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Unique UK's Licensing Policy Favours the State than the Industry: Contradicting Conventional Wisdom

Introduction

The world petroleum industry is globally interdependent. International oil companies tend to compare investment opportunities worldwide and pursue global strategies: investment opportunities compete with each other and fashion tends to possess world's oil companies.¹ Under such circumstances the role of the state acting as the regulator is of paramount importance especially where the oil and gas industry is a countries key industry.² In the United Kingdom the government has proprietary rights to the petroleum reserves but they lack capacity to carry out technical tasks as drilling wells and laying pipelines.³ Consequently, the Governments is compelled to turn to private companies who hold most of the financial and technical means needed for the exploration and exploitation of petroleum resources.⁴ In the United Kingdom, this symbiotic relationship is given effect through the petroleum licensing mechanism.

This paper brings to light the various features of the UK licensing regime consequently bringing to light how this regime is favourable to the state than the industries, by laying emphasis on the proprietary rights to the petroleum revenue which vest in the UK through its governing legislations.

Legislation

The legislative framework for oil and gas exploration and production activities in the North Sea is as originally established by the Petroleum (Production) Act 1934 for onshore activities, subsequently extended to the UK continental shelf by the Continental Shelf Act 1964 and ultimately consolidated by Part I of the Petroleum Act 1998. The fundamental principle of this framework is that all proprietary rights in UK oil and gas vested in the Crown and that approved commercial enterprises are specifically licensed by (acting

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¹ Daintith, T.–Gault, I.: *Pacta Sunt Servanda and the Licensing and Taxation of North Sea Oil Production*. *Cambrian Law Review*, (1977), 242.

² Lucas, A. R.: *State Petroleum Corporations: the Legal Relationship with the State*. *Journal of Energy and Natural Resources Law*, 8 (1985).

³ *Ibid.*

⁴ Walde, T. W.: *International Energy Investment*. *Energy Law Journal*, 17 (1996), 12.

through the Secretary of State for Trade and Industry—in turn represented at the administrative level by the Department of Trade and Industry (DTI)) to undertake oil and gas exploration and production activities.⁵

Licence, blocks and fields

The UK government grants licences for designated blocks on the continental shelf, through the Secretary of the state by issuing invitations relating to particular blocks for which potential licences apply according to specified criteria, also known as the 'Round System'.⁶

The terms or phases of a licence tend to represent the stages of exploration, appraisal development and production. There are two broad categories of licence: Exploration and Production.⁷

Exploration licences⁸ are sought by companies who wish to explore large areas of the seabed for seismic survey opportunities. Licences are non-exclusive and valid for three years (extendable for a further three years) and enable access for surveying and shallow drilling over areas which are not currently covered by a Production licence. (Although, with permission, surveys can extend into these licensed areas.)

Production Licences⁹ are required by anyone who wishes to exploit UKCS oil and gas resources and are categorised into: Traditional, Promote and Frontier licences. Production licences span the entire process from exploration to decommissioning. These licences give exclusive rights to the licensee. Licensees must supply regular updates to BERR and separate consents are required for significant activity and developments.

The North Sea licensing regime distinguishes between: exploration activities (surveys and drilling); and production activities (appraisal, development and production), which may be undertaken in: landward areas (i.e. onshore, inland waters and marine areas down to the low water mark); and seaward areas (i.e. the remainder of the territorial sea).¹⁰

“A seaward petroleum exploration licence gives the licensee a non-exclusive authority to explore for oil and gas bearing areas by way of geological surveys and limited drilling rights in any seaward area not the subject of a seaward petroleum production licence. A seaward petroleum production licence gives the licensee the exclusive authority to ‘search and bore for, and get,’ oil and gas in the seabed and subsoil within the block or blocks covered by the licence. The provisions of a production licence require the licensee to ‘surrender’ part of the licensed area after an initial period and so over time many blocks have been divided and the surrendered areas may be re-licensed by the Crown as part blocks.”¹¹

⁵ Park, P. D.: *Energy law and Environment* (published by CRC Press 2002), 124.

⁶ *Ibid.* 134.

⁷ Vinter, G. D.: *Project Finance: a Legal Guide*. London, 2006, 110.

⁸ Oil and Gas UK – Industry Issues – Licensing, Exploration and Appraisal, <http://www.oilandgasuk.co.uk/>, accessed on Nov 25, 2012.

⁹ *Ibid.*

¹⁰ Investment Opportunities in the UK North Sea, http://www.jonesday.com/files/Publication/254f023ac95bb73256fd769/Presentation/PublicationAttachment/3ff1356a-7ccf-40e8-ad4e04d7e53c2ca2/A4_NorthSea.pdf, accessed on 25 nov.2012

¹¹ *Ibid.*

“A field is defined for the purposes of a licence as strata forming part of a single geological petroleum structure or petroleum field. Thus, the provision for unitization is applied. The licensee holds the legal interest conveyed by its licence over the whole of the licence area. The licence makes no provision for a licensee to hold legal title over part of the licence area. In order to effect a transfer of interests in a block or field forming only part of the licence area the transferor will as a rule agree to transfer its legal title under the licence to the transferee, with the parties entering into a trust deed for the transferee to hold that legal title on trust for the transferor in respect of any section of the licence area not forming part of the block or field being transferred.”¹²

Thus, it can be construed that under such qualified licence mechanism the industries have a limited say or right of maximizing their own profit.

The licence regime

The U.K. issues seaward petroleum production licenses to “search and bore for and get petroleum” in the North Sea. Those licenses have a mixed character: they are in the form of a commercial contract, yet incorporate mandatory, model clauses required by law.¹³ They provide administrative and contractual rights, and are best construed as conferring an exclusive license to search for petroleum, together with a grant of all the petroleum extracted under the license.¹⁴

Also, the U.K. issues a single production license for a North Sea block. That license sets out the rights and obligations between the joint licensees and the U.K., such as, royalty payments, approval of the operator, and periodic reports. It does not address the position of the joint licensees relative to each other.¹⁵ That matter, together with the rules regulating the operation of the joint venture, are set out in a joint operating agreement (JOA) that is generally negotiated after the production license has been awarded to the joint licensees.

Under the license, U.K. controls all development and production activities.¹⁶ A licensee must submit its production program for U.K. approval prior to carrying out any development or production of petroleum. Further, under the licence regime U.K. may also control petroleum production at any time after the initial approval of the production program.¹⁷ Breach of the approval provisions is generally grounds for revocation of the license.

¹² Supra n. 10.

¹³ Black, A. J.-Dundas, H. R.: Joint Operating Agreements: An International Comparison from petroleum Law. *Journal of Natural Resources and Environmental law*, 8 (1992), 64.

¹⁴ *Ibid.*

¹⁵ Supra n. 2.

¹⁶ Breckhus: *Petroleum Production Licences on the Norwegian Part of the Continental Shelf*. 2nd ed., 1975, 126.

¹⁷ Dam, K. W.: Evolution of North Sea Licensing Policy in Britain and Norway. *Journal of Law and Economics*, 17 (1974), 97.

The current U.K. practice requires that development and production proceed under a three stage approval process.¹⁸ The first stage grants approval for the exploration phase. The second stage grants approval for the major production period. The third stage grants approval for the remainder of production.

Regulatory features of the licence

The character of production licences changed when the 1934 Act vested in the Crown, proprietary rights in petroleum.¹⁹ The new licensing regime was no longer based on the need to prohibit unlicensed exploration and exploitation of petroleum resources, but on the transfer of the proprietary rights of the Crown.²⁰ The subject of the licence is mainly the transfer of valuable rights in return for financial remuneration.²¹ The licence evidently contains many provisions that bestow great powers of control on one party—the minister, over the other—the private company.²²

The licence is granted by the Secretary of State under powers conferred directly by section 3 of the 1998 Petroleum Act (as amended). The same Act in section 4 provides that the Petroleum (Production) Regulations contain model clauses, which are not binding regulations, but derive their legal force in relation to the licence, from being incorporated into it.²³ Arguably, it is the model clauses and not the licence itself that are regulatory in character. And the model clauses are applied to all licences.²⁴ As to the form of the licence, the standard clauses, which are to be incorporated into the licence, are strikingly similar to the way statutory powers are framed.²⁵ In substance, modern licences (as opposed to those granted pre-1934) are agreements, which provide for substantial state participation in, and control over, the petroleum venture.²⁶ The extensive powers of the minister provided in the model clauses, and the fact that they are laid down by regulations at the insistence of Parliament, clearly taints the licence with a regulatory flavour.²⁷ The licence confers on the licensee, the right to take any hydrocarbons found, and not much else in the nature of rights. The obligations it imposes on the other hand are draconian, regulating such matters as working methods, pollution and training.²⁸ The popular consensus of writers on this topic is

¹⁸ Moss, G. C.: Contract of Licence? Regulation of Petroleum Investment in Russia and the Role of Foreign Legal Advice. Vol. 3-11 Article. On Line Journal *CEPMLP* (last visited on Nov 23, 2012).

¹⁹ Cameron, P.: *Petroleum Licensing, a Comparative Study*. London, 1984, 310.

²⁰ Daintith, T.—Willoughby, G.—Hill, A. (eds): *Daintith and Willoughby's United Kingdom Oil and Gas Law*. London, 2000, 1045.

²¹ Daintith, T.: The Petroleum Production Licence in the United Kingdom. In: Daintith, T. (ed.): *The Legal Character of Petroleum Licences: A Comparative Study*. London, 1981, 216.

²² *Supra* n. 20.

²³ See T. Daintith, *supra* note 15, at 1064.

²⁴ Except in exceptional circumstances. Petroleum Act 1998, s. 4(1)(e).

²⁵ Daintith, T.: Regulation by Contract: The New Prerogative. In: of Hampstead, Lord L.—Rideout, R. W. (eds): *Current Legal Problems*. London, 1979, 32.

²⁶ Cameron: *op. cit.*

²⁷ Daintith, T.: The Petroleum Production Licence in the United Kingdom. *op. cit.* 217.

²⁸ Armstrong, J.: *UK Petroleum Licensing—An Introduction* (unpublished). Paper presented at the University of Dundee CEPMLP Summer Course 1994.

that the petroleum production licence is a contract between the minister and the licensee that has to it a regulatory flavour.

Further the power of parliament to make unilateral alterations is important, it has been opined that “(t)he principle of government freedom of action means nothing more than that the government has the inherent power to override its contractual obligations by unilateral action in so far as public interest demands so”.²⁹ Therefore, the argument that such actions undermine the protection to the licensee does not hold firm ground. The ability of the government to effect subsequent changes on existing licences must be appreciated in the light of the effect it may have on future investments.³⁰

Conclusion

State petroleum enterprises obtain and maintain commanding positions indicating the symbolic, political and economic importance attached to the state enterprise as vehicle for national ownership, control and management of the petroleum industry. In producing countries, they often became the richest, best-paying instrumentality of the state; control over them is hence much in demand. Nevertheless, greatly influenced by the market-oriented policies of the Thatcher government in the United Kingdom, there has been a movement towards both privatisation of state energy companies (BP, British Gas, later and more gradually Elf, REPSOL and Petro-Canada), introduction of a liberalised legal regime and replacement of government ownership by a state regulator monitoring public service obligations.³¹ Therefore, it's pertinent to note that the licensing policy is designed not to extract the maximum amount of rent from oil companies. Quick exploitation is the main driving force behind opting for a discretionary system of allocation. This also aims to ensure that the applicant for a license would be incorporated in the UK and the profits of the operation would be taxable here, and enable the choice of the applicant with the work programme most suitable with respect to British interests. The policy is therefore concerned to enhance government control within a context of fast development.

On the basis of the above mentioned it is submitted that the UK's licensing approach contradicts the conventional wisdom that such systems concede more to the industry at the expense of the state.

²⁹ Jok, J.: *The Concession and the Licence as Oil Production Titles* (unpublished Dip. Pet. Law dissertation submitted to CEPMLP, University of Dundee, (1982), 69.

³⁰ General Assembly Resolution No. 1803 XV11 of December 14, 1962, which states that “Nationalization, expropriation or requisitioning shall be based on grounds or reason of public utility, security or the national interest which are recognised as overriding purely individual or private interests, both domestic and foreign.... the state taking such measures in the exercise of its sovereignty and in accordance with international law.”

³¹ Walde, T. W.: *The Current Status Of International Petroleum Investment: Regulating, Licensing, Taxing and Contracting*. CEPMLP www.dundee.ac.uk/cepmlp/journal/html/Vol1/article1-5.html - 153k/ accessed on 25 Nov, 2012.