JOURNAL OF CHINESE LAW

VOL. 9 FALL 1995 NO. 2

The Legal Framework for Joint Development of China's Onshore Oil Resources: Negotiation Strategies and Future Prospects

KEVIN M. WOLF*

I. INTRODUCTION

On June 8, 1995, the China National Petroleum Company ("CNPC") announced a third round of bidding for onshore petroleum exploration and development projects in locations in northwest China.[1] The offering was of potential interest to foreign investors because it included twelve exploration blocks in the Tarim and Junggar Basins, remote areas in Xinjiang that are widely regarded as two of the most prospective yet underexplored oil regions in the world.[2] As a result, on

* Master's degree candidate in East Asian Affairs at Columbia University School of International and Public Affairs; Associate, Anderson Kill Olick & Oshinsky, P.C. (1990-1995); J.D., University of Michigan Law School; A.B., University of North Carolina at Chapel Hill. The author is grateful for the critical contributions of those who read previous drafts of this article. Essential input and encouragement were provided by Patricia A. Thayer, Richard Aguirre, Esq., and Nicholas C. Howson, Esq. Special thanks is due to Warren Huang for his commitment to shaping a final product that could be more than the sum of its parts. Although benefitting from the generous assistance of those listed above, the author is entirely responsible for any errors contained herein.

1. Overseas Oil Firms Invited to Bid for Exploration Rights, BBC Summary of World Broadcasts, June 10, 1995, available in LEXIS, World Library, Allwld File.

2. Id., China's New Oil Import Status Underpins World's Most Dynamic Petroleum Scene, Oil & Gas J., May 9, 1994, available in LEXIS, News Library, Arcnws File. In 1994, Chinese geologists informed the World Petroleum Congress that the Tarim Basin alone may contain 88 billion barrels of oil, nearly four times the proved oil reserves of the United States. Jim Landers, Scaling the Wall; Oil Execs Enter China With High Expectations, Dallas Morning News, Feb. 23,

February 5, 1996, Texaco, Inc. and Agip (Overseas) Ltd. jointly signed two petroleum contracts with the CNPC to explore and develop reserves in two exploration blocks located in the Tarim Basin.[3] On March 19, 1996, Esso China Upstream Ltd., a subsidiary of Exxon, also signed two petroleum contracts with the CNPC to explore and develop two additional exploration blocks in the northwestern part of the Tarim Basin.[4]

The June 8, 1995 offering represents the third time that the CNPC has offered onshore concessions to foreign corporations under recently-promulgated legislation designed to provide the legal framework for foreign onshore investment.[5] The 1993 legislation, entitled "Regulations for Exploration and Exploitation of Onshore Hydrocarbon Resources in Cooperation with Foreign Companies (State Council Decree 131 of 17 October 1993)" ("1993 Regulations"), extends limited rights to foreign corporations to explore and develop onshore oil properties in cooperation with the CNPC.[6]

While the 1993 Regulations provide the overall legal framework for the participation of foreign oil companies in onshore exploration and development, three model contracts, "Model Contract of May 1993 for the First Round of Onshore Bids for Exploitation of Land Petroleum Resources of P.R. China" ("1993 Model Contract"), "Onshore Chinese Second Round Model Contract (February 1994)" ("1994 Model Contract"), and "Model Contract of 1995 for the Third Round of

---

1995, at 1D. A somewhat lower figure appearing in the Oil Daily estimates Tarim Basin reserves to be approximately 70 billion barrels. Campion Walsh, U.S.-China Energy Deals Neglect Oil; Firms Await Prize — Onshore Prospects, Oil Daily, Feb. 27, 1995, available in LEXIS, News Library, Curnws File.

3. P.T. Bangsberg, Texaco, Agip Sign Pacts for Chinese Fields, Hous. Chron., Feb. 11, 1996, at 7; Texaco and Agip Sign Tarim Basin Joint Venture Oil Development Contracts, BBC Summary of World Broadcasts, Feb. 13, 1996, available in LEXIS, World Library, Allwld File.

4. See Esso Signs China Deal; Esso China Upstream Ltd., Oil Daily, Mar. 20, 1996, available in LEXIS, News Library, Curnws File.

5. See Zhiguo Gao, International Petroleum Contracts: Current Trends and New Directions 149-50 (1994) [hereinafter Gao].

6. See Regulations for Exploration and Exploitation of Onshore Hydrocarbon Resources in Cooperation with Foreign Companies (State Council Decree 131 of 17 October 1993), arts. 3, 7, translated in Asia & Australia — Basic Oil Laws and Concession Contracts (Original Texts), Supplement No. 121 (Barrows Co., Inc. 1994) [hereinafter 1993 Regulations]. Unless stated otherwise, all citations to the 1993 Regulations are taken from the translation by the Barrows Co., Inc. See also Brian Chi, Onshore Petroleum Exploration in China: A Legal Perspective, Petroleum Economist, Sept. 1994, available in LEXIS, News Library, Curnws File [hereinafter China Legal Perspective].

Bidding" ("1995 Model Contract") (collectively, "the Model Contracts"),[7] elaborate the specific rights and obligations of the CNPC and foreign contractors.[8] As with prior offshore contracts, the onshore Model Contracts have "no formal legislative standing" but have been promulgated by the CNPC to provide a starting point for negotiations.[9]

Foreign oil companies have praised the 1993 Regulations and the Model Contracts, stating that the Chinese legal regime offers "good terms in comparison with those offered by other countries" and is "flexible yet complete."[10] In terms of potential financial returns to foreign investors, China's onshore prospects hold great promise. A

7. While the complete text of the model contract for the third round of bidding has not yet been published by Barrows in English translation at the time of the writing of this article, Barrows has released a summary of the third-round model contract that sets forth the changes that have been made from the 1993 and 1994 Model Contracts.

In the 1993 Model Contract, the CNPC authorized the China National Oil and Gas Exploration and Development Corporation ("CNODC"), a subsidiary of the CNPC, to carry out certain activities on behalf of the CNPC, including the negotiation of petroleum contracts with foreign companies. Model Contract of May 1993 for the First Round of Onshore Bids for Exploitation of Land Petroleum Resources of P.R. China, art. 27.3, translated in Asia & Australia — Basic Oil Laws and Concession Contracts (Original Texts), Supplement No. 119 (Barrows Co., Inc. 1993) [hereinafter 1993 Model Contract]. Except when quoting from the Model Contracts, this article will refer to the CNODC by the name of its parent corporation, the CNPC.

8. See generally Robert C. Goodman, Jr., Offshore Oil Exploration: An Overview of the Legal and Organizational Aspects, E. Asian Executive Rep., May 15, 1984, available in LEXIS, World Library, Allwld File. As with prior offshore contracts, the Model Contracts are designed to fill and explain gaps in the 1993 Regulations. The absence of a complete legal framework for onshore oil development in the 1993 Regulations has necessitated the adoption of such measures. Where the 1993 Regulations and the Model Contracts conflict, however, the formal legal framework of the 1993 Regulations takes precedence. Id.

9. Gao, supra note 5, at 157; Kim Woodard & Bruce Vernor, Petroleum Exploration Update: China's Strategy into the '90s; Part II: Offshore Contracts, Opening the West, E. Asian Executive Rep., Apr. 15, 1989, available in LEXIS, World Library, Allwld File. See also Walter Taylor, U.S. Companies Eye China's Offshore Oil, U.S. News & World Rep., May 30, 1983, available in LEXIS, News Library, Arcnws File. A new model contract has been promulgated for each of the three rounds of onshore bidding conducted by the CNPC since 1993. The first model contract, promulgated in 1993, established a set of contractual provisions that have remained substantially unchanged in subsequent model contracts. Where changes and variations have been made in subsequent model contracts (generally in the form of concessions and improved terms for foreign contractors), the most recent model contract represents CNPC's current negotiating position with respect to such items.

10. See Gao, supra note 5, at 198 (comment by Arco China, Inc. Vice President, D.C. Thost). See also Andrew Browne, Texaco to Boost Oil Output in China, Reuter Asia-Pac. Bus. Rep., Mar. 1, 1995, available in LEXIS, World Library, Allwld File (comment by Texaco Senior Vice President, Peter Bijur, noting that the Chinese attitude toward production sharing is "cooperative" and "reasonable").

combination of (1) the largest proved reserves in East Asia,[11] (2) the existence of new, highly prospective oil fields in northwest China, and (3) a financial structure whose estimated rate of return (22% to 25%) exceeds that of all other major East Asian oil producers except the Philippines[12] appears to confirm the fact that China is currently, in the words of one oil analyst, "the best place in the world for foreign oil companies to be."[13]

Over time, however, industry representatives have begun to question their previously optimistic outlook. Despite the promise of high returns once new oil fields are found and developed, the quality of the exploration blocks offered by the CNPC in the first three rounds of onshore bidding has not lived up to expectations, particularly in the oil-rich territories of northwest China.[14] In the Tarim Basin, for example, the blocks offered in the first two rounds were located in the least attractive, least accessible parts of the Basin. Consequently, only two petroleum contracts and one seismic commitment were signed, despite the fact that over sixty-five foreign companies initially expressed interest in submitting bids.[15] While the third round of bidding has seen some improvement in the quality of the blocks being offered, only four petroleum contracts have been signed at the time of the writing of this article.[16]

11. See Oil and Gas Journal Data Book, Pennwell Publishing Co. 272 (1994) [hereinafter OGJ Data Book].

12. See World Petroleum Arrangements 8-11 (Barrows Co., Inc. 1995) [hereinafter WPA]. Taiwan's rate of return is also higher than China's, but Taiwan's estimated proved reserves of 4 million barrels in 1994 and its estimated daily oil production of 1,100 barrels per day do not make it a helpful basis for comparison with China, Indonesia, Malaysia, the Philippines, or Vietnam (whose estimated proved reserves and estimated daily production range from ten to one-thousand times the size of Taiwan's). Id. at 6; OGJ Data Book, supra note 11, at 272.

13. Gregg Jones, Exxon Signs China Oil Pacts; Deals More Than Triple Territory, Dallas Morning News, Apr. 8, 1995, at 1F

14. Derek Bamber, Late Welcome for Foreign Funds; Petroleum and Gas Exploration in China, Petroleum Economist, June 1994, available in LEXIS, News Library, Curnws File; David Hanna & Winnie Lee, New Tarim Acreage Part of 3rd Round: Possible Reaction to Industry Complaints, Platt's Oilgram News, Jan. 3, 1995, available in LEXIS, News Library, Curnws File.

15. See supra note 14. See also China Legal Perspective, supra note 6.

16. The petroleum contract signed with Texaco and Agip grants exploration rights in a prospective area located southwest of Tazhong-4, the largest oil field discovered to date in the Tarim Basin (over 700 million barrels of confirmed reserves). See P.T Bangsberg, Texaco, Agip Sign Pacts for Chinese Fields, Hous. Chron., Feb. 11, 1996, at 7; Texaco and Agip Sign Tarim Basin Joint Venture Oil Development Contracts, BBC Summary of World Broadcasts, Feb. 13, 1996, available in LEXIS, World Library, Allwld File.

China's tendency to reserve the best acreage for its own national oil company has prompted large Western oil companies to begin lobbying the Chinese government for better opportunities.[17] Others have concluded that there is little room for further foreign participation in onshore oil development in China.[18]

The 1993 Regulations and the Model Contracts reflect China's apparent ambivalence toward inviting foreign corporations to assist it in developing its onshore petroleum resources. On the one hand, China wishes to exploit foreign expertise and advanced technology to help it access crude oil in remote and inhospitable areas.[19] On the other, it wishes to exert a high degree of control over its own resources and over the foreign companies that it permits to enter.[20] Thus, to attract foreign investors, the preceding legal instruments create a relatively favorable financial structure for onshore investment. They also offer limited incentives to foreign contractors with respect to performance of the onshore contract, management of operations, and dispute resolution. However, to maintain Chinese control, the 1993 Regulations and the Model Contracts impose extensive performance requirements and managerial controls over foreign contractors. As will be seen later, these requirements and controls have the potential to be quite burdensome to foreign contractors wishing to invest in onshore petroleum development in China.

Many of the performance requirements and managerial controls contained in the 1993 Regulations and the Model Contracts are not unique to China. Other East Asian countries that use production sharing agreements employ similar contract provisions designed to achieve substantially identical results. However, unlike the financial provisions mentioned in the preceding paragraph, the Chinese performance and management provisions are frequently stricter than those in other East Asian countries and, in some cases, the language contained in the Chinese provisions is unique.

17. See William Mullins, Exxon Pushing China on Tarim Blocks, Platt's Oilgram News, Apr. 27, 1995, available in LEXIS, News Library, Curnws File (comment by Exxon Chairman, Lee Raymond).

18. Jane Macartney, China Reports Record Onshore, Offshore Oil Output, Reuters World Service, Jan. 5, 1996, available in LEXIS, World Library, Allwld File.

19. Robert Tansey, Black Gold Rush: Chinese Petroleum Industry, Chinese Bus. Rev., July 1994, available in LEXIS, World Library, Allwld File; China Pushing Bigger Foreign Role in Onshore Exploration, Oil & Gas J., Oct. 11, 1993, available in LEXIS, News Library, Arcnws File.

20. See Gao, supra note 5, at 156.

Companies planning to participate in future rounds of onshore bidding should take advantage of the fact that, since "[t]he model contract has no formal legislative standing," the CNPC may, depending upon the provision at issue, have some flexibility to negotiate changes in the contract.[21] Under the 1993 Model Contract, foreign contractors may also negotiate amendments or supplements to the contract "in the course of implementation of the Contract."[22] However, significant modifications are subject to approval by the Ministry of Foreign Trade and Economic Cooperation ("MOFTEC").[23] Foreign companies negotiating with the CNPC should prepare to seek changes and/or clarifications in their contractual obligations based on (1) a close reading of the 1993 Regulations and the Model Contracts, (2) an analysis of those provisions of the Model Contracts for which China has shown itself willing to make concessions in the past, and (3) an analysis of comparable but more favorable language contained in other East Asian petroleum contracts.

This article focuses on an examination of the basic provisions of the 1993 Regulations and the 1993 Model Contract. Where relevant, changes appearing in the 1994 and 1995 Model Contracts as well as variant provisions in prior offshore model contracts are also discussed. The purpose of this article is to provide a strategic analysis of China's onshore oil law in order to prepare practitioners for negotiations with the CNPC. Part II of this article focuses on the financial obligations and privileges of foreign contractors under China's onshore oil law and strategies for maximizing their returns. Part III is devoted to a discussion of each party's privileges and obligations with respect to the performance of the contract. Part IV centers on the ability of each contracting party to constrain the actions of the other during the performance of the contract and includes a discussion of contractual provisions relating to oversight, management and dispute resolution. Parts III and IV are each divided into three subsections: Section A of each part describes the

---

21. Id. at 160-61.

22. 1993 Model Contract, supra note 7, art. 27.3.

23. Article 27.3 of the 1993 Model Contract reads as follows: "If in the course of implementation of the Contract, the Parties decide through consultation to make amendment or supplement to any part of the Contract, a written agreement signed by the authorized representatives of the Parties shall be required. Such written agreement shall be subject to the approval of the Ministry of Foreign Trade and Economic Co-operation of the People's Republic of China should there be any significant modifications hereof. Such agreement shall be regarded as an integral part of the Contract." The phrase "significant modifications" is not defined in the 1993 Model Contract.

constraints and obligations that China's onshore oil law places on the foreign contractor; Section B outlines the constraints and obligations placed on the CNPC and its affiliates; and Section C sets forth negotiating strategies for coping with the negative features encountered in Sections A and B. Finally, at the conclusion of the article, I address China's present situation with respect to onshore oil development and discuss future prospects for onshore investment.

II. FINANCIAL PROVISIONS OF CHINA'S ONSHORE OIL LAW

The financial privileges and obligations accruing to foreign contractors under China's onshore oil law are clearly set forth in the 1993 Regulations and the Model Contracts and are relatively well-understood. China's onshore oil law specifies that the ownership of onshore territory in areas such as the Tarim and Junggar Basins remains vested at all times in the People's Republic of China.[24] Any rights acquired by foreigners, either to the resources located in such territories or the proceeds thereof are "purely contractual in nature."[25] More specifically, under the 1993 Regulations, title to oil lands remains with China, while foreign corporations gain limited rights to explore and develop such properties in partnership with the CNPC.[26]

As detailed in the 1993 Regulations and the Model Contracts, foreign contractors pay 100% of exploration costs and bear all risks of non-discovery.[27] If commercial quantities of oil are found, then a foreign contractor may elect to continue as CNPC's co-venturer, paying a share of the costs to develop the new oil field and begin commercial production.[28] In return for helping to explore, develop, and operate the field, a foreign contractor may recover its costs and receive profits "in kind." In other words, the foreign contractor will be entitled to receive specified percentages of the oil produced from that field for a fixed

24. The preamble to the 1993 Model Contract states: "[A]ll Petroleum resources within the limits of national jurisdiction of the People's Republic of China are owned by the People's Republic of China."

25. Gao, supra note 5, at 160-61.

26. 1993 Regulations, supra note 6, arts. 3, 7, 8.

27. Article 12.2.2 of the 1993 Model Contract states: "If no Oil Field and/or Gas Field is discovered within the Contract Area, the exploration costs incurred by the Contractor shall be deemed as its loss. Under no circumstances shall CNODC reimburse the Contractor for such loss." See also 1993 Regulations, supra note 6, art. 13; 1993 Model Contract, supra note 7, art. 2.5; WPA, supra note 12, at 521.

28. 1993 Model Contract, supra note 7, arts. 2.4, 12.

period of time.[29] The foreign contractor's share of cost oil and profit oil may be either exported or sold in the Chinese domestic market, provided such sales are made through the CNPC.[30]

As stated previously, the Chinese fiscal regime is viewed positively in comparison to the regimes of other East Asian countries. However, care must be taken not to place too much emphasis on discrete differences between the financial components that make up these regimes. For example, despite the disparity in tax or royalty rates between China and other East Asian countries, negotiators can often tailor other items like the "x factor" used in the Chinese Model Contracts to achieve financial outcomes similar to those in other countries.[31] With this qualification in mind, the next three sections will discuss the Chinese fiscal regime, comparing it, where appropriate, with prior offshore model contracts and the regimes of four other major East Asian oil producers that use production sharing arrangements: Indonesia, Malaysia, the Philippines, and Vietnam.[32]

A. *Financial Obligations of Foreign Contractors*

Under China's onshore oil law, foreign contractors have six major financial obligations. The foreign contractor must pay the following:

> (1) a signature fee of $1 million (U.S.) upon the signing of an onshore petroleum contract (a cost that cannot be recovered later);[33]

---

29. Id. arts. 12, 13.

30. 1993 Regulations, supra note 6, art. 15; 1993 Model Contract, supra note 7, art. 13.8.

31. See discussion infra section II.B.

32. These four countries have been selected for comparison with China for two reasons. First, all four countries represent petroleum contract regimes located in East Asia. Since competition for direct foreign investment in this sector tends to be regionally focused, it is appropriate to look at countries located near China that possess legal regimes designed to attract foreign investment that could go to China. See WPA, supra note 12, at 5 ("It appears that Governments compete regionally, while oil companies compete globally.").

Second, ranked on a composite basis using an equal weighting of (1) proved reserves as of January 1, 1994, (2) estimated 1993 production, and (3) estimated rates of return, these four countries (along with China) rank the highest among East Asian petroleum contract regimes. Items (1), (2), and (3) are broad measures of a country's investment potential based on: (1) how much petroleum is thought to be present in the subsurface; (2) the actual volume of petroleum currently being produced; and (3) financial returns attainable by foreign contractors investing in future production.

33. 1993 Model Contract, supra note 7, art. 30.5; WPA, supra note 12, at 523.

(2) 100% of exploration costs, with expenditures determined by expected minimum exploration work expenditures negotiated as part of the petroleum contract;[34]

(3) 49% of the costs for developing and operating a new field (unless either the foreign contractor or the CNPC chooses to opt out);[35]

(4) a zero to 12.5% royalty fee, paid in kind out of the total oil produced by the field;[36]

(5) a value added tax (VAT) of 5%, paid in kind from annual gross production;[37] and

(6) a corporate income tax of 33% on production revenues less costs, expenses, and losses.[38]

China has taken a relatively flexible approach in designing these obligations. Regarding Item (1), signature bonuses, the government has permitted contractors signing offshore petroleum contracts to pay the signature bonus in installments: one-quarter when the contract is signed; one-quarter when the contractor decides to enter the second phase of exploration or to evaluate a new discovery; and one-half when an overall development plan is approved.[39] In principle, there is no reason why a similar concession could not be made for onshore petroleum contracts.

---

34. 1993 Model Contract, supra note 7, art. 2.4. Expected minimum exploration expenditures are a key item left open for negotiation between the parties. The 1993 Model Contract permits the parties to negotiate expected minimum exploration expenditures for each phase of exploration. See id. arts. 6.2.1-2.3.

35. Id. arts. 2.4, 11.6.1, 12.1.2.

36. WPA, supra note 12, at 514-15. The operator of the field withholds the royalty oil prior to the sharing of production by the contracting parties and pays the royalty oil directly to the CNPC.

37. Onshore Chinese Second Round Model Contract, art. 13.2.1(a), in WPA, supra note 12, at 522 [hereinafter 1994 Model Contract]. While it is believed that a 5% VAT will be applied to petroleum production, pertinent regulations have not yet been promulgated.

38. WPA, supra note 12, at 514. See generally Gao, supra note 5, at 180-82.

39. Model Offshore Contract of October 1992 for the Fourth Round of Bidding, translated in Asia & Australia — Basic Oil Laws and Concession Contracts (Original Texts), Supplement No. 120 (Barrows Co., Inc. 1994) [hereinafter 1992 Offshore Model Contract]; WPA, supra note 12, at 512. See also Gao, supra note 5, at 160.

As to Item (2), exploration costs, the exploration period is eight-years long and is divided into three phases of four, two, and two years. At the end of each phase, if the foreign contractor has performed its minimum exploration work commitments for the preceding phase(s), it has the right to withdraw from the petroleum contract without further financial obligation.[40]

Regarding Item (3), the equity shares of the foreign contractor and the CNPC are initially set at 49% and 51%, respectively Each partner pays development and operating costs and is entitled to recover costs and receive profits in proportion to its percentage of equity in the new field. After petroleum is discovered, if one of the contracting parties decides that the discovery has commercial value and should be developed but the other disagrees, then the latter partner may opt out of the developing the field.[41] If the foreign contractor chooses not to participate in the development of the new field, then CNPC's equity in the field will rise to 100%. After opting out and prior to the expiration of the development period, however, the foreign contractor may change its mind and participate in the development of the field but must pay a substantial penalty to exercise this privilege.[42]

Alternatively, the CNPC may choose to participate at a level lower than 51%, in which case the foreign contractor's equity will rise to 100% minus the amount of CNPC's reduced share.[43] Unlike the foreign contractor, the CNPC does not have to choose between full and zero percent participation but may choose any level of participation between zero and 51%. If the CNPC chooses to participate at a level lower than 51%, then the foreign contractor's share of development and operating

40. Model Contract of 1995 for the Third Round of Bidding (Summary), in Petroleum Concession Handbook, at 2 (Barrows Co., Inc. 1995) [hereinafter Handbook Summary 1995 Model Contract].

41. The procedure for determining whether a field has commercial value and is worthy of development is set forth in Article 11 of the 1993 and 1994 Model Contracts. The determination of commerciality is discussed at greater length in section III.B below.

42. 1993 Model Contract, supra note 7, arts. 2.4, 11.6.1, 12.1.2. If the foreign contractor initially chooses not to participate in developing the field but later changes its mind prior to the expiration of the development period, then it must pay (1) its unpaid share of development costs (49% of the development costs already expended by the CNPC) with deemed interest thereon, and (2) a penalty fee equivalent to three times the amount paid in (1). Id. art. 11.6.1.

43. The sharp growth in China's domestic demand for crude oil makes it unlikely that the CNPC will wish to forfeit any of the share oil to which it is entitled to receive after commercial production begins. See discussion infra section II.B.

costs will increase proportionately However, the foreign contractor's share of cost recovery and profit oil will also increase.[44]

Regarding Item (4), royalties have been progressive since 1990 to encourage the development of small fields. Royalty percentages are structured on a sliding scale, with one of two different scales applying depending on whether the producing area is in (1) Qinhai Province, Tibet Autonomous Region, Xinjiang Uigur Autonomous Region, or a shallow sea area, or (2) an onshore area other than those listed in (1). In Case (1), a zero percent royalty applies to production volumes less than or equal to 1 million tons annually In Case (2), a zero percent royalty rate applies to production volumes less than or equal to 500,000 tons, and a two percent royalty rate applies to any volume in excess of 500,000 tons through 1 million tons.[45]

For production volumes above 1 million tons, the royalty percentage applicable to each tier of production is identical in Cases (1) and (2): 4% for any volume in excess of 1 million tons through 1.5 million tons; 6% for any volume in excess of 1.5 million tons through 2 million tons; 8% for any volume in excess of 2 million tons through 3 million tons; 10% for any volume in excess of 3 million tons through 4 million tons; and 12.5% for any volume in excess of 4 million tons.[46]

As to Item (6), corporate income tax, domestic enterprises with foreign investment or foreign enterprises with establishments in China pay a national income tax of 30% and a local income tax of 3%. The foreign contractor's taxable income is equal to "the excess of gross amount of revenue in each tax year after deducting costs, expenses and losses."[47] Article 12 of the 1991 Foreign Enterprise Income Tax Implementing Regulations states that foreign contractors involved in cooperative exploitation of petroleum resources "shall be considered as receiving income when they receive their share of crude oil, and the amount of their income shall be computed according to the prices which

44. See discussion infra section II.B.

45. See Amendment to Interim Provisions Concerning the Payment of Royalties for Chinese-Foreign Cooperative Exploitation of Petroleum Resources on Land, at 1-2 (1995).

46. Id. For example, if a well in Xinjiang produces 1.7 million tons of crude oil per year, then the total royalty fee will be the sum of the royalties for each tier: 0%(1 million tons) + 4%(0.5 million tons) + 6%(0.2 million tons) = 32,000 tons. Dividing the total royalty fee by the total production volume yields a composite royalty rate of approximately 1.88%.

47. See Income Tax Law of the People's Republic of China Concerning Enterprises with Foreign Investment and Foreign Enterprises, arts. 4, 5 (Paul Weiss trans., 1991) [hereinafter 1991 Foreign Enterprise Income Tax Law].

are regularly adjusted with reference to the international market prices of crude oil of equal quality."[48]

According to articles 32 and 36 of the 1991 Foreign Enterprise Income Tax Implementing Regulations, the foreign contractor's exploration costs for each field are accumulated and counted as capital expenditures and then depreciated by the composite life method over a period not less than six years from the month following the date that commercial production begins. In accordance with article 4 of the 1991 Foreign Enterprise Income Tax Law, these costs are subtracted from gross income as part of the calculation of the foreign contractor's taxable income for the year.[49]

If operations in a particular contract area are terminated because the foreign contractor has failed to find oil, then reasonable exploration expenses for the old field may be deducted from the production income generated by a new field as long as the petroleum contract for the new area is signed within ten years after the termination of the petroleum contract for the old area. In order to do this, the foreign contractor must submit the expenses incurred in exploring the old area to the relevant tax authorities and obtain a certifying document confirming these expenses.[50]

The foreign contractor's financial obligations are lower in China than in Indonesia, Malaysia, or Vietnam. Indonesia and Vietnam have higher signature fees and higher progressive royalties than China, and all three have higher effective tax rates.[51] In China, the foreign contractor pays only 49% of development and production costs (except in the

48. See Detailed Rules and Regulations on Implementation of Income Tax Law of People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises, art. 12, in China Econ. News Service, Aug. 5, 1991, available in LEXIS, News Library, Txtnws File [hereinafter 1991 Foreign Enterprise Income Tax Implementing Regulations].

49. 1991 Foreign Enterprise Income Tax Law, supra note 47, art. 4; 1991 Foreign Enterprise Income Tax Implementing Regulations, supra note 48, arts. 32, 36.

50. 1991 Foreign Enterprise Income Tax Implementing Regulations, supra note 48, art. 48.

51. Indonesia has signature fees of $1 million to $3 million. Vietnam has signature fees of $5 million to $10 million. WPA, supra note 12, at 780.

Royalties in Indonesia, referred to as "First Tranche" petroleum, may reach as high as 17% (calculated as the Indonesian share of First Tranche petroleum, or 85% x 20%). Id. at 220, 780-81. Vietnam's royalties range from a minimum of 6% to a maximum of 25%. Id. at 737.

In Indonesia, a 35% income tax and a 13% final tax on profits combine for an effective tax rate of 48%. Id. at 220. Malaysia's income tax rate is 40%. Malaysia also imposes two other types of taxes on oil production: an export tax on profit oil and a so-called "excess profits" tax. Id. at 535. No such taxes are levied in China. Vietnam imposes a corporate income tax of 50% as well as a "profits withholding tax" of 10%. Id. at 712, 737.

unlikely event that the CNPC chooses to reduce its 51% equity share), a percentage much lower than in Indonesia, Malaysia, or Vietnam, where the state oil companies in those countries may choose a participation rate between 10% and 20%, leaving the foreign contractor's participation rate, and thus its share of costs, somewhere between 80% and 90%.[52]

Of the four regimes being compared with China, only the Philippines has lighter financial obligations. In the Philippines, the absence of signing bonuses and royalties, combined with a tax exemption for the first five years of production, result in smaller outlays and potentially higher returns for the foreign contractor.[53]

B. Financial Privileges of Foreign Contractors

In exchange for its participation in exploration and development, a foreign contractor is entitled to two categories of compensation paid in kind: (1) a specified share of cost recovery oil; and (2) a specified share of profit oil or "remainder oil."[54] The 1993 Regulations state that China will not appropriate a foreign contractor's share of cost recovery or profit oil except under "special circumstances" in return for "appropriate compensation."[55] "Special circumstances" and "appropriate compensation" are not defined in either the 1993 Regulations or the Model Contracts.

52. Id. at 738, 784. It is important to bear in mind, however, that the foreign contractor will receive a correspondingly lower share of cost recovery oil in China (49% of the cost recovery oil allocated to development and production costs) than in the other four countries to reimburse it for these expenses. See discussion infra section II.B.

53. WPA, supra note 12, at 113, 780-81.

54. 1993 Model Contract, supra note 7, arts. 12.2.2-.2.3, 13.2.2-.2.4. See also Handbook Summary 1995 Contract, supra note 40, at 8-10; Gao, supra note 5, at 172-76. The quantity of oil to be used for in-kind reimbursement of costs is determined by taking the amount to be reimbursed and dividing that sum by the crude oil price per unit of volume. The crude oil price is determined each quarter by agreement between the parties. If the parties cannot agree on a price, then the price is calculated in accordance with article 14 of the 1993 Model Contract. Article 14 sets forth alternative methods for calculating the price of oil, using (1) the parties' previous course of dealings and/or (2) a basket of prices from the world markets. See 1993 Model Contract, supra note 7, art. 14.4.

55. Regulations of the People's Republic of China Concerning the Exploitation of On-Shore Petroleum Resources in Cooperation with Foreign Enterprises, art. 5 (Baker & McKenzie trans., 1993). While the translation of this provision published by Barrows does not state that the foreign contractor is entitled to receive "appropriate compensation," an unofficial translation of the 1993 Regulations made by Baker & McKenzie as well as several independent translations based on the original Chinese text of the 1993 Regulations confirm the existence of the foreign contractor's right to such compensation.

To reimburse the foreign contractor and the CNPC for exploration and development costs, 60% of annual gross production is set aside for cost recovery until these costs are fully paid.[56] Cost recovery oil goes to defray operating costs. Any excess oil is then used to reimburse exploration costs. After exploration costs have been fully recovered, any oil in excess of operating costs is used to reimburse development costs.[57] Oil for operating cost recovery and development cost recovery is split between the parties according to their respective equity shares; thus, the foreign contractor generally receives 49% of the oil allocated to operating and development costs. However, since the foreign contractor pays 100% of exploration costs, it receives 100% of the cost recovery oil allocated to exploration.[58]

Oil left over after taxes, royalties, and cost recovery oil have been paid is designated "remainder oil."[59] Before recovery of exploration and development costs has been completed, remainder oil will constitute 22.5% to 35% of total production.[60] After recovery of exploration and development costs, remainder oil will constitute approximately 62.5% to 75% of total production (assuming ongoing operating costs of 20%).[61]

Using percentages negotiated as part of the original petroleum contract ("x factors"), remainder oil is divided into "allocable remainder oil" (remainder oil multiplied by x) and "share oil" (remainder oil multiplied by 100-x). The allocable remainder oil is split between the parties according to their respective equity shares (49% to the foreign contractor, 51% to the CNPC). The share oil goes to the Chinese government.[62]

X factors are negotiated on a sliding scale to ensure that, as field production increases, a larger amount of share oil is allocated to the Chinese government.[63] Thus, high production volumes reduce the

56. 1993 Model Contract, supra note 7, art. 13.2.2.

57 Id.

58. Id. arts. 12.2.1, 13.2.2.2.

59. Id. art. 13.

60. Gao, supra note 5, at 174. This arrangement ensures that the Chinese government and the CNPC will receive a share of profits as soon as field production begins.

61. Id.

62. Handbook Summary 1995 Model Contract, supra note 40, at 9-10; 1993 Model Contract, supra note 7, art. 13.2.3; Gao, supra note 5, at 174.

63. 1993 Model Contract, supra note 7, art. 13.2.3. X factors are nothing more than a sliding scale of percentages, ranging from a high value for low production volumes to a low value for high production volumes. A typical petroleum contract contains eight x factors for the following tiers of production: less than or equal to 0.5 million metric tons of crude oil; above 0.5 million through

percentage of remainder oil that goes to the foreign contractor. On the other hand, low production volumes decrease the percentage of remainder oil that goes to the Chinese government. With respect to offshore petroleum contracts, the Chinese government reportedly has been willing to forfeit its share oil (the Chinese government's portion of the remainder oil) if production is less than 7.33 million barrels per year.[64]

The 1993 Model Contract sets aside a high share of gross production for cost recovery (60%) in comparison to the Chinese offshore contract (50% to 62.5%) and the onshore contracts of Malaysia and Vietnam (50% and 35% to 40%, respectively).[65] Although the Chinese shares are not the highest among petroleum contract countries (the levels set aside in Indonesia and the Philippines both begin at 80% in the first year of production),[66] they still permit rapid recovery of exploration and development costs and, as a result, swift progress to higher rates of return.

Since x factors are kept secret and vary from contract to contract, it is difficult to determine how the foreign contractor's share of remainder oil in China compares to the foreign contractor's share in other countries. If, as one commentator suggests in the context of

---

1 million metric tons; above 1 million through 2 million metric tons; above 2 million through 3 million metric tons; above 3 million through 5 million metric tons; above 5 million through 7.5 million metric tons; above 7.5 million through 10 million metric tons; and above 10 million metric tons of crude oil. Id.

If production exceeds the level to which the first x factor applies, then a second, lower x factor will apply to the excess amount of production. If production exceeds the level to which the first and second x factors apply, then a third, even lower x factor will apply to the excess — and on up the scale. This means that, when production volume is low, the joint venture will receive a higher percentage of the remainder oil. When production volume is high, the joint venture will receive a lower average percentage of the remainder oil, depending on how many x factors have been triggered.

In practice, the composite x factor used in a particular case will be the weighted average of one or more of the x factors listed in the original contract. Each x factor is weighted by production volume in the tier of production to which that x factor applies. The 1993 Model Contract furnishes the following sample calculation. Assuming a petroleum contract with x factors of x1 through x8 and total field production of 2.4 million tons, the composite x factor should be calculated as follows: composite x = [x1(0.5 million tons) + x2(0.5 million tons) + x3(1 million tons) + x4(0.4 million tons)] / 2.4 million tons. The numerator of this fraction is the "allocable remainder oil," the amount that goes to the joint venture (in millions of tons). The denominator is the total amount of oil produced by the field. To obtain a percentage figure for the amount of oil that goes to the joint venture, the fraction is simply multiplied by 100. See id.

64. Gao, supra note 5, at 175.

65. Id., WPA, supra note 12, at 525, 534, 712, 773, 779.

66. WPA, supra note 12, at 113, 779.

offshore contracts, we assume that a foreign contractor receives approximately 25% to 27.5% of the remainder oil (that is, the CNPC receives 26% to 28.5%, and the Chinese government receives 44% to 49%),[67] then the foreign contractor will receive a somewhat smaller percentage of the remainder oil than in Malaysia and the Philippines.[68]

However, it is best to think of the x factor as a negotiable variable. The x factor may be used to enhance or compensate for other differences among the financial structures of different countries. But, since the value of the x factor is not fixed prior to negotiations, historical x factors, even if they were known, would not always provide a reliable basis for comparison with other onshore regimes.

C. *Financial Strategies for Foreign Contractors*

When negotiating the petroleum contract, the foreign contractor should attempt to lower its front-end costs, including (1) the signature fee and (2) minimum exploration work expenditures. With respect to the signature fee, a negotiator should look for the installment feature already used in offshore contracts in which one-quarter of the signature fee is paid when the contract is signed, one-quarter when the contractor enters the second phase of exploration or decides to evaluate a new discovery, and one-half when an overall development program is approved.

Minimum exploration work expenditures will be negotiated simultaneously with minimum exploration work commitments.[69] The foreign contractor should argue that it is not necessary to set expensive minimum exploration work expenditures as long as minimum exploration work commitments are clearly specified in the petroleum contract.

---

67. These percentages are calculated as follows. The CNPC and the foreign contractor receive remainder oil in the proportion of 51% to 49%, respectively. Thus, if the foreign contractor receives 25% to 27.5% of the remainder oil, then the CNPC receives 26% (25% x (51/49)) to 28.5% (27.5% x (51/49)) of the remainder oil. Deducting the shares of the foreign contractor and the CNPC from 100% results in the Chinese government receiving "share oil" of 44% (100%-27.5%-28.5%) to 49% (100%-25%-26%).

68. See Gao, supra note 5, at 177 (citing G.C.L. Jones, F.A. Jacobs & Chin Heng Toh, The Economics of Marginal Offshore Oil Discoveries in China, Oil & Gas J., Mar. 12, 1984, available in LEXIS, News Library, Arcnws File); WPA, supra note 12, at 114, 534, 773. In practice, since composite x factors are a weighted average of the x factors listed in the petroleum contract, the composite x factor, depending on the total volume of production, will vary significantly from the 25% to 27.5% average postulated above.

69. See discussion infra section III.A.

When negotiating the petroleum contract, foreign contractors should also seek to maximize the x factor (that is, to increase the amount of remainder oil allocated to the joint venture). As mentioned previously, the Chinese government has already shown discretion in waiving its share oil for small or marginal offshore fields. Similar concessions should be sought for onshore contracts.

After commercial quantities of oil are found, the foreign contractor should attempt to persuade the CNPC to reduce voluntarily its equity in the new field. Reducing its equity would enable the CNPC to reduce its outlay for development and operating costs while permitting the foreign contractor to receive a higher share of remainder oil. China's burgeoning domestic demand, however, makes it unlikely that the CNPC will wish to forfeit any of the share oil which it is entitled to receive after commercial production begins.

III. Contract Performance Under China's Onshore Oil Law

The 1993 Regulations and the Model Contracts contain detailed requirements with respect to logistical support and other forms of assistance that each party must provide to the other in performing the onshore petroleum contract. Because these requirements are meant, primarily, to benefit China's domestic petroleum industry, they impose significant and sometimes heavy burdens on the foreign contractor.

China's need for foreign assistance in developing its onshore oil resources is a relatively recent phenomenon. China lost its petroleum self-sufficiency between 1992 and 1993. In 1992, China became a net importer of refined products.[70] That same year, crude oil imports rose 90%.[71] In 1993, China's overall oil imports exceeded exports for the first time in almost thirty years. Crude oil exports fell 60% while imports of crude and refined products increased nearly 38% and 100%, respectively.[72] Without new domestic sources of oil, the shortfall in domestic production is projected to continue, rising from a current deficit

70. China's Refiners Face Massive Overhaul, Expansion to Meet Demand Growth, New Crude Slate, Oil & Gas J., May 9, 1994, available in LEXIS, News Library, Arcnws File.

71. China Joins List of Net Oil Importers, Oil & Gas J., Feb. 28, 1994, available in LEXIS, News Library, Arcnws File.

72. Id.

of 600,000 barrels per day, to more than 1 million barrels per day by the year 2000, and nearly 3 million barrels per day by the year 2010.[73]

The 1993 Regulations and the Model Contracts reflect China's desire to acquire foreign expertise and technology for future exploration and development of its onshore oil resources. In the early 1990's, at approximately the same time that China's onshore oil law was being drafted, China had fewer exploratory wells per basin of reserves than other producers, and Chinese find rates, per kilometer of seismic survey and per meter of wildcat drilling, were lower than those of any other major oil-producing country.[74] To remedy such deficiencies, the onshore oil law contains provisions designed to speed up exploration, support and enhance the capabilities of China's domestic petroleum producers, and ensure a stable supply of oil for the Chinese domestic market. In return for promising to fulfill these obligations, the foreign contractor has the privilege of entering Chinese territory to find and extract oil and is permitted either to transport its share oil out of the country or to sell it to the CNPC.

A. *Performance Obligations of Foreign Contractors*

With certain limitations enumerated in greater detail below, a foreign contractor has five major performance obligations under the 1993 Regulations and the Model Contracts:

> (1) Minimum exploration work commitment — During the exploration period, the foreign contractor must fulfill minimum exploration work commitments negotiated as part of the petroleum contract.[75]

73. See Kent E. Calder, Asia's Empty Tank, Foreign Affairs, Mar./Apr. 1996, available in LEXIS, News Library, Curnws File. Regarding the latter figure of 3 million barrels per day, Calder comments as follows: "That huge total — nearly half Saudi Arabia's current production — would represent almost 20 percent of Asia's oil imports." Id. See also Derek Bamber, Late Welcome for Foreign Funds; Petroleum and Gas Exploration in China, Petroleum Economist, June 1994, available in LEXIS, News Library, Curnws File.

74. See China Stepping Up Foreign E&P Investment as Oil Imports Soar, Oil & Gas J., May 9, 1994, available in LEXIS, News Library, Curnws File.

75. See 1993 Model Contract, supra note 7, art. 6.2.

(2) Relinquishment — During the exploration period, the foreign contractor must relinquish specified percentages of the contract area back to China.[76]

(3) Share requisition — The foreign contractor must surrender its share of production to the CNPC upon request, but only under "special circumstances" in return for "appropriate compensation."[77]

(4) Local preference — The foreign contractor must give preference to Chinese employees and vendors in its hiring and purchasing decisions.[78]

(5) Training and technology transfer — The foreign contractor must train Chinese personnel and transfer foreign technology to China, including patented and proprietary technology The 1993 Model Contract, however, imposes a ceiling of $250,000 on the foreign contractor's annual costs for training and technology transfer.[79]

(6) Surrender provisions — At specified times during the term of the contract and upon its expiration, the foreign contractor must surrender assets, operations, production facilities, and land associated with the contract to China.[80]

Item (1), the minimum exploration work commitment, is a key obligation left open for negotiation between the parties. The 1993 Model Contract permits the parties to negotiate (1) the total length of seismic lines to be completed during each phase of the exploration period and (2) the number and total depth of wildcat wells to be drilled during each phase.[81] Wildcat wells that fail to meet their predetermined geological objective will not fulfill the negotiated well commitment unless the

76. See Handbook Summary 1995 Model Contract, supra note 40, at 2-3.

77. Regulations of the People's Republic of China Concerning the Exploitation of On-Shore Petroleum Resources in Cooperation with Foreign Enterprises, art. 5 (Baker & McKenzie trans., 1993). See discussion supra note 55.

78. 1993 Regulations, supra note 6, art. 22; 1993 Model Contract, supra note 7, arts. 15.1-.2.

79. 1993 Model Contract, supra note 7, arts. 16, 16.7, annex 4, arts. 2, 4.

80. Id. art. 17.1.

81. See id. arts. 6.2.1-.2.3.

foreign contractor obtains CNPC's consent.[82] If the foreign contractor does not obtain CNPC's consent, then it will be required to drill a substitute well at its own expense.[83] In addition, the first wildcat well to be drilled must meet certain depth requirements specified by the Model Contract.[84]

Item (2), the "relinquishment requirement," obligates the foreign contractor to withdraw from a specified percentage of the contract area in three phases during the eight-year exploration period: 40% of the contract area at the end of the first four years; 25% of the remaining contract area (after deducting the area relinquished in the first phase of exploration and areas chosen for development and/or production, if any) at the end of the first six years; and any remaining undeveloped area at the end of the full eight-year period.[85] The relinquishment provision requires the foreign contractor to decide which portions of the exploration block it is ready to give up and which it wishes to retain for further investigation.[86]

The time limits in the Chinese relinquishment provision force the foreign contractor to complete its survey rapidly The larger the exploration block, the faster a foreign contractor will have to deploy its technology to cover it. The rapidity of relinquishment works to China's advantage in the northwest, where tracts are larger and less accessible than elsewhere in China, and foreign contractors are under correspondingly greater pressure to mobilize their resources quickly

Item (3) requires the foreign contractor, upon request, to surrender its share of production from a field developed by the joint venture, but only under "special circumstances" and in return for "appropriate compensation."[87] "Special circumstances" and "appropriate compensation" are not defined anywhere in the 1993 Regulations or the Model Contracts. If the Chinese government wished to requisition the foreign contractor's share, then it is unclear when or how it would proceed and whether it would provide compensation at world market

82. Id. art. 6.2.5.

83. Id.

84. See id. arts. 6.2.5, 6.3.

85. See Handbook Summary 1995 Model Contract, at 2-3. "Relinquishment" means the periodic surrender of acreage in an exploration block back to the host country. Relinquishment provisions are a standard feature of petroleum contracts in other oil-producing countries.

86. 1993 Model Contract, supra note 7, art. 5.3.

87. 1993 Regulations, supra note 6, art. 5.

prices.[88] The quoted limitations on the government's ability to requisition oil may be weaker than they appear, particularly if China's growing oil deficit begins to be viewed as a "special circumstance." Nevertheless, China presumably anticipates the chilling effect that such share requisition could have on international investment and is unlikely to assert this right unless strong internal political or economic forces compel it to do so.

Items (4), (5), and (6) comprise a number of lengthy provisions and are major concerns of the 1993 Regulations and the Model Contracts. Item (4), the local preference clauses, can be divided into two subparts: (1) preference for Chinese employees; and (2) preference for Chinese vendors when purchasing machinery and raw materials, leasing equipment, or entering into subcontracts.[89] The first preference obligates the foreign contractor to employ "competent Chinese personnel" or "those who have become qualified" after participating in training programs provided by the contractor.[90] The second obligates the contractor to make its purchases from Chinese vendors either "when terms and conditions are identical on both domestic and international markets" (the 1993 Regulations) or "provided that they are competitive in terms of price, quality and term of delivery" (the 1993 Model Contract).[91] The terms "competent," "identical," and "competitive" are not defined anywhere in the 1993 Regulations or the Model Contracts.

Since the foreign contractor must inform the CNPC of all of its personnel and procurement needs,[92] the CNPC has an early opportunity to search for local employees, goods, and services to provide to the foreign contractor. The foreign contractor will find it difficult to reject what the CNPC offers unless it can show that the prospective employees are not competent or that the proffered goods and services are not competitive internationally in price, quality, or terms of delivery Disputes may arise over the definitions of "competent," "identical," and "competitive." Foreign contractors will have more discretion to refuse

88. The 1982 Offshore Regulations do not contain any analogous provision. Regulations of the PRC on the Exploration of Offshore Petroleum Resources, translated in Asia & Australia — Basic Oil Laws and Concession Contracts (Original Texts), Supplement No. 74, at 1 (Barrows Co., Inc. 1982) [hereinafter 1982 Offshore Regulations]. Similarly, the 1992 Offshore Model Contract does not mention share requisition nor does it define the terminology quoted above. See 1992 Offshore Model Contract, supra note 39, at 1.

89. 1993 Regulations, supra note 6, art. 22; 1993 Model Contract, supra note 7, arts. 15.1-.2.

90. 1993 Model Contract, supra note 7, art. 15.2.

91. 1993 Regulations, supra note 6, art. 22; 1993 Model Contract, supra note 7, art. 15.1.

92. 1993 Model Contract, supra note 7, arts. 7.6.1, 15.2.

Chinese goods and services if they are required to be identical to what is available in world markets. Conversely, the CNPC may have an advantage if such goods and services only need to be competitive. Since the 1993 Regulations carry greater force of law than the Model Contracts, the foreign contractor should argue that any inconsistency be resolved in favor of the 1993 Regulations.

In the past, the high cost of Chinese personnel has troubled foreign contractors signing offshore petroleum contracts. However, since then, personnel costs have been reduced significantly for onshore contracts.[93] The highest executive salary in the 1993 Model Contract (for a senior Chinese representative to the Joint Management Committee) is $43,200 per year. A "Level Three" worker (the highest classification for an ordinary laborer) earns, at most, $11,400 per year.[94] A provision in the 1993 Model Contract mandating international bidding has helped implement the "competitiveness" requirement for local purchases of goods and services; Chinese suppliers must now compete internationally on a level playing field.[95] The Joint Management Committee ("JMC") must approve the procurement of any budget item with a unit price exceeding $500,000 as well as any single purchase order with a total value exceeding $2 million.[96] Nevertheless, the 1993 Model Contract gives the CNPC procurement representative a significant role in the evaluation of international bids and, in consultation with the foreign contractor, some ability to influence the choice of vendor.[97]

Item (5), the training and technology transfer obligation, requires the foreign contractor to train Chinese personnel and transfer its technology and managerial expertise to the CNPC. The goal of such training and technology transfer is to enable the CNPC to take over production operations and to undertake full responsibility for the new field.[98]

---

93. Gao, supra note 5, at 183.

94. See 1993 Model Contract, supra note 7, annex 3, art. 5.

95. See id. art. 7.6.3.

96. See id. art. 7.2.4.

97 1993 Model Contract, supra note 7, arts. 7.6.1-.6.5. See discussion infra section IV.A. The CNPC procurement representatives have the right "to take part in evaluation of bids" and "to consult with the Operator the determination of award of contracts and to participate in negotiations for subcontracts and services contracts." 1993 Model Contract, supra note 7, art. 7.6.4.

98. Article 2.3 of the 1993 Model Contract establishes this goal as one of the primary objectives of the petroleum contract: "During the performance of the Petroleum Operations, the Contractor shall transfer its technology to the Chinese Personnel and train them in accordance with Article 16 hereof and Annex IV — Training of Chinese Personnel and Transfer of Technology

A controversial component of this obligation is the requirement that patented and proprietary technology also be transferred. In 1988, the China National Offshore Oil Corporation ("CNOOC") loosened this requirement for offshore contracts by making it operate only after exploration has been completed (at the time of the approval of the overall development plan).[99] The CNOOC also deleted an annex to the offshore model contract detailing the content of the requirement. The CNOOC stated that, henceforward, arrangements for training and technology transfer would be determined by consultation between the parties.[100]

Another potentially burdensome aspect of the training and technology transfer obligation is the requirement that the parties to the contract conduct "scientific and technical cooperation and academic exchange in connection with the Petroleum Operations."[101] The exact parameters of such cooperation and academic exchange are not specified in the Model Contracts. The 1993 Onshore Model Contract imposes a ceiling of $250,000 on the foreign contractor's total annual costs for training and technology transfer unless otherwise agreed by the parties.[102]

Under the 1993 Model Contract, the foreign contractor may negotiate royalties with the CNPC and require the CNPC to pay for the privilege of using patented or proprietary technology after the CNPC takes over the field. Annex 4 of the 1993 Model Contract, which exempts the CNPC from having to pay royalties for the use of patented or proprietary technology "[i]n the course of such training or transfer of technology" (i.e. prior to the time the CNPC takes full control of operations), implies that the CNPC will be obligated to pay royalties after it takes over the field — if royalties have been negotiated as part of the initial petroleum contract.[103] According to the 1991 Foreign Enterprise Income Tax Law and the 1991 Foreign Enterprise Income Tax Implementing Regulations, the foreign contractor may be eligible to

hereto in order to enable CNODC to take over the Production Operations of any Oil Field in accordance with Article 8.8 hereof." See also id. arts. 16, 16.7, annex 4, arts. 2, 4. This transfer of responsibility may take place, at the CNPC's discretion, any time after the completion of cost recovery. See discussion infra section III.A.

99. WPA, supra note 12, at 513.

100. Gao, supra note 5, at 186; WPA, supra note 12, at 513.

101. 1993 Model Contract, supra note 7, art. 16.5.

102. Id. art. 16.7.

103. Id. annex 4, art. 2.1.

obtain a reduction in or an exemption from income tax for royalty payments received in exchange for the use of its petroleum technology.[104]

Item (6), the surrender provisions, can be divided into three subcategories. First, article 17 of the 1993 Model Contract states that, upon full recovery of development costs or at the end of the production period, whichever comes first, the ownership of all assets that the foreign contractor has purchased, installed, and constructed under the work program (except equipment and facilities belonging to third parties that are either leased or temporarily brought into the PRC) passes to the CNPC.[105] Although title passes to the CNPC, the foreign contractor, during the production period, retains the right to use the surrendered assets free of charge while it is the operator of the field.[106]

Second, article 8 of the 1993 Model Contract permits the CNPC, after development costs have been fully recovered, to take over production operations unilaterally at any time.[107] At CNPC's request,

---

104. Article 19 of the 1991 Foreign Enterprise Income Tax Law provides for a reduction of income tax on royalty payments of this type to 10% or, under special circumstances, to zero percent: "Fees for the use of proprietary rights received from the provision of proprietary technology for ... the development of the energy and communications industries ... may, upon approval by the departments in charge of taxation of the State Council, have income tax imposed at a reduced rate of 10 percent. In cases where the technology is advanced or the terms preferential, exemption from income tax may be granted." The 1991 Foreign Enterprise Income Tax Implementing Regulations makes clear that the above-quoted provision applies to "[r]oyalties obtained from the provision of proprietary technology for the exploitation of energy resources ...." See 1991 Foreign Enterprise Income Tax Law, supra note 47, art. 19, sec. 3, cl. 4; 1991 Foreign Enterprise Income Tax Implementing Regulations, supra note 48, art. 66(3).

105. The provision excepting leased equipment and equipment temporarily brought into the PRC reads as follows: "Equipment and facilities which are owned by a Third Party and are either leased by the Operator or temporarily brought into the territory of the People's Republic of China for the performance of the Petroleum Operations shall not be deemed as assets owned by CNODC. Such equipment and facilities may be exported from the People's Republic of China, but, CNODC shall assist in handling export formalities." 1993 Model Contract, supra note 7, art. 17.2.

106. Id. art. 17.1. These provisions differ from, but are not inconsistent with, their counterpart in the 1993 Regulations. Article 20 of the 1993 Regulations states that, after ownership of assets has vested in the CNPC, "[t]he foreign contractor is entitled to the use of these assets during the entire length of the contract period." 1993 Regulations, supra note 6, art. 20.

107. 1993 Model Contract, supra note 7, art. 8.8. Article 8 sets forth detailed procedures for the transfer of production operations. The process is designed to take approximately one year (up to 360 days) from the time the CNPC first provides the foreign contractor with written notice of its intent to take over production operations. Id. arts. 8.8.1-.8.3. Before development costs have been recovered, the CNPC may assume control over production operations only if (1) the JMC agrees and (2) "conditions permit." Id. The 1993 Model Contract does not define the phrase "conditions permit" quoted above. See also id. arts. 7.1.1, 7.3. After development costs have been recovered, the CNPC is no longer required to satisfy conditions (1) and (2).

the foreign contractor must surrender the management of day-to-day operations but retains the right to its 49% share of allocable remainder oil.[108] Since, after such surrender, the CNPC becomes the "operator" of the field, the foreign contractor loses the right to use assets that it previously surrendered ownership of under article 17

Third, article 4 of the 1993 Model Contract requires that, at the end of the production period (lasting fifteen years from the date of commencement of commercial production but, under special circumstances, extendable to thirty years from the first day of the month following the month in which the foreign contractor receives notice of approval of the petroleum contract by MOFTEC), all land and production facilities revert to China.[109] At this point, all remaining land and assets in the production area, except leased and temporarily imported items covered by article 17, are surrendered to China.

The Chinese performance obligations do not compare as favorably with other East Asian petroleum contract regimes as the financial obligations and incentives described in Section II.A. Overall, China is not clearly superior to any of the four comparison countries and possesses shortcomings in certain key areas.

The foreign contractor's only other procedural argument against the CNPC taking over production operations would be if the CNPC failed to provide the foreign contractor with written notice of its intentions—an unlikely scenario. See id. art. 8.8. The 1992 Offshore Model Contract grants the CNOOC a similar right to take over production operations after the recovery of development costs. See 1992 Offshore Model Contract, supra note 39, art. 8.8.

108. For further discussion of the structure and management functions of the JMC prior to such a takeover, see discussion infra sections IV.A and IV.B. It is unclear whether the foreign partner retains representation on the JMC after it surrenders control over production operations. However, an analogous provision in article 11 of the 1993 Model Contract supports the argument that the foreign contractor should retain its representation on the JMC.

Article 11 of the 1993 Model Contract states that, even if a foreign partner chooses not to participate in financing the development of a new field, the foreign contractor, subject to CNPC's consent, may still participate in making development and production decisions relating to the new field. 1993 Model Contract, supra note 7, art. 11.6.3 ("Unless otherwise decided by CNODC, the Development Operations and Production Operations of an Oil Field solely financed for development by CNODC shall still be upon agreement between the Parties through consultation performed by the Operator subject to terms and conditions agreed between CNODC and the Operator.").

Since, under article 11.6.3, "consultation" with the foreign contractor occurs when the CNPC is the sole developer and operator of a field, there does not appear to be any basis for restricting consultation when the CNPC becomes the operator of a field previously operated by the foreign contractor. The foreign contractor should attempt to negotiate a provision similar to article 11.6.3 that protects its right to participate in JMC decisionmaking after the CNPC takes over production operations.

109. Id. arts. 4.5, 4.7. See also id. art. 1.44.

China presently requires foreign contractors to relinquish 40% of the contract area at the end of the first four years of the exploration period followed by 25% of the remaining contract area at the end of the next two years. While this percentage is superior to the original 1993 Model Contract (40% relinquishment at the end of the first three years followed by 50% of the remaining contract area at the end of the next three), China's relinquishment requirement is still more stringent than those of Indonesia (50% in the first six years) and the Philippines (25% in the first five years).[110]

As previously discussed, China's requirement that the foreign contractor give up its share of production under "special circumstances" and for "appropriate compensation" is problematic due to the lack of guidance as to what kind of "special circumstances" would justify such a taking or how "appropriate compensation" may be measured. Despite its potential severity, however, the Chinese provision regarding the requisition of the foreign contractor's share is superior to Indonesia's. Indonesia requires the foreign contractor to sell part of its share (up to 25% of total production) to Pertamina upon request. If more than five years have elapsed since production began, then the contractor must make these sales at a fraction of fair market value.[111] China may also be superior to Vietnam and the Philippines, which, like Indonesia, do not limit the foreign contractor's obligation to sell to the domestic market to "special circumstances."[112] The Philippines, however, does protect the foreign contractor by promising to pay market price for the foreigner's share.[113] The Philippine provision thus goes further than China in defining the compensation that the foreign contractor will receive if its share is requisitioned.

Due to the complexity of procuring Chinese workers, goods, and services through the CNPC, China's local preference requirements are more burdensome than those of the other four countries. In the Philippines, the foreign contractor only needs to hire qualified personnel in the municipality where oil operations are located; Vietnam merely demands priority for domestic employees "wherever possible."[114] As to local preference for goods and services, China may be better than

110. Id. arts. 5.1.1-.1.3; WPA, supra note 12, at 112, 250.
111. WPA, supra note 12, at 219.
112. Id. at 137-38, 754.
113. Id. at 137-38.
114. Id. at 137, 737.

Vietnam and Malaysia, neither of which limit local preference to "identical" or "competitive" goods, but is inferior to the Philippines, which imposes no local preference requirement for goods and services.[115]

Regarding training and technology transfer, China's $250,000 cap on annual expenditures for such training and transfer limits the foreign contractor's costs in a way that the other four countries do not. Since overall investment by the foreign contractor is likely to be large in comparison to this figure, the Chinese provision represents a relatively generous concession. The Chinese Model Contracts, however, require the transfer of patented and proprietary technology and contain detailed lists of the fields of specialization in which the contractor must train and transfer technology[116] While the other four countries impose the same general training obligations in order to enable the domestic oil industry to acquire the skills needed to take over operations, China's requirements are more extensive in their magnitude and depth.[117]

In comparison to other countries, China's surrender provisions are in the middle of the pack. Asset surrender under the Chinese provision, where title passes upon completion of cost recovery, is superior to the asset surrender provisions of Indonesia and Malaysia, where title passes as soon as the contractor (1) imports or (2) purchases the goods, respectively[118] In contrast, China's provision is inferior to Vietnam's, which permits the contractor to reexport any equipment that is not permanently installed.[119]

Finally, in China, after completion of cost recovery, the CNPC possesses the unilateral right to take over all production operations. None of the other four countries reserves such a privilege prior to the expiration of the contract. When the contract period comes to an end, however, China closely resembles the other four comparison regimes: at this point, all remaining land and assets not reexportable under article 17 of the 1993 Model Contract revert to the State.

---

115. Id. at 137, 540, 737.

116. See 1993 Model Contract, supra note 7, annex 4, arts. 4.1, 4.3. Fields of specialization include such areas as petroleum geology, field development, engineering project management, oil and gas recovery technology, drilling, economics, finance, safety, and environmental protection. Id.

117. Gao, supra note 5, at 184; WPA, supra note 12, at 114, 221, 239, 541.

118. WPA, supra note 12, at 238, 540.

119. Id. at 738.

B. *Performance Privileges of Foreign Contractors*

To maximize financial returns on its capital investment, the foreign contractor is entitled to take an active role in:

(1) Exploration — The eight-year exploration period is designed to encourage rapid exploration by foreign contractors.[120]

(2) Appraisal — The Model Contracts do not specify a time period for the appraisal of potential commercial discoveries. However, the foreign contractor must include a proposed timetable for appraisal operations in an appraisal Work Program submitted to the JMC. If the JMC approves the appraisal Work Program, then the foreign contractor must complete its work within the proposed time period.[121]

(3) Development of new fields — If the Overall Development Program is approved, then the foreign contractor must initiate development operations within ninety days. If development operations are not initiated with ninety days, then the CNPC has the right to request that the foreign contractor resume development operations within a specified period of time or forfeit its right to the field.[122] The development period lasts as long as is required to carry out the development operations set forth in the approved Overall Development Program.[123]

(4) Production of crude oil — The commercial production period is limited to fifteen years from the date that commercial production commences unless the foreign contractor obtains an extension from the Petroleum Industry Administration

120. See Handbook Summary 1995 Model Contract, supra note 40, at 2; 1993 Model Contract, supra note 7, art. 4.2.

121. See 1993 Model Contract, supra note 7, art. 11.

122. Id. art. 11.4.

123. Id. art. 4.4. See also id. art. 1.10; WPA, supra note 12, at 521.

("PIA").[124] The total contract term is limited to thirty years from the date when the petroleum contract was first implemented.[125]

(5) Domestic sales — The foreign contractor may either transport its share oil abroad or sell it to the CNPC for domestic distribution.[126]

(6) Assistance provided by the CNPC — The foreign contractor is entitled to receive assistance from the CNPC with obtaining office space, procuring local goods and services, banking approvals, foreign exchange, and other related formalities and logistical matters.[127]

As described under Item (1), the onshore exploration period in the 1995 Model Contract is eight years, one year longer than the 1994 Model Contract and identical in length to the original 1993 Model Contract.[128] The relative brevity of this period is designed to encourage rapid exploration by foreign contractors.

Regarding Item (2), the Model Contracts do not specify a time period for the appraisal of a potential commercial discovery Appraisal operations must be carried out in accordance with a timetable set forth in an appraisal Work Program submitted to and approved by the

124. 1993 Model Contract, supra note 7, art. 4.5. Article 1.43 of the 1993 Model Contract states that the Petroleum Industry Administration is "a government authority designated by the State Council to be responsible for administration of the Petroleum Industry of the PRC."

125. Article 4.7 of the 1993 Model Contract states: "The term of the Contract shall not go beyond thirty (30) consecutive Contract Years from the Date of Commencement of the Implementation of the Contract, unless otherwise stipulated hereunder." Article 1.44 of the 1993 Model Contract defines the "Date of Commencement of the Implementation of the Contract" as "the first day of the month following the month in which the Contractor has received the notification from CNODC of the approval of the Contract by the Ministry of Foreign Trade and Economic Co-operation of the People's Republic of China." Unless the exploration and development periods are extremely short, the production period, even if it is extended, is unlikely to exceed twenty-five years.

126. 1993 Regulations, supra note 6, art. 15; 1993 Model Contract, supra note 7, art. 13.8.

127. 1993 Model Contract, supra note 7, art. 9.

128. Handbook Summary 1995 Model Contract, supra note 40, at 2; 1993 Model Contract, supra note 7, art 4.2; WPA, supra note 12, at 521 (citing article 4.2 of the 1994 Model Contract).

JMC.[129] The foreign contractor, with the consent of the CNPC, may extend the exploration period for whatever "reasonable" period of time the CNPC agrees is necessary to complete the appraisal process.[130] At the conclusion of the appraisal period, the foreign contractor must submit an appraisal report to the JMC.[131] If the foreign contractor and/or the JMC determines that the discovery has commercial value and should be developed, then the JMC must submit (1) the appraisal report and (2) an Overall Development Program to the CNPC.[132] The CNPC will then submit these documents to the PIA for review and approval.[133]

Item (3) specifies that, if the Overall Development Program is approved, then the foreign contractor must initiate development operations within ninety days of receiving such approval.[134] If development operations are not initiated within ninety days, then the

---

129. Under article 11 of the 1993 Model Contract, the appraisal Work Program must be submitted to the JMC within ninety days of the date when the contractor and/or the JMC decides that the discovery is worthy of appraisal. Once approval is received from the JMC, appraisal operations must be carried out "as soon as possible without unreasonable delay in accordance with the timetable set forth in the approved appraisal Work Program." 1993 Model Contract, supra note 7, art. 11.2. The appraisal report must be submitted to the JMC within 180 days of the drilling of the last appraisal well. However, the preceding periods may be "reasonably extended upon agreement of the parties." Id. art. 11.3. The JMC must meet to review the appraisal report within thirty days after it is submitted for consideration. Id.

130. Id. art. 4.3. Since appraisal work is only performed during the exploration period, article 4 of the 1993 Model Contract accommodates extended appraisal periods by permitting the exploration period to be extended (1) where time is insufficient to complete appraisal of a discovery made shortly before the expiration of the exploration period or (2) where the appraisal period in the approved appraisal Work Program extends beyond the exploration period. Id. The criteria for extension are similar to those set forth in article 11 for the appraisal period itself: "The period of extension shall be subject to the approval of CNODC and shall be a reasonable period of time required to complete the above-mentioned appraisal work. " Id.

131. Id. art. 11.3.

132. Id. Previously, under the 1993 Model Contract, the foreign contractor was permitted to apply for an extension to delay developing a new field. If the foreign contractor wished to apply for an extension, then it became advisable *not* to submit an Overall Development Program to the CNPC because the 1993 Model Contract assumed that the operator's primary reason for applying for such an extension was that it was "unable to prepare the Overall Development Program before the expiration of the exploration period." Id. art. 4.3. See discussion infra note 136. The submission of an Overall Development Program would have been a clear indication that the extension being applied for was not needed.

Since, under the 1995 Model Contract, it is no longer possible to apply for an extension to delay developing a new field, the foreign contractor should always submit the Overall Development Program on a timely basis if the foreign contractor and/or the JMC determines that the discovery has commercial value and should be developed. See Handbook Summary 1995 Model Contract, supra note 40, at 2.

133. 1993 Model Contract, supra note 7, art. 11.3.

134. Id. art. 11.4.

CNPC has the right to request that the foreign contractor resume development operations within a specified period of time or forfeit its right to the field.[135] Although the foreign contractor was previously allowed to seek CNPC approval to delay a development decision for three years or longer, the more permissive provision from the 1993 Model Contract has since been dropped.[136]

Once field development begins, the development period lasts as long as is required to carry out the development operations set forth in the approved Overall Development Program.[137] Since the proposed development period must be included in the Overall Development Program when it is submitted to the CNPC and the PIA for approval, the foreign contractor does not have complete freedom in choosing the length of the development period.[138]

The procedure for choosing the development period requires the foreign contractor to propose a length of time for completing development operations that will be acceptable to the authorities, an estimate that could change drastically if there are difficulties or delays in field development.[139] Unfortunately, the Model Contracts currently do not provide for extension of the development period should such an extension become necessary In addition, if the foreign contractor intentionally and unilaterally suspends development operations for ninety

135. Id.

136. See Handbook Summary 1995 Model Contract, supra note 40, at 2. Previously, under the 1993 Model Contract, if the foreign contractor wished to delay making a development decision, then, instead of submitting an Overall Development Program, it was required to submit a written application for an extension to the JMC at least ninety days prior to the expiration of the exploration period. 1993 Model Contract, supra note 7, art. 4.3. The foreign contractor was permitted to seek such an extension if: (1) appraisal had confirmed that recoverable reserves in the contract area were greater than or equal to 15 million metric tons (112.5 million barrels); and (2) the infrastructure for transportation of crude oil ("the trunkline for Crude Oil transportation") had not yet been put into operation. Id. After receiving an extension, the foreign contractor was permitted to delay developing the new field for up to three years beyond the expiration of the eight-year exploration period. Id. At the end of the three-year extension period, the foreign contractor was permitted, if it wished, to seek a second extension from the PIA. Id. Compare Gao, supra note 5, at 171 (citing China Pushing Bigger Foreign Role in Onshore Exploration, Oil & Gas J., Oct. 11, 1993, available in LEXIS, News Library, Arcnws File) (stating that foreign companies were allowed to delay a development decision for as many as seven years after a commercial discovery was made).

137. 1993 Model Contract, supra note 7, art. 4.4; WPA, supra note 12, at 521.

138. See supra note 137.

139. Delays could occur for any number of reasons, including the inability to obtain equipment, difficulty in transporting equipment to remote areas, requirements of proper reservoir management, and/or other technical issues.

continuous days, then the CNPC, as stated previously, has the right to request that the foreign contractor resume development operations within a specified period of time or forfeit the field.[140] Since, in theory, this provision will apply even when there are compelling reasons to suspend operations (i.e. emergency situations), it appears to be unreasonably inflexible.

As to Item (4), the production period is ordinarily limited to fifteen years from the date when commercial production begins.[141] The exact production period must be proposed and approved as part of the Overall Development Program.[142] Depending on when the CNPC chooses to take over operations, the foreign contractor may be responsible for handling day-to-day operations for all or part of the production period. The production period may be extended, but only under "special circumstances" with the approval of the PIA.[143]

Article 4.5 of the 1993 Model Contract defines the "special circumstances" under which the production period will be extended as situations that require either (1) large-scale construction or (2) production from multiple oil or gas-producing zones.[144] There is also a catch-all provision that permits the extension of the production period in other unspecified special circumstances.[145] However, in view of China's growing domestic demand for oil, China is unlikely to extend the production period unless it feels that it will reap substantial benefits by doing so.

If, during the first fifteen years of production, the foreign contractor has transferred the management of day-to-day operations to the CNPC, then the PIA is even less likely to view an extension as being beneficial to the CNPC. With no further benefits flowing from the foreign contractor to the CNPC, extending the production period would be

---

140. See 1993 Model Contract, supra note 7, art. 11.4.

141. Id. art. 4.5.

142. Id. art. 4.5. The "Date of Commencement of Commercial Production" is defined as "the date on which a cumulative total of one hundred thousand (100,000) metric tons of Crude Oil shall have been extracted and delivered on a regular basis out of the Oil Field " Id. art. 1.17.

143. Id. art. 4.5.

144. Article 4.5 of the 1993 Model Contract states: "Under such circumstances as where the construction of an Oil Field and/or Gas Field is to be conducted on a large scale, and the time span required therefor is long, or where separate production of each of the multiple oil or gas producing zones of an Oil Field and/or Gas Field is required, or under other special circumstances, the production period thereof shall, when it is necessary, be properly extended with the approval of the Administration."

145. Id.

tantamount to giving the foreign contractor a gift of 49% of the allocable remainder oil for the additional period. This the PIA is unlikely to do.

Item (5) permits the foreign contractor to transport its share oil abroad and remit its recouped investment and profits back to its home country[146] The foreign contractor may also sell its share oil to the CNPC for distribution in the domestic market.[147] The CNPC, however, is the only rightful purchaser of foreign share oil that is sold domestically, and the foreign contractor is currently prohibited from distributing or selling its products directly to consumers in China, a significant and undesirable restriction.[148]

The 1993 Regulations and the Model Contracts are silent on the following three issues concerning the sale of a foreign contractor's share oil to the CNPC: (1) the price at which the CNPC will purchase the foreign contractor's share; (2) the convertibility of any currency received by the foreign contractor as a result of the sale; and (3) whether the CNPC will pay transport costs.[149] Since Chinese producers face price controls in their own domestic market, a foreign producer might not be offered a world-market price higher than the existing domestic price.[150] On the other hand, the pressures of domestic demand, combined with China's potential unwillingness to requisition the foreign contractor's

146. 1993 Regulations, supra note 6, art. 15; 1993 Model Contract, supra note 7, art. 13.8. The foreign contractor's profits are subject to China's corporate income tax as described in section II.A above.

147. 1993 Regulations, supra note 6, art. 15.

148. Id. This restriction limits the foreign contractor's freedom to make its own marketing, pricing, and distribution decisions and may prevent the foreign contractor from earning the level of returns that would otherwise be available in a more liberal market context.

149. On April 1, 1996, the State Council promulgated new foreign exchange regulations entitled "Regulations of the People's Republic of China on Foreign Exchange Control." Under Article 15 of these regulations, institutions residing in the PRC that need to remit legitimate renminbi revenues out of the PRC "shall take relevant evidentiary materials to make an application to the Foreign Exchange Control Authorities and, on the strength of a foreign exchange sales notice issued by the Foreign Exchange Control Authorities, go to designated foreign exchange banks for conversion and payment." Although the regulations reflect a liberalization of foreign exchange controls with respect to trade-related foreign exchange receipts and disbursements, it is unclear what effect they will have on the repatriation of revenues received by foreign contractors for oil sales in the Chinese domestic market. See Regulations of the People's Republic of China on Foreign Exchange Control, arts. 15, 16 (Paul Weiss trans., 1996); Foreign Exchange; Relaxed Foreign Exchange Controls to Take Effect, BBC Summary of World Broadcasts, Mar. 21, 1996, available in LEXIS, World Library, Allwld File.

150. See Lao Chang, China: Oil Drilling Methods Improve, Bus. Week (China Daily Supplement), Nov. 19, 1995, available in LEXIS, World Library, Allwld File.

share, may cause China to offer foreign contractors a market price that will be more attractive to them.

Regarding Item (6), CNPC's obligation "to assist the contractor at its request to go through the formalities of exchanging foreign currencies" does not guarantee that currency will be convertible under all circumstances, least of all when the foreign contractor is attempting to exchange very large quantities of renminbi.[151] The issues of price and convertibility become even more important when the foreign contractor does not have the option of exporting its oil to foreign consumers (i.e. when all or a portion of its share oil has been requisitioned by the Chinese government).[152]

The preceding point about currency convertibility can be extended to other areas where more than one Chinese governmental entity is involved. Although the CNPC is obligated to assist the foreign contractor, at its request, with all necessary approvals, formalities, and logistics, there is no guarantee that such assistance will be effective. Other organs of the Chinese government that have responsibility for aspects of the petroleum contract (i.e. the PIA, MOFTEC, the Customs Administration, the State Administration of Taxation, etc.) may still interfere with or delay implementation of the contract.[153] Unlike the equity participants, such governmental entities may be more concerned about the immediate political or economic benefits of such intervention and less interested in the overall success of the petroleum contract.

The performance privileges of foreign contractors operating in China are inferior to those offered by the Philippines but, aside from the comparatively short initial production period, are not clearly superior or inferior to the performance privileges offered by Indonesia, Malaysia and Vietnam. China's eight-year exploration period is longer than Malaysia's or Vietnam's (both five years) and longer than Indonesia's initial period of six years.[154] However, both Indonesia and the Philippines permit exploration to be extended to ten years, a figure that China is unlikely to match unless a particularly lengthy extension is granted to

151. 1993 Model Contract, supra note 7, art. 9.1.2. See discussion supra note 149.

152. 1993 Regulations, supra note 6, art. 5. See discussion supra section III.A.

153. See Bruce Vernor, Offshore Oil Contracts; Each Bidding Round Brings Better Terms For Foreign Companies, China Bus. Rev., Mar. 1990, available in LEXIS, World Library, Allwld File ("Onshore oil ventures, being more complex than offshore, require working with a wider range of organizations in China's bureaucracy, making development more risky and expensive.").

154. WPA, supra note 12, at 218, 736, 773.

accommodate appraisal operations, as discussed under Item (2) above.[155]

Since CNPC's representatives on the JMC help set reasonable periods for appraisal and development, it is unclear how long these periods will be or how they will compare with those of the other four countries. During the appraisal period, the foreign contractor must be careful about making a determination of commerciality If the foreign contractor determines that a discovery is commercial in the appraisal report, then it must begin development within ninety days or risk losing its rights to the field. On the other hand, if the foreign contractor determines that a discovery is not commercial, then the CNPC may go ahead and begin development without the foreign contractor. If, during the development period, the foreign contractor wishes to renew its participation, then it will have to pay substantial penalties.[156]

The relative favorability of China's production period depends on whether it is extended or not. The initial fifteen-year production period is clearly less advantageous than those of the four comparison countries, all of which are in the twenty to twenty-five year range.[157] In the unlikely event that the production period is extended beyond twenty-five years, however, China's production period becomes longer than all the others except the Philippines, where the initial twenty-five year production period may be extended to forty years.[158] Also, since the fifteen-year production period under the Model Contracts does not begin to run until the end of the development period, the foreign contractor, if it begins production during the development period, may achieve a de facto extension of the production period beyond the fifteen-year limit. Currently, there is no requirement to seek approval for such an early commencement of production.

Since foreign contractors are permitted to sell oil to the CNPC but are not generally required to do so, the foreign contractor may have greater freedom of choice in deciding whether to sell its oil domestically or for export. As previously discussed, in the other four countries, the foreign contractor's domestic obligation is not limited to "special circumstances."[159] The Philippines, however, provides better terms for

155. Id.
156. 1993 Model Contract, supra note 7, art. 11.6.1.
157. WPA, supra note 12, at 218, 736, 773.
158. Id. at 112.
159. Id. at 137-38, 219, 754.

domestic oil sales than China. Unlike China, the Philippines guarantees a market price for domestic sales and promises to exchange domestic currency earned from such sales for remittance abroad.[160]

C. *Negotiation Strategies for Performance Provisions*

During negotiations, the foreign contractor should attempt (1) to extend the time period of its privileges and (2) to define and narrow the scope of its obligations. Since performance obligations are a central concern of the Model Contracts, negotiators will find it difficult to win major concessions on these issues. A better approach is to suggest incremental changes in contract provisions based on recognizable models from China's own past practice or from other East Asian petroleum contract regimes.

If the exploration block is a large one and/or is located in a remote area in the northwest, then the foreign contractor may wish to propose that the exploration period be extended beyond the current eight-year limit. The minimum work requirement for the early phases of exploration should be set as low as possible and increase gradually in each subsequent phase.

The gradual reduction in the relinquishment requirement over the past three rounds of bidding suggests that the foreign contractor may fruitfully seek further reductions in the future.[161] The rationale for such reductions would be to (1) enable the foreign contractor to explore large blocks in northwest China efficiently and (2) match lower relinquishment rates in Indonesia and the Philippines.

160. Id. at 114, 137-38.

161. The relinquishment requirement has been reduced as follows: (1) the 1993 Model Contract — 40% at the end of the first phase of exploration followed by 50% of the remaining contract area at the end of the second phase and the remaining contract area at the end of the third phase; (2) the 1994 Model Contract — 40% at the end of the first phase followed by 25% of the remaining contract area at the end of the second phase and the remaining contract area at the end of the third phase; and (3) the 1995 Model Contract — 40% at the end of the first phase followed by 25% of the remaining contract area at the end of the second phase and the remaining contract area at the end of the third phase. The total exploration period in the 1995 Model Contract is one year longer than in the 1994 Model Contract. See Handbook Summary 1995 Model Contract, supra note 40, at 3; 1993 Model Contract, supra note 7, arts. 5.1.1-.1.3; WPA, supra note 12, at 521. "Remaining contract area" means the portion of the original contract area remaining after excluding (1) the area relinquished at the expiration of the first phase and (2) any development and/or production areas.

The foreign contractor should seek maximum flexibility in the appraisal and development phases and plan carefully for a potential commercial discovery If the area to be explored currently lacks sufficient pipelines or other infrastructure, then it may be advisable to seek advance consent from the CNPC and/or the PIA to delay a development decision in the event that commercial quantities of oil are found. As mentioned earlier, the provision of the 1993 Model Contract permitting the foreign contractor to seek an extension to delay developing a new field for up to three years beyond the expiration of the eight-year exploration period and to seek a second extension from the PIA after the first extension expired has been dropped from the 1995 Model Contract.[162]

If possible, the foreign contractor should negotiate a provision similar to the provision formerly contained in the 1993 Model Contract. The new provision should empower the foreign contractor to seek an extension as a matter of right as long as (1) appraisal has confirmed that recoverable reserves in the contract area are greater than the agreed-upon number (112.5 million barrels in the 1993 Model Contract) and (2) infrastructure for transportation of crude oil has not yet been put into operation. The petroleum contract should also specify circumstances in which a suspension of development operations for more than ninety days will be excused. At a minimum, such circumstances should include: (1) emergency situations; (2) situations where unforeseen technical difficulties or equipment shortages have arisen; and (3) situations where a majority of the Project Management Team ("PMT") and/or the JMC believes that optimal reservoir management requires a temporary suspension of operations.[163]

To avoid requisitions of the foreign contractor's share oil and, potentially, lost profits, negotiators should attempt to define "special circumstances" and "appropriate compensation" as part of the petroleum contract. Special circumstances leading to such a requisition should be defined as more than a sudden surge in domestic demand.[164] Appropriate compensation should be defined using a basket of export prices from a chosen group of market economies in East Asia.

162. See discussion supra note 136.

163. For further discussion of the structure and management functions of the PMT, see discussion infra sections IV.A and IV.B.

164. A contractual provision providing for requisition in cases of "war or national emergency" with carefully drafted definitions of "war" and "national emergency" (perhaps taken from standard-form liability insurance policies) may be offered as an appropriate gloss on the 1993 Regulations.

Regarding voluntary sales in China, foreign oil companies should continue to lobby the Chinese government for the right to bypass the CNPC, create distribution networks, and sell directly to Chinese consumers. Although obtaining permission to build a domestic sales and marketing network has been a priority for some time, foreign companies have so far been unable to win any meaningful concessions.[165] In the short run, it remains unlikely that the Chinese government will be willing to dismantle CNPC's monopoly[166]

Whether it chooses to sell its share oil to the CNPC or for export abroad, the foreign contractor should make early arrangements for transporting its oil from China's landlocked interior. In the northwest, where oil presently has to travel by tanker truck and by rail before it can be piped, the foreign contractor should obtain a provision guaranteeing that space will be available for its share oil and that, if it is charged for transportation, it will be charged transport costs equivalent to transport costs in other countries with comparably remote fields. Where appropriate infrastructure is not available, foreign contractors should attempt to negotiate separate joint ventures with Chinese engineering companies, if feasible, to construct the items that are needed.[167]

---

165. As early as 1982, Exxon opened at least one retail service station in China. Gregg Jones, Exxon Signs China Oil Pacts; Deals More Than Triple Territory, Dallas Morning News, Apr. 8, 1995, at 1F However, since then, further openings for foreign companies have been limited.

166. But see Lu Hongyong, China: New Company Oils Wheels of Competition, China Daily, Mar. 14, 1996, available in LEXIS, World Library, Allwld File (discussing a recent proposal by the Chinese government to create a third state-owned oil company in addition to the CNPC and the CNODC).

167. Needed infrastructure in remote areas in the northwest has included pipelines, tank farms, and roads. Although production capacity in the Tarim Basin is now up to 5 million tons, lack of transportation infrastructure is limiting actual annual production to 3.6 million tons. 1994 World Energy Outlook 194-95 (1994); Robert Tansey, Black Gold Rush: Chinese Petroleum Industry, China Bus. Rev., July 1994, available in LEXIS, World Library, Allwld File; Ian Johnson, China Invests Big Money in Desert Oil Field, but Results Are Economic Trickle, The Sun, June 18, 1995, at 6A, China-Taklimakan Highway to Cross Western China's Taklimakan Desert, Xinhua News Agency, Mar. 7, 1995, available in LEXIS, World Library, Allwld File; Oil and Gas Exploration in Tarim Basin Beneficial, Xinhua News Agency, Jan. 23, 1995, available in LEXIS, World Library, Allwld File.

A project of great potential interest to foreign investors is a proposed oil pipeline from the Tarim Basin to coastal markets in eastern China. If built, the pipeline would cost between 10 and 20 billion dollars. Foreign observers have noted that, if the project came to fruition, China would undoubtedly seek foreign assistance to build such a pipeline. Halliburton, an American engineering firm, has participated in a route survey for the proposed 2,050 mile pipeline, and an Italian firm, Snamprogetti, has landed a design project for the first 310 miles of the line. Robert Tansey, Black Gold Rush: Chinese Petroleum Industry, China Bus. Rev., July 1994, available in LEXIS, World Library, Allwld File. See also A.D. Koen, Warren R. True, World Pipeline Construction Survey, To minimize the negative impact of local preference clauses in the petroleum contract, the foreign contractor may wish to team up with a local partner to form its own "service and supply" joint venture. The joint venture may then serve as a conduit for qualified personnel as well as imported equipment and supplies.[168] Alternatively, the foreign contractor may wish to contract with a third-party joint venture, where the foreign contractor is an established driller that possesses the desired technology and expertise. A recent example of such a joint venture is the partnership of Parker Drilling Company, a Texas drilling firm, with Great Wall Drilling Company, a subsidiary of the CNPC. The joint venture agreement between Parker and Great Wall includes a training provision in which Chinese personnel are brought to Texas to learn drilling techniques from the American partner.[169] If Chinese domestic drillers are used, then the foreign contractor should be aware that domestic drillers have been struggling to remain competitive in a depressed market and avoid overpaying for drilling services.[170] This may entail renegotiating the wage scale in annex 3 of the 1993 Model Contract.

In negotiating local preference for goods and services, the foreign contractor should request the language of the 1993 Regulations (local preference only when terms and conditions "are identical on both domestic and international markets") rather than that of the 1993 Model Contract (local preference provided that goods and services "are competitive in terms of price, quality and term of delivery").[171] A carefully drafted provision may then be used to justify choosing foreign contractors, if desired, during the international bidding process.

On the issue of training and technology transfer, an effort should be made to define the categories of technology to be transferred. According to the Regulations on Administration of Technology Import Contracts of the People's Republic of China ("1985 Technology Import Contract Regulations"), when technology is to be transferred by a foreign corporation or enterprise to a corporation or enterprise within the

---

Oil & Gas J., Feb. 6, 1995, available in LEXIS, News Library, Curnws File.

168. See China Legal Perspective, supra note 6.

169. See Parker Signs China Contract, PR Newswire, Oct. 26, 1995, available in LEXIS, World Library, Allwld File.

170. See Drilling Groups See Bright Prospects for Next Five Years, Xinhua News Agency, Dec. 12, 1995, available in LEXIS, World Library, Allwld File. The foreign contractor's negotiating position is enhanced by the fact that it need not purchase drilling services from Chinese drilling companies unless the services they offer are at least "competitive in terms of price, quality and term of delivery." 1993 Model Contract, supra note 7, art. 15.1.

171. 1993 Regulations, supra note 6, art. 22; 1993 Model Contract, supra note 7, art. 15.1.

territory of the P.R.C., technology import contract(s) must be concluded by the supplier and recipient of that technology.[172] If technology is to be transferred from the foreign contractor to the CNPC, then the guidelines contained in the 1985 Technology Import Contract Regulations and in the Detailed Implementing Rules for the Regulations of the People's Republic of China Concerning the Control of Technology Import Contracts ("1988 Technology Import Contract Implementing Rules"), requiring the execution of technology import contracts, should be followed.[173] According to article 7 of the 1988 Technology Import Contract Implementing Rules, technology import contracts, at a minimum, must specify:

(1) the title of the contract;

(2) the contents, scope, and requirements of the imported technology;

(3) the standards, terms, and methods for assessing and determining whether the imported technology has reached the objective, and the allocation of risk;

(4) the obligation to maintain the confidentiality of the imported technology, and the ownership and sharing of improvements to the technology;

(5) the total price or remuneration and a breakdown thereof, and the method of payment;

172. Regulations on Administration of Technology Import Contracts of the People's Republic of China, arts. 2, 4 (CCH Australia Ltd. trans., 1985) [hereinafter 1985 Technology Import Contract Regulations]. Technology import contracts are required for the acquisition of technology by enterprises within China from enterprises outside China and must be executed for the transfer of the following types of information: (1) assignment or licensing of patents or other industrial property rights; (2) knowhow provided in the form of drawings, technical data, and technical specifications; and (3) technical services. Id.

173. Detailed Implementing Rules for the Regulations of the People's Republic of China Concerning the Control of Technology Import Contracts, art. 2 (Baker & McKenzie trans., 1988) [hereinafter 1988 Technology Import Contract Implementing Rules]. Categories of technology import contracts requiring examination and approval by MOFTEC include, among others: (1) contracts for the licensing of proprietary technology; (2) contracts for technical services; and (3) contracts for cooperative production or design. Id.

(6) the method of computing the amount of liquidated damages;

(7) the method for settling disputes; and

(8) the interpretation of nouns and terms.[174]

When setting forth the above-listed items, technology import contracts associated with the petroleum contract (and, if appropriate, the petroleum contract itself) should also contain:

(1) descriptions of the technology to be transferred;

(2) the obligations of the CNPC with respect to the use of proprietary technology and/or information (during the period of training and technology transfer and after the CNPC has taken over day-to-day operation of the field);

(3) the period during which the CNPC must continue to maintain the confidentiality of relevant documents, information, data, and reports after the petroleum contract has expired;[175]

174. See id. art. 7.

175. The confidentiality period is to be determined by the CNPC in accordance with article 22 of the 1993 Model Contract: "CNODC shall, in conformity with applicable laws and regulations of the Government of the People's Republic of China on confidentiality and by taking into account international practice, determine the confidentiality periods for which the Contract and all documents, information, data and reports related to the Petroleum Operations within the Contract Area shall be kept confidential." 1993 Model Contract, supra note 7, art. 22.1.

Article 8 of the 1985 Technology Import Contract Regulations, in turn, states that the duration of technology import contracts generally should not exceed ten years: "The duration of the contract shall conform to the time needed by the recipient to assimilate the technology provided and, unless specially approved by the approving authority [MOFTEC or its authorized designee], shall not exceed ten years." 1985 Technology Import Contract Regulations, supra note 172, art. 8.

To avoid the ten-year limit on the duration of technology import contracts, the foreign contractor should (1) attempt to have MOFTEC authorize the CNPC and/or the PIA to approve technology import contracts associated with the petroleum contract and (2) seek special permission from the latter authorities for a confidentiality period longer than ten years based on "international practice." 1993 Model Contract, supra note 7, art. 22.1.

(4) the amount of royalties to be paid for the use of proprietary technology and/or information after the period of training and technology transfer has ended; and

(5) a listing of penalties for failure to make royalty payments and for improper disclosure to third parties.

In accordance with article 7 of the 1988 Technology Import Contract Implementing Rules, Item (5) should include a method for computing liquidated damages and specify a tribunal in which the penalty will be enforced. When specifying a tribunal, the foreign contractor is best advised to refer the issue to arbitration in accordance with a suitably drafted arbitration clause.[176]

The foreign contractor should seek to curtail training and technology transfer by seeking concessions already granted by the CNOOC for offshore contracts. These include: (1) requiring training and technology transfer only from the date of the approval of the development plan, effectively protecting the foreign contractor's most sensitive and advanced exploration technology; and (2) dropping annex 4 of the 1993 Model Contract setting forth the details of training and technology transfer, making these issues a matter to be determined by consultation between the parties.[177] The foreign contractor should also ensure that the cost of any training and technology transfer that does occur be treated as a recoverable expense.

As presently structured, the fifteen-year production period is short compared with comparable petroleum contract regimes and may not be extended except under "special circumstances."[178] A longer base period and a better renewal provision should be negotiated to bring China in line with the four comparison countries. If possible, extension of the production period should be made automatic if the foreign contractor meets defined performance criteria.

176. See discussion infra section IV.C. While article 22 of the 1993 Model Contract prohibits the disclosure of patents, know-how, or proprietary technology belonging to the foreign contractor to third parties, either during the term of the petroleum contract or during any applicable confidentiality periods following its expiration, article 22 fails to specify a penalty for violating these prohibitions. Accordingly, emphasis should be placed on negotiating appropriate penalty provisions pursuant to the above recommendations. See 1993 Model Contract, supra note 7, arts. 22.3-4.

177. See Gao, supra note 5, at 186; WPA, supra note 12, at 513.

178. 1993 Model Contract, supra note 7, art. 4.5.

The foreign contractor should also take care in crafting a strategy to cope with the surrender provisions. First, to avoid having to transfer ownership of assets to the CNPC, and to be able to reexport high-technology equipment, the foreign contractor should consider trying to bring itself within the exception for leased or temporarily-imported equipment in article 17.2 of the 1993 Model Contract:

> Equipment and facilities which are owned by a Third Party and are either leased by the Operator or temporarily brought into the territory of the People's Republic of China for the performance of the Petroleum Operations shall not be deemed as assets owned by the CNODC. Such equipment and facilities may be exported from the People's Republic of China, but, the CNODC shall assist in handling export formalities.[179]

Obviously, the decision whether to lease an asset so that it can be exported from China later or, alternatively, to allow it to be transferred to the CNPC after cost recovery depends on the useful life of the asset and on its salvage value. The foreign contractor may prefer the second option of "temporarily" bringing assets owned by a third party into China in order to be able to export them later. If the contractor anticipates seeking either treatment for asset(s) associated with the petroleum contract, then it should try to negotiate mutually acceptable criteria for (1) ownership "by a Third Party," (2) the definition of a "lease," and (3) when an asset has been "temporarily brought into the territory of the People's Republic of China."[180] For these assets, the foreign contractor should then closely conform to the agreed criteria.

As to assets being transferred to the CNPC, the 1993 Model Contract states that "[t]he Operator [of the field] shall be responsible for the acceptance[,] inspection or testing of the said assets and CNODC may, as it deems necessary, send its experts to participate in such acceptance[,] inspection or testing."[181] Care should be taken to define an acceptable outcome of such inspection or testing. CNPC experts should be invited to inspect all equipment at regular intervals prior to the

179. Id. art. 17.2.

180. Companies familiar with the criteria for leasing arrangements under United States tax law and under GAAP may wish to refer to these standards during their negotiations with the CNPC.

181. 1993 Model Contract, supra note 7, art. 17.1.

time when ownership is transferred so that there are no unpleasant surprises when the transfer actually takes place.

Second, regarding CNPC's right to take over operations after the recovery of development costs, the foreign contractor should define the boundaries of its involvement during the period after it surrenders management of day-to-day operations to the CNPC but prior to the expiration of the contract. Will the contractor retain its representation on the JMC? Will the contractor still have input on decisions regarding production and field management? The petroleum contract should be drafted in such a way as to preserve as many of the foreign contractor's management rights as possible.

As mentioned earlier, article 11.6.3 of the 1993 Model Contract envisions management by "agreement between the parties through consultation" even where the CNPC is the sole developer of a field.[182] Arguing by analogy from this provision, the foreign contractor should negotiate a provision that protects its right to participate in JMC decisionmaking after the CNPC takes over production operations. The foreign contractor should also seek to enlarge the scope of its right during the production period to use assets purchased, installed, and constructed under the work program after ownership of those assets passes to the CNPC. Article 17 of the Model Contract states that assets may not be used (1) in any operations other than operations under the contract or (2) in any operations by third parties "without the consent of the Parties."[183] Where appropriate, the foreign contractor should seek to obtain CNPC's consent to use specific categories of assets for other operations in China, even after the CNPC takes over the operation of a particular field.

Third, with respect to the final surrender of land and assets to the CNPC at the end of the contract period, it may be useful to define criteria for the acceptance of assets by the CNPC. Specifically, the same criteria should apply as apply to the inspection and testing of assets when ownership is transferred prior to the expiration of the contract. The foreign contractor should be careful to protect itself from having to pay damages or levies that may be imposed because assets are allegedly not in acceptable condition at the time the contract expires.

182. See discussion supra note 108.

183. See id.

IV CONSTRAINING THE ACTIONS OF THE OTHER PARTY TO THE PETROLEUM CONTRACT: OVERSIGHT AND MANAGERIAL CONTROLS

As seen in Section III, China's onshore oil law seeks to harness the expertise of foreign oil companies in order to bring China's domestic producers up to world standards. At the same time, China's onshore oil law is designed to enable China to retain sovereignty over its natural resources and maintain strong managerial controls over its foreign contractors.

Historically, China has limited its offerings of onshore oil properties.[184] Energy conservatives in the government — Premier Li Peng, Vice Premier Zhu Jiahua, and CNPC Chairman Wang Tao — have favored keeping a tight rein on energy policy and facilities.[185] In the mid-1980's, when China was still self-sufficient in petroleum resources, the majority of foreign activity in China was in offshore exploration.

By the time the 1993 Regulations and the Model Contracts were being drafted, China's historic policy of trying to develop its onshore oil resources independently was beginning to weaken. However, even as China began soliciting foreign assistance, China's onshore oil law imposed tough operational controls on foreign petroleum enterprises involved in onshore exploration and development. While foreign enterprises were given some ability to constrain the actions of their Chinese counterparts through provisions relating to oversight and dispute resolution, the vast majority of these provisions were intended to operate in the other direction, enabling the CNPC and its affiliates to monitor and oversee the activities of CNPC's foreign contractors. Taken as a whole, these managerial controls are more burdensome in China than in other comparable East Asian petroleum contract regimes.

A. CNPC's Ability to Constrain the Actions of Foreign Contractors

Four structural features of the Model Contracts are designed to reinforce CNPC's management authority and operational control over foreign contractors:

184. See Chinese Foreign Economic Law: Analysis and Commentary 1-3 (M. Rui & G. Wang eds., 1990).

185. Jim Landers, Fuel for a Struggle; Freedoms, Peace at Risk in China's Quest for Energy, Dallas Morning News, Feb. 7, 1995, at 1A.

(1) Participating interest — The CNPC retains a controlling 51% equity stake in the venture and has the right to participate in all managerial decisionmaking.[186]

(2) Joint Management Committee — The JMC approves the annual work program and budget and oversees field operations during each phase of the petroleum contract. Each party appoints an equal number of representatives (from two to five) to the JMC, which acts as the board of directors for the joint venture.[187]

(3) Project Management Team — Each party appoints representatives to the PMT, an operating group under the JMC that handles day-to-day development and production activities.[188]

(4) Dispute resolution — Each party has the power to call for arbitration or, if certain conditions are met, to sue if a dispute cannot be resolved through consultation or mediation within a specified period of time.[189]

While the above-described contractual provisions enable the CNPC to maintain a degree of control over the foreign contractor, the provisions are relatively symmetrical: the foreign contractor retains rights that are similar in kind, if not always in degree, to those retained by the CNPC. Joint venture decisionmaking by the JMC is required to be unanimous.[190] Thus, each party retains veto power over the other. The chairman of the JMC is the chief representative of the CNPC, and the vice-chairman is the chief representative of the foreign contractor.[191] The CNPC, however, has begun to show flexibility on this issue.[192]

---

186. 1993 Model Contract, supra note 7, arts. 7, 12; WPA, supra note 12, at 784. Chinese government officials familiar with the legal structure of the model contract have stated that "the two percent equity advantage is viewed as representative of China's permanent sovereignty over its resources." See Gao, supra note 5, at 167.

187. 1993 Model Contract, supra note 7, art. 7

188. Id. art. 8.7.

189. 1993 Regulations, supra note 6, art. 26; 1993 Model Contract, supra note 7, arts. 26.1-.2.

190. 1993 Model Contract, supra note 7, art. 7.3.

191. Id. art. 7.1.1.

192. Gao, supra note 5, at 168.

Regarding the PMT, at least one-third of the representatives on the PMT must be CNPC personnel.[193] The foreign contractor designates the manager of the PMT, and the CNPC designates its deputy manager.[194] Unlike the JMC, however, there is no specified procedure for PMT decisionmaking. The PMT must be established within thirty days of the date of approval of the Overall Development Program by the PIA.[195]

Finally, if a dispute arises, the parties must initially attempt to resolve their disagreement through consultation or mediation.[196] If a dispute has not been settled within ninety days after the dispute arises, then either party may call for arbitration in accordance with the arbitration clause in the petroleum contract.[197] If there is no arbitration clause, and the parties have subsequently failed to reach a written arbitration agreement, then either party may bring an action in the Chinese People's Court.[198]

Under these provisions, the parties' powers are relatively evenly balanced. Like the CNPC, the foreign contractor has: (1) a participating interest in the petroleum contract (though one of only 49%);[199] (2) equal representation and veto power on the JMC (though not the chairmanship thereof);[200] and (3) the power to call for arbitration or sue if consultations fail (though, under certain circumstances, before a Chinese rather than an international tribunal).[201] The only area where the foreign contractor may retain somewhat greater managerial control than the CNPC is on the PMT. The foreign contractor is permitted to

193. 1993 Model Contract, supra note 7, art. 8.7.

194. Id.

195. Id.

196. 1993 Regulations, supra note 6, art. 26; 1993 Model Contract, supra note 7, art. 26.1. The 1993 Regulations do not specify who qualifies as a mediator or how such a mediator is designated.

197. 1993 Model Contract, supra note 7, art. 26.2.

198. Regulations of the People's Republic of China Concerning the Exploitation of On-Shore Petroleum Resources in Cooperation with Foreign Enterprises, art. 26 (Baker & McKenzie trans., 1993). While the translation of this provision published by Barrows states that, in the absence of an arbitration clause in the contract, a dispute may be settled in accordance with "any written agreement reached afterwards," an unofficial translation of the 1993 Regulations made by Baker & McKenzie as well as an independent translation based on the original Chinese text of the 1993 Regulations confirm that a subsequent written agreement between the parties must be an "arbitration agreement."

199. 1993 Model Contract, supra note 7, art. 12.1.2.

200. Id. arts. 7.1.1, 7.3.

201. See discussion infra section IV.B. See also 1993 Regulations, supra note 6, art. 26; 1993 Model Contract, supra note 7, arts. 26.1-.2.

appoint up to two-third of the representatives to the PMT and designates its manager as well. However, even here, the CNPC is guaranteed a minimum number of representatives to the PMT and has the right to designate the deputy manager of the team.[202]

Other provisions designed to reinforce CNPC's management authority and operational control do not distribute power symmetrically between the CNPC and the foreign contractor. Powers retained by the CNPC for which the foreign contractor has no formal counterpart fall into six categories. The CNPC retains:

> (1) veto power over the appointment of the foreign contractor's senior staff in charge of field operations;[203]
>
> (2) power over the local and international procurement of goods and services through a "procurement representative" who is appointed by the CNPC and participates in all local and international procurement decisions;[204]
>
> (3) responsibility for recruiting or assisting in the recruitment of Chinese employees (to enforce the local preference requirement);[205]
>
> (4) the right to appoint professional representatives to monitor and report on activities in the foreign operator's administrative and technical departments;[206]
>
> (5) the right to participate in master design and engineering work and to receive local preference for engineering design subcontracts; and[207]
>
> (6) as previously described, the unilateral power to take over field operations after the full recovery of development costs.[208]

202. 1993 Model Contract, supra note 7, art. 8.7.
203. Id. art. 8.2.
204. Id. arts. 7.6.1-.6.5.
205. Id. art. 15.2.
206. Id. art. 7.5.
207. Id. art. 15.3.
208. Id. art. 8.8.

Taken together, Items (1) through (6) present a sharp contrast to other East Asian petroleum contract regimes. With limited exceptions, Chinese-style "control provisions" are almost completely absent from the onshore oil law of Indonesia, Malaysia, the Philippines, and Vietnam.

Under Item (1), when production operations are to be performed under the supervision of the foreign contractor, the "names, positions and resumes of the staff and organization chart of the Operator shall be submitted in advance to the CNPC and the appointment of the Operator's senior staff must be subject to the consent of CNPC."[209] Although this requirement appears to be a formality, circumstances may arise in which a foreign contractor will be unable to install its favored nominees for senior staff positions to manage operations. A manager perceived to be effective by the foreign side could fail to pass muster with the CNPC. If, for example, the CNPC feels that nominees have been sprung on it without warning, then this could create a climate in which nominees might be vetoed without explanation. The 1993 Model Contract does not require the CNPC to provide an explanation if it chooses to reject such an appointment. In addition, there is no corresponding provision in the 1993 Model Contract that makes the appointment of CNPC's senior staff in charge of field operations subject to the consent of the foreign contractor.

The CNPC procurement representative, Item (2) above, is a professional appointed by the CNPC to perform a number of significant managerial functions. First, the field operator must inform the procurement representative of all items and equipment needed for operations, with the specifications thereof.[210] Second, the operator must consult with the procurement representative when preparing a procurement plan.[211] Third, the procurement representative uses the list of items needed for operations to generate an inventory of items that can be furnished by Chinese suppliers and a list of companies that can provide required services and subcontracting work.[212] Fourth, the procurement representative determines which Chinese companies are interested in bidding and submits the list in advance to the operator.[213] Fifth, the procurement representative takes part in calling for domestic

209. Id. art. 8.2.
210. Id. art. 7.6.1.
211. Id. art. 7.6.2.
212. Id.
213. Id. art. 7.6.4.

and international bids (all Chinese manufacturers and enterprises on the procurement representative's final list must be invited to participate in the bidding).[214] The procurement representative's right to participate in the bidding process extends to "examination of the list of bidders to be invited, preparing and issuing bidding documents, opening bids, evaluation of bids, and the right to consult with the Operator the determination of award of contracts and to participate in negotiations for subcontracts and services contracts."[215] As to those items not put out for bidding, the operator must still consult with the procurement representative in order to determine which items will be procured in China and which will be procured abroad.[216]

Item (3) extends CNPC's procurement function to the recruitment of Chinese employees. In order to implement the local preference requirement, the foreign contractor must submit, in advance, a plan for the employment of Chinese personnel, listing "all the posts and number of the persons involved."[217] The CNPC then provides or assists in recruiting personnel to fill the listed positions. Although this procedure is not specifically required to be conducted through the office of the procurement representative as in Item (2), the channeling of such requests through the CNPC still gives the CNPC a considerable degree of leverage over the process. The 1993 Model Contract does not provide for alternative methods of recruiting Chinese personnel if the CNPC is unable to find qualified workers to fill the listed positions.

Items (4) and (5) envision a high degree of participation by CNPC's professional and engineering representatives in all aspects of field development and production operations prior to the time that operations are turned over to the CNPC. These provisions go well beyond the training obligations discussed in Section III.A above. They ensure that CNPC personnel can observe and, if necessary, propose operational changes and/or bring important developments to the attention of CNPC's representatives on the JMC.[218] Item (4) grants the CNPC the right to

214. Id. arts. 7.6.3-.6.4.

215. Id. art. 7.6.4.

216. Id. art. 7.6.5.

217. Id. art. 15.2.

218. While the CNPC professional representatives may not interfere in decisionmaking by the operator's departmental managers, they still retain significant power to influence such decisionmaking: "Professional representatives of CNODC, except for the professional representatives in charge of procurement who shall undertake their functions in accordance with Article 7.6 herein, shall not interfere in the decision making on relevant matters by departmental manager(s) of the Operator. However, such professional representatives shall have the right to

appoint professional representatives to work side-by-side with the operator's personnel in the operator's administrative and technical departments.[219] These representatives are sent to each department to monitor and report on operations, keeping CNPC's representatives on the JMC as well as their own superiors informed of developments. The operator must give CNPC's professional representatives access to all research, design, data processing, and operational information relating to the execution of the petroleum contract.[220]

Under Item (5), engineering design corporations designated by the CNPC (either third parties or CNPC affiliates) have the right to participate in the creation of master designs and engineering designs to implement the petroleum contract.[221] The meaning of the phrase "right to participate" is unclear. One interpretation is that CNPC's engineering design affiliates and/or designees merely have the right to bid on subcontracts for master designs and engineering designs.[222] A second interpretation is that CNPC's design affiliates and/or designees have the right to work with the foreign contractor on master designs regardless of the identity of the subcontractor.[223]

---

make proposals and comments to departmental manager(s) of the Operator or to report directly to CNODC's representatives in JMC." Id. art. 7.5.

The above-quoted provision implies that the CNPC procurement representative *may* "interfere in the decision making on relevant matters by departmental manager(s) of the Operator." Id. Under article 7.5 of the 1993 Model Contract, the procurement representative, unlike CNPC's other professional representatives, is expected to play an integral role in the foreign contractor's procurement decisions.

219. Id.

220. Id.

221. Article 15.3 of the 1993 Model Contract states: "The engineering design corporations under or entrusted by CNODC shall have the right to participate in the master designs and engineering designs made by the Contractor for the purpose of the implementation of the Contract."

222. This interpretation is supported by the next sentence of the provision, which states that Chinese engineering design corporations must be given preference in the award of design subcontracts: "Engineering design companies within the territory of the People's Republic of China shall be given preference in entering into the subcontracts for the aforesaid master designs and engineering designs, provided that their technical level, price and delivery time are competitive." Id. If this sentence is construed to explain the sentence immediately preceding it, then CNPC's "right to participate" is plausibly limited to participation in the bidding for subcontracts. As mentioned in the previous discussion of local preference requirements, the 1993 Model Contract does not define the word "competitive" in this context.

223. This interpretation is also plausible, since CNPC's design affiliates and/or designees have "the right to participate in the master designs and engineering designs made by the Contractor " Id. The implication is that the CNPC plays an ongoing, auxiliary role in master design work performed by the foreign contractor.

Item (6) permits the CNPC to take over production unilaterally any time after development costs have been fully recovered.[224] It is a highly asymmetrical provision that gives the CNPC a significant amount of discretion as to how and when it will assume control from the foreign contractor. Knowing that the CNPC may assert this right at any time could chill the foreign contractor's desire to assert its own rights under the contract with respect to (1) field management and (2) obtaining assistance from the CNPC with approvals and logistical matters.[225] Even if the foreign contractor is permitted to continue managing the field after the recovery of development costs, it will be inclined to defer more readily to the CNPC on operational matters simply to forestall the CNPC from taking over the field.[226]

Chinese-style "control provisions" similar to Items (1) through (6) are almost completely absent from the onshore oil law of the four comparison countries. The exception is Malaysia, where the state-owned oil company retains veto power over the appointment of foreign staff.[227]

Apart from the local preference requirements previously discussed, none of the other four countries has procurement procedures as complex and detailed as China's. The CNPC procurement representative is a unique creation of the Chinese Model Contracts. Although, in practice, professional representatives and engineers from host countries often do become involved in onshore development and production operations, none of the four comparison countries requires that such representatives be granted the level of access and participation that China does. Despite the fact that the four countries require foreign contractors to surrender all land, assets, and managerial control at the end of the contract period,

224. Id. art. 8.8.

225. See id. art. 9.1.

226. During negotiations, this concern may be remedied by clarifying that the foreign contractor will retain representation on the JMC after the CNPC takes over the field. In addition, as discussed in note 238 below, the foreign contractor will probably retain its representation on the PMT after such a takeover. By negotiating a clause to protect its representation on the PMT, the foreign contractor can ensure its continued involvement in day-to-day operations. Of course, if the CNPC feels that it will need the foreign contractor's technical and managerial expertise to effectively manage operations, then it will be more inclined to agree to such a provision.

227. WPA, supra note 12, at 541. The Malaysian provision vests Petronas with veto power over the appointment of foreign staff. The Malaysian provision is similar to, but even more burdensome than, the Chinese provision. In Malaysia, foreign contractors must obtain written approval from Petronas for any position to be filled by foreign personnel, not merely senior management positions. Id.

none gives the state oil company the unilateral power to take over operations prior to the expiration of the contract period.

In sum, the six provisions listed above enable the CNPC to influence the actions of foreign contractors without granting foreign contractors similar powers with respect to the CNPC. They also saddle onshore investors with unique burdens when compared to other East Asian petroleum contract regimes.

B. Foreign Contractor's Ability to Influence the Actions of the CNPC

The foreign contractor possesses four tools for influencing the actions of the CNPC:

(1) Participating interest — The foreign contractor retains a 49% minority equity stake in the venture and, like the CNPC, has the right to participate in all managerial decisionmaking.[228]

(2) Joint Management Committee — Like the CNPC, the foreign contractor is equally represented and has de facto veto power within the JMC.[229]

(3) Project Management Team — The foreign contractor may appoint up to two-thirds of the representatives to the PMT and is entitled to the top managerial position thereof.[230]

(4) Dispute resolution — Like the CNPC, the foreign contractor has the power to resort to arbitration or litigation if other methods of dispute resolution fail.[231]

(5) Stability clause — If new Chinese laws or regulations cause a material change in the foreign contractor's economic benefits under the contract, then the foreign contractor is entitled to consult with the CNPC and, together with the

228. 1993 Model Contract, supra note 7, arts. 7, 12; Gao, supra note 5, at 167; WPA, supra note 12, at 784.

229. 1993 Model Contract, supra note 7, arts. 7.1.1, 7.3.

230. Id. art. 8.7.

231. 1993 Regulations, supra note 6, art. 26; 1993 Model Contract, supra note 7, arts. 26.1-.2.

> CNPC, to amend the contract in order to maintain reasonable economic benefits for the foreign contractor.[232]

None of these tools, however, provides the foreign contractor with foolproof protection should the CNPC begin to act in a difficult or objectionable manner.

The foreign contractor's 49% participating interest, for example, merely represents a set of contractual privileges and obligations such as the right to share in cost recovery and profits and the duty to share costs. If the CNPC chooses a participation rate less than 50% and gives the foreign contractor a "majority" interest, then this does not mean that the foreign contractor will have any additional managerial control within the JMC, only that its share of cost recovery and/or profit oil will increase. Article 2 of the 1993 Model Contract states that the foreign contractor receives no implied rights under the petroleum contract: "Nothing contained in the Contract shall be deemed to confer any right on the Contractor other than those rights expressly granted hereunder."[233]

The foreign contractor and the CNPC each have equal representation on the JMC, with one important caveat: if the foreign contractor is comprised of more than one company, then each foreign company comprising the contractor has the right to appoint one representative to the JMC.[234] If the foreign companies comprising the contractor have divergent points of view, then the CNPC may have an advantage in presenting a "unified front" during JMC discussions.

All representatives on the JMC have the ability to participate in and, if necessary, veto group decisions. The unanimity requirement enables foreign contractors to prevent decisions from being made that may damage their interests but also has the unfortunate potential to lead to deadlock, even over small issues. The only exception to the unanimity requirement occurs during the exploration period: article 7.3.1 of the 1993 Model Contract specifies that if the parties fail to reach agreement

232. 1993 Model Contract, supra note 7, art. 28.2.

233. Id. art. 2.6.

234. Id. art. 7.1.1. Article 7.1.1 of the 1993 Model Contract offers no guidance in situations where there are more than five foreign companies comprising the contractor, thereby forcing the JMC to exceed its maximum size limit. Moreover, if there are two foreign companies comprising the contractor and the foreign contractor and the CNPC each have four representatives on the JMC, then the Model Contract provides no formula for allocating representation. If this situation arises, then each of the two foreign companies would presumably have the right to appoint two representatives to the JMC. See id.

during the exploration period, then the foreign contractor's proposal will prevail, provided that it is not in conflict with the provisions of the contract relating to exploration.[235]

After the exploration period, the lack of majority voting makes the activities of the JMC susceptible to being blocked by one or two recalcitrant members. While Indonesia, Malaysia, and Vietnam all have versions of the JMC (joint operating bodies with equal numbers of foreign and domestic representatives), none of the three requires the decisions of these bodies to be made unanimously[236] In 1988, in an attempt to minimize the problems of management by excessively large committees, investment incentives were promulgated for Chinese offshore contracts that reduced each party's representation on the JMC from three to five representatives down to one to three.[237] However, the 1988 offshore revisions left the unanimity requirement untouched.

Regarding the PMT, the foreign contractor may designate up to two-thirds of the representatives to the team. The foreign contractor's greater representation on the PMT reflects the fact that the foreign contractor, at least initially, is likely to have greater expertise in modern techniques of field development and operation. However, the PMT has less power than the JMT. it is a subordinate body responsible mainly for executing the instructions of the JMC in accordance with the Overall Development Program. Although it is unclear whether the PMT survives after the CNPC takes over field operations, it is likely that the foreign contractor's representation on the PMT will be permitted to survive such a takeover.[238] During its period of representation on the PMT, the foreign contractor should take advantage of its leadership role to (1) promote effective management of Chinese labor and (2) encourage superior implementation of the Overall Development Program.

In case a serious disagreement arises in the course of performing the petroleum contract, the foreign contractor, like the CNPC, may call

235. Id. art. 7.3.1.

236. WPA, supra note 12, at 222, 538, 738.

237. Id. at 513.

238. If Article 8.8 of the 1993 Model Contract regarding the transfer and takeover of production operations by the CNPC is taken to mean a complete transfer of operational responsibility from the foreign contractor to the CNPC, then one possible interpretation is that the foreign contractor must surrender its role on the PMT. See 1993 Model Contract, supra note 7, art. 8.8. However, since the PMT is "established in the organization of the Operator" rather than in the organization of the foreign contractor, the foreign contractor should be able to clarify during negotiations that the PMT will survive regardless of whether the joint venture or the CNPC is the operator of the field. See id. art. 8.7.

for arbitration or bring an action in the Chinese People's Court, as long as certain conditions are met. Article 26.1 of the 1993 Model Contract states that the parties "shall make their best efforts to settle amicably through consultation any dispute arising in connection with the performance or interpretation of any provision hereof."[239] If the dispute is not settled within ninety days after it arises, then either party may request arbitration as follows: (1) if the parties agree, then the dispute may be referred to the China International Economic and Trade Arbitration Commission ("CIETAC") to be arbitrated in accordance with CIETAC rules;[240] or (2) if the parties fail to reach agreement on the arbitration arrangement mentioned in (1), then the dispute may be referred to ad hoc arbitration.[241]

The ad hoc arbitration panel is composed of three arbitrators.[242] Each party appoints one arbitrator, who then together choose a third.[243] If, after the first party chooses an arbitrator, the second party does not choose one within sixty days, or if the first two arbitrators fail to choose a third within sixty days, then the Arbitration Institute of the Stockholm Chamber of Commerce is responsible for appointing the second and/or third arbitrator.[244] Ad hoc arbitration is conducted in accordance with the rules of the United Nations Commission on International Trade Law ("UNCITRAL").[245]

Article 26 of the 1993 Regulations strongly suggests that the parties may provide in the petroleum contract for an arbitration tribunal other than CIETAC or the ad hoc panels described above:

> If the parties are not willing to resolve the dispute through consultations or mediation or if consultation or mediation is unsuccessful, the dispute may be submitted for arbitration by a Chinese arbitration institution or another arbitration institution in accordance with the arbitration clause in the

239. Id. art. 26.1.
240. Id. art. 26.2.1.
241. Id. art. 26.2.2.
242. Id. art. 26.2.2.1.
243. Id.
244. Id.
245. Id. art. 26.2.2.4.

> contract or a written arbitration agreement entered into subsequently.[246]

Under this provision, the parties, in theory, could choose another international arbitration body such as the Stockholm Chamber of Commerce or some other international arbitration body for the resolution of disputes arising in connection with the petroleum contract. Finally, article 26 of the 1993 Regulations provides that either party may bring an action in the Chinese People's Court if (1) there is no arbitration clause in the contract and (2) the parties subsequently fail to execute a written arbitration agreement.[247]

As presently drafted, the arbitration clause in the 1993 Model Contract favors CIETAC arbitration over the ad hoc procedure. This may present difficulties for foreign contractors worried about having disputes resolved before a Chinese tribunal. Those who favor the ad hoc procedure outlined above will find it problematic that the parties must first "fail to reach an agreement" on referring the dispute to CIETAC before the ad hoc procedure can be used.[248] In practice, this means that the foreign contractor will have to refuse to refer the dispute to CIETAC in order to obtain the kind of arbitration it wishes. Such procedural maneuvering may not be looked upon favorably by the ad hoc arbitration panel once its proceedings begin.

The Chinese ad hoc arbitration procedure itself, however, compares favorably to the arbitration provisions of other East Asian petroleum contract regimes. Indonesia and Malaysia both have procedures for choosing an arbitration panel that are similar to China's: each party appoints one arbitrator who then together choose a third.[249] Unlike Indonesia and Malaysia, though, China provides for the appointment of arbitrators by a neutral third party should the primary method of

---

246. Regulations of the People's Republic of China Concerning the Exploitation of On-Shore Petroleum Resources in Cooperation with Foreign Enterprises, art. 26 (Baker & McKenzie trans., 1993). See discussion supra note 198.

247. Regulations of the People's Republic of China Concerning the Exploitation of On-Shore Petroleum Resources in Cooperation with Foreign Enterprises, art. 26 (Baker & McKenzie trans., 1993).

248. 1993 Model Contract, supra note 7, art. 26.2.2. Since article 26 of the 1993 Regulations permits the parties to contract away arbitration by CIETAC in favor of a mutually acceptable alternative, the foreign contractor should attempt to amend this provision of the petroleum contract pursuant to the recommendations discussed in section IV.C below.

249. WPA, supra note 12, at 239, 541.

appointment fail.[250] The Chinese ad hoc arbitration provision is also more specific regarding the procedures to be used than the arbitration clauses of the Philippines and Vietnam, which provide, respectively, that disputes "may be settled in accordance with generally accepted arbitration practice" or referred to "an international arbitral tribunal" if settlement attempts fail.[251]

Finally, with respect to Item (5), the stability clause is not as protective of the foreign contractor's economic benefits as it may first appear.[252] The most significant problem is that a "material change" in the foreign contractor's economic benefits could be interpreted as being either an adverse or a beneficial change. Thus, it is conceivable that a new law or regulation that materially benefits the foreign contractor could trigger the parties' duty to confer and, ultimately, to make compensating adjustments to the contract. In addition, any revisions or adjustments that are made pursuant to the stability clause will be designed to maintain the foreign contractor's "reasonable economic benefits" rather than the foreign contractor's full economic benefits under the contract. The fact that the stability clause merely maintains the foreign contractor's "reasonable economic benefits" detracts from the purpose of such clauses, which is to put the foreign contractor back in the position it was in when it signed the contract.

C. *Negotiation Strategies for Control and Dispute Resolution Provisions*

Given the extensive control machinery described in the preceding two subsections, it is clear that China attaches a high priority to these provisions. Negotiators will find it difficult to (1) reduce the burden of CNPC's managerial control over the foreign contractor and (2) strengthen the foreign contractor's influence over the actions of the CNPC. Since, for the most part, the other four East Asian regimes do not contain such

---

250. 1993 Model Contract, supra note 7, art. 26.2.2.1.

251. WPA, supra note 12, at 114, 738.

252. The complete provision reads as follows: "If a material change occurs to the Contractor's economic benefits after the effective date of the Contract due to the promulgation of new laws, decrees, rules and regulations or any amendment to the applicable laws, decrees, rules and regulations made by the Government of the People's Republic of China, the Parties shall consult promptly and make necessary revisions and adjustments to the relevant provisions of the Contract in order to maintain the Contractor's reasonable economic benefits hereunder." 1993 Model Contract, supra note 7, art. 28.2.

provisions, they offer little guidance as to how the scope of the Chinese provisions might be modified or limited.

Foreign contractors should seek to obtain certain key changes in the structure of the JMC and to clarify the dispute resolution procedure. Foreign contractors should also implement the recommendations made in Section III.C above with respect to (1) safeguarding proprietary technology and (2) defining the foreign contractor's managerial rights during the period after the CNPC has taken over operations but before the expiration of the contract. Apart from amending and clarifying the language of the petroleum contract, the best way to reduce the negative impact of the control provisions is to begin as early as possible to lay the groundwork for a lasting cooperative relationship with the CNPC. An important foundation of this relationship is the development of good face-to-face rapport with CNPC "contact people" appointed under the petroleum contract (the procurement representative, professional representatives, and engineers).

Regarding the composition of the JMC, negotiators should seek the same reduction in size that has already been implemented for offshore contracts (each party limited to one to three representatives on the JMC instead of three to five).[253] To avoid the increased possibility of deadlock inherent in having multiple voters with veto power, the parties may wish to agree that each side will have only one voting representative on the JMC. This proposal, however, will be a viable solution only where there is only one foreign contractor participating in the petroleum contract.

One commentator suggests that foreign contractors should request an opportunity to chair the JMC and seek contract language that permits the JMC to make minor decisions with a less-than-unanimous vote of the committee.[254] The latter change, however, may not be as helpful as it appears. To achieve a favorable majority on a controversial issue, the foreign contractor would have to persuade a CNPC representative to disagree openly with the other CNPC representatives on the JMC, a relatively unlikely scenario. If there are multiple foreign contractors with divergent interests represented on the JMC, then the reverse is more likely to occur: the CNPC may be able to persuade one or more of the foreign contractors to break ranks with its compatriots and achieve a majority favorable to the CNPC. To avoid disagreement under these

253. WPA, supra note 12, at 513.
254. Gao, supra note 5, at 168.

circumstances, the foreign companies comprising the contractor should make an effort to achieve consensus on potentially divisive issues prior to meeting with the CNPC.

As previously described, the foreign contractor must submit in advance a proposed list of nominees for senior staff in charge of field operations to the CNPC. The foreign contractor should attempt to reduce the threat of the CNPC vetoing the appointment of its favored managers. This may be done either by (1) seeking to make article 8.2 of the 1993 Model Contract a pure notification provision (by dropping the consent clause) or (2) trying to secure a symmetrical provision that gives the foreign contractor corresponding veto power over the CNPC's senior staff appointments. To reduce the burden of having to recruit qualified Chinese employees through the CNPC, the foreign contractor should also secure a provision permitting it to seek qualified Chinese personnel from any available source.

In order to strengthen the dispute resolution procedures, ad hoc arbitration should be made the primary method of dispute resolution under the petroleum contract. If possible, the requirement that the parties must fail to agree to arbitration by CIETAC before other forms of arbitration may be used should be deleted from the contract.[255] Article 26 of the 1993 Regulations, which permits the parties to contract away arbitration by CIETAC in favor of a mutually acceptable alternative, should be cited as authority for such a change. Using the ad hoc procedure would bring the composition of the Chinese arbitration panel in line with those of the other four East Asian petroleum contract regimes and help to ensure impartial results.

The CNPC, however, may not be willing to eliminate references to CIETAC from the contract entirely From the point of view of the foreign contractor, dispute resolution by CIETAC should probably be viewed as a second-best option. Although the prestige of CIETAC is high in comparison to the Chinese court system, local protectionism in Chinese tribunals is reportedly widespread, making recourse to either CIETAC or the courts potentially riskier than ad hoc arbitration.[256] Regardless of which form of arbitration is used, the parties should agree upon arbitation as the exclusive remedy for resolving disputes in order to avoid the more costly possibility of actions being brought in court.

255. See 1993 Model Contract, supra note 7, art. 26.2.2.

256. See China's Arbitrary State, Economist, Mar. 23-29, 1996, available in LEXIS, News Library, Curnws File; Why "Laws Go Unenforced," Beijing Rev., Sept. 11-17, 1989, at 18.

The permissive language of article 26.2 should also be amended to mandate that disputes go to arbitration after the required ninety-day consultation period expires.[257]

Article 26.2.2.4 of the 1993 Model Contract specifies that the ad hoc panel use the 1976 UNCITRAL arbitration rules.[258] However, foreign contractors may wish to request an arbitration clause that mandates using the rules of the Stockholm Chamber of Commerce. Unlike the rules of the International Chamber of Commerce (which are often used in contractual arrangements in Taiwan), the Stockholm rules have proven acceptable to Chinese negotiators in the past.

As to the stability clause, the foreign contractor should seek to clarify that the clause will apply only when new or amended regulations have caused an "adverse material change" in the foreign contractor's economic benefits under the contract. If such an adverse material change occurs, then the stability clause should mandate that the contract be revised to maintain the foreign contractor's full "economic benefits under the contract," rather than merely its "reasonable economic benefits" thereunder.[259]

To develop a smooth working relationship with the CNPC, foreign contractors should appoint contact people to act as counterparts to each of the CNPC representatives discussed above. These "counterpart representatives" should have a good preexisting relationship with the CNPC and be given long-term responsibility for keeping open lines of communication with the CNPC procurement representative as well as other professional representatives, engineers, and members of the JMC.

The foreign contractor's nominees for senior staff positions should be floated informally with the CNPC ahead of time, well before the

257. Article 26.2 of the 1993 Model Contract states: "Any dispute mentioned in Article 26.1 herein that has not been settled through such consultation within ninety (90) days after the dispute arises may be referred to arbitration at the request of and by either Party to the Contract." This provision may be amended to read as follows: "Any dispute mentioned in Article 26.2 herein that has not been settled within ninety (90) days after the dispute arises shall be referred to arbitration."

258. Id. art. 26.2.2.4.

259. The provision immediately preceding the stability clause contains similar qualifying language to weaken the thrust of an otherwise liberal provision. The provision states that while the petroleum contract is generally governed by Chinese law, non-Chinese law may apply under the following circumstances: "Failing the relevant provisions of the laws of the People's Republic of China for the interpretation or implementation of the Contract, the principles of the applicable laws widely used in petroleum resources countries acceptable to the Parties shall be applicable." Id. art. 28.1. Since the use of the phrase "acceptable to the Parties" potentially limits the application of international principles and practice based on the objection of one of the parties, the foreign contractor should seek to have this phrase deleted from the contract.

formal submission of the list of nominees required by the Model Contracts. All nominees should be introduced to relevant CNPC personnel and spend time with them outside of a purely business context. The foreign contractor's obligation to train Chinese personnel provides a good opportunity to develop mutual loyalty and trust. Some companies may find it feasible to send Chinese candidates to one or more of their offices in the United States for a brief period of orientation and training.[260]

Where possible, foreign contractors should attempt to take the initiative, both in the management and the technical aspects of onshore projects. The foreign contractor's representation on the PMT, in particular, will enable it to take a leadership role in the implementation of the contract. While the CNPC will have a significant amount of managerial influence under the petroleum contract, the foreign contractor, in practice, need not cede so much control. As long as the foreign contractor is diligent about maintaining relationships and acquits itself well in the role of teacher and foreign expert, it may be possible to overcome some of the more burdensome obligations of the Model Contracts.

V CONCLUSION: PROSPECTS FOR THE FUTURE

As we have seen, China's onshore oil law is designed to make onshore oil exploration and development financially attractive to foreign investors. Nevertheless, the purpose of the 1993 Regulations and the Model Contracts is to enable China to maintain control over its domestic oil resources while maximizing its ability to draw on foreign technology and expertise.

Foreign negotiators seeking to obtain the types of concessions and changes to the Model Contracts described in Sections II through IV will be interested in knowing whether the CNPC and other organs of the Chinese government seriously intend to (1) offer better onshore exploration blocks and (2) negotiate petroleum contracts that will work to the advantage of both parties. As the first three rounds of onshore bidding have already indicated, China's intentions are notoriously hard

260. As mentioned previously, this strategy has been used by the Parker Drilling Company, the first American drilling contractor to be extended an onshore drilling contract in China and a firm with a long-standing commitment to the China market. See Parker Signs China Contract, PR Newswire, Oct. 26, 1995, available in LEXIS, World Library, Allwld File.

to gauge. On the one hand, China's growing oil deficit and professed need for foreign assistance hold out great hope for future cooperation. On the other, the poor quality of recent offerings, coupled with Chinese reports of sharp production increases and improved find rates in the northwest achieved by Chinese producers with minimal foreign assistance, may be an attempt by the Chinese government to show that it intends to rely on the CNPC for the bulk of onshore exploration and development.

By the fourth quarter of 1995, China claimed that thirty-eight oil fields had been developed in the Xinjiang onshore region with total estimated reserves of 30 billion tons (219 billion barrels) — a figure too large to be reliable until further evidence is gathered.[261] China stated that, overall, oil production for the three major northwestern basins was up 31.6%, with the largest increases in production occurring in the Turpan-Hami Basin (58%) and the Tarim Basin (37%).[262] Annual production capacity from the Tarim Basin alone was said to have increased to 5 million tons.[263] The CNPC claimed that it had invested over 10 billion yuan ($1.2 billion) in the Basin and had achieved oil output during the previous six years equivalent to half its investment.[264]

Press releases have also claimed that Chinese producers have achieved (1) a higher success rate for deep exploratory wells in the Tarim Basin than the world average (47% versus 31%) and (2) higher verified oil and gas reserves for each exploratory well in the Tarim Basin than the Chinese national average.[265] Finally, in the past three years,

261. Fu Jian, China: Oil Energizes the Economy in Xinjiang, China Daily, Oct. 7, 1995, available in LEXIS, World Library, Allwld File. The credibility of this estimate is open to doubt. China has claimed that the Tarim Basin contains 19 billion tons of verified oil and gas reserves. Foreign industry publications, however, have estimated the proven reserve base in the Tarim Basin to be only 270 million tons of oil (1.97 billion barrels) and 100 billion cubic meters of natural gas. Compare Oil Development Brings Prosperity to Xinjiang, Xinhua News Agency, Oct. 17, 1995, available in LEXIS, World Library, Allwld File with Asian Fuel Security: Better the Devil You Know, Power Asia, Dec. 11, 1995, available in LEXIS, World Library, Allwld File. But see Kent E. Calder, Asia's Empty Tank, Foreign Affairs, Mar./Apr. 1996, available in LEXIS, News Library, Curnws File ("China appears to have huge reserves in the 220,000-square-mile Tarim Basin of western Xinjiang province, close to the Russian border; some experts suggest that Tarim could top Saudi Arabia's proven reserves of nearly 250 billion barrels.").

262. China's Oil Production Up in First Ten Months, Xinhua News Agency, Nov. 8, 1995, available in LEXIS, World Library, Allwld File.

263. China: Profits Are on Tap in Xinjiang's Tarim Basin, China Daily, Oct. 10, 1995, available in LEXIS, World Library, Allwld File.

264. Id.

265. Id.

China is said to have narrowed the gap with world standards of petroleum engineering and, in some respects, attained the level of international petroleum technology in the early 1990's.[266]

Does such positive news from China's domestic oil producers indicate a waning desire to cooperate with potential foreign contractors? In the short term, China may be showing that it still intends to work as independently from foreign producers as possible. But the recent press releases may also represent an attempt to create a stronger bargaining position: China may be trying to foster the impression that the CNPC can, if it wishes, walk away from deals that do not adequately serve Chinese interests.

The published figures regarding Chinese onshore production, profitability, and success rates, however, are subject to question. For example, although production capacity in the Tarim Basin is now up to 5 million tons, the lack of transportation infrastructure is limiting actual annual production to 3.6 million tons.[267] CNPC's profitability statistics for the Tarim Basin reportedly may have failed to take certain subsidized expenses into acount, including a purported sum of $400 million spent on exploration and development as well as other government loans and grants.[268] Finally, foreign observers claim that the efficiency of Chinese drilling teams is still well below international standards, with nine out of ten wells allegedly having to be redrilled.[269]

If the latter explanation is true and unduly optimistic statistics are being used to bolster China's negotiating leverage, then it appears that foreign contractors can and should hold out for better terms than they have previously been offered. Other factors point to China's willingness and need to offer concessions to foreign contractors negotiating future petroleum contracts. China's recent flexibility in modifying contract terms, first in the 1988 revisions to the 1982 Offshore Model Contract, then in the 1994 and 1995 revisions to the 1993 Onshore Model Contract, bodes well for the future. The reported advances in production efficiency in the northwest have been insufficient to replace the rapid

266. Lao Chang, China: Oil Drilling Methods Improve, Bus. Week (China Daily Supplement), Nov. 19, 1995, available in LEXIS, World Library, Allwld File.

267. Ian Johnson, China Invests Big Money in Desert Oil Field, but Results Are Economic Trickle, The Sun, June 18, 1995, at 6A.

268. Id.

269. Id.

depletion of China's other developed onshore fields.[270] Each percentage point increase in China's GDP has been estimated to cause a corresponding 0.7% rise in the domestic consumption of petroleum products.[271] Sustained double-digit economic growth is likely to cause China's oil needs to grow at a rate of more than 7% per year to the year 2000 and beyond.[272]

To achieve more substantial success in making up its oil deficit, China may be forced to take a "fast track" approach to developing its onshore resources by soliciting the help of foreign capital and technology As one oil executive commented in 1995, even if China were to invite greater foreign participation in onshore development in the northwest immediately, "it would at least take ten years to start production if you begin exploration work now"[273] As potential foreign contractors continue to wait for further onshore opportunities, the only clear financial winners have been foreign equipment suppliers.[274]

Overall, however, it is likely that economic pressures, China's looming oil deficit, and its need for foreign capital and technology to develop its existing resources will eventually steer the CNPC toward greater cooperation with foreign contractors. At that time, foreign contractors should seek to lighten the burden of the performance and oversight provisions previously described. The hope is that the drafters of the original provisions will see the benefits of flexibility and make a commitment to long-term international cooperation. As always, however, the paramount issue is not the Chinese legal or political context. Rather, the most important contingency is whether future onshore contractors will strike oil and, ultimately, earn a satisfactory financial return.

---

270. David Hanna & Winnie Lee, New Tarim Acreage Part of 3rd Round: Possible Reaction to Industry Complaints, Platt's Oilgram News, Jan. 3, 1995, available in LEXIS, News Library, Curnws File; Geoffrey Murray, Chinese Oil Industry Faces Big Obstacles to Growth, Japan Econ. Newswire, Feb. 26, 1995, available in LEXIS, News Library, Curnws File.

271. See China Stepping Up Foreign E&P Investment as Oil Imports Soar, Oil & Gas J., May 9, 1994, available in LEXIS, News Library, Arcnws File.

272. See Derek Bamber, Late Welcome for Foreign Funds; Petroleum and Gas Exploration in China, Petroleum Economist, June 1994, available in LEXIS, News Library, Curnws File.

273. Winnie Lee, 2,000-Mile Tarim Pipeline Under Study By China, Platt's Oilgram News, Apr. 24, 1995, available in LEXIS, News Library, Curnws File.

274. Ian Johnson, China Invests Big Money in Desert Oil Field, but Results Are Economic Trickle, The Sun, June 18, 1995, at 6A.