Stabilisation Clauses in International Petroleum Contracts
Illusion or safeguard?

East Africa
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Preface

International oil companies contend with the risk of changes to the fiscal terms of petroleum agreements signed with the host state which may adversely affect the commercial viability of the exploration and exploitation project as previously appraised. Despite protests that stabilisation clauses fetter their sovereign legislative prerogative as well as their permanent sovereignty over natural resources, governments in developing countries have been amenable to requests by investors to include stabilization clauses in their petroleum agreements. These clauses provide, at least in appearance, a bulwark against unilateral host review of the initial contract terms through legislative or administrative action. This paper discusses the value of stabilisation clauses to the foreign investors, the host state and other stakeholders in the petroleum industry. The essence of the inclusion of stabilisation clauses is the reaffirmation of the host state of its belief in the sanctity of contracts and assurance that fiscal commitments under their investment agreements will outlive the government that welcomed the venture and endure for the duration of the project.[1] Host States (mostly developing nations) are usually amenable to these demands despite arguments that this encumbers their sovereign legislative prerogative as well as permanence of sovereignty over natural resources.

This paper therefore examines the value if any that stabilisation clauses confer to the various stakeholders in petroleum exploitation investment ventures. It also outlines their scope and nature. It further concludes a stabilisation clause may not in all instances be a panacea to the stability quest for investors in long term energy investment ventures.

Please note that in this article, for convenience, the term production sharing agreement (PSA) has been used to cover all forms of contractual agreements for the exploitation of a country's hydrocarbon resources.

1 Ibid Page 4

Introduction

Prior to committing an investment, international oil companies usually undertake a comprehensive due diligence of the host state's geological, socio-economic, political, legal and fiscal environment. The findings form the basis for negotiating the fiscal and related terms of the project. This is in addition to laying out parameters for appraising the commercial viability of the venture envisioned to be pursued. The objectives of the two principal agents to petroleum exploitation namely the host state and international oil companies not only diverge but also frequently clash.[2] Whilst international oil companies are driven by their desire to maximise profits, host states on the other hand are interested in revenue maximisation and the realisation of other state objectives. The conflicts that may arise between these two principals fundamentally derive from this.

Petroleum exploitation projects are not only capital intensive but also span a long period of time. Many developing countries do not have the financial means or technical means required to develop the petroleum resources and seek out the partnership of well capitalised international oil companies. The host states may be developing countries that are beset by political and economic crises and potentially laden with a history of coups and counter coups. They may offer fiscal incentives to entice companies to provide the needed capital, expertise, and management for the successful exploitation of their petroleum resources.[3] The international oil companies become vulnerable once an investment is committed because they may not easily exit without serious adverse financial ramifications. At this stage, they are at the mercy of the host state.

International oil companies from the very outset of their petroleum exploration and exploitation projects seek risk mitigation tools to protect against a future that may be beset with demands from the host state to review the initial terms of their petroleum agreement. The cyclical variations in petroleum prices have the potential to make an apparently profitable deal look unattractive should there be a significant rise in the future. This is the most common trigger point of tension between the international oil companies and the host state determined to seek adjustment to the initial IPA in response to both political pressure and changed circumstances.

Investors' quest for stability in the legal and fiscal terms is driven by their objective of recouping a reasonable return on investment and in the shortest time possible. There are other financial and non-financial considerations that concern the investors. These include the threat of confiscatory measures such as direct expropriation and other subtle manoeuvres that interfere with the investors' rights. International oil companies may also be reluctant to incur additional operational costs resulting from changes in labour law or new health, safety and environmental demands.

International oil companies' priority at the outset of a project is therefore to devise a risk management framework to restrain or at least mitigate the exercise of host state legislative prerogative which may adversely affect returns. There are three broad techniques that International oil companies have used in this respect and these are contractual, legislative and treaty- based tools. Though the focus of this paper is the contractual tool of stabilisation clauses, it also includes a brief discussion of how legislative and treaty based mechanisms operate in the context of international energy investment projects.

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2 Bindemman, Kirsten. Production sharing agreements: an economic analysis. Oxford: Oxford Institute for Energy Studies, 1999 page 5

3 Emeka J. Anchoring Stabilisation clauses in International Petroleum Contracts, Int'l Law 42 (2008) 1317-1338

Stabilisation tools

Law based stabilisation tools

Legislative support can be provided in two main ways. First, there may be substantive provisions in laws that set out more or less specific guarantees for the stabilisation of a category of investments.[5] The table below depicts as an example some provisions in Uganda's legislation that address the investors' quest for the protection of their investment.

Uganda legislation	Discussion
Investment Code Act	Section 22 provides that the business enterprise of an investor which is licensed under this Code, or an interest or right over any property or undertaking forming part of that enterprise, shall not be compulsorily taken possession of or acquired except in accordance with the Constitution of Uganda subject to national interest considerations and fair compensation.
Income Tax Act	Section 89(B) 2 provides that where there is inconsistency in the taxation of contractors and subcontractor's income from petroleum operations, the provisions of part IXA of the Act and petroleum agreement shall take precedence over other parts of the Act. Whilst there is still a lingering ambiguity from the reading of this provision, the better view is that PSA terms take precedence over the Income law terms. This ensures the incentives and fiscal terms in relation to income tax provided under the PSA are stabilised.

The basic criticism of law based stabilisation is that, '' what parliament enacts, parliaments may undo.'' On this premise, attempts to grant additional stability by legislative means may act as a little more than a fig leaf comfort to the foreign investor. However, if they are available, they are useful in bolstering an investor's legitimate expectations about the host state's intent.[6]

An interesting and controversial example of using legislation to provide stability for an investment project is the Nigeria LNG Act of 1990. The Act included a prohibition on unilateral change, freezing of the fiscal regime and effective grant of legal enclave status to the project. Since the provision of international project finance was so crucial to its viability, the degree of assurance required by lending institutions was very high, extending beyond a contractual form of stabilisation.[7]

5 Cameroon Peter, ''International Energy Investment Law: pursuit of stability'' OUP Catalogue (2010) page 62

6 Ibid page 63

7 Ibid page 64

Treaty based stabilisation tools

These are mechanisms for the stabilisation of an investment that are found in international investment instruments such as bilateral and multilateral investment treaties. As an international agreement concluded between two states, typically between a developed and developing country, a bilateral investment treaty commits the contracting states to offer both substantive and procedural protections to investors and to an investment which originates in the other state party. This allows an investor to initiate an arbitration claim against the host state, without relying upon the intervention of the home state in the prosecution of the claim.[7]

An important feature of bilateral investment treaties for foreign investors and the host states lies in the consequences of their existence as well as their potential for enforcement. A host state may, in developing a new policy which threatens an investor's interest, be reminded by the investor or its home state of the foreign investor of its bilateral investment treaty obligations and the risk of arbitral proceedings. This informal use of a bilateral investment treaty in negotiations with the host state is well known to legal advisers. At the very least, the foreign investor's threat of arbitral proceedings under a bilateral investment treaty can lead to consultations, renewed efforts by the parties to reach a settlement in a dispute, and potentially a change in policy by the host state.[8]

East African Countries Bilateral Treaties		
Uganda	**Kenya**	**Tanzania**
Egypt (not in force yet)	Germany	Denmark
France(not in force yet)	Italy	Finland
Germany	Netherlands	Germany
Italy	Switzerland (not in force yet)	Italy
Netherlands		Korea (not in force yet)
South Africa (not in force yet)		Netherlands
Switzerland		South Africa
United Kingdom		Sweden
		Switzerland
		United Kingdom

7 Ibid page 65

8 Ibid page 66

Nature and scope of stabilisation clauses in petroleum agreements

Stabilisation clauses are specific commitments by the Host State not to alter the terms of the International Petroleum Agreements by legislation or other means, without the consent of other contracting parties.[10] One commentator has traced the origin of stabilisation clauses to the period between World War 1 and World War 2 when US companies began to include them in concessionary agreements because of nationalisations in Latin America. [11]

The perception by many host states that International Oil Companies have reaped a windfall in the climate of high energy prices and unfairly benefited from the terms of their PSA's coupled with the cycle of soaring oil and gas prices has driven many countries into repudiating or altering fiscal regimes.[12] Often forgotten in the scramble is the colossal risk undertaken by the international oil companies in exploring new frontiers, the risks of a dry hole and unrecoverable costs not to mention the high volatility in the oil and gas prices.[13]

International oil companies are keen to anchor the terms of their PSA's with host states premised on the legal regime in effect at the time of the investment. This is aimed at ensuring predictability a critical concern for the investors in recouping their investment at reasonable returns. Comprehensive stabilisation clauses would preclude the host state from applying amended legislation that would impact their investment. Modern day stabilisation clauses do not restrain the Host State from applying amended legislation but rather outline the need for reinstatement to the prior balance of economic benefits in the event of adverse legislative changes. Stabilisation clauses may be comprehensive or limited[14] as discussed in the table below.

Scope of stabilisation clauses	Discussion
Comprehensive	All the terms of the PSA are insulated against any subsequent change arising in the legislation of the host state.
Limited	A limited range of PSA terms are insulated against subsequent changes in legislation. These could pertain to terms such as taxes, social security, import and exportation and the free transferability of currency. The limited scope of stabilisation clauses is more appealing to the developing countries because it does not limit legislative powers.

10 Margarita T.B, Stabilisation Clauses in International Petroleum Transactions, 30 Denver J. International Law and Policy 217 (2003).

11 Bishop R Doak, International Arbitration of Petroleum Disputes : The Development of a Lex Petrolea, Rocky Mountain Mineral Law Foundation of International Energy and Minerals Arbitration Law Series 2-18,18(2002) page 28

12 See supra 2 Emeka

13 Ibid

14 Faruque Abdullah, Validity and Efficacy of Stabilisation Clauses Legal Protection Versus Functional Value Journal of International Arbitration 23(4):-317-336, 2006

Types of stabilisation clauses

There are four principal categories of stabilisation clauses namely: freezing, prohibition on unilateral change, balancing and allocation of burden: further detail is set out below [15]

Type of stabilisation clause	Discussion
Freezing clauses[16]	These ordinarily preclude the host state from changing its legislation. This is criticised as an encumbrance on the host state's sovereign legislative prerogative and the permanency of sovereignty over its natural resources. It has come under scathing attacks from civil society organisations and is frowned upon by most governments. In the alternative, any changes in host state legislation subsequent to the PSA do not apply to the specific project. PSA terms take precedence in the event of a conflict with new legislation. The general practice in Uganda is the primacy of the PSA terms in the event of a conflict with the Income Tax Act in relation to the taxation of petroleum operations
Prohibition on unilateral changes[17]	They are commonly dubbed intangibility clauses. The terms of the PSA may not be modified or abrogated except with the contracting parties' mutual consent.
Balancing clauses[18]	They are commonly dubbed the economic stabilisation clauses. They provide for automatic adjustments or negotiations to restate the initial economic balance of the PSA should legislative changes be introduced after signature. An example of this kind of stabilisation clause can be found in the Tanzania Model PSA of 2004.
Allocation of burden[19]	These clauses seek to allocate the fiscal and related burdens created by a unilateral change in the law. It is common for the resultant burden to be borne by the National Oil Company or the State. An example would be Kenya's PSA where income tax is allocated from NOCK's share of profit hydrocarbons.

15 See supra note 4 Cameron page 69

16 Ibid page 70

17 Ibid page 74

18 Ibid

19 Ibid page 80

Assessment of the value of stabilisation clauses

This issue has generated heated debate in recent years. Host states notably from emerging economies have been firm in their position that stabilisation clauses potentially encumber their sovereign legislative power and permanency of sovereignty over their natural resources. They have however been amenable to the demands of foreign investors to include these in PSAs. Civil society actors have also intensified their criticism notably of the freezing type clause, contending they can undermine the willingness and ability of the host state to fulfil its human rights obligations pursuant to international human rights law especially in the areas of health and safety, labour and employment rights and the protection of cultural heritage and environment.[20]

The foregoing criticism notwithstanding, stabilisation clauses continue to play an influential role in the extractive industry because of the perceived protection from political risk and the legal certainty accorded to foreign investors which both combine to promote foreign investment in petroleum exploration and exploitation notably in the developing countries.

A pertinent question to ask is why international oil companies are willing to invest in developed countries that do not provide stabilisation clauses but are hesitant to do so in the developing countries in their absence. Governments in developed countries decline granting stabilisation clauses on the premise they cannot bind a future government to the policies of the current administration.[21] On the other hand, the International oil companies demand for stabilisation clauses in the developing countries is premised on suggestions that rule of law is either not firmly entrenched or simply does not operate in the way they would expect. It is further suggested Latin America, Africa and Middle East are also laden with deep and long-lasting legacies of anti-colonialist sentiments or populist suspicion of foreign investment.[22] The petroleum sector is often a principle source of government revenue. The International oil companies therefore fear that new governments can easily tap into "neo-colonialist exploitation" with a view to making greater demands for a higher share of economic rent. [23]

Stabilisation clauses have been argued to promote foreign investment in the international energy sector. The collapse of planned economies in the late 1980s and the rise of market based capitalism marked a shift in paradigm with many developing countries seeking greater foreign investment participation in their extractive industry. Developing countries reversed many of their protectionist policies and there was a rush to reform fiscal laws as well provide incentives, including stabilisation, to lure inward investment.

The bankability of many petroleum exploitation ventures funded by project finance on limited recourse basis is also enhanced by the inclusion of stabilisation clauses in the relevant agreements especially in the emerging markets. International bankers and financiers have in some instances insisted on the inclusion of these clauses before they can provide financing to a project. Stabilisation clauses are perceived favourably by the bankers to provide a bulwark against legislative or administrative action that may erode the project returns ultimately compromising its ability to meet its debt repayment obligations.

19 Shemberg, Andrea, and Stabilisation Clauses. "Human Rights' (11 March 2008) http://www. reportsand-materials. org." Stabilization-Clauses-and-Human-Rights-11-Mar-2008. pdf.

20 See Supra note 3 Cameron page 17

21 ibid

22 ibid

As already mentioned, stabilisation clauses enhance certainty and predictability which are key ingredients for the success of long term investment projects. Petroleum exploitation is capital intensive and recouping the investment takes much longer than most sectors. Any subsequent changes in the laws of the host state may significantly alter the economics of the economics of a project. By constraining the legislative prerogative of the host state to amend laws unilaterally, the certainty and predictability of the project returns is increased.

Reinforcing the effectiveness of stabilisation clauses

The use of stabilisation clauses as a risk management tool can create a false sense of security and undermine an investor's ability to timely initiate negotiations and explore dispute resolution alternatives when faced with a government measure that alters the fiscal landscape.[24] Though international tribunals have generally upheld the validity of stabilisation clauses notwithstanding dissenting views, these clauses are not a panacea and experience has shown that they may not deter a determined government from pursuing alterations to the country's legislative regime ore even expropriation the investment concerned.[25]

What is insufficiently stressed in many publications arguing the benefits of the stabilisation clause is that its apparent effectiveness and validation by arbitration tribunals is contextual and rooted in an international anchor in the arbitration clause.[26]

Absent an international anchor, the stabilisation clause little provides more than psychological comfort, as the wronged party must litigate in the host state with the attendant perils. Domestic arbitration in the host state and under domestic law is generally rife with risk. For example, it is necessary to determine which local courts would exercise supervisory jurisdiction over the arbitral tribunal, whether local courts would issue an injunction or order remedies in aid of arbitration, or recognize and enforce an award.[27]

Legal questions may similarly arise when the only party to the PSA is the National Oil Company. It is recommended, to the extent that it is practical, to include the state as a party to the agreement even if only for the limited purpose of the stabilisation clause thereby restraining the exercise of sovereign power. Without adding the state to the agreement, the International oil company faces uncertainties in proceeding solely against the NOC.[28]

It is also important that the International oil companies carefully review the constitution and other applicable laws to confirm that the Ministry, National Oil Company or other relevant bodies that conclude the PSA on behalf of the government has unfettered powers to grant the fiscal and tax incentives in question. The fiscal terms and incentives granted may be challenged on the basis they were granted by a body lacking formal powers to do so.

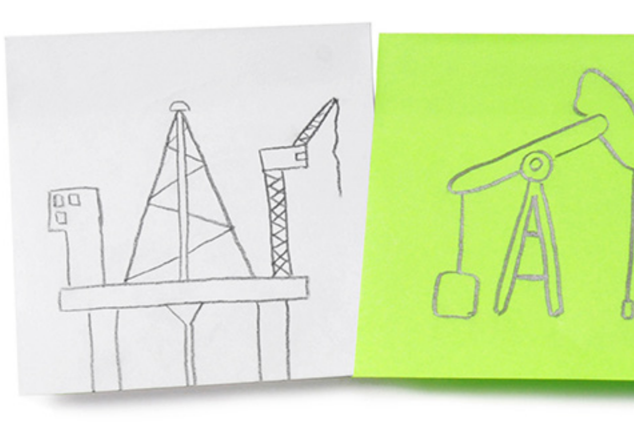
24 See supra 2 Emeka

25 See supra 3 Cameroon page 100

26 See supra2 Emeka

27 Ibid

28 Ibid



Conclusion

The significance of stabilisation clauses in promoting inward investment to the energy sector in the developing world cannot be overstated. Whilst International oil companies' concerns for stability in these capital intensive and long term investments is understood, it is also necessary that the terms requested to be the subject of stabilisation clause are reasonable.

A disproportionately favourable deal for the investor can be counterproductive as it may spark a political revolution in the host state resulting in instability that distorts the project returns which the International Oil Companies was keen to insulate against. ("If it looks too good to be true, it probably is…") Further, International oil companies should not take for granted the efficacy of stabilisation clauses.[29] Without a properly drafted arbitration clause providing an international anchor contractually through express approval by the host state, international governing law and venue, the utility of a stabilisation clause is suspect as the international oil company likely becomes trapped in the maze of domestic arbitration and litigation.[30]

The verdict to the central theme underlying this paper is that stabilisation clauses are indeed a safeguard to international energy investments.

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