

## Stabilization and renegotiation clauses in international energy transactions

Aditya Gandotra

Assistant Lecturer, Jindal Global Law School, O.P. Jindal Global University, Haryana, India

### Abstract

Energy Contracts being long term contracts require that any change in law or circumstances of the host state shall not affect the commercial deal or status quo between the contracting parties. When a foreign legal entity enters into a contract with a state-owned entity, it invests substantial amount of money and resources. The state may unilaterally change its law to the detriment of the foreign party thereby jeopardizing the financial interest and legitimate business expectations of the foreign investing party.

Foreign investors, therefore, always aim for stable contractual relationship for the investment on the basis of legal regime in effect at the time the investment was made. For the promotion and protection of foreign investment in the negotiation of modern energy contracts, stabilization clauses figure prominently as contractual mechanisms.

This article will examine purpose, types, validity and enforceability of stabilization clauses and its relationship with applicable law.

**Keywords:** international energy arbitration, contract, stabilization clause, renegotiation clause, sovereignty human rights, umbrella clause, bilateral investment treaty

### 1. Introduction

During this century, petroleum <sup>[1]</sup> has been one of the most important commodities in the modern world, referred to as “critical to national strategies and crucial to international politics. As the modern petroleum industry emerged in developing countries, where ownership of petroleum almost universally belongs to state, international oil companies (IOCs) with necessary capital and expertise-controlled exploration and exploitation of petroleum. This situation has not changed substantially even though almost all petroleum producing countries today have state-owned oil companies. This reality therefore requires that the state and international oil company reach some agreement <sup>[2]</sup> about the development of those resources <sup>[3]</sup>.

One of the key features of energy contracts, whether they relate to exploration, energy production or are mere trade contracts such as petroleum supply, is that they are long-term contracts. The commercial deal or status quo between the parties to the contract may sometimes be frustrated due to changes in law or circumstances, which are sometimes inevitable. It is not easy for the parties to anticipate and provide for the consequences in the event of *all* possible changes <sup>[4]</sup>.

When a foreign legal entity is contracting with a state or a state-owned entity and invests a substantial amount of money and resources, there is an additional concern that the state may unilaterally change its law, to the detriment of the foreign party and its financial interest and legitimate business expectations. Such risks of legal changes by host state is categorized as ‘political risk’ and political risk include the risk of nationalization or expropriation, as well as indirect and creeping expropriation and regulatory changes depriving the foreign investor of the benefits reasonably to be expected from its investment <sup>[5]</sup>.

As risk-averse entities, foreign investors always aim for stable contractual relationship for the investment on the

basis of legal regime in effect at the time the investment was made. For the promotion and protection of foreign investment in the negotiation of modern petroleum contracts, stabilization clauses figure prominently as contractual mechanisms <sup>[6]</sup>.

Much academic debate has been generated regarding the efficacy and validity of stabilization clauses. This article will therefore examine the purpose and types of stabilization clauses and the levels on which stability can be ensured before critically examining the validity and enforceability of stabilization clauses. In determining the validity and enforceability of stabilization clauses, the article will explore the functional relationship between stabilization clauses and applicable law <sup>[7]</sup>. Concepts of permanent sovereignty over natural resources and protection of human rights and environment have also been examined critically in order to examine the validity and effectiveness of stabilization clauses.

### 2. Purpose of Stabilization Clauses

In international energy projects, the core objective for investor is to repatriate capital and obtain a return proportionate to the magnitude of its investment and risks. Whereas for the host state, main goal is to obtain its agreed share of revenue from the project alongwith other benefits such as job creation and industrial spin-off. For the investor, achievement of its objective is vulnerable to the effects of economic change of circumstances, an abrupt regime change or change in policy by a successor government as the term of any typical energy project will be much longer than term of office of the host state government that welcomed the investment and committed itself to the investor’s terms and conditions <sup>[8]</sup>.

The investors therefore require for their security, contractual guarantees such as ‘stabilization’ clauses intended to ensure stability of atleast the financial requirements especially

taxes, exchange controls and other important provisions that affect the investor's projected rate of return<sup>[9]</sup>. In international energy projects, commitment of considerable capital for a very long duration is required and these projects are exposed to various risks like commercial, political and geological risks<sup>[10]</sup>.

To invest in a resource-rich nation, an IOC conducts due diligence to review the tax, fiscal and legal regimes in the host nation and before massively investing to exploit oil and gas resources, the IOC is well aware of the risks. Once an investment is made, given the scale of its committed resources, the IOC cannot pull out in case a dispute arises and is essentially at mercy of host nation. On the other hand, host nations richly endowed with mineral resources which tend to be developing economies are prone to political and economic crises<sup>[11]</sup>.

As IOC explores and produces oil and gas on behalf of host country and the state entity-a National Oil Company (NOC) bearing all the risk, an IOC seeks reassurance that host nation continues to believe in the sanctity of the contract and the fiscal incentives offered to such IOC will outlive the contracting political leaders. Therefore, there is a requirement of stabilization clauses in international energy contracts<sup>[12]</sup>.

IOCs fear that a sovereign can unilaterally increase its government take by enacting new taxes upon a venture, by increasing present taxes or by forcing increased participation of its own NOC. In the light of length of contracts and the capital-intensive nature of ventures, private companies seek to reduce the risk of unilateral alteration of the contract<sup>[13]</sup>.

An important number of contracts include stabilization clauses in response to the possibility of modification of contractual rights by unilateral government action. The sole objective behind use of such clauses is to preclude the application of any subsequent administrative (regulatory) or legislative (statutory) act by the government to an agreement that modifies the legal situation of the investor<sup>[14]</sup>.

### 3. Types of Stabilization Clauses

In traditional or classical practice, there are five types of stabilization clauses:

- a. Stabilization clause *stricto sensu*: It intends to freeze governing law of contract, the fiscal regime and other necessary investment conditions. It provides that during the lifespan of the investment project, the governing law of contract will not change. In other words, the law of host state at the time of accomplishment of contract will be the law applicable to the contract thereby excluding application of subsequent changes in the host state's law<sup>[15]</sup>. This clause does not amount to waiver of state sovereignty to legislate; rather that subsequent legislation will not apply to contract. Therefore, if any conflict arises between new legislation and provisions of the agreement, the latter will prevail. Such clauses are in consistence with principle of non-retroactivity of laws<sup>[16]</sup>.
- b. Intangibility clause: It provides that for contracts to be modified or abrogated, mutual consent of contracting parties is required. This clause is widely used in petroleum contracts. These clauses also do not contain explicit waiver of legislative sovereignty but aim at preventing unilateral modifications of contract by host

state. The difference between stabilization clause *stricto sensu* and intangibility clause is that former intends to protect investors from host state legislative intervention in the contract through changes in applicable law or enactment of new legislation, whereas the latter safeguards investor from exorbitant powers of government trying to change contract terms unilaterally by acting as public authority<sup>[17]</sup>.

- c. Hybrid clause: Some contracts include both stabilization clause *stricto sensu* and intangibility clause. The idea behind such a clause is to make provision against destabilization and unilateral change in future<sup>[18]</sup>.
- d. Economic stabilization clause: As the state party to a contract cannot be completely restrained to exercise sovereign authority by virtue of classic stabilization clause, a modern technique recently developed helps respect this reality and at the same time protects the economic equilibrium of the contract. This technique is known as 'economic balancing provision' or 'economic stabilization clause'. It ensures the balance of the interests of concerned parties<sup>[19]</sup>.

This clause requires that host state will not take any administrative measure or enact any legislation having the effect of escalating the costs of project. If any subsequent legislation is passed having adverse effects on the foreign investor's rights, then the parties will consult each other to settle on the economic consequences of such a change and host state will restore the foreign investor's economic loss. Such clauses are compatible with notion of legislative freedom of state as they don't prevent enactment of subsequent legislation but aims at mitigating its adverse consequences on economic equilibrium of the contract<sup>[20]</sup>.

IOC's favour economic balancing provision because if State's unilateral acts adversely affect the contract, the available remedies could be more favourable than under freezing clauses. In contractual practice, freezing and economic balancing provisions are often employed together and sometimes individually. Where they are used together, economic balancing provision provides an additional layer of protection<sup>[21]</sup>.

A question arises as to the procedure for adjusting the terms of contract once an equilibrium clause is triggered. Three approaches can be adopted. One approach is to provide for an automatic adjustment. Second approach provides for leaving adjustment mechanism to mutual agreement of the parties. In some contracts where this approach is adopted, specific mechanism is not addressed and this issue is left out of the clause. Third approach provides for a period of negotiation to resolve the equilibrium and where a satisfactory resolution is not reached, such clauses provide for arbitration or expert determination<sup>[22]</sup>.

- e. Allocation of burden clause: If there is governmental intervention which introduces burden some provisions beyond the level prescribed in original agreement, then the state company contracting with international investor may be asked to carry such risk on behalf of investor. This clause is called 'allocation clause'. These clauses without challenging State's sovereign power provide contractual stability<sup>[23]</sup>.

This clause may look similar to a balancing clause that specifies the means of offset. However, no balancing is

implied and instead involves transferring additional burden on NOC if laws are changed. NOC will be required to take remedial action which may involve payment of additional tax or royalty from its own share of oil. There is a risk associated with this mechanism that share of NOC may be insufficient or may be pre-sold. Alternatively, it may be provided that NOC is required to pay additional tax or royalty irrespective of its source of funds. Also, foreign investor may be required to pay an additional amount required by new measure but will then be indemnified by NOC or the Government<sup>[24]</sup>.

f. Good faith clause: This clause requires that the contract shall be performed in 'good faith' or in 'good will'. Host states are required to abstain from unilaterally modifying or terminating the contract by exercising its legislative or administrative powers<sup>[25]</sup>. Even international law requires that host state performs its obligations in good faith<sup>[26]</sup>. The duty of good faith is itself a principle of general law and acts as basis for prohibition of unjust enrichment and of the rule that state entity cannot breach a contract on the pretext of change of law<sup>[27]</sup>.

#### 4. Stability on Different Levels

In order to mitigate political risks and to limit resulting economic loss international investors can use three legal techniques in their investment contracts which can be categorised as follows:

- a. Contractual support: Though investors, for the purpose of seeking stability of contract will choose law of host state as applicable law but international investors in an event of dispute remain doubtful about degree of protection that they will receive under domestic law of host state. The contract can be 'internationalized' by making a choice other than domestic law of host state or by including a clause that invokes principles and rules of international law and general principles of law<sup>[28]</sup>.
- b. Legislative support: There are two ways in which legislative support can be provided. Firstly, substantive provisions in certain legislative acts may be provided that set out more or less specific guarantees for the stabilization of a variety of investments. General legislation applicable to energy and foreign investment projects normally contain such provisions but as the value of energy and natural resources projects is high, a special legislative instrument may be used.

Secondly, for providing additional legal support to contractual instruments which have been negotiated by an investor and concerned department of state, conventional legislative procedures may be used. The investment agreement on submission to legislature for approval, if granted, will get force of law adopted by legislature of host state, a *lex specialis* having supremacy over other legislative acts<sup>[29]</sup>.

c. Treaty based support: In international investment instruments such as bilateral investment treaties (BITs), mechanisms for stabilization of an investment can be found. Two provisions in BITs that provide for stability of an investment are Umbrella clause and FET standard.

*Umbrella clause*: wording of umbrella clause in a BIT will normally be broad. For example in US-Ecuador BIT, the wording is 'Each party shall observe any obligation it may have entered into with regard to investments'. Now it can be interpreted to elevate every single contractual obligation entered into by state to status of treaty obligation or on the other hand, it may be restricted to mean any *treaty* obligation but that involves inferring a word not normally present in the text of BIT umbrella clause. Middle ground may mean distinguishing certain acts of state as commercial on one hand and sovereign acts on the other<sup>[30]</sup>.

The tribunal in respect to investment dispute arising under US-Argentina BIT concluded that it was limited to one 'resulting from violation of a commitment given by state as a sovereign state either through an agreement, an authorization or a BIT'<sup>[31]</sup>. This interpretation means umbrella clause covers additional investment protection contractually agreed by state as sovereign. Therefore, if there is prior agreement in form of stabilization clause, BIT provides additional level of protection<sup>[32]</sup>.

*FET standard*: This standard has potential of providing support for stability of an investment as it provides protection to legitimate expectations of an investor.

It may be well argued that inclusion of stabilization clause in contract creates

legitimate expectation that law will not be changed or if it is changed, a renegotiation will follow for restoring investor's original position. If the tribunals are to be persuaded that investor did have legitimate expectations, a stabilization clause shall be included in the agreement. This was emphasized in *El Paso* award<sup>[33]</sup>.

#### 5. Validity and Enforceability of Stabilization Clauses

Under international jurisprudence, stabilization clauses are valid and binding. However, it should not be hastily assumed that stabilization clauses are inherently valid and enforceable<sup>[34]</sup>.

##### a. Validity

Stabilization clause is valid and effective when it is contained in an agreement to which state is directly or indirectly a party. It should be signed by host state or a competent authority or by a state company. Where private parties agree among themselves that host state should not apply changes in its own law to the contract which has been signed, no purpose is served. Moreover, if the clause is not in conflict with any legislative or constitutional requirements, there is nothing that can stop a state from entering into a contract with stabilization clause<sup>[35]</sup>.

Choice of governing law in international energy investments is another key point for understanding the validity of stabilization clauses. As the interpretation of a stabilization clause in an international agreement can involve strands of arguments from international public law, national law and possibly an international *lex mercatoria*, the resulting issues are arguably some of the most complex in international business law<sup>[36]</sup>. Three situations may arise in regard to applicable law: first, national law may apply which is the general trend. Second, contract may be governed by international law, general principles of law, principles and practice of petroleum industry which is rare now. Third, contract may be governed by domestic law, with recourse where necessary to international law, or by both municipal law and international law<sup>[37]</sup>.

### National Law

Where host country's municipal law exclusively governs the contract, then stabilization clause in addition to being subjected to this law is also subjected to any future legislative changes. National law as governing law can be chosen as the only law or one of applicable laws by way of party autonomy. In case, host country's law exclusively governs the contract, 'constitutional and legal constraints on the capacity of state to enter into contract may have major legal implications on validity and enforcement of stabilization clause<sup>[38]</sup>.

Legal principles established in several nations have the effect of invalidating stabilization clauses and rendering them legally ineffective. For instance, American courts recognize permanent sovereignty as an inalienable right which cannot be waived. Also, under English law and other countries having adopted English common law as part of national law, state through contracts cannot be prevented from performing functions essential to its existence. Therefore, keeping in mind that legal concept of stabilization clauses is inherently problematic, its validity will depend on hierarchy of norms applicable in that state<sup>[39]</sup>.

It shall be borne in mind that a right which is given by sovereign authority might be taken by sovereign authority as nothing would prevent national legislature from retroactively cancelling and revoking rights awarded<sup>[40]</sup>. This raises a pertinent question as to whether granted stabilization guarantees can be invalidated subsequently. In such a scenario, protection of property rights against direct and indirect expropriation will become significant. International law standard for treatment of property of international investors would apply, whereby they should not be unjustly discriminated through taxation, exchange regulations etc. Moreover, their property shall not be taken by host state except for public purpose and without adequate compensation. Lastly, their property shall be treated by host state as it treats property of its own nationals<sup>[41]</sup>.

### International Law

When international law is the law applied to international investment agreements, the contract is "internationalized<sup>[42]</sup>" and renders the doctrine of sanctity of contract (*pacta sunt servanda*) applicable to agreement whereby any breach of contractual obligations by state engages the responsibility of state under international law<sup>[43]</sup>.

Even though international law provides external legal protection to relations and conflicts between host state and the international investor, it should be specifically chosen as it is not applicable by itself<sup>[44]</sup>. Where international law applies, stability of contract appears to be enhanced since state cannot amend these principles or laws (which also tend to evolve more slowly than municipal law).

This however is not guarantee of contractual stability because host state's regulatory and legislative competence and right to nationalize is well recognized in international law irrespective of guarantees contained in contract. Moreover, despite the contract being governed by international law, it is subject to overriding mandatory public law rules as a consequence of which state may interfere with contract when its vital interests are at stake<sup>[45]</sup>.

When nexus between international law and investment agreement is absent, host government may have little

enticement to honour the agreement especially when judicial system is weak and government is in a position to prevail in a dispute with IOC. Even if local courts appear to be independent, local laws may have been drafted poorly or local rules may give room to gamesmanship eventually thwarting an IOC's effort to litigate or arbitrate a dispute<sup>[46]</sup>.

Therefore, the question is if a contract contains a stabilization clause, is it solely governed by international law or by national and international law together. Internationalization of an IEA does not necessarily mean that it is governed solely by international law. Rather, it may be governed by local law except to the extent that its law is inconsistent with international law. In this way, there is nothing to prevent an International Energy Agreement (IEA) from being governed by more than one legal system<sup>[47]</sup>. Further, if the stabilization clause is not valid under law of host state, international law may not come to its rescue<sup>[48]</sup>. No matter what law governs the contract, be it international law or law of host state, exercise of sovereign authority by state in public interest cannot be denied either in case of classic stabilization clauses (freezing clause) or modern stabilization clauses<sup>[49]</sup>.

### b. Enforceability

Stabilization clauses are generally presumed to be enforceable in arbitration proceedings. However, what effect the enforcement of such clauses would have is less clear. Enforceability can be analysed from two following approaches:

#### Historical Approach

According to some arbitral tribunals, when States or state-owned NOCs with approval of state enter into agreements with stabilization clauses voluntarily, they exercise their sovereign power in doing so and hence cannot nullify their obligations<sup>[50]</sup>. With regards the validity and enforceability of such clauses, there is a clear declaration and various well-known nationalization cases hold that the State cannot invoke its sovereign rights to regulate in order to escape commitment it undertook in a stabilization clause<sup>[51]</sup>. In *Texaco v Libya*<sup>[52]</sup>, the oil sector was nationalized by Libya and the sole arbitrator found that Libya had breached concession agreements by not acting in accordance with stabilization clause. Tribunal stated that "*in respect of international law of contracts, nationalization cannot prevail over an internationalized contract, containing stabilization clauses entered into between a State and a foreign private company*"<sup>[53]</sup>.

However, in *Aminoil*<sup>[54]</sup>, the majority of tribunal did not agree with Aminoil's argument that nationalization was prohibited by stabilization clause and that consequences of nationalization could be addressed meaningfully by compensation. Cases like Aminoil challenged the importance and validity of stabilization clauses as it proved insufficient to block nationalization however investor was effectively compensated<sup>[55]</sup>.

#### Contemporary Approach

Tribunals in recent times have been looking at various considerations to determine whether stabilization clause would be enforceable or not. The considerations are specific language of the stabilization clause, law applicable to merits and other related terms of contract in addition to circumstances of the case. As guarantee of stability,

stabilization clauses are considered one possibility among others because under International Investment Agreements, there has been increased reliance on other protections as well <sup>[56]</sup>.

Tribunals have found that under IIAs, stabilization clauses can create legitimate expectations that the legal or tax regime applicable to investment will remain stable and therefore 'windfall profit' taxes imposed on investor can violate fair and equitable treatment (FET) standard. For example in *Occidental v Ecuador* <sup>[57]</sup> tribunal found that Ecuador could not unilaterally change prices and impose 99 per cent windfall tax therefore violating FET provision of the Ecuador-US BIT. While there is no requirement for stabilization clause to exist in a BIT in order to trigger the treaty's FET protection, such a clause is definitely helpful. Through this shift, stabilization clauses have been given effect without challenging the regulatory sovereignty of state <sup>[58]</sup>.

As the effectiveness of a stabilization clause is dependent on its enforceability, it shall have a nexus with international arbitration. Therefore, the stabilization clause shall be buoyed with well-tailored arbitration clause including governing law and arbitration venue <sup>[59]</sup>. In determining the legality of stabilization clauses, role of arbitral tribunal will be twofold. First, to verify whether the legislative change or administrative measures conform to host country's municipal law. Second, whether by unilaterally modifying or abrogating contractual rights, the state has violated its international obligations <sup>[60]</sup>.

## 6. Stabilization Clause and Permanent Sovereignty

The conflict between the aim of traditional stabilization clauses and principles of permanent sovereignty over natural resources creates doubts about the validity and efficacy of stabilization clauses <sup>[61]</sup>. An important question that arises for consideration is how to enforce stability agreements when state in customary international law has a right to expropriate an investment made in its sovereign space at some future date? <sup>[62]</sup>

A host state usually invokes the doctrine of permanent sovereignty of natural resources in its defence when it undermines or revokes the conditions of original agreement with the foreign investor <sup>[63]</sup>. This defence gets support from UN General Assembly's Resolution on Permanent Sovereignty over Natural Resources.

Article 1(1) of Resolution 1803 <sup>[64]</sup> provides that 'the right of peoples and nations to permanent sovereignty over their natural wealth and resources must be exercised in the interest of their natural development and of well-being of the people of the state concerned.' Article 4 declares that states have the right to nationalize or expropriate property with payment of 'appropriate compensation' on the grounds of national interest, security or public order overriding private interests. Article 8 asserts that international investment agreements freely entered into by or between sovereign states shall be observed in good faith; States and international organizations shall strictly and conscientiously respect the sovereignty of peoples and nations over their natural wealth and resources <sup>[65]</sup>.

International Court of Justice in the case of *Democratic Republic of Congo v Uganda* further endorsed the principle of permanent sovereignty over natural resources <sup>[66]</sup>. Where a country recognizes that stabilization clause is oppressive and is limiting its sovereignty, it can make it subject to

renegotiations. This was the case in Ghana-Valco renegotiations whereby stabilization of law of Ghana was given-up <sup>[67]</sup>.

Though stabilization clauses seem to be invalid from the perspective of the principle of permanent sovereignty over natural resources, it will be an extreme position to consider stabilization clauses as purposeless. When the State itself agrees to bind itself through a stabilization clause but it threatens exercise of sovereign power by state, the stabilization clause can be subjected to renegotiation <sup>[68]</sup>.

Therefore, the freezing function of stabilization clause is just a part of picture, the political, economic and social components of the relationship shall be considered while construing the effectiveness and validity of stabilization clause <sup>[69]</sup>. Principle of permanent sovereignty is a part of *jus cogens* <sup>[70]</sup> and any agreement which a State may conclude restricting its sovereignty is automatically invalid.

## 7. Effectiveness of Stabilization Clauses in Preventing Current Regulatory Risks: Environment and Human Rights

New concerns for the environment have been witnessed in the last decade. While the major impact of petroleum products on the global environment is the burning of hydrocarbons, the exploration and even the extraction stages are not immune from environmental effects, in particular that of offshore oil pollution from well and tankers <sup>[71]</sup>. Human rights issues have also figured in a growing number of debates on how contract structures in long-term energy and natural resources projects may restrict the legal capacity of host states to safeguard the interests of their citizens, particularly localized groups such as communities and indigenous people <sup>[72]</sup>.

Stabilization clauses are sometimes used by international investors to insulate themselves from having to implement new social and environment laws or to provide themselves with an opportunity to be compensated for compliance with such laws <sup>[73]</sup>. Though it cannot be denied that there is a legitimate need to adapt the environment and human rights regulations to new national and international standards but both laws are very prone to post-investment regulatory surprise and compliance with new standards and regulations may require the foreign company to spend huge amounts of money thereby adding to cost of the project <sup>[74]</sup>.

An important question in this respect therefore is, whether a stabilization clause can create obstacles to applying new social and environmental legislation to investment projects in the host state and if so, to what extent or whether a State can surrender its international treaty obligations by way of stabilization clauses to international pipeline companies or IOCs? <sup>[75]</sup>

In answering the question, it is pertinent to state that the source of all problem lies with international law as it imposes international obligations including that concerning human rights, the environment, labour etc <sup>[76]</sup>. Some stabilization clauses can be used to limit the state's action to implement new social and environmental legislation to long-term contracts.

Full and limited freezing clauses can thus potentially insulate investors from new social and environmental laws because the text of agreement supports a reasonable interpretation that compliance is not required. Hybrid clauses generally give the investor an opportunity to demand adjustments to the contract, including exemption

from law, to compensate the investor. Economic equilibrium clauses allow an investor to demand contract adjustments to compensate the investor. Some stabilization clauses therefore give the leverage to investor to negotiate informally a lower level of compliance with the new law, or a delay in law's applicability to the project, or compensation for compliance<sup>[77]</sup>.

In the context of environmental and social stability, undoubtedly the role of third parties (Non-Governmental Organizations, Human Rights Interest Groups and Environmental Organizations), has become increasingly important in influencing the operation of an investment contract between foreign investor and host state. Role of third parties for instance in infrastructure projects of Sakhalin-II Gas Project, The Chad-Cameroon Oil Pipeline has been robust and effective to varying degrees. Although stabilization measures in investment contracts have been subject to critical scrutiny by third parties, it does not appear that they have been an obstacle to the development of enforceable environmental standards and access to justice<sup>[78]</sup>.

Another important issue is whether an investment contract can contain a stabilization clause which explicitly aims to cover health, safety and environmental exemptions. In practice, it can be seen that such clauses are contained in petroleum contracts in order to protect investors as a result stabilization clauses in this matter are criticized by states, NGOs etc<sup>[79]</sup>. The reason is that the provision of stabilization clauses (especially in the practice of cross-border pipeline regimes) are so encompassing that the ability of host state in respect of its administrative acts, legislative power, judicial decisions of its courts and other governmental acts is reduced to such an extent that it becomes very difficult for the state to regulate matters in public interest. When the State exercises regulatory power which adversely affects the economic equilibrium of the contract established in it, it will incur the obligation to pay compensation. Stabilization clauses constrain the ability of host state to implement international treaty obligations concerning human rights and the protection of environment, etc<sup>[80]</sup>.

In theory, if any legislation is amended or imposed by state which is contrary to the stabilization clause, then international investors may be entitled to compensation. However, two things need to be considered regarding compensation. First, stabilization clauses may not by itself be effective device for achieving stability in these humanitarian matters. Petroleum companies are under strong pressure from various organizations about this matter. Therefore, international petroleum investors have serious reputation concerns when taking action against states in this manner. Consequently, most international petroleum companies prefer not to insist on strict enforcement of stabilization clauses<sup>[81]</sup>.

For instance, in the Baku-Tbilisi-Ceyhan (BTC) pipeline project, the BTC Co. published an amendment called the 'Human Rights Undertaking' in which it undertook not to invoke the compensation clauses in the Host Government Agreement (HGA) if new laws are introduced for human rights or environmental reasons<sup>[82]</sup>.

Second, a legal problem may arise when distinguishing between non-compensable bona-fide environmental and social regulation and compensable regulation or indirect expropriation, since stabilization clauses do not generally

make a distinction between them. It is necessary to consider that host states' actions or measures may not be arbitrary or discriminatory even where such actions diminish the value of petroleum investors' property.

One of the biggest concerns for the NGOs and states is if the international investors require the host state to compensate the investor for compliance. Where only 'sole effect' doctrine is used by tribunals to determine the occurrence of indirect expropriation, then there could be a major problem for the host state. However, if 'purpose or intention-oriented' approach is taken by the tribunal, the problem may not arise<sup>[83]</sup>.

Therefore, the real issue is not so much whether the host state can change the contractual relationship unilaterally but rather what is the result of such legislative action in terms of lump-sum damages or possible specific performance of stabilization mechanisms. The legislative or regulatory action may trigger a form of indemnification in a stabilization clause. To conclude, it will depend on international petroleum investors whether or not to insist on enforcement of stabilization clauses in this highly sensitive area<sup>[84]</sup>.

## 8. Renegotiation Clause

In the light of the fact that effectiveness of stabilization clauses maybe doubtful, renegotiation clauses in contrast may offer protection against unilateral revocation or modification by the state. Under a renegotiation clause, in case of supervening circumstances, a state binds itself to renegotiate the agreement instead of altering or revoking the terms of agreement by unilateral action<sup>[85]</sup>.

Terminology used for renegotiation clauses can be confusing. One finds clauses for review, revision, adaptation, adjustment, restructuring, rescheduling, variation and so on. While dealing with these terms, a strict and consistent classification shall give preference to extent of change that these clauses produce in a contract. There are three categories:

- a. Adaptation clauses: These contract provisions allow contract changes by following an automatic or predetermined pattern or which are merely designed to fill gaps in contract.
- b. Force Majeure clauses: These clauses produce radical change as they normally suspend or terminate the further continuation of the contract.
- c. Renegotiation clauses: These clauses require mutual effort of both parties to agree to significant material change of the contract to an extent usually determined at time of conclusion<sup>[86]</sup>.

Renegotiation without renegotiation clause: In the absence of special mechanisms for dealing with a change in commercial equilibrium in the contract, a renegotiation of contract to changed circumstances can only be taken into consideration where other contractual terms or applicable law provide an appropriate starting point. The question of law applicable to contract is important to determine the conditions under which and to what extent a party is entitled to change the contract. The law applicable also determines the legal consequences of failed negotiations if failed negotiations are attributable to conduct of one of the parties<sup>[87]</sup>.

Under the legal system of England, contracts are considered absolute and parties are required to perform the contract

however burdensome it may have become and however much the circumstances might have changed. However, in case of “frustration” English Courts have recognized relief from contractual liability. But the English doctrine of frustration is strict and narrow to produce the degree of adjustment. The US practice is more liberal to question of excuse in cases of changes in circumstances and this approach is referred to as “commercial impracticability”. In *Essex Group Inc* <sup>[88]</sup>, the court found that a drastic increase in energy prices would be sufficient reason to adjust the price for a long-term alumina processing contract <sup>[89]</sup>.

Under International law, the existence of doctrine of *rebus sic stantibus*/change of circumstance has been widely accepted in modern times. The principle applies irrespective of inclusion of change of circumstances clause in agreement itself. Even under Vienna Convention on Law the Law of Treaties 1969, fundamental change of circumstances has found its way under Article 62 and the legal effect of change of circumstances under the treaty is that the disadvantaged party can request for withdrawal or renegotiation of his treaty obligations <sup>[90]</sup>.

Renegotiation with a renegotiation clause: Some contracts may contain a definite clause that requires the parties to renegotiate specified terms affected by changes in circumstances or unforeseen circumstances such as those concerning governmental regulations, commodity prices. Few examples where clauses have been included are Model Exploration and Production Sharing Agreement of State of Qatar, of Turkmenistan, PSA concluded between Government of Ghana and Shell Exploration and Production Company of Ghana Ltd. Such clauses constitute a private law agreement according to which parties undertake to renegotiate the agreement when certain conditions are met <sup>[91]</sup>.

A question that arises is who can initially invoke the renegotiation clause. Host state is more likely to invoke renegotiation clause first as the extent, quality and the future prices of the resources explored and exploited by IOC is often unknown to host state <sup>[92]</sup>. Renegotiation is however also available to investor who wants to change the agreement in times of recession and depressed prices <sup>[93]</sup>. For the foreign investor, major concern is not the insertion of renegotiation clause *per se*, but the fear that state could alter key investment conditions to its advantage by misusing the flexibility created by insertion of renegotiation clause <sup>[94]</sup>.

The fear that such clause can open door to abusive requests for changes in contract should be overcome because, renegotiation provisions while showing a willingness of parties to change can simultaneously signify means of stabilizing the contract as its aim is to regulate and consequently delineate contract change <sup>[95]</sup>. There is however a procedure for renegotiation which is as follows:

- a. Occurrence of triggering events: Events triggering renegotiations must have occurred. Determination of whether such events have occurred or not may lead to disagreement between the parties especially where renegotiation clause incorporates an undetermined trigger. Therefore, it being important legal question under contract can be determined by court or arbitral tribunal in case parties fail to decide so <sup>[96]</sup>.
- b. Duty to renegotiate: Parties actually need to renegotiate a potential solution for their problem after the conditions for applying the renegotiation clause are

realized. Important question that arises is what if one of the parties refuses to enter into renegotiation or if parties fail to agree on renegotiated terms? If a party refuses to enter into renegotiation, it is in breach of contract and such action could warrant legal action <sup>[97]</sup>.

Even if parties enter into renegotiation, there are certain obligations cast upon them. First being “no profit no loss rule” whereby original equilibrium of contract should be maintained and neither party as a result of renegotiation should be allowed to profit or suffer a loss. Second, parties are required to be serious throughout the renegotiation process with an endeavour to resolve the disputes. Thirdly, parties need to understand the purpose behind such clauses which is limited to adaptation of contract to the changed circumstances and not restructuring the whole contract unless expressed clearly in the clause <sup>[98]</sup>.

There is a possibility that despite entering into renegotiation, parties are not able to reach an agreement. In such case, question arises whether inclusion of such clause means reaching an agreement is obligatory or whether the contract will stay or be terminated? Usually the renegotiation clause does not denote compulsion of parties to reach an agreement. Parties are only required to pursue successful negotiation in good faith and reaching an agreement is not compulsory. As the contract stays even after failed negotiations, parties are required to fulfil their obligations as originally agreed to by virtue of principle of *pacta sunt servanda*. If the state declines to deliver on its contractual commitments, it would be a breach of contract and would make state liable for damages which would be calculated on the basis of original contract terms <sup>[99]</sup>.

## 9. Conclusion

The contractual mechanism of stabilisation clause remains one of the most significant legal guarantees of stability of contract and foreign investors prefer it over legislative mechanisms. For the long-term survival of a contractual relationship between host state and investor through a stabilization clause, reconciliation of the tension between public interest of state party and legislative freedom is required. While the legal validity of a stabilization clause must be acknowledged, its legal effect can be diminished by considering public interest <sup>[100]</sup>.

Though no form of stabilization clause can fully restrict a determined government from an act of expropriation if it has mind to do so, the provision of stability mechanisms in contracts can provide a way for framing subsequent negotiations between investor and host state. A stabilization clause may encourage more accommodating behaviour on the part of the host state. For the investor, there is a strong encouragement to ensure that stabilization provision is complemented by details including penalties for non-compliance, specifying time-limits on negotiations, compensation that must follow loss or damage, basis for calculating compensation and recourse to arbitration when negotiations fail <sup>[101]</sup>.

It is also important for the parties to consider the scope of stabilization clauses carefully and the drafters of such clauses are required to anticipate and manage expectations and consider different variables such as whether the host state currently has flexible taxation or progressive taxation system. It is also important for investors to understand local law and taxation requirements. Further, it is vital that long-

term energy contracts with various forms of stabilization clauses have provision for international arbitration<sup>[102]</sup>.

As nations with significant petroleum reserves without financial capacity to develop these resources continue to rely upon foreign oil companies for technological and financial development, exploration and production of these resources, stabilization clauses will continue to be used in concession agreements to protect foreign companies from subsequent unilateral actions by foreign state. To meet this challenge, it is imperative for host countries and investors to understand how, when and why stabilization clauses have been used in the past and how such clauses have been dealt with by arbitral awards. It is pertinent to state that these clauses infact have been taken seriously by arbitrators and will be taken so in times to come<sup>[103]</sup>.

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