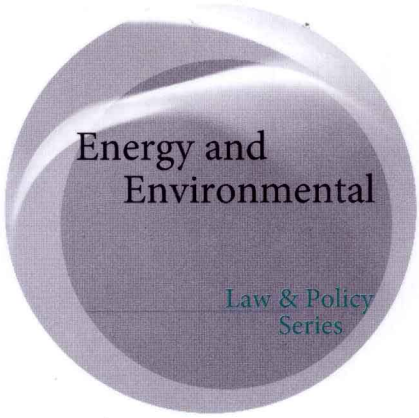

International Energy Investment Law

Stability through Contractual Clauses

By Mustafa Erkan

Wolters Kluwer
Law & Business

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To My Family

About the Author

Mustafa Erkan is a lecturer in Private International Law at the University of Marmara, Istanbul. During his career, he has worked closely and extensively with legal practitioners and academics whilst remaining based in academic institutions. He specializes in international dispute resolution through arbitration, mediation or litigation. He has a special focus on energy investment disputes with State parties, including issues of State responsibility, sovereign immunity and investment treaty protections.

Mustafa regularly lectures on matters connected to arbitration, energy law and private international law. He is also the author of several articles in his expertise area.

Mustafa received an LL.B Degree in law from the University of Ankara in Turkey. He also holds an LL.M in International Commercial Law from the University of Leicester and a PhD in law from the University of Exeter in the UK.

Mustafa worked as a visiting scholar at Center for Energy Economics, University of Texas at Austin. He is a member of the AIPN. Before entering the law, he worked as a paramedic. Mustafa may be contacted by email at mustafa.erkan@marmara.edu.tr.

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Preface

This book – **International Energy Investment Law: Stability through Contractual Clauses** – focuses on political risks, particularly the risk of expropriation, and examines specific contract clauses to evaluate the extent to which they play a role in mitigating the political risks in transnational energy projects. International energy investors face a number of political risks during the life span of energy projects. The management of these risks through contract clauses, analysed primarily from a legal and an empirical perspective, is the focus of this book. The research was based on a review of the existing literature and a questionnaire-based survey circulated to the main players in the petroleum sector: International Oil Companies, National Oil Companies, Lawyers, Arbitrators, Academics and Research Institutions.

The book is divided into three parts and the parts are also divided into chapter(s). Part One provides a background to the study. Chapter I is the introduction chapter, which defines the significance of this study, the scope of the book, research hypothesis and questions, and methodology. Chapter II deals with political risks in international energy investments. First, political risk is defined and categorized and then the susceptibility of transnational energy projects to political risks is examined, followed by a historical analysis of political risk to international energy investments. Chapter III begins by examining the concept of expropriation, followed by the legal requirements for lawful expropriation. Then it explains why indirect expropriation is a long-term and difficult issue for the energy industry. The chapter also addresses the question of how to distinguish between legitimate non-compensable regulation and indirect expropriation. The chapter concludes by looking briefly at contractual clauses used by international energy investors to manage political risk.

Part Two takes a closer look at specific contractual clauses in light of political risk management and analyses the results of the empirical survey. Chapter IV

examines the validity and effectiveness of traditional stabilization clauses. Chapter V considers renegotiation clauses and their effectiveness to mitigate political risk as an alternative to stabilization clauses. Chapter VI deals with equilibrium clauses as a modern practice. Chapter VII examines choice of law and alternative dispute resolution clauses in connection with the management of political risks.

The overall conclusions of the book are presented in Part Three.

Foreword

For international investors in the hydrocarbons industry, the subject of political risk has always been a sensitive one, and never more so than today. They commit resources to an enterprise that remains dependent on the uncertainties of geology; they do so in countries that are the owners of the resource and which in the event of success normally take a less favourable view of the rewards that are appropriate for the initial investment; and they do so in a context in which the environmental and social consequences of their investments are increasingly scrutinized and challenged by a variety of players. Beyond the hydrocarbons sector, political risk affects investors in the energy industry generally, albeit in different ways: in energy network-bound industries and in the growing renewable energy sector, the State has a very high profile in ensuring that private investment is mobilized, and has the capacity to intervene at a later date in ways that can adversely affect the investment made.

Over the years, investors have built up an armoury of legal defences against the risk of governments changing the rules of the game at some future date once the investment has proved successful. They have done so, however, against an international backdrop of growing state control over natural resources, and declining access to available or prospective hydrocarbon reserves. As far back as the 1930s, investors attempted to hold back the wave of state interventions that had begun in Latin America by introducing clauses in new contracts with host states in the new oil provinces of the Middle East that became known as 'stabilization clauses'. The inclusion of such clauses became common practice in long-term contracts between investors and host states in the international energy industry. The essential idea is that the parties seek to provide contractual assurance that the investment terms at the core of the agreement on the date of signature will remain the same over the life of the agreement. Sometimes, the stabilization will be defined narrowly to comprise only fiscal matters but for many investors a wider formulation will be

preferred, including the right to monetise (which may include the right to export products, and sell interests in the investment), the right to develop a hydrocarbons discovery deemed to be commercial, an exchange regime (to keep payments in hard currency, repatriate funds outside the host state and make payments) and the governance of the project itself.

The greatest threat faced by investors is expropriation of their interests, and over time such expropriations indeed occurred in the Middle East and North Africa, and in parts of Latin America. Stabilization clauses figured in several of the resulting arbitrations from this period. The classical form of stabilization clause, known as freezing, proved to be of limited value in resisting these trends although it may have helped investors to secure an exit on better financial terms than they would otherwise have obtained. Mustafa Erkan's book addresses stabilization in the international energy world that emerged from these events. It is one in which outright expropriation of investor assets is a much rarer occurrence, but one in which the phenomenon of *indirect* expropriation is regrettably all too common. It is a kind of political risk facing investors in both developed and developing countries. However, one of the curiosities of stabilization clauses is that no developed country will offer them to investors (as far as I am aware), leaving governments in developing countries with a sense that investors treat them differently and more circumspectly.

It is also an energy world in which more complex forms of stabilization have been developed by investors in their negotiations with host governments. Two in particular have proved popular. In line with the growth of National Oil Companies (NOCs) and production sharing contracts, some investors and host governments developed a form of stabilization by shifting the burden of fiscal risk to the NOC. The Allocation of Burden form of stabilization exempts the contractor from paying tax and/or provides that the tax that the investor is liable to pay is actually paid on its behalf by the state party (the NOC), with the result that any tax imposed at a later date by the host state has no consequences for the contractor or for the economics of its venture.

The other innovation is variously called a renegotiation, adjustment or economic balancing clause. Essentially, in the event of any unilateral measure taken by the host state at some future date, the parties agree to initiate a renegotiation to achieve the equilibrium that had been established in the original bargain. It is discussed at length by Dr Erkan in two, highly comprehensive chapters. This analysis is an important contribution to our understanding of such clauses, drawing upon data obtained through a questionnaire circulated to a wide range of players and professionals on the energy scene. This helps to provide Dr Erkan with a perspective on how these clauses are perceived and how they operate in practice, a matter rendered difficult by the dearth of published arbitral awards that examine this kind of stabilization clause. A number of cases are now pending before arbitral tribunals that will no doubt generate insights into the legal character of 'modern' stabilization clauses such as these.

In recent years the subject of stabilization has shown a new life, with various authors making important contributions to our understanding of its relationship to

human rights and environmental matters; others examining its relationship to the provisions on legal stability that are found in the fair and equitable treatment provisions of investment treaties. The scholarly contribution of Dr Erkan will be a very worthy addition to this body of literature for years to come, and will surely become a point of reference to other scholars and many professionals in the field of international law. The subject matter has as much concern to governments and companies today as it ever has, and is unlikely to become less so in the foreseeable future.

Peter D Cameron
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Dundee, UK

30 November 2010.

Acknowledgements

Political risks are a crucial matter for international energy projects. Conflicts may arise due to the very nature of international energy projects. An energy investment contract is a long-term contract; one side, generally is a state; it is very complex and technical; it involves large sums of capital; and there is much uncertainty in the energy sector, for instance as to the price of the product. Political risk management in transnational energy projects plays an increasingly important role when the crude oil price is extremely high, because a high oil price can lead to resource nationalism in this sector. The very different objectives and philosophies of the parties can create major problems. Therefore, most international investors (if not all) are concerned with political risks, particularly with indirect expropriation.

This book is derived from my PhD thesis written at the University of Exeter.

I would like to express my sincere and special thanks to Robert R. Drury, senior lecturer, who stood behind me as doctoral thesis supervisor during the phases of this work, and gave me his valuable support and advice. The hours he spent editing and consulting will not be forgotten.

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I remain responsible for any errors and omissions.

Mustafa Erkan
Istanbul/TURKEY
August 2010

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