

SERVICE CONTRACT CONCEPTS IN ENERGY

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INTRODUCTION

The history of oil exploration began in 1859 when a successful drilling of the Drake oil well at Titusville, Pennsylvania yielded a commercial production of crude petroleum, thus, marking the beginning of the modern oil industry.¹

In the Philippines, petroleum exploration started in 1896 when Smith Bell drilled the first well in our country,² but, it yielded negative results. The Philippine Government thereafter enacted the Philippine Bill of 1902 which provides in part under Section 21 thereof "that all valuable mineral deposits in public lands in the Philippine Islands, both surveyed and unsurveyed, are hereby declared to be free and open to exploration, occupation and purchase, and the land in which they are found to occupation and purchase by citizens of the United States or of said island." On August 31, 1920, Act No. 2932 was promulgated. This provided for the exploration, location and lease of lands containing petroleum and other mineral oils and gas in the Philippine Islands. Later enactments which are also considered as early legislation on the matter are Commonwealth Act No. 137, Act No. 2719, Republic Act No. 387 and Republic Act No. 5092. The first is known as the Mining Act and was approved on November 7, 1936, while the second is commonly known as Petroleum Act of 1949 and was approved on June 18, 1949. Act No. 2719 is the law governing the exploration, development and administration of coal-bearing lands and Republic Act No. 5092 is the law on the promotion and regulation of the exploration, exploitation and development of geothermal energy, natural gas and methane gas.

The Mining Act or Commonwealth Act No. 137 was not only purposely intended to regulate the conservation, disposition, and development of mineral lands and minerals, but also regulated the licensing, leasing and granting of concessions for the exploration, development or utilization of coal lands and lands containing petroleum and other mineral oils and gases by prescribing the citizenship requirements and maximum period

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¹ RUBIO, PETROLEUM EXPLORATION IN THE PHILIPPINES: A CHALLENGE TO EVERY FILIPINO, 31 (1974).

² Energy Development Board Backgrounder No. 3, Meeting the Energy Challenge: The Philippine Experience, 2.

for such license, lease or concession. The Mining Act also reiterated the Regalian Doctrine by providing that mineral lands and minerals shall be owned by the State, and excluding mineral deposits from private ownership arising from land titles and patents.

The Petroleum Act of 1949 or Republic Act No. 387, on the other hand, was primarily designed to promote the exploration, development, exploitation and utilization of the petroleum resources of the country, and to encourage the conservation of such petroleum resources. The adoption of the Petroleum Act of 1949 resulted in petroleum exploratory activities beginning in 1950 and 22 years thereafter, as the number of drilled wells totalled to 270, compared to some 30 wells that were previously drilled since 1896.³ The Petroleum Act of 1949 introduced the Concession System which became the basic exploration law in our country up to 1972. Private companies operating under the Concession System have drilled 80% of the total number of wells drilled in the 1950's and early 1960's, all of which, however, were either dry or non-commercial.⁴ Such disappointment from so many unproductive wells took its toll. Many multinationals pulled out of the operations, leaving the country starved of capital and technology and for half a decade afterwards, drilling was at a standstill.⁵

In the past, the search for petroleum in the country had not merited an accelerated and rationalized action from the Government. Exploration activities were in fact stifled by the Petroleum Act of 1949, a law that wrongly presupposed that such a capital-intensive, high risk and speculative venture could be successfully undertaken by a single individual or company.⁶ As a result, funds of the petroleum concessionaires were exhausted. Moreover, the concession system practically closed its doors to foreign investors. Hence, all exploration was financed primarily with local capital, which was stretched to its limit.⁷

A renewed interest in oil exploration came about in 1969 as oil prices went up with the closure of the Suez Canal to sea traffic. Local reaction saw the emergence of some 60 Filipino exploration companies, with a total of 15 concession blocks auctioned off in biddings. Drilling operations, however, were still sporadic. Lack of high-risk capital and expertise, compounded by the absence of government incentives, spelled the drawbacks.⁸

To remedy such a situation, the Philippine Government has liberalized and made more reasonable our petroleum and investment laws so that

³ SALI, REEF EXPLORATION IN THE PHILIPPINES, 4 (1978).

⁴ See note 2, *supra*.

⁵ *Ibid.*

⁶ *Ibid.*

⁷ *Ibid.*

⁸ *Ibid.*

foreign capital and technology are now given greater and more meaningful incentives to participate more actively as service contractors in oil exploration in the Philippines.

In view of such aim, on October 2, 1972, Presidential Decree No. 8 decreed into law Senate Bill No. 531 entitled "An Act to Promote the Discovery and Production of Indigenous Petroleum". However, said law was short lived, for in less than three (3) months after its promulgation, it was superseded by Presidential Decree No. 87, approved on December 31, 1972 and known as "The Oil Exploration and Development Act of 1972". Said law was an improvement of Presidential Decree No. 8 and it was considered as the most important energy legislation for it activated a new period for the petroleum industry. By virtue of said Presidential Decree No. 87, it was declared as a State policy "to hasten the discovery and production of indigenous petroleum through the utilization of government and/or private resources, local and foreign, under the arrangements embodied in this Act which are calculated to yield the maximum benefit to the Filipino people and the revenues to the Philippine Government for use in furtherance of national economic development, and 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".

The above-cited law as can be gleaned from its tenor, is intended to attract foreign companies with capital, technology and experience to explore and develop the country's oil resources. For this reason, Section 17 of Presidential Decree No. 87 organized the Petroleum Board and introduced the concept of the "Service Contract" in place of the concession system espoused under Republic Act No. 387 (Petroleum Act of 1949).

Under the concept of Service Contract, services and technology are to be furnished by the service contractor for which it shall be entitled to the stipulated service fee, while financing is provided by the Government to which all petroleum recovered shall belong exclusively. However, any service contractor may also provide financing in addition to services and technology it will introduce if the Government is agreeable or cannot finance the petroleum operations, but it shall be entitled to reimbursement for all production expenses once crude oil is discovered in a commercial quantity.

Very attractive incentives were provided by the above law, the most important of which were exemption from all taxes and import duties except income tax⁹ and exemption from publication requirements under Rep. Act Nos. 5455 and 6173 (now the Omnibus Investment Code).

⁹ Under Presidential Decree No. 1354 (1978), 52 Vital Docs. 71, subcontractors and alien employees of service contractors and subcontractors engaged in petroleum operations in the Philippines under Presidential Decree No. 87 (1972), 3 Vital Docs. 80, are subject to a final income tax of 8% and 15% of gross income, respectively.

Though the Government had already been attracting foreign investors for oil exploration by virtue of Presidential Decree No. 87, the oil crises in the latter part of 1973 prompted the leaders of our Government to institute still other measures, the effect of which are of wide importance to our economy. Thus, on November 9, 1973, Presidential Decree No. 334 was approved creating the Philippine National Oil Company (PNOC). The PNOC was designed to alleviate the adverse impact of the oil crisis by initiating a vigorous program of diversification of oil sources through government to government negotiations. But more significantly, the creation of PNOC signalled the start of active government participation in the exploration, development and exploitation of oil, and on April 30, 1976, Presidential Decree No. 572 was promulgated, expanding the operation of PNOC to cover not only oil but other sources of energy as well.

Another important law on petroleum exploration is Presidential Decree No. 575 (approved November 8, 1974), creating the Philippine National Petroleum Center (PNPC) and making it an integral unit of the Petroleum Board. The PNPC is intended to be the central repository of all data and information on our country's petroleum potentials and resources and has the further function of training Filipino technical personnel in petroleum exploration and development.

Likewise, on August 25, 1975, through Presidential Decree No. 782, the Petroleum Board's functions were expanded in order to integrate in a single governmental agency the functions, responsibilities and regulatory powers of the different agencies in the field of oil exploration and development. These expanded functions included:

1. The powers and duties vested in the Secretary of the Natural Resources under Rep. Act No. 387, particularly the provisions of Chapter IX on duties of officials;
2. The function of the Petroleum Division of the Petroleum Technical Committee in the Bureau of Mines, relative to the implementation of Rep. Act No. 387, together with applicable appropriation, records, equipment and property; and
3. The Petroleum Concessions under Rep. Act No. 387, which are now required to be converted into service contracts under Presidential Decree No. 87.

The Petroleum Board was subsequently abolished and in its stead was created the Energy Development Board pursuant to Presidential Decree No. 910.

The Energy Development Board (Petroleum Board) and the Philippine National Petroleum Center, who, in one way or another, were engaged in the exploration and development of petroleum, were then subsequently abolished and in their stead created the Bureau of Energy Development.

(BED) in accordance with Presidential Decree No. 1206, as amended by Presidential Decree No. 1573. The BED is presently the government agency concerned with exploration and development of petroleum and other energy sources.

The Bureau of Energy Development absorbed the powers and functions of Energy Development Board under Presidential Decree Nos. 87, 910, 972 and 1068. Among others, the BED was tasked with administering a national program for the encouragement, guidance, and whenever necessary, regulation of such business activities relative to the exploration, exploitation, development and extraction of fossil fuels such as petroleum, coal, natural gas and gas liquids; nuclear fuel resources, geothermal energy resources and non-conventional forms of energy resources. In other words, BED was made responsible for the upstream activities relating to energy resources.¹⁰ Additionally, BED was given concurrent authority with the Bureau of Mines over the regulation of the mining of radioactive minerals. With the creation of the Bureau of Energy Development, the government has been able to attract several private investors in the search for oil due to the reasonable terms of service contract offered to them.

Parenthetically, it should be noted that government encouragement in oil exploration and development and discovery and production of energy from indigenous sources with the ultimate aim of bolstering the prosperity of our national economy are in keeping with the mandate of the new Constitution. And, in this connection, it is worthwhile to remember the pertinent provisions of the 1973 Constitution on Natural Resources. These are:

"PREAMBLE

We, the Sovereign Filipino People, imploring the aid of Divine Providence, in order to establish a government that shall embody our ideals, promote the general welfare, conserve and develop the patrimony of our nation, and secure to ourselves and our posterity the blessings of democracy under a regime of justice, peace, liberty and equality, do ordain and promulgate this Constitution.

ARTICLE I—THE NATIONAL TERRITORY

Section 1. The national territory comprises the Philippine archipelago, with all the islands and waters embraced therein, and all the other territories belonging to the Philippines by historic right or legal title, including the territorial sea, the air space, the subsoil, the sea-bed, the insular shelves, and the other submarine areas over which the Philippines has sovereignty or jurisdiction. The waters around, between, and connecting the islands the archipelago, irrespective of their breadth and dimensions, form part of the internal waters of the Philippines.

¹⁰ National Environmental Protection Council, II Philippine Environmental Law, 248 (June 5, 1978).

ARTICLE XIV — *THE NATIONAL ECONOMY AND THE PATRIMONY OF THE NATION*

Section 1. The national Assembly shall establish a National Economic and Development Authority to be headed by the Prime Minister, which shall recommend to the National Assembly after consultation with the private sector, local, government units, and other appropriate public agencies, continuing, coordinated, and fully integrated social and economic plans and programs.

Section 8. All lands of the public domain, waters, minerals, coal, petroleum and other mineral oils, all forces of potential energy, fisheries, wildlife and other natural resources of the Philippines belong to the State. With the exception of agricultural, industrial or commercial, residential and resettlement lands of the public domain, natural resources shall not be alienated, and no license, concession, or leases for the exploration, development, exploitation, or utilization of any of the natural resources shall be granted for a period exceeding twenty-five years, renewable for not more than twenty-five years, except as to water rights for irrigation, water supply, fisheries, or industrial uses other than the development of water power, in which cases, beneficial use may be the measure and the limit of the grant.

Section 9. The disposition, exploration, development, exploitation or utilization of any of the natural resources of the Philippines shall be limited to citizens of the Philippines, or to corporations or associations at least sixty percentum of the capital of which owned by such citizens. The National Assembly, in the national interest, may allow such citizens, corporations or associations to enter into service contracts for financial, technical, management, or other forms of assistance with any foreign person or entity for the exploration, development, exploitation, or utilization of any of the natural resources. Existing valid and binding service contracts for financial, technical, management or other forms of assistance are hereby recognized as such.

Section 11. The National Assembly, taking into account conservation, ecological and development requirements of the natural resources, shall determine by law the size of lands of the public domain which may be developed, held or acquired, or leased to any qualified individual, corporation, or association, and the conditions therefor.

ARTICLE XV — *GENERAL PROVISIONS*

Section 9. (1) The State shall promote scientific research and invention. The advancement of science and technology shall have priority in the national development.

ARTICLE XVII — *TRANSITORY PROVISIONS*

Section 12. All treaties, executive agreements, and contracts entered into by the Government, or any subdivision, agency, or instrumentality thereof, including government-owned or controlled corporations, are hereby recognized as legal, valid, and binding. When the National interest so requires, the incumbent President of the Philippines or the interim Prime Minister may review all contracts, concessions, perfits, or other forms of privileges for the exploration, development, exploitation, or utilization of natural resources entered into, granted, issued, or acquired before the ratification of this Constitution.

II

ENERGY MANAGEMENT SYSTEMS

This paper is an analysis of the service contract concept in Philippine energy exploration and development. The paper likewise discusses the concession system in which Philippine petroleum development agreements were structured before the introduction of service contract by Presidential Decree No. 87. Before discussing the concession and service contract systems, it is worthwhile to note that many countries' energy management system will cover more than one category, and it is possible to identify four (4) principal types of energy systems. They are as follows:

1. The concession (frequently styled "permit", "license" or "lease");
2. The production-sharing contract or service contract;
3. The joint venture; and
4. The full state "participation" or ownership.

These systems likewise apply for the other energy sources like coal, geothermal energy and nuclear fuel resources.

For purposes of this paper, we shall examine the positive and negative aspects of the concession and service contract systems, competitive versus noncompetitive allocation of the resources and the advantages and disadvantages thereof. For the concession system, the law is Republic Act No. 387, otherwise known as the Petroleum Act of 1949 and the agreement is the Model Petroleum Exploration Concession issued by the Bureau of Mines (now Bureau of Mines and Geosciences). For the service contract system, the law is Presidential Decree No. 87, otherwise known as the Oil Exploration and Development Act of 1972 and the agreement is the Model Service Contract issued by the Bureau of Energy Development of the Ministry of Energy.

To understand the variations among the concession and the service contract systems, it is useful to place them in a historical context. A modern history might begin with the entry of the international oil companies into the Middle East in the 1920's. At that time, the oil companies operated pursuant to concessions, which were granted by the sovereign, and which imposed contractual obligations upon both parties. Typically, the oil company was given the right to explore for, develop, produce, treat and export petroleum at prices and rates of production determined by it. In return, the host government was compensated by means of royalties and in some cases, by rents and bonuses or the payment of an income tax. The duration of the concession generally ran for 50 years or more.

¹¹ Krueger, World Petroleum Policies Report, Energy Law Service, Monograph 13C, section 13C.01 (1981).

¹² See note 11 at section 13C.03, *supra*.

Under the concession system, the host country conceded part of its territory in exchange for the windfall resulting from petroleum production.¹³ The dominance of the oil companies persisted through 1930 to 1940. By the 1940's, there was now a continuing demand by host governments for higher revenues and direct participation. Through its Law No. 44 of 1960, Indonesia, although not among the founders of the Organization of Petroleum Exporting Countries (OPEC), proclaimed that the foreign oil companies would henceforth be contractors instead of concessionaires. In 1966, Indonesia established the concept of the production-sharing contract or service contract, a type of joint venture in which the contracting company furnishes not only exploration and development but production operations as well with, however, a right of recoupment of costs from a stated percentage of production. The remaining amount of production is thereafter shared between the oil company and either the State or a national oil company.¹⁶

III

THE CONCESSION SYSTEM

1. *Elements of the System.* A concession, termed a lease or license in some countries, typically provides a private company with the right to explore for, produce, transport, and sell hydrocarbons produced within the concession area for a fixed period of time. Typically, it will terminate if hydrocarbons are not found in commercial quantities within a period of time, usually under ten years.¹⁷
2. *Characteristics.* A concession will usually impose drilling obligations on the oil company. Specifically, the company may be required to commence exploratory work e.g. reconnaissance geology, geophysical or seismic testing within a stated period of time, commence a test well or wells within somewhat longer period, often on an annual basis, and spend at least a stated minimum on exploratory operations. In addition, the company may be required to relinquish a certain percentage of the concession area from year to year.¹⁸
3. *Fiscal Elements.* Concession frequently includes the payment of bonuses. Bonuses may be owned upon the concession becoming effective (a "signature bonus"), upon the oil company making a commercial discovery (a "discovery bonus") and upon production reaching certain stipulated

¹³ FABRIKANT, OIL DISCOVERY AND TECHNICAL CHANGE IN SOUTHEAST ASIA, LEGAL ASPECTS OF PRODUCTION SHARING CONTRACTS IN THE INDONESIAN PETROLEUM INDUSTRY, 101-102 (1972).

¹⁴ See note 11 at section 13C.06, *supra*.

¹⁵ *Id.*, at section 13C.12.

¹⁶ *Id.*, at section 13C.13.

¹⁷ *Id.*, at section 13C.14.

¹⁸ *Id.*, at section 13C.18.

levels (production bonuses). Other fiscal elements include the payment of rentals; taxes and royalties.¹⁹

4. *Advantages of Concession.* Whether it emphasizes income tax or royalty, the most positive aspect of the concession system is that the State's financial involvement is virtually risk free and administration is simple and comparatively low in cost. Furthermore, if there is a competitive allocation of the resource leading to substantial bonuses and/or greater royalty coupled with a relatively high level of taxation, revenue accruing to the State under the concession system may compare favorably with other financial arrangements.²⁰
5. *Disadvantages of Concession.* There are, however, major negative aspects to this system. Because the Government's role in the traditional concession is passive, it is at a distinct disadvantage in managing and developing policy for the nation's petroleum resource. This is true for several reasons. First, even though most concession agreements contain covenants requiring diligence in operations and production, this establishes only an indirect and passive control of the host country in resource development. Second, and more importantly, the fact that the host country does not directly participate in resource management decisions inhibits its ability to train and employ its nationals in petroleum development. This factor could delay or prevent the country from effectively engaging in the direct development of its resources. Lastly, a direct role in management is usually necessary in order to obtain a knowledge of the international petroleum industry which is important to an appreciation of the host country's resources in relation to those of other countries.²¹

IV

THE SERVICE CONTRACT SYSTEM

1. *Elements of the System.* Under this system, the private company bears production as well as exploration and development expenses and it is entitled to recoup its costs only out of a stipulated percentage of production set aside from that purpose or out of its fixed production share, depending upon the agreement.²²
2. *Characteristics.* The majority of agreements allow the contractor to recover its costs out of a stipulated percentage of production and then allocate remaining production between the State or a national oil company and the contractor. The company's production costs are typically recoverable in the year in which they are incurred while pre-discovery

¹⁹ *Id.*, at section 13C.19.

²⁰ *Id.*, at section 13C.24.

²¹ *Id.*, at section 13C.25.

²² *Id.*, at section 13C.26.

costs are amortized over a fixed number of years. Allocation of "profit oil" (production remaining after accounting for recoverable costs and, if applicable, royalties), frequently changes as different production levels are reached.²³

3. *Advantages and Disadvantages.* This system typically frees the host state from any financial burden in connection with operations. It allows the State participation in the control of petroleum operations and ensure that the State will be allocated as agreed upon a minimum share of production, irrespective of the exploratory and development costs of the oil company.²⁴

V

THE EVOLUTIONARY PROCESS FROM CONCESSION TO SERVICE CONTRACT SYSTEM

Historically, the concession contract was a post-colonial device which enabled Western companies to retain control of raw materials in less developed countries, since developing countries did not possess the necessary financial, technical and managerial capability to engage in such field as petroleum exploration involving high-risk ventures requiring large amounts of capital and sophisticated technological skills to attract foreign enterprises. However, the increasing nationalistic impulses and national patrimony of the host country have influenced its policies to shift from the concession scheme to the service contract arrangement for more economic benefits or profits to its people.

In this country, Presidential Decree No. 782 dated August 25, 1975 required all holders of valid and subsisting petroleum exploration concessions or published petroleum exploration concession applications under the Petroleum Act of 1949, as amended, to convert their concession or concession application to a service contract under the terms and provisions of Presidential Decree No. 87, either alone or with any local or foreign oil company of companies within a period of one (1) year from the effective date of this Decree. Any concession or concession application not so converted for any cause within the said one (1) year period shall be deemed automatically cancelled and the area covered thereby shall become part of the National Reserve Area.

As declared under said Presidential Decree which phased out the concession system, the service contract was made mandatory in the Philippines and was expected to yield maximum benefits to the Filipino people and revenues to the government as well as assure fair returns to the

²³ Pres. Decree No. 782, sec. 2 (1975), 27 Vital Docs. 66, 68.

²⁴ See note 13 at 104, *supra*.

participating enterprises, particularly those that would provide the necessary services, financing and technology and fully assume exploration risks.

All holders of valid and subsisting petroleum exploration concessions or published petroleum exploration concession applications under the Petroleum Act of amended, were required to convert their concessions or concession applications to service contracts under terms and provisions of Presidential Decree No. 87 within a period of one (1) year from the effective date of the Decree which was August 25, 1975.²⁵ Pursuant to Presidential Decree No. 987 issued on August 25, 1976, the deadline to convert concessions to service contracts was extended from August 25, 1976 to December 31, 1976.

VI

THE CONCESSION SYSTEM UNDER REPUBLIC ACT NO. 387 OR THE PETROLEUM ACT OF 1949

The concession system in the Philippines is embodied in R.A. 387, as amended by Republic Act Nos. 3098 and 4889, otherwise known as the Petroleum Act of 1949.

It is expressly provided under Article 3 of R. A. 387 that all natural deposits or occurrences of petroleum or natural gas in public and/or private lands in the Philippines, whether found in, on, or under the surface of dry lands, creeks, rivers, lakes or other submerged lands within the territorial waters or on the continental shelf, or its analogue in an archipelago, seaward from the shores of the Philippines which are not within the territories of other countries, belong to the State, inalienably and imprescriptively. This is a reiteration of the Constitutional mandate that all minerals, petroleum and other mineral oils and other natural resources of the Philippines belong to the State.²⁶

The right to explore for, develop, exploit or utilize the petroleum resources was only granted to duly qualified persons by means of concessions,²⁷ the terms of which ran for four to ten years, depending upon compliance to certain requirements. An individual, partnership or corporation was deemed qualified for concession as soon as satisfactory evidence of financial and technical competence was presented; and as long as the applicant conforms to the Filipino citizenship requirement (in the case of an individual) or to the 60% Filipino capital requirement (in the case of a partnership or a corporation). An approved concession consists of anywhere from up to half a million hectares of exploration areas in any one petroleum region or a maximum of one million hectares throughout the country.

²⁵ Const. (1935), art. XIII, sec. 1; Const., art. XIV, sec. 8.

²⁶ Rep. Act No. 387, art. 8 (1949), 4 Laws & Res. 480, 483.

²⁷ Rep. Act No. 387, art. 6 (1949), 4 Laws & Res. 482.

A concessionaire paid to the government a minimum royalty of 12½% of production, less the amount consumed in the operations. In the production stage, the concessionaire was required to pay an annual exploitation tax at a graduated scale on a per-hectare per year basis.

Notwithstanding the good intentions of the Petroleum Act of 1949, the concession system could not have properly spurred sustained oil exploration activities in the country, since it assumed that such a capital-intensive, high risk venture could be successfully undertaken by a single individual or a small company. In effect, concessionaires' funds were easily exhausted. Moreover, since the concession system practically closed its doors to interested foreign investors, local capital was stretched to the limits. The old system also failed to consider the highly sophisticated technology and expertise required, which would be available only to multinational companies.

Hereunder are the more salient characteristics of the concession system more particularly under Rep. Act No. 387, and the Deed of Petroleum Exploration Concession categorized under the following features of subject matter viz:

1. Control by the Government;
2. Work and Financial Commitments;
3. Royalty and Taxes;
4. Incentives;
5. Submission of Required Reports, Inspection of Operations and Examination of Book Accounts.

1. *Control by the Government.* The granting of concession under the Act is discretionary with the Government²⁹ and the concessionaire hereby recognizes the authority of the Secretary and/or the Director of Mines personally, or through their duly authorized agents or representatives, to inspect any operation by the concessionaire at all reasonable times to carry out any other inspection authorized by law.³⁰ Please note the passive role of the Government in the petroleum operation. Although the granting of the concession is at the discretion of the Government, once it is issued, the concession holder is in full control over that portion of the Philippine Territory as to the performance of its petroleum operation. The Government is limited to inspection of operation.

2. *Work and Financial Obligations.* Concessions are granted at the complete risk of the interested party. The Government does not guarantee the existence of petroleum or undertake, any case, title warranty.³¹ Upon

²⁹ Rep. Act No. 387, art. 8 (1949), 4 Laws & Res. 483.

³⁰ See note 28 at par. 6, *supra*.

³¹ Rep. Act No. 387, art. 65 (1949), 4 Laws & Res. 505.

the granting of the Deed of Concession and at the beginning of each calendar year during the life of the concession, the concessionaire was required to submit to the Government a program of exploration work which the Concessionaire expects to undertake within his concession during this year. He was obliged to spend in the direct prosecution of exploration work within his concession, such as topographic or geological surveys, mapping or cross sectioning, geophysical surveys or other means of investigation, core or exploratory drilling the sum of ₱2.00 and ₱4.00 per hectare for onshore and offshore areas, respectively. For failure to comply with the minimum work obligations in any one year, the concessionaire would pay to the Government the difference between the minimum amount required and that actually spent for any year.

The Concessionaire commits itself to a program of test drilling such that failure to drill an exploration well on its concession within a sedimentary basin within one (1) year after the granting of the concession shall subject the concession to cancellation of one-half ($\frac{1}{2}$) of the exploration area and further failure to drill on the same basin within the next year shall result in the automatic cancellation of the entire exploration area in said basin.³²

3. *Royalty and Taxes.* Countries which utilize the concession form of petroleum agreement employ either or both royalty and taxes as revenue mechanisms. Royalty provisions are easy to administer. If the royalty is based on units of production, the Government needs only to monitor production. The royalty is linked to the volume of production irrespective of the developer's profits.

Under Rep. Act No. 387, concession holders were required to pay to the Government a royalty which shall not be less than twelve and one-half percent ($12\frac{1}{2}\%$) of the petroleum produced and saved, less that consumed in the operations of the concessionaire. Ten percent (10%) of the royalty paid to the Government would be deducted and paid to the discoverer of the deposit.³³

Each holder of a Concession would pay throughout the life of the concession, an exploitation tax on an amount per hectare per year or fraction thereof.³⁴ All exploitation taxes to which a concession holder shall be liable under Article 64, shall be credited against the total royalty payments on all the petroleum produced by the concessionaire, provided, that such deduction would apply only to amounts due for exploitation tax in excess of fifty centavos per hectare per year.

Concessionaires were not subject to any provincial, municipal or other local taxes or levies nor would any sales tax be charged or any

³² Rep. Act No. 387, art. 64 (1949, 4 Laws & Res. 505.

³³ Rep. Act No. 387, art. 102 (1949), 4 Laws & Res. 522-23.

³⁴ Rep. Act No. 387, art. 103 (1949), 4 Laws & Res. 523.

petroleum produced from the concession or portion thereof. All such concessionaires, however, were subject to such taxes as are of general application, in addition to taxes and other levies provided in Rep. Act No. 387.³⁵

4. *Incentives.* Under Article 103 of Rep. Act No. 387, the concessionaire could, during the first years following the granting of any concession, import free of customs duty, all equipment, machinery, materials, instruments, supplies and accessories.³⁶

No export tax would be levied upon petroleum produced from exploitation concessions as well as on equipment, machinery, materials, instruments, supplies and accessories imported and used exclusively in the furtherance of the operations of the concessionaire under the Act if exported any time after such bona fide use thereof.³⁷

5. *Submission of Required Reports, Inspection of Operations and Examination of Books and Accounts.* The concessionaire was required to furnish to the Government all technical and accounting data. For this purpose, each concessionaire was required to retain within the country all original records or original carbon copies thereof which are essential for the purpose of determining the amount of taxes and royalties due to the Government.

The Government, through its duly authorized representatives, could inspect any operations of the concessionaire at all reasonable times and examine all the books and accounts pertaining to operations or conditions related to payment of taxes and royalties, and to carry out any other inspections authorized by law.³⁸

THE SERVICE CONTRACT CONCEPT UNDER PRESIDENTIAL DECREE NO. 87 OR THE OIL EXPLORATION AND DEVELOPMENT ACT OF 1972

The Service Contract Alternative

Any discussion on contracts for energy-related activities in the Philippines, specifically energy resources exploration and development, gravitates around the *service contract concept*. The service contract was first established for oil exploration operations in 1972 pursuant to Presidential Decree No. 87 and in later years was adopted for coal and geothermal resources development as well, pursuant to Presidential Decree Nos. 972 and 1442, respectively.

³⁵ Rep. Act. No. 387, art. 104 (1949), 4 Laws & Res. 523.

³⁶ Rep. Act No. 387, art. 106 (1949), 4 Laws & Res. 523-24.

³⁷ Pres. Decree No. 87, sec. 6 (1972), 3 Vital Docs. 84.

³⁸ Pres. Decree No. 87, sec. 7 (1972), 3 Vital Docs. 84.

The service contract concept is a production-sharing formula which balances benefits to the host-government on the one hand, and reasonable remuneration to the operator-enterprise on the other. The concept borrows the basic features of the South American and Indonesian production-sharing schemes but also factors in wholly Philippine criteria, such as conformity to the requirement that, all resources being owned by the State, Filipinos shall be the principal beneficiaries in their exploitation and usage.

The Service Contract System offers a more liberalized atmosphere conducive to oil search. The system reaffirmed the sovereignty of the State over its resources while assuring just returns to those who could offer financing and technology. Thus, section 2 of Presidential Decree No. 87 provides that it is the policy of the State to hasten the discovery and production of indigenous petroleum through the utilization of Government and/or local and foreign private resources, under arrangements embodied in the Act, which are calculated to yield the maximum benefit to the Filipino people and the revenues to the Philippine Government for use in furtherance of national economic development and to assure just returns to participating private enterprises, particularly those that will provide the necessary services, financing and technology and fully assume all explorations risks.

Under the new system, joint-venture agreements were encouraged between foreign and local exploration companies. For a time, the Filipino Participating Incentive Allowance (FPIA) was an integral part of the negotiated service contract, which allowance was granted by the Government to encourage petroleum concessionaires under the old system to participate and convert their concession areas into service contracts.

Private industry, both foreign and local, responded well to the service contract system. From 1972 up to the present, a total of 34 service contracts have been awarded, of which 12 are currently active. In between, 37 geophysical survey contracts were granted, of which 13 are in force. All in all, the private companies have sunk some US-\$500 million in oil exploration and development activities, and another US\$1,000 million is programmed to be spent over the next seven years.

Nature of the Service Contract

A service contract is a form of arrangement, embodied in Presidential Decree No. 87 designed to hasten the discovery and production of indigenous petroleum. It is a formal agreement between the private enterprise and the Philippine Government represented by the Ministry of Energy through the Bureau of Energy Development for the privilege to engage and participate in the petroleum exploration, development and production activities.

In a service contract, service and technology are furnished by the service contractor for which it shall be entitled to the stipulated services

fee while financing is provided by the Government to which all petroleum produced shall belong.³⁹

However, where the Government is unable to finance petroleum exploration operations and if contractor shall furnish services, technology as well as financing, the proceeds of sale of the petroleum produced under the contract shall be the source of funds for payment of the service fee and the operating expenses due the contractor.⁴⁰

Who May Apply for Service Contracts?

Any private enterprise determined by the Bureau of Energy Development to be technically and financially qualified under prescribed guidelines to undertake the operations required in the contract may apply and be a service contractor.

Prequalifying Guidelines

A service contract applicant must exhibit the capability to furnish the necessary technological expertise and financial competence to undertake such high-risk, capital intensive venture as oil exploration.

The implementing guidelines drawn up by the former Petroleum Board and adopted by the Bureau of Energy Development had as one of its premises the negotiations policy requiring firm drilling commitments during the contract term. On this basis, a hypothetical annual exploration investment pattern under the service contract was set up, out of which the annual capital requirement was determined. The Petroleum Board then consulted with the petroleum industry to determine what a realistic capitalization figure should be, and what actual working capital was necessary to fund the initial two years of exploration. Under Circular No. 2, Series of 1976 of the Bureau of Energy Development, a company to be financially qualified to convert into a service contract must have a minimum working capital of ₱15 million and a debt to equity ratio of 70/30. In case of a consortium, the ₱15 million working capital will be required of the operator and a minimum of ₱6 million for each member of the consortium. Working capital in the concept of the guidelines refers to the company's net liquid assets consisting primarily of cash, temporary investment (marketable securities), short term receivables and deposits.

Aside from the capability to raise the needed capital, an applicant-company is required to maintain a permanent staff of technical personnel to ensure that a valid and continuing exploration program is undertaken. At least two (2) full-time geologists shall be in the employ of a company applying for a service contract. It must, however, have complete coverage of services and technical expertise required during actual operation.

³⁹ Pres. Decree No. 87, sec. 5 (1972), 3 Vital Docs. 83-84.

⁴⁰ See note 11 at sec. 13C.30, *supra*.

In order for local companies to be able to conform to the prequalifying guidelines, especially with respect to upgrading financial competence, the consortium approach was encouraged, in which each member should have at least 15% interest in the contract, whether participating or carried.

The Negotiation Option

In opening contract areas and/or selecting the best program for petroleum operations, the Government implementing agency (The Bureau of Energy Development under the Ministry of Energy) is authorized to award a service contract through either of two (2) alternative procedures: (a) Bidding off a selected area, either specifying the minimum terms and conditions or by selecting through a weighted system the best exploration program; or (b) leaving the choice of the area to the interested party and then negotiating the terms and conditions of the contract.⁴¹ The latter procedure has been followed by the Bureau of Energy Development and its forerunner government organizations.

Minimum Terms and Conditions of the Service Contract

A service contract shall contain the following minimum terms and conditions:

1. Work Obligation

Every contractor shall be obliged to drill three (3) wells during the initial two year exploration period and to spend in direct prosecution of exploration work and in delineation and development following the discovery of oil in commercial quantity, an amount equivalent to at least the cost of drilling a well. Under present cost parameters, one onshore well will cost around US \$3 to 4 million and one offshore well will cost around US \$6 million.

2. Exploration Period

Under every contract, the exploration period shall be seven (7) years, extendible for three (3) years if contractor has not defaulted in any of his obligations.

The first 2-years of the contract are firmed contract years and the service contract has to drill the three (3) wells in two (2) years. From the 3rd to the 7th year, the contract term is converted into a year to year contract wherein each contract year shall carry at least a minimum of one well to be drilled. If the service contractor continues with the term of the contract, the number of wells to be drilled need to be fulfilled.

The contract is deemed lapsed by the end of the tenth year, unless petroleum has been discovered and contractor requests for a further extension of one (1) year for exploration will be granted.

⁴¹ *Id.*, at section 13C.31.

3. *Minimum Footage*

Every service contract stipulates the total minimum footage of test wells for the 7-year period. Strict observance of this minimum is additional requirement for the grant of 3-year extension of exploration period.

4. *Relinquishment*

a) Compulsory relinquishment of at least 25% of the initial area at the end of five years from its effective date and in the event of an extension of the contract from seven to ten years, an additional relinquishment of at least 25% of the initial area at the end of seven years from its effective date shall be provided in every contract.

b. Renouncement or abandonment of contract within two years from effective date of contract shall require the contractor to pay the Government the amount it should have spent, but did not spend for exploration work during said two years, for which payment, among other obligations, the performance guarantee posted by the contractor shall be answerable.

5. *Production Period*

Where petroleum in commercial quantity is discovered during the exploration period, the contract, with respect to said area, shall remain in force for production purposes during the balance of the ten (10) year exploration period and for an additional period of 25 years thereafter, renewable for another 15 years.

Obligations of the Contractor in a Service Contract

Contractor shall undertake, manage and execute petroleum operations. The Government, however, shall oversee the management of the operations contemplated in the contract and shall require contractor to:

1. Provide all necessary services and technology;
2. Provide requisite financing;
3. Perform exploration work obligations and program as provided in the contract. The work programs are approved by the Government;
4. Once petroleum in commercial quantity is discovered, operate the field on behalf of the Government in accordance with accepted good oil field practices;
5. Furnish the BED with geological and other information, data and reports which the Bureau will require;
6. Maintain technical records and accounts of its operations;
7. Maintain safety, demarcation of agreement acreage and work areas and non-interference with the rights of other petroleum, mineral and natural resources operations;

8. Assume of exploration risks such that if no petroleum is produced, it will not be entitled to reimbursement;
9. Be subject to Philippine income tax.

Obligations of the Government in the Service Contract

1. Reimburse the contractor for all operating expenses not exceeding 70% of the gross proceeds from production in any year. Any expense incurred in excess of 70% shall be recovered in the operations of succeeding years;
2. Pay the contractor a service fee the net amount of which shall not exceed 40% of the balance of the gross income after deducting the Filipino Participation Incentive Allowance (FPIA) if any and all operating expenses are recovered.

Incentives for the Contractor

Incentives were adopted to stimulate the interest of competent foreign and local explorationists, such as:

1. Exemption from all taxes except income tax;
2. Exemption from payment of tariff duties and compensating taxes on machinery and equipment imported for use in the petroleum exploration and production operations;
3. Exemption, upon approval by the BED, from laws, regulations, and/or ordinances restricting the construction, installation or operation of a power plant and exportation of machinery and equipment imported for its petroleum operation when no longer needed;
4. Exemption from publication requirements under the Omnibus Investment Code;
5. Exportation of petroleum subject to satisfying the domestic demand for petroleum;
6. Bringing in of foreign technical and specialized personnel for petroleum exploration and production operations; and
7. Repatriation of capital and retention of profits abroad.

Other Contract Features

- (1) *Extensions.* Extensions of certain contract deadlines are allowed for technical reasons and for delays in the processing and interpretation of technical data. As a rule, however, drilling schedules under the service contracts are firm commitments and cannot be extended.
- (2) *Assignment of Interest.* Assignments under a service contract are allowed, to spread the risks involved, and are approved on the basis of: (a) the technical and financial capability of the assignee in connection with the amount of interest being assigned; and (b) the technical and financial improvement that the assignment will render to the contract.

Other Types of Contracts

There are two other types of arrangements open to an interested party for the conduct of petroleum activities in the Philippines. These are: (a) The *seismic permit*, under which the contractor is granted the right to conduct seismic activity for a period of six (6) months on a non-exclusive basis; that is, what preferential option for an exploration contract over the area; (b) the *geophysical survey contract*, under which the contractor is granted the exclusive right to conduct geological and geophysical investigations over the area, including the seismic shooting (without drilling), for a period of one year for onshore areas and two years for offshore areas. It also gives the contractor an option to a service contract, the terms of which may be pre-negotiated. The geophysical survey contract, a truly Filipino innovation, was developed by the Government to provide private exploration companies the necessary geological basis for firming up drilling commitments under the contract proper.

Applicability to Coal and Geothermal Energy

Recognizing the merits of the system, the Government decided that the system could be applied, with certain modifications, to coal and geothermal resources development as well.

In 1976, the Coal Development Act was promulgated under Presidential Decree No. 972, enjoining the national exploration and development of the country's coal resources through coal operating contracts with the Government. Although resisted by claimowners and coal leaseholders in the beginning, the service contract system for coal was eventually accepted by the industry and provided the necessary impetus for technologically and financially qualified coal developers to participate in the coal program. The service contract propelled coal development in the country to a stage where coal is now looked upon as a most prospective alternative fuel for the medium term. To date, a total of 53 coal contract holders are effectively pursuing coal exploration and development operations nationwide. In 1981, coal production was 220,720 metric tons, the highest production level ever recorded in the history of Philippine coal exploration. With more big mines expected to be developed during the next five years, coal production is targeted to reach as much as 3.74 million tons by 1986, an amount which will supply about 13 percent of the country's energy requirements by then. The service contract system has also been established for geothermal development by virtue of Presidential Decree No. 1442.

VIII

FINANCIAL RESULTS OF CONCESSION AND SERVICE
CONTRACT SYSTEMSA. *Hypothetical Proceeds and Costs*

In this part of this paper, we will examine on a hypothetical basis the income which the Philippine Government might derive from utilizing the concession system provided in the Petroleum Act of 1949 and the service contract system prescribed in Presidential Decree No. 87. The following assumptions will be made:

- a. ₱1,000 — exploration costs;
- b. ₱2,000 — development costs;
- c. 25 barrels at ₱240 per barrel (US \$30 x ₱8.00) selling price resulting in a ₱6,000 gross proceeds;
- d. ₱100 operating expenses;
- e. Contract area is 1,000 hectares.

B. *Concession System*1. *Royalty*

₱6,000 x 12½%	—	₱ 750
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2. *Income Tax*

Gross Income	—	₱6,000
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Less: Operating costs	₱100	
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Less: Exploration costs	1,000	
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Less: Development costs	2,000	
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	<u>₱3,100</u>	
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		<u>3,100</u>
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Net Profits		₱2,900
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Corporate Income Tax		x 35%
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Income Tax		₱1,015
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Less: Royalty (Tax Credit)		750
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		<u>₱ 265.00</u>
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3. *Exploitation Tax*

1,000 hectares x ₱0.50 — ₱ 500
 (exploitation taxes in excess
 of ₱0.50 is deductible from
 royalty).

4. Total Government Take ₱ 750 — royalty
 265 — income tax
 500 — exploitation tax

 ₱1,515

5. No oil is produced under the concession system and the liability for income tax by the concessionaire is assumed in Art. 102 of Republic Act No. 387 which subject a concessionaire to such taxes as are of general application.

6. Exploitation taxes are credited against royalty if in excess of fifty centavos per hectare per year under Art. 66 of Republic Act No. 387.

7. Royalties are creditable against income tax.

C. *Service Contract*

Hereunder is a diagram of the formula on the recovery of operating expenses and payment of service fee:

Gross Proceeds	100%
Less: FPIA	7.5
	<hr/>
	92.5%
Less: Reimbursement of Expenses	70.0%
	<hr/>
Net Profit	22.5%
	<hr/>
Service Fee for Contractor (40% x 22.5%)	9%
Share of Government (60% x 22.5%)	13.5%
	<hr/>
	22.5%
	<hr/>

1. Current service contracts no longer provide for the FPIA. The FPIA was granted to encourage holders of petroleum exploration concessions

(PEC) and petroleum exploration concession applications (PECA) to convert the same into service contracts. However, since the promulgation of Presidential Decree No. 782, as amended by Presidential Decree No. 987, cancelling the concession system, the rationale for the grant of the FPIA has ceased to exist. Therefore, the FPIA has not been part of recently awarded service contracts.

2. The maximum cost recovery allowed by the Act is 70% of the gross proceeds. However, current contracts now provide for a 65% to 60% cost recovery on gross proceeds.
3. For the contractor's service fee (share in the production), the law allows the maximum of 40% of the balance of the gross income after deducting the FPIA, if any, and all operating expenses, with the remaining 60% as share of the government. Recent contracts, however, only provide for a production-sharing splits of from 65%-25% to 70%-30% in favor of the government.
4. The share of the Government, which shall not be less than sixty percent of the difference between the gross income and the sum of operating expenses and FPIA, shall include all taxes including income tax paid by or on behalf of the contractor as provided for under special tax provisions, Section 19 to Section 25, of the Act.

Recently, however, the US-IRS issued a ruling to the effect that income taxes paid by service contractors under the Act are not available for foreign tax credit in the United States. Therefore, steps were taken to revise our present taxation scheme for petroleum service contractors to conform to the US-IRS ruling. In this connection, Presidential Decree No. 1682 is issued prescribing income taxation of petroleum service contractors.

Gross Proceeds	₱6,000	
Less: FPIA (7.5%)	450	
	<hr/>	
	₱5,550	
Less: Cost Recovery (70%)	₱3,100	
Net Profit	₱2,450	
Service Fee for Contractor (40% x ₱2,450)	₱ 980	— the income tax on ₱980 is paid from the Gov- ernment's share of ₱1,470.
Share of Government (60% of ₱2,450)	₱1,470	
Total Contractor's Take	₱ 450	— F.P.I.A.

	3,100 — Cost Recovery
	980 — Service Fee
	<hr/>
	₱4,530
Total Government Take	+ 1,470
	<hr/>
Gross Proceeds	6,000

X

CONCLUSION

It is readily apparent that there are similarities between the various systems and that desirable substantive elements can be incorporated in any of them with approximately the same degree of success. The controlling factors which ineluctably must be faced by the host country in developing a policy are largely economic. The State is faced with the need to develop an investment arrangement which will attract investment by private companies.⁴² The development of the initial exploration program must be attractive to the investor both geologically and economically.⁴³ Likewise, there must be an establishment of maintenance of an attractive investment climate including possibly the making of binding commitments with respect to foreign investment to guarantee their good standing and stability.⁴⁴ A third is the development of a natural resources policy which include a policy of independence from foreign imports, conservation, employment and training of nationals at all stages of the proposed petroleum operation.⁴⁵

In both the concession system and the service contract scheme, work and financial obligations are required of the developer. Under Republic Act No. 387 and Presidential Decree No. 87, the concessionaire and the service contractors are exacted certain taxes in favor of the government. In both arrangements, the explorationist/developer is given incentives in the form of tax exemptions in the importation or disposition of machinery, equipment, materials and spare parts needed in petroleum operations.

The concessionaire and the service contractor are required to keep in their files valuable data and information and may be required to submit needed technological or accounting reports to the Government. Duly authorized representatives of the Government could, under the law, inspect or audit the books of accounts of the contract holder.

⁴² *Ibid.*

⁴³ *Ibid.*

⁴⁴ *Ibid.*

⁴⁵ *Ibid.*

In both systems, signature, discovery or production bonuses may be given by the developer to the host Government.

The concession system, however, differs considerably from the service contract system in important areas of the operations. In the concession system, the Government merely receives fixed royalty which is a certain percentage of the crude oil produced or other units of measure, regardless of whether the concession holder makes profits or not. This is not so in the service contract system. A certain percentage of the gross production is set aside for recoverable expenditures by the contractor. Of the net proceeds the parties are entitled percentages of share that will accrue to each of them.

In the royalty system, the concessionaire may be discouraged to produce more for the reason that since the royalty paid to the host country is closely linked to the volume of production, the greater the produce, the more amount or royalty would be allocated to the Government. This is not so in the production sharing system. The share of the Government depends largely on the net proceeds of production after reimbursing the service contractor of its recoverable expenses.

As a general rule, the Government plays a passive role in the concession system, more particularly, interested in receiving royalties from the concessionaire. In the production-sharing arrangement, the Government plays a more active role in the management and monitoring of oil operations and requires the service contractor certain obligations designed to bring more economic and technological benefits to the host country.

The service contract worked successfully for petroleum exploration and development. Under the system, a total of 121 wells had been drilled since 1972, yielding a remarkable 15 oil and gas discoveries and paving the way for the era of oil production in the country. In addition to the Nido Oilfield, which started production in 1979 and the Cadlao Oilfield in 1981 located in Northeastern Palawan, another structure, the Matinloc Pandan, is expected to be put on stream this year.

The service contract, first an experimental concept, is now an effective institution in the development of energy resources in the Philippines, and is serving as a truly reliable vehicle by which the Government may be able to carry out the country's indigenous energy development program towards an energy-reliant future.