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# TRANSPARENCY IN PETROLEUM CONTRACTS

## A Comparative Study of Ecuador and Bolivia: What are the Strengths, the Weaknesses, the Opportunities and the Threats?

### I. Summary & Introduction: What is contract transparency and why does it matter?

Historically, the hydrocarbons industry has been considered very complex. Access especially to information that explains its management, its agreement, and its economic, social and environmental impacts, despite the important role these impacts have played, has been extremely limited. Governments have failed to create clear and viable mechanisms to control the industry and the channels of interaction; the coordination with national and international operators has also been non-existent or nuclear. Thus, promoting transparency mechanisms in the sector can help avoid the misuse of public resources, secrecy, improvisation, inefficiency, and discretionality in terms of resource management and practices. Therefore, generating and accessing truthful, timely and systematic information about the industry becomes indispensable. In addition, transparency can strengthen and promote citizen participation.

Within this context, and if we consider that 'transparency is not one of the qualities of petroleum, there is no other product that generates so much corruption, the producing countries are characterized by highly concentrated power, very weak democracies, and a weak state of law'<sup>1</sup>; this study will reflect upon the main changes and current rules and conditions of **petroleum contracts in Ecuador and Bolivia**. Because the transparency of contracts between governments and the hydrocarbons industry is essential for any effort to trace income and expenses, the focus will be on contract transparency, but other aspects of the industry will also be discussed. Both countries have undertaken numerous changes to the industry in the recent past; they have undergone a process of migration from participation to service lending, or politically speaking, from 'privatization' to 'nationalization' of contracts. The significance of these changes and the role of transparency in these processes and going forward is the subject of this paper.

Several main conclusions come from this study, which assess both historical evolutions and makes suggestions for the future. First, experience demonstrates that an attitude of transparency does not occur spontaneously among public institutions. Many times, State Management is interested in maintaining an asymmetry of information that favors the government over their citizens, given that this facilitates political success and permanency in position. And yet, transparency can emerge, but it might be limited. In Ecuador and Bolivia, contracts are disclosed. In Ecuador, contracts are disclosed once they have been negotiated and awarded. In Bolivia, contracts are to be approved by parliament; yet this has not been fully implemented.

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<sup>1</sup> Comment taken from the Systemization Forum 'Los Contratos Petroleros Y Sus Implicaciones Sociales, Económicas y Ambientales' 'Petroleum Contracts and their Social, Economic and Environmental Implications', Guayaquil, 20-21 January 2011

Nevertheless, it is not only the public sector that must make its information transparent. Private stakeholders involved in the production chain of a specific product or service and who act as allies of a specific government, be it strategic or not, must seek sufficient mechanisms to ensure the transparency of information. And in that regard, contract transparency is not enough. Much more information about operations, environmental concerns, strategy to diversify the economy, domestic use of resources, among many other topics, is needed for full citizen engagement in this important sector. Contract transparency is an important and necessary start, and Bolivia and Ecuador should be applauded for these disclosures; but both countries could do much more. This paper highlights some of these areas and yet acknowledges that consolidating the gains around other disclosures remains a high priority as well.

**a. What is meant by 'contracts' in this context?**

One important threshold question is 'which contract'? Experts estimate that a single oil or gas project is built, operated, and financed with around 100 major contracts, i.e. not smaller and repetitive contracts done in the ordinary course of business, like employment agreements. Which of these contracts can and should be publically available?

The question is not a simple one, but there are areas of clarity within it. Freedom of information and public participation principles dictate that government decisions and the deliberative process preceding decisions should have citizen engagement. Access to information is critical for meaningful participation in all aspects of government. For example, oversight of governments and the ability to change government necessitates access to information after decisions have been made.

Of the hundreds of contracts involved in an oil and gas project, the contracts to which a State or a state-owned company is a party should be made publically available under these principles. These are typically a contract to prospect, explore, or exploit hydrocarbons resources. These could be called licenses, permits, agreements, or other names in different countries. In the oil and gas sector, three prevailing types of contracts exist:

- 1) Production Sharing Contracts, in which the field operator is allowed to recover its operating costs (opex) and capital (capex) prior to sharing income and/or a share of oil with the State;
- 2) Service contracts, in which the field operator receives a certain amount of resources, generally a percentage of gross income, to cover its opex, capex and still earn reasonable profits; and
- 3) Concessions, or 'tax/royalty' contracts, in which the field operator has a main (but not single) obligation to the State, which is to pay taxes and royalties. The contractor has rights to all the hydrocarbon resources.

**Participation Contracts vs Service Contracts**

In general, the differences between these types of contracts is the manner in which each assumes operating risks, payment for services, and the modality in which adjustments are made when there are variations in international prices. For example, in service contracts, the potential upside for windfall profits is retained by the state instead of the contractor; in a concession system, this upside potential would typically be retained by the contractor. Similarly, the downside risk of price collapse is retained by the state in the

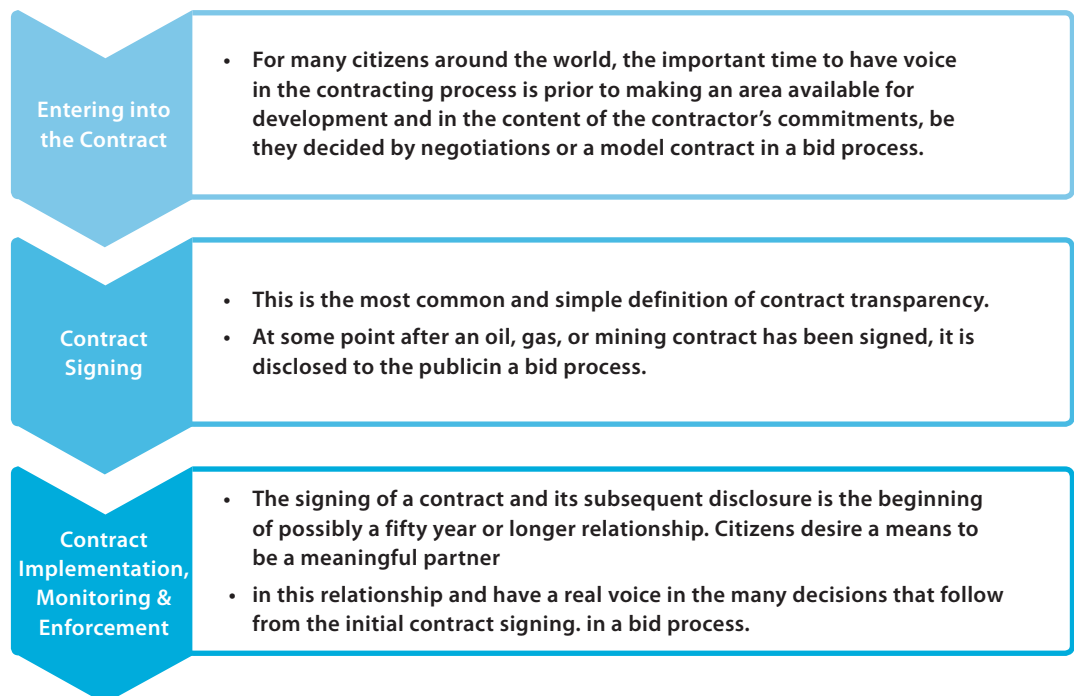
service contract whereas it is borne by the contractor in the Concession, unless particular mechanisms are put into these contracts to mitigate this.

It is common that States use a combination of aspects of all of these contract types to allocate risks and responsibilities or to laud a change of policy or both. Interest in signing one of these contracts will depend on the expectations of the contracting parties (the State and the private companies) to smooth imbalances between the benefits perceived by the parties, consolidating greater participation in oil earnings, and promoting reasonable profit horizons with regard to the various price fluctuation scenarios that could arise in international markets.

**b. What constitutes transparency?**

While transparency might seem far more straightforward, in fact it may also have different meanings for different people and in different contexts. For some authors who talk of governmental transparency, for example, transparency consists of opening up government information to the public, to scrutiny by society. Transparency does not imply an act of accountability to a specific person or the simple disclosure, but the democratic practice of revealing governmental information and creating participatory and public processes for engaged democracy.

Here is one way to conceptualize possible points for 'contract transparency' to occur in the life cycle of a hydrocarbons project:



**c. Why does contract transparency matter?**

Contract transparency is a prior and essential condition to ensure all parties benefit from the hydrocarbons industry. Disclosure is a prior necessary requisite for coordinated and

effective management of the extractive sector by governmental organisms. It allows citizens to follow up on contracts in areas which they could be better situated such as fulfillment of environmental norms and social commitments. Contract transparency provides incentives for improving the quality of contracting: it prevents government employees from prioritizing their interests above those of the population, and in time, governments can begin to increase their negotiation power if they learn from contracts signed in other parts of the world.

Secrecy hides incompetency, poor management and corruption, but only from public opinion, not from the industry which generally knows the terms of a transaction and even the text of the supposedly secret contracts. As to 'confidential' contracts, rights of access to information must be instrumentalized as few countries have public transparency policies regarding hydrocarbons exploration and exploitation studies.

Likewise, contracts unknown to the public should be made transparent such as those referring to types of concession, shared production, jobs, project funding, and contract transference. Although treaties, laws, regulations and other legal documents that define relationships between government and private companies are public documents, petroleum, gas and mineral extraction contracts between governments and extractive industries are shrouded in mystery. In general, they are not available to the citizens of the countries rich in resources, in which the extraction takes place, and often they contain confidentiality clauses that explicitly limit access to public opinion. Internationally, there is more and more demand to make contracts with the extractive industries available to the public and to establish new standards to define what information is revealed and what isn't regarding transactions between the government and the industries.

Unfortunately, contract transparency remains a nascent practice, including the most straightforward form described above, disclosing the signed agreement. Bolivia and Ecuador are among a few countries that do this. If the arguments for contract transparency are so compelling, why is it not yet common practice? Responses to common arguments against contract transparency are detailed below.

1) Confidentiality clauses do not allow for contract transparency.

Both governments and companies have consistently argued that confidentiality clauses in their contracts forbid the disclosure of the contract. A global survey of over 150 oil, gas, and mining contracts demonstrated that this assertion is partly a myth and partly a truth. There are many ways in which confidentiality clauses are not an obstacle to contract transparency, which makes this statement a myth. For example: the parties to a contract can always agree to make certain information public that would otherwise be covered by confidentiality clauses. In other words, governments and companies can always agree to publish contracts and can agree to modify confidentiality clauses to allow contract transparency. Even when the parties can't agree on making certain information public, the confidentiality clauses of the extractive industries almost always include an exception for disclosure that is required by law. In this manner, governments can demand contract transparency through legal means.

In sum, this argument is only correct if neither the governments nor the companies desire to approve contract transparency. In this case, the confidentiality clause would impede citizens from having access to the contract, unless some other legal mechanisms are used to annul the government's and company's decision, such as the stipulations of the freedom of information law.

- 2) Contracts contain sensitive commercial information and should, therefore, be confidential.

Governments and companies argue that contracts contain delicate commercial information that, if revealed, would jeopardize their ability to be competitive. The information considered sensitive includes: financial conditions, labor obligation commitments, and environmental mitigation and protection measures to be taken.

One problem with this argument is that much of the information is already known in the industry (for example, financial conditions). In such cases, the information cannot be considered an industrial secret that merits legal protection. Another factor is that frequently the sensitive commercial information is not contained in the main contract, which activists want to see. It can be found in documents such as environmental management plans and documents on costs. Thus, contract transparency doesn't mean that information that was previously secret will now be made available to the competition. Additionally, the highly sensitive information can always be redacted before it is revealed.

For these reasons it is necessary to acknowledge that transparency contributes to modernizing the State and its institutions, along with acknowledging citizens as observers. We should also ask ourselves, once the information is known, are citizens capable of correcting things that seem undue or inadequate? The question leads us to acknowledge another profound deficit of democracy: the lack of instruments to democratically control governments in decision-making processes and in their actions.

## **II. Background: Resource Extraction-based Economies in Ecuador and Bolivia**

Petroleum is the main source of funding for the Ecuadorian economy. According to 2010 official data it represents fully one-fourth of the GNP, 35% of the State's budget, and over 50% of exports. From crude oil exports, according to a sum of official data, between 1972 and December 2009 the government obtained 77.568 billion dollars. The foreign companies earned 20.096 billion dollars from crude oil exports just between 2000 and 2008. Between 2007 and 2010 the government received about US\$ 30 billion.

Hydrocarbons are also one of the main sources of funding for the Bolivian economy. In 2010, the revenues perceived by the Bolivian government from the production of oil and natural gas approximately represented 21.1% of the national budget and 5.20% of the GDP (gross domestic product). Data released by the Instituto Nacional de Estadística (The National Institute of Statistics) indicates that over this period Bolivia exported the equivalent of 2.942 million dollars for hydrocarbons only; this amount represents 42.29% of the 6.956 million dollars generated by the country through exports. Between 2001 and 2010, the Bolivian government approximately received 8.188 million dollars in royalties, shares, and taxes on hydrocarbons.

### **a) Ecuador Hydrocarbons History**

The history of petroleum in Ecuador dates back to 1875 when a field on the peninsula of Santa Elena was given under concession to the transnational company Anglo Ecuadorian Oilfields Ltd. The State received 1% of the benefits of exploitation.

The second stage of the country's petroleum history took place near the end of the 1960's when oil fields were discovered in the Amazon region, even though in the 1950's

companies such as Shell had researched the area and determined that the quality of crude oil was not as interesting as compared to Arab countries with much safer and more trustworthy sources.

Since then, the Ecuadorian state began to intervene in petroleum policy but most of the hydrocarbons activities have been managed by the transnational companies, especially by Texaco and Gulf. Historically there was a break in 1981, which led to the famous lawsuit that is currently covered in international media, the case against Texaco for environmental damage. At the time, the State was not as involved in the hydrocarbons sector. The neoliberal politics of the moment stated that, 'Ecuador does not have the necessary capital to carry out petroleum activities. We need capital for health, education, highways, public housing. We must attract international capital. Ecuador doesn't have the technology and we must attract foreign investments, as foreigners have the necessary technology'...

Many critics of this policy believe that this argument was the basis for planned weakening of the state petroleum company to enable foreign companies to enter. Although in the 80's and 90's attempts were made to improve national operations, the results were given very little importance. At the time, petroleum was extracted but it was not based on the country's energy needs, the aim was to receive monetary compensation from foreign oil companies.

#### **Principal Figures for Petroleum Exploitation**

Today, much of Ecuador's petroleum resources have been depleted. In 1970, when the mini-petroleum boom began, the country had 8.084 billion barrels of proven reserves. Forty years later, the remaining commercially exploitable reserves have been reduced to half of that, including the ITT (Ishpingo, Tambococha, Tiputini) Block. The 43 Block contains the 3 fields Ishpingo, Tambococha, and Tiputini (ITT). According to experts, the total proven reserves from the 43 ITT Block are 856 million barrels of heavy crude (14°API). The proven reserves from North and South Ishpingo total 450 million barrels alone. The reserves at Tambococha and Tiputini are approximately 400 million barrels. 80% of ITT is located inside Yasuní Park, a no-go zone and also the buffer zone where exploitation is prohibited perpetually.

The temptation to exploit the ITT reserves will be great, particularly in the current era of high oil prices. Historically, the government obtained 77.568 billion dollars from crude oil exports from the period between 1972 and December 2009, according to a sum of official data. Foreign companies earned US\$ 20.096 billion dollars from crude oil exports just between 2000 and 2008. Between 2007 and 2010 the government received about US\$ 30 billion.

#### **b) Bolivia's Hydrocarbons History**

Bolivia has recently gone through two very important moments in the oil sector; first, due to a capitalization and privatization process of the main business units of the state company Yacimientos Petrolíferos Fiscales Bolivianos (YPFB) and second, due to a nationalization process whose main objective was the recovery by the State of the ownership of the hydrocarbons and of those companies that were capitalized and privatized.

### ***Period of Capitalization and Privatization***

As a result of bilateral negotiations between Bolivia and the Federative Republic of the Brazil, a sales contract of natural gas for a volume of 30 million cubic meters day (MMcmd) during 20 years, was signed in 1996. For the execution of this contract, a search for foreign investments that would allow the increase of the certified reserves of Bolivia as well as the levels of production of hydrocarbons became necessary, given the low financial capacity of YPFB.

For this reason, Hydrocarbons Law N° 1689 was passed in April of 1996, establishing a regime of Shared Risk Contracts and declaring them free to make decisions regarding the exploration, exploitation, refinement, industrialization and commercialization activities of the hydrocarbons and their by-products. Also, together with the promulgation of this law, began the transfer of the exploration and production unit of Andina SAM, owned by YPFB, for a total of US\$ 264.8 million dollars; the exploration and production unit of Chaco SAM was capitalized, also owned by the state, for \$US. 306.7 million, as well as the Transportadora Boliviana de Hidrocarburos-unit for 263.5 million dollars.

On the other hand, between 1998 and 1999 the main refineries of the country were privatized (Gualberto Villarroel and Guillermo Elder Bell) on a base of US\$ 102 million dollars and the Compañía Logística de Hidrocarburos Bolivia for US\$ 12 million dollars. In total, revenues in the order of approximately US\$ 935 million dollars were obtained. With regards to the newly established contracts regime, the Executive Branch of Government of that time period submitted a model of a shared risk contract for the approval of the national congress. This model was approved and applied and started in 1996, for all the exploration and exploitation activities of hydrocarbons. As a result of this process, more than 70 shared risk contracts were entered into between YPFB and the transnational companies.

Among the main aspects contemplated by this contract model was the transfer of the ownership of the exploited hydrocarbons in favor of the private companies, which were responsible for the direct payment of the petroleum income in favor of the State. In equal manner, these companies could decide the destination of the production they generated as well as the commercial conditions (price, volume, etc.).

Regarding the topic of information and confidentiality, this contract model, in its tenth clause stated the following: 'YPFB, the National Secretary of Energy and any other State body, will maintain the information received as confidential and the information may not be of the knowledge of any person that is not in service of the State who will also maintain the information in confidential manner...' Therefore, the information generated starting from the signing of these contracts had a confidential character and it was not of easy access for the civil society in order to make an appropriate monitoring of the situation of the hydrocarbons sector in Bolivia.

Another important point that should be mentioned is that according to what is stated in numeral 5 of article 59° of the Political Constitution of the State, effective from the beginning of the year 2009, one of the attributions of the Legislative Power was to 'Authorize and approve the contracting of loans that commit the general income of the State, as well as the contracts related to the exploitation of the national wealth'. However, the national congress did not move forward with the analysis and the approval of each one of the 75 oil contracts, limiting itself to approving the basic contract model for the negotiations. Under this framework, it became more difficult still to access the content of the contracts that were being subscribed by YPFB starting from 1996 until the year 2005;



up to now those contracts have not been published or revealed for the consideration of the population in general.

The regime of the shared risk contracts made it possible to obtain important investments mainly in exploration, production and transport activities of the hydrocarbons; these investments also impacted on larger certified reserves of natural gas and petroleum and in the discovery of mega fields that began to dedicate its production toward the Brazilian market. It is important to mention however, that due to the lack of approval of each one of these share risk contracts on the part of the legislative power, the government of Evo Morales has initiated legal liability actions to four former presidents of the Republic, by considering these contracts as unconstitutional.

### ***Nationalization Period***

In 2002, the Bolivian government of that time began to negotiate the execution of a potential project for the export of liquefied natural gas (LNG) to Mexico and the United States through a Chilean port. This project was a nuisance to the Bolivian population due to political problems between Bolivia and Chile over the loss of the Bolivian coastline in 1879. This reason, along with the low level of the export prices that were being negotiated and the differentiated petroleum income that existed among old and new fields generated a social protest in October 2003 on the part of all the organizations and social movements forcing then President Gonzalo Sánchez de Lozada, to resign and escape from the country.

In July 2004 and as a response to these social demands, Bolivia applied a binding referendum whose main results were the recovery on the part of the State of the ownership of all the hydrocarbons, the non-export of natural gas through Chilean ports and a level of petroleum income for all the fields equivalent to 50% of the value of the production in favor of the State.

In May 2005, the Hydrocarbons Law N° 3058 was enacted, creating the Direct Tax to Hydrocarbons with a tariff of 32% totalling together with the royalties of 18%. Also, this law established three new modalities for the oil contracts: of operation, of shared production and of association.

One year after the approval of this regulation and under the government of Evo Morales, the Supreme Decree N° 28701 was promulgated for the Nationalization of the Hydrocarbons; among the most important aspects that are contemplated in this legal disposition are the following:

- The State recovers the property, ownership and total and absolute control of all the hydrocarbon resources of the country. Likewise, it recovers the property of those companies that were capitalized and privatized during the period 1996-1999.
- YPFB, in the name and in representation of the State, in full exercise of the ownership of all the hydrocarbons produced in the country, assumes their commercialization, defining the conditions, volumes and prices for the internal market as well as for the export and industrialization.
- A period no longer than 180 days is established in order for the private companies that carried out exploration and production activities to regularize their activities, by means of operation contracts that comply with the legal constitutional conditions and requirements. At the end of this period, the companies that had not subscribed new contracts cannot continue to operate in the country.



- YPFB will not be able to perform contracts for the exploitation of hydrocarbons that have not been individually authorized and approved by the Legislative Power in the middle of the execution of the mandate from section 5 of article 59 of the Political Constitution of the State, effective then.

This last point settled down in S.D. 28701 was an important landmark in matters of transparency in oil contracts since each one of the 44 operation contracts that were negotiated and undersigned between YPFB and several oil companies, had to be necessarily approved by the Chamber of Deputies, as well as the Chamber of the Senators of the Honorable National Congress. In this sense, they were the national authorities chosen by vote who approved by means of a law of the Republic and in representation of the Bolivian population, the oil contracts that are being applied nowadays in Bolivia. After their approval, YPFB as well as the Ministry of Hydrocarbons published, in their web pages, the summarized content of the 44 contracts. However, to this date and due to the constant changes of authorities and technical teams in this sector, these contracts have not been published by these instances and it is very difficult to find them in the electronic pages.

There is also Law N° 3740 that has to do with the Sustainable Development of the Hydrocarbons Sector, promulgated in August 2007, that in its article 6 on Transparency of the information states that 'YPFB will publish biannually and in an official manner, in its institutional web page and in writing by means of official communications, all the information referred to Recoverable Costs and the calculation carried out for the determination of the participation of YPFB and of the oil companies in the benefits of the hydrocarbons activities'.

Among the minimum contents of information that will be submitted by each producing field of hydrocarbons are the following:

- Personnel costs of the operating companies
- Mobilization and demobilization costs of the personnel
- Transport and relocation costs of the personnel
- Costs of the materials
- Taxes, Royalties and Participations, Direct Tax to Hydrocarbons (IDH), patents, contributions, compensations and indemnifications
- Exchange differences
- Protection of the environment, industrial security and occupational health.
- Legal costs
- Insurance, administration costs and services
- Depreciation of the fixed assets.
- Production volumes, prices and gross income of the hydrocarbons for each component (natural gas, liquids, etc.) for the internal market as well as for the foreign market.

This is a very large amount of information for a country to disclose. Although a large part of this information is published at the moment by YPFB, full compliance with this regulation is still not being observed neither the disaggregation of it at the level of the producing fields, though it is established in the aforementioned law. We believe that one of the main shortcomings of this regulation is the absence of sanctions for cases of non fulfillment on the part of YPFB.

### III. Strengths: leaders in transparency

#### a) High levels of transparency, but on a relative scale

In most societies around the world, the primary contract for the exploration and exploitation of oil, gas, and mining resources is not available to the public. Countries far more dependent on these non-renewable resources do not disclose these vitally important contracts to their citizens. A 2009 study on contract transparency worldwide noted that: 'to date, many countries have not yet committed to full contract transparency.'<sup>2</sup> And very few, if any, have undertaken full contract transparency: disclosure of all past contracts, public voice and participation in contract awarding, disclosure of all signed contracts, and a post-contract award monitoring mechanism. In short, in most countries, the hydrocarbon sector remains beyond the oversight of citizens and of other governmental oversight institutions, like the parliament, the media, and even 'independent' government bodies, which may be too conflicting to perform such functions well.

Globally, the Latin American region does quite well compared to other regions vis-à-vis government transparency in the oil, gas, and mining sector. In the first ever ranking of resource-rich government transparency, The Revenue Watch Index, all Latin American countries in the 30-country ranking scored over 50 out of a total 100. On contracts and legal terms, many countries in the region have disclosed contracts, including Ecuador and Bolivia. A notable feature of Ecuador's contract disclosure is that it has historically been done under the country's LOTAIP – its freedom of information law.<sup>3</sup> The contracts were published by the government without citizens needing to go through long and costly administrative or judicial procedures to gain access to these contracts in Ecuador, which is much more faithful to freedom of information principles and practice. In other countries, contracts are not disclosed as a matter of course, even though there is a freedom of information law. In Mexico, citizens had to file a claim to gain access to contracts. Citizens were successful, which is a great achievement; however, disclosure without such costly and time-consuming process would be far better.

Bolivia's contract disclosure is driven by similar concerns and strong principles of public voice and participation, though disclosure has not been expressly governed by freedom of information law. The levels of transparency regarding the approval of oil contracts in Bolivia has increased significantly, seeing that its approval is an indispensable requirement on the part of the legislative power (deputies and senators) and that the information resulting from the application of these contracts also has a public character when Law N° 3740 is being applied. This is a crucial means for public participation in the contract award process – the first step in the chart above in 'What is Contract Transparency?' As the representatives of the people, parliamentary vote should provide a check and voice for citizens in the contracting process. A number of countries from diverse parts of the globe follow this practice: Azerbaijan, Egypt, Georgia, Liberia, Sierra Leone, Yemen, for example.

Bolivia's new policy is still quite nascent, and its implementation is remains limited. To date, due to constraints in technical teams and changes in leadership, a number of contracts have not been published. But, the law provides strong grounds for the future.

#### b) Groups are engaged in contract issues and policy formation

Citizen groups in both Bolivia and Ecuador are deeply engaged in contract issues despite limited access to these contracts during their negotiation or other awarding process.

<sup>2</sup> See Contracts Confidential: Ending Secret Deals in the Extractive Industries available at <http://resources.revenuewatch.org/sites/default/files/RWI-Contracts-Confidential.pdf>.

<sup>3</sup> See <http://www4.petroecuador.com.ec/lotaip/pdfs/acp/contrato16.pdf>

Both countries have seen the reformations of their hydrocarbons sector in recent years, and access to information and principles of public participation have resulted in reforms according to citizen demands. While it is too soon to say what benefits these reforms have brought, there is evidence that renegotiated and new contracts are better contracts and there have been improvements in the sectors in both countries more broadly.

**Early Indications of Better Contracts and Stronger Benefits**

In 2010, Ecuador renegotiated its contracts as a result of the introduction of reforms to the Hydrocarbons Law and the Tax Regimen Law. This generated a transition from participation contracts to service contracts, and a new focus from ‘privatization’ to ‘nationalization’ of this activity (see Table 1).

The context of this change was the Correa government’s ‘2007-2011 energy agenda’ which refers to the Montecristi Constitution regarding state control over natural resources. This changed the logic regarding the use and destination of natural resources in Ecuador.

**Table 1 Key differences between Service Contracts and Participation Contract**

	<b>Service Contracts</b>	<b>Participation Contracts</b>
<b>Risk</b>	The risk associated with the exploration and commercialization phases is assumed by the State	The global risks of the operation are assumed by the contracting company
<b>Payment for Services</b>	The state owns all production and pays a fee which includes operating costs, investments, and a profit margin	The company receives part of the crude oil it produces
<b>Price Fluctuation</b>	No mechanisms for acknowledging extraordinary earnings when there are positive variations in prices	Law 42-2006 and its reforms, as well as Article 170 of the Tax Fairness Law, establish a share of 70% in extraordinary earnings
<b>Companies operating under this figure</b>	Agip operates under a service lending contract with rates set based on costs. Ivanhoe signed a service contract that contemplates payment of a fixed rate (37 USD)	Repsol, Perenco, Andes Petroleum, Petroriental, and Petrobras operate under this contractual formula. Only the Andes Petroleum contract clearly establishes sharing extraordinary earnings (50%) when prices surpass 17USD per barrel

Source: ‘Lupa Fiscal, Nuevos esquemas en política petrolera: Monitoreo de la Industria Petrolera’ (Grupo FARO, 2009)

Tariffs. The fundamental idea in the renegotiation of the oil contracts is given in a tariff that will serve to bolster the operation of currently productive fields and another oriented toward the promotion of new investments that will finance exploration and prospecting plans in fields not yet exploited. In both cases, it was contemplated that the value of the tariff be adjusted according to the inflation that is registered in the costs associated to the production of the resource (infrastructure, inputs, oil services, among others).

**Table 2 Types of tariffs in the contractual model for the rendering of services**

	The Tariff	Other scope
Fields in operation	The tariff is equal to a fixed value per barrel. The operative costs are recognized plus a tariff close to 5%	If the company carries out investments to empower the fields it is already operating, an additional tariff in a range between 15% and 18% is recognized
Fields non exploited	A return rate of 25% is obtained in the measure in which an exploration plan bears a higher risk	This tariff shall also be applied in fields where improved recovery systems are implemented

*Source: 'The oil companies will have the model of the contract next week' Interview with Wilson Pastor, published in the El Comercio newspaper on June 24, 2010.*

Taxes. The reduction of the percentage of payment of the income tax from 44.4% to 25% was introduced because its contracts now pass to the rendering of services model for the exploration and exploitation of hydrocarbons (article 27 of the Reform Law). Additionally, the deduction of the expenses of the companies is modified. The companies won't be able to report as expenses, the financial costs nor the costs of transport through the pipeline (article 27 of the Reform Law). Likewise, a maximum limit of 5% of the tax charged for the deduction by concept of expenses in technical and administrative services is established (article 26 of the Reform Law).

These changes indicate that the Ecuadorian state should earn more in terms of financial benefit from its oil contracts in the future; but it is too soon to tell, and whether the deal was the best possible deal for the state is also opened to debate. And, despite the regular disclosure of contacts after signing (or renegotiation in this case) citizen groups in Ecuador seek more voice during the negotiation phase. These are areas discussed in greater detail in the next section, 'Weaknesses.'

Like Ecuador, Bolivia has also seen numerous changes in its hydrocarbons sector in the recent past at the demands of the citizens, as detailed in the historical background section, above. Similarly, it is too soon to quantify the benefits of these changes; and, the government is considering further changes in its legal structure, including contracts, at the time this report went to press. Citizen groups are actively involved in working with the government on thinking about these changes. The extent of meaningful citizen participation in these processes will only be known in the future. And, finding long-lasting

legal structures that benefit the society is no easy task. It takes time and may take several tries before finding the structure that will work. On the positive side, both countries are doing more vis-à-vis transparency and participation than many other countries—for example, Nicaragua, another country in the TRACE programme, where contracts are not disclosed at all and avenues for citizen participation are extremely limited.

#### **IV. Weaknesses: the limits of current policy**

Bolivia and Ecuador have disclosed more than many other countries and have principles of public participation that exceeds many countries. But this is in a context of limited disclosure worldwide, where all countries and the companies that operate in them could do much more. Transparency itself is a means for more meaningful participation in a critical sector of many economies.

##### **a. Participation and voice in negotiations/award is very limited in practice**

A common theme of citizens and citizen groups worldwide is the need for greater participation in the contracting award and/or negotiation process. While the disclosure of contracts after their signing can be an incentive for a government to act in the public interest while engaging in this process since the final product of the process will be available for public view, citizens may still see a closed approach as indicative of a process which does not have their interests sufficiently represented.

How to manage a participatory process remains an open question. Parliamentary involvement is one method, through either having legislation dictate the majority of the legal terms that companies are obliged to fulfill and/or contract approval; and, having citizen groups a part of the advisory team in contract negotiations, as has been done in Sierra Leone's contract renegotiation process with success. In a sector that has historically been so closed to any form of public information, much less participation, models and country experiences are limited.

##### **b. Monitoring and enforcement of the contract post-signing is challenging**

Even with strong commitments to disclose much information about the sector's operations from both Bolivia and Ecuador, actual disclosure has not been complete and can be out of date or inaccurate.

In Ecuador, a challenge in terms of monitoring and enforcing the contracts going forward will be whether the new regulatory structure mandated by the Monticristi Constitution and new laws will be fully implemented. Within the reform of the law, when PETROECUADOR was replaced by 'The Secretary of Hydrocarbons', new responsibilities are granted to the Ministry of Natural Resources, such as the awarding, subscribing and expiration of the different contracts through the Secretary of Hydrocarbons, infringing what was established in articles 313, 315, 316 and 317, of the Montecristi Constitution and the opinion is that the Secretariat of Hydrocarbons will become a SUPER ministry, concentrating important powers in just one institution.

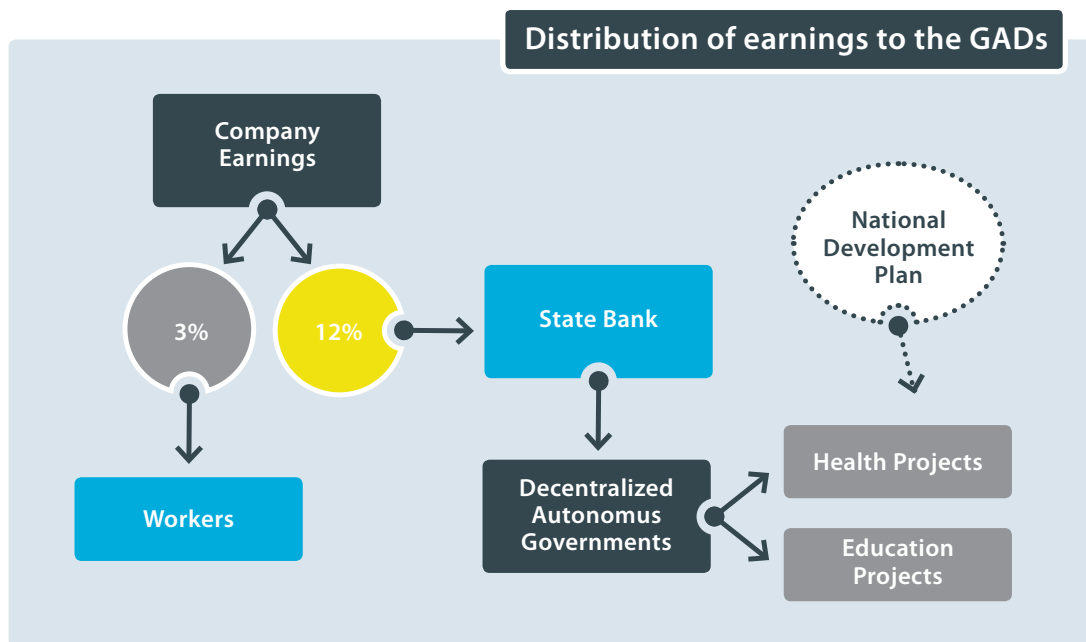
Also, Articles 204 and 213 of the Constitution point out that the activities of control cannot be subordinated to the executive branch, the Ministry of the Sector; instead, the controlling institution should enjoy autonomy, specialization, independence and social participation; and, delegate those activities to the new Agency of Regulation and Control of Hydrocarbons. The new Agency replaces the DNH, which was attached to the Ministry of Natural Resources. If this new independence is not fulfilled, the regulatory structure

of the hydrocarbons sector looks unconstitutional and antidemocratic, perpetuating the impunity of the oil sector.

There are other inconsistencies because the reform ostensibly surrenders strategic sectors: SOTE, secondary pipelines, multiple pipelines, gas pipelines and terminals, refineries. These are all highly profitable business deals for foreign investors, via delegation, something that is not allowed by the new Constitution.

In the Reform Law, a new outline for the distribution of the earnings was also established: 3% of the earnings will be surrendered to the workers linked to the hydrocarbon activities and the remaining 12 % will be paid to the State. The destination of this last amount shall be invested in social projects for health and education (in line with the National Development Plan) and it will be distributed equally from the Decentralized Autonomous Governments (GADs) located in the areas defined by the contracts in which the hydrocarbon activities are being carried out.

**Table 3 Distribution of the earnings from the State to the Decentralized Autonomous Governments (GADs)**



Source: Article 16 from the Hydrocarbons Reformatory Law

As for tariffs, the State introduced the 'margin of sovereignty' approach, by means of which they seek to guarantee a participation of 25% on the gross income generated through the exploitation of any of the fields surrendered for such effect. That is why they considered the possibility that the investment programs (which are part of the development plans) of each company be supported with bank guarantees that are cashed in the measure in which they are fulfilled and the payment of a **unique tariff** that covers costs, investments, earnings and taxes, was proposed. This could be paid in foreign currency or in kind (provided the internal supply from the refineries to the country is not affected).

Additionally, an earning capacity between 15% and 20% will be allowed in fields with a current production and a profit margin that will make the exploration and operation of new fields attractive.

### **c. Historical problems persist**

Despite efforts to fundamentally change the trajectory of resource exploitation, great challenges remain. Current transparency efforts do not make old problems disappear: environmental degradation from historical exploitation is not cured by good policies today; exporting resources while insufficiently providing energy for citizens is not rectified by better resource revenues or increased state participation or control in the sector.

According to environmental experts, the reforms to Ecuador's Hydrocarbons Law unfortunately do not demonstrate any real changes to what happened historically. Despite the fact that the problem of climate change is intimately related to petroleum and the exploitation of fossil fuels, and the country wants to move to a better future less reliant on these fuels, there are not clear signs that the country will, in fact, move away from exploiting petroleum resources that cause climate change.

And, while the Yasuni initiative has sought to protect nature over the exploitation of hydrocarbons, the temptation to exploit the ITT reserves will be great. A feasibility study done by PDVSA-PETROECUADOR (2008) stipulates an investment of 6 billion dollars, and operating costs of 3.5 billion dollars over the course of 20 years. Total reserves, at current value, with an average price of \$US 60.00 per barrel, would total US\$ 50 billion dollars. If only two Tambococha and Tiputini (TT) were exploited, approximately 400 million barrels, the economic reality would change substantially as the value of the reserves would be US\$ 29 billion dollars, at current value.

If investments, costs and operating expenses represent about US\$ 9.5 billion dollars, and the profits made by the operating company that partners with Petroecuador are about 15%, this would be approximately US\$ 3 billion dollars. The company's investments, costs, expenses and profits would be about 12.5 billion dollars. This analysis determines that earnings for the State would be approximately US\$ 16.5 billion dollars over 20 years, equivalent to US\$ 775 million dollars annually. This suggests that exploitation should be redefined.

Finally, hydrocarbon resources up to this point have not been successfully used to diversify the economy, and the reserves are being depleted quickly:

- The economy is anchored in petroleum. Petroleum represents between 20 and 40% of the income of the State budget. Raw materials are exported, derivatives are imported.
- No new reserves of petroleum and gas have been incorporated.
- The reserves are being depleted very quickly from 8.2 billion to half that, including ITT. With daily production of 480 thousand barrels of medium and heavy crude.
- Ecuador is a net importer
- External trade of hydrocarbons and derivatives is controlled by foreign traders.
- There is legal, political, labor and administrative instability in the sector.
- Environmental, collective rights, and prior consultation laws are not complied with.



Bolivia faces many of the same challenges: information is not always timely, though there has been significant progress in making it available. Social divisions are still deeply connected to the hydrocarbons sector. Environmental damage continues to occur, and government officials are slow to respond.

In sum, while the disclosure of contracts has been a significant step in the right direction, there is still much to be done for Bolivia and Ecuador's goals and vision of a better future to be fulfilled.

## **V. Opportunities**

### **a. Greater engagement could lead to less conflict**

A common refrain heard in favor of greater transparency and public participation is that it will lead to greater stability for the investments for at least two reasons: (1) communities will have their true consent and voice taken account in the process of resource extraction (assuming they do consent); (2) the investments will be less subjected to the political process. Natural resource contracts are the most unstable and regularly renegotiated among all investment contracts with foreign governments, and politics plays a key role. Contracts may be signed by one government only to be repudiated by the next. The secrecy of these contracts and negotiations must, the theory says, play a role in political grandstanding about these contracts. A public vetting of these contracts could go a long way towards buffering contracts from this source of instability.

Bolivia and Ecuador's steps towards greater public participation and transparency could blaze this path and test these theories, which, if correct, could provide much-needed trust and stability.

### **b. Revenues from the hydrocarbons sector can be used to promote industries and societal goods that will survive these resources**

Both Bolivia and Ecuador have historically been primarily extraction and resource-based economies. A well-planned strategy for using remaining hydrocarbons resources to diversify the economy away from extraction and into other sectors could result in an inherently non-renewable resource providing a more sustainable and diverse future for both countries.

Ecuador and Bolivia both have considerable mining resources that have not yet been extracted. In Bolivia, large lithium deposits are said to be world-class. Under the 'Buen Vivir' (good living) plan, the Ecuadorean government has introduced a proposal to begin mining metals on a large scale considering that Ecuador's petroleum reserves are now 50% of what they used to be, the remaining amount continues to decrease, and it is found in some sensitive areas.

If not thoroughly planned and designed to promote other sectors, both of these new areas could continue the path of resource extraction as the primary driver of the economy. Lessons must be learned from the past decades of extraction to move to something more environmentally and economically sustainable.

## **VI. Threats**

### **a. Disaffection at the lack of transformative change through transparency**

Even though Ecuador and Bolivia have high levels of transparency compared to other countries world-wide, the commitments of these countries to hold themselves to the high levels of genuine public participation in a new Constitutional order has created an expectation that the political reality will change from past policies. Contract transparency, and transparency more generally, cannot, alone, create a meaningful public participation. It demands innovative mechanisms and testing new means of governance that perhaps no other country has tried before. And while citizens should continue to demand new models of governance and participation, there is the risk that the important gains in transparency could be forgotten or their importance under-estimated. Continued pressure to maintain high levels of transparency will require constant monitoring and a balanced approach of understanding its limits while acknowledging its importance as well.

### **b. Resource extraction always has risks, no matter how transparent it is**

There is no way to extract petroleum without causing environmental and social impacts. They can only be mitigated. And large-scale disasters cannot be avoided, as the cases of Texaco in Ecuador and the Gulf of Mexico spill demonstrate. This activity cannot be nature-friendly nor does it conserve biodiversity. It is an inherently risky business, and some argue that for Ecuador, the damages have outweighed the benefits.

The reforms to the Hydrocarbons Law do not respect the new Constitutional framework as they do not discourage the expansion of the petroleum industry or its negative impacts and the reform seeks to motivate hydrocarbon activities by increasing production levels in oil fields.

What is seen as positive is the inclusion of the following text, 'The Ministry of this Sector may declare the contracts void if the contractor: causes, either by action or omission, damage to the environment, quantified by the Ministry of the Sector; if it does not remedy the damage according to the dispositions of the competent authority.' But this brings up the question: to what extent can this feasibly be fulfilled? If the environmental damage will be quantified by the Ministry of the Sector, meaning the Ministry of Natural and non-Renewable Resources, can the Ministry, whose function it is to promote petroleum exploitation, be expected to quantify environmental damage so as to make voiding the contract possible?

Also positive is the incorporation in the Constitution, of the term 'Integral Reparation' which includes the restoration of nature. This is much more extensive than simple 'remediation', a term which has been used and is not effective. It explains that 'remediation has meant eliminating the black oil slick so it can't be seen and nothing else, and that is what Texaco did after its operations and this caused environmental damage and an international lawsuit with this multinational company.'

In another of the reformed articles, regarding the distance that must be kept between the construction of petroleum infrastructure and nearby population centers, there is discretionality because in practice there is no new prohibition in terms of installation. Previously a distance of 10 kilometers from towns was specified and petroleum infrastructures could not be installed closer. But now, with this reform, the distance is at the discretion of the environmental authority who could easily determine a distance less than 10 kilometers, if a technical report recommends it.

For environmentalists it's time to seriously think about Post-petroleum Ecuador.

## **VII. Conclusion: Charting a Path to Consolidate Gains and Chart New Territory to Ensure Leadership**

The transparency of contracts is fundamental to promote the good handling of the hydrocarbon resources. Ecuador and Bolivia are two countries highly dependent on their non renewable resources. Even so, the efforts of these States to benefit from the related industries are in their primary stage. Within this line, Ecuador as well as Bolivia have migrated their models of participation contracts to service contracts, where the State has the role of proprietor of the resources and the oil companies are the operators. The national company becomes a marketer in this transition. To institutionalize these new administration models, the two countries have reformed their respective hydrocarbons laws.

One particularly salient difference between the countries is in the approval process of the new models of contracts. In Bolivia, contracts should be approved by the legislature, whereas this is not the practice in Ecuador. Whether parliamentary approval of contracts will be a viable mechanism to achieve meaningful public participation in the contracting process of the hydrocarbons sector remains to be seen. If parliamentary approval is successful in this regard, it could be a possible mechanism for many other countries, including Ecuador, where citizens seek greater involvement and oversight over the contracting out of the sovereign, non-renewable resources of the State. With much greater democratization of the hydrocarbons sector, more trust could be built, leading to more stable investments—which would benefit all involved. Furthermore, the revenues, if invested wisely, could create other industries that are not inherently dependent on a non-renewable resource.

And yet, resource extraction, no matter how transparent and participatory it is, comes with great risks, particularly for environmental destruction that cannot be undone. Ecuador has had a bitter history of environmental damages already. Moving away from an extraction economy becomes even more important when this is considered.

The steps towards greater transparency and contract transparency are good and in the right direction. It is the TRACE participants' hope that this is the first step of many more in a direction of greater transparency, public participation, and non-dependence on the hydrocarbon sector for our countries.

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**TRACE Briefings 2010-2011**

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