

THE STABILIZATION OF INVESTMENT CONTRACTS IN THE OIL AND GAS INDUSTRY

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INTRODUCTION

The two (2) main characters of investments in international petroleum industry (oil and gas) are:

- long term (25 years or more)
- capital intensive (importance of economic & financial model to assess profitability over the course of the project)

This situation underlines the vulnerability of the foreign investor when unilaterally the host government alters, changes or modifies some provisions at some moment in the life of the contract.

Therefore, the guarantee for STABILITY in the contract itself is for international petroleum companies (IOC's) and their bankers, is one way of mitigating that RISK.

Exceptions to stabilization

It is important to note however that there are many petroleum rich host countries that do not offer clauses designed to provide STABILIZATION and that IOCs have no difficulty living with such a legal regime, as the legal and political risks are low in those host countries (UK, Norway are few examples).

In other countries, while the legal and political risks may be high, the perception of the geological risk is so low that IOCs accept a contract without stabilization provisions (Saudi Arabia, Brazil are some examples).

Some host countries may offer stabilization clauses that are not enforceable. Therefore, caution has to be exercised in dealing with this subject. Therefore, importance of due diligence must be highlighted.

HISTORICAL BACKGROUND OF STABILIZATION CLAUSES (SC)

In the period between the first and second world war, American companies began to include stabilization clauses in the concession contracts to prevent acts of nationalisation by Latin American governments.

Objective: to ensure that the concession contract remains in force throughout the period agreed in the contract.

However, these stabilization contracts did not invalidate a nationalisation, but they did have the effect of making it UNLAWFUL and affect the amount of compensation that a tribunal might award.

It is a settled matter in public international law that States have the right to nationalize foreign investments provided it is not discriminatory and a just and fair compensation is offered.

Nationalisation trend continued generating numerous arbitration claims.

An illustration

In a case TOPCO v. Libya (1979)

The clause provided that the host government « *shall take all the steps that are necessary to ensure that the company enjoys all the rights conferred upon it by this concession, and the contractual rights expressly provided for this concession shall not be infringed except by agreement of both parties.* »

Despite such a clause, Libya nationalised the IOC's investments. The Arbitration Tribunal held that Libya violated the specific contractual undertakings and therefore that such nationalisation was a breach of the deeds of concession.

In the early 1980s, revision of petroleum contracts and nationalisation of petroleum industry assets triggered confrontational arbitration procedures: a few cases:

- Saudi Arabia v. Arabian American Oil company (Aramco)
- Kuwait v. American Independent Oil Company (Aminoil)
- Agip Company v. People's Republic of the Congo
- Amoco International Finance Corporation v. Islamic Republic of Iran.

National Oil Companies (NOCs) and the Contract Stability

In the 1980s, the growth of NOCs also affected contract stability. This means that sometimes, the contract of exploration and production (E and P) is made between the foreign investor(s) and the NOC rather than the State itself, and in other occasions between the NOC and the host government. Concession agreements were replaced by Production Sharing Agreements/Contracts (PSA/PSC) .

In these cases, the stabilization clause may be negotiated with the NOC, which makes it easier to reach an agreement.

If there is an increase in the fiscal obligations, a tax exemption on behalf of the IOC will be applicable to the extent of the NOC's (or host government's) share of profit oil (Trinidad and Tobago). Otherwise only lumpsum damages are available for the IOC.

WHY DO HOST GOVERNMENTS CHANGE RULES?

Motives are not uniform

- Steep rise in international oil prices as from 2003 or currently (70 -100 USD)
- Change in bargaining power, as producing countries seek to improve the benefits from their contractual arrangements.

Some examples

1) In 2005, UK increased its petroleum taxation burden – Its Minister of Finance (Chancellor of the Exchequer) declared that: *« returns in the North Sea are now nearly 40 percent of capital, compared with ordinary returns of 13 percent.*

With the tax on new development in the North Sea now lower than the USA and the Gulf of Mexico, Norway, Italy and Australia, and in order to strike the right balance between producers and consumers, I will raise the supplementary North Sea charge from 10 percent to 20 percent.

2) In May 2006, the U.S. House of Representatives approved a plan to renegotiate Gulf of Mexico petroleum leases granted between 1998 and 1999 that exempted petroleum companies from fees from exploitation in the Gulf of Mexico regardless of how high prices went.

LEGAL TOOLS TO INTRODUCE RULES CHANGES & THEIR IMPACT

Changes can take the form of laws, decree or regulations with two (2) series of impacts:

- 1) Impact on the LEGAL and ECONOMIC environment of the petroleum contract with NEGATIVE EFFECTS in terms of reputation and publicity .
- 2) DIRECT Impact upon the terms of the petroleum contract itself. These may include MEASURES such as the following:
 - An increase in the applicable tax rate or royalty rate
 - An increase in the applicable tax base
 - Imposition of new taxes or new royalties
 - Revisions, in the context of PSC, to the calculation of « cost petroleum » or the « profit petroleum split »
 - An increase in the percentage of participation available to the host government designated participant in the context of « government participation » or in the cost sharing obligations of the host government participant
 - A change in the allocation , between the IOC and the host government , of management and control over petroleum operations, inclusive of contracting for goods and services with third parties

- Increases in, or imposition of, restrictions in regard to the IOC's right to < monetize » a discovery .
- Increases in, or imposition of restrictions to the IOC's right to export, or
- Increases in, or imposition of, the IOC obligation to market petroleum within the host country (including pricing), by way of a « domestic sales obligation ».

There are other INDIRECT tools/instruments/ levels available to the host country such as the following:

- The State's rights in many PSA projects to veto the proposed annual budgets;

- State's powers over local contents;
- Investor's liability over project delay and use of environmental compliance powers (which are not usually stabilized)

WHAT ARE THE RISKS TO THE HOST GOVERNMENT ?

Two (2) types of risks if the HC modifies or changes fiscal provisions of the contract :

- 1) Investor brings the case before an arbitral tribunal and seeks compensation
- 2) Negative publicity for the host country's investment climate.

If the host government takes unilateral action, what happens next?

- i. In some contracts, there is a provision for NEGOTIATION aimed at restoring the disrupted equilibrium, as we will see later in the presentation;
- ii. Even if such a provision does not exist, parties will probably choose to use some sort of NEGOTIATION to remedy the situation.

- iii. For example, the IOC will refer the matter to arbitration. In such instances, parties will produce economic models to support their case with the IOC arguing that the economic equilibrium has been disturbed in a way that negatively impacts on it. The host government will have to prove that the damage is marginal or negligible.
- iv. Where it is determined that the Stabilization mechanism has been significantly disrupted the host government's share of profit oil will be reduced accordingly.
- v. In general, arbitration awards provide for a lump sum damages and/or specific performance for the breach of stabilization clause.

PRACTICE OF FISCAL STABILIZATION

At the heart of negotiations about any international petroleum contract is the fiscal regime which, in the event of commercial discovery, will determine how the profits and revenues are to be divided between the state and the IOC. This will involve more than taxes and royalties.

Example: In a PSC, provisions will deal with timing of cost recovery and the division of profit oil.

If agreement is reached on these essentials, this may be undermined if the contract cannot be given some degree of STABILITY.

Apart from the fiscal regime, other concerns of the investor will be those provisions that are likely to have an impact on INVESTMENT RECOVERY AND PROFITS such as:

- i. Security of contractual and proprietary rights and titles
- ii. The right to sell petroleum and the right to export;
- iii. The right to retain and repatriate foreign exchange earned (same issue as in Bilateral Investment Treaties (BITs);
- iv. The right to retain the proceeds of export sales offshore without mandatory currency conversion;
- v. And operational freedoms consistent with international standards;

This does not mean that a specific stabilization clause is essential. Reference can be made in the petroleum contract or licence, without any undertaking by the host government to stabilize the fiscal regime.

Definition of the notion of stabilization

All the mechanisms, contractual or otherwise, which aim to subject the contract provisions to specific economic and legal conditions which the parties considered appropriate at the time the contract was concluded.

Two (2) categories of stabilization provisions:

1. Freezing Clause :

It stipulates that neither the fiscal, nor the non-fiscal elements (social & environmental issues) of the contract may be changed by the host government during life of the contract without the two parties consent (Angola, Tunisia).

Sometimes, the stipulation of the clause is direct at preventing expropriation by the host government or expressly permits expropriation but provide for an applicable amount of damages on such an event.

Art 30.7(d) Mozambique PSC Model (2001) :

« The Government **shall not** revoke or amend the Autorisation granted to ENH to explore for and produce Petroleum from the contract Area **without taking effective measures to ensure that** such revocation or amendment **does not affect the rights granted** to the Contractor hereunder »

AND

Art 30.7(e) « The Government **will not without the agreement of the contractor** exercise its legislative authority to amend or modify the provisions of this Agreement and will not take or permit any of its political subdivisions, agencies and instrumentalies to take any administrative or other action to prevent or hinder the contractor from enjoying the rights accorded to it hereunder »

Art. 18(m) Ivory Coast 1996 Petroleum Code

« The petroleum **contract** in particular **must set....** The legal conditions concerning the applicable law, **the stability of conditions**, the cases of force majeure and the regulation of disagreements... »

Art. 24.1 Tunisia 1989 PSC Model – emphasis is put on the pre-eminence of contractual terms over all other regulations and further, interpretation of the agreement is mentioned.

*« The contractor shall be subject to the provisions of this Contract as well as to all laws and regulations duly enacted by the Granting Authority and which are not incompatible or conflicting with the Convention and/or this Agreement. It is also agreed that **no new regulations, modifications or interpretation which could be conflicting or incompatible with the provisions of this Agreement and/or the Convention shall be applicable** »*

2 – Economic Balancing Clause

Essentially, the provision stipulates that if the host government adopts a measure subsequent to the conclusion of the petroleum contract in which the fiscal terms are stated, that is likely to have damaging consequences to the economic benefits for one or both parties, a re-balancing will take place in order to restore the economic balance of the contract.

Two (2) ways to achieve the economic balance:

- (i) Adjustment may be automatic or achieved in a manner stipulated in the contract ;
- (ii) Make express provision for the parties to negotiate how amendments should be

Exploration, Development and Production of Petroleum, which take place after the Effective Date, and which significantly affect the economic interest of this Agreement to the detriment of CONTRACTOR or which imposes on CONTRACTOR an obligation to remit to the Arab Republic of Egypt the proceeds from sales of CONTRACTOR's Petroleum, CONTRACTOR shall notify EGPC (the NOC) of the subject legislative or regulatory measure.

In such cases, the Parties shall negotiate possible modifications to the Agreement designed to restore the economic balance thereof which existed on the Effective date.

The Parties shall use their best efforts to agree on amendments to this Agreement within 90 days... These amendmentsshall not diminish or increase the rights or obligations of the CONTRACTOR as agreed on the Effective Date.

Failing agreement between the Parties... the dispute may be submitted to arbitration as provided inthis Agreement ».

CONCLUSION

African_governments_should be advised to secure the right for changes or modifications in their PSCs with the option of re-balancing by way of negotiation. Of course, such an option should be complemented by penalties for non-compliance and arbitration in case of failure of the negotiations.