FISCAL STABILITY ASSURANCE IN PETROLEUM AGREEMENTS: FINDING THE BEST PRACTICE MODEL FOR THE MODERN FISCAL STABILISATION CLAUSE

By

TSHEGOFATSO MATSOBANE RAMMUTLA

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prepared under the supervision of

Adv. Leonardus J. Gerber

Department of Public Law

Faculty of Law

University of Pretoria

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DECLARATION OF ORIGINALITY

I, TSHEGOFATSO MATSOBANE RAMMUTLA, hereby declare that this dissertation is my original work, and other works cited or used are clearly acknowledged. This work has never been submitted to any University, College or other institution of learning for any academic or other award.

Signed: ………………………

Date: ………………………

This dissertation has been submitted for examination with my approval as University supervisor.

Signed: ………………………

Adv. Leonardus J. Gerber

University of Pretoria

Date: ………………………

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ABSTRACT

The petroleum industry is beset with risks that can threaten the commercial viability of extractive companies. These risks also pose a danger to the economies of countries and the jobs of the men and women on the ground. Some of these risks are unavoidable and come part and parcel with extracting hydrocarbons. However, fiscal risk is something that can be managed and thereby minimized – for the good of both the state hosting the resource and the extractive company. A number of tools exist to manage this risk; this study looks at the fiscal stabilisation clause as it is a particularly popular option for investors.

The study takes a qualitative approach through an investigation into literary works and explores how and why the fiscal stabilization clause has become a popular option for fiscal risk management. These clauses have been heavily criticized by various stakeholders and yet they remain as relevant today as when they were first shaped in the 20th century. The study also looks at the controversy surrounding the validity of such clauses by examining various legal sources – particularly doctrinal writings and international arbitration rulings. The investigation reveals a shift in the stabilisation clause's scope, and more importantly its objective, over the years. Drafters as well as legal opinion seems to be at odds with the restrictive nature of yesteryear clauses, which may unjustly tie the hands of a host state – and as such a more balanced approach is sought.

These considerations lead to the main thrust of the study which is to determine what practical drafting steps can be taken to ensure the efficacy of these clauses. The focus leans on the most pertinent substantive components that such a clause should contain to ensure the risks and benefits of resource development are shared fairly. The procedure and objective of the renegotiation mechanism contained the clause is particularly important as it is this key ingredient that makes or breaks the fiscal stability of a project. The study builds on extensive writings on the subject and attempts to build a body of best practice in this regard.

LIST OF ACRONYMS

AEB	Automatic Economic Balancing
FSC	Fiscal Stability Clause
ICSID	International Centre for the Settlement of Investment Disputes
IOGC	International Oil and Gas Company
LIAMCO	Libyan American Oil Company
NEB	Negotiated Economic Balancing
NSEB	Non-stipulated Economic Balancing
OECD	Organization for Economic Cooperation and Development
PDVSA	Petróleos de Venezuela S.A.
PSA	Production Sharing Agreement
SOE	State-Owned Entity
UK	United Kingdom
US$	United States Dollar
ZCCM	Zambia Consolidated Copper Mines

KEYWORDS

Best Practice, Due Diligence, Economic Stabilisation Clause, Fiscal Risk, Fiscal Stability Clause, International Law, Petroleum Agreement, Political Risk, Renegotiation, Risk Management, Stabilisation.

CONTENTS

CHAPTER 1: INTRODUCTION

1.1 Background of study

Late 2014 saw the oil price fall sharply from levels above US$100 to below US$40 per barrel. This is the nature of the unpredictable commodity markets. Accordingly, investors are looking for ways to protect their capital and assets by investing in markets that have fiscal regimes which are stable and predictable. In the oil and gas sectors volatility is the only certainty, with governments continually introducing new policy and regulatory frameworks to achieve a specific objective whether it is to stimulate new foreign direct investment or to capture a greater share of production revenue.[1]

One way in which investors try to balance out this volatility is through the use of stabilisation mechanisms – particularly the stabilisation clause. The basic concept of such clauses is that they ensure the terms of an investment agreement (i.e. the petroleum agreement) are insulated from changes in law and unilateral actions by a host state.[2] Their use has been traced back to the 1930's when American companies began to include them in concession contracts due to acts of nationalisation by Latin American governments.[3] The essential goal of such clauses was to ensure that the investor was financially protected from nationalisation by providing for a mechanism by which the investor could at least claim compensation. Thus, they did not invalidate a nationalisation but they did have the effect of making it unlawful, and thereby affect the amount of compensation that an arbitration tribunal might award.[4]

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1 Daniel P and Sunley E (2010) 'Contractual Assurances of Fiscal Stability', in Philip Daniel, Michael Keen, and Charles McPherson (eds)¸ The Taxation of Petroleum and Minerals: Principles, Problems and Practice, IMF, Washington, p.7.

2 Maniruzzaman AFM 'The pursuit of stability in international energy investment contracts: a critical appraisal of the emerging trends' (2008) 1 Journal of World Energy Law & Business 121, p.122.

3 Cameron PD (2006) 'Stabilization in investment contracts and changes of rules in host Countries: tools for oil & gas investors', Final Report prepared for the Association of International Petroleum Negotiators (APIN), http://iba.legis.state.ak.us/sga/doclog/2006-07-05-aipn-stabilization-camaron-final.pdf (accessed on 22 September 2016), p.15.

4 *Ibid.*

Today, stabilisation clauses are used in many sectors and industries, including the hydrocarbons sector, throughout the world in regions such as Sub-Saharan Africa; North Africa; South and Central Asia; Eastern and Southern Europe; the Middle East; and Latin America. However, their use is most predominant in developing and non-OECD countries.[5] This is due to the perceptions that such countries most often carry political risks which have been manifested in the past by spates of "nationalisation, other undue political interference, and/or frequent reporting of indicators of an 'uncivilised' situation (insecurity, civil war, endemic corruption, lack of effective rule of law and public order, general non-compliance with law, and rebellious sub-central powers)"[6]. This is the reason why most investors push for the inclusion of stabilisation clauses in investment contracts in these markets. In turn, some developing countries have tried to make allowances for such clauses by passing legislation that provides for the guarantee of contractual stability between the State and the investor.[7]

Investors and governments have a common interest in the efficient development of the petroleum resources, however, how this is achieved in practice is problematic. The investor wants to make a reasonable return on investment while the government wants to capture what it deems a "fair share" of the rents received from exploitation of the resource. This is difficult to achieve considering the underlying volatility of the commodity markets. What a government finds to be a "fair share" today could be totally unacceptable tomorrow if prices rise and investors receive huge windfall rents. On the other hand, investors don't want to find themselves in a situation where there is no certainty on the fiscal regime of a state in which they have committed their capital.

5 See Cameron PD (2006) and Shemberg A (2008) 'Stabilization clauses and human rights', study report prepared for the International Finance Corporation (IFC) and the United Nations Special Representative to the Secretary General on Business and Human Rights. http://www.ifc.org/ifcext/media.nsf/Content/Stabilization_Clauses_Human_Rights (accessed on 22 September 2016) (accessed on 16 September 2016).

6 See Mansour M and Nakhle C (2016) 'Fiscal Stabilization in Oil and Gas Contracts: Evidence and Implications' Oxford Institute for Energy Studies https://www.oxfordenergy.org/wpcms/wp-content/uploads/2016/02/Fiscal-Stabilization-in-Oil-and-Gas-Contracts-SP-37.pdf (accessed on 20 September 2016).

7 *Ibid.*

A good way to manage this dynamic relationship and mitigate the risk of unilateral action by the state is to implement a fiscal stability clause (hereafter "FSC"), that deals exclusively with taxes and royalties, which will balance the interests of the parties and keep the investment attractive. Finding a formulation of the FSC that seeks to find this balance serves as the main thrust of this study.

1.2 Statement of the problem

With commodity price volatility being the order of the day, international oil and gas companies (hereafter "IOGC") and investors will be wary of investing in new projects if they cannot be certain that their investment will not be negatively impacted by unilateral government action in host states. Even in states where they are already invested and are looking to renegotiate terms due to financial viability concerns, some form of investment security will be required to deal with risks going forward.

The second biggest risk to this group, after commodity prices, is the risk of an unstable fiscal regime; where a unilateral action by a host state, implementing new taxes and royalties, can decimate the profitability and attractiveness of a project. On the other hand, host states are looking for ways to become more attractive to investors and to stimulate investment into the development of their natural resources.[8]

Thus, investors and host states are looking for stabilisation mechanisms that have functional value and will ensure the costs and rents of exploration and exploitation are stable and predictable – at least from a fiscal policy point of view.

1.3 Thesis statement and research questions

This study addresses the question: What are the best practices to consider when drafting and implementing a fiscal stabilisation clause?

To address this question, the study posed the following research questions:

(1) What are the drivers for fiscal stability?

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[8] See *fn* 1.

(2) Which stabilisation clauses are most suitable to dealing with the complexities of international law as well as commercial considerations?

(3) What does current stabilisation practice look like in terms of the nature and scope of such clauses?

(4) What are some of the most important substantive issues that should be covered in such clauses?

(5) What are the underlying issues that challenge the effectiveness of such clauses and how can they be eliminated/minimized?

The aim is not to create a one-size-fits-all clause but rather to explore various drafting practices that form the basis of good practice and can assist negotiators tailor an appropriate clause for their particular circumstances.

1.4 Significance of the study

The study will be significant to the IOGCs as well as host states which are negotiating or renegotiating petroleum contracts as it will allow these parties to be aware what kinds of formulations of fiscal stability clauses exist and which could be most suitable for their particular circumstances. Also, it will be a guide for what substantive issues need to be addressed by the clause.

1.5 Literature review

At their core, stabilisation clauses serve as a risk mitigation tool for investors. Petroleum agreements are characterised as being long term and capital intensive and as such depend on the effective and efficient distribution of risk and reward between the parties and adjustment to future pressures for change.[9]

Two essential issues that form part of the rationale for stability of petroleum contracts have been raised in scholarly literature. The first is that the long term nature of petroleum contracts brings the unavoidable risk that changes of circumstances may

[9] Faruque A (2005) Stability in petroleum contracts: rhetoric and reality. (Lessons from the experiences of selected developing countries and economies in transition 1980-2002) LLD thesis, University of Dundee, p.16.

eventually materialise and may frustrate the objectives of the parties.[10] Therefore if the contractual relationship seeks to survive these changes it must find stability by anticipating and dealing with the reaction to such changes. Secondly, because petroleum contracts involve the state as a party in most cases (a state owned entity in others), the issue of state sovereignty must be dealt with. Arbitral jurisprudence has revealed that state prerogative will always allow for a state to act in the public interest and to take measures that affect the broad social, economic, and political conditions under which the contract is entered into and is performed.[11] Against this backdrop, investors recognise that there are risks that political and financial instability in a host state may adversely impact the continued existence of the project or its capacity to generate revenue.[12] This risk can be manifested in a number of ways such as expropriation or nationalisation; refusal of government to grant permits; and increases in taxes and royalties or removal of concessions to name but a few.[13] The provision of a guarantee for stability in the contract itself is one way of mitigating these risks.

Generally, a stabilisation clause can broadly be defined as "contract language which freezes the provisions of a national system of law chosen as the law of the contract as to the date of the contract in order to prevent the application to the contract of any future alternations of this system".[14] Taken further, a stabilisation clause will typically also prohibit any administrative and regulatory acts by the government that may adversely impact the contractual regime already entered into by the parties.[15]

Stabilisation clauses come in different categories in terms of nature and scope. There are three main types of stabilisation clauses: the freezing clauses, economic

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10 *Ibid.*

11 *Parkerings - Compagniet v Republic of Lithuania, ICSID Arbitration Case No ARB/05/8 (2007)*.

12 Kudnig M (2014) 'Stabilisation Clauses' SADC Law Association Conference www.sadcla.org/new/sites/default/files/2014-08-18%20STABLISATION%20CLAUSES%20Ashurst_0.pptx (accessed 25 August 2016).

13 *Ibid*.

14 *Amoco International Finance Corporation v. Iran, Iran-U.S.C.T.R. vol. 15 (1987-II), Award No. 310-56-3 of 14 July, (1984),* 239.

15 Maniruzzaman AFM (2005) 'Some reflections on stabilisation techniques in international petroleum, gas and mineral agreements' International Energy Law and Taxation Review 96, p.97.

balancing clauses and hybrid clauses. The freezing clause, also known as the traditional approach, is designed to make new laws inapplicable to the petroleum contract. The economic balancing clause, also known as the modern approach, provides that although new laws will apply to the investment, the investor will be compensated for the cost of complying with them. The hybrid clause is a combination of freezing and balancing clauses.[16] The scope of such clauses can be sweeping covering every law/regulation that affects the contract. Alternatively, it could cover only certain areas of the law such as fiscal, social or environmental laws.

Historically, the validity of such clauses have been analysed from a domestic law context and an international law context. From a domestic point of view, any undertakings given by the host state's government must be given in a form that is consistent with the state's legal and constitutional framework.[17] Some jurisdictions have established legal principles that have the effect of invalidating stabilisation clauses.[18] One such principle found in numerous jurisdictions is that the executive powers of the state may not be fettered by a contract with a private individual or corporation.[19] Investors should be aware of the particular local legal system and dynamics of a state they wish to conclude stability agreements with.

From an international law point of view, many commentators have held such clauses to be invalid under the 'state sovereignty argument', providing that states have permanent sovereignty over their natural resources which they cannot contract out of. However, numerous international arbitration tribunals have held otherwise.[20] It must be

16 See generally Shemberg, Cameron, Dansun, Maniruzzaman

17 Cameron PD (2006), p.13

18 Clinch D and Watson J 'Stabilisation clauses - issues and trends' http://www.lexology.com/library/detail.aspx?g=c5976193-1acd-4082-b9e7-87c0414b5328 (accessed on 20 September 2016).

19 Countries such as England and Wales, as well as some Middle Eastern and francophone African jurisdictions.

20 See *Texaco Overseas Petroleum Company and California Asiatic Oil Company v The Government of the Libyan Arab Republic, 53 I.L.R. 389 (1977), Government of Kuwait v. American Independent Oil Co. (Aminoil), Arbitration Award, 21 I.L.M. 976 (1982), AGIP Company v People's Republic of the Congo, Award, 30 November 1979, 21 I.L.M. 726 (1982), Revere Copper & Brass, Inc. v. Overseas Private Investment Corporation (OPIC), 56 I.L.R. 257 (1978)*.

kept in mind that a country will always retain the sovereign power to enact new laws that may supersede existing laws and contracts, however it is this very sovereignty of the state that gives it the power to grant rights which it is prohibited from breaching.[21] Although still contested the prevalent view today is that a stabilisation clause does not limit the state's sovereignty. Instead, a state's agreement to be bound by a stabilisation clause is considered a valid exercise of that state's sovereignty.[22]

The FSC, which is the primary focus of this study, is a mechanism which is used to deal with the risk of changing tax laws that may have an adverse effect on the financial viability of a project. It is the possible answer to what is known as the “obsolescence bargain” in which the host state can use changes in circumstances to impose new financial burdens on the investor.[23] These changes in circumstances can include rising/falling oil prices, regional benchmarking and the most obvious a change in political circumstances.

Over time the use of freezing FSCs has waned somewhat considerably due to the argument that the exercise of sovereign power should not be completely restrained by such clauses. In their place the economic balancing FSCs have found favour as they are seen to respect sovereign authority while seeking to maintain the balance of the contract through the use of techniques such as negotiation and international arbitration. Their aim is to keep the investor in the same financial position as when the contract was signed by ensuring that the investor complies with new laws but is compensated for such so that it remains in the same economic situation it would have been in had the laws not changed.[24]

As much as the modern approach has tried to deal with the shortcomings of its predecessor, it could still face a number of challenges. These challenges include an underlying fiscal regime which provides for unsustainable benefits to the investor,

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21 In *Saudi Arabia v. Arabian American Oil Co* the court held “[b]y reason of its very sovereignty within its territorial domain, the state possesses the legal powers to grant rights [by] which it forbids itself to withdraw before the end of the concession.”

22 See *fn* 18.

23 Shemberg A (2008), p.vii.

24 Mansour M and Nakhle C (2016), p.15.

thereby creating an unstable relationship. Another is the administrative burden that comes with having an individualised fiscal regime for each project. The state agency in charge of monitoring and enforcing fiscal laws would have to commit time and resources to decipher what the original financial position of a particular project was and what effect the new law(s) has had on that position in order to compensate for it – and it would have to do this with every project. These and other issues need further consideration.

1.6 Research methodology

This is a desk and library literature based research. It analyses both the relevant primary and secondary sources of information on the topic and reliance is placed on materials such as petroleum contracts, journals, textbooks, arbitral case law, conference papers, law reports, legislation and internet sources.

1.7 Outline of the study

Chapter 1 serves as an introduction of the study. Chapter 2 will look at the purpose of fiscal stability clauses and asks the question of whether FSCs are necessary and justified. The legal value of stabilisation clauses will also be considered. Chapter 3 looks at the different approaches that have emerged over time in the formulation of FSCs, what the legal effects of these different approaches are in terms of nature and scope, and also looks at the ways they are drafted by extracting from real petroleum contracts. The chapter also delves into specific substantive issues that must be considered by negotiators in drafting an FSC. Chapter 4 looks at some issues that are external of the FSC but that may impact upon its effectiveness. Chapter 5 provides the concluding remarks and recommendations.

1.8 Scope and limitations of the study

Because this study seeks to elucidate best practice principles of contractual drafting, the net has been cast quite widely with respect to the timeframe as well as jurisdiction by not prescribing any limit or scope for either. Thus, the study will consider the jurisprudence of quite a wide array of countries but limited to petroleum agreements.

1.9 Definition of concepts

In this study, unless the context suggests otherwise, the term “Petroleum Agreement” has been used to describe all forms of contractual agreements for the exploration and exploitation of a country’s hydrocarbon resources. The term “investor” and “international oil and gas company” (or IOGC) will be used interchangeably and denote a foreign entity which is involved in the development of hydrocarbon resources.

CHAPTER 2: STABILISATION IN THE FISCAL REGIME OF PETROLEUM CONTRACTS: DRIVERS AND PERCEPTIONS

2.1 Introduction

Before delving into the practical side of negotiation and drafting of fiscal stabilisation clauses it is important to look at the underlying factors which have contributed to their necessity and continued relevance. This chapter discusses the primary reasons for fiscal instability in host states, including oil price volatility and change of political circumstances; the rationale behind fiscal stability clauses and the current value of fiscal stabilisation clauses

2.2 The fiscal regime in context

Investors in the extractive industry are very sensitive to issues of fiscal stability and predictability. Their funding models take into account a number of risk factors including financial risk, geological risk, technical, natural risk and of course that of political risk. Governments seeking to attract investment into the petroleum sector need to be keenly aware of this risk and manage it – since the ability to control fiscal policy falls squarely in their sphere of competence.[25] An unstable fiscal regime will in most instances lead to low investor confidence in the host state's fiscal policy, resulting in general underinvestment in the sector.[26]

In most regions of the world, fiscal regimes are continuously changing. This is due to a number of reasons, some of which will be explored in detail below. What's important to note is that most host state governments find it hard to adhere to established fiscal policies simply because of the existence of significant unknowns when the fiscal regime

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[25] Mansour M and Nakhle C (2016), p.6.

[26] *Idem,* p.13.

is first designed.[27] Of course, in oil rich nations this dynamic is exacerbated by the mercurial nature of oil production and income.

Host states have numerous tools at their disposal to affect revenue collection from upstream petroleum activities including a variety of tax and non-tax instruments. There are three main types of regimes that can be used to secure an economic rent for the host state: (1) Contractual, including production sharing or service contracts; (2) Tax and royalty and; (3) State ownership or participation.[28] The central objectives of a well-designed fiscal regime are (or should be) *inter alia*: to ensure that the state as resource owner gets an 'appropriate' share; to be attractive enough to encourage investments, now and in the long run and; to be stable and credible.[29] However these objectives are not always easily achieved due to changes in circumstances. The different types of changes in circumstance that cause fiscal instability are inexhaustible, however some of the most pertinent precipitating indicators of fiscal change worthy of examination are: changes in oil prices and changes in political circumstances.

2.2.1 Oil Prices

In the past the oil price has played a significant role in contributing to fiscal instability as many governments have tinkered with fiscal terms subsequent to changes in prices. The World Bank has recorded more than 30 countries as having revised petroleum contracts, or entire fiscal regimes between 1999 and 2010 – a period which witnessed major changes in the price of oil.[30] The price of oil had climbed from around US$50 per barrel to around US$100 per barrel and some governments felt that their fiscal regimes were too generous to the investors as they reaped massive windfall profits.[31] These revisions come at a sensitive stage from the investors point of view, with operations

27 *Idem,* p.5.

28 Mullins P (2014) 'Designing a Fiscal Regime for Deep Sea Mining' Deep Sea Mining Workshop dsm.gsd.spc.int/public/files/2014/may/05_PeterMullins.pdf (accessed on 19 September 2016).

29 *Ibid.*

30 Mansour M and Nakhle C (2016), p.7.

31 *Ibid*. To further illustrate this volatility in the short term oil prices soared to US$147 per barrel in July 2008 and falling to US$55 per barrel in November 2008.

running and massive sunken costs. The governments have the upper hand in such situations as they can force IOGC to the negotiating table.[32]

Of course, in more recent times the oil price has not been doing so well, touching a low of under US$35 at the end of February 2016.[33] This has had quite an impact on the revenues that governments receive and has thrown their budgets into a tailspin.[34] As a result some have been forced to again revise their fiscal regimes to improve production and attract investment. Thus it can be seen that the movement of the oil price, in any direction, has an adverse impact on fiscal stability.[35]

2.2.2 Shifting political landscape

Historically, changes of government have presented a significant risk to petroleum projects and their fiscal regimes. A fiscal regime designed by an outgoing administration will invariably be reviewed critically by a successor with a different political persuasion or ideology. Often, we find situations whereby a new government has second thoughts about a fiscal regime negotiated by the previous administration and consequently forces the IOGCs to renegotiate terms or cancel the petroleum agreement. By this time the IOGC has invested significant resources and perhaps even brought the resource to production. The latter's bargaining power will have diminished severely because it cannot recover that investment should it pull out. Nna Emeka presents a summary of examples of host governments' repudiation of fiscal terms in petroleum agreements and in some instances their complete nationalization:

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32 Mansour M and Nakhle C (2016), p.7.

33 Rogoff K 'What's behind the drop in oil prices?' https://www.weforum.org/agenda/2016/03/what-s-behind-the-drop-in-oil-prices/ (accessed 26 August 2016).

34 'Falling oil prices: How are countries being affected?' http://www.bbc.com/news/world-35345874 (accessed 26 August 2016).

35 See Scargill W 'Increased fiscal Regime instability unlikely with continued low prices' http://energy.globaldata.com/resources/expert-insights/oil-and-gas/increased-fiscal-regime-instability-likely-with-continued-low-prices (accessed 15 September 2016)

"In Russia, the government of Vladimir Putin acquired Gazprom and revoked a permit for a Shell oil and gas project.[36] In Chad, the government demanded that international operators Chevron, Exxon Mobil, and Petronas renegotiate their revenue share.[37] In Venezuela, President Hugo Chavez took control over the formerly independent Petroleos de Venezuela (PDVSA)[38] and ordered the IOCs to turn over their majority interest to PDVSA or face complete nationalization of their interests in the oil-rich Orinoco River Basin, forcing out ExxonMobil and ConocoPhillips. In Bolivia, President Evo Moralez mobilized the army into Bolivian gas fields and nationalized Bolivia's industry[39]…"[40]

As previously stated these are not the only causes behind fiscal instability. Other factors such as investment trends, the production life cycle and deteriorating government finances can have a similar adverse impact on investor/government relations.[41] These examples are the very manifestation of the political risk which investors seek to guard against and the reason they look for risk management strategies that prioritize the safety of their investment and its returns. Amongst others, the fiscal stabilisation clause has gained popularity as a contractual mechanisms of risk management.[42]

2.3 Nature and purpose of fiscal stabilisation clauses

A fiscal stabilisation clause is aimed at rendering an agreement and the underlying project's fiscal terms immune from any subsequent adverse act of the government,

[36] Brunet A and Lentine JA (2007) "Arbitration of International Oil, Gas, and Energy Disputes in Latin America" 27 New Jersey International Law & Business 591, p.622.

[37] *Ibid.*

[38] *Ibid.*

[39] *Ibid.*

[40] Nna Emeka J (2008) 'Anchoring Stabilization Clauses in International Petroleum Contracts' 42 *The International Lawyer* 1317, p.1319.

[41] See Mansour M and Nakhle C (2016) generally.

[42] Other strategies to protect the fiscal regime of a petroleum project include: spreading risk between multiple parties by means such as joint ventures and the inclusion of multilateral funding institutions; the procurement of political risk insurance and; keeping good relations founded on open communication, trust and fairness with all stakeholders (also known as social licence to operate).

whether legislative or administrative.[43] Thus "ensuring that the law of the host state, in so far as it impacts on the economic and financial performance of an investment venture, remains unchanged for the duration of the investment venture or such other period as may be agreed between the host state and the investor."[44]

Upstream oil and gas projects are invariably long term and capital intensive requiring significant capital outlays - particularly those that are offshore.[45] The recovery of costs can take decades as the period between the initial discovery of oil reserves to the time of first production can take several years. Adding to the complexity of the situation is the risk of a dry hole which is quite common and whatever capital is invested in such instances will be lost.

The length of time from initial exploration stages to production presents the time/ dynamic inconsistency problem. This concept is synonymous with the "obsolescence bargain" in that during the planning stages the host state will start off with a particular policy stance which is usually investor friendly; however, as time goes by and conditions change the host state reneges on that policy commitment. According to the obsolescence bargain theory the investor is in the greatest position "at the moment of entry, and he is best able to secure terms favourable to himself."[46] At the same time the host state is incapable of exploiting the resource and "needs the power of foreign investor to perform production operations".[47] However, once the project takes off or production starts, the situation turns around completely in terms of power dynamics. Because the investor has sunk huge amounts of resources into bringing the project to this point he becomes the captive of the state. The investor is then in a vulnerable position and the host state may exploit this vulnerability by requesting renegotiation

43 Maniruzzaman AFM (2005), p.97.

44 Mukwasa M (2010) "When is compensation payable for breach of a stabilisation clause? The case for the cancelled mining development agreements in Zambia" LLM thesis, University of Pretoria, p.16.

45 Mansour M and Nakhle C (2016), p.11.

46 Sornarajah M (2010) "The International Law on Foreign Investment" Cambridge: Cambridge University Press, p.402.

47 Sulaimanov R (2011) "Balancing state and investor interests in international petroleum contracts: Comparison of legislation in Kazakhstan and other central Asian countries" LLM thesis, Central European University, p.28.

under some legitimate or flimsy legal reasoning or even going as far as unilaterally altering the petroleum agreement.[48]

This underlies the precarious situation an investor is likely to face. And the risk of failure, especially in petroleum and mining, can have very damaging effects financially.[49] The fear of such failure is shared by third parties such as multilateral funding institutions and banks that finance the project.[50] As such these parties also view the fiscal stabilisation clause as a necessity to improving the bankability of a project.[51]

The unique challenges presented by this sector, such as expropriation, the obsolescence bargain, and changes in circumstance make the fiscal stabilisation clause a very attractive risk mitigation tool for the investor. A contractual commitment not to change the tax regime and any other regulations that may have an effect on project finances can go a long way in creating a friendly investment environment.[52]

The host state can also benefit from the inclusion of a fiscal stabilisation clause. It is important to note that developed countries are less likely to accept or even allow the inclusion of stabilisation clauses – there are a number of reasons for this distinction. Typically, developed countries, such as Norway, UK, Canada and Australia, have petroleum regimes which are static and relatively inflexible.[53] The contents of their petroleum agreements are to a large extent standardized and not open to negotiations. In contrast, developing countries tend to negotiate individual terms under the aegis of attracting much needed foreign investment. The levels of political risk between

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48 Waelde TW and Ndi G 'Stabilizing international investment commitments: international law versus contract interpretation' (1996) 31 Texas International Law Journal 215, p.225.

49 The costs of exploration and exploitation in the hydrocarbons industry is very high. An offshore drilling rig can for example cost anything from US$800 million. See Rowell J (2015) "How much does it cost to build a drilling rig?" http://oilpro.com/q/436/how-much-does-it-cost-to-build-a-drilling-rig (accessed 20 September 2016)

50 Maniruzzaman AFM (2005), 96.

51 Shemberg A (2008), p.vii.

52 Johnson posits: "Oil companies are so vulnerable to potential changes in fiscal terms that they behave much more conservatively if they cannot limit this risk. Conversely if they can mitigate, reduce or eliminate certain elements of risk they can be more aggressive in their investment efforts." Johnston, Daniel (2010) 'Stabilization Provisions Economic Logic', Daniel Johnston & Co., Inc.

53 Cameron PD (2006), p.17.

developed and developing states is also a noteworthy point contrast as the latter include some of the world's most unpredictable and unstable countries – beset with political and economic crises and potentially laden with a history of coups and countercoups.[54] To suggest that only developing countries are exposed to such risks would be disingenuous; however, investors tend to place a greater weight on such risks materialising in developing countries on the basis of historical analysis where political instability and reaction to possible windfalls have traditionally led to adverse changes in the contractual relationship.[55]

The political risk factor is not the only factor that separates countries that offer fiscal stabilisation clauses and those that do not; in fact, it may not be a determinative factor in some instances. Another important factor is that of geological risk. Some countries, such as Saudi Arabia, Brazil and Nigeria, may be considered as having a high political risk factor but the geological risk is so low (i.e. the proven oil reserves are significant and commercially viable) that governments do not feel the need to have a contractual assurance of stability – investors, likewise, are willing to accept a contract without stabilisation provisions under these circumstances, risking capital on exploration according to terms that afford them a much lower degree of security.[56] Ultimately what appears to be an emerging pattern is that bargaining power of respective players will play the biggest role as to whether such clauses are acceptable to the palate of a host state.[57]

The FSC is a mechanism which lends credibility to the host state's openness to investment and it is a rejection of unnecessary interference by that host state's government into the financial aspects of the project. It is a bargaining chip that can be used to increase attractiveness to international markets and to compensate for existing risks.[58] If a country is perceived to have an environment in which investors and

54 Mansour M and Nakhle C (2016), p.13.

55 *Ibid.*

56 Cameron PD (2006), p.13 and Mansour M and Nakhle C (2016), p.13.

57 Mansour M and Nakhle C (2016), p.13.

58 *Ibid.*

companies will be exploited it will experience underinvestment in general. Mansour and Nakhle posit:

> "A credible assurance not to change tax terms once investment has been committed should, in principle, raise the level of investment. The presence of stabilisation mechanisms in a petroleum contract can act as a psychological boost, giving confidence to investors at the initial stage of the investment, and can thus have an important 'market function' in developing countries"[59]

In allowing for the inclusion of a FSC, the host states bind themselves to a commitment of wider fiscal discipline and ensuring a stable flow of returns from exploitation of the resource.[60] Furthermore their inclusion is supported by economic logic and imperative, promoting the alignment of interests between the IOGCs and host governments.[61]

2.4 Legal value of fiscal stabilisation clauses

The legal value of stabilisation clauses has generated heated debate over the decades. To answer the question of how valuable these clauses are commentators have focused on two aspects: (1) the validity of stabilisation clauses under domestic law and; (2) the validity of stabilisation clauses under international law.

2.4.1 The validity of stabilisation clauses under domestic law

Many host states claim to have their sovereign legislative power encumbered by stabilisation clauses whereas others have been amenable to the demands of foreign investors to include these in petroleum agreements.[62] The consensus among different scholars is that the contractual assurances of stability contained in an investment agreement between an investor and a host state will be valid under that state's

59 *Ibid.*

60 *Idem,* p.14.

61 *Ibid.*

62 Deloitte (2014) 'Stabilisation Clauses in International Petroleum Contracts Illusion or safeguard?' http://www2.deloitte.com/content/dam/Deloitte/ug/Documents/tax/tax_StabilisationClauses_2014.pdf (accessed on 30 August 2016).

domestic laws if the legislative and constitutional framework provides for them.[63] The validity of a stabilisation clause concluded outside the parameters of that state's legal framework will undoubtedly be invalid.[64] Walde & Ndi posit:

> "Clauses negotiated under the shadow of *ultra vires* and constitutional invalidity cannot generate valid rights simply by appearance or legitimate reliance on the state agency's contracting powers."[65]

Even if a stabilisation clause is concluded in observance to all prerequisite legal requirements it must be borne in mind that every country will retain its sovereign authority to enact laws that legally will 'trump' previous laws[66] - in spite of any existing laws or agreements to the contrary.[67] The notion of sovereignty under domestic law means that "the legislator can take what he has given."[68] This authority could be used to render a stabilisation clause invalid *ex post facto* in terms of domestic laws. The effect of such an action has legal consequences. Depending on the effect of the changes to the law it can amount to expropriation or creeping expropriation (a strategy used by a host state which involves increasing taxes or financial burdens on operations until the cash flow and/or income of the IOGC are so marginal or unprofitable that the venture losses its character as an investment). This could have quite a devastating effect on the investor/government relationship.[69]

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[63] See Cameron PD (2006), Waelde TW and Ndi G (1996), Maniruzzaman AFM (2008).

[64] Cameron PD (2006), p.13.

[65] Waelde TW and Ndi G (1996), p.239.

[66] Cameron PD (2006), p.14 and Waelde TW and Ndi G (1996), p.239.

[67] Cameron PD (2006), p.13.

[68] Waelde TW and Ndi G (1996), p.239.

[69] In Zambia, for example, the 1995 Mines and Minerals Act which permitted government to grant stability commitments to mining companies was repealed and replaced by the Mines and Minerals Development Act of 2008 which contained the express provision (Section 160) that the mining development agreements entered into between government and mining companies under the repealed Act would no longer be binding on the Zambian government notwithstanding anything contained in any other law or in the mining development agreements themselves. This meant that the fiscal stability clauses contained in those agreements were no longer binding on the Zambian government. See Mukwasa M (2010).

With the stakes being so high, it is imperative that the investor is informed about the legal position regarding stabilisation clauses in a prospective jurisdiction before making an investment decision. An investor will likely be unsuccessful in arguing for the validity of a fiscal stabilisation clause where such a clause was concluded without sufficient authority or in non-compliance with material procedural rules *and* where such defect was known or could have been identified by the investor applying due diligence.[70]

2.4.2 The validity of stabilisation clauses under international law

International law can be a secondary safeguard against unilateral actions by a host state if it is included as the governing law of a petroleum agreement (this will be considered in detail in chapter 4). Some authors have even gone as far as claiming that a stabilisation clause is an independent obligation rooted in international law, regardless of the governing law of the contract as a whole.[71] Either way, International law is not monolithic and adducing which norms would apply to protect the contractual rights of the investor and the host state is not an easy task.[72] There appears to be a juxtaposition of international norms that pits property rights, as they relate to the protection of contractual rights and expropriation, against sovereign rights, as they relate to permanent sovereignty over natural resources.[73] The question here is whether one enjoys precedence over another or whether these norms can be harmonized and applied simultaneously. Scholars are divided in this regard. The first group argues that the host state cannot contractually abrogate its sovereign powers by binding itself to a stabilisation clause thus such clauses were inconsistent with the principle of permanent

70 Waelde TW and Ndi G (1996), p.235 and Cameron PD (2006), p.57. Also see *MTD Equity v Republic of Chile 44 ILM 91 (2005)*. If one reads the portion of this award relating to the foreign investor's obligation to perform due diligence, one acquires some idea about the burden of proof on the foreign investor. If the latter did not make the necessary effort to understand what the legislative/contractual regime was in regard to the right that it thought that it had acquired, then the foreign investor cannot be considered as having justifiably relied upon such a right being available to it, as an essential part of its decision to invest.

71 Maniruzzaman AFM (2008), p.138.

72 Waelde TW and Ndi G (1996), p.242.

73 *Ibid.*

sovereignty over natural resources.[74] The second group argues that in voluntarily entering into a stabilisation agreement the host state is exercising its very power of sovereignty and as such the provision is not contrary to international law.[75] To gain a better understanding doctrinal writing as well as arbitral jurisprudence must be analysed.

Doctrinal writing in support of validity recognises from the outset that a host state "may take necessary regulatory measures which are not arbitrary or discriminatory even where these diminish the value of petroleum agreements."[76] Furthermore "It cannot be denied that a State has certain exceptional prerogative powers to exercise for the public good and in the public interest that are generally recognized as inalienable."[77] In the extractive industry context this principle is known as permanent sovereignty over natural resources. However, also to be considered, the value of stabilisation clauses cannot be discounted as there are a number of factors which support the validity of these clauses namely: (1) that international arbitration has on many occasions ruled in favour of such validity;[78] (2) that certain states have adopted legislation which allows for such clauses and;[79] (3) the prevalent use and observance of such clauses throughout numerous jurisdictions provides an indication in favour of validity. Of course, tying all of these factors together is one of the cornerstones of contract law and international law, the doctrine of sanctity of contract (i.e. *pacta sunt servanda*) which requires all parties to observe and refrain from breaching the terms of an agreement.

On the other end of the spectrum scholars against validity suggest that a clause which seeks to freeze the applicable law of a host state as of the date of contracting amounts to unlawful restraint of public powers of the state and a derogation of the

74 Mukwasa M (2010), p.40.

75 *Ibid.*

76 Cameron PD (2006) at p.49.

77 Maniruzzaman AFM (2008), p141.

78 See para 2.4.

79 See for instance: Resource Contracts Fiscal Stabilization Act (2000) of Papua New Guinea; Code of the Republic of Kazakhstan "On Taxes and Other Obligatory Payments to the Budget", adopted in June 2001; Timor Sea Petroleum Development (Tax Stability) Act (Law No.3/2003 of 1 July),

principle of sovereignty.[80] This argument stretches further to state that the principle of permanent sovereignty over natural resources, constitutes *jus cogens* (i.e. the principles which form the norms of international law that cannot be set aside) and as such cannot be derogated.[81] An understandable assertion. However, the advent of the modern stabilisation clauses, which rather than freezing the laws applicable to a petroleum agreement, attempts to find an economic balance of the parties interest, appears to somewhat allay these grievances (see chapter 3).

The foregoing presents a summary of the doctrinal writings that are quite divergent on validity stabilisation clauses in international law. The arbitral jurisprudence surrounding the issue presents divergent views as well – these views will be briefly examined.

In one of the earliest arbitration cases *AGIP v. Popular Republic of Congo*,[82] the government of Congo nationalised the oil distribution sector in 1974. Only AGIP was able to save its agreement as the petroleum agreement contained several stabilisation clauses. In 1975 AGIP was nationalised by Congo. The tribunal held that the presence of a stabilisation clause did *not* derogate the host state's sovereignty or regulatory powers and that the host state retained both powers in relation to those with whom it had not entered into such an undertaking.[83] Thus holding the stabilisation clause to be valid and binding. In *Saudi Arabia v. Arabian American Oil Co*,[84] the sole arbitrator held "[b]y reason of its very sovereignty within its territorial domain, the state possesses the legal powers to grant rights [by] which it forbids itself to withdraw before the end of the concession."[85] In Texaco Overseas Oil Petroleum Co./Califorina Asiatic Oil Co. v Libya, the tribunal based its finding (in favour of the therein contained stabilisation clause) on the principle of *pacta sunt servanda* and ruled that it was, in fact, possible for a sovereign state to bind itself to a contract with an investor. Other examples of

80 Waelde TW and Ndi G (1996), p.244.

81 *Ibid.*

82 21 I.L.M. 726, 735-36 (1982).

83 At Sec. 86.

84 27 I.L.R. 117 (1963).

85 *Ibid.*

arbitrations ruling in favour of stabilisation clauses show a similar if not identical line of reasoning as the above.[86]

In spite of the seemingly sound logic behind these rulings and a general leaning towards validity in the arbitral jurisprudence, there have been cases that have gone against the grain. In *LIAMCO v Libya*,[87] the arbitral tribunal held that the host state was well within its rights to expropriate the contractual rights of the IOGC and that stabilisation clauses which sought to prevent such an action were interfering with the host state's sovereignty. In another case, Aminoil v Kuwait,[88] the arbitral tribunal again had to deal with the issue of stabilisation clauses and their effect on the legality expropriation.[89] The ruling was quite peculiar and convoluted, arguing that the expropriation of the IOGC's concession and infrastructure was not in breach of the stabilisation as compensation had been offered from the outset (i.e. it did not constitute the "confiscatory taking" necessary to trigger a breach of the clause). This is not necessarily true as upon proper interpretation of the stabilisation clause any form of expropriation would be confiscatory in nature and thus in breach of the stabilisation clause even if compensation is offered. In a separate opinion Judge Fitzmaurice postulates: "Nationalisations may be lawful or unlawful, but the test can never be whether they are confiscatory or not; because by virtue of their inherent character, they always are."[90]

One thing that is clear from this analysis is that the status of stabilisation clauses on international law is unclear at best. There is a lack of consistency in doctrinal debate and international arbitral jurisprudence. Furthermore, it must be noted that there is no

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86 See *Sapphire International Petroleum Ltd. v. National Iranian Oil Co*; *Aramco v. Saudi Arabia*; *BP v Libya*.

87 20 I.L.M 1 (1981)

88 21 I.L.M. 976 (1982)

89 The stabilisation clause read as follows: "The Shaikh shall not by general or special legislation or by administrative measures or by any other act whatever annul this Agreement except as provided in Article 11. No alteration shall be made in terms of this Agreement by either the Shaikh or the Company except in the event of the Shaikh and the Company jointly agreeing that it is desirable in the interests of both parties to make certain alterations, deletions or additions to this Agreement."

90 See separate opinion of Judge Fitzmaurice, 21 I.L.M (1982) 1043.

arbitral ruling that deals with modern economic balancing stabilisation clauses and as such the precise status of these clauses is uncertain and will have to approached by analogy to their predecessor. What is clear however, is that the sovereignty argument is increasingly being looked at unkindly by arbitrators as host states always enter into these agreements voluntarily.[91] Governments cannot conclude stabilisation agreements and then suddenly turn around and invoke the principle of sovereignty in order to abdicate responsibility for their actions.[92]

2.5 Conclusion

The practice of using stabilisation clauses of some kind is widely established across industries and regions of the world. From an investor's perspective FSCs are a risk-mitigation tool drafted to help protect investments from a number of sovereign risks in the context of foreign investments. Utilised correctly, the host state can also benefit from their inclusion. The legal validity of such clauses is still debated; however, their continued use provides the business case for finding ways of better balancing investors and host states interests through their use.

91 Ng'ambi S 'Stabilisation Clauses and the Zambian Windfall Tax' (2011) 1 Zambia Social Science Journal 107, p.113.

92 *Ibid* (needs more credit).

CHAPTER 3: DESIGNING A MODERN STABILISATION CLAUSE THAT IS EFFECTIVE AND MUTUALLY BENEFICIAL

3.1 Introduction

The previous chapter elucidated the continued relevance and importance of stabilisation clauses in the petroleum industry; especially those that focus on protecting the fiscal framework of a project. This chapter will analyse how some of these FSC's have been drafted in practice. Furthermore, the chapter will look at ways of improving the clause to better ensure the improved efficacy of the clause to protect parties' interests

3.2 Categorization of fiscal stabilisation clauses

Broadly speaking there are three recognized categories of stabilisation clauses that have been prominent in petroleum agreements:

(1) the *freezing clause,* which aims to restrict the legislative and administrative powers of a host state to take unilateral action to the effect of altering or annulling the provisions of the petroleum agreement;

(2) the *economic balancing clause*, which allows for the application of new laws, regulations, interpretations etc. to the petroleum agreement with the proviso that the investor will be compensated for or indemnified from the cost of complying with them.[93] These clauses do not aim to freeze law, but aim to maintain the economic equilibrium of the project;[94]

(3) finally, the *hybrid clauses,* which contains elements of both freezing and economic equilibrium clauses, providing that an investor will not be automatically exempt from new laws, providing for compensation, but also

[93] Shemberg A (2008), p.5.

[94] *Ibid.*

allowing certain laws, such as fiscal terms, to be explicitly exempt from applying to the agreement going forward.[95]

The above clauses can be subcategorized into "full" stabilisation clauses and "limited" stabilisation clauses depending on the scope of laws covered. Full stabilisation clauses apply to *all* laws and actions that impact the provisions of the petroleum agreement whereas the limited stabilisation clauses focus on *specific* laws and actions to the exclusion of others. The FSC (whether in freezing, economic balancing or hybrid form) is an example of a limited stabilisation clause because its scope only covers fiscal interventions; thus, laws pertaining to the environment, human rights etc. would not be stabilised.

3.2.1 Freezing stability clause

The freezing stabilisation clause, also referred to as stabilisation clause *stricto sensu or intangibility clause*, is quite a common occurrence in older petroleum agreements. It provides that the governing laws applicable to operations under a contract between a IOGC and a sovereign state should be those of the state at the time the contract was executed.[96] A Fiscal freezing stability clause will usually cover all tax policy changes that could affect the tax situation of an investment project, whether such taxes are included in the contract or are externally determined.[97] Some examples of such a clause are the following:

(1) DNO ASA, Tawke Block, PSA, 2004 (Iraq) provides:

> "The Government agrees and commits to DNO ASA to exercise its best efforts to maintain stability of the fiscal conditions for the duration of this contract"[98]

and

[95] *Ibid.*

[96] Mansour M and Nakhle C (2016), p.14.

[97] *Ibid.*

[98] Article 26.2.

(2) Tullow Ghana Limited, Sabre Oil and Gas Limited, North, South and West Tano Fields, Concession, 2006 (Ghana) provides:

> "No other taxes, fees or duties will be imposed to Contractor aside from those expressly listed in Article 12 of the agreement. With respect to income tax, if any new income tax regime comes into force, the Contractor may choose to either continue under the existing Petroleum Income Tax Law or applying the new Petroleum Income Tax Law. Any legislative or administrative act of the state or its agencies that purports to vary any of the terms of the agreement will be considered a breach of the agreement."[99]

Although freezing clauses are still being utilized in some host states today, their popularity has substantially waned due to the criticism that has been raised in regards to the effect they have in limiting the host state's powers. Since their aim is to neutralize the state's power, they are seen as incompatible with the state's permanent sovereign power, which, in the opinion of some, cannot be limited to contractual mechanisms.[100] I would argue that the use of a fiscal freezing clause in a petroleum agreement is undesirable. The practice is somewhat outdated and questions surrounding the validity of such clauses does not serve the interests of the investor nor the host state.

3.2.2 Economic stabilisation clause

The modern approach to insulating the terms of a petroleum agreement comes in the form the economic stabilisation clause, also known as an 'economic equilibrium clause' and 'economic balancing clause'. This clause seeks to address more deftly the issues concerning the exercise of sovereign authority by the host state by allowing the state to retain full authority to enact new laws that may impact the project but at the same time keeping the same financial position of the investor as provided by the contract on the date it was signed.[101] So the new laws will apply to the project but the investor will be compensated. This is achieved through the use of a number of various mechanisms such as automatic adjustment, renegotiation and adaptation. These

[99] Article 12.1.
[100] See Chapter 2 (2.4.2).
[101] Mansour M and Nakhle C (2016), p.15.

mechanisms will be further examined below. As opposed to the freezing stabilisation approach, this approach ensures a balance of the interests of the parties concerned. However, just like the fiscal freezing clause the economic stabilisation clause can also be limited to focus on fiscal matters only. A basic example of a fiscal economic stabilisation clause can be found the Current Indian Model PSC:

> "If any change in or to any Indian law, rule or regulation imposed by any central, state or local authority dealing with income tax or any other corporate tax, export/import tax, customs duty or tax imposed on petroleum or dependent upon the value of petroleum results in a material change to the economic benefits accruing to any of the Parties after the Effective Date, the Parties to this Contract shall consult promptly to make necessary revisions and adjustments to the Contract in order to maintain such expected economic benefits to each of the Parties as of Effective Date"[102]

The economic stabilisation clause is a flexible tool to manage risk and can be formulated in different ways to deal with the changed circumstances brought about by the unilateral acts of the State.[103] Per its *modus operandi,* the clause can be subdivided into three categories: (A) the automatic economic balancing clause; (B) the non-stipulated economic balancing clause and; (C) the negotiated economic balancing clause.

A. Automatic Economic Balancing (AEB)

The AEB clause provides for automatic adjustment of the contract terms in a stipulated manner. This can be achieved, for example, by way of a specified percentage readjustment of 'profit petroleum split' in the case of a production sharing contract.[104]

B. Non-stipulated Economic Balancing (NSEB)

The NSEB also provides for automatic adjustment of the contract terms but does not specify the nature of the adjustment. Nor does it require the consent of the parties to take effect (unlike the negotiated economic balancing clause).[105]

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[102] Article 16.7.

[103] Maniruzzaman AFM (2008), p.127.

[104] *Ibid*.

C. Negotiated Economic Balancing (NEB)

The third type of economic balancing clause, also the most promising, is the NEB, which requires that the parties come together to negotiate and agree to amendments to the contract.[106] It is my opinion that the economic balancing clause, especially the NEB, presents the best opportunity to secure the interests of the parties. An analysis to support this assertion follows.

The economic balancing clause can be an effective tool in extending the life of a petroleum agreement by giving the agreement a degree of flexibility to deal with changing circumstances. In this regard Maniruzzaman posits:

> "The breach of a freezing clause may result in only lump sum damages, which could be far below what the company considers would be necessary to 'keep it whole'. Under an economic balancing clause, however, the government would have to indemnify on an ongoing basis".[107]

The clause allows the parties to modify the agreement instead of terminating the relationship considering changes which could happen during the life of the contract – particularly the NEB clause which would bring both parties to the negotiating table with a view of working harmoniously and in a collaborative manner to reach a beneficial equilibrium.

The NEB clause can be utilized to ensure the equality of treatment of both parties in respect of economic balance of the contract by allowing for renegotiation in cases where not only the interests of the investor has deteriorated, but also in instances where the action of the host state has negative impacts on itself.[108] For example, if the tax rate goes up, the investor's interest will deteriorate whereas if the tax rate goes down, the investor's profit will improve.[109] In the latter instance the NEB clause would allow the

105 *Ibid*.

106 *Ibid*.

107 Maniruzzaman AFM (2008), p.126

108 *Idem,* p.129.

109 "The Negotiated Economic Balancing Clause in Production Sharing Agreements and its function to avoid problems in the event of unforeseen circumstances in future."

host state to negotiate an amendment to secure the same result as if the tax rate not gone up. An example of this is represented in Kazakhstan's law concerning Production Sharing Agreements (2005):

> "If during the effective term of the production sharing agreement other norms are established by legislation of the Republic of Kazakhstan which *deteriorate* or *improve* commercial results of the activity of the contractor within the framework of the production sharing agreement, amendment shall be introduced to the production sharing agreement which secure commercial results to the contractor which might have been obtained by the contractor in the event of application of the Republic of Kazakhstan in effect as of the moment of the execution of the production sharing agreement."[110]

The pragmatic approach of the NEB clause, which in our case would be drafted to cover fiscal terms, has made it more common feature than freezing clauses in recent years.[111] However, a great deal of attention must be paid to how it is drafted. Its effectiveness will be determined by a number of crucial elements which must be taken into consideration and could play a pivotal role in giving credence to the clause and deciding its fate.[112]

3.3 Crucial aspects to consider

The following elements should be highlighted in an NEB clause: (1) the scope of triggering events; (2) the objectives of renegotiation; (3) the procedures of the renegotiation and; (4) the procedure to be followed if renegotiation fails. These are the most important substantive issues that should be covered by negotiators on both sides of the aisle.

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http://s3.amazonaws.com/academia.edu.documents/36866865/Contracting_Essay.docx?AWSAccessKeyId=AKIAJ56TQJRTWSMTNPEA&Expires=1476913228&Signature=9iI2v7jn1fyvGVP95AZiOrB%2BYYQ%3D&response-content-disposition=attachment%3B%20filename%3DThe_Negotiated_Economic_Balancing_Clause.docx (accessed 22 September 2016)

110 Article 25(2). Own emphasis added.

111 Among the contracts available to public scrutiny.

112 See *fn* 109.

3.3.1 The scope of triggering events

In the modern NEB clause, the unilateral intervention of a host state triggers an amendment of the petroleum agreement which must be offset to restore the agreement to its original equilibrium.[113] Thus, the parties will be obliged to enter negotiations to restore the original balance.[114]

A key issue to be considered with the NEB clause is how to define the threshold that would trigger renegotiation.[115] Suffice it to say, it would be impractical to have a clause which requires the renegotiation of the fiscal terms of the agreement even if the change in law is quite modest. This would open the door to abuse of the protective mechanism and lead to a frustration of the parties. Thus, these clauses typically use language such as 'material change';[116] 'materially adverse effect';[117] 'detrimentally affects' and;[118] 'Profound Changes in Circumstances' to define the triggering event for renegotiation.[119] It is fair to say that the use of such language without clarification has led to conflicting interpretations in different contexts. However, Bernardini posits that what should be understood by all parties is that "the change must be such as to cause a disproportionate prejudice or substantial detriment or substantial economic imbalance to the interests of one of the parties".[120] It would be prudent that the parties explicitly provide guidance for determining at what point the economic equilibrium can be deemed to have been affected - without being too rigid.[121] An example of such guidance

113 Nna Emeka J (2008), p1321.

114 *Ibid.*

115 Maniruzzaman AFM (2008), p.129.

116 Indian Model PSC.

117 Azeri Model PSC.

118 Iraq Model PSC.

119 Maniruzzaman AFM (2008), p.129.

120 Bernardini P 'Stabilization and adaptation in oil and gas investments' (2008) 1 Journal of World Energy Law & Business 98, p.104.

121 Cotula L 'Reconciling regulatory stability and evolution of environmental standards in investment contracts: Towards a rethink of stabilization clauses' (2008) 1 Journal of World Energy Law & Business 158 166.

would be 'material decrease in project benefits or company value'.[122] The point of refining this element is to reduce the level of uncertainty that has plagued the practice. To try to make an inventory of triggering events would be a fruitless exercise considering the vastly varying unforeseeable circumstances that could materialize.[123] Thus, In the drafting of the NEB clause, the parties should not be concerned with all possible potential scenario's but rather the effect that those scenarios may have on the fiscal terms of the agreement and tailor their triggering event with sufficient clarity.

3.3.2 Objectives of renegotiation

What the parties wish to achieve through renegotiation should be clearly defined to ensure that the parameters of such negotiations are known beforehand and avoid situations where a party may attempt to derive benefits which are not due to it. Since the point of an economic balancing clause is to ensure the maintenance of predefined standards, the aforementioned triggering event would have caused an economical imbalance which the renegotiation seeks to address. In this regard the clause should contain wording such as 'removing the unfairness or adopting an equitable revision'[124] or 'restoring the economic results anticipated under the terms and conditions of this Agreement'[125]. As previously stated an NEB clause should be drafted to ensure that not only one of the parties feels the effect of changed laws and that the economic balancing goes both ways. Through renegotiations the parties will hopefully find ways to achieve this balance using whatever means are available at their disposal.

3.3.3 Procedure for renegotiation

Once the prerequisites for opening the renegotiation phase have been met the parties will have a set amount of time to achieve the objective of renegotiations.

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122 *Ibid*. Also see the West African Gas Pipeline International Project Agreement (IPA) between Benin, Ghana, Nigeria and Togo on the one hand, and the West African Gas Pipeline Company Ltd on the other, signed on 22 May 2003 [WAGP IPA].

123 Bernardini P (2008), p.103.

124 Bernardini P (2008), p.105.

125 Turkmenistan Model PSC.

However, there are several issues that need to be considered regarding the renegotiation procedure.

Firstly, it is imperative that all the parties recognise that the obligation to negotiate does not equate to the obligation to come to an agreement. The parties are only required to use their best endeavours or to do their utmost to reach an agreement. Therefore, the failure to agree is not a breach of contract for which either party might be held responsible.[126] The way forward from here will be examined below.

Secondly, a common feature of any process of renegotiation is that the same should be conducted in good faith.[127] In fact, both the request for renegotiation as well as the conduct of the parties during the process should reflect good faith and fairness.[128] A renegotiation process which is confrontational in nature will result in reputational costs for future investment.[129] This offending conduct may also result in an adverse finding against the *mala fide* party by a judge or an arbitrator called upon to settle the dispute resulting from the failure of the renegotiation process.[130] I would posit that as a basic tenet of law, the requirement to act in good faith will still apply even if not expressly stipulated in the clause.

Lastly, in the thick of negotiations the parties should keep in mind the international competitiveness of the petroleum agreement. An examination of the terms of parallel or more recent agreements, investment or tax legislation in other jurisdictions should be undertaken so as to keep the agreement internationally competitive and fair to both parties.[131]

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126 Bernardini P (2008), p.105.

127 *Ibid.*

128 Al Faruque A 'Renegotiation and Adaptation of Petroleum Contracts: The Quest for Equilibrium and Stability' (2008) 9 The Journal of World Investment & Trade 113, p.121.

129 *Ibid.*

130 Bernardini P (2008), p.105.

131 Al Faruque A (2008), p.122.

3.3.4 What happens if renegotiations fail?

It is of vital importance that the NEB clause provides guidance on steps to be taken should the renegotiation process fail. Typically, the clause will direct that the parties refer the dispute to arbitration which is preferable to court litigation as it saves valuable time and costs.[132]

What is important to note in this instance is that the arbitrator will first look at whether the triggering requirement has been satisfied. If the arbitrator is not satisfied that a triggering event has occurred as envisaged by the parties he/she will be obliged to declare that the agreement continues without amendment.[133] However, should the arbitrator's decision be in the opposite direction, the arbitrator will then look at the terms which should be made subject to revision and the extent of such revision in order to re-establish the economic equilibrium of the parties.[134] The next question to be asked is 'what powers does the arbitrator have in settling the dispute?'

Depending on the way the economic balancing clause is drafted, three possible solutions may be available to the arbitrator: (1) the arbitrator may make findings on the merits of the dispute and invite the parties to enter into further renegotiations based on those findings; (2) if the above renegotiation fails, or in its absence, the arbitrator may declare that the one of the parties has acted outside the objectives and/or procedures of renegotiation, in which case compensation may be awarded to the aggrieved party. Additionally, the arbitrator may order the parties return to the negotiating table or terminate the agreement or; (3) the arbitrator may proceed to make findings on the manner in which the terms of the agreement should be revised to restore the balance of the agreement and then issue an award effectuating such a revision.[135] It must be kept in mind that the economic balancing clause needs to be specific in what powers it confers to the arbitrator to avoid problems regarding the nature and extent of the

132 Chapter 4 will more closely examine the arbitration clause.

133 Bernardini P (2008), p.106.

134 *Ibid.*

135 *Ibid.*

arbitrator's intervention, considering that an arbitrator normally lacks the power to rewrite the parties' agreement.[136]

3.4 Conclusion

The practice of including economic balancing clauses in petroleum agreements has become common place in recent times; owing to its functions which cannot be found in the freezing clause. The NEB clause, specifically, does not aim to prevent a change in the law by the host state but, rather, to address the economic impact of such changes by way of renegotiation to re-establish the equilibrium of the contract. The above crucial aspects which determine the workability of the clause should be considered by practitioners and the conclusions drawn therefrom are what constitute best practice in the drafting of FSC's.

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136 *Ibid.*

CHAPTER 4: CHALLENGES AND OPPORTUNITIES FOR PRACTIONERS

4.1 Introduction

It would be a foolhardy to believe that considerations of contractual stability should be left to the specific stabilisation clause alone. There are a number of other factors both contractual and exogenous that can play a role in contributing to the strengthening as well as weakening of the contractual relationship. This chapter will look at the challenges to the implementation of a FSC and how they can be overcome as well as opportunities for practitioners to consider to strengthen the stability of the contractual relationship.

4.2 Challenges to the effective implementation of the fiscal stability clause

Despite the popularity of stabilisation clauses, their practical value to investors can be questionable when confronted with certain practical realities.[137] Previous chapters have discussed and addressed the issues of validity and legality; however, certain practical issues remain. Issues such as an underlying fiscal regime which is susceptible to criticism because it confers the IOGC with unsustainable benefits; or the practical difficulties that arise when trying to quantify the contractual equilibrium after amendment. These difficulties need further examinations to seek possible solutions that may alleviate their effect.

4.2.1 Problematic underlying fiscal regime

Previously it was state that one of the key elements of attracting much needed foreign direct investment into a host state's upstream petroleum industry is a favourable investment climate.[138] A sound underlying fiscal regime is one that can achieve a balance of fair resource rent while also taking into account the fiscal risks that an

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137 See generally Mansour M and Nakhle C (2016) and Nna Emeka J (2008).

138 Al Faruque A 'The Rationale and Instrumentalities for Stability in Long-term State Contracts: The Context for Petroleum Contracts' (2006) 7 The Journal of World Investment & Trade 85, p.98.

investor must circumvent. However, in what can be described as either desperation, overzealousness or lack of understanding, some fiscal stability arrangements made by host states may provide IOGCs with unsustainable benefits. This means that the locked-in law or equilibrium may be defective or perceived to be unfair, and this may be a point of difficulty between the parties if they are not all amenable to its repair.[139]

A number of examples of the above scenario have occurred. In the 1990's the government of Kazakhstan agreed to fiscal terms which it arguably did not fully understand.[140] Conferring to IOGCs revenue and profit sharing benefits that were quite generous, and that it found to be unacceptable several years later; leading to a battery of changes in the tax and subsoil legislation.[141] Fortunately, in this instance, the host state initiated a review of fiscal policies without attempting to amend existing contracts that had stabilisation clauses.[142] Thus, the changes applied to future agreements and there was no need to invoke the stabilisation clause. Not all investors have been this fortunate though, as with the following example from outside the petroleum industry. In Zambia the privatization of the state monopoly mining company ZCCM (Zambia Consolidated Copper Mines) from 1997 onwards was accompanied by a very investor friendly fiscal regime aimed breathing life into the dying sector.[143] With the rapid boom of copper prices and production *circa* 2004–07, the Zambian government had a change of heart regarding the fiscal policies. Daniel and Sunley state: "The government acted first to revise the fiscal regime for new projects in 2007, and then in 2008 it amended the Mines and Minerals Act to invalidate all existing Mining Development Agreements—thus also invalidating, under Zambian Law, the fiscal stability assurances."[144] This was obviously a major blow to the investor and the detrimental effect of a weak underlying fiscal regime was exposed.

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139 Al Faruque A (2008), p.117. Also see Daniel P and Sunley E (2010), p.14.

140 Cameron PD (2006), p.22.

141 *Ibid.*

142 *Ibid.*

143 Daniel P and Sunley E (2010), p.14.

144 *Idem,* 15.

FSC's are not a panacea for a poorly designed fiscal regime.[145] A FSC cannot substitute a sound fiscal regime. Parties to a petroleum agreement should construct fiscal regime terms which provide for progressive taxation (within the contractual terms if not available in legislation). This entails that government take will rise automatically with rising profitability.[146] Thus, providing the predictability of receiving a rising share of any price windfall and reducing the need for intervention to change the fiscal regime in the future. Other strategies to counter the effects of a dubious fiscal regime include giving the host state a high take from the outset; further, giving the host state equity in the venture through joint ventures, local employee ownership schemes and equity ownership by local entrepreneurs.[147]

4.2.2 Administrative burden

The outcome based nature of negotiated economic balancing presents a challenge to its administration. The negotiation process to restore the economic balance of the agreement presumes that the effect of the change in the fiscal terms can be appraised and an offsetting change agreed to – which is not always the case.[148] Firstly, the fiscal policy tools subject to stabilisation (e.g. corporate income taxes; royalties; rent tax/additional profits tax) are typically not defined exhaustively and as such it becomes difficult to ascertain a calculated outcome at any point in time.[149] In this regard Daniel and Sunley state:

> "If there is no uncertainty about costs and revenues and agreement on an appropriate discount rate, the effect of the change in the fiscal terms may be quantifiable. Under these conditions, an increase in the income tax rate could be offset by a reduction in the royalty rate, but the changed fiscal regime would have different economic effects at the margin. Moreover, with uncertainty as to costs and revenues, the offsetting change that

145 *Idem,* 22.

146 Mansour M and Nakhle C (2016), p.19.

147 *Idem,* p.20.

148 Daniel P and Sunley E (2010), p.18.

149 Mansour M and Nakhle C (2016), p.24.

would be appropriate under one set of assumptions would likely be too generous or not generous enough under a different set of assumptions."[150]

Another issue would be the information and resource advantage that IOGCs have. Host states, particularly developing ones, do not have all the information and analytical tools necessary to calculate outcomes and will have to rely on IOGCs to compensate for the disadvantage.

The above issues are a matter of collaboration as well as smart accounting. A possible approach to the administration of fiscal measures under the economic balancing clause would be to calculate the fiscal impacts of new fiscal measures *ex post facto*.[151] The parties could determine the effect of a change in fiscal policy and provide adequate adjustment a year after those changes take effect. Thereby using retrospective adjustments to restore the contractor's economic position.[152] The FSC certainly does make revenue management trickier, but it is a challenge that can be overcome if IOGCs assist host states to develop capacity and internal competencies. This is beneficial to the investor as well because it assists in building stronger relations with the host state government and results in a more conducive operating environment.

4.2.3 Failure to carry out full due diligence

As previously stated, it is of crucial importance that an investor familiarise themselves with the constitutional and legislative capacities of a host state to conclude stabilisation clauses. The sensitivity of this issue and the delicate question of legislative sovereignty could impact on the very foundation of validity.

However, there are other critical matters which must fall into the scope of conducting due diligence. For instance, when contracting with a state owned entity (SOE), the investor must ensure that the SOE has full capacity to conclude a stabilisation clause.[153] In the past there has been contestation on the issue of attributing actions of SOE's to

[150] Daniel P and Sunley E (2010), p.18.
[151] *Idem,* p.19.
[152] *Ibid.*
[153] Nna Emeka J (2008), p.1330.

the host states.[154] It is safe to say that if an investor is unsure of the validity of a stabilisation commitment provided by a SOE he should look towards expressly, directly, and unequivocally binding the host state, thereby avoiding uncertainty over whether the SOE is an agent of the State and providing basis for a potential claim against the host state.[155]

Other issues that should be explored and considered to gauge the strength of the FSC *inter alia* include: the power of the host state's local courts to frustrate arbitration; local law's may be poorly drafted, developed, or inconsistent and; the ability to enforce arbitral awards against the host state.[156]

4.3 Opportunities to strengthen fiscal stability

It must be appreciated that are other mechanisms that can work alongside a FSC to ensure protection of the investor. The law that applies to such an agreement and the venue of the settlement of any dispute arising out of the agreement is ever more important. These issues will be briefly analysed below. These tools are the strongest instruments that support the functional value of the FSC; and practitioners, particularly counsel for the IOGC, should familiarize themselves with their utility.

4.3.1 Applicable law clause

Inasmuch as a petroleum agreement has its commercial heart (i.e. its place of execution) in the host state, the laws of that host state could pose a threat to the effectiveness of a stabilisation clause. The host state can use its sovereign powers to modify its domestic law and, accordingly, the legal environment of the agreement. The mining and petroleum laws can offer certain guarantees, such as allowing for the use of stabilisation clauses but those guarantees are limited by the legislative or regulatory power of the host state.[157] The reality is that foreign investors are distrustful of the legal

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[154] *Idem,* p.1328.

[155] *Idem,* p.1330.

[156] See generally Nna Emeka J (2008).

[157] Loncle JM and Philibert-Pollez D "Stabilisation Clauses in Investments Contracts" (2009) International Business Law Journal 267, p.273.

systems of developing countries as it is well recognized that the host state can change its law at its whim – as was shown in Zambia 2008. As such the applicable (or governing) law clause, which deals with the laws that will govern a contractual agreement, needs to be drafted to avert such risk.[158]

The idea of including international law as the applicable law in an agreement is that the it ensures more security for foreign investment than national law as the former is not susceptible to change by the host state.[159] However, practically speaking international law cannot cover all aspects of a commercial agreement. It is advisable that the applicable law clause should have a hybrid approach which is based on the host state's domestic law being supported by international law.[160] The advantage of such an approach is that it respects the commercial and legal reality that the agreement is in operation in that particular state (thus it respects state authority) while conferring onto the agreement the buffering security of the principles of international law.[161]

Of course, there are other options that exist should the investor find the host state's laws or legal system wholly unworkable, such as choosing a non-national governing law (e.g. the general principles of law, lex mercatoria, etc)[162] This however does not have the extensive cover offered by the first approach such non-national laws may also be insufficient to deal with every aspect of a state contract.

The provision of international law as part of the applicable law is novel but logical; and in the event of dispute relating to the breach of a stabilisation clause its inclusion should assist the investor in securing a fair if not favourable outcome.

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[158] Maniruzzaman AFM "The Issue of Resource Nationalism: Risk Engineering and Dispute Management in the Oil and Gas Industry" (2009) 5 Texas Journal of Oil, Gas and Energy Industry Law 79, p.91.

[159] Maniruzzaman AFM (2008), p.124.

[160] *Idem,* p.125.

[161] An example of such a clause is contained the Libyan concession contract concluded with BP, Liamco and Texaco-Calasiatic. Providing: "The present agreement will be governed by and must be interpreted according to Libyan law in that these principles can be interpreted in common with international law. In the absence of common ground between the principles of Libyan law and those of international law, it will be governed by and conform to general principles of the law of the country in which the contract is performed."

[162] Maniruzzaman AFM (2008), p.125.

4.3.2 Dispute resolution clause

The previous section as well as other parts of this study have stressed the unreliability and/or distrust of the legal system of some developing countries. Thus "the provision for international arbitration is often seen as not only a safeguard against such apprehension but also as a source of stability for the relationship between the host state and the investor, as well as the contractual regime."[163] Being able to have a dispute referred to international arbitration takes the matter out of the hands of the local courts and/or arbitrations which be manipulated against the investors interests.[164] The functional utility of a stabilisation clause is rooted in the arbitration clause. Without it the stabilisation clause "provides little more than psychological comfort, as the wronged party must litigate in the host state with the attendant perils."[165]

Another strong cause to insert an international arbitration clause is that even if domestic laws are the governing law of the petroleum agreement the arbitrator/tribunal is more likely to "interpret the chosen host state's law in light of international law on the basis of various international elements of the contract concerned, and thus could come up with an acceptable decision on the dispute."[166]

Various international forums for dispute resolution exist, some with governing conventions which stipulate their jurisdictions, scope and functions. The International Centre for the Settlement of Investment Disputes (ICSID) is one such forum.[167] It has been a popular arbitration destination for the settlement of disputes relating to stabilisation clauses.[168] Although the ICSID has jurisdiction to hear matters that relate to

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163 Maniruzzaman AFM (2009), p.93.

164 *Ibid.*

165 Nna Emeka J (2008), p.1317.

166 Maniruzzaman AFM (2009), p.93.

167 The Convention on International Centre for the Settlement of Investment Disputes between States and Nationals of Other States (the ICSID Convention), (18 March 1965) 575 UNTS 159.

168 *Feldman Karpa v. Mexico, Award and separate opinion, ICSID Case No ARB(AF)/99/1; IIC 157 (2002); (2003) 18 ICSID Rev—FILJ 488; (2003) 42 ILM 625, despatched 16 December 2002.; Liberian Eastern Timber Corporation (LETCO) v. Republic of Liberia, ICSID Case No. ARB/83/2, Final Award, 31 Mar 1986; CMS Gas Transmission Company v. Argentina, Award, ICSID Case No ARB/01/8, IIC 65 (2005), signed 12 May 2005*.

the breach of legal rights it cannot settle conflicts of interests in situations whereby renegotiation for the economic balancing fail.[169] Such a power falls outside of its mandate and cannot be conferred contractually by parties to a petroleum agreement. Thus, a FSC which confers unto the arbitrator the power to readjust the contract when renegotiation fails cannot be referred to the ICSID if that failure relates to the parties commercial interest and not legal duties. This analogy is used merely for the sake of illustrating that practitioners should look at the terms of a petroleum agreement holistically so as to avoid redundancies and points of failure in the agreement. Practitioners need to ensure that the arbitration clause is well aligned with the FSC to ensure the two are co-operative.

4.4 Conclusion

The FSC is one part of a bigger puzzle that keeps the fiscal terms as well as contractual relationship between parties stable. There are external elements that pose a threat to stability. For instance. if a government becomes unhappy with a fiscal regime which it promulgated/agreed to that could result in conflict that destabilizes the relationship. Investors need to be keenly aware and assistive when it comes to such elements. Further, other clauses in the petroleum agreement, namely the applicable law clause and the arbitration clause, can be of massive impact on the functionality and effectiveness of the FSC. Careful attention must be paid to these clauses to ensure that the FSC can deliver its intended results.

169 Article 25(1) of the ICSID Convention.

Chapter 5: Conclusion

The long term, capital intensive, exploration and exploitation of oil and gas resources is fraught with risks. Apart from the geological and commercial risks that are omnipresent in the upstream activities, the producer must also factor in the political risks that come with extracting natural resources in a world where resource nationalism swings in and out of vogue. Host states, particularly developing ones, seem to have a difficult time finding the right balance between attracting foreign investment into the development of their natural resources and ensuring that the interests of the populace are protected. Unfortunately, many of these states have failed to strike the right balance and have resorted to taking actions which are detrimental to their investment climate – as well as damaging their relations with investors. For decades, investors have pushed for the inclusion stabilisation mechanisms in the petroleum agreements they conclude with host states to minimize, at the very least, political risk. The objective of this paper has been to analyse how contractual stabilisation devices can be drafted to adequately address the needs for fiscal stability during the life of the agreement.

This paper started off by analysing the most significant causes of fiscal instability. The oil price stood out as a major factor of instability. This has been illustrated by the fact The World Bank has recorded more than 30 countries as having revised petroleum contracts, or entire fiscal regimes between 1999 and 2010 – a period which witnessed major changes in the price of oil. Another factor that stands in the way of stability is that of 'changing political circumstances' and the simplest way to explain this factor is that the government of today may wholly oppose the agreements entered into by the government of yesteryear and seek to review them. What has come out the analyses of these factors is that investors are indeed justified in seeking risk management strategies that prioritize the safety of their investment and its returns – in particular, the FSC.

The paper then looks broadly at the nature and purpose of stabilisation clauses. Asking the question what are they and are they necessary? Well, a stabilisation clause can is a provision aimed at rendering an agreement terms immune from any subsequent adverse act of the government, whether legislative or administrative. Thus, it ensures that the law of the host state, in as far as it relates to the petroleum agreement, remains unchanged for the duration of the agreement or for as long as the parties agree. These clauses have come about because of the risky nature of long term state contracts. The political risk aforementioned is what makes it an attractive option for investors. Issues such as the "obsolescence bargain" and changes in circumstance are what make it often a necessity when making an investment or funding decision.

The next issue to be considered was whether such clauses are legal valid. This question should be looked at on a domestic law scale and an international law scale. On the domestic front a stabilisation clause is valid and binding if the legislative and constitutional framework provides for them. If a host states concludes a stabilisation clause contrary to its legal framework it has acted *ultra vires* and such a clause will be invalid. From an international perspective things get a little complicated. There has been a debate regarding the validity of stabilisation clauses under international law. One side argues that stabilisation clauses are not valid because they violate the principle of permanent sovereignty over natural resources. The other side argues that the conclusion of stabilisation clauses is an exercise of that very sovereignty and as such the clause is valid. The latter group also argue that arbitration cases have recognized these clauses as valid and biding in the past. This is a contested topic; but it is safe to say that the use of stabilisation clauses is popular and will continue for some time to come.

The practice of contractual drafting of stabilisation clauses has evolved quite a bit over the decades. The form of stabilisation commitments sought by investors has shifted from an emphasis upon 'freezing' the terms and conditions of contracts to one in which stabilisation can take a number of forms, often with an emphasis on balancing achieved through negotiation. To summarize the reason for this Cameron provides: "…This volatile context facing investors suggests that those forms of stabilisation that attempt to 'freeze' the provisions of a petroleum contract over long periods of time are likely to prove much less effective than provisions that focus on the results of a possible unilateral revision in the petroleum contract and which adapt the wording of the stabilisation mechanism accordingly."[170]

The main crux of this paper has been to ascertain the best practices to consider when drafting an FSC. Firstly, I argue that a NEB clause is the best form of FSC because it would bring both parties to the negotiating table with a view of working harmoniously and in a collaborative manner to reach a beneficial equilibrium. Further, it allows the parties to modify the agreement instead of terminating the relationship considering changes which could happen during the life of the contract and; can be utilized to ensure the equality of treatment of both parties in respect of economic balance of the contract by allowing for renegotiation in the event of a deterioration *or* improvement of the investors position. Thus, the ideal FSC would be one based on negotiated economic balancing.

The next consideration to be made is what exactly should go into the clause? Some substantive issues were that require special attention are:

(1) the scope of events that trigger and activate renegotiation clauses, specifically whether the events must be unforeseen and beyond the parties' control. These events can be defined in general or specific economic terms;

(2) the objective of the renegotiation by stating clearly the aim, whether economic readjustment of the contract or indemnification to the affected party;

(3) the procedures of the renegotiation, It is thought that having such procedures, if specified in the agreement, can strengthen the clause by way of imposing procedural obligations on the parties;

(4) due to the fact that an obligation to negotiate is not an obligation to agree, this clause should provide for solution if the renegotiation fails; such as calling a third party or arbitration to adapt the contract in the event that the parties are unable to reach an agreement through renegotiation.

170 Cameron PD (2006), p.96.

It is argued that if the negotiating parties pay special attention to these factors when drafting an FSC it should yield the best results for all parties by making the latter more certain and consequentially more effective.[171]

The last section of this paper looked at factors outside the FSC that can influence the effectiveness of the clause. These factors presented both challenges and opportunities to the functionality of the FSC. Practitioners need to stay aware of the challenges relating to having an underlying fiscal regime which is weak or unsuitably biased in favour of the investor. Another challenge that should be considered is how is the fiscal regime of the petroleum agreement going to be administered? It can be quite a burdensome undertaking on the part of an under resourced developing state. Parties need to consider meaningful ways to collaborate to overcome this issue. Finally, the parties must also pay careful attention to the applicable law and arbitration clauses of the petroleum agreement as it could have major implications on the functional value of the FSC.

This paper has delved into some of the most pertinent issues regarding the drafting of FSCs and it is hoped that it may serve as a guide to practitioners around the world to assist them in making considerations when tailoring what should be in their FSCs and petroleum agreements.

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[171] See *fn* 109.

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