Association of International Petroleum Negotiators
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Stabilisation in Investment Contracts and Changes of Rules in Host Countries: Tools for Oil & Gas Investors

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Table of Contents

TABLE OF CONTENTS **2**

EXECUTIVE SUMMARY & GUIDE TO THE READER **4**

GLOSSARY OF TERMS AND ACRONYMS **6**

FOREWORD & ACKNOWLEDGEMENTS **8**

Scope of the Study *8*
Structure of the Study *9*

PART 1: THE PROBLEM **12**

CHAPTER 1: WHY ATTEMPT TO STABILISE INVESTMENT CONTRACTS IN THE OIL AND GAS INDUSTRY? **12**

1.1 THE QUESTION: TO STABILISE OR NOT? 12
1.2 TWO LIMITATIONS ON STABILITY 13
1.3 HOW HAS STABILITY BEEN ADDRESSED OVER THE YEARS? 15
1.4 SUMMARY 19

CHAPTER 2: WHY DO HOST GOVERNMENTS CHANGE RULES? **20**

2.1 WAVES AND THEIR EFFECTS 20
2.2 THE ARMOURY 22
2.3 RISKS TO THE HOST GOVERNMENT 24
2.4 SUMMARY 25

PART 2: THE TECHNIQUES & THEIR ENFORCEMENT **27**

CHAPTER 3: THE PRACTICE OF FISCAL STABILISATION **27**

3.1 THE HEART OF THE MATTER 27
3.2 THE MARKET PLACE OF STABILISATION PROVISIONS 28
3.2.1 Freezing – Wholly or in Part *28*
3.2.2 Economic Balancing *31*
3.2.3. Circumstances of Balancing *36*
3.2.4 Balancing and Expropriation *38*
3.2.5 Legislative Support for Stability *39*
3.2.6 Stability and BITs *40*
3.2.7 Stability and Hardship *41*
3.3 STABILISATION AND CROSS-BORDER PIPELINE PROJECTS 41
3.3.1 The West African Gas Pipeline Project *43*
3.3.2 The BTC Pipeline Project *46*
3.4 CAN THE STATE BIND ITSELF BY CONTRACT? 48
3.5 SUMMARY 51

CHAPTER 4: ENFORCEMENT OF STABILISATION PROVISIONS **53**

4.1 THE OLD AND THE NEW 53
4.2 THE CLASSICAL AWARDS 54
4.3 STATING THE OBVIOUS: DUE DILIGENCE 56
4.4 INDIRECT EXPROPRIATION 58
4.4.1 Metalclad *59*
4.4.2 Occidental v Ecuador *60*
4.4.3 Feldman *63*
4.4.4 EnCana v Ecuador *64*
4.4.5 CMS v Argentina *68*
4.4.6 CME v Czech Republic *68*
4.4.7 TECMED *69*

4.5 FAIR AND EQUITABLE TREATMENT 70
4.6 THE GOVERNING LAW 72
4.7 SUMMARY 74

PART 3: CONTRACT STABILITY IN NON-FISCAL AREAS 76

CHAPTER 5: ENVIRONMENTAL, SAFETY AND HEALTH EXCEPTIONS 76

5.1 MANAGING UNCERTAINTY 76
5.2 VULNERABILITY IN NON-FISCAL AREAS 77
5.3 EXAMPLES OF ENVIRONMENTAL RULE DEVELOPMENT 79
5.3.1 Tanzania 79
5.3.2 Kazakhstan....... 80
5.4 DESIGNING SOLUTIONS....... 81
5.5 BENCHMARKING....... 83
5.6 STANDARDS AND LIABILITY 85
5.7 ACCESS TO JUSTICE 88
5.8 SUMMARY 93

PART 4: CONCLUSIONS AND RECOMMENDATIONS....... 95

CHAPTER 6: TOOLS FOR OIL AND GAS INVESTORS 95

6.1 CONCLUSIONS....... 95
6.2 TOOLS FOR OIL & GAS INVESTORS 99

SELECT BIBLIOGRAPHY 101

1. LAWS & CONTRACTS CITED IN TEXT 101
5.1 Country Legislation and Contracts....... 101
5.2 International Instruments 103
2. AGREEMENTS CONSULTED IN RESEARCH 104
3. ENFORCEMENT....... 107
4. INTERNET WEBSITES....... 109
5. COMMENTARIES....... 110
5.1 Books and Monographs 110
5.2 Reports....... 110
5.3 Chapters in Books....... 111
5.4 Articles and Papers....... 111

Executive Summary & Guide to the Reader

The focus of this paper is on mechanisms of contract stabilisation in the international oil and gas industry. In particular, it examines the stabilisation clauses that are often introduced into petroleum contracts between host governments and international oil companies (IOCs).

The **first part** of the paper examines the context in which stabilisation issues arise and the various justifications advanced by host governments for changing the rules (Part 1, chapters 1 and 2).

The **second part** considers stabilisation techniques and their enforcement, noting that the classic stabilisation clause amounted to an attempt to 'freeze' the terms and conditions for the life of the contract, while the modern approach is amenable to negotiation between the parties. A survey of legal practice reveals a number of published awards that are directly relevant to disputes over the first kind of stabilisation but with respect to the second, guidance is currently available only from cases that are principally concerned with related issues such as indirect expropriation. This part addresses issues that are primarily concerned with fiscal obligations (Part 2, chapters 3 and 4).

The **third part** addresses issues of contract stability in non-fiscal areas, and focuses primarily on the risks to IOCs of instability arising from unilateral changes in areas that are often expressly excluded from stabilisation clauses in petroleum contracts (Part 3, chapter 5).

The principal **conclusions** and recommendations of this paper are set out in Chapter 6 and include the following:

- The classic view of stabilisation as a kind of 'freezing' of contract terms over long periods of time has been in decline, and is probably not enforceable;

- The interest of IOCs (and their bankers) in such mechanisms is likely to remain high due to the continuing risk of unilateral alteration of contract terms (albeit for a variety of reasons);
- The ‘modern’ versions of stabilisation are ones that provide for a re-balancing of the benefits from the contract in the event of a unilateral action by the host government;
- Guidance on the enforceability of such clauses is sparse and only available by analogy;
- Considerable diversity in the design of stabilisation clauses remains with hybrid forms and approaches to economic balancing in evidence;
- Evidence of reasonable due diligence before conclusion of the petroleum contract is an essential requirement for the IOC before trying to rely on a stabilisation clause;
- For cross-border, regional approaches, IOCs are experimenting with innovative approaches to stabilisation;
- In non-fiscal areas, such as environmental, safety and health matters, host governments usually seek to exempt them from stabilisation, and
- In these areas, IOCs are seeking to develop mechanisms that ‘manage’ the resulting risks and provide them with a measure of stability.

Glossary of Terms and Acronyms

APPEA	Australian Petroleum Industry Association
API	American Petroleum Institute
BIT	Bilateral Investment Treaty
BTC	Baku-Tbilisi-Ceyhan (pipeline project)
EIA	Environmental Impact Assessment
EU	European Union
HGA	Host Government Agreement
ICC	International Chamber of Commerce
ICSID	International Centre for the Settlement of Investment Disputes
IFC	International Finance Corporation
IGA	Inter-Governmental Agreement
ILM	International Legal Materials
IOC	International Oil Company
LCIA	London Court of International Arbitration
NGO	Non Governmental Organisation
NOC	National Oil Company
OECD	Organisation for Economic Cooperation and Development
OGP	Oil and Gas Producers Group
PSA	Production Sharing Agreement
PSC	Production Sharing Contract
SIA	Social Impact Assessment

VAT	Value Added Tax

Foreword & Acknowledgements

This study has been commissioned by the Association of International Petroleum Negotiators, with a view to elucidating issues that concern the stability of contracts in an international context in which that stability has become increasingly subject to challenge. At the time of writing, there is much publicity surrounding the efforts of some governments in petroleum producing States which are seeking to obtain improved benefits from the terms and conditions of existing contracts. The reasons behind these unilateral actions vary but the overriding imperative behind them is a substantially higher price of oil and gas.

The study does not attempt to cover in an exhaustive way the many issues that are might be considered relevant to this topic but rather tries to capture some of the essentials and to comment on how they are being impacted on by some notable recent trends. There is not a lot here about the history of stabilisation clauses, nor is there much about the classic arbitral awards such as *Aminoil* that have attracted an enormous amount of comment over the years. The assumption is made that most AIPN members will be familiar with such matters. However, the bibliography at the end provides ample references for further reading on these aspects, as well as those that receive most of the attention in this study.

Scope of the Study

The subject matter is stabilisation mechanisms in the context of international petroleum contracts, and related legal instruments made with respect to petroleum exploration and exploitation and to a more limited extent to petroleum pipeline infrastructure projects. These mechanisms provide (or are designed to provide) stability in these particular kinds of long term investment agreements. In fact, stability mechanisms may be included in a potentially wide range of legal instruments applicable to the petroleum contract, including inter alia: the petroleum law and regulations made hereunder; the foreign investment law; sub-surface code; environmental law; tax laws and treaties; arbitral award enforcement; arbitral rules and enforcement treaties; bilateral investment treaties; multilateral investment treaties and the frameworks of the civil or the common law (or both). Inevitably, the focus of this study on stabilisation issues means that the emphasis falls largely on mechanisms that are designed to maintain the position of the IOC in the petroleum contract itself. Hopefully, the exercise will also prove worthwhile and even illuminating for those approaching stability issues from the host government side. The method is comparative and analytical, illustrating the issues discussed by considering a number of cases of how such mechanisms work in practice.

Structure of the Study

Part 1 comprises two chapters that set out the foundations for the study. They attempt to explain – in a very summary way – why contract stability should be problematic in the international oil and gas industry. They do so firstly from the investor's point of view and secondly from the host government's position. Chapter 1 addresses the question: why do IOCs seek to stabilise investment contracts in the petroleum industry? It examines their goals in trying to secure this and observes that in some significant cases stabilisation by contract is not provided by host governments. Chapter 2 asks why host governments have taken steps to change the rules of the investment game after contracts have been signed. A variety of circumstances is possible, and some of them are considered in this chapter.

Part 2 is concerned with the techniques of stabilisation and their enforcement. The classical method is usually understood as a 'freezing' of the contract terms and conditions. This has been eclipsed in recent years by provisions that focus on a balancing of economic interests between the parties. In a way, it recognises that some change over the life of the project is probably inevitable but, when it happens, there has to be a corresponding adjustment to ensure that the original terms of the deal struck in the contract will survive any such change. Chapter 3 examines the market place of stabilisation techniques, attempting a tentative classification to promote understanding. Chapter 4 addresses what is perhaps the crucial issue: enforcement of stabilisation provisions. It distinguishes the various cases that address stabilisation dating from the 1970s and 1980s from the more recent arbitral awards that address expropriation, indirect expropriation and fair and equitable treatment. While the former category is likely to be familiar to most readers, the latter is not. Some tentative conclusions are drawn.

Part 3 considers some new developments with respect to stabilisation that are non-fiscal in character. These touch mainly on matters that are often treated as 'exceptions' to the scope of conventional stabilisation mechanisms: environment, health and safety matters. Some of the ways in which IOCs have attempted to address these issues by developing stabilisation mechanisms are considered.

Finally, **Part 4** presents some conclusions and recommendations, and offers some guidance with respect to 'tools for oil and gas investors' on the basis of the analysis presented in this study.

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I wish to thank the many AIPN members who have shared their ideas and materials with me in the course of carrying out this study. As is often the case with AIPN studies, this author has benefited from access to the very extensive Barrows collection of materials, and I thank Gordon Barrows for his cooperation. The AIPN appointed a peer reviewer, Frank C. Alexander Jr., for this study, and I wish to thank him for his extensive comments on the first draft. His many helpful comments and suggestions were (and are) much appreciated. As always, responsibility for the contents of this study lies with the author.

One small caveat may be added. The diversity of practice in the international oil and gas industry is recognised by all practitioners working in it. This study makes generalisations on the basis of the data available to this author, as well as discussions with colleagues in the AIPN and draws on his own experience as a consultant over several decades in this industry. It should be seen as a contribution to discussion and good practice but no substitute for an analysis of the particular and unique constellation of factors from which each stability issue springs.

Part 1: The Problem

Chapter 1: Why Attempt to Stabilise Investment Contracts in the Oil and Gas Industry?

1.1 The Question: To Stabilise or Not?

The *long term* and *capital intensive* character of investments in the international oil and gas or petroleum industry underlines the vulnerability of the foreign investor to unilateral alteration of the petroleum contract by the host government at some moment in the life of the contract. The provision of a guarantee for stability in the contract itself is one way of mitigating that risk[1]. This is its principal attraction for investors such as international oil companies (IOCs) and their bankers. It has been 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"[2]. However, a striking feature of petroleum regimes around the world is that many of them do not offer clauses designed to provide 'stabilisation' – and in those cases the IOCs appear to have no difficulty in living with this. Those States that do provide a form of stabilisation may nonetheless offer a decree of protection that is much less sweeping in scope than that implied in the above quotation. Whatever its attractions to an IOC,

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[1] For some recent discussions of stabilisation, see: FA Alexander, 'The Three Pillars of Security of Investment Under PSCs and Other Host Government Contracts, chapter 7 of Institute for Energy Law of the Center for American and International Law's Fifty-Fourth Annual Institute on Oil and Gas Law (Publication 640, Release 54), Lexis Nexis Matthew Bender (2003), 7.16-7.28; M Maniruzzaman, Some Reflections on Stabilisation Techniques in International Petroleum, Gas and Mineral Agreements, International Energy Law and Taxation Review (2005) 96, B Montembault, 'The Stabilisation of State Contracts using the Example of Oil Contracts: A Return to the Gods of Olympia?' In RDAI/IBLJ (2003) No. 6, 593-643, and A Alfaruque, *Stability in Petroleum Contracts: Rhetoric and Reality* (unpublished PhD thesis, University of Dundee, 2005). For further references see the Bibliography.

[2] Amoco International Finance v Iran, 15 Iran-U.S. C.T.R. 189, 239 (my italics).

it appears that a stabilisation clause is not a mandatory requirement for a host government that seeks to attract investment into its petroleum sector.

Some countries have a good track record in dealing with IOCs and as a result the perception is that political risk is low. Such countries may not offer stabilisation provisions to an IOC at all (Norway and the UK are examples of this). In other cases, the perception of political risk may well be high but the perception of geological risk is low enough for IOCs to accept a contract without stabilisation provisions (Saudi Arabia, Brazil). A slight variation on this is that some countries will offer the kind of stabilisation provision that is in fact unenforceable. Some caution has therefore to be exercised when dealing with this subject. While stabilisation is a way of managing the risk of unilateral host government changes in the rules, there are many other aspects of investment that cannot be approached in this way. Even where a host government does not offer fiscal stability to the IOC, the IOC will use the same methodology to estimate cash flows, net present value and internal rate of return. These will be nevertheless only estimates since a commercial discovery may not be made in the first place; the commercial discovery may have greater or lesser production reserves or rates than estimated; the cost may be more or less than estimated, and the petroleum prices may be more or less than estimated.

1.2 Two Limitations on Stability

Where an IOC decides to go ahead and negotiate a stabilisation provision, there are two important limitations to this exercise. A **first limitation** is that any undertakings given by the host country government must be given in a form that is consistent with the country's legal and constitutional framework. In most countries (including the UK, for example), the executive cannot give binding commitments about taxes or rates of taxation in the future. Indeed, it can be assumed that in every country the sovereign retains the power – in spite of any laws or contracts to the contrary – to enact laws that legally will 'trump' previous laws (and contracts) and that attempts to 'freeze' a petroleum contract will be unenforceable. It is a settled part of international law that host governments have the right to expropriate, even where a previous law or contract provides a guarantee that they will not. In cases where an increase in fiscal obligations is proposed, the relevant question will be about the result of such ‘creeping expropriation’ in terms of damages to the IOC or specific performance. The same will apply with respect to environmental, health and safety obligations although this is still a relatively untested area.

There are ways around the above constraint however. The NOC may be asked to carry the burden of any additional fiscal obligations levied beyond the level prescribed in the contract (on behalf of the investor). Indeed, the host government may choose to do this itself (*Qatar* model PSAs; the current model PSA in *Trinidad and Tobago*). In some cases, this may only extend as far as the host government’s share of profit oil. Alternatively, an increase in fiscal obligations that adversely affects the foreign investor may trigger a provision that other parts of the fiscal regime should be adjusted to ensure there is no effective change for the foreign investor in the aggregate of burdens and benefits. This approach (balancing) is discussed elsewhere in this study (see Chapter 3). In addition, the fiscal regime as a whole has to be defined in a sufficiently flexible manner that it can respond to a wide range of economic variables within the contract itself. For example, a fiscal regime may be provided that is ‘progressive’: as the overall profitability goes up, a larger percentage of the overall profit goes to the host government, or a fiscal regime could include an ‘effective royalty rate’ that varies in accordance with profitability. In conclusion then, there are many ways of providing the required flexibility. The key point is that a flexible, responsive fiscal regime is very helpful if a State is to provide guarantees of fiscal stability which can be honoured.

A **second limitation** on the introduction of a stabilisation provision does not concern the fiscal package itself. Some governments will tend to be wary about providing guarantees about contract stability that go beyond the fiscal package. In other words, if a company seeks to obtain guarantees over non-fiscal elements – such as a guarantee over *any* legislative change that adversely affects the economics of the project – and requests an exemption from compliance or, where such exemption is not possible, an adjustment of the fiscal terms by way of compensation. There is a difference here between a fiscal guarantee and the granting of something like a separate legal regime to the petroleum contract. In this respect, the legislative capacity of the State with respect to environmental, health and safety issues which when exercised may result in an increase in business costs is less likely to be granted a special protection. Many governments will wish to retain the right unilaterally to revise the relationship with the IOC in the context of health, safety and environment matters, without triggering an applicable stabilisation provision. This allows them to address a situation in which different standards may become applicable in future (for example, with respect to environmental impact assessment), or that a new interpretation of existing law in these areas (which is often couched in general and open-ended terms) is required or that new or amended legislation becomes necessary.

1.3 How has Stability been addressed over the Years?

The origins of stabilisation clauses lie in the period between the first and second World Wars, 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 provisions was to ensure that the concession contract remain in force throughout the period stated in the contract. From the mid 20th century to the 1970s the thrust of stabilisation clauses in petroleum contracts was to act as a defence against expropriation. They did not invalidate a nationalisation but they did have the effect of making it unlawful, and thereby affect the amount of compensation that a tribunal might award.

An example of this is the role of a stabilisation clause in a petroleum contract in Libya, which was reviewed by a tribunal in the context of a nationalisation of the investor's interests. 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 in this

[3] *Kuwait v Aminoil*, 21 ILM 976, 1052 n.7 (1982), 9 YB Com Arb 71, 95 (1984) (Separate Opinion by Sir G Fitzmaurice).

concession shall not be infringed except by agreement of both parties"[4]. Further, the concession was to be interpreted according to the laws and regulations in effect at the time it was concluded and amendments were only permitted with the investor's consent. The arbitration tribunal held that Libya could not exercise its sovereignty to nationalise the investor's interest in violation of these specific contractual undertakings, and therefore that such nationalisation was a breach of the Deeds of Concession.

This period had ended by the early 1980s, following highly confrontational revisions of petroleum contracts and nationalisations of petroleum industry assets, which triggered several arbitral awards[5]. It was a period characterised by an analysis of stabilisation commitments in terms of state responsibility, protection of foreign property against nationalisation and breach of proprietary contractual interests by the State: what might be called the classical approach, highly dependent upon public international law concepts rather than international economic law[6]. It has been argued that the years that followed were characterised by an atmosphere of pragmatism in which mutuality of interests was better understood, especially by the host governments[7]. In this context of reasonableness, it might be thought that concerns about contract stability would become subdued and perhaps even invisible in negotiations over petroleum contract terms. This did not happen.

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[4] *TOPCO v Libya*, 17 ILM 3, 24 (1978), 4 YB Com Arb 177, 178, 183 (1979).

[5] A non-exhaustive list would include the following: Saudi Arabia v Arabian American Oil Company (Aramco), 27 ILR 117 (1963); Sapphire Petroleum Ltd v National Iranian Oil Company, 35 ILR 136 (1967); Texaco Overseas Petroleum Company/California Asiatic Oil Company v Libyan Arab Republic, 17 ILM 1 (1977); BP Exploration Company (Libya) v Libya Arab Republic, 53 ILR 297 (1979); Alcoa Minerals of Jamaica v Jamaica, YB Com Arb 206 (1979); Libyan American Oil Company (LIAMCO) v Libyan Arab Republic, 20 ILM 1 (1981); Kuwait v American Independent Oil Company (Aminoil), 21 ILM 976 (1982); AGIP Company v Popular Republic of the Congo, 21 ILM 726 (1982). Arising from the Iran-US Claims Tribunal a little later were: Amoco International Finance Corporation v Islamic Republic of Iran, 15 Iran-US Claims Tribunal Rep 189 (1987); Mobil Oil Iran Inc v Islamic Republic of Iran, 16 Iran-US Claims Tribunal Rep 3 (1987); Phillips Petroleum Company Iran v Islamic Republic of Iran, 21 Iran-US Claims Tribunal Rep 79 (1989).

[6] TW Waelde and G Ndi, Stabilising International Investment Commitments: International Law Versus Contract Interpretation, in 31 Texas International Law Journal (1996), 215, 219.

[7] R Brown, `Contract Stability in International Petroleum Operations', The CTC Reporter, No. 29 (spring 1990), 56-60.

Two broad patterns of behaviour became discernible with respect to stabilisation. Firstly, a significant number of countries chose not to provide commitments on contract stability at all. Countries with significant proven reserves such as Saudi Arabia, Nigeria or Indonesia did not regard it as necessary to provide such guarantees to foreign investors. Among the OECD countries, many petroleum regimes provide for a static, relatively inflexible, fiscal regime, which contains no stabilisation provision (Norway, UK, Canada, the USA and Australia, for example). In these cases, the content of such contracts or licences is scarcely affected by any negotiations between IOCs and host governments, since the terms on offer are largely standardised. Secondly, a large group of countries, eager to attract foreign investment in a competitive international market place, offered stabilisation commitments to investors, and many continue to do so. However, the form of these provisions is frequently different from those in the period we have called 'classical'. In particular, there were elements of balancing or negotiation introduced, and sometimes a combination of these with the familiar element of 'freezing' of some of the contract terms. This group included a number of the so-called transition economies in the 1990s, as well as African states, and in Latin America, it included Bolivia, Ecuador and Peru.

Contract stability was also affected – and arguably enhanced for the IOCs – by the growth of NOCs since the 1980s. This means that sometimes the contract for exploration and production is made between the foreign investor(s) and the NOC rather than the State itself, and on other occasions between the NOC and the host government. A stabilisation clause may therefore be negotiated with the NOC rather than the State itself. This is not in practice a complicating factor and may make it easier to reach an agreement. It has a bearing on situations where, in the case of PSCs, the host government pays additional fiscal obligations on behalf of the IOC (Azerbaijan, 1980s Qatar model PSC) or does so only to the extent of the host government's share of profit oil (current PSCs in Trinidad and Tobago; current PSCs in Egypt). This effective tax exemption is only applicable to the extent of the NOC's (or host government's) share of profit oil.

With respect to its impact on fiscal stability, the host government seems to be effectively granting a specific tax exemption in the event of a change in the overall tax regime. However, in cases where the NOC or host government share of profit oil is relatively small, this mechanism will provide only a modest 'insurance policy' against increased taxes, especially where the PSC regime provides for royalty and/or state participation. In some PSCs in Trinidad and Tobago, the host government's share of profit oil has been used up in the face of additional fiscal obligations. Moreover, in cases where the stabilisation provision in a contract provides for a re-balancing of the fiscal provisions in the event of a unilateral measure taken by the host government (see Chapter 3), not all of the fiscal obligations are necessarily included in the re-balancing that the contract envisages in such an event. Some may address only increases in taxes. As a result, the IOC is left with a significant exposure to the imposition of other forms of fiscal obligation. With respect to enforcement of a stabilisation provision, the NOC as signatory to the contract might improve the likelihood of the IOC obtaining specific performance and not just lump sum damages from a tribunal. However, there are (as far as I am aware) no known arbitral awards for these more modern stabilisation mechanisms that involve some re-balancing of the economic interests of the parties in the event of a unilateral change by the host government[8]. The awards that are currently available for reference in this context (see Chapter 4) are concerned with expropriation or more recently with 'freezing' of contractual provisions, where only lump sum damages are available.

Finally, it may be noted that the current generation of petroleum contracts are much more complex than the old style concessions that contained the 'anti-expropriation' stabilisation clauses. A principal reason why the contracts have become complex is simply that the parties are attempting to ensure that the agreement concluded will as far as is possible respond to changing or unpredictable circumstances. The way in which the contract has been negotiated and drafted will determine just how adaptable it is in practice. The subjects too that a petroleum agreement will attempt to address

[8] RD Bishop, 'International Arbitration of Petroleum Disputes: The Development of a Lex Petrolea' (author's copy).

have considerably broadened in recent years, with a considerable increase in the impact made by non-fiscal issues such as environmental and social ones.

1.4 Summary

- The long term character of international petroleum investments coupled with the history of unilateral action by a number of host governments has made stabilisation commitments in petroleum contracts attractive to investors;

- 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;

- A significant number of countries, especially (but not only) those with proven petroleum reserves, do not feel the need to offer stabilisation provisions to attract investors;

- Many stabilisation provisions are likely to be subject to two limitations: the constraints imposed by the wider legal and constitutional framework on the guarantees provided in the petroleum contract, and any exceptions required for non-fiscal matters.

Chapter 2: Why do Host Governments Change Rules?

2.1 Waves and their Effects

From 2003 onwards, host governments in a number of countries began efforts to change the fiscal arrangements in petroleum contracts in several major petroleum producing countries[9]. The motives for these unilateral steps are far from uniform although the steep rise in international oil prices played an important part. At a macro-level they reflected a change in producer-consumer country dynamics or bargaining power, with the producing countries seeking to improve the benefits from their contractual arrangements.

As noted in the previous Chapter, there have been several sweeping attempts at expropriation and forced renegotiations in Latin America and the Middle East in the 1970s, resulting in much discussed arbitral awards addressing compensation issues[10]. Among the OECD countries, those few countries with petroleum resources were also quick to take action against perceived unfair contract terms. The United Kingdom was an example of this. In the mid 1970s, it introduced a wholesale renegotiation of license terms, a new form of petroleum taxation and a forced introduction of a carried interest for its newly established state oil company in all North Sea field developments[11]. In the current wave of government actions, both the UK and the USA have imposed additional obligations on investors in the light of oil price increases. The UK increased its petroleum taxation burden in December 2005. In his Statement

[9] Argentina does not fit into this category but disputes arose before the ICSID over stabilisation commitments with respect to stability provisions in agreements reached from 2003 onwards between producing and refining companies over crude oil, gasoline and gas oil prices, discussed in Chapter 4 below. The Government was the driver behind the conclusion of these stability agreements.

[10] In Ecuador's case, this appears to have occurred the other way round: first, an arbitration award in favour of an IOC (Occidental), then an expropriation: Occidental Press Release, 17 May 2006: 'Occidental Files Claim against Government of Ecuador'. The ICSID cases that prefigured this action are discussed in Chapter 4.

[11] This is described in considerable detail in my book, 'Property Rights and Sovereign Rights: The Case of North Sea Oil', Academic Press, London, 1983.

the Chancellor of the Exchequer (the Finance Minister) noted that "returns in the North Sea are now nearly 40 per cent on capital, compared with ordinary returns of 13 per cent". He added that "(w)ith the tax on new development in the North Sea now lower than in 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 per cent to 20 per cent…"[12]. It should be noted however that tax arrangements lie outside the licences or contracts and are not stabilised. Separately, the US House of Representatives approved a plan to renegotiate Gulf of Mexico petroleum leases in May 2006, addressing 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. It appears that this was designed to correct an error in the Deep Water Royalty Relief Act of 1995 that was designed to cut royalties when energy prices were low and boost them when prices were high. While this operated with respect to leases in 1996, 1997 and 2000, the leases in question were not subject to a price threshold[13]. At a time of high oil and gas prices, this was highly beneficial to the lease holders.

However, caution should be exercised in making comparisons with the current wave of host government unilateral action. The motivations appear to arise from very different political pressures and changed circumstances in each case, with actions in Venezuela being hard to compare with host government actions in Nigeria or even elsewhere in Latin America[14]. Most importantly, for our purposes, the host government actions are not necessarily taking place in countries that have offered stabilisation provisions in their contracts. They do underline the fact that unilateral amendments to petroleum contracts by host governments remain a significant risk factor for investors, especially when the oil price rises substantially as it has in recent years. In the latter circumstances, experience suggests that governments in producing

[12] HM Treasury, Pre-Budget Report 2005, 5 December 2005 at www.hm-treasury.gov.uk
[13] Bloomberg News Service, 'House Approves Proposal to Recover $10 Bln from Oil Producers', May 19, 2006.
[14] The increase in royalty proposed in Bolivia called the IDH appears to be in breach of a provision in the 1996 Hydrocarbon Law 1689 which stabilised royalties (only) for the duration of the Joint Venture form of contract. The circumstances behind unilateral state action in Venezuela and Ecuador appear to be quite different.

countries will usually tend to put measures on the table that secure for them a larger share of the rent than was agreed upon at the time the contract was made. This could even be seen as a normal reaction to a certain phase in the price cycle.

Another reaction is more relevant to this study. One of the effects of a wave of unilateral actions is that both IOCs and host governments eager to attract petroleum investment may respectively seek and offer stabilisation provisions that they might not otherwise have sought or offered. In a climate of uncertainty they appear to offer an additional security against political risk. However, this may have the consequence that in future years such provisions prove too inflexible or become otherwise a source of dispute. An echo of this process may be found in the case of Kazakhstan in the 1990s, which arguably agreed on fiscal terms that it did not fully understand (or its advisers did not fully explain), with revenue and profit sharing implications that it found to be unacceptable several years later, leading to a battery of changes in the tax and subsoil legislation[15]. However, Kazakhstan also provides a good example of how a host government can, at a later stage in its petroleum development and capacity building, carry out an overhaul of its regime in such a way as to continue the grant of stability provisions in future contracts and insistence on a 'no-revision' policy with respect to existing petroleum contracts[16].

2.2 The Armoury

One of the reasons why a host government may choose to introduce rule changes to the petroleum contract at a later date is simply that it can. Any host government possesses a wide range of instruments that it may use against an incumbent investor, a

[15] An overview of the changes proposed at that time is contained in Aset Shyngyssov's article, 'Tax Stability and Assurances for Petroleum Operations', in Oil & Gas of Kazakhstan (2004), 60-67 (www.oilgas.kz).

[16] This was particularly evident in 2003 when two new taxes were being introduced (on export of crude oil and on windfall profit). It was expressly stated that the new taxes were only applicable to new oil projects; all the contracts concluded before the new law were subject to a stabilised tax regime. The country has many stability guarantees in its laws including those on investment, foreign investment, subsoil and petroleum. However, the various Tax Codes adopted since 1995 do show a gradual whittling away of the guarantees on stability with respect to adverse changes in the tax laws. Moreover, tax stability is now provided through several different provisions that are not entirely consistent.

veritable armoury of legal and policy instruments. This feature of the investment climate merits some consideration.

A host government may introduce new laws, decrees or regulations that have an impact upon the legal and economic environment of the petroleum contract with negative effects upon its terms as a result. However, it may also introduce a measure that has a direct impact upon the terms of the petroleum contract itself. These may include measures such as the following[17]:

- 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 PSCs 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 'monetise' 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'.

These are only the more obvious levers at the disposal of a host government that is seeking to change the terms of an existing petroleum contract. Indirectly, there are other levers available to it in any complex petroleum development project, which do not fall directly under the heading of 'tax or legal stabilisation'. Examples would

[17] FA Alexander Jr. (2003), see note 1, 7.16-7.17.

include: the State's approval for a field development plan and powers to issue other necessary permits; the State's right in many PSA projects to veto the proposed annual budgets; powers over local content; investor's liability over project delay and use of environmental compliance powers (which are not usually stabilised). The investor may also be keen to expand its business in the host country by bidding for or negotiating entry into new projects. This may be raised by the host government in its 'discussions' with the investor.

2.3 Risks to the Host Government

For a great many governments around the world that play or would play host to petroleum investors, there is plenty of evidence of the risks and uncertain rewards of unilateral action against investor interests. The foregoing examples illustrate the speed with which a number of investors will bring a case before an arbitral tribunal and seek compensation. Apart from the legal counter-measure from the investor, there is also an effect of negative publicity for the country's investment climate.

If the host government does elect to take unilateral action, what happens next? In some agreements there is a provision for a measure of negotiation that aims at restoring a disrupted equilibrium (discussed in Chapter 3). Even if there is not a formal provision that requires this (and often there is), some form of negotiation will probably be the first step of choice by the parties that will result from disrupted equilibrium. The IOC will invoke the stabilisation clause and probably also refer to the provision on arbitration. Usually, the 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 may have difficulty in providing a reasonable model to the effect that the damage is marginal or negligible if there has been an increase in income taxes or royalties, or if some other fiscal obligation has been imposed. Where this increased fiscal obligation is in defiance of a stabilisation mechanism, the 'cost' of the additional tax could be determined with some precision, and indeed could lead to a corresponding reduction in the host government's share of profit oil.

In the face of failure of this initial step, the State will have to consider how to address a possible activation of the arbitration mechanism. However difficult it may be to ensure that the relevant considerations are present for a stabilisation mechanism to be enforceable and lead to the award of damages, there are other grounds on which investors may justify and enforce a claim. Recent arbitral awards are fairly consistent, although as far as this author is aware, none of them relate directly to stabilisation provisions. The thrust, as we shall see, is clear however. In all of these awards, compensation in the form of lump sum damages and/or specific performance of the stabilisation provision was required for breach of the investment agreement.

2.4 Summary

- The risks of unilateral action by host governments remain as significant for investors today as ever before and are evident among a wide range of governments. For that reason the provision of a stabilisation clause holds out the prospect of additional security. However, an over-eager willingness on the part of host governments to offer such security may spring more from a policy of investment promotion rather than a full appreciation of the commitment that is being made. In this respect, investors would be wise to take extra care with the design of mechanisms for possible use in enforcement at a later date.

- Host governments have a wide range of instruments at their disposal for the introduction of unilateral measures. It should also be noted that other powers deriving from the petroleum law regime will usually offer the government opportunities to persuade the investor of its case or to strike a compromise arrangement.

- The risks to the host government itself of taking unilateral action (such as the damage to its reputation as an investment location) offer potential solutions. Negotiation about the differences generating a proposed unilateral action should be enhanced by an awareness of these possible consequences.

- 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.

Part 2: The Techniques & their Enforcement

Chapter 3: The Practice of Fiscal Stabilisation

3.1 The Heart of the Matter

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 usually the NOC) on the one hand and the IOC on the other. This will involve more than taxes and royalties. The determination of a modern fiscal regime – in a PSC at least - will involve agreement on the provisions for and the timing of cost recovery and the division of profit oil. If agreement is reached on all the essentials, this may nonetheless be undermined if the contract cannot be given some degree of stability.

Apart from stability of the fiscal regime, the other concerns of the investor will be those provisions that have a likely impact upon investment recovery and profit such as security of contractual and proprietary rights and titles, the right to sell petroleum and the right to export. Further, the investor will seek the right to retain and repatriate foreign exchange earned, to retain the proceeds of export sales offshore without mandatory currency conversion, and operational freedoms consistent with international standards.

This does not mean that the parties will consider that a specific clause on 'stabilisation' is essential. A number of countries have not found it necessary to offer any kind of stabilisation provision in their petroleum regimes. Examples are the North Sea states of Norway and the UK, several Latin American countries such as Brazil and Colombia, and the United States. In these cases the fiscal terms will be stipulated (or referred to) in the petroleum contract (or licence) and no additional undertaking by the host government to stabilise the fiscal regime will normally be considered necessary.

If a definition may be ventured at this stage, it could be said that in the context of an international petroleum contract, the notion of stabilisation can be taken to mean *all of 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 that the contract was concluded*[18]. As we shall see, in many petroleum contracts such references to maintaining the relationship which prevailed at the time of signature of the contract are explicitly provided. However, more often, the term `stabilisation' is applied less to the exclusion of future legislation but to the provision of mechanisms which can manage the impacts of new legislation on the petroleum contract.

3.2 The Market Place of Stabilisation Provisions

3.2.1 Freezing – Wholly or in Part

Even if a host government decides to provide for stability in the contractual relationship, it will rarely provide the kind of full scale stabilisation that stipulates that neither the fiscal nor the non-fiscal elements of the contract may be varied by the host government during the life of the contract. This is sometimes called a 'freezing' of the contractual terms. However, less extensive forms of 'freezing' are indeed found, such as in Angola, Cambodia, Guyana, Iraq, Kazakhstan (in a highly qualified way, with some exceptions), Malta, Poland and Tunisia[19]. Other forms of 'freezing' may be essentially directed at insulating the IOC from expropriation by the host government

[18] The purpose is not necessarily to subject an IOC to all relevant legal conditions that prevail at the time the agreement is concluded since the parties may wish to provide that the host government shall indemnify the IOC from the application of certain laws that are in fact applicable as of the date at which the agreement was concluded.
[19] However, it should not be assumed that such an approach is a matter of petroleum policy that influences the design of all petroleum contracts awarded at all times.

or which expressly permit expropriation but provide for an applicable amount of damages in such an event. In the former case, such efforts to immunise the contract are not likely to prove enforceable or otherwise reliable as a way of providing the IOC with the amount of damages that the IOC would be seeking in the event of unilateral changes.

Some examples of 'freezing' are the following:

(1) An express stipulation of inviolability (Mozambique):

> *"The Government shall not revoke or amend the Authorisation 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"*[20],

And:

> *"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 instrumentalities to take any administrative or other action to prevent or hinder the Contractor from enjoying the rights accorded to it hereunder".*

(2) Stabilisation stricto sensu and inviolability (Nepal):

> *"His Majesty's Government shall ensure that during the term of this Agreement the Contractor's rights and obligations hereunder shall not be changed unilaterally"*[21].

Similarly (The Ivory Coast):

> *"The petroleum contract in particular must set: …(t)he legal conditions concerning the applicable law, the stability of conditions, the cases of force majeure and the regulation of disagreements …"*[22]

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[20] Model Production Sharing Contract, 2001, Art 30.7(d) and (e).
[21] Model Production Sharing Contract, 1994, Art 70.1.
[22] Petroleum Code 1996, Art 18(m).

(3) Some agreements attempt to ensure the pre-eminence of contractual terms over all other regulations. In the example below (from Tunisia) not only regulations are mentioned but also their interpretation:

> *"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"*[23].

A more common approach than an attempt to 'freeze' the terms and conditions of the contract *in toto* is to provide 'partial' stability, with respect to an element or elements of a contract such as royalty or income tax. Another category of partial stability may be distinguished that emphasises areas that are to be excluded from contract stability. Some governments grant a comprehensive fiscal stability that includes all measures that impact on the financial position of the IOC but excludes measures taken by the host government with respect to environmental protection, safety and health.

This example from Bolivia provides stability only for royalty and permits:

> *"In Article 52 of the Hydrocarbons Law, the system of royalties and permits to apply to this Contract shall remain fixed throughout its term"*[24].

This example from Chile stabilises only taxes:

> *"The tax regime, benefits, privileges and exemptions provided in any of the articles hereof, which shall be recorded in the special operation contract, shall remain invariable for the duration thereof"*[25].

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[23] Model Production Sharing Contract, 1989, Art 24.1.
[24] Model Production Sharing Contract, 1997, Art 12.
[25] Decree-Law 1089 of 1975, Art 12 and 12.1.

3.2.2 Economic Balancing

In many parts of the world, the most typical kind of commitment involves some form of 'economic balancing'. 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 of the parties, a re-balancing will take place. Petroleum contracts differ in their treatment of how that balancing will be effected. On one view, the adjustment may be automatic or achieved in a manner stipulated in the contract so that the economic balance struck between the parties on the effective date of the contract is re-established. On another view, however, there is no need to provide in the contract for the manner of such adjustment or to stipulate that it should be the result of mutual agreement between the parties. A third approach is to make express provision for the parties to discuss how amendments should be made to the contract to permit economic balancing[26]. Inevitably, the very large number of petroleum contracts in existence around the world allows for a considerable diversity of approaches including hybrids of the ones outlined above.

An example of the economic balancing approach with a strong element of negotiation (the third approach above) is contained in a Concession Agreement awarded in Egypt in 2002. Article XIX reads:

> *"In case of changes in existing legislation or regulations applicable to the conduct of 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 A.R.E. (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 case,* ***the Parties shall negotiate possible***

[26] FA Alexander Jr. refers to these three approaches as, respectively, 'Stipulated Economic Balancing'; 'Non-Specified Economic Balancing', and 'Negotiated Economic Balancing': see Three Pillars (see note 1).

> ***modifications to this 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 ninety (90) days from aforesaid notice.*
>
> *These amendments to this Agreement shall not in any event diminish or increase the rights or obligations of CONTRACTOR as these were agreed on the Effective Date.*
>
> *Failing agreement between the Parties during the period referred to above in this Article XIX, the dispute may be submitted to arbitration, as provided in Article XXIV of this Agreement."*[27](Author's emphasis added)

Clearly, the level of comfort provided by such a clause will not be great, and more reassurance may be found in the arbitration provision. In the second paragraph, the Parties – namely, the Government, the NOC and the investor - commit themselves to a 'best efforts' approach to negotiating their economic balancing. A time limit to the negotiations is however stipulated and the third paragraph appears to suggest that the amendments sought through negotiation are intended to restore the disrupted equilibrium: no more and no less (although the wording is not free from ambiguity).

A similar approach to rebalancing the contract with negotiations included is found in Vietnam. Currently, all Vietnam PSCs use stabilisation clauses in some form or another, stating generally that if any change in law or regulation adversely affects the Contractor's interests or revenue, the Contractor and PetroVietnam (the NOC) shall meet and agree on changes to the contract to ensure the Contractor's interests are not diminished in any way. Occasionally, the stabilization clause will also specifically include rights to go to arbitration if agreement is not reached within a certain time period. It does not seem that the arbitrator would necessarily have the power to rewrite the contract without clear 'amiable compositeur' authority being granted to

[27] Concession Agreement of 2002 for Petroleum Exploration Exploration & Exploitation between Egypt & The Egyptian General Petroleum Corporation & Dover Investments Limited (East Wadi Araba Area Gulf of Suez): source: Barrows Company Inc.

the tribunal in the contract itself. Instead, a tribunal would probably award the IOC only lump sum damages.

The Russian law on production sharing (1996, as amended) is another example of economic balancing, but with the inclusion of exceptions. Article 17.2 provides that in the event of a national or local regulation affecting the commercial results of the investor the agreement is to be varied in order to ensure that the investor obtains the same commercial results as would have flowed had the regulation in existence at the time of the contract conclusion continued to apply. In certain circumstances this rule does not apply however: in cases such as those where the variations apply to the security of the works, conservation of mineral resources, and protection of the environment or public health[28]. The latter approach to a 'carve-out' is not unusual.

A further illustration of a provision on economic balancing – from Mozambique – contains a strong element of negotiation in it and includes a provision for exemptions. Alongside the stabilisation requirement for the fiscal package, it includes another provision that asserts the State's continuing capacity to take measures in certain areas such as environmental protection. However, such measures are not without restriction: they must not be unreasonable and they must be in accordance with the standards generally accepted from time to time in the international petroleum industry. The words `from time to time' imply that such standards will develop in the course of the petroleum project and that the actions of the investor will be expected to reflect that development. The clause also provides an illustration of the dual focus of modern stabilisation concerns: firstly, the economic issues that lie at the heart of a petroleum or pipeline agreement and secondly, the various, non-economic matters that are occupying a role of growing importance in negotiations on petroleum projects, whether upstream or downstream.

Mozambique[29]

[28] The value of the example is undermined however by the fact that only one PSC has been awarded under this – essentially defunct – law (which also grandfathered in three other PSCs).
[29] Mozambique (1998) – Sofala field; contract from author's collection; author's italics.

> *1. In the event that after the Effective Date any applicable law, decree, rule or regulation of the Republic of Mozambique including the Income Tax Code as the same applies to Industrial Tax, not being a law, decree, rule or regulation of the kind referred to in Article [ ], is made or amended which results in an adverse change of a material character to the economic value derived from the Petroleum Operations by the Contractor, the Parties will, if the Contractor so requests, meet as soon as possible thereafter, to agree on* ***changes to this Agreement*** *which will ensure that the Contractor derives from the Petroleum Operations, following such changes, the same economic benefits as it would have derived if the law, decree, rule or regulation aforesaid had not been made or amended.*
>
> *2. Nothing in the provisions set out in this Article shall be read or construed as imposing any limitation or constraint on the scope, or due and proper enforcement, of Mozambican legislation of general application which does not discriminate, or have the effect of discriminating, against the Contractor, and provides in the interest of safety, health, welfare or* ***the protection of the environment*** *for the regulation of any category of property or activity carried on in Mozambique; provided, however, that the Government will at all times during the life of the Petroleum Operations ensure in accordance with Article [ ], that measures taken in the interest of safety, health, welfare or the protection of the environment:*
>
> *(a) Are* ***in accordance with standards generally accepted from time to time in the international petroleum industry****; and*
>
> *(b) Are not unreasonable.*

Another notable feature is the use of the words 'changes to this Agreement': if the parties fail to agree upon the changes, what recourse might the IOC have? Would a duty of good faith effectively constitute an obligation on the part of the host government to agree upon any such changes? The questions suggest that this is not to be recommended as a model, but is nonetheless worthy of inclusion as an illustration of *possible* problem areas in its operation.

A further example is one of a stabilisation clause that attempts to combine freezing with economic balancing by negotiation – very common around the world. It is contained in a Kazakh PSA[30]. It begins with a simple statement that the contract terms must remain inviolable during the entire life of the contract. Then it adds that any changes made in the country's general laws shall not worsen the contractor's position.

Article 21 reads (on stability of the tax regime):

21.1. *The Tax Regime set forth in the Contract shall be permanently in effect until the expiration of the Term of the Contract.*

21.2. *If changes are made in the law after the Contract signing data that make further observance of the original terms and conditions of the Contract impossible or that lead to a significant change in its general economic terms and conditions, the Contractor and representatives of the Competent Body and Tax Agencies may make changes in or correction to the Contract that are needed to restore the economic interests of the Parties as of the Contract signing date. These changes in or correction to Contract terms and conditions shall be made within sixty days of the time of written notification of a Tax Agency or the Contractor.*

The references to possible changes in the general laws make it quite clear that what they envisage are economic and not only fiscal changes. This could include, for example, abrogation of the IOC's right to export or abrogation of the IOCs right to develop and/or produce a discovery. The requirement that changes are to be made within sixty days raises the question: what are the IOC's available remedies if there is no agreement during this period?

[30] Contract for additional exploration for and production and production sharing of crude hydrocarbons in the Chinarevskoye Oil and Gas-Condensate Field in West Kazakhstan Oblast pursuant to licence series MG no. 253D (Petroleum) between the Republic of Kazakhstan State Committee for Investments (the Competent Body) and Production sharing agreement between The Republic of Kazakhstan State Committee for Investments (the Competent Body) and the Zhaikmunai Limited Liability Partnership (the Contractor), Kazakhstan, 1997.

One final example will illustrate how pivotal the role of the NOC can be during any economic balancing. The PSA for several fields in Azerbaijan concluded in 1994[31] states that if the rights or interests of the Contractor have been adversely affected by unilateral action by the host government with negative consequences for the Contractor's rights or interests, the NOC (SOCAR) "shall indemnify the Contractor (and its assignees) for any disbenefit, deterioration in economic circumstances, loss or damages that ensue therefrom". The NOC is also charged to "use its reasonable lawful endeavours" to take appropriate measures "to resolve promptly in accordance with the foregoing principles any conflict or anomaly between such treaty, intergovernmental agreement, law, decree or administrative order and this Contract".

The role of SOCAR in the contract underlines an important point. In a number of cases the host country's NOC will play a central role in the operation of fiscal stabilisation. It may provide for adjustment by paying any additional taxes out of its share of profit petroleum or royalty under a PSA or it may reimburse the IOC directly out of general revenues. Under a rate of return system, the NOC could pay from its share of royalty and/or excess profits tax.

3.2.3. Circumstances of Balancing

The need for economic balancing may not always arise because the IOC interest has been damaged by a legal measure unilaterally introduced by the host government or the NOC[32]. It is possible that a unilateral action by the host government has the effect of improving the benefits of the IOC that accrue from the contract, in relation to the

[31] Agreement on the Joint Development and Production Sharing for the Azeri and Chirug Fields and the Deep Water Portion of the Gurashli Field in the Azerbaijan Sector of the Caspian Sea, 20 September 1994, Article XXIII.2.

[32] In practice, the effects of a new legal or regulatory measure may not be easy to assess in advance, especially if a combination of possible favourable and unfavourable elements is involved (or could be asserted to exist). The Mauritania PSC of 1994 Article 27.3 states: "No legislative provision can apply to a Contractor which has as its effect the aggravation, directly or indirectly, of the duties and obligations under this Contract and under the legislation and regulations in force as at the date of signature of this Contract, without the prior agreement of the Parties". The IOC has to meet the test that damage has occurred.

balance struck at the time of signature of the contract. In some cases, a stabilisation clause may be designed so that a re-balancing is required when either the IOC's position is damaged <u>or improved</u>.

In some circumstances, a host government might insist upon adherence to a stabilisation clause in spite of difficulties that have arisen for the investor through actions by a neighbouring government, and not by any action of its own. The Karachaganak field PSC contained a stabilisation clause which led to exactly this effect in 2002[33]. The Kazakh tax regime which was applicable at the date when the contract was stabilised, implied that VAT for sales of hydrocarbons into the Russian Federation was to be charged in Kazakhstan. Russian buyers could reclaim (offset or obtain a refund from the Russian budget) input VAT charged in Kazakhstan against their output VAT in Russia. However, with effect from 1 July 2002, Russia changed its tax code so that foreign VAT could not be included in the calculation of VAT to be paid in Russia. The economic effect on the buyers of Karachaganak condensate was that their purchasing costs increased by the amount of VAT charged on the Karachaganak consortium in Kazakhstan (20%). Hence, the Russian buyers requested that the sales price of Karachaganak condensate should be reduced by the amount of the now non-recoverable VAT. The consortium could not agree to this proposal, the sales contracts were not signed and the field was shut-in for more than two months from September 2002. Production restarted from the field in November 2002 when the consortium realised that the losses from suspended production exceeded the negative effect from the reduced sales price. So what was the position of the Kazakh tax authorities on the applicability of the stabilisation clause to this case? The clause in the PSA was as follows:

> *"<u>Stability of Tax Regime</u>. The tax regime provided by Article XIX is stable for the entire effective period of this Agreement pursuant to the provisions of Article 94-3 of the Tax Code existing at the date hereof.*
>
> *Taking into account that the Tax Regime was established by Tax Legislation of the Republic existing as of October 1, 1997, the authorized bodies of the*

[33] The project was operated by a consortium of ENI-BG-Chevron-Lukoil.

> *Republic are liable to inform Contractor in writing concerning any amendments and additions of the Tax Legislation or other legal acts regulating payments of taxes and fees prior to the date hereof. In the case of absence of such notifications, provisions of those amendments and additions from October 1, 1997, till the date hereof shall not apply to Contractor and each Contracting Company."*

The Kazakh authorities took the view that the tax stabilisation clause was entirely applicable to this case and that Kazakh VAT should continue to be charged at the rate of 20% in Kazakhstan irrespective of any changes in the tax legislation in the Russian Federation. The consortium elected to accept this decision and to live with a reduced sales price that appeared to be legally unchallengeable. One risk to the investor of attempting to change the above clause to meet this situation was that the Government might take the opportunity to renegotiate the entire PSA or other parts of it that it deemed unsatisfactory. Annual losses of revenue to the consortium from this development were probably in the region of US$50 million.

3.2.4 Balancing and Expropriation

The target of a balancing provision is <u>not</u> to tackle an attempt at expropriation by the host government. If a host government aims at full nationalisation of the IOC operations, this is unlikely to be anticipated in this kind of stabilisation provision. Other approaches to stabilisation have however taken such expropriation into account and may be designed to prevent it. However, a more common risk facing an IOC in practice is that of 'creeping expropriation', where a unilateral revision of the contractual relationship (or some aspect of it) results in damage to the IOC's position but does not amount *prima facie* to an act that could be described as one of expropriation. This subject is addressed in some detail in Chapter 4 below (see also section 3.4 of this Chapter).

3.2.5 Legislative Support for Stability

In a number of countries *legislative support* may also be given to petroleum agreements concluded between the State and a foreign investor or investors. In the 1990s there were such risks in certain CIS countries, like Azerbaijan, and as a result petroleum agreements with foreign investors have been approved by Parliament with the intention of giving them the status of a law and thereby granting stability to them. This practice of enacting contracts into laws is also evident in Egypt and Chad, as well as other countries.

Of course, such Parliamentary approvals and any other legislative protections are capable of being changed at a later date, and might therefore be thought to have limited value (see the section below: 'Can the State Bind Itself by Contract?'). However, the idea behind this approach is that contractual mechanisms offer a greater degree of security for the investor. The law might therefore be *contractualised.* For example, in Chile, a petroleum law provided that the legislative regime, the advantages, exemptions and taxation benefits which are applicable have to be recorded in the operating agreement and will not vary throughout the duration of the contract[34].

It is debatable whether contractual legislative mechanisms offer a greater degree of security than do mechanisms provided for in the applicable law. The possibility of future changes in law can negatively impact upon the foreign investment contracts in the same way as it can negatively impact on already enacted laws. Moreover, most arbitral awards suggest (see Chapter 4) that the IOC will be entitled to damages if the host government breaches the agreed arrangements (whether formalised in law or contract) that the IOC reasonably relied upon to conduct its business (estoppel). The IOC would however have the obligation to perform due diligence. Indeed, if the performance of reasonable due diligence would have shown that the law or contract relied upon would not be enforceable under the applicable law, the IOC's reliance on either the law or the contract would not be treated as justified (see the discussion of

[34] Decree-Law No. 1089 (1975) Art 12.

the *Metalclad* case below). It may also be noted that in some Civil Code countries (for example, the Ukraine), such an 'incorporation by reference' approach with respect to exemptions (of laws other than the petroleum law) might not be enforceable if they attempted to include so-called imperative laws such as a general environmental law. In such a legal context, any such exemptions would have to be placed in the petroleum law itself, and would normally apply to laws that were enacted earlier in time than the petroleum law.

3.2.6 Stability and BITs

There are other mechanisms for stabilisation that are to be found in international conventions such as bilateral investment treaties (BITs). In BITs the guarantees for stabilisation could take the form of guarantees in relation to freely convertible currencies for transfers linked to investments. The exact language providing for stabilisation would be important however, with the host government guaranteeing a right, or providing for a particular regime (or portion thereof) to be 'frozen', or provides for the result of the host government imposing additional obligations, or diminishing the IOC's rights. In another respect, BITs can be important. They may lend Treaty status to stabilisation provisions contained in a host government's petroleum regime by way of the 'fair and equitable treatment' provision that is contained in most BITs, or by means of the language that only some BITs have. For example, a requirement that the host government "shall observe any obligation it may have entered into with regard to investments of nationals of the other Contracting Party"[35]. Such 'obligations' could be imposed by way of a law or by way of a foreign investment contract.

Where the IOC does not enjoy a right to apply international law as the governing law of the contract by means of an applicable treaty, it may make an effort in negotiations on the petroleum contract to stipulate international law as the governing law of the

[35] The Gambia-Netherlands BIT (2002) at Article 3(4).

contract instead of the domestic law of the host country (which is what the majority of petroleum contracts continue to provide for).

3.2.7 Stability and Hardship

The view of stabilisation in the preceding sections may be seen as narrow by some writers. It is principally concerned with stabilisation provisions that are designed to effectively maintain the position of the IOC as described in the relevant petroleum contract. It does not include *force majeure* or hardship, which may be viewed by some as agents for stabilisation[36]. However, it might be more appropriate to view them as providing justifications for non-performance, allowing the IOC justification for loosening its position.

This was the case in a number of `transitional' countries that have emerged from the former Soviet Union such as Russia, Kazakhstan and Azerbaijan. It may also apply to a number of developing countries.

3.3 Stabilisation and cross-border pipeline projects

There are a variety of intergovernmental and specialist organisations that have been involved in designing model provisions for possible use in negotiations and as guidance as to good international practice in particular economic activities. The AIPN is a notable example of this[37], but the OECD and UNCITRAL have also been active in this respect in international investment law. The idea is usually to provide a template of prescriptive clauses that are designed to reflect generally accepted

[36] Bertrand Montembault, see note 1 above. The distinction between these concepts is not as clear as it once was; UNIDROIT essentially merges the concepts of force majeure and hardship, stipulating the percentage by which the cost of performance has to go up before such a cost increase would constitute an excuse for non-performance. An example of hardship is Article 17.1 of the Russian PSA (1996) which provides that "amendments to the agreement shall be allowed only by consent between the parties, as well as upon request of one of the parties in case of a significant change of circumstances as defined by the Civil Code of the Russian

[37] Volume 2 of the AIPN Host Government Agreement Handbook (forthcoming) will address *inter alia* stabilisation issues in petroleum contracts.

practices. Obviously, this is not legally binding. An area of note where stability clauses are being developed in models is that of inter-state or cross-border pipelines for oil and/or gas.

In this respect, we may note the development of an Inter-governmental Agreement (IGA) and a Host Government Agreement (HGA) by the Energy Charter Treaty Secretariat. The former represents a 'treaty model' governed by public international law, which deals mainly with horizontal issues that concern the pipeline infrastructure as a whole. The latter deals mainly with vertical issues that concern the project activity within the territory of each State involved in the pipeline project. It provides a template for an agreement between each of them and the project investor. It contains *inter alia* a model clause on economic stabilisation. It reads:

> *"The Host Government shall take all actions available to them to* ***restore the economic Equilibrium*** *established under this Agreement and any other Project Agreements if and to the extent the Economic Equilibrium is disrupted or negatively affected, directly or indirectly, as a result of any change (whether the change is specific to the Project or of general application) in [name of country] law (including any laws regarding Taxes, health, safety and the environment) occurring after the Effective Date, as applicable, including changes resulting from the amendment, repeal, withdrawal, termination, expiration of [ ] law, the enactment, promulgation or issuance of [ ] law, the interpretation or application of [ ] law, whether by the courts, the executive or legislative authorities, or administrative or regulatory bodies), the decisions, policies or other similar actions of judicial bodies, tribunals and courts, the Local Authorities, jurisdictional alterations, and the failure or refusal of judicial, bodies, tribunals and courts, and/or the Local Authorities to take action, exercise authority or enforce [ ] law (a Change in Law)"*[38].

[38] HG Agreement, Article 31.3. See Energy Charter Treaty Secretariat website: www.encharter.org

The language is likely to be too open-ended to appeal to many investors and there is no guidance about how the economic equilibrium is to be restored. The concept of a Change in Law in defined very widely in Article 31.2 as:

> *"any domestic or international agreement, any legislation, promulgation, enactment, decree; or any other form of commitment, policy or pronouncement or permission has the effect of impairing, conflicting or interfering with the implementation of the Project, or limiting, abridging or adversely affecting the value of the Project or any of the rights, indemnifications or protections granted or arising under this Agreement or any other Project Agreement".*

In practice, there have been several attempts to tackle the specificities of a cross-border pipeline project, including the design of stability mechanisms. The roots of this lie *inter alia* in the emergence of new regional energy markets and a growing concern among governments for additional security of energy supply. The challenge has faced investors in various regional settings, such as the West African Gas Pipeline Project and the Baku-Tbilisi-Ceyhan (BTC) Oil Pipeline. The legal arrangements that resulted contain interesting new approaches to stabilisation in cross-border pipeline projects, and the sub-sections below make some comments on each of these two projects in this respect.

3.3.1 The West African Gas Pipeline Project

The pipeline project commenced construction in 2005, on the basis of legal arrangements that comprise an inter-governmental agreement (IGA)[39] and a treaty to which all of the participating nations are party[40]. The IGA contains some significant stabilisation commitments. These are a little unusual, not least because the four States (Benin, Ghana, Nigeria, Togo) each had to implement an entirely new, harmonised

[39] West African Gas Pipeline Agreement: International Project Agreement, 22 May 2003 (author's copy).

[40] Treaty on the West African Gas Pipeline Project between the Republic of Benin, the Republic of Ghana, the Federal Republic of Nigeria and the Republic of Togo (author's copy).

regime for this cross-border project, and the obligation of the developer was contingent on that regime being implemented in each State. Moreover, the stabilisation commitments extend well beyond the fiscal regime. Essentially, the agreement sets out in some detail the new regime to be implemented (the "Agreed Regime"[41]), which includes an "Agreed Fiscal Regime"[42] (an entirely new fiscal regime applying to the project as a whole, without regard to the international boundaries), but it also includes other investment regime features including exchange controls, foreign investment rules and regulatory control over the pipeline.

Once the Agreed Regime has been implemented, and the developer is committed to construction, the States thereafter are contractually liable to the developer to pay damages for `Regime Failure': that is, any deviation away from that Agreed Regime. Clause 36.1 gives an extensive definition of Regime Failure, resulting in a limitation on the potential for disputes regarding interpretation of regime failure. This includes the following eventualities:

- a decision of a court or tribunal that the Agreed Regime or part of it is not in force or is not valid;
- the coming into force in a State of a law, as a consequence of which the Agreed Regime or part of it ceases to be in force or maintained;
- the entering by a State into any international agreement or similar or other commitment that conflicts with, impairs or interferes with, or adversely affects such State's performance of or ability to perform its obligations under the Treaty or agreement or implementation of the project.

In the event of a Regime Failure, which results in a material adverse effect on the Company, certain remedies are provided. In the case of a decision by a court or tribunal, the State or States concerned are required (under 36.2(b)) to make their `best endeavours' to appeal the decision to reinstate the agreed regime. Otherwise, the States are required to meet with the Company at its request and "endeavour in good faith to negotiate a solution which restores the Company and/or its shareholders to the

[41] Clause 7.
[42] Clause 29, and Schedule 8.

same or an economically equivalent position it was or they were in prior to such change" (36.2(a)). This is equivalent to the economic balancing with a strong negotiating element discussed in Section 3.2.2 above. A failure to comply by the State triggers a compensation requirement in Clause 36.4.

The fiscal stabilisation is a part of this, but it is not quite the same as the other parts. In the case of the fiscal regime, the States undertake not to take any executive, regulatory or legislative action that amounts to a violation of the treaty regime. However, it is agreed that the States are free to change some aspects of it (including the most important components like the tax rate) after 20 years, and therefore a change after that time is not an instance of Regime Failure. However, the States do commit that they will maintain the harmonisation between the States, so if one of the States unilaterally changes an element without the others also changing, that would amount to Regime Failure.

The linkage of the IGA to the Treaty is notable since the latter is governed by principles of international treaty law and in particular, by the Vienna Convention on the Law of Treaties of 1969. The stability measures under the Treaty might therefore be expected to enjoy a higher legal status than those under host government-company agreements as a treaty is usually 'insulated' from unilateral actions of the host government that may amount to a breach of contract or an abrogation of contract. Therefore, any claim under the agreement can be espoused at the international level by virtue of the treaty protection. However, this implication of 'freezing' may be more apparent than real. The same result – enforceability - may also be attainable in the absence of a treaty under the petroleum regime of one of the host governments if international law was provided as the governing law, and other provisions were included in it (waiver of sovereign immunity from execution and an appropriate arbitration clause, for example).

In addition to the above, the States undertake not to expropriate or nationalise the assets of the company[43]. However, this is in practice not enforceable, since a State may expropriate under international law, and indeed there may be provisions in the States' Constitutions that would facilitate such action within each State's own borders. The issue would be the applicable quantum of damages. This legal undertaking is not a convincing step towards enhancing the stability of the pipeline agreement by protecting the company from unilateral actions of the States parties, although it may have a certain moral authority. The same Clause provides in the next paragraph – more realistically – that in the event of an 'Expropriation Event' occurring, the State or States taking such action shall make "prompt, adequate and effective compensation" under public international law to the company or companies affected by the expropriation or nationalisation[44]. The result of a breach of the first paragraph (an Expropriation Event) may therefore be enforceable.

With respect to future amendment, the Agreement requires consultation with the operating company prior to any amendment and makes provision for periodic review and amendment with the parties' consent. This recognises the likely need for adjustment of the contractual relationship in the face of changing circumstances.

3.3.2 The BTC Pipeline Project

The BTC pipeline project is a highly complex example of a cross-border project involving an integrated approach to stabilisation between the pipeline project and the upstream petroleum developments in Azerbaijan's Caspian Sea area (ACG). No less than 78 parties were involved in BTC, with 208 finance documents and 17,000 signatures on them[45].

[43] Clause 35.
[44] Clause 35.2.
[45] See the documents at www.caspiandevelopmentandexport.com. For a very different experience of pipeline regime design including the provision of a stability regime, see the account by Steve G Forsyth and Vianney Boiteau: 'Chad-Cameroon Development and Pipeline Project Legal Issues, in International Energy Law and Taxation Review (2004), 112-123.

In the context of this study, only a few remarks are made that contribute to the subject of this section. Host Government Agreements were signed by the project consortium and the respective host governments (Azerbaijan, Georgia and Turkey). They contain similar but not identical provisions on stabilisation. The HGA binds the parties but also binds state authorities generally. A number of themes already discussed appear in the context of the Host Government Agreements: economic equilibrium, expropriation and compensation, but are dealt with in a fairly sophisticated way.

With respect to economic balancing, the Azeri HGA requires the State Authorities to "take all actions available to them to restore the Economic Equilibrium established under the Project Agreements if and to the extent that Economic Equilibrium is disrupted or negatively affected, directly or indirectly, as a result of any change…"[46] This obligation includes the obligation to take all appropriate measures to resolve promptly by whatever means may be necessary "any conflict or anomaly between any Project Agreement and such Azerbaijan Law".

The provision on compensation in Article 9 is quite specific and focuses upon the result of a breach. A failure to maintain economic equilibrium is expressly provided for as a trigger for an obligation to pay monetary compensation. It adds that the obligation of the Government extends to loss or damage caused by or arising from any person which was a state entity at the time the applicable project agreement was executed by it. It also spells out in detail the kind of monetary remedies appropriate to compensation: money damages; restitution, reimbursement and indemnification.

Moreover, the possibility of expropriation is expressly anticipated. Instead of striking a moral note that it should never happen, it states:

[46] Host Government Agreement between and among the Government of the Azerbaijan Republic and the State Oil Company of the Azerbaijan Republic, BP Exploration (Caspian Sea) Ltd., Statoil BTC Caspian AS, Ramco Hazar Energy Limited, Turkiye Petrolleri A.O., Unocal BTC Pipeline Ltd., Itochu Oil Exploration (Azerbaijan) Inc., Delta Hess (BTC) Limited, 17 October 2000, Article 7.2(x). The other HGAs appear to be identical in wording.

"In the event that the State Authorities should ever carry out any act of Expropriation with respect to the Project, the State Authorities shall do so only where such Expropriation is (i) for a purpose which is an overriding public purpose, (ii) not discriminatory, (iii) carried out under due process of law and (iv) accompanied by the payment of compensation as provided"[47].

"Due process" in respect of a claim is to include the parties' right to resort to arbitration under the Agreement to (1) establish that an expropriation has taken place and (2) to assess the amount owed by the State Authorities as adequate compensation for loss or damage arising from the expropriation.

Finally, it may be noted that State authorities are defined in Article 15 (Binding Effect) to include the Government, all State entities and all local authorities. Moreover, this applies "notwithstanding any change in the constitution, control, nature or effect of all or any of them and notwithstanding the insolvency, liquidation, reorganisation, merger or other change in the viability, ownership or legal existence of the State authorities (including the partial or total privatisation of any State entity)". This is strengthened by a further provision in Article 20.2, in which the parties acknowledge that it is their mutual intention that no law (this is described as variously, Azeri, Georgian or Turkish in the respective HGA) now or in future, or the interpretation or application procedures of such law, if that should be contrary to the terms of the HGA or any project agreement, "shall limit, abridge or affect adversely the rights granted to the MEP participants or any other project participants in this or any other project agreement". Such a law is also precluded from amending, repealing or taking precedence over the whole or any part of this or any other project agreement. It is hard to see how this particular obligation would be enforceable however.

3.4 Can the State Bind Itself by Contract?

[47] Article 9.4.

At its boldest, the aim of a stabilisation clause is to ensure that the terms and conditions of a contract (and their effects) are 'frozen' from the time of signature over the life of the contract. However, this is a view that most stabilisation clauses would be unable to achieve in practice. A State may take necessary regulatory measures which are not arbitrary or discriminatory even where these diminish the value of petroleum agreements. This is a principle established in international law[48]. However, the real issue is not so much whether the host government can unilaterally change the contractual relationship but rather *what is the result of such legislative action in terms of lump sum damages or possible specific performance of stabilisation mechanisms*. The legislative or regulatory action may trigger a form of indemnification in a stabilisation clause.

If rights under an agreement made with a foreign investor are viewed as a form of property, then the legal issue in a particular case will be whether interference by a State with these rights amounts to expropriation, for which the State may incur responsibility if appropriate compensation is not paid. In this context, there is a distinction to be drawn in international law between lawful and unlawful expropriation[49]. However, the principal difference in practice is the quantum of damages such as book value or net book value versus some element of lost profits[50]. Moreover, if a host government does not pay 'appropriate compensation' it may have the responsibility to pay a higher quantum of damages. The principal aim of the IOC in providing for an expropriation provision (in addition to a stabilisation mechanism for 'creeping expropriation') is to stipulate a high quantum of damages applicable in the event of any kind of expropriation, whether lawful or unlawful. This would be drafted in line with normal BIT language on this: market value prior to the news of the expropriation reaching the marketplace, along with normal commercial interest.

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[48] For example, Brownlie, `Principles of Private International Law'; Mann, `State Contracts and State Responsibility', in his `Studies in International Law' (1973), 302-26.

[49] There are several arbitration cases that have discussed this, including *BP v Libya* (1979); *LIAMCO v Libya* (1981); *AGIP v Congo* (1982) and *Amoco International Finance v Iran* (1987)(see note 5 above). Essentially, expropriation is unlawful if it is discriminatory, if it is not motivated by the public interest of the expropriating country, if it breaches stabilisation clauses of the parties' contract, or if no compensation is paid, offered or other provision is made for it.

[50] DR Bishop, 'International Arbitration of Petroleum Disputes: the Development of a *Lex Petrolea*' (author's copy).

A question that has commonly been asked is whether a State can indeed fetter itself by the conclusion of a contractual clause in a long-term agreement. Based on a review of the ‘expropriation awards’ from the 1970s and 1980s, and of the more recent arbitral awards, it appears that a host government can indeed fetter itself to a stabilisation provision. Although it has the sovereign power to unilaterally revise its relationship with the foreign investor, the result of a stabilisation mechanism which applies to such unilateral action is that the host government would have to pay lump sum damages.

It may be noted that in a few cases the petroleum contracts may be `internationalised’ by arbitral tribunals in the absence of the governing law containing an element of international law. The inclusion of a stabilisation clause may be seen as evidence of the intention of a state party to the agreement not to subject the contract to the domestic law of the State but rather to some external system of authority. The latter would ensure the validity of the stabilisation clause and the contract of which it is a part. However, the IOC has the obligation to perform reasonable due diligence and the stabilisation must appear to be enforceable under the laws of the host government on the effective date of the petroleum contact. In this respect, the stabilisation clause may play an important role in allowing the inference to be drawn that a foreign investment contract is not subject to the domestic law of the host state.

On balance then, the value of an enforceable stabilisation clause remains significant in spite of the limitations imposed by the risks of unilateral state action. The key word here is ‘enforceable’. The stabilisation mechanism may be provided for in a law (say, a foreign investment law) or ‘contractualised’ by way of a law referencing the petroleum contract (as in certain Central Asian countries) or it may be in the petroleum contract itself. However, it must appear to be enforceable under the domestic law of the host government on the effective date of the foreign investment contract as a result of reasonable due diligence. This enforceability applies to the *result* of the unilateral change imposed by the host government. While other considerations would have to be taken into account in designing a fully effective stabilisation mechanism, the essential point here is that it can have value as a response to unilateral state action.

3.5 Summary

- A number of countries still provide for stability in the form of ‘freezing’ obligations in the contract. However, given the high risk of unilateral action at some future date this is in itself a highly unreliable mechanism. Perhaps in recognition of this, the long-term trend has unmistakeably been one in which economic balancing has been favoured, often involving negotiations between the parties about the result.

- An open-ended approach to negotiated economic balancing however is also a high risk strategy. It should be complemented by details and penalties for non-compliance: imposition of time limits on negotiations, recognition that compensation must follow a loss or damage and recourse to arbitration if the negotiations fail.

- In a number of cases the NOC will play a central role in fiscal stabilisation. It may provide for adjustment by paying any additional taxes out of its share of profit petroleum or royalty under a PSA or it may reimburse the IOC directly out of general revenues. Under a rate of return system, the NOC could pay from its share of royalty and/or excess profits tax. However, the NOC share of production may prove insufficient or it may be pre-sold.

- The object of an economic balancing provision is not to address an act of expropriation by the host government but other approaches to stabilisation do take this into account. A more difficult area is the impact of an act of ‘creeping expropriation’.

- States *can* revise contracts unilaterally. The real issue in designing the appropriate stabilisation mechanisms is not so much *whether* the host government can unilaterally change the contractual relationship but rather what is the result of such legislative action for the investor in terms of lump sum damages or possible specific performance of stabilisation mechanisms.

- The growing interest in cross-border pipeline projects is generating new approaches to stabilisation involving a more complex set of legal arrangements. It is too early to say whether such arrangements are as effective as they are innovative in their approaches to fiscal stability.

Chapter 4: Enforcement of Stabilisation Provisions

4.1 The Old and the New

The jurisprudence relevant to enforcement of stabilisation clauses may be rather crudely divided into two categories. On the one hand, there are the 'classical' cases, dating from the 1970s and 1980s, which address stabilisation clauses as instruments for freezing contact terms for the life of the contract, and which are much discussed in the literature on international investment law and in oil and gas law manuals[51]. On the other hand, there are a number of published arbitral awards in recent years that address issues of fair and equitable treatment and indirect expropriation which by analogy have a bearing on the likely enforceability of modern stabilisation clauses. As we have seen in Chapter 3, the modern trend is for stabilisation clauses to provide that if governmental action adversely affects the economics of the project to the investor, the terms of the contract will be adapted to restore the financial position of the investor to that on the effective date when the contract was signed. As one informed commentator has noted, "No published international arbitration awards have dealt with this type of stabilisation clause"[52].

With respect to the modern form of stabilisation (which has many forms and which may be combined with freezing), it is probably helpful to consider by way of analogy the category of reported awards as indicated above. However, a survey of the latter group of cases suggests a very different and more complex approach may be required than that required by the classical cases (not that those cases displayed a strong

[51] For example, 'International Petroleum Transactions' (2nd ed)(2000), by EE Smith, JS Dzienkowski, OL Anderson, GB Conine, JS Lowe and BM Kramer; see chapter 5: Assessing Political and Economic Risks in an International Energy Transaction, 338-391. Many of the articles in the Select Bibliography discuss these 'classical' awards.

[52] Doak Bishop, 'Survey of Published International Arbitration Awards Involving the Petroleum Industry: the Development of a Lex Petrolea', 2002 Rocky Mountain Mineral Law Foundation International Energy and Minerals Arbitration Mineral Law Series 2-25 (2002).

consistency or homogeneity of approach). The recent cases also reflect the advent of more professional dispute settlement bodies such as the International Centre for the Settlement of Disputes (ICSID), rather than the ad hoc tribunals that figured largely in the classical awards. Such bodies are specifically focussed on settling disputes which arise from foreign investment transactions involving States and private parties.

There are other contextual differences of note. The classical awards addressed disputes arising from an international petroleum industry that bears only a passing resemblance to the one we have today. The producer-consumer dynamics have changed but more importantly there are new market players both as producers (Kazakhstan, Azerbaijan, Russia and several African States, for example) and as consumers (China and India for example). The latter group appear to be willing to conclude contract terms that differ from those offered by traditional players in terms of incentives for host countries. The players themselves (the IOCs) have changed and the current generation of IOCs is learning to live with both NOCs in the host countries and globally operating NOCs as competitors[53]. Above all, the market place for stabilisation provisions has changed dramatically, with a growth in hybrid forms of stabilisation provision between the classic 'freezing' kinds on the one hand and the economic balancing variety on the other.

4.2 The Classical Awards

A review of the leading arbitration awards from the 1970s and 1980s shows that tribunals have on several occasions ruled in favour of the validity of stabilisation clauses, such as in the *Agip v Congo*, *BP v Libya*, *Liamco v Libya* and *TOPCO v Libya* cases[54]. However, the focus of the stabilisation clauses concerned was to ensure that the concession contracts were operative for the full term provided in the contract, and so targeted expropriation (or a similar confiscatory measure) as the 'event' to be prohibited.

[53] An excellent overview of these and other changes in the international oil market is contained in Paul Stevens's paper, 'Oil Markets', Oxford Review of Economic Policy, vol.21, 19-42.
[54] See note 5 above.

In the Libyan concession at the core of the TOPCO v Libya[55] arbitration, the host government was required to "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 in this concession shall not be infringed except by agreement of both parties". The clause was to be interpreted according to the laws and regulations in force at the time of the concession award, and no amendments were to be made without the Company's consent. The tribunal decided that the host government could not exercise its sovereignty to nationalise in violation of its specific contractual commitments in the stabilisation clause, and that the nationalisation was in breach of the concession.

In the case brought by AGIP against the Government of the Congo[56], the Company relied upon a guarantee of stability for the subsidiary's legal status and not to apply any laws or decrees that would alter the Company's legal status. An ICSID tribunal found that the nationalisation of AGIP's subsidiary was inconsistent with the stabilisation clauses and gave rise to an obligation to compensate AGIP in full.

In the much discussed Aminoil[57] case, stabilisation clauses were again at the centre of a case involving expropriation. The concession provided in Article 17 that it could not be annulled or altered by legislation or regulations unless jointly agreed. A Supplemental Agreement of 1961 also provided that the concession could not be terminated before the end of its term except by surrender or by default. The tribunal held that the purpose of the stabilisation clauses was only to prohibit any measures of a confiscatory character. The clauses were held to create legitimate expectations with respect to damages and those had to be taken into account.

In a later case, before the US-Iran Claims Tribunal, a contract involving Amoco International Finance[58] was at the core of a dispute, and was alleged to contain

[55] See TOPCO v Libya (1978), see note 4 above.
[56] AGIP v Congo (1983), see note 5 above.
[57] Kuwait v AMINOIL (1982), see note 5 above.
[58] Amoco International Finance v Islamic Republic of Iran (1987), see note 5 above.

stabilisation clauses. The first of these was held by the tribunal to provide no guarantee for the future and was not a stabilisation clause. The second, contained in Article 21.2, provided that no measures could be taken to annul, amend or modify the contract unless by mutual consent. The tribunal held that this created a principle of interpretation and implementation of the contract in a cooperative manner but did not bind Iran because the host government was not a signatory to the contract. It was not a stabilisation clause. In the tribunal's view, any contractual limitation on a State's right to nationalise must be expressly stipulated, be within the State's regulatory powers and should cover only a relatively limited period of time. The nationalisation was held not to be unlawful.

The significance of the above awards for the modern investor is questionable. Not only has the context changed: the risk of full-scale nationalisations has become much less to an IOC than the risk of more subtle forms of unilateral action by host governments (creeping expropriation). There is also general acceptance that under customary international law States have the right to expropriate the property of foreign investors[59]. This is subject to four conditions: the expropriation must be undertaken for a public purpose; it must be non-discriminatory; it must comply with principles of due process of law, and compensation for the expropriation must be paid to the foreign investor. In this context, the classic stabilisation clause appears to be of much less relevance. It is hardly surprising then that modern stabilisation clauses favour some form of economic balancing or at least a hybrid of this with some of the traditional elements of freezing.

4.3 Stating the Obvious: Due Diligence

If an investor elects to take action to enforce a stability clause in the face of a unilateral legislative or regulatory measure by the host government, an initial test

[59] See L Yves Fortier and Stephen L Drymer, 'Indirect Expropriation in the Law of International Investment: I Know it When I See It', 19 ICSID Review – Foreign Investment Law Journal 293 (2004). This is perhaps the best source containing a thorough analysis of all recent awards until the date of its publication. We may note the decision in *LIAMCO v Libya* that restitution of the contract is not available since it could only take effect by rescinding the nationalisation itself.

concerns proof that the investor has taken the appropriate steps with respect to due diligence. The recent ICSID case of *MTD Equity v Republic of Chile*[60] underlines the importance of this – perhaps rather obvious – first step in making a case.

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.

The relevant part of the MTD award[61] states that the Claimant company showed a lack of meaningful due diligence in making its investment in Chile. It relied on self-serving statements by a prospective business partner and failed to carry out the most rudimentary of inquiries. The Respondent contrasted the practices of MTD with those followed by other foreign investors. It was alleged that MTD was quite unfamiliar with the host State's business environment, had not secured the resources and services needed to implement the project and had not commissioned a feasibility study worth the name. The foreign investor was also alleged to have taken at face value statements made by an intermediary that land use restrictions could be modified and failed to carry out any further investigation to prove their validity. A piece of land it wished to purchase was valued for the foreign investor but the latter failed to examine that valuation critically. Indeed, an examination of a very basic kind would have revealed its shortcomings (failure to conduct reasonable due diligence and consult with an urban planner, environmental expert, architect or lawyer with experience in real estate development issues). It appears that the foreign investor was in a hurry to start the project and overlooked the necessity of taking the above precautions.

The tribunal concluded that the foreign investor should bear the consequences of its own actions as a group of experienced businessmen. Their choice of partner,

[60] 44 ILM 91 (2005).
[61] Para. 116 et seq.

acceptance of a land valuation based on future assumptions without protecting themselves contractually in case the assumptions would not materialise, are all risks that they took irrespective of Chile's actions[62].

Among the more complex areas for attention in this respect is the role of understandings or assumptions about common practices. Where it has been common practice for example for the NOC to absorb the cost of any additional fiscal obligations imposed by the host government, it would be important to ensure that such a government practice or understanding thereof was documented, that the host government had confirmed it and that this understanding played an important role in the decision to invest in the first place. If a dispute arose, since the IOC had justifiably relied upon the 'agreed upon' interpretation of a practice (or law, regulation, etc.) to its detriment, the government may be estopped from later taking the position that the practice should be interpreted differently than had been 'informally agreed' previously.

4.4 Indirect Expropriation

The dearth of published arbitral awards that directly concern the enforcement of fiscal stabilisation provisions (at least in recent years) means that we need to consider the body of international arbitral awards that are relevant to anti-expropriation provisions and to proceed by way of analogy. The cases below may not be immediately familiar to some oil and gas practitioners and so they are described in some detail.

There are a number of recent cases in which there appears to be no evidence of a *direct* seizure of assets by the State[63]. At the outset, however, it should be noted that there is much disagreement about the significance of the following decisions[64]. There

[62] Para. 178.
[63] The notion of 'creeping expropriation' in the petroleum industry is not completely new however: see *Sedco, Inc. v National Iranian Oil Co.(NIOC)*, Award No ITL 55-129-3 (28 October 1985), 9 Iran-US CTR 248; *Phillips Petroleum v Iran*, 21 US-Iran CTR 79..
[64] For a review of the principles of international investment protection in relation to these cases, see Chapter 6 of N Rubins and NS Kinsella's *International Investment, Political Risk and Dispute*

are several doctrines of expropriation that are applied by arbitrators[65] and not applied with a scholarly neatness. For our purposes, the key point is that the awards have not found a host government responsible for expropriation, which suggests that investors should be as wary of relying on a defence of indirect expropriation as on direct expropriation.

4.4.1 Metalclad

The best starting point is the case of *Metalclad Corp v United Mexican States* (2001) since it has had a significant impact upon other cases[66]. The panel in that case stated at Paragraph 103 that expropriation includes:

> *"not only open, deliberate and acknowledged takings of property … but also covert or incidental interference with the use of property which has the effect of depriving the owner, in whole or in significant part, of the use or reasonably-to-be-expected economic benefit of property even if not necessarily to the obvious benefit of the host State…"* (Author's italics).

This case – and the above remarks – touches on an important issue raised by the so-called 'effects' doctrine. What is the threshold level of interference that will trigger State liability for expropriation? Governmental measures that result in the total destruction of investment value are easily classifiable as expropriation. However, a claim will be much harder to maintain when most of the value of the investment remains.

In *Metalclad* a US investor had acquired land in Mexico for use as a landfill. The company had obtained assurances from the federal government that all necessary permits had been issued but the local authorities had refused to grant permission to

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Resolution: A Practitioner's Guide (2005), Oceana Publications, New York, 189-259. See also the OECD Working Paper, '"Indirect Expropriation" and the "Right to Regulate" in International Investment Law', No. 2004/4, September 2004.

[65] In particular, the doctrines based on effects, purpose, proportionality and legitimate expectations.

66 Metalclad Corp. v. United Mexican States, Award (ICSID (Additional Facility) Case No. ARB (AF)/97/1, Aug. 30, 2000, 16 ICSID Rev.-FILJ (2001), 168.

begin construction. Work on the new facility, which included a clean up of the residues left by the previous operators, was completed in March 1995 but opposition from local interests intensified and ultimately the municipality denied Metalclad's construction permit in a process that was closed to Metalclad. The Tribunal concluded that the host government's actions had deprived Metalclad of the ability to use its property for its intended purpose, and that this was sufficient harm to constitute expropriation. It also faulted the lack of transparency in the Mexican legal system for siting of hazardous waste disposal facilities. The Tribunal identified standards to the effect that there must be a deprivation, that it had to affect at least a significant part of the investment and that all of it relates to the use of the property or a reasonably expected economic benefit. Little importance was placed on the justification provided by the host State for its action that was considered to be equivalent to expropriation.

Although this has been an influential case, there is one limitation to the significant interference threshold that it articulated. The test was included in dictum by the Panel since in practice the investor's landfill enterprise was completely prevented from operating and therefore determined to have lost all value. In other situations it might not be so easy to apply the *Metalclad* formula in order to identify the level of damage to investment that qualifies as "substantial".

4.4.2 Occidental v Ecuador

Another case on indirect expropriation concerned an oil company. In *Occidental Exploration and Production Co. v Republic of Ecuador* (2004)[67], the Claimant argued that the host State's refusal to refund VAT payments constituted an expropriation of its investment: that is, the claim to receive reimbursement. The Tribunal ultimately found that **no expropriation had occurred, although it did conclude that Ecuador had violated its duty to accord Occidental (OEPC) fair and equitable treatment**. With respect to the claim that expropriation had taken place, the Tribunal relied on the

67 Occidental Exploration and Production Company v. The Republic of Ecuador, Final Award, LCIA Case No. UN3467 of 1 July, 2004, 43 ILM 1248 (2004).

Metalclad case and noted that the deprivation to the company had to affect a significant part of the investment, which was not apparently the case here[68].

Taking a closer look at the issues in this case, we see the following. The dispute arose because of the actions of the Tax Office (SRI) which passed several Resolutions that resulted in the oil company, OEPC, not being able to recover VAT paid on local purchases and on the import of goods made in connection with export activities. The oil company assumed virtually all of the costs of its exploration and exploitation activities and had to pay VAT on expenses it incurred. The question of any refund of VAT is not dealt with expressly in the contract. In return for providing its services OEPC received a percentage of the oil produced and it was enabled to export that oil. In the participation agreement there is a method for the calculation of the contractor participation which includes a mechanism called a Factor X. This was calculated using an elaborate formula and once computed it was to be multiplied by the production figure and then divided by 100. That exercise produced the proportion of the total oil production to which OEPC was entitled under the participation agreement.

OEPC argued that when the participation agreement was being negotiated, a critical element in reaching agreement on the formulation of Factor X and so the level of participation by OEPC in the production of oil from the relevant block was the parties' joint understanding on how the VAT payments would be treated. OEPC argued that its investment was based on an agreed economic model by which VAT would be paid by OEPC but would then be reimbursed by the Ecuadorian authorities, a claim that was challenged by the host government. OEPC argued that Ecuador's refusal to refund the VAT constituted a breach of its BIT obligations inter alia in terms of its obligation to afford equal treatment to that of other investors, both domestic and foreign in like circumstances; to grant fair and equitable treatment and not to expropriate an investment either directly or indirectly.

[68] The second stage of proceedings in this case in the English courts involved an arbitration held under the Arbitration Rules of UNCITRAL with the seat of arbitration in London: The Republic of Ecuador v Occidental Exploration and Production Company, LCIA Case No. 04/656 (2 March, 2006)..

The precise way in which the mechanism in the petroleum agreement was triggered in relation to VAT on imports was not considered relevant. What was relevant was that there was a contractual provision to make corrections if tax changes have an impact on the 'economy' of the contract. That is because the contractual mechanism assumes and is intended to give effect to the underlying understanding of the parties as to what the proper 'economy' of the contract must be. That provision creates an express obligation to make a correction factor if the identified events have an impact on the contract's proper 'economy'. Another provision in the OEPC contract (Clause 11.11) stipulated a similar type of obligation to make a correction factor if there was an unforeseen modification in the tax regime which has an impact on the economy of the Contract. This presumes that the parties had considered and decided on what was 'the economy' of the contract. It may also be noted that the question of what VAT would be paid on items such as imports of equipment, machinery; materials and other consumable supplies had been raised by OEPC during negotiations on the participation agreement.

In the second stage of the proceedings in 2006 Mr Justice Aitkens held that the dispute involved a matter of taxation not only in relation to the relevant BIT but one that had reference to the performance of the obligations of the contract. He supported this conclusion by three reasons. Firstly, the matter of the right to a VAT refund or not had reference to the obligations of OEPC to do all that was necessary to exploit the relevant block including the obligation to build all the systems needed for that exploitation because the VAT was paid in respect of purchases made to fulfil that obligation. Secondly, the issue of a VAT refund had reference to the performance of OEPC's contractual obligation to pay all taxes according to the laws of Ecuador. Essentially, the dispute turned on whether that contractual obligation was concluded on the assumption or understanding that there would be a refund of VAT paid. Finally, the tax issue had reference to the underlying assumptions of the parties as to the 'economy' of the contract which formed the basis for the bargain contained in the contract's terms. Therefore, the underlying assumptions of the parties as to the 'economy' of the contract were fundamental to how the contract terms were to be observed and enforced.

The Panel concluded that the VAT refund was not within Factor X as calculated under the petroleum agreement and so OEPC was entitled to have it refunded under Ecuadorian law. Because the refunds had not been made, Ecuador was in breach of its obligation to accord OEPC a treatment no less favourable than that accorded to nationals or other companies. The claim that OEPC's investment had been impaired by arbitrary measures was only upheld in part since the Tax Office (SRI) had not acted deliberately to deprive the Company of the VAT refunds but rather this had resulted from "an overall rather incoherent tax legal structure". However, that confusion and lack of clarity resulted in "some form of arbitrariness, even if not intended by the SRI". The arbitrariness had not given rise to any impairment of the management, operation, maintenance, use, enjoyment, acquisition, expansion or disposal of the investment of OEPC. The conclusion was that damage had been caused and that OEPC could retain the VAT refunds it had obtained.

The approach to the expropriation issue in the first set of proceedings was influenced by the *Metalclad* decision (and was expressly upheld in the second set of proceedings). Although the claim that expropriation took place was ultimately unsuccessful, the Tribunal did agree with OEPC that expropriation need not involve the transfer of title to a given property: the distinctive feature of traditional expropriation in international law. It may affect the economic value of an investment. Taxes can have the effect of expropriating property as can other types of regulatory measures. Indirect expropriation has significantly increased the number of cases before bilateral investment tribunals. However, it had to meet the standards applicable to such a wide definition of expropriation as were set out by the Tribunal in the *Metalclad* decision.

4.4.3 Feldman

There are other cases that address indirect expropriation and are potentially relevant such as *Feldman v Mexico* (2002)[69] and *Pope & Talbot Inc. v Canada* (2000)[70]. In the first of these cases, the claimant sought compensation for tax rebates denied to his products. However, the tribunal found that no expropriation had occurred because some activities of the claimant remained unaffected by the practices at issue. The *Metalclad* case was considered but it was noted that in that case the assurances received by the investor from the host government were definitive, unambiguous and repeated in stating that the government had the authority to authorize construction and operation of hazardous waste landfills and that Metalclad had obtained all the necessary federal and other permits for the facility. In *Feldman* the Mexican authorities opposed the investor's business activities at every step of the way, and assurances relied upon by the claimant were "at best ambiguous and largely informal. They were also in direct conflict with Article 4(III) of Mexico's IEPS law requiring the possession of invoices stating the taxes separately as a condition of receiving tax rebates" (Para. 149). Similarly, a rather limited interpretation of the term 'tantamount to expropriation' was given in *Pope & Talbot*, where a NAFTA tribunal found that even if the investor's argument could be accepted that the profits of the enterprise had been significantly reduced by a change in Canadian lumber export quotas, it was necessary to produce more tangible forms of interference in business operations before it could be said that expropriation had occurred.

4.4.4 EnCana v Ecuador

A parallel arbitration to the one above with Occidental also involved a US company and Ecuador was *EnCana Corporation v Republic of Ecuador*, which produced an award on 3 February 2006[71]. The issues involved were similar; the result of the award was that EnCana's claim to be the victim of indirect expropriation was rejected. It

[69] Marvin Roy Feldman Karpa v United States of Mexico (2002), ICSID Case No ARB(AF)/99/1, Award.
[70] Pope & Talbot Inc. v Government of Canada, Interim Award of 26 June, 2000, 40 ILM 258 (2001).

[71] EnCana Corporation v Republic of Ecuador (2006), London Court of International Arbitration, Award & Partial Dissenting Opinion (Horacio A Grigera Naon)

may be noted however that there was a dissenting opinion, which supported EnCana's case. Since this covers a number of issues that have already been discussed but treats them rather differently, it is worth considering why.

Among the facts of this case it may be noted that the claims concern claims for VAT refunds that arise out of the performance of four petroleum agreements in the host country that were entered into by two companies before and after being acquired by EnCana. As with the *OEPD* case above, there was a provision for amendment of the tax regime in the petroleum agreement: a correction factor in the participation percentages was to be included to absorb the increase or decrease of a tax charge or labour participation. There is no express reference to VAT in the petroleum agreement. The oil company argued that Ecuador had changed its interpretation of the Hydrocarbons Law relating to exemption from various taxes imposed on imports (three years after the petroleum agreements were concluded). The change in interpretation occurred in 1997 and before that time the Law was interpreted as meaning that no input VAT was chargeable on imports. Until March 2000 however the oil company made no claim for VAT refunds. It appears that adjustment of the agreement was sought by seeking to shift the burden to Petroecuador but the state company rejected this on the ground that VAT refunds were a matter for the state tax office. In relation to the host government's failure to provide a tax refund, EnCana made claims of indirect and direct expropriation of its investment.

The issue of indirect expropriation was viewed by the Tribunal as lacking substance. The claim was that even if the subsidiaries had no right to a tax refund under the municipal law, the denial of refunds had such a significant impact on the subsidiaries as to be equivalent to expropriation of the investment. The Tribunal held that unless there is a specific commitment from the host state, "the foreign investor has neither the right nor any legitimate expectation that the tax regime will not change, perhaps to its disadvantage, during the period of the investment". Further, the Tribunal noted that by its very nature all taxation reduces the economic benefits which an enterprise would otherwise derive from an investment, and only in exceptional cases can a tax measure which is general in character be judged as equivalent in effect to an expropriation of the enterprise itself.

The Tribunal discussed the effects of the denial of VAT refunds and the recovery of VAT refunds wrongly made, noting that they did not prevent the company from functioning profitably nor to engage in the normal range of activities of extracting and exporting oil. The companies were not brought to a standstill, nor were the rewards from their activities made so marginal or unprofitable that they lost their character as investments. In their decision they referred to the much earlier case of *Revere Copper & Brass Inc v Overseas Private Investment Corporation (1978),* which involved a claim under the US foreign investment programme. In that case, the tribunal held that various acts by the host government including tax measures amounted to a repudiation of an investment agreement between Revere and Jamaica which prevented Revere from exercising effective control over the use of disposition of a substantial portion of his property. However, this case concerns the imposition of a tax (the Bauxite Levy) that was in breach of an express tax stabilisation clause in the investment agreement and involved a tax ranging from 15-35% on gross receipts. It was not an income tax. The unreasonableness of the tax itself was not the basis for the majority decision in favour of Revere, so that it did not support the argument that a refusal to refund VAT amounts to an expropriation of the enterprise.

The Tribunal paid special attention to the dictum about expropriation as covert or incidental interference (see Para. 9 above) in *Metalclad* to support its claim of unreasonable interference with the ability of the Claimant to make use of and benefit from their economic entitlements. It noted that *Metalclad* had nothing to do with taxation and that from the point of view of expropriation; taxation is in a special category. Only if a tax law is extraordinary, punitive in amount or arbitrary in its incidence would issues of indirect expropriation be raised. The denial of VAT refunds to the amount of 10% of transactions associated with oil production and export did not deny EnCana the benefits of its investment in whole or in part. The claim that indirect expropriation had taken place was rejected.

A final issue which was examined by the Tribunal was whether the host government action amounted to expropriation or conduct equivalent to expropriation of accrued rights to tax refunds. The Tribunal considered the case of *Waste Management Inc* and noted that it was concerned not with tax legislation but rather with a breach of contractual rights by local government bodies. It noted the differences between alleged governmental non-performance of contractual obligations and a governmental refusal to make payments allegedly required by statute, in particular tax refunds. It distinguished between a "questionable position taken by the executive in relation to a matter governed by the local (i.e. municipal) law and a definitive determination contrary to law". Under the BIT, the executive was entitled to take a position in relation to claims brought forward by individuals, even if that position turns out to be wrong in law *as long as it did so in good faith and is ready to defend its position before the courts*. To the extent that the host government contested the existence of the obligations it was not repudiating them and one of its agencies was not expropriating the value represented by a statutory obligation to make a payment or refund by a mere refusal to pay. The Tribunal added a minimum set of conditions for this: as long as the refusal was not merely wilful; the courts are open to the aggrieved private party and the courts' decisions are not themselves overridden or repudiated by the State. **It concluded that the policy of the tax authority on oil refunds never amounted to an actual and effective repudiation of Ecuadorian legal rights**.

The decision of the Tribunal was the subject of a lengthy dissenting opinion. Mr H A Grigera Naon argued against the Tribunal's insistence that a prior determination of the validity of the host state's objections to the grant of refunds was required from its own courts and its own laws as a kind of 'substantive' exhaustion of local remedies which constitutes a precondition for accessing substantive rights from the BIT Treaty. Essentially, he concluded that EnCana had legitimate expectations under the BIT and under Ecuadorian law that were violated by the state body, and that there was no need to go through the courts to exhaust local remedies.

4.4.5 CMS v Argentina

Another case that is relevant in this context is *CMS v Argentina*[72]. There, the claimant demonstrated that the Argentine Government's freeze of gas transportation tariffs and forced conversion of private service contracts from dollars to devaluated pesos at a one-to-one rate had the effect of massively reducing the local investment vehicle's profitability. The Tribunal calculated that the claimant's investment had lost about 98.5% of its value. The Tribunal found that Argentina's actions had violated other standards of protection contained in the relevant BIT, but the Tribunal declined to hold that it was liable for expropriation of the investment. The Argentine Government demonstrated that the list of issues to be taken into account for reaching a determination on substantial deprivation was not present in the dispute. The case supports a view that other arguments are likely to prove a more reliable basis for a claim that one based on a claim that a host government's action has been 'tantamount to expropriation'. There is evidence in the above cases of such arguments however.

Another element in the *CMS Gas Transmission* Case may be noted. In that case, Argentina relied on the explicitly temporary nature of the emergency measures that had caused harm to the claimant's investments. A subsequent renegotiation of the foreign investor's licences would eliminate any offending State actions in the near future, it argued. Such negotiations had been ongoing for five years and so "if delays exceed a reasonable period of time the assumption that they might become permanent features of the governing regime gains in likelihood" (Para. 107). For a case to be considered as expropriation it has to be non-ephemeral, which it was in that case in spite of the host government's claims to the contrary.

4.4.6 CME v Czech Republic

72 CMS Gas Transmission Co. v Argentina (2005), ICSID Case No. ARB/01/8, Award f 12 May, 2005.

Another award that should be mentioned in this context is the *CME v Czech Republic* (2003)[73]. The claimant argued that the Czech Republic had deprived a local media company, in which the Dutch claimant corporation owned a share of the ability to broadcast according to the initial conditions of its licence. The tribunal implied that this exclusion of the broadcast company from its sphere of activity constituted a complete destruction of its value. However, the final damages award revealed that the company's loss of value was in fact only about 87%. The Tribunal followed the precedent of *Metalclad* to establish indirect expropriation of the claimant's investment.

4.4.7 TECMED

Another case which touched on expropriation is the *TECMED* case (*Tecnicas Medioambientales Tecmed SA v The United Mexican States* (2003))[74]. In this case, the action by the host government had "negative effects on the Claimant's investment and its rights to obtain the benefits arising therefrom". In particular, "economic and commercial operations in the Landfill after such denial (of a licence) have been fully and irrevocably destroyed, just as the benefits and profits expected or projected by the Claimant as a result of the operation of the Landfill". This shifted the burden of proof to Mexico to show that the expropriation was justified as falling within the State's police power. The task of the Tribunal was to determine:

> *"Whether such actions or measures are proportional to the public interest presumably protected thereby and the protection legally granted to investments, taking into account the significance of such impact plays a key role in deciding the proportionality".*

The Tribunal took the view that "a serious urgent situation, crisis, need or social emergency" could be "weighed against the deprivation or neutralization of the

[73] CME Czech Republic B.V. v Czech Republic (2003)(available at www.investmentclaims.com).

[74] Tecnicas Medioambientales Tecmed S.A. v. Mexico, Award of May, 2003, 43 ILM 133(2004).

economic or commercial value of the Claimant's investment" to lead to the conclusion that an otherwise expropriatory regulation does "not amount to an expropriation under the Agreement and international law"[75]). The Tribunal decided that ultimately neither the environmental concerns nor the threat of civil disturbance due to public protests could provide a satisfactory justification for the host government's effective taking of the claimant's investment.

4.5 Fair and equitable treatment

Many tribunals have ruled that this standard is intended to grant foreign investors broad protections including stable and predictable investment enforcement in order to maximise the volume of foreign direct investments. This trend of thinking was summarised in the *MTD v Chile* case, which states that:

> *"Fair and equitable treatment should be understood to be treatment in an even-handed and just manner, conducive to fostering the promotion of foreign investment. [The BIT's] terms are framed as a pro-active statement – "to promote", "to create", "to stimulate" – rather than prescriptions for a passive behaviour of the State or avoidance of prejudicial conduct to the investors"*[76].

On the above view, a State may violate its obligation to grant investments fair and equitable treatment if it substantially alters the legal or regulatory framework under which those investments were made. In the case of *CME v Czech Republic* (involving the claimant's investment in a joint venture to operate a local television station) the tribunal found that the Republic's legislative and regulatory changes had unlawfully harmed CME's investment by ignoring the rules governing the investor's business. It held that the Government had "breached its obligation of fair and equitable treatment by evisceration of the arrangements in reliance upon [which] the foreign investor was

[75] Para. 139.
[76] Para. 113.

induced to invest"[77]. The obligation to safeguard "pre-existing decisions that were relied upon by the investor to assume its commitments as well as to plan and launch its commercial and business activities" (TECMED) is central to the concept of fair and equitable treatment. The CMS case also emphasised the concept of investment stability, when it found that the alteration of the gas transportation regulatory regime was unfair and inequitable:

> *"One principal objective of the protection envisaged is that fair and equitable treatment is desirable "to maintain a stable framework for investments and maximum effective use of economic resources". There can be no doubt, therefore, that a stable legal and business environment is an essential element of fair and equitable treatment"*[78].

In *CMS Gas Transmission* the State incurred liability irrespective of its motivation for taking the offending measures[79]. This principle was reaffirmed in *Occidental v Ecuador:*

> *"The stability of the legal and business framework is …an essential element of fair and equitable treatment … Moreover, this is an objective requirement that does not depend on whether the Respondent has proceeded in good faith or not"*[80].

Support for the above approach is also found in the recent UNCTAD publication, 'Investor-State Disputes arising from Investment Treaties: A Review' (2006) where it is stated that fair and equitable provisions may be construed as applicable not only to flagrant abuses of government power but to any open and deliberate use of government power that fails to meet the requirements of "*good governance, such as transparency, protection of the investor's legitimate expectations, freedom from coercion and restraint, due process and procedural propriety and good faith*". It is

[77] Para.611.
[78] Para. 274.
[79] Para. 280.
[80] Paras. 183, 186.

also relevant to consider whether the treatment is in breach of representations made by the host state that the investor reasonably relied upon. With respect to the latter point the case of *Waste Management Inc v United Mexican States* (2004) is relevant.

One issue that may be relevant concerns possible discriminatory treatment. Only a very few tribunals have directly applied ‘arbitrary and discriminatory measures’ clauses to particular facts. This was addressed as was its relation to national and MFN treatment to prohibit discrimination on bases other than nationality in *CMS Gas Transmission*. The claimant argued that the suppression and freeze of gas transmission tariffs by the Argentine Government through ‘pesification’ was de facto discriminatory and violated the relevant BIT. It was demonstrated that the measure affected only gas transmission companies and not other public services. Exporters (dominated by local interests) reaped very large benefits from the measure. The Tribunal concluded that the measures were indeed unfair and inequitable but could not be deemed discriminatory since businesses in other sectors could not be proven to be in ‘similar circumstances’ to the gas transmission companies[81].

4.6 The Governing Law

A review of both old and new available arbitral awards relevant to stabilisation yields the conclusion that even if stabilisation is provided for in the petroleum agreement or upstream petroleum regime, tribunals will require that international law be at least one element of the governing law (in the legislative/contract regime) in order to award a decision that the stabilisation is enforceable in the face of subsequent unilateral revision of the regime by the sovereign. The exceptions would include the relatively rare cases where, even though international law is not at least one element of the governing law, the tribunal decides to ‘internationalise’ the foreign investment contract, and to apply international law even though it is not provided for in the legislative/contractual regime.

[81] Paras. 293-295.

In this context, application of a Bilateral Investment Treaty (BIT), and particularly the application of the standard of 'fair and equitable treatment', might lend this key element of international law to the formula required for stabilisation. That formula appears to require, for arbitration purposes, a stabilisation provision in the petroleum agreement (or elsewhere in the regime) in the first place, and international law as the governing law in the second. In fact, there are several recent cases that are relevant to this issue of whether a BIT can provide support to the element of stabilisation in a petroleum agreement (but not if there is no stabilisation clause in the agreement already).

In the ICSID case between CMS Gas Transmission Company and the Argentine Republic (2004), it is stated that:

> *"It has also been established that the guarantees given in this connection under the legal framework and its various components were crucial for the investment decision"*[82], and
> *"In fact, the Treaty (i.e. BIT) standard of fair and equitable treatment and its connection with the required stability and predictability of the business environment, founded on solemn legal and contractual commitments, is not different from the international law minimum standard and its evolution under customary international law"*[83].

The CMS Case also refers to a quote from the CME Case (cited by the Claimant):

> *"The Government breached its obligation of fair and equitable treatment by evisceration of the arrangement in reliance upon [which] the foreign investor was induced to invest"*[84], and

The following quote from TECMED is cited to the effect that fair and equitable treatment

[82] Section 275, p.80.
[83] Section 284, p.82.
[84] Section 267, p. 78.

> *"requires the Contracting Parties to provide to international investments treatment that does not affect the basic expectations that were taken into account by the foreign investor to make the investment"*[85]

One possible reading of these available awards is that under international law, if a foreign investor risks its capital in reliance upon a stabilisation obligation described in an applicable host country petroleum regime, then a unilateral revision by the host country of that regime, to the detriment of the foreign investor, would constitute a breach of the stabilisation obligation for which damages, and possibly specific performance, depending upon the circumstances, would be available to the foreign investor. If, however, there is no stabilisation provision in the petroleum regime (not applicable in this case), then the foreign investor could not reasonably claim that it had made its investment in justifiable reliance upon stabilisation.

4.7 Summary

- The classical arbitration awards largely relate to a form of stabilisation and a kind of 'event' that are at best marginal today. A whole-scale attempt to freeze the provisions of a contract over long periods of time is unusual, as are explicit attempts at full-scale expropriation.

- The more recent awards concerning indirect expropriation are potentially relevant in connection with the imposition of fiscal obligations that alter the economic balance struck between the parties at the time that the contract became effective. There appear to be no published awards dealing with stabilisation provisions of the modern variety, which are sometimes no more than 'agreements to agree'. However, the awards made in cases of alleged indirect expropriation offer only small comfort to investors. Each case has to be analysed in the light of its

[85] At Section 268, p.78; also cited in MTD v Chile, at Section 114, p. 105, noting that TECMED was in turn referring to the ELSI Case.

particular facts, but the general conclusion is that expropriation claims are unlikely to be accepted as a basis for compensation.

- Another conclusion is that a finding in favour of the investor on the basis of unfair and inequitable treatment may have greater chances of success than one based on indirect expropriation. However, the law is in a state of flux in this area so much will depend on the context of the particular case brought before the tribunal.

- There are obvious limitations on the relevance of the more recent awards since they involve the consideration of the implications of stabilisation clauses by analogy. Some of the modern stabilisation clauses are more than agreements to agree and contain elements that stipulate outcomes if the parties fail to agree and rights for IOCs to refer the matter to arbitration if negotiations fail. These offer improved prospects of a remedy in the form of compensation at least.

- The role of due diligence in facilitating the enforcement of a stabilisation clause has been emphasised. Some government measures that impose fiscal obligations may be rooted in changes to practice rather than overt legislative adoption of new measures. Evidence of having carried out due diligence will be important in taking a case to arbitration.

Part 3: Contract Stability in non-Fiscal Areas

Chapter 5: Environmental, Safety and Health Exceptions

5.1 Managing Uncertainty

In Part 3 we noted the existence of ‘carve-outs’ and exceptions for areas that some host governments deemed to be inappropriate to subject to the kind of constraint that they were prepared to accept for the regime applicable to fiscal stability. The areas typically reserved by States are those concerning rules on environmental management, safety, health, and sometimes defence and local community interests. In addition to these familiar areas, on the horizon we can see that changing perceptions of ‘human rights’ are likely to impact upon international investment, and perhaps impose new kinds of obligations on investors.

This is an area in which IOCs have important concerns with respect to ‘reputation risk’. Yet, taking action to tackle the challenges is far from straightforward. Although many host governments are reluctant to include these subjects in their stabilisation commitments, the risk to investors is less from a deliberate act from a host government than from changing public perceptions about what governments or their agencies should be doing, the impact of new treaty obligations, better quality information about, for example, environmental impacts and the open-ended and voluntary character of many of the terms and concepts used.

One response would be to address this new category of risk in the manner that one authority identifies: “the strategy of investors has been to negate environmental laws through stabilisation clauses in the contract which seek to freeze such controls at the time of entry and exclude the application of later improvements to environmental standards to the investment"[86]. As we have argued here, many governments have been understandably reluctant to concede such a wide application of the 'freezing' concept, and its poor chances of enforceability make it unlikely to attract many reputable investors. Another response would be to engage with these trends, and this chapter is designed to assist investors with such an open frame of mind.

5.2 Vulnerability in Non-Fiscal Areas

The increasingly difficult and sometimes controversial area of environmental management in oil and gas projects needs to be set in what is gradually becoming a well established institutional framework, frequently established in a petroleum code or basic law. This should enable the issue of contract stability vis-à-vis environmental management to be seen in the way in which it generally arises in practice. It is now common form to require an independent environmental impact assessment before proposals for development of a petroleum field are submitted to government or to its agencies for approval. An environmental management plan which takes account of the conclusions of the impact assessment will normally form a key part of the investor's proposals, and if, and when, approved will constitute a contractual commitment which the investor is expected to honour. The investor will, however, expect, or at least hope, that what has been agreed with the host government in the relevant environmental provisions of the petroleum contract (and the country's environmental law regime) will mark the limit of his obligations. However, the reluctance of most governments to close off their environmental jurisdiction by agreeing to limit an investor's obligations to what has been set out at the time of signing the contract has sometimes been the source of problems currently arising in negotiations (not least at the development plan stage). This can lead to a difficult search for acceptable words which will define the circumstances in which the government can impose new obligations on the investor that go beyond what is in the development plan, or are set out in applicable legislation in force when the petroleum contract was agreed.

[86] M Sornarajah, The International Law on Foreign Investment (2nd ed), 180.

An illustration of the complicated wording that may result from the attempts to balance the Contractor's concerns for stability with the government's reluctance to tie its hands with respect to environmental management may be gained from the second version of a model contract that the Government of Trinidad and Tobago has issued. In the Article on conduct of petroleum operations, it states that the

> *"Contractor shall conduct Petroleum Operations hereunder in a continuous, diligent and workmanlike manner, in accordance with applicable law and the Contract, and sound and current international Petroleum industry practices and environmental standards applicable from time to time in similar circumstances, all designed to achieve efficient and safe Exploration and Production of Petroleum and to maximise the ultimate recovery of Petroleum from the Contract Area. In this regards, Contractor shall ensure that all materials, equipment, technologies and facilities used in Petroleum Operations comply with engineering and environmental standards generally accepted in the international Petroleum industry, and are kept in good working order".*

The very open-ended character of `standards that may be applicable from time to time' is qualified by the words `in similar circumstances' and by the notion of purpose attached to the operation of such standards. There appears to be no question of their being linked to an increased economic take.

Some further remarks may be made on the notion of the `investor' used above. Some oil and gas companies, usually the larger ones, have become pro-active in adopting the best international practice with respect to environmental and safety standards. This is partly an insurance against future claims against them and partly an attempt to raise the bar so that the risk of amendment in the near future declines. Other investors may take a more cavalier approach to the definition of environmental and social obligations that they are expected to assume at the outset of a project. This may lead to potential difficulties if the host government seeks to upgrade the relevant environmental provisions at a later date in line with changing international patterns of petroleum conduct. There is plenty of evidence of countries updating their rules on environmental management in recent years.

5.3 Examples of Environmental Rule Development

5.3.1 Tanzania

In a production sharing agreement of 1990[87], the provisions with respect to environmental protection are very limited. The contractor has to take all necessary and adequate steps to prevent pollution and protect the environment. A failure to comply which results in pollution or damage to the environment or marine life means that the contractor will have to take remedial measures, and such costs are not to be a recoverable contract expense. This follows closely the wording of a model agreement issued in 1989. It contrast with the kind of provision found in neighbouring Kenya in 1989, where the contractor was required to carry out petroleum operations "diligently and in accordance with good international petroleum industry practice"[88] (and the IOC's exposure is thereby more limited in this case).

By 1995 these requirements had expanded to include a mandatory requirement that the contractor should undertake at his own expense (but as a legitimate recoverable cost) at least one comprehensive environmental impact assessment prior to commencing major operations[89]. Compensation for injury to persons or damage to property caused by the effects of petroleum operations was also added. It could be asked whether the IOC's liability under these arrangements might not be greater than they would be under an 'international standard'.

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[87] Texaco Production Sharing Agreement dated 7 May 1990 between the Government of Tanzania, Tanzania Petroleum Development Corporation and Texaco Exploration Tanzania Inc (Ruvuma Basin).
[88] Production Sharing Contract of 1989 between Total/Amoco/Marathon/Texaco and the Government of Kenya (Block 1). Pollution had also to be avoided and all waste materials disposed of in accordance with good international petroleum industry practice (Art 8).
[89] Model Production Sharing Agreement between the Government, TPDC and the Contractor, 1995.

The most extensive changes are not evident, however, until the production sharing agreement concluded with Pan African Energy in 2001[90]. This makes express reference to compliance with the applicable laws of Tanzania (creating an open-ended exposure to the IOC) and with good oilfield practices, as well as an external frame of reference on environmental management standards, the ISO 14000 series, as amended. The requirement to carry out an EIA is mandatory for each major operation, perhaps implicit in previous agreements but now more clearly spelled out. There is a requirement to notify in the event of an emergency or accident affecting the environment and is required to take such action as may be necessary or prudent according to good oilfield practices in such circumstances. A failure to take prompt action to control or clean up any pollution or make good any damage caused, means that the state company may take action in accordance with good oilfield practices and the applicable laws of Tanzania.

5.3.2 Kazakhstan

In a production sharing agreement from 1993[91] the clause on environmental matters proves to be very limited. The parties to the contract are obliged to comply with the applicable environmental laws of Kazakhstan; to submit a plan for development of the local environment and to accept responsibility for any petroleum lost by accident or leakage due to the contractor's equipment or operations.

By contrast, the model contracts issued in 1997 and 2001[92] by the Government contain much more detailed provisions on environmental matters. For example, a permit is required for the use of natural resources from the state conservation authorities. The provision contains nine as opposed to three paragraphs in the 1993 contract, and is accompanied by provisions on safety of personnel and liabilities of

[90] Production Sharing Agreement between the Government of the United Republic of Tanzania, the Tanzania Petroleum Development Corporation and Pan African Energy Tanzania Ltd, relating to the Songo Songo Gas Field, 2001.
[91] Production sharing agreement dated 8 April 1993 between the Government of the Republic of Kazakhstan and the Oman Oil Company Limited (Atyrau Exploration Area).
[92] Model Contract for Oil and Gas (Decree 108 of 17 January 1997) and Model Contract of 31 July 2001.

the parties for violating the provisions of the contract. Provisions for state monitoring for compliance are included as are clean-up obligations.

Legal development continues and the overall framework for stability of contracts is now framed by the 2005 PSA Law. The general principle established in the PSA Law is that contract provisions remain in effect for their entire term. Amendments may be introduced only by agreement of the parties. If, during the PSA term, there are any legislative changes "that worsen or improve the commercial results of the contractor's activity under the PSA, then amendments are to be introduced to give the contractor the commercial results it could have received under the legislation in effect at the time the PSA was signed. However, there is no provision for stabilisation by indemnity in case full compensatory amendments cannot be agreed. There is also an exemption for changes in the law that concern environmental protection or safety. Elsewhere in the law, there are guarantees of contractor's rights such as protection form acts of the executive branch and local government acts that would restrict PSA rights. But, there are express and indirect exemptions to this: expressly, for lawful acts in the areas of environment, safety, health and social and national security; indirectly, by the possible application of certain special Civil Code rules that could allow termination initiated by one party; also, in the event of the PSA development period renewal beyond the original term.

There are a number of termination risks but it is worth noting that PSAs have a civil law character, and so they are subject to the Civil Code grounds and procedures for contract termination as well as the provisions of the PSA law. In contrast to Russia, provisions of international treaties to which Kazakhstan is a party prevail over any inconsistent provisions in the domestic law.

5.4 Designing Solutions

During the past 10-15 years it appears that some mechanisms for the promotion of environmental protection have been introduced into standard forms of petroleum contract with very little controversy or litigation. Examples include the now common use of environmental impact assessments and planning mechanisms for decommissioning of petroleum installations and structures. It is more difficult to identify published evidence that would support the claim that these instruments have been introduced into existing agreements without triggering any implications for stabilisation arrangements in those agreements. However, informal discussions with industry and government personnel seem to support the view that acceptance of changes has been possible after consultations and compromise so that any economic consequences for the petroleum agreement are managed in a way that is fair to the investor and host government. The progress made in this area suggests that a pragmatic, conflict-free approach to the adaptation of petroleum agreements in future years is a real possibility.

In the BTC pipeline project the parties decided to make specific references to the kind of standards that they deemed appropriate. In an Appendix to the HGAs, there is a Code of Practice on Environmental and Social Issues (Appendix 5). On environmental matters it includes a stabilisation provision in Clause 3.3. Wisely, it is directed at "any regional or intergovernmental authority having jurisdiction" and states that if it enacts or promulgates environmental standards relating to areas where pipeline activities occur, the project parties and the Government of the respective host country are to confer on the possible impact of this measure. It adds: "in no event shall the project be subject to any such standards to the extent that they are different from or more stringent than the standards and practices generally operating in the international petroleum pipeline industry for comparable projects". In the same Code, there is an almost identical provision in Clause 4.2 that has the same stabilising intention with respect to "social regulations or guidelines".

One issue that arises from the greater weight given to this subject is the priority given to environment in relation to safety and health and other similar objectives. The State of Qatar provides an illustration as to how this might be addressed in a contract concluded in 2001. The contractor is required to act at all times according to the `internationally accepted petroleum industry practices prevailing at the time'. It is to do so to minimise any adverse impact to the general environment. The agreement then adds: "The order of priority for actions shall be (i) the protection of life; (ii) environment, and (iii) property"[93].

5.5 Benchmarking

There is a procedural difference between amendment of a fiscal element or elements in a petroleum agreement and amendments that affect the 'exceptional' issues at issue here. There is of course the possible situation in which a host government will seek to amend the agreement's environmental provisions with a view to extracting additional revenue from the contractor. If there is evidence that this is the principal objective of the host government, then it could be addressed by the contractor as a breach of the agreement and the normal remedies would apply. However, where a host government is proposing in good faith to update or expand the environmental obligations of a contractor, it will have to make reference to developments in the `global market' for environmental regulation: that is, to specific changes in international standards, regional conventions, or industry standards, that require the injection of new content into its national legal framework. An example, from the field of decommissioning of petroleum installations and structures would be the IMO Guidelines and Standards or the OSPAR Convention Decision 98/3. This need for `international referencing' is made more complex (than say referring to an internationally set oil price) by the fact that there is no single source of environmental standards relevant to petroleum operations. In most cases, the host government has a freedom to choose which standards to adopt and whether to treat them as a minimum or not.

This procedural difference is complicated by the fact that it may not be the government that is the principal mover for such international referencing. The investor may take the initiative because it has an interest in creating as much stability as possible in the performance of the contract. Given the highly uncertain character of

[93] Development & Production Sharing dated 23 December 2001 for Dolphin Contract Location, North Field between Qatar & Offset Investments Company Limited & TotalFinaElf E&P Dolphin, Arts 9.1 and 11.1.

international environmental rules, guidelines and standards, and above all, their unsettled or developmental aspect, an attempt by the investor to secure agreement on standards that might prevail for many years would be understandable. It has been a feature in negotiations with several of the larger western companies in recent years. An agreement on an international frame of reference has the advantage that it is more likely to survive a change of government in the host country.

In this attempt at securing an international footing for environmental standards, the investor may have the support of the state petroleum company, which may be the principal interlocutor in this respect, and may also be an international investor. This may facilitate discussion of another important element in the discussions: how to meet any additional cost of a transition to a new set of environmental standards. That said, the possibility that a change in standards may lead to increased costs is one that will inevitably encourage the investor to try to limit the host government’s freedom to make future changes in this respect.

On this matter of potential costs, some sense of perspective is advised however, since the costs are unlikely to reach levels that they might in the hard rock mining industry, although with respect to oil pipelines they might be significant. This suggests that this is an area that is likely to be manageable if approached in a spirit of good faith by the parties and if it involves consultation and negotiations with a view to reaching a fair and reasonable outcome.

To make progress on this issue, the effectiveness of the means will be influenced by the stage at which they are introduced. If the discussions take place before a contract is signed, it will be a less sensitive topic than if an agreement has already been concluded and is in operation. However, the kind of wording that is evident from the sample of contract provisions given in section 3, shows that this provides little security for the investor. There may in practice be little difference between the stages at which the issue of new environmental standards is raised.

In terms of means, it seems important to try to eliminate any impression of arbitrariness and to provide the investor with as much certainty as possible at an early stage. One way of proceeding would be to try to establish some benchmarks with which to assess the adequacy of the standards referred to in the agreement. These might include: international conventions and other international law instruments; improved scientific knowledge as evidenced in various published reports, and the various industry standards. These could be prioritised. Above all, they would act as reference points for the host government and the contractor/investor. There would also have to be a notification mechanism, in which the government would signal to the investor that it considers a modification of the existing environmental standards to be necessary within an agreed time frame. This would allow the investor to factor in a potential change to its business calculations well in advance of any action being required. It would avoid any unilateral action, with the inevitable risk of litigation or other legal proceedings arising from the contract. There would also be little risk of such a procedure being used by a host government as an excuse for removing the contractor from the project.

5.6 Standards and Liability

There are many different forms of soft law international standards, guidelines, codes and recommendations that apply in the petroleum industry. Oil and gas companies have a plethora of operational guidance available to them from the API, the IP, EU, SPE, and so on. These are technical or professional or industry-wide standards rather than the incipient form of some global regulation. Moreover, these have only limited effect in any given instance, in which the soft law will be interpreted and applied in a specific way; in other words, the body of norms which is to be complied with is to be selected on a case by case basis. These are carried indirectly into a particular jurisdiction by filling out open-ended legal or contractual requirements to conduct petroleum operations at all times according to `good international petroleum industry practice’, or wording to similar effect. They do not have the full force of international law nor do all of the various standards enjoy a universal acceptance, not even in the international petroleum industry itself. These standards are also in a state of evolution and are periodically updated. Determining the standards that are relevant in a particular case may require an expert opinion.

In spite of the foregoing, many petroleum contracts continue to rely heavily on wording such as “internationally accepted petroleum industry standards”. There are many industry bodies that could be said to have authority for issuing standards, but none are likely to accept any liability for reliance upon Codes or guidelines that they issue on these matters. The Australian Petroleum Industry Association (APPEA) for example, specifically states in its Environmental Code of Practice that it accepts no liability for any reliance upon this Code to satisfy legal obligations. The Code would probably represent what is “generally accepted as good and safe” for a company seeking to rely on it as a defence against prosecution for a breach of obligations arising from the agreement’s provisions on conduct of petroleum operations. However, there would be no guarantee of this. The Code may also be open to criticism as out-of-date or insufficiently comprehensive.

A development of importance is the evidence that some host governments and investors are attempting to identify specific external sources of reference for benchmarking of evolving standards. This has figured most prominently in the legal arrangements made for the BTC pipeline. Clearly this approach has advantages for an investor in managing the risk that standards may be applied in future that are unreasonable and/or unfair. There is scope for discussion about how this linkage can be achieved in a particular case but reference to other countries that have similar circumstances and keep their standards abreast of technological improvements and environmental needs is surely a useful way of concretising this general wording.

There are also rules and principles to be found in voluntary codes and guidelines adopted by the international petroleum industry, usually through the main industry associations[94]. Most petroleum contracts make reference to standards of conduct such

[94] OGP (formerly the E & P Forum): “Principles for Impact Assessment: The Environmental and Social Dimension” (Report No. 2.74/265); “Decommissioning, Remediation, and Reclamation Guidelines for Onshore Exploration and Production Sites (Report No. 2.70/242); “Exploration and Production Waste Management Guidelines” (Report No.2.58/196), and “Oil Industry Operating

as Good Oilfield Practice or Best Pipeline Practice. This is not a new development in the international petroleum industry: for many years such standards have been taken by courts in the US to refer to clearly defined standards provided by respected industry bodies such as the American Petroleum Institute or the Energy Institute in the UK. This has helped to make such wording justiciable.

The bodies that are most active in this area are the petroleum industry associations, the OGP, the Energy Institute (UK) and the API. They have produced guidelines and codes of conduct that represent sources for the identification of `internationally acceptable operating practices', covering a wide variety of operations in different contexts[95]. Given their very wide membership comprising reputable companies, the outcome of their collective deliberations must be seen as exhibiting a high degree of professional consensus. The guidelines they produce do indeed have legal significance but not as legally binding rules. Their relevance is as points of reference – benchmarks even - that no judicial or mediating body could afford to ignore. They therefore have more than a highly persuasive character. On the other hand, there is no single set of guidelines or global Code of Practice that may be referred to, but rather a multiplicity of not always harmonious sets of norms and standards. This is relevant since an oil company may be a member of more than one association that has produced a set of guidelines, standards and Best Practices.

Of increasing importance are the standards adopted and promoted by the international financial institutions, and especially the World Bank Environmental and Safety Standards and Guidelines[96]. Since these institutions have provided finance and

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Guideline for Tropical Rainforests" (Report No. 2.49/170). Also: International Association of Geophysical Contractors: "Environmental Guidelines for Worldwide Geophysical Operations, 1994 and the International Petroleum Industry Environmental Conservation Association, which has a series of Best Practice papers available at www.ipieca.org, and the websites of the American Petroleum Institute (www.api.org) and the UK Offshore Operators Association (www.oilandgas.org.uk).

[95] See for example the discussion in `Key Questions in Managing Social Issues in Oil and Gas Projects', available on OGP website, and the references in Note 5 of this Report.

[96] The World Bank Group has produced various documents including OP 4.01 on Environmental Assessment, the Environmental Assessment Sourcebook and OP 4.20 on operating procedures concerning indigenous peoples. The International Finance Corporation (IFC) has published a Manual on Consultation available at www.ifc.org/enviro/. This follows closely the approach of the World Bank.

guarantees for a number of cross-border pipeline projects in developing countries, their insistence upon conduct in accordance with these standards is potentially of great importance[97]. The OECD (an international organisation but not a financial institution) adopted Guidelines for Multinational Enterprises in 2000 which allow members of the public to allege breaches of the Guidelines' recommendations before designated follow-up institutions. Chapter V of the Guidelines is directly aimed at the performance of enterprises in environmental areas. However, several of the recommendations go beyond this focus upon typical issues such as environmental management systems and risk prevention and mitigation. Enterprises are encouraged to engage in stakeholder communication and consultation and to contribute to this process by means of partnerships and initiatives that will enhance environmental awareness and protection[98].

It may be noted that there are at least three types of standards or guidelines that assist in protecting the environment. These are: standards for equipment and products (construction requirements for pipelines, for example); standards that address environmental practices, such as emissions limits, and a third type of standard that assists companies to improve environmental performance by adopting environmental management procedures and systems. In the latter group may be found best practices for environmental protection such as EIAs and SIAs, environmental management systems, environmental performance evaluation, environmental monitoring and auditing and environmental reporting[99].

5.7 Access to Justice

[97] In this context, mention should be made of the New Equator Principles based on World Bank and IFC standards, which promote a variety of goals in project lending such as the making of environmental and social assessments as standard practice.

[98] See some corporate responses in the various documents produced by the International Association for Impact Assessment: www.iaia.org

[99] A very comprehensive treatment of this is to be found in A S Warwyk, `Adoption of International Environmental Standards by Transnational Oil Companies: Reducing the Impact of Oil Operations in Emerging Economies', 20 Journal of Energy and Natural Resources Law (2002) 402-434.

With respect to the issue of access to justice, which might be considered a 'human right', the legal parameters of this are set by the provisions of the Aarhus Convention[100]. Members of the public may under Article 9(3) seek judicial review of acts which contravene environmental law. They may do so irrespective of whether the acts complained of transgress public participation rights endorsed in the treaty. In particular, the Convention provides that each State that is a party to the Convention:

> *"shall ensure that, where they meet the criteria, if any, laid down in its national law, members of the public have access to administrative or judicial procedures to challenge acts and omissions by private persons and public authorities which contravene provisions of its national law relating to the environment".*

However, the words which limit such acts to those that `meet the criteria, if any, laid down in its national law' are significant. They provide a great deal of discretion to States Parties as to implementation by allowing the public access only in certain circumstances.

The provisions of Article 9(2) are narrower and address the issue of standing in relation to the review of the public participation provisions in Article 6 of the Convention, as well as other relevant provisions of the Treaty. This provision also suffers from some weaknesses. The State has to ensure that within the framework of national legislation the members of the public have sufficient interest or have access to a review procedure before a court of law and/or another independent or impartial body established by law to challenge the substantive and procedural legality of any decision. However, "what constitutes a sufficient interest and impairment of a right shall be determined in accordance with the requirements of national law and consistently with the objective of giving the public concerned wide access to justice within the scope of the Convention". The interest of an NGO falls within this

[100] Convention on Access to Information, Public Participation in Decision-Making and Access to Justice in Environmental Matters, done at Aarhus, Denmark, on 25 June 1998. Annex I contains a List of Activities which includes pipelines for the transport of gas, oil or chemicals and installations for the storage of petroleum, petrochemical or chemical products.

provision. However, the requirements to guarantee access to justice appear to leave the signatories a considerable degree of control over the procedural conditions under which such access is provided. The rights of access to justice guaranteed by Article 9(2) are in any case less explicit in relation to the participatory rights granted under Article 6 than the rights granted under the other pillars of the Convention (access to information, public participation in decision-making). Moreover, they do not extend to the enforcement of participatory rights guaranteed in relation to the preparation of plans and programmes.

It is striking that so far there appears to be little that is relevant to this issue in the provisions of any petroleum contracts reviewed in the course of this study. This may be explained by the early stage which the international law on this subject is. It may also be that in this area the issues are not considered to be pressing in most countries. However, if so, this situation is unlikely to remain for long.

The hard international law is to be found in international environmental treaties, such as the Aarhus[101] and Espoo[102] Conventions but also in regional agreements such as the EC Environmental Impact Assessment Directive 85/337/EEC, as amended by Directive 97/11/EC and Directive 2003/35/EC. Other international conventions may also be relevant, as well as soft instruments such as Declarations[103]. Currently, there are 40 signatories and 30 parties to the Aarhus Convention including Azerbaijan, Georgia, the European Community and the UK. Initially, the practical implications of such treaties are often unclear. Ratification is the beginning of a process; implementation, especially in the poorer developing countries, is likely to be uneven.

[101] Aarhus Convention, points 14 and 18 respectively.
[102] Convention on Environmental Impact Assessment in a Transboundary Context, done at Espoo, Finland, on 25 February 1991.
[103] A list of the relevant conventions and declarations would include the following: the Stockholm Declaration 1972; the UN Convention on the Law of the Sea 1982; the Vienna Convention for the Protection of the Ozone Layer 1985; the Montreal Protocol on substances that delete the Ozone Layer 1987; the Convention on the Control of Trans-Boundary Movements of Hazardous Wastes and their Disposal (Basel Convention 1989); Rio Declaration on the Environment and Development 1992; UN Framework Convention on Climate Change 1992; the Convention on Biological Diversity 1992; the UNFCC Kyoto Protocol 1997. Note also ILO Convention No 169, which stipulates inter alia that indigenous people shall be consulted, their environment shall be protected and their rights to natural resources pertaining to their lands shall be safeguarded when undertaking any extractive industry related project (Arts 6, 7.4 and 15 respectively).

That said, the principles articulated in the Aarhus Convention on access to information, public participation and access to justice have been widely adopted in international forums and are acting as benchmarks against which many organisations assess their performance in these areas[104]. Its relevance to the design and negotiation of petroleum contracts justifies some brief consideration of its main provisions.

The Aarhus Convention requires States Parties to guarantee the rights of access to information, public participation in decision-making, and access to justice in environmental matters (Art 1). It links environmental rights with human rights and establishes that sustainable development can only be achieved through the involvement of all of the stakeholders. The main thrust of the Convention is directed at public authorities at all levels and bodies performing public administrative functions (although it does this via the States Parties to the Convention, not directly to the citizens and other stakeholders). Procedural requirements are included for public participation in decisions for specific activities. In the Annex listing the activities, item 14 refers to large-scale pipelines for the transport of gas and oil and item 18 refers to large installations for the storage of oil and gas. For enforcement of environmental law actions may be initiated by members of the public, whose standing is to be determined at the national level. In the context of this review, Article 9 on access to justice is of particular importance. Each party shall ensure that any person who considers that his or her request for information has been ignored or wrongfully refused or inadequately answered has access to a review procedure before a court of law or another independent and impartial body established by law. Each party has to ensure that members of the public concerned have access to a review procedure before a court of law to challenge the substantive and procedural legality of any decision, act or omission. To further the effectiveness of Article 9, each party shall consider the establishment of assistance mechanisms to remove or reduce financial and other barriers to access to justice. The parties are expected to take action within the framework of their national legislation.

[104] See the survey in the UN ECE document on this: 12 September 2002, UN website GE.02-32477.

The seven standards set out in the Aarhus Convention for access to justice are as follows:

1. Access to justice to be available for any person within the limits of the Convention means access to judicial or other independent and impartial review in an expeditious and affordable manner;
2. Review of the handling of information requests;
3. Review of the handling of public participation;
4. Review of acts and omissions of persons or public authorities concerning national law relating to the environment;
5. Minimum standards, including adequate and effective remedies, fairness, equity, timeliness and reasonable cost;
6. Decisions in writing and publicly accessible, and
7. Appropriate assistance mechanisms to remove or reduce financial and other barriers to access to justice.

Another relevant instrument of international law is the Espoo Convention on Environmental Impact Assessment in a Transboundary Context. Addressed to States, it obliges the parties to assess the environmental impact of certain activities and to notify and consult neighbouring states on all major projects under consideration that may have a significant adverse environmental impact across boundaries. In its Appendix, item 8 expressly refers to large diameter pipelines for the transport of oil and gas among the activities listed as falling within the scope of the Convention. Article 2.2 requires Parties to establish a national EIA procedure that permits public participation, but the Convention does not specify the detail of such procedure, regarding it as a matter for the national authorities to determine. Where signatories are also parties to the Aarhus Convention and the EU, the detail will have to comply with those provisions, including in the EU case, the EIA Directive 85/337/EEC, as amended.

5.8 Summary

It does not appear that, in a general sense, stabilisation mechanisms have been an obstacle to the process of developing more exact and enforceable environmental standards and access to justice. So far, their raison d'etre has been in very large part limited to concerns for economic and fiscal issues (and understandably so). The impact of stabilisation mechanisms in this area has yet to be felt.

Some investors and host governments are attempting to identify specific *external* sources of reference for benchmarking of evolving standards. This has figured prominently in the legal arrangements made for the BTC pipeline. Clearly this approach has advantages for an investor in managing the risk that standards may be applied in future that are unreasonable and/or unfair. There is scope for discussion about how this linkage can be achieved in a particular case but reference to other countries that have similar circumstances and keep their standards abreast of technological improvements and environmental needs is surely a useful way of concretising this general wording.

In the example of the BTC agreement, both general industry standards and international law are applicable but the curious feature of this agreement is the extent to which the host government has given up its claim to be the principal source of authority on environmental matters falling within its own territory. The approach adopted by the investors has been to persuade the host government to accept a standard of good international petroleum industry practice. This is not unusual but it was supplemented in this case by reference to the environmental standards applied to similar pipelines in two EU Member States, with similar, challenging geographical features (mountains, coastline). The justification for this is that the two countries could be expected over time to keep their standards abreast of technological improvements and environmental needs; that the standards applicable to these pipelines were in this way more readily identifiable and that the reference countries had a track record of effective, realistic environmental regulation which balances environmental goals with a recognition that solutions need to be cost effective.

Part 4: Conclusions and Recommendations

Chapter 6: Tools for Oil and Gas Investors

6.1 Conclusions

- 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;

- A significant number of countries, especially (but not only) those with proven petroleum reserves, do not feel the need to offer stabilisation provisions to attract investors;

- Many stabilisation provisions are likely to be subject to two limitations: the constraints imposed by the wider legal and constitutional framework on the guarantees provided in the petroleum contract, and any exceptions required for non-fiscal matters.

- The risks of unilateral action by host governments remain as significant for investors today as ever before and are evident among a wide range of governments. For that reason the provision of a stabilisation clause holds out the prospect of additional security. However, an over-eager willingness on the part of host governments to offer such security may spring more from a policy of investment promotion rather than a full appreciation of the commitment that is being made. In this respect, investors would be wise to take extra care with the design of mechanisms for possible use in enforcement at a later date.

- Host governments have a wide range of instruments at their disposal for the introduction of unilateral measures. It should also be noted that other powers deriving from the petroleum law regime will usually offer the government opportunities to persuade the investor of its case or to strike a compromise arrangement.

- The risks to the host government itself of taking unilateral action (such as the damage to its reputation as an investment location) offer potential solutions. Negotiation about the differences generating a proposed unilateral action should be enhanced by an awareness of these possible consequences.

- 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 <u>results</u> of a possible unilateral revision in the petroleum contract and which adapt the wording of the stabilisation mechanism accordingly.

- A number of countries still provide for stability in the form of 'freezing' obligations in the contract. However, given the high risk of unilateral action at some future date this is in itself a highly unreliable mechanism. Perhaps in recognition of this, the long-term trend has unmistakeably been one in which economic balancing has been favoured, often involving negotiations between the parties about the result.

- An open-ended approach to negotiated economic balancing however is also a high risk strategy. It should be complemented by details and penalties for non-compliance: imposition of time limits on negotiations, recognition that compensation must follow a loss or damage and recourse to arbitration if the negotiations fail.

- In a number of cases the NOC will play a central role in fiscal stabilisation. It may provide for adjustment by paying any additional taxes out of its share of profit petroleum or royalty under a PSA or it may reimburse the IOC directly out of general revenues. Under a rate of return system, the NOC could pay from its share of royalty and/or excess profits tax. However, the NOC share of production may prove insufficient or it may be pre-sold.

- The object of an economic balancing provision is not to address an act of expropriation by the host government but other approaches to stabilisation do take this into account. A more difficult area is the impact of an act of ‘creeping expropriation’.

- States *can* revise contracts unilaterally. The real issue in designing the appropriate stabilisation mechanisms is not so much *whether* the host government can unilaterally change the contractual relationship but rather what is the result of such legislative action for the investor in terms of lump sum damages or possible specific performance of stabilisation mechanisms.

- The growing interest in cross-border pipeline projects is generating new approaches to stabilisation involving a more complex set of legal arrangements. It is too early to say whether such arrangements are as effective as they are innovative in their approaches to fiscal stability.

- The classical arbitration awards largely relate to a form of stabilisation and a kind of ‘event’ that are at best marginal today. A whole-scale attempt to freeze the provisions of a contract over long periods of time is unusual, as are explicit attempts at full-scale expropriation.

- The more recent awards concerning indirect expropriation are potentially relevant in connection with the imposition of fiscal obligations that alter the economic balance struck between the parties at the time that the contract became effective. There appear to be no published awards dealing with stabilisation provisions of the modern variety, which are sometimes no more than ‘agreements to agree’. However, the awards made in cases of alleged indirect expropriation offer only small comfort to investors. Each case has to be analysed in the light of its particular facts, but the general conclusion is that expropriation claims are unlikely to be accepted as a basis for compensation.

- Another conclusion is that a finding in favour of the investor on the basis of unfair and inequitable treatment may have greater chances of success than one based on indirect expropriation. However, the law is in a state of flux in this area so much will depend on the context of the particular case brought before the tribunal.

- There are obvious limitations on the relevance of the more recent awards since they involve the consideration of the implications of stabilisation clauses by analogy. Some of the modern stabilisation clauses are more than agreements to agree and contain elements that stipulate outcomes if the parties fail to agree and rights for IOCs to refer the matter to arbitration if negotiations fail. These offer improved prospects of a remedy in the form of compensation at least.

- The role of due diligence in facilitating the enforcement of a stabilisation clause has been emphasised. Some government measures that impose fiscal obligations may be rooted in changes to practice rather than overt legislative adoption of new measures. Evidence of having carried out due diligence will be important in taking a case to arbitration.

- A new generation of risks is arising for investors in the petroleum sector as a result of changing attitudes to environmental issues. To a limited extent this is reflected in the body of international law that is now emerging to address such concerns and in the provisions of petroleum contracts over the past 10-15 years. However, in order to provide investors with the continued stability they seek a review of the traditional definitions of standards such as Good Oilfield Practice is required. In particular, efforts should be made at developing an industry-wide code that host governments could refer to in future agreements and which could be enforced.

- A benchmarking approach to the design of industry standards seems likely to capture the balance between flexibility and certainty that companies and host governments will need to recognise in designing provisions. However, this would have to be accompanied by clear provisions on how the cost of any such amendments is to be met and by whom.

6.2 Tools for Oil & Gas Investors

- As a tool for stabilisation the classical approach of freezing is not recommended given the difficulties in enforcing it in arbitration in current circumstances. It is much more in line with the trend of arbitral awards **to design a stabilisation clause that provides for specific actions to be triggered as a result of a unilateral alteration in the economic equilibrium.** In this sense, the approach of ‘negotiated economic balancing’, which amounts essentially to an agreement to agree, appears an unsatisfactory choice, precisely because of its lack of provision for specific actions. However, a stipulated result in the event that the parties do not agree and an express right granted to the investor to take the issue to arbitration would be important elements to include.

- The economic balancing provision is one that has several forms but all of them have a weakness with respect to the NOC or host government share of profit petroleum which may be used up at a time to recourse. The more secure approach is to require the NOC to pay for any increased fiscal obligation or obligations and to have the host government act as guarantor for this.

- Care should be taken to examine the potential role of BITs in providing additional support for a stabilisation clause in a particular context. Where international law is not provided as the governing law in the event of a dispute, the application of a BIT (and possibly a multilateral investment treaty) might provide this key element, greatly increasing the prospects not only for arbitration in the event of a dispute but also for enforcement of the contract and the award of damages. This would only apply if a stabilisation provision existed in the petroleum contract in the first place.

- As the review of cases in Chapter 4 has shown, ICSID is becoming an important forum for state-investor disputes in expropriation matters. While caution should be exercised with respect to its jurisdictional requirements, it remains a highly attractive form of dispute resolution and enforcement.

- Provision for damages in the event of unilateral action should be expressly provided for in the petroleum contract. The obligation of the host government to pay monetary compensation should be accompanied by detail on the kind of monetary remedies that are appropriate: a stipulated quantum of money damages; restitution, reimbursement and indemnification.

- The proper design of protections for the investor in the event of unilateral alteration of the economic equilibrium should be seen as enhancing the investor's position in the first stage of discussions or negotiations with the host government. It may persuade the host government to address the issue without any recourse to arbitration.

- A full and comprehensive documentation of due diligence may appear to be obvious to a prudent investor but at a later stage such documentation could prove to be decisive in determining whether the investor has a case or not.

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