

## LEGAL



# A matter of risk

**Investors in offshore Latin American oil and gas projects need to be aware of four common investment risks and how best to mitigate them, writes Gunjan Sharma, Associate at international law firm Volterra Fietta.**

Investment in offshore Latin American blocks has grown rapidly in the last few years. However, investors in the region often face similar investment risks. Four of the most common are competing maritime claims by states to the same block; the administrative ability to terminate a licence or production sharing contract (PSC), often without material cause (called *caducidad* and ‘administrative rescission’); limited recourse to international arbitration to resolve disputes; and the implications of low carbon sources.

Investors should be aware of these four risks, and how to mitigate them, when they seek to invest in offshore Latin American blocks.

#### **Lack of delimited maritime areas**

A common risk in Latin America is competing sovereign claims to the same offshore block. Under international law, states can exercise sovereign rights over their continental shelves, which extend at least 200 nautical miles from their coasts. However, the boundaries of a state’s maritime areas are not always established and two or more states often lay claim to the same maritime areas. This is especially true in Latin America, including in the Caribbean.

Despite this, a single state can, and often does, license operations in a maritime area subject to a competing claim from another state. Unsurprisingly, the other state objects to this conduct – as seen, for example, in Venezuela’s deployment of naval vessels in the Guyana-claimed Stabroek block. Even states

in less contentious relationships object to each other’s claims.

Although there are doctrines of public international law that can protect investors who make investments in good faith despite competing claims, the risk of a loss could still be high if sovereign control of the block does not end up with the initial licensing state.

This risk may not be sufficiently mitigated because the definition of the licensed area expressly extends ‘up to the maritime boundary’ between the licensing state and its neighbour. Instead, the competing claim can encompass a material portion of the licensed block.

Investors, particularly operators, should consider other types of risk mitigation. This includes drilling exploratory and productive wells in areas of the licensed block that are less likely to be subject to a dispute, subject to any minimum exploration commitments or other PSC terms; assessing the possible final delimitation of a disputed maritime area with oceanographers and experienced counsel; and reviewing and anticipating possible transboundary unitisation schemes or joint development zones, such as the recent Unitisation Agreement signed by Barbados and Trinidad and Tobago in February 2020.

#### ***Caducidad* and administrative rescission**

A significant risk in offshore Latin American projects is the risk of *caducidad* and/or administrative rescission. Under these legal concepts, the licensing state may administratively terminate a PSC in the event of certain pre-defined

events. These events are often defined by political, not experiential, considerations. In many cases they would not be considered a material breach of a PSC as a matter of best international practice.

Nevertheless, the laws of certain Latin American countries (such as Chile, Colombia, Mexico, Panama, Paraguay and Venezuela) provide for limited or sometimes no compensation in the event of *caducidad* or administrative rescission. Moreover, in the event of such an administrative termination, the operator may even be required to transfer its immovable and sometimes other operating assets to the state, free of charge. These practices can stand in stark contrast to how administrative rescission or *caducidad* is practised in continental European law.

In addition, disputes concerning an administrative rescission or *caducidad* might also be considered nonarbitrable and subject to the exclusive jurisdiction of domestic courts (such as in Mexico). Investors may therefore lack access to a neutral forum to adjudicate these important disputes.

The risks of these types of administrative termination are well-established. *Caducidad* was invoked by Ecuador to terminate offshore interests held by Occidental on the basis of a potentially unauthorised partial farm-out, after Occidental had prevailed in an arbitration concerning a tax dispute with the government. KBR’s interests in the construction of natural gas platforms were administratively rescinded by Pemex in 2004 – at the same time that Pemex and KBR had a separate contractual dispute. That administrative rescission resulted in 13 years of multijurisdictional arbitrations and litigations.

Contractual terms can be used to limit the risk of these often mandatory concepts of laws. For example, the licence contracts for Mexico’s Ronda 1 auction contained terms requiring non-binding expert consultation prior to an administrative rescission, compensation for administrative rescission and a protection of the investor’s treaty rights. Investors can also structure their investments to benefit from the protections found in bilateral investment treaties, which can provide more robust protections than domestic law.

Relatedly, special attention should be paid to PSC terms that require the reversion of immovable

and other operating assets to the state upon the termination of the underlying PSC. Although these clauses may make commercial sense if a PSC expires in the ordinary course, the clauses ideally should not apply to the early termination of the PSC, with or without fault. If they do, there is a risk the investor may therefore bear the loss of the assets without any chance of return, even if there is a commercial discovery.

#### No international arbitration

International arbitration remains a key protection in oil and gas investments by providing investors with a neutral forum to resolve their disputes with the state and national oil companies (NOCs). However, in many civil law systems in Latin American, only 'free transferable patrimonial rights' (or similar concepts) can be subject to arbitration. This phrase is variedly and ambiguously defined throughout the region. In particular, certain administrative acts concerning PSCs – such as the failure to provide necessary licences – might be considered non-arbitrable issues of administrative law. Sometimes, claims for damages arising out of such acts may still be arbitrable, even if the validity of those acts cannot be challenged in

arbitration. However, it is unclear how that would work in practice.

Investors should determine if and how this risk applies to them. If so, this risk might be mitigated by providing the legal seat of arbitration in a neutral, well-respected venue, such as London, New York or Miami; and broadly defining what is subject to arbitration in the PSC.

#### Energy diversification and low carbon sources

Investors should also be aware of a region-wide movement to transition to low carbon sources and energy diversification. To date, the member states of CARICOM (Caribbean Community), as well as Argentina, Brazil, Chile, Colombia, Costa Rica, Mexico and Uruguay (undoubtedly among others), have undertaken to expand the role of renewable energy in their markets.

Although energy diversification can be a laudable goal, offshore oil and gas investors should remain alert to potential state measures that purport to advance environmental interests but are unfair, unreasonable, arbitrary or conducted without due process of law or compensation.

Of course, states are entitled to regulate, but they must do so within legal parameters. Governments

and NOCs should therefore plan and execute regulatory changes carefully and with expert advice to comply with legal obligations, including under public international law.

For example, recent state drafts of PSCs in the region have expanded the discretion of environmental agencies to impose limits where exploration or production can occur in a block, even after a licence has been granted for the block. These clauses should be carefully considered in light of their potential abuse.

Although not solely relevant to offshore operations, investors might also want to take the possibility of energy diversification into account in long-term price and cost projections, especially after the COVID-19 pandemic.

#### An attractive proposition

To conclude, offshore Latin America remains a considerably attractive commercial proposition. However, investors should maximise their potential returns by carefully considering and, where possible, mitigating the four risks identified above. ●

\* Rescission – the revocation, cancellation or repeal of a law, order or agreement.

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