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# THE COLOMBIAN ROYALTY SYSTEM: HOW FLEXIBILITY IN LAW-MAKING GENERATES INVESTMENT

*Maria Angelica Espinosa\**

## I. INTRODUCTION

ONE year ago, Colombians wondered if the government of newly elected president Alvaro Uribe would live up to its promises.<sup>1</sup> Uribe campaigned on putting an end to the guerrilla conflict and orchestrating peace. Uribe, like the country's previous president, Pastrana,<sup>2</sup> has compromised his image with the willingness to negotiate a peace treaty with insurgent groups, who are as likely to agree to it as the government is willing to stick to its word.<sup>3</sup>

The battle between settling the armed conflict through negotiation or force brings Colombia face to face with the economic crisis suffered by the country, especially with unemployment reaching 19 percent and a slump in the number of energy contracts being signed and developed.<sup>4</sup> Colombia, now largely dependent on oil and gas exploration<sup>5</sup> and development contracts, suffers from a slowing worldwide economy and the decrease in foreign capital expenditures.<sup>6</sup> The new royalty system is a reasonable solution in an effort to increase foreign investment.

## I. THE IMPACT OF THE OIL MARKET IN COLOMBIA'S ECONOMY

The petroleum industry in Colombia has an enormous impact on the economy, with the oil sector representing 4.5 percent of the gross domestic product.<sup>7</sup> Colombia "seems poised for a period of sustained economic

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1. Energy Information Administration, *Colombia Country Analysis Brief*, available at <http://www.eia.doe.gov/emeu/cabs/colombia.html> (last visited Sept. 16, 2002).

2. See Jorge L. Esquirol, *Can International Law Help? An Analysis of the Colombian Peace Process*, 16 CONN. J. INT'L L. 23, 31 (2000).

3. Alicia Puyana, *Colombia: Prospects for the Oil Industry*, at <http://www.cera.com> (last visited Sept. 20, 2002).

4. See *id.*

5. Juan Carlos Palau, *Transactional, Social, and Legal Aspects of Oil Exploration and Extraction in Colombia*, 22 NW. J. INT'L L. & BUS. 35, 36 (2001).

6. Puyana, *supra* note 3.

7. Fossil Energy International, *An Energy Overview of Colombia*, available at <http://www.fe.doe.gov/international/colbover.html> (last visited Oct. 15, 2002).

development”<sup>8</sup> with improving development factors including political stability, debt reduction, new fiscal policy, economic development, and government non-intervention in the form of privatization.<sup>9</sup>

Today, Colombia is ranked fifth in Latin America for crude oil production.<sup>10</sup> It achieved self-sufficient oil energy status in the early 1970s, only to require oil imports again in 1976.<sup>11</sup> As most worldwide projects in exploration and production surfaced in the decade of the seventies, Colombia saw the oil industry contributing largely to its gross domestic product.<sup>12</sup> These “black gold” sales amounted to 20 percent of Colombia’s total exports, with prices averaging \$20 a barrel; the oil business contributes \$1.8 billion annually in taxation and royalty checks to the Colombian government.<sup>13</sup> As of 2001, oil and gas derivative exports make up 25 percent of Colombia’s revenues, but crude oil production fell in production figures from 604,399 BPD (barrels of oil per day) to 540,000 BPD forecasted for the 2002 calendar year.<sup>14</sup>

A climate of violence persists in Colombia with the emergence of “resource curse” gangs. These insurgent groups flourished through the implemented pipeline distribution locations in the country by bombing the major pipelines in Colombia.<sup>15</sup> This results in the country’s untapped oil reserves remaining unproductive.<sup>16</sup> Only 20 percent of the country’s potential oil territories have actually been surveyed and explored, a factor reflecting the difficult investment climate for foreign multinationals.<sup>17</sup>

Insurgent organizations like National Liberation Army (ELN) and Armed Revolutionary Forces of Colombia (FARC) have named oil companies, in particular Occidental Petroleum and Spanish-owned Repsol, as prospective military targets for actively working in the oil fields.<sup>18</sup> The guerrilla groups have bombed Colombia’s oil pipelines more than 1,000 times since 1986, creating a negative atmosphere for capital inflows by portraying a dangerous image of the country.<sup>19</sup> In 2001, these two armed groups bombed the nationally renowned Caño Limón pipeline in excess

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8. Jay G. Martin, *Venezuela as an Opportunity for Investment in the Petroleum Industry*, 20 *ENERGY L. J.* 325 (1999); Thomas W. Waelde, *International Energy Investment*, 17 *ENERGY L. J.* 191, 196 (1996).
  9. See Mario Andrade & Mario A. de Castro, *The Privatization and Project Finance Adventure: Acquiring a Colombian Public Utility Company*, 19 *Nw. J. INT’L L. & Bus.* 425, 444 (1999). See also Martin, *supra* note 8; Waelde, *supra* note 8.
  10. Fossil Energy International, *supra* note 7.
  11. *Id.*
  12. *Id.*
  13. Puyana, *supra* note 3.
  14. Mary Morrison, *Colombian Congress Ok’s New Range for Oil Royalty Tax*, available at <http://www.petroleumworld.com/story8377.htm> (last visited Oct. 15, 2002).
  15. Fossil Energy International, *supra* note 7.
  16. Energy Information Administration., *supra* note 1.
  17. Thad Dunning & Leslie Wirpsa, *Oil Rugged*, available at <http://www.globalpolicy.org/security/natres/oil/2001/0201colo.htm> (Feb. 2001).
  18. Energy Information Administration, *supra* note 1; see Esquirol, *supra* note 2, at 30-31.
  19. Dunning, *supra* note 17.

of 170 times.<sup>20</sup> The latest incident on September 30, 2002, affected production in 3,000 BPD of the 100,000 BPD produced in this field.<sup>21</sup> Due to these security risks, not only are foreign multinationals wary about prospective financial investments in the country, they inherently fear for the safety of their partners and employees.<sup>22</sup>

Nearly 80 percent of the country's unexplored territory awaits a more stable investment climate.<sup>23</sup> Though Colombia and its oil-rich neighbors (primarily Venezuela) import more oil derivatives to the United States than all Persian Gulf countries combined,<sup>24</sup> pipeline bombings<sup>25</sup> and kidnappings create an unwanted image to potential investors.<sup>26</sup>

## II. COLOMBIA'S ASSOCIATION CONTRACT

Despite obvious threats to Colombia's economic lifeline, investment in the oil industry has begun to moderately improve as the number of signed contracts in 2002-2003 has increased.<sup>27</sup> The slight improvements in the oil industry<sup>28</sup> are bolstered by new discoveries, such as the Guando field in nearby Bogotá, which add to the overall enthusiasm in the industry.<sup>29</sup>

The government and Ecopetrol, the state oil company, recognize the situation, and must encourage both a more favorable investment climate and a friendlier business place<sup>30</sup> "to attract foreign investment for exploration and exploitation of additional sources and the existing ones."<sup>31</sup> Since its inception, Ecopetrol manages all association contracts<sup>32</sup> and constitutes the vehicle through which investment capital is applied.<sup>33</sup> As oil prices rose deeply in the early 1970's, the Colombian government decided to make some important changes to exploration and production policies. The most important change to the association contract was the

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20. Energy Information Administration, *supra* note 1.

21. Ecopetrol, *Atentados en Pozos de Caño Limón [Bombings in Caño Limón]*, available at <http://www.ecopetrol.com.co/news/not30-09-02.htm> (Sept. 30, 2002).

22. See Dunning, *supra* note 17.

23. *Id.*

24. *Id.*

25. But see Charles Roth, *As Oil Prices Rise, Andean Region's Crude Output Sags*, available at <http://www.petroleumworld.com/storyT336.htm> (August 27, 2002) (showing that in 2002, attacks have been reduced to five per month, compared to fourteen in 2001, thus allowing higher production numbers and increased exports of Caño Limón crude to the United States.)

26. See Energy Information Administration, *supra* note 1; see also Dunning, *supra* note 17.

27. Puyana, *supra* note 3.

28. See *id.*

29. Fossil Energy International, *supra* note 7; see also Ecopetrol, *El Campo ya Completó su Primer Millón de Barriles de Producción [The Field Completed its First Million Barrels Per Day]*, available at <http://www.ecopetrol.com.com/news/not31-05-02.htm> (May 31, 2002).

30. Puyana, *supra* note 3.

31. Palau, *supra* note 5, at 36.

32. Association contract is the term given to a signed contract between the foreign investment company and Ecopetrol.

33. See Ecopetrol, *Empresa Colombiana de Petróleos*, available at <http://www.ecopetrol.com.co/ingecopet/localiza.htm> (last visited Oct. 27, 2002).

adjustment from fixed oil prices to international levels of the commodity.<sup>34</sup>

Prior to the 1973 adjustment, foreign investors had the right to sell and Ecopetrol had the right to buy production at fixed petroleum prices that it determined.<sup>35</sup> The inability to command international premiums at the time of the OPEC oil embargo made investment in Colombia's petroleum industry unpopular.<sup>36</sup> Once the adjustment took place in the association contract, foreign investors started reaping larger benefits from international petroleum prices. No longer depressed, prices skyrocketed and Colombia was able to attract foreign investment capital to its oil fields. After the biggest oil discovery in 1989, Caño Limón, Ecopetrol created a sliding-scale production-sharing agreement targeted at larger deposits.<sup>37</sup> These larger deposits allowed Ecopetrol to demand a higher rent for production figures. Most international companies with active investments in South America were not enthusiastic about this sliding scale agreement and concluded Ecopetrol was taking up too large a share whenever most convenient.<sup>38</sup>

In 1994, the Colombian Congress and Ecopetrol, the main two agents in the policy-making process, adjusted this sliding scale production-sharing feature of the association contract to lure more foreign capital into the energy industry.<sup>39</sup> The association contract incorporated the "R" factor, eliminating the sliding scale system.<sup>40</sup> Under the "R" factor system, production is split fifty/fifty for each partner until costs are recovered or production exceeds sixty million BPD.<sup>41</sup> Thereafter, the government's take on production increases up to 75 percent.<sup>42</sup> Despite the changes in the contracting system, the royalties remained too generous with the State, and with safety issues at their worst levels, a new legislative approach was needed in order to correct the lack of foreign investment.

### III.    LEGISLATING TOWARDS A MORE DIVERSE AND           ATTRACTIVE ROYALTY SYSTEM

In June 2002, the Colombian Congress signed into law the amendment to the royalty rate in exploration and development projects. It sets out a royalty scale on the daily production rate on a monthly average production basis.<sup>43</sup>

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34. Armando Zamora, *Fourth Generation Association Contracts in Colombia: Has the Model Been Exhausted*, at <http://www.dundee.ac.uk/cepmlp/journal/html/article7-16.html>

35. *Id.*

36. *Id.*

37. *Id.*

38. *Id.*

39. *Id.*

40. *Id.*

41. *Id.*

42. *Id.*

43. Ecopetrol, *Fiscal Aspects*, at [http://www.ecopetrol.com.co/vep/engl/financial\\_aspects-royalties.htm](http://www.ecopetrol.com.co/vep/engl/financial_aspects-royalties.htm) (last visited Oct. 5, 2002).

CHART 1

Royalty Rate for Monthly average of daily oil production	
5,000 bpd or less	5%
above 5,000 bpd and below 125,000 bpd	5-20% straight line
above 125,000 bpd and below 400,000 bpd	20%
above 400,000 bpd and below 600,000 bpd	20-25% straight line
600,000 bpd or more	25%

From a previous fixed rate of 20 percent royalty on production across the board,<sup>44</sup> Colombia took steps to create a sliding scale royalty determined on the amount of production recovered from the ground. First, royalties now start at 5 percent on production up to 5,000 BPD, which will gradually increase until 20 percent is reached at levels between 200,000 and 400,000 BPD. At 400,000 BPD, the royalty increases again until it finally reaches 25 percent at production levels of 600,000 BPD. Production levels over 600,000 BPD cap the royalty rate at 25 percent.<sup>45</sup> Ecopetrol's participation in the joint venture is lowered from 50 to 30 percent,<sup>46</sup> making participation in exploration and development much more attractive to foreign investment companies willing to take the investment risk. The country's economic conditions, prospects, environmental regulations, legal security, and public order are factors weighed when deciding to participate in a risk project,<sup>47</sup> for which the industry is well known for.<sup>48</sup>

Despite a growing number of signed contracts, which largely depend on the Colombian Congress passing the new royalty amendment into law, the new reinvigoration in exploration activity is still lower than in past years.<sup>49</sup> The year 2000 marked another declining year "with investments of \$140 million, only half of the peak level" registered for the 1992 calendar year.<sup>50</sup> During 2001, Ecopetrol saw total investments surpass 2000's by more than double, but still below 1997-98 levels.<sup>51</sup> Ecopetrol's investment in exploration peaked at about \$20 million for 2001.<sup>52</sup>

Even though the Colombian Congress made it more appealing for foreign investment firms to invest in Colombia's oil industry, the lack of in-

44. Business News Americas, *President Stamps New Royalty Law—Colombia*, at <http://www.Bnamericas.com> (last visited Oct. 5, 2002).

45. Law No. 126, June 19, 2001. Article 16, (by which Law 141, 1994 is modified).

46. Ecopetrol, *New Oil Policy for Colombia*, at <http://www.ecopetrol.com.co/prin/review/carta/jul99/infor59b.htm>; see also Energy Info. Admin., *supra* note 1.

47. Ecopetrol, *New Oil Policy for Colombia*, *supra* note 46.

48. *Id.*

49. Ecopetrol, *Crece Exploración Petrolera en Putumayo [Petroleum Exploration Grows in Putumayo]*, at <http://www.ecopetrol.com.co/news/not06-08-02.htm> (August 6, 2002); see also Oil and Gas International, *Argosy Energy Scores More Favorable Terms from Ecopetrol*, at [http://www.oilandgasinternational.com/departments/licensing\\_concessions/aug02\\_argosy.html](http://www.oilandgasinternational.com/departments/licensing_concessions/aug02_argosy.html) (August 6, 2002).

50. Puyana, *supra* note 4.

51. *Id.*

52. *Id.*

vestment by Ecopetrol and international companies in association contracts and the lack of discoveries such as Caño Limón or Cusiana in the 1994-2000 period<sup>53</sup> impact the decline of reserves. At its peak, these fields added a total of 129 million barrels of oil in new reserves,<sup>54</sup> a positive and encouraging factor for attracting international capital. As OPEC tries to regulate oil prices in the \$22-28 range, Ecopetrol still needs to sign more contracts to encourage a higher level of discovery, which in turn gives new life to added reserves and the sliding scale royalty system now in place.<sup>55</sup>

These new amendments to the royalty rate in Colombia are instrumental in bringing about a different level of foreign capital to the country.<sup>56</sup> As security measures increase, it would be very difficult to sustain the level of royalty rate. The final effect would be the aversion of foreign companies to risk their employees' security, their goals, and their budgets. The equation becomes rather simple for the Colombian congressmen adjusting the law; as social circumstances deteriorate, one must alleviate the economic burden.

Colombia's possible benefit from the exploration of oil is immense. Not only will foreign capital supply a much needed source of government revenue in the form of royalty, but it will also allow Ecopetrol to increase its investment in the fields and take on more responsibility as operator and sole owner of reserves. Ecopetrol has decided to invest \$610 million in direct exploration for 2002 through 2006, doubling current investment rates from Colombia's state oil company.<sup>57</sup> The company has set aside nearly 19 percent of the 5 billion in investment dollars for new association contracts.<sup>58</sup>

Congress's change to the royalty rate is not a gamble. The country's previous discoveries of oil and the subsoil's richness in hydrocarbons are two very positive facts that support its decision. First, the crude discovered so far has been light; and second,<sup>59</sup> the country's comparatively low domestic consumption levels leave aside a larger share of oil export capacity than would be expected.<sup>60</sup> The surplus profit created by a slowing use of energy in the country invariably leads to more allocated funds for social as well as economic needs. This surplus could be reinvested in the substantial new exploration Ecopetrol must embark on if it wants to discover new and necessary oil reserves. A cycle of sustained growth must develop if the energy sector is to jumpstart the Colombian economy.<sup>61</sup>

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53. Fossil Energy International, *supra* note 7.

54. Puyana, *supra* note 3.

55. Morrison, *supra* note 14.

56. Business News Americas, *supra* note 44.

57. Puyana, *supra* note 3.

58. *Id.*

59. *Id.*

60. Palau, *supra* note 5, at 36.

61. Puyana, *supra* note 3.

#### IV. CONCLUSION

Colombia's economy is, and will continue to be, largely dependent upon the government revenues of its energy industry. After four different association contracts, the Colombian Congress adopted a sliding scale royalty rate that should not only increase the number of contracts signed, but also create a new wave of domestic exploration through Ecopetrol.

Although unemployment and violence are still issues to be addressed, Colombia's energy sector has an advantage with respect to its undiscovered reserves and its ability to export crude oil. For further economic recovery to occur, the slowing world economy must gain some of its lost momentum. The Colombian government officials and private sector entrepreneurs must also develop a strategy to attract foreign capital into Colombia's petroleum business. A surplus in crude oil in the form of royalties and exports will give the Colombian population a much needed source of revenue, which is committed to satisfy social and economic necessities.

As 2002 comes to an end, Ecopetrol has actively doubled its investment funds for the energy sector. If the whole country is to benefit from these economic investments, all Colombians must also take part by acknowledging the crisis, and by stopping the violence and corruption. A joint effort, the revenues obtained from exploration and development of crude, are only one side of a much larger and more important issue: the recovery of national respect and the ability to look forward to a prosperous future. Only then will Colombians enjoy their beautiful land and its natural resources.



## NOTICE OF ERRATA

To the Subscribers of *Law and Business Review of the Americas*:

In the article, "Corporate Governance: A Perspective" from Volume 9, No. 1, Winter 2003, Mr. Busbee's bio was omitted. We apologize to the author and subscribers for this omission.

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