Financing the Oil and Gas Industry: The Re-emerging of Countertrade

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Abstract
Despite the significant increase in the use of this particular type of trading system, there seems to be no universal consensus agreed upon the terms and definitions of countertrade. Nevertheless, it could be argued that the common understanding regarding the operation of countertrade is that it involves the practice of swapping products or services among parties for mutual benefits, in other words, the practice of reciprocity. Countertrade entails a number of specific characteristics. It is often established that countertrade is formed upon the concept of bilateralism where two main parties are involved in the transaction. Although there are various forms of countertrade, with regard to oil and gas industries nowadays, two main forms of countertrade are commonly used between trading parties. Throughout this essay, the author will discuss the following issues. Firstly, (i) the introductory information regarding countertrade practices in oil and gas industry, secondly, (ii) a number of legal financing instruments commonly used in this business. Also, (iii) the legal principles involved in the financing of international countertrade will be critically discussed and last but not least, the author will perform an overall evaluation as to whether the law and regulations relating to international countertrade can be considered sufficient to support business in such industry.
Keywords: Countertrade, Oil and Gas Industry, International Trade Law

Background on Countertrade

Barter
Although nowadays currency has replaced barter, the system still plays a major role in international trade. Barter, as it is known nowadays, refers to a practice of trade financing which, by allowing an exchange of goods or services, provides an alternative mean of payment that does not involve monetary instrument. Generally, barter is an agreement between two parties who have double coincidence of wants. In oil and gas industries, barter in crude oil is the best-known example of a convenient arrangement for the energy source is sought by all countries. Oil is currently treated as 'cash commodity' and most of the European countries are engaged in oil barter as purchasers (Guyot, 1986). Also, barter in crude oil transfer is often employed in order to convey crude below official prices set by the Organisation of Petroleum Exporting Countries (OPEC) (Kerres, 1991).

Counter-Purchase
A more common form of countertrade is known as a counter-purchase. In this transaction, an exporter purchases goods from a country in exchange for that country's purchase of an equivalent valued amount of the exporter's product. Each party is paid in currency upon delivery of its goods to the other party. Generally, the parties would agree upon a list of goods from which the private firms will later choose the items which it will purchase. Evidently, the most desirable goods are ores, chemicals and energy sources, which are oil and gas in particular (Lochner, 1985). In counter-purchase contract, it usually permits Western companies to delegate their counter-purchase obligation to a third party, a specialised trading house (a 'disagio'), or another foreign buyer. In 1977, a counter-purchase contract was entered into by a German steel company and an Iranian state corporation. As a countertrade

obligation, German company committed itself to buy crude oil from an Iranian second state corporation for a hundred percent of the value of the turnkey plant, which it had to deliver according to the stipulated terms of contract (Dusseldorf, 1982).

The Need for Financing and Security

Generally, all forms of countertrade require certain kind of financing. In oil barter, occasionally the value of the exchanging goods may not be entirely equal; therefore, the differences will be paid in currency. Moreover, trading in oil and gas industry involves a number of important risks and uncertainties such as the fluctuation in the market price of crude during the term of the countertrade contracts, the quality of oil and gas, and its significant susceptibility to political problems. These risks could easily lead to an event of non-fulfillment or default in the contract. Hence, there is also the need for security of performance required by trading parties. Accordingly, a range of payment methods and financing instruments are employed in oil and gas countertrade.

Letters of Credit (L/C)

'*Letters of credit are the single most important instrument used in international trade to guarantee the payment of money or the performance of other obligations*.' (Agasha, 2003). It is arguably the most popular security instrument used worldwide. L/C provides both sellers and buyers with certain degree of security and protection. For the seller, L/C would ensure him the payment from the sale of his goods or services whereas for the buyer L/C would act as a guarantee assuring him that he will obtain the goods or services he had paid for. Two main types of L/C are commonly used in countertrade transaction in oil and gas industry. These are regular commercial L/C, often called the documentary credit or banker's credit, and Standby L/C (SLC) respectively. Although these two instruments are named L/C, their functions and rules of application significantly differ from one another. In fact, scholars have grouped SLC into the same category as bank guarantee and performance bond, of which we will be examining in the following paragraph.

Bank Guarantee

First and foremost, a bank guarantee must not be confused with a common law guarantee for their legal applications and functions are distinctly different. As mentioned above, bank guarantee, performance bond and SLC serve the same purpose for commercial transaction, which is to guarantee the performance of an obligation owed to the beneficiary. Unlike common law guarantee where the nature of its obligation is secondary to the underlying contract, bank guarantee and SLC operate upon the same principles applied to L/C. That is to say, they are primary and independent undertakings by the bank, requiring payment without investigating facts of performance or default on the underlying contract (Mugasha, 2003).

On-Demand Guarantee

Despite its similar name and functionality presented in bank guarantee, on-demand or first demand guarantee is unconditional. In other words, the bank is obliged to pay the beneficiary on 'first demand' or 'on demand' regardless of any objections by the applicant. In this type of guarantee, there is no condition precedent since the requirement of presentation of conforming document is specifically displaced.

Escrow Arrangement

This is also known as a blocked account. In this payment arrangement, both parties will agree that the importers' payment by the exporters is to be deposited in an account at the agreed financial institution (a trustee bank) and the use and release of the funds deposited in the account will be subject to certain stipulated conditions. After the money have been deposited in the account, the importer will counter-exports i.e. deliver the goods and obtains payment from blocked account. The trustee bank will then pay the importer upon the presentation of stipulated documents (the UNCITRAL Legal Guide on International Countertrade Transactions).

Legal Principles Involved in the Mentioned Financing Instruments

It has been strongly established that due to the similarities in the functionality of L/C, bank guarantee and SLC, certain fundamental legal principles applied in L/C would apply to bank guarantee and SLC as well (Denning, 1978). For the purpose of this essay, I will focus on the autonomy principles and its exceptions with regard to the financing methods utilised in countertrade transactions in particular.

The Autonomy Principle

Most of oil and gas countertrade agreement involves two essential contracts:

1) The countertrade agreement contract. It sets forth stipulations regarding the manner in which the countertrade transaction is to be implemented. Additional clauses such as provisions concerning security for performance would be incorporated into this contract.

2) The supply contracts. These are generic contracts for the supply of goods in one or in both directions. Also, terms such as counter-purchase, counter-export or counter-import contracts are essentially the same as supply contract.

Regarding oil barter agreement, in the event where an occidental oil importer wishes to seek security while contracting with an oil exporter, an importer normally asks an exporter to provide bank guarantee or SLC[3] issued in the importer's country in favour of the importer (the beneficiary). The guarantee issued in favour of the beneficiary will be incorporated into the countertrade agreement contract, which is underlying contract. Provided that an oil exporter somehow fails to deliver its countertrade commitment to supply crude whereas the importer has already performed the undertaking on his part, for instance, delivering 10 Boeing 747's, the exporter could recourse to the issuing bank and demand for payment.

Accordingly, the issuing bank acting as a guarantor would have to pay the demand payment to the beneficiary upon the presentation of required documents specified in the contract. Thanks to the autonomy principle governing SLC, the issued guarantee would still be valid regardless of any breach occurred in the underlying contract. Nevertheless, this is not the case with common law guarantee where its validity coexists and depends on the validity of the main contract. Therefore, in order to avoid complications and disruptive disputes arising from arguments concerning the essence of the underlying contract, most oil countertrade agreements would use independent bank guarantee as a security device.

The above logic concerning the principle of autonomy would apply the same to other types of countertrade transactions provided that they employ L/C or independent guarantee as a security instrument.

Nonetheless, minor dissimilarity can be found in oil counter-purchase contract. In this type of countertrade, the deal is usually concluded between a private firm (e.g. Exxon Mobile Corp. selling oil) and a sovereign nation or state enterprise. Here, it is the sovereign nation who wishes for security guaranteeing the private firm's commitment to buy their commodities. Hence, sovereign nation will ask the private firm to apply for a bank guarantee, on-demand guarantee in particular, to be issued by the private firm's bank in favour of the nation (beneficiary). If the private firm later fails to perform his promised undertaking for any reasons, the beneficiary can proceed to the issuing bank and demand for payment regardless of any disputes concerning a breach in the contract. This is because, as mentioned, the principle of autonomy used in L/Cs also governs practices of bank guarantees. Additionally, if the parties had chosen on-demand guarantee as a payment-securing device, once the

[3] In this article, the term SLC and bank guarantee will be used interchangeably for they are essentially identical.

beneficiary claim for payment, the issuing bank has to pay promptly upon request without the presentation of documents and must disregard any objections raised by the applicant.

In an escrow arrangement, bank guarantee is usually issued between the two banks involved in the transaction of the blocked account (let us assume bank(A) is the trustee bank and bank(B) is the other bank). Guarantee is commonly issued by bank(B) in favour of the trustee bank. This is to protect the trustee bank in the event where the L/C applicant of bank(B) refuses to pay for the counter-purchase goods. Without such guarantee issued by bank(B), bank(A) who is responsible for the escrow account would have to pay his own client (as a confirming bank) and also have to pay bank(B) for the goods his client had contracted to purchase (here bank(A) is an issuing bank and have to pay bank(B), the confirming bank, for the reimbursement bank(B) demanded). In practice, bank(B) would always pay upon demand to bank(A) regardless of any disputes arising from the two countertrading parties. This is a standard practice of international banks and failure to do so would result in bank(B)'s credibility and possibly a sanction imposed by other international banking associations.

The Fraud Exception

Whilst the fraud exception is not mentioned in the UCP, the UN Convention on Independent Guarantees and Stand-by Letter of Credits has affirmed the use of fraud exception to the autonomy principle, which can be found in the 1995 UN Convention Article17, 19 and 20. In most countries, the fraud exception has been invented by domestic courts and such practice has been supported in the ICC Publication No. 399 where it states that this issue should be left to domestic laws. In the leading case of *Sztejn* (NYS, 1941), it has established that the beneficiary who commits fraud is not entitled to payment and the procedure for stopping payment is to obtain an injunction against the issuing bank. Similarly, in landmark case of *Edward Owen*, the fundamental characteristic of independence applied in L/C and bank guarantee was clearly stressed by Lord Denning who later held that issuing bank does not have to pay in the event where the beneficiary lacks an honest belief in its entitlement to demand payment.

Nevertheless, as most of fraud allegations are nearly always made in respect of on-demand guarantees (Bertrams, 2004); therefore, I would like to confine my examination to this particular type of guarantees. Although it has been commonly established that fraud can be used as a defence for stopping payment to the beneficiary, when considering fraud exception with on-demand guarantee, more attention will be required in order to properly assess their relevancies. Notably, in an on-demand guarantee, the applicant party accepts that the beneficiary is entitled to financial compensation without having to prove the applicant's default or the beneficiary's substantive right to compensation. More importantly, the beneficiary is entitled to immediate payment once the terms and conditions of the guarantee have been fulfilled. Such allocation of risks is expressed by the phrase 'pay first, argue later'. Disputes normally arise when the applicant is able to present clear evidence of fraud thereof immediately upon the demand for payment. Some commentators viewed that the beneficiary should not be able to claim payment if the applicant can establish beyond reasonable doubt that the beneficiary has no right to payment. Others suggest that 'paying first' would make no sense if the outcome of 'later arguments' is already evident' (Bertrams, 2004). These statements seem to suggest that '*whatever the notion of fraud may exactly entail, the evidence in this respect must be clear and it should be produced immediately without extensive investigation*' (Bertrams, 2004).

Nonetheless, when paying close attention to the functionalities entailed in on-demand guarantees, if the fraud exception can be, without much difficulty, relied on and accepted by the courts, it seems that courts might overlook the distinct feature of on-demand guarantee, which is the offer of prompt liquidation promised to the beneficiary who seeks emergency monetary recourses. Hence, by allowing the fraud exception to be used in stopping payment, arguably, it is possible that such intervention would undermine the fundamental purposes of on-demand guarantee. This controversial issue coupled with its legal uncertainty could possibly produce adverse impacts on the use of on-demand guarantee practiced in worldwide commercial transactions.

Evaluation

The use of L/Cs and bank guarantees discussed above is, however, presented with certain shortfalls. These instruments do not ensure performance but rather provide security that parties can resort to something in the event of the other party's failure to perform and they sometimes entail certain disadvantages.

Although in L/Cs, banks are obligated to pay upon presentation of the specified documentation, however, many companies in reality cannot provide such security for they would be asked to deposit the entire amount of fund with the bank. Also, in practice, SCLs issued by some banks will not be worth very much and would be disregarded by partner trading parties, especially if they cannot be confirmed, insured, or discounted. For an alternative financial arrangement of escrow account, it basically provides the same security as SLCs, depending upon the working of the trust agreement. However, this is a costly method of providing security and it is likely that your trading partner would resist the option (Ruttel, 2017).

Moreover, private firms who trade in oil and gas business are usually in need for financial support. This is because oil industry is usually reigned over by major enterprises who have full access to specialised resources which enable them to control the market share and dominate the practice of the industry (Haberman, 2016). Therefore, the law needs to facilitate and help other smaller firms who wish to conduct their business in oil and gas sector. In order to support private business in this area, many nations have initiated Export Credit Insurance and Guarantee Schemes (ECGSs), and established export credit agencies (ECAs). In general terms, official financial support to exporters and importers is provided through direct export financing and credit insurance. The aim is to insure exporters and importers against political and commercial risks by facilitating the access to bank finance and other significant resources of expertise as well as providing the information regarding partner countries or individual trading parties and associated risks. Still, there seems to be problems regarding the operations of the ECAs. Essentially, many argue that ECAs do not provide adequate information regarding their activities and there is a lack of trust in their services. These concerns coupled with the lack of reliable credit information systems and re-insurance facilities have effectively discouraged commercial banks from accepting insurance policies as a security (Friedland, 2002).

Nevertheless, most of the oil and gas countertrade agreements have been conducted between either state-to-state or at least state-involved basis. The reason is that the value of such trading transaction is usually significantly high and nearly always involved governmental participation. Moreover, private firms (exporters of oil and gas) do not normally wish to be paid by commodities and neither do they wish to perform counter-purchase commitment on products that are not in their interests. Hence, financing by international organisations will be examined here. Two major international organisations have played important roles in financing sovereign nations, LDCs (Least-Developed Countries) particularly. Usually, LDC nations would wish to trade their local commodities for oil or other energy supplies. The problem for LDCs is that they often find it difficult to finance the counter-purchase agreement due to their perhaps large foreign debt and trade balance deficit. Accordingly, the need to find financing credit is paramount. Organisations such as the IMF, whose purpose is to help expand and balance international trade, to promote international monetary cooperation, and to make loans that allow member nations to finance temporary international payment imbalances (found in IMF Charter Article I.), and World Bank could provide financial support for these less developed nations. Nevertheless, the lending practices of these organisations are subjected to strong criticisms. It is argued that the entire IMF lending program creates long- term dependency rather then short-term assistance (Johnson, Schaefer, & Kingham, 1997). Less-developed nations increasingly rely on IMF loans for longer periods and most borrowers of conditional loans are economically worse off than before the loan. More importantly, the conditions sometimes require countries to de-regulate its economy by eliminating tariffs, trade barriers and subsidies to local industries; this tend to benefit multi-national firms more than the nation itself.

Considering participations of the World Bank, its task today is to provide loans to poorer, economically developing countries in Africa, Asia, and Latin America. Nevertheless, like the IMF, World Bank's policy is also confronted with harsh criticisms. Many observe that its policies favour the interests of the richest industrialised nations. These countries require poorer nations to deplete their natural resources, such as oil, gas and lumber, in order to repay massive debt loads, this is viewed as major exploitations to less-developed nations where often it has been discovered that the oil used in repayment for foreign debts are being traded at heavily discounted and disadvantageous rate.

Conclusion

Generally, both domestic and international laws governing the financing of countertrade should be transparent and just. The application of such laws and principles concerning L/C and bank guarantee should also be clear and consistent so as to provide confidence to exporter/importer who rely on these financial instruments. Evidently, there are still certain inconsistencies amongst different jurisdictions regarding the application and interpretation of the law related to international countertrade transaction. Furthermore, regarding oil and gas countertrade conducted between states and powerful cartels such as OPEC, BP and Exxon Mobile, stronger supports, legally and financially, should be provided to nations or private firms trading with these oil and gas giants. Therefore, I am of the opinion that, in order to support oil and gas countertrade especially for less-developed countries, it is crucial to impose policies which aim at achieving sustainable development for these countries. Stricter surveillance and vigorous enforcement on regulations and conditionality imposed by international organisations must be met and implemented effectively.

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