[42] Although this increased contract may result in certain irritants, the risk is deemed necessary if the Indonesians are to eventually take over. Morever, this goal of eventual takeover is explicit in most PSC's.

Under Presidential Decree No. 87, the BED oversees the management of the operations contempalted. It is not primarily responsible for the management. This is perhaps due to fact that while Pertamina is a state enterprise, the BED is a government agency.[43] Thus, their positions are vastly different. The BED, therefore, has no direct hand in the management of the oil contractors' operations. While this may result in more efficiency on the part of the contractor's operations, this is certainly a loss to the government in the sense that there is no opportunity for two-way interaction.

It should be also noted that while we assume eventual Filipino takeover to be the goal of service contracts, there is no express provision in the presidential decree for such an eventuality.

Annual work obligations

The provision on annual work obligations is designed to force the contractor to make use of their funds in the exploration and development work. This, together with the provisions limiting the term of the contract, serves as a mechanism to compel the contractor to hasten the exploration and development work. It prevents, thereby, purely speculative ventures.

The mechanism, however, is not flawless nor fully effective in achieving the goal of discovering and producing petroleum as early as possible. It may very well happen that funds for the personal and corporate interests of the contractor can be easily justified as made in direct prosecution of the exploration and development work. Furthermore, the sanction for the failure to comply with the obligation is purely monetary in nature. Such a loss can be deducted later as part of the operating expense account. The law does not prohibit such an action.

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[42] *Ibid.*, p. 348.

[43] Note that the Constitutional provision (Art. XIV, sec. 9) provides that the National Assembly may *allow citizens*, corporations or associations sixty per centum of the capital of which is owned by Philippine citizens who have been granted licenses for exploration development and exploitation, to enter into service contracts. Under Pres. Decree No. 87, however, it is the government which enters into the contract directly.

It would have been more equitable if the law were to provide that in case of failure to comply with the obligation, the contract is automatically rescinded and the contractor may be held liable for damages. After all, such a condition is essential to the contract. As it were, the contractor, who is the obligor, has failed to perform its obligation under a reciprocal contract.

Compulsory relinquishment

This provision is intended to gradually phase out the contractor and at the same time allow the government an opportunity to take over the relinquished areas. The intent seems to be for the contractor to make initial exploratory work on the areas and for the government to take over where the contractor leaves off. Also, it of the law since the discovery and development work on a smaller area where the possibilities of discovering oil in commercial quantity are greater.

In a sense, the provision works well for the avowed objective of the law since the discovery and development work on a smaller area will definitely hasten the pace. It is disadvantageous in another sense, however, because the government is made to take over areas which the contractor, who has the freedom of choosing which areas are to be relinquished, will not give up the areas where it thinks there are better prospects for striking oil. In fact, when oil in commercial quantities is discovered, the contractor has the freedom of delineating a production area which is not included in accounting for the 25% relinquishment. Neither does the law define or limit the contractor's freedom in delineating the production area. The only limitation is the time within which the area may be delineated, which period is to be agreed upon in the contract.[44]

If oil is found in the 11th year, there is no time limit as to the exploration period for the 12½% area retained. The contractor is merely obliged to pay the rentals. These rentals may be set-off with actual exploration expenses, thus the contractor can see to it that he spends as much as the rentals due from him and thereby earn the right to explore the area indefinitely without having to pay anything.

Operating expenses

The law provides that the Government shall reimburse the contractor for all operating expenses not exceeding 70% of the gross proceeds in any year.

[44] Pres. Decree No. 87 (1972), sec. 9(d).

Laying down a very general rule such as this is fraught with danger. Setting 70% as the upper limit is very high in operations of this nature. It would be relatively easy for the contractor to justify his claim for the full amount of 70% because the law does not lay down any rules as to the allowable items in the operating expenses account. Section 3(u) defines "Operating expenses" thus: "the total expenditures for petroleum operations made by the contractor *both within and without* the Philippines as provided in a service contract." On the other hand, "petroleum operations" is defined as: "searching for and obtaining petroleum within the Philippines through drilling and pressure of suction or the like and other operations incidental thereto. It includes transportation, storage, handling and sale (whether for export or for domestic consumption) of petroleum. . ."[45]

The legal definition of "operating expenses" includes expenses "within and without the Philippines." There lies open the possibility of padding the expense account with items which the authorities of the host country cannot verify. Even those expenses incurred in the Philippines will be justified by documents within the control of the contractor. It is true that the contractor has the obligation to open its books of account to the revenue authorities [Sec. 8(j)], but this measure does not sufficiently protect the interest of the host country because manipulation of the accounts can easily conceal the real source and destination of the expense.

Furthermore, the contractor can easily organize foreign and domestic subsidiaries or affiliates which will contract with them for services in transporting, storing, handling and selling the petroleum products. In this way, the subsidiary or affiliate makes a profit on the transaction while the contractor is allowed reimbursement for an expense on which it indirectly makes a profit.

Also, the operating expenses account is practically limitless. Whatever exceeds the 70% limit for every year can be charge to the operating expenses in the succeeding year.

By way of comparison, it should be pointed out that PSC's in Indonesia provide for operating cost the maximum of which shall not exceed 40% of the oil produced annually from the petroleum operation[46]. This percentage is very low compared to our 70% limitation.

The law provides for reimbursement to the extent of 70 per cent of the *gross proceeds* from production. Gross proceeds imply

[45] Pres. Decree No. 87 (1972), sec. 3(d).
[46] Fabrikant, *op. cit., supra*, note 7 at 321.

that there has been a sale of the product, before a determination of gross income may be made. At present, the problem may be more theoretical, as we do not produce oil in commercial quantities yet. The government, however, projects that the value of Nido oil production in terms of foregone exportation and/or export revenues will be around $174 million.[47] Thus, the question of prices now comes in.

It cannot be ignored that oil prices are not the result of the mechanism of supply and demand in the world market, but is a function of the decisions of the Organization of Petroleum Exporting Countries (OPEC) as well as international oil cartels (with which the transnational corporations have links.)[48]

The question is especially crucial with regard to domestic supply. The law merely states that the contractor may be authorized to dispose of and market all petroleum subject to supplying domestic requirements on a pro-rata basis.[49] The provision is vague, because it does not provide for exact figures and proportions. Moreover, it seems that domestic oil supplies which are derived from local production will have to be priced according to market prices.[50] Thus, oil prices within the Philippines will be high, even if domestic oil does become reality.

The Government's share

The government is to get, as revenue, 60% of whatever remains from the gross proceeds after deducting the operating expenses and the Filipino participation incentive, whenever allowable. Section 18 (b) in part provides: ". . . in no case shall the annual net revenue or share of the Government *including all taxes paid by or on behalf of the contractor,* be less than 60% of the difference between the gross income and the sum of operating expenses and Filipino participation incentive. . . ."

The government's share in the proceeds already includes the taxes paid by or on behalf of the contractor. In effect, the income tax which the government receives is already its part of its share in the petroleum operation.

The government had adopted the service contract system so that it may have revenues for use in the furtherance of national economic development. The 60% share of the government seems

[47] Ministry of Energy, *op. cit., supra,* note 39 at 5.
[48] For a comprehensive discussion, see: SAMPSON, THE SEVEN SISTERS (1975).
[49] Pres. Decree No. 87 (1972), sec. 8.
[50] *Ibid.,* sec. 20.

big, but put in practical terms it becomes small, considering the depletion of our natural resources. The contractor pays little more than the ordinary corporation (which pay 25% on the first ₱100,000 and 35% on all additional amounts)[51] for the privilege of exploiting our natural resources.

The right to export the petroleum produced

The Contractor may be allowed in the contract to export petroleum subject to prior filling the domestic needs of the Philippines on a pro-rata basis.

The granting of this privilege runs afoul with the declared policy that the service contract is calculated to yield the maximum benefit to the Filipino people. A stipulation to this effect in the contract will allow the contractor to export the petroleum produced as long as he appropriates an amount covering his share in filling up Philippine domestic requirements. This domestic consumption requirement is to be filled up by all the contractors producing petroleum.

The privilege is contrary to the policy because the domestic production is not even sufficient to cover the domestic needs. If the contractors are allowed to share the responsibility on a pro rata basis and export of petroleum is allowed, the domestic requirement will not be filled. (1977-78 Report of the Ministry of Energy).

Furthermore, such a privilege will encourage the entry of middlemen and traders. Eventually, the Filipino consumer will suffer because the oil which came from his own country, which was passed on as raw material to middlemen, he now has to purchase at a price which includes profits for the middlemen.

It would be better for the government to market the petroleum products itself if there is any surplus production because it can obtain better prices and the profits from the sale can be channeled directly to the national economic program. If the contractor is allowed to sell the petroleum products, it may sell these products to its own affiliates and subsidiaries at a low price while said affiliates and subsidiaries will be able to re-sell the same products at higher prices. Thereby, even if the contractor does not make much of a profit directly it is able to make much more indirectly.[52]

[51] Pres. Decree No. 1158 (1977), sec. 24 (National Internal Revenue Code).
[52] This problem was also met in Indonesia. Later contracts permit commission on sales only to non-affiliates (see Fabrikant, *op. cit., supra*, note 7 at 318).

Repatriation of capital and retention of profits abroad

The change from colonialism to neo-colonialism has brought about a corresponding change in its means of amasing super-profits from underdeveloped countries. From what used to be direct and indiscreet methods, indirect and more subtle means have been employed to insure a continuous source of cheap raw materials, cheap labor and a place to dump surplus products.

The transnational corporations could be regarded as the acme of this transformation in means and methods. Unlike its military and political colonial counterparts, they have become accepted by some leaders of underdeveloped countries as a necessity to their countries political and economic advancement, enabling these companies to entrench themselves in the economic and political life of these nations.

Their detrimental role has, however, in recent times been brought to light. Focus has been brought on their capital repatriation and profit remittance scheme which has made underdeveloped countries the milking cow of the western world and to which the Philippines has been an easy prey.

Not only does profit remittance and capital repatriation constitute a long term leakage of resources much needed by a developing economy, it also subjects an economy dependent upon foreign resources to external manipulation. Furthermore, this manipulation by transnational corporation is not only limited to the economic sphere, but as shown by the recent Latin American experience, it may result in attempts to transform political structures to suit corporate interests.[53]

Transnationals have therefore been severely criticized for their use of local credit. A study on the utilization of local credit sources showed that 84% of the total amount invested by US companies in the Philippines from the period 1956-1965 came from funds borrowed locally. Only 16% came from US sources.[54]

In recent times this has hardly changed, if not worsened. For as of December 1974, of the total foreign investments in the Philippines, 39, 87% of financing came from local sources and the remaining 60.13% came from foreign sources. However, only 3.5% of the

[53] Jurado, *Foreign Trade and External Debt*, PHILIPPINE ECONOMIC PROBLEMS IN PERSPECTIVE 292 (1976).

[54] Submitted by Dr. B. G. Bantegui, Director, Office of Statistical Coordination and Standards, National Economic Council (NEC), to Staff Secretariat of NEC Working Committees on Laurel-Langley Trade Agreement.

latter amount are equity investments, meaning capital put in by foreign investors themselves into the business. This should be distinguished from non-equity financing which refers to loans, credits for machinery, equipment and raw materials, mostly from the parent company, inter-company transfer of funds, retained earnings, depreciation and depletion funds.[55] The great part of the 60.13% consists of this. The effect is that local businessmen are unable to compete with the transnationals for the acquisition of local credit. More importantly, such a practice negates the reaosn for attracting foreign capital. If foreigners who come into the Philippines are going to use local money anyway, there is little point in allowing them to invest here.

According to Dr. Augusto Caesar Espiritu,[56] the martial law administration has laid down a policy which would minimize the slice of local credit traditionally awarded to transnationals and other foreign investors. It has approved policy guidelines governing the availment of peso borrowings, which prescribe the maintenance of a debt-to-equity ratio. This would be applicable to service contractors under Presidential Decree No. 87 because these rations are applicable to vital industries as defined under LOI No. 368.[57] Said letter of instruction includes companies engaged in exploration, development, mining... of oil... and other minerals.

Under these policy guidelines, a 60-40 debt-to-equity ration must be maintained.[58] Certain questions must be raised, however.

The policy guidelines in question are not embodied in any statute. The classification of service contractors as engaged in vital industries is embodied in letter of instruction, not in a presidential decree. The relative positions of policy guidelines, letters of instructions and decrees all emanating from the same authority as regards their binding effect is subject to question. It would be logical to assume, however, that a decree, promulgated as law, would be less easy to set aside than a guideline or an LOI. Yet the ratios abovementioned have not been embodied in a decree.

Presidential Decree No. 87, moreover, does not make reference to debt-to-equity ratios. Neither does the contractor have to be registered with the Board of Investments, under the Investment Incentives Act. It would be easy to argue, considering the unique position of the contractor as an entity with which the government

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[55] Jurado, *Industrialization and Trade*, in PHILIPPINE ECONOMIC PROBLEMS IN PERSPECTIVE 310 (1976).

[56] Espiritu, *op. cit., supra*, note 40 at 42.

[57] Letter of Instructions No. 368 (1976).

[58] *Ibid.*, No. 4.

has entered into an agreement, that it is not covered by these guidelines.

We have seen that it is highly possible that the service contractor makes use of local funds for its operations. Even assuming it follows the 60:40 requirement, it would still be availing of a large amount of local funds to finance its operations. The repatriation of profits abroad, as provided under Section 13 of Presidential Decree No. 87, therefore, seems inequitable. A large percentage of it would possibly come from local funds, and should be reinvested in the Philippines—not end in the exclusive benefit of foreigners.

The Philippine experience has been that the rate of outflow in relation to inflow has been very high. There seems no indication that it will be different in the case of petroleum service contractors. Moreover, these entities are allowed to convert into foreign exchange for remittance abroad the money that they earn here. This would have adverse effects on our dollar reserves, which are crucial to maintaining our position in the world economy.

An interesting feature of Presidential Decree No. 87 is that it allows, in Section 13, the retention abroad of foreign exchange proceeds from exportation of crude oil, deducting therefrom only revenues due the government and local costs for administration and operations of the exported crude oil. The implication seems to be that as regards crude oil NOT exported (that is, sold domestically for our consumption, pursuant to Section 8). Foreign exchange earnings need not be used for production. In effect, all that need be remitted to the Philippines for operational expenses is an amount proportionate to the expenses needed to export crude oil. This provision, if taken literally, seems unfavorable to the host country, because it would mean a lessening of capital entering into the country.

Equity Interest in the contractor

Section 14 of the Presidential Decree No. 87 allows interest in the contractor by domestic mining and petroleum companies and/or the latter's stockholders to any extent, provided, there is full disclosure to, and approval by, the BED.

The original provisions of the Philippine Corporation Law prohibited any mining corporation to have an interest in another mining corporation. The purpose of the prohibition was to avoid monopolies and combinations, which were deemed contrary to public policy.[59] Republic Act No. 5167, however, amended the Corporation Law and

[59] CAMPOS & CAMPOS, NOTES AND CASES ON CORPORATION LAW 400 (1969).

allowed such an interest to the extent of 40% of the outstanding voting stocks thereof. The amendment was enacted to foster faster and full development of mineral resources.[60]

Oil exploration and exploitation firms are generally considered to fall under the same classification as mining firms. Certainly the rationale for the prohibition applies to oil firms as much as they do to other mining entities. Yet Presidential Decree No. 87 does away with the limitation.

The provision refers to domestic mining and petroleum firms. It must be emphasized, however, that domestic firms need only be 60% Filipino. Thus, if the purpose is to encourage Filipino participation and control over petroleum contractors the end does not seem to be met. A domestic corporation with 40% held by one foreign interest and 60% scattered among Filipinos would certainly reflect primarily foreign interest. Such a firm holding an interest in another petroleum firm would only strengthen control. Again, Filipino capital would be used for the operations, such that less capital from alien sources would come in. Although the situation is different because then Filipino money has equity participation, the over-all effect would be the same, considering this 60-40 requirement for domestic corporations.

Filipino Participation Incentive

This appears to be an encouragement for the contractor to allow Filipino citizens and corporations to work in the contract area in order that the Filipino participant can get training in the field, both technical and managerial.

This, however, is very idealistic in outlook. The natural attitude of the contractor is to put the Filipino participant in an area where the contractor thinks it can do the least economic harm. The law requires participation in 15% of the contract area. The contractor is allowed a large production area in the contract. He can set aside an area which he thinks will not really be a productive area. In this way, the contractor is able to reap all the benefits and at the same time take advantage of the 7½% government subsidy.

Furthermore, the contractor can himself or through an affiliate or subsidiary put up 40% of the capital for a Philippine corporation to participate in 15% of the contract area. By controlling the flow of technology into the Philippine corporation, the contractor can obtain all the benefits and still take advantage of the incentive.

[60] *Ibid.*, No. 4.

Participation clauses have also been included in Indonesian PSC's. These provisions, however, call for an offer of a stipulated percentage of contractual rights and obligations to an Indonesian participant[61] (not 15% of the *contract area* as provided in Presidential Decree No. 87).

Although such a provision has caused some discomfort to contractors in the Indonesian situation, operational autonomy is not sacrificed because the contractor remains the sole operator and is responsible for the work program and budget.[62] In the Philippines, there is little possiblity of even discomfort since the contractor and the participant are separate entities.

Tax Provisions

Many features of the tax provisions on service contractors have already been discussed above. And additional feature which must be considered is Section 22 which calls for the deductibility in full of intangible exploration costs. What is covered by the term "intangible exploration costs" may be the subject of much discussion. Generally, however, they refer to business items like goodwill or intellectual property like inventions and patents. The law provides that intangible exploration costs may be deducted from the gross income in full.[63]

It would seem that the costs referred to in the law contemplates the royalties and/or rentals paid by the contractor for the use of the intangible assets of some other person or entity. This would probably be in the nature of royalties for existing patents on certain types of machinery and equipment, the use of which is peculiar to petroleum ventures.

This provision opens the door for the contractor to declare that it is paying huge amounts of royalties and/or rentals for certain assets which are not owned by them but are under the ownership and control of persons or entities affiliated or in some way connected with the contractor. This gives rise to a double benefit to the contractor. He is able to avail of the full deduction and at the same time, he profits indirectly from the payment of the said amount. This provision deprives the government, to a large extent, of much needed revenues.

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61 Fabrikant, *op. cit., supra,* note 7 at 330.
62 *Ibid.*
63 Pres. Decree No. 87 (1972), sec. 22.

CONCLUSION

The above has been an attempt to analyze Presidential Decree No. 87 and its effectiveness in pursuing declared government aims and policies. From the discussion, it is perhaps safe to generalize that the statute leaves much to be desired in terms of protecting the interests of the Philippines as a developing nation so that its political independence and economic stability may be maintained. As the decree stands, there is much room for the transnational corporation to entrench itself in the Philippine economy, leaving us dependent on it. Moreover, the provisions of the decree seem to unduly favor the transnational, at the expense of the national interest.

In terms of the balance of conflicting interests, discussed in the first few pages of this paper, the over-all picture seems to be that it is the service contractor, or the foreign capitalist which prevails over the others.

It may be argued that at this point in time, when the question is primarily of exploration rather than exploitation, the service contractor should be favored because it is a highly speculative undertaking. Also, at the initial stage of oil production, it is logical that the government and the contractor would have an identity of interests because their main goal is to discover oil. Such an argument implies that only when oil has been discovered, and commercial production commences, should we seriously consider protecting our interest. This argument is not acceptable. Once the government has entered into contracts with foreign nations, it cannot unilaterally change its provisions. The problem of a government amending agreements has been met in other parts of the world. In these instances, a lot of difficulties were met, not least among them the unwillingness of the contractor to accede. If the Philippine government were to hold such an attitude, the effect would be more negative than positive.

It is not our position, however, that service contracts should be totally scrapped. It is our contention that the whole system of allowing such contracts be reexamined with the view of eliminating and adjusting the inequitable and objectionable provisions of law and eventually infuse more equitable stipulations in the contract. The Philippines, though it may be a developing country, must negotiate from a position of strength. After all, the Filipino nation holds the unquestioned title to these resources. As it were, we are the employers; we are merely looking for employees to service our needs, not to rob us of our bounty. In the interplay of interests, the welfare of the Filipino people must prevail. The government is duty-bound to see to it that this interest, economic or otherwise, is never subjugated.

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