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Stabilization Clauses in Petroleum Agreements: Limitations and Legal Implications of a Breach

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Abstract: ***State participation in petroleum exploration usually results in contractual agreements between the governments and International Oil Companies (IOCs). The bargaining powers between these are not of equal because the host states reserve the right over their natural resources even in the presence of any contractual provisions. This is recognized and endorsed international law under prescribed conditions put the states at the higher of the bargaining powers and the exercise of state sovereignty. Based on the imbalance of bargaining powers between the contracting parties. The IOCs normally anticipate possibility of unilateral change or untimely termination of investments contracts by the host state through the use of its legislative powers. As an antidote to such unilateral actions of the host governments, foreign investors and for that matter IOCs employ stabilization clauses to indemnify their investments. This paper seeks to explain petroleum agreements, indemnify stabilization clause, the types, limitations and legal implications of a breach of the stabilization clauses.***

List of Abbreviations

NOCs– NATIONAL OIL COMPANIES
OPEC - ORGANISATION OF PETROLEUM EXPORTING COUNTRIES
FID - FOREIGN DIRECT INVESTMENT
IEIs - INTENATIONAL ENERGY INVESTMENTS
MDA - MINISTRIES, DEPARTMENTS & AGENCIES
PSAs - PRODUCTION SHARING AGREEMENTS
PSCs - PRODUCTION SHARING CONTRACTS
SA - SERVICE AGREEMENTS
NGOs - NON - GOVERNMENTAL ORGANIZATIONS
WAGP - WEST AFRICAN GAS PIPELINE

1. Introduction

According to Stanislaw (2009) National Oil Companies (NOCs) controlled a larger proportion of world energy resources today as opposed 1978 where major International Oil Companies (IOCs) were controlling 70% of these resources. The turn of events, according to Stanislaw, (2009) has significantly affected the relations that existed between states International Oil Companies (NOCs). It is also indicated that the present - day's resource nationalism, led by Russia including Organization of Petroleum Exporting Countries (OPEC) usually tend to use their control over natural resources to enhance policy goals, particularly in the arena of economic development and foreign policies.

Further, the intensity of natural resource nationalism and increase global search for energy are compelling many resource rich countries to give a second to their contractual relationships with the International oil companies. in the face of resource nationalism, these countries, especially developing countries are stepping up strategies in order to be more attractive for Foreign Direct Investment [1] (FDI). In order to be attractive, many developing countries have resorted to legal arrangement which they think are basic in international business transactions. Such legal arrangements spelt out the provisos and conditions of foreign investments as well as the modalities of how cost and benefits should be shared among the contractual parties – that is the host state and the foreign investor.

Since host states can use their resources as economic, political and policy 'tools' and investors therefore, rely on legal arrangements such stabilization clauses to ensure the security of their investments – that is the security of their assets, entitlements including the stability of legal framework guiding their overall operations. International Energy Investments (IEIs) being capital intensive, investors are usually critical about the viability of the investment so as to recuperate a good capital return. They are also wary of the subservient nature of the investment to administrative, legal and regulatory actions of the host states governments which may hamper the investment viability or expropriation of assets. This brings into mind the different objectives that may exist between the contracting parties – the host states and the investors. The motives of the international energy investors are usually profit maximization at the lowest risk possible, liberty in their operations as well as management gaining good returns investment capital[2]. These motives may further include unlimited restrictions in remitting the start - up investments and any other benefits that can be accrued. However, the host states may entirely different interest in such investment's agreements. The prime interest of host states is to use the such investments to develop their energy resources, so as to make their economies viable and at the same time uplift the social and living conditions of the populates. To curb such potential investments' risks in terms of political, legislative, regulatory and fiscal, legal arrangements are provided for by international law [3]. Furthermore, under such contractual agreements are found stabilization clauses and the intent is to institute measures of non - state interference with the operations of the investment.

The objective of this paper is to identify stabilization clauses, types, intended purposes, and to evaluate the

[1] Cotulla, L. Regulatory Taking, Stabilization Clauses and Sustainable Development: The Policy Framework for Investment: Social & environmental Dimensions, OECD Global Forum on International Investment VII, (2008)

[2] Elkan, M. (2011, p.42 – 43), International Investment Law: Stability through Contractual Clauses

[3] Maniruzzaman, A.F.M., Drafting Stabilization Clauses in International Energy Contracts: Some Pitfalls for the Unwary, Oil, Gas & Energy Intelligence, Vol. 5 – issue No. 2 (2007)

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limitations and legal implications in terms of a breach. The relevance of the paper provided basic understanding of stabilization clauses and answered the question on why host states and investors employ stabilization clauses in contractual petroleum agreements.

2. Synopsis of Petroleum Agreements

States reserves the sovereign rights over their natural resources as well as the onus for sustainability and regulation of petroleum operations. This is strongly buttressed by the 1958 convention on continental shelf[4]. It is usually not uncommon for one to trace the legal basis of petroleum exploration and production activities to the state constitution. As a result, several rules and regulations have been designed to deal with the obligations of the host governments and private investors.

These legal regimes of petroleum and production can be classified into three – namely Production sharing, risk service and tax royalty, otherwise known as license or modern concession [5] but there may exist a defuse type agreement (hybrid). These concepts may exist under different legal regimes instituted by the host governments and also in terms of the level of control, ownership rights and mode of compensation [6]. The Production Sharing Contracts or Agreement is entered into by either one or more foreign investor (s) with the host state government or party where the government may be represented by a relevant Ministry, Department or Agency (MDA).

Under the PSA/PSC, the oil investor company or consortium is accorded the rights to search for and produce petroleum within a specific are for a limited period of time. As the name suggested, proceeds are divided among parties under the agreement in accordance with the laws. One notable factor under the PSA/PSC is that ownership of the investor or company over the petroleum resources is limited to the share of the total production with delivery taking effect at the point of export[7].

On the other hand, the risk Service Agreement (SA) portrays situation where the state hires the contractor to execute an exploration and production service within a specific location and within a stipulated time period. However, the hired contractor in return of the service delivered is compensated in a form of fees which can either be fixed or varied but the ownership over the resources is still vested in the state[8]

In another development, concessions as explained by the World Bank Group (2009) report, bestowed a complete incense rights to a qualify contractor to explore for and produce petroleum within a specific area a long period of time. This accord the contractor a certain amount of control over reserve and management of operational activities aside of these variations, they can be employed to achieve the same mission. One would notice that in all the agreements the level of control over the petroleum resources is tilted in favor of the state except in the case of concession where the contractor has some amount of control over reserves but only limited to a particular area and also by a reasonable period. In the agreements, it is observed again the company or the investor provides for the entire financial and technical services except in the PSA/PSC where the host state may participate to share the cost of field development activities. Petroleum exploration and production activities being characterized by long - term investment and capital intensive, give the understanding of why investors or companies usually push for stabilizing such contracts especially in countries that characterized by political, legal, and geological risk. It is the same case that states absolute control over natural resources put fears of investors concerning nationalization and expropriation by governments of the host states, hence, the need for protection of the investment.

3. Stabilization Clauses and the Intended Purposes

International Finance Corporation, (2008) report on stabilization clauses and human rights referred to stabilization clauses as clauses found in private contracts between investors and the host states that address changes in law and the host states during the life of a project [9]. Furthermore, from the investor point of view, stabilization clauses are considered as risk - mitigation tools used to safeguard foreign investment against arbitral actions or sovereign - risk like nationalization, expropriation or obsolescence bargain which the host state government can employ to effect changes in the initial contract terms to the detriment of the investor. Stabilization clauses usually seek to safeguard the project against environmental and social legislation[10]. However, environmental and socio - economic impacts of projects, particularly, within the oil and gas industry is a major concern for the international community, national governments, Non - Governmental Organizations (NGOs) and the industry itself. This seriously challenged the validity of the stabilization clauses in petroleum agreements.

However, Professor Cameron traced the beginning of stabilization clauses in the petroleum agreements to the 1930s and commonly practiced in many parts of the globe. Cameron indicated that stabilization clauses provide platform where parties to an energy investment agreement endeavor to bestow contractual assurance the contract provisions remains unchanged, sting from the date of signing the contract and through the entire life of the project. The motivation is for parties to guarantee the economic terms and implementation of the project [11]. Stabilization

[4] Tardo et al, Countries Experience with the Allocation of petroleum Exploration and Production Rights: Strategies and Design issues, The World Bank Group (2009)
[5] Cameron, P.D., (2010, p.36) International Energy Investment Law: The Pursuit of Stability
[6] Supra note 4
[7] ibid
[8] ibid

[9] Ruggic, Stabilization Clauses and Human Rights: A Research Project conducted for IFC and the United Nations Special Representative to the Secretary-General on Business and Human Rights, (2008) World bank Group
[10] ibid
[11] Supra note 5, Cameron tried to defined Stabilization clauses in the International Energy investment contract perspective. He

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clauses are considered necessary for long - term contracts because they are usually directed towards the prevention of legislative interference in the implementation of the contract.

In the nutshell, they are instituted with the intention to protect petroleum investment projects against political risk, guarantee legal certainty and for government to attract foreign investment. The availability of legal protection of the investment against political risk in host countries' law is an important factor in determining the location of capital intensive and long - term projects[12]. One cardinal principle of the legal system is that the law must be certain and predictable. These two features of any legal system are very important in the determination of the rights and positions of the parties in long - term petroleum investment agreements. In addition, certainty of the support's efficiency in commercial and investment operations. Consequently, the inclusion of stabilization clauses in petroleum agreements by the host states is to attract foreign investment and to give a boost to the psychological confidence of investors[13].

Furthermore, it is important to indicate that not all petroleum resource rich - countries subscribed to stabilization of contracts' agreements. Some example includes the United Kingdom and Norway. Despite, that these countries do not subscribed to stabilization of petroleum resource development contracts, International Oil Companies (IOCs) find it convenient to operate in these countries. The main reason is that the political and legal risk in these countries are minimal. On the contrary, these companies may also choose to operate in natural resource rich - countries that may be characterized by legal and political risk on the condition that the geological risk in these countries is also low. Saudi Arabia and Brazil are classical examples of such countries[14]. It is therefore, important to note that the choice and motive of location for investment by IOCs may greatly be influenced the aforementioned factors as well as profit maximization.

3.1 Types of Stabilization Clauses

The types of stabilization clauses are the end products of the negotiating process and the level of strength of each of the contracting parties, thus reflect the balancing of their divergence interests. Based on these on these divergence interests, Stabilization clauses can be classified into three main categories - namely, freezing, intangible clause and economic stabilization clauses[15].

3.1.1 Stabilization Clauses Stricto Sensu

Stabilization clauses in the strict sense (stricto sensu) seeks to make sure that the applicable law contained in petroleum agreement do no vary during the life span of the investment projects. It is more traditional in approach and strives to impose a complete frustration on the legislative competence of the host countries. This then give birth to freezing stabilization ice up the applicable national laws to the contracts from the date the contract takes effect and throughout the entire period of the project implementation. In effect, any further legislation opposing the original provisions is not applicable to the contract[16]. This implies that there shall be no conflict between the provisions of any new legislation and those of the contract and in the event that it does happen the provisions as contained in the contract shall prevail over those over the new legislation, thus suggesting consistency in the contract provisions. However, when the new regulatory change affects the investments the government is obliged to make compensation to the investor under circumstance. This, therefore, makes the host state legislative power in relation to the contract ineffective. An example of this clause was contained in the concession agreement between the state of Iran and the Anglo Iranian Oil Company[17].

*"*The concession shall not be annulled by government and the terms herein contained shall not be altered either by general or special legislation in the future or by legislative measure or any other acts whatever of executive authority*"*

3.1.2 Intangible Clauses

Intangible clauses usually express the fact that the contract will not be change or terminated without the agreement of all the parties. It simply commits governments not to nationalize the concerned investments. These types of clauses are commonly used in many petroleum agreements because it does not curtail the legislative dominion of the host state. It is only intended to prevent the host state governments from the exercise of arbitrary administrative power to vary the contract terms. The preambles to intangible clauses usually sound this way:

"The contract shall not be annulled, amended or modified in any respect, except by the mutual consent in writing of the parties hereto[18]".

Once again, Cameron indicated are advantageous in petroleum agreements in the sense that they provide procedural means negotiation among the parties about the

maintained that any definition of the term relates to all of the mechanisms that seek to protect contract life's span, the benefit of specific economic and legal which the parties deemed to be important at the time contract was concluded and signed

[12] Farauque, Validity and Efficiency of Stabilization clauses: Legal vs Functional Value, Journal of International Arbitration, (2006) – 317 - 336

[13] ibid

[14] Aboubacar, (2012) The Stabilization Clauses in the International Petroleum Investment Contracts, Conference Paper, Pan African Lawyers Union (PALU)-African Legal Support Facility (ALSF) joint workshop Kigali (Rwanda) & Yaoundé (Cameroon - published by ALSF May 2012

[15] Al-Faruque, A., Typologies, Efficiencies and Political Economy of Stabilization Clauses: A Critical Appraisal of Transnational Disputes Management, (2007), Vol. 4, Issue No.5

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[17] Erkan, M., (2011, p.104 -100), International Investment Law: Stability through contractual Clauses, Khwer, Law International BV Netherlands

[18] Supra note 12

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prospects of the agreement. Cameron gave a sample of such a clause as the agreement that was concluded between the government of Yemen and the foreign investor in 1992 which stated that:

The "contractor shall be solely governed by the provisions of the agreement and [the contract] may be altered or amended only by the mutual agreement of the parties[19]"

3.1.3 Economic Stabilization Clauses

Economic stabilization clauses otherwise known as economic equilibrium clauses is another type of clauses. Under such clauses, changes in the contract terms require parties to renegotiate in order to restore the initial economic balance of the investment. Aside renegotiation appropriate compensation is required from the host government in the case of regulatory changes. Such regulatory changes occurring may usually vary the economic terms and conditions of the contract within the investment life's span. The compensation can be in the form of adjusted tariffs, extension of concession, tax reduction, monetary terms and some others. When a situation like this occurs, all parties are bound to negotiate in good faith[20]. Also, failure for parties to negotiate can trigger arbitration. In contrast with freezing clauses which are usually targeted at frustrating the legislative capability of the host government, the economic stabilization clauses strive at stabilizing the economic prospects or balance of the investment. Examples of economic stabilization clauses feature very well in the West African Gas Pipeline (WAGP) agreement[21].

4. Legal Implications of a Breach of Stabiliztion Clauses

There is a continuous debate with respect to the legal implication for that legal effect of the violation of stabilization clauses. One school of thought is of the opinion that resource nationalism, in others words, expropriation, termination of or modification to the contract agreement are unlawful acts. The other school of thought has it that violation of stabilization is not to a breach of the contract, therefore, any act done as found in the contract may be lawful. However, both thoughts are grounded on the guarantee of a special significance attached to the presence of stabilization clauses in the contract document. In any case, the bottom line is that, upon the fulfillment of all interactions with respect to lawful expropriation or nationalization, where the state is said to have acted in the interest of the public, non - discriminatorily, pays sufficient damages and within due process of the law, then the expropriation or nationalism is considered lawful[22] and the vice versa.

However, the consequences of a breach of stabilization clauses are of a major concern to players in the oil and gas industry and have been tackled with all seriousness in some arbitral awards, despite that they merely addressed matters of expropriation. Payment of damages, in this regard, is manifested as the most important legal implication for a breach of contract provisions in the face of stabilization clauses. Besides, assessment of damages leading to payment may rest on a variety factors like cost sustained by the investor as the product of violation of the contract terms. Examples include costs arising as result of regulatory change in breach of a freezing clauses and restoration of economic equilibrium with respect to economic equilibrium clauses. The other factor is the legal expectation of the investor initiated by the presence of stabilization clauses as was evident and held by the arbitrators in the case of Liamco. In this particular case, the submission of the arbitrator indicated that when a contract is internationalized, the rights for the host state to nationalize the contract or investment are limited. It was therefore, improper for the Libyan government to nationalize the contract or the investment, hence, the need for the payment of the compensation for frustrating the intentions and expectations of the other contracting party[23]. The events that can trigger payment of compensation following a violation may depend the various clauses concern. In the case of freezing clauses, the state is liable for compensation when regulatory changes affect the invest while negative effects on the economic prospects of the investment can also trigger compensation payment on the part of economic equilibrium clauses.

Furthermore, the legality of these clauses find strength from the seriousness international arbitrators attached to them in terms in the case of a breach. It is clear that states and investors must always honor contractual commitment they have made. The legality of stabilization clause, however, came to test in the case entitled - Texacov Libya[24] in 1977. The Arbitrators in their ruling upheld that Stabilization clauses were valid and have legal effect under international law. Notably, most of the cases brought against Libya, the tribunals at separate conclusions indicated that the government of Libya did not stand up to its obligations and therefore, violated the provisions of the agreements. This was considered tantamount to nationalization in bad taste and required the government to pay compensation to the affected IOCs. In addition, it was also declared that states cannot rubbish the contractual obligations to foreign investors[25]. Also, provisions found in investments treaties and where states pledged their commitments to contractual agreements (umbrella clauses) in terms of fair treatment in business transactions with nationals of other states gave boost the legality of stabilization clauses.

In a nutshell, arbitration decisions do not point out to the fact that, if indeed the host state take an action that contravenes the stabilization clause it made commitment to, then the state must pay for damages suffered by the investor; but that is one side of the coin.

[19] Supra note 5
[20] Mamiruzzaman, Damages for Breach of Stabilization Clauses in the International Investment Law: Where do We Stand?, International Energy Journal and Tax Review, (2007), 246 -251, Issue No. 11 & 12
[21] Supra note 1
[22] Supra note 20
[23] Supra note 5
[24] Supra note 17
[25] Supra note 5

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5. Limitations of Stabilization Clauses

In spite of the fact stabilization clause are recognized legal and binding under international law, there still exist questions marks about their legality under domestic or national law, for that matter within the host state. They are legally challenged in two main areas. In the first place, stabilization clauses are handicapped by constitutional limitations. It usually required that all undertakings of the host state government must be consistent with the legal and constitutional provisions. A clear example is the case of the United Kingdom where it is not legally acceptable for the government to agreements that would act as a constraint on the ability of future government to raise taxes or enact laws[26].

In another development, international law recognized host state powers to expropriate in the interest of public interest, environmental, health and safety as well as human rights issues. As a result, host state legislative powers are limited by international obligations to recognize environmental, health and safety including human rights. In short, stabilization clauses are valid and legal but cannot over ride those of human rights and environmental standards under domestic and international law

6. Conclusion

Stabilization clauses are force to reckon with in many petroleum or investment agreements. The reason is that they remained to be the most reliable means of ensuring stability in long - term and capital - intensive contracts. In the eyes of the investors, they are considered effective and best choice as compared to legislative instruments. This is because modern stabilization clauses, particularly, the economic balancing and tangible clauses intend to promote negotiation and reconciliation process among contracting parties – in the case of when the terms and conditions of the contract are varied to the disadvantage of any of the parties. In spite of the gradual shift from traditional to modern stabilization clauses in a bid to make them flexible and suitable for contracting parties; the support drawn from international law and tribunals' awards, they are constitutionally challenged by domestic law or courts as well as superiority of public interest, environmental and human right issues. In summation, host governments are advised to study meticulously stabilization clauses usually included in petroleum agreements by taking into consideration the scope and structure of the contract and its provisions.

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