Illusory Control of State Controlled Resources Through Stabilisation Clauses: Renegotiation Clauses May Save the Contract

Jeffery R Ray
Illusory Control of State Controlled Resources Through Stabilisation Clauses: Renegotiation Clauses May Save the Contract by J.R. Ray

About OGEL

OGEL (Oil, Gas & Energy Law Intelligence): Focusing on recent developments in the area of oil-gas-energy law, regulation, treaties, judicial and arbitral cases, voluntary guidelines, tax and contracting, including the oil-gas-energy geopolitics.

For full Terms & Conditions and subscription rates, please visit our website at www.ogel.org.

Open to all to read and to contribute

OGEL has become the hub of a global professional and academic network. Therefore we invite all those with an interest in oil-gas-energy law and regulation to contribute. We are looking mainly for short comments on recent developments of broad interest. We would like where possible for such comments to be backed-up by provision of in-depth notes and articles (which we will be published in our 'knowledge bank') and primary legal and regulatory materials.

Please contact us at info@ogel.org if you would like to participate in this global network: we are ready to publish relevant and quality contributions with name, photo, and brief biographical description - but we will also accept anonymous ones where there is a good reason. We do not expect contributors to produce long academic articles (though we publish a select number of academic studies either as an advance version or an OGEL-focused republication), but rather concise comments from the author's professional 'workshop'.

OGEL is linked to OGELFORUM, a place for discussion, sharing of insights and intelligence, of relevant issues related in a significant way to oil, gas and energy issues: Policy, legislation, contracting, security strategy, climate change related to energy.
Illusory Control of State Controlled Resources Through Stabilisation Clauses:
Renegotiation Clauses May Save the Contract

Jeffery R. Ray*

ABSTRACT

This article addresses the problem associated with loss of effective control of hydrocarbon resources in states that use production-sharing agreements. The stabilisation clause is examined first while taking account of the parties’ interests, bargaining power issues and human rights concerns. Both parties’ interests are taken into account and this article argues that a renegotiation clause could bridge the two interests whilst keeping the intent of the agreement intact. The renegotiation clause is developed during the second half of the article. Covering the purpose, role, benefits, faults and other concerns of the use of a renegotiation clause.

I. INTRODUCTION

Renegotiation Clauses in Production-Sharing Agreements (PSA) can provide an answer to control problems whilst offering an opportunity to balance the competing interests of control and stability needed by the state and foreign investors respectively. The state has particular concern regarding the control over its hydrocarbon resources. The PSA allows the state to retain ownership of its hydrocarbons for longer during the production and export activities. However, the

* The author, at the time of writing this paper, was an LLM Candidate at the University of Aberdeen. His J.D. was earned at the Florida A&M University.
true concern arises in that the PSA tends to lock the state into a long-term agreement with a stabilisation clause, which the state may or may not be aware of the consequences related to the decision or the capacity to foresee inherent changes. This article will discuss the following: the diametrically opposed interests of state and investor; concepts of stabilisation clauses; issues that present a human rights query; and what the renegotiation clause is, as well as, how it can help or hinder the interests of the state or investor. This discussion will be most relevant during the initial contract negotiation between the state and foreign investor’s agents.

II. ANALYSIS

A. Stabilisation Clause

Stabilisation clauses are the product of an investor’s desire for long term stability by ‘freezing’ the state’s legislative ability to alter the contract.¹ This clause is the investor’s protagonist approach to create a comprehensive legal stability for the term of the venture. Stabilisation clauses are, further, an attempt to restrain the state’s ‘inalienable right…to freely dispose of…[its] natural…resources in accordance with…[the state’s] national interests’². However, Brownlie poignantly opines that poorer states [that] have accepted foreign investment[s]’ may have effectively ceded control over a portion of the state

² United Nations General Assembly Resolution 1803 (XVII) (14 December 1962) ‘Permanent Sovereignty over Natural Resources’
economy which may or may not be able to legally, or practically, remedy.³ Waelde considers the stabilisation clause to be tantamount to a waiver of sovereign immunity.⁴

Production sharing agreements have inherent interests involved. Maier eloquently elucidated the ‘divergence of interests’ between the state’s sovereignty over natural resources and the interests of the investor in the energy sector.⁵ The state is pressured, politically and economically, to control its resources by ensuring maximum beneficial use of its natural resources while maintaining optimal ‘flexibility in extracting, refining and selling the resources’.⁶ This control, however, may be illusory based on various issues.

Increase in the price of oil, if not accounted for in the PSA, may create an illusory control issue as it relates to the national profit from its natural resources.⁷ Nigeria, for example, entered into agreements when ‘crude oil prices was closer to $20 per barrel’ and the costs of deep-water development was ‘very high’.⁸ Prices of oil soared leaving Nigeria anchored to terms that were formerly appropriate, however, as prices soared, the terms shifted from being indicative of state control

---

³ Ian Brownlie, ‘Principles of Public International Law (7th ed) (Oxford University Press 2008) 537
⁴ Waelde (n 1) 254
⁵ Bernhard Maier, 'How has international law dealt with the tension between sovereignty over natural resources and investor interests in the energy sector? Is there a balance?’ [2010] I.E.L.R. 95
⁶ Ibid at [95]
⁷ Idornigie Oboarenegbe, 'What is the justification for the proposed renegotiations of deep offshore production-sharing contracts in Nigeria?’ [2008] I.E.L.R. 196, 196
⁸ Ibid
to terms that created unmitigated windfall profits for multinational oil companies.\textsuperscript{9} This fiscal loss of control must be differentiated from legislative loss of control.

States’ negotiation power increases once there is significant progress on the project or hydrocarbons are found within its territory.\textsuperscript{10} However, there are two issues that combine to usurp the state of its control. First, a state new to the hydrocarbon industry will likely have deficient technical capabilities or legislative regime, regarding hydrocarbons, to deal with the various intricacies involved in the industry.\textsuperscript{11} Second, the stabilisation clause needed to attract investors may effectively hamstring future attempts to regulate, redistribute windfall profits, or alter tax structures on the hydrocarbon sector without highly undesirable reactions.\textsuperscript{12} These issues effectively force the state to anticipate decades into the future, which is, in essence, a gamble.

On the other hand, the investor will have peak authority in the beginning of the negotiations and will seek to obtain favourable terms while wielding this power.\textsuperscript{13} The investor’s interests seek to minimise risks through ‘consistent and transparent legal frameworks’ for the maximum length of time possible.\textsuperscript{14} Together, these diametrically opposed interests create a significant tension to capture the maximum fiscal yield from the relationship.\textsuperscript{15} These interests are often

\begin{footnotes}
\item[9] Ibid
\item[10] Muthucumaraswamy Sornarajah, ‘The International Law on Foreign Investment’ (Cambridge University Press 2010) 278; Oboarenege (n 7) 201
\item[12] Oboarenege (n 7) 201
\item[13] Sornarajah (n 10) 278
\item[14] Maier (n 5) 95
\end{footnotes}
eager to create a union and may leave non-pecuniary concerns unresolved. The temporal length of a PSA may create an illusory notion of control for the state.

The diametric interests involved, with substantial pecuniary risk, may lead to tunnel vision when addressing other issues that may be considered as a separate issue—such as human rights. This separate issue, however, may nonetheless be impacted by a PSA. Therefore, we turn to briefly consider relevant human rights concerns.

Whilst drafting a PSA, stabilisation or renegotiation clause, the state and investor should consider the human rights perspective of the local population especially in regard to minority and indigenous peoples, if applicable, to avoid undesirable legal, political and public scrutiny. The state no longer holds sole responsibility to human rights violations.\(^{16}\) While the liability for corporate actors is not entirely clear, there is enough litigation that foreign investors should be concerned. The development of corporate social responsibility, or corporations voluntarily adopting self-regulating principles such as the Valdez Principles, indicates that the corporate sector is becoming aware of environmental and human rights concerns and their impact on the corporate entity and its investors.\(^{17}\)

States that have granted oil concessions have later been found to be in violation of indigenous peoples’ human rights.\(^{18}\) An interesting question at this point would be whether states could be considered incompetent to contract when it


\(^{18}\) Maya Indigenous Communities of the Toledo District v Belize, Report No 40/04, Case 12.053 Merits (12 October 2004)
is in contravention to a human rights regime? If so, then what responsibility would this place upon corporations attempting to rely upon a voidable contract? While the analysis required to answer these questions is outside the scope of this paper, the mention of the above issues is appropriate to promote awareness.

The purpose of the stabilisation clause is to effectively freeze the regulatory framework to create investor security and thereby attract investors to develop and exploit resources. Then how does one deal with unexpected implementation of the contract when circumstances change? One potential remedy is to include a renegotiation clause within the PSA. Therefore, it is now appropriate to examine the renegotiation clause.

B. Renegotiation Clause

The overarching purpose of a renegotiation clause is to put the parties in the position that they originally bargained for and would be in currently, except that circumstances, typically oil prices, have changed and produced undesired results. Perhaps to say it differently, a renegotiation clause helps the interests involved maintain the status quo ante throughout the life of the agreement. When there has been a fundamental change in circumstances or supervening event occurring, then the economic equilibrium can shift causing enough pressure on the opposing interests of the parties to require amendment or abandonment of the agreement.¹⁹ The state, if backed into the proverbial corner, could nationalise the industry and attempt to use the defence of state of necessity to preclude required

¹⁹ Tade Oyewunmi, ‘Stabilisation and renegotiation clauses in production sharing contracts: examining the problems and key issues’ [2011] I.E.L.R. 276, 277-78
compensation.\textsuperscript{20} This is the result of an inflexible stabilisation clause. However, the purpose of the renegotiation clause is to provide the stabilisation clause with enough flexibility to survive in the event of such a substantial change.

The role of the renegotiation clauses is to oblige the production sharing agreement’s parties to negotiate for equitable terms upon the occurrence of a mutually agreed event, circumstance or time.\textsuperscript{21} Usually, the clause will provide for parties to operate in good faith to restore the effect of the agreement to an economic equilibrium for the parties.\textsuperscript{22} Trigger events or time, good faith and reference to negotiate toward an equitable or economic equilibrium remains a legally broad stance regarding renegotiation clauses.

‘An obligation to negotiate is not an obligation to agree’.\textsuperscript{23} As Oyewunmi thoroughly illustrates, the renegotiation clause must be specific and consider including an internal adaptive mechanism.\textsuperscript{24} In other words, care must be taken to include enough specificity to ensure that the internal mechanism or third party arbitrators have the legal framework, guidance and authority to adapt the agreement to modern circumstances. Profit or price changes are also reasonable issues to consider including in a renegotiation clause.

Creating a mechanism within the renegotiation clause (or potentially elsewhere in the contract) that utilized a profit or price scheme in order to return the parties to an economic equilibrium is an interesting and potentially useful tool. Oboarenegbe proffered that a premium factor to be included within a renegotiation clause...
clause is the ‘R factor’ or better explained as ‘price changes on a production-based sliding scale’.

There are other methods that could provide self-adjusting mechanisms that may provide both parties equitable benefits. However, there are complicated factors that may prove difficult in order to make such a mechanism functional. The implementation of a complex algorithm may be a valid and equitable opportunity if crafted correctly. This allows the state to ensure the foreign investors are not taking a windfall profit from the state’s natural resources while protecting the investor upon a downward shift in the price of oil or profitability for a particular venture.

Renegotiation clauses are not without faults. These faults create concerns, which should be given adequate attention. The nature of a renegotiation clause creates a degree of uncertainty. Uncertainty in contractual relations tends to have a negative effect on costs involved in negotiating and maintenance of the agreement. Nwete mentions that renegotiation clauses that are adequate for the purposes intended may, nevertheless, involve intrinsic costs that are unavoidable, such as: transaction costs; ‘loss of man-hours’; or arbiter fees.

‘Foreseeability’ of a trigger event, that activates a renegotiation measure, is difficult due to the potential for unaccounted-for events to occur. Oyewunmi poignantly suggested that in the event of a renegotiation failure, the renegotiation clause should provide for a ‘political[ly] and legal[ly]’ independent third party to

25 Oboarenegbe (n 7) 201
26 Ibid 198
27 Ibid 198
28 Oyewunmi (n 19) 284
29 Nwete (n 21) 61
30 Oyewunmi (n 19) 284
adapt the agreement. Foreseeable circumstances and remedial measures are concepts that both the investor and the state should take time to address in order to maintain stability and control under a PSA in the event of a change in circumstances.

The analysis above has implicitly indicated that balance is key to production sharing agreements. Careful drafting of the renegotiation clause will expressly show an intricate balance in the ‘mutuality of interests’ between the state and investors. The PSA that is bargained for is the effective middle ground by which the renegotiation clause will seek to return the parties to later. The method by which the clause uses, such as the formula or equation to shift short or excess profits, will determine the means that will either keep the contract healthy and equitable or provide an opportunity for the parties to salvage a sour deal.

Often focus is placed upon which factor to build the renegotiation clause around. However, an alternative to this method would be to negotiate for a multi-pronged renegotiation clause. The price of oil will be the obvious first choice. Quantity of production, as shown above, is used in tandem with the cost of oil with renegotiation clauses. The temporal position of production such as year 1, 10 or 20 of the production cycle may be considered as another factor because investors’ level of profit can be maintained at agreed reasonable thresholds after their investment is recouped. Also, the temporal lifecycle of the well has a natural change in its ability to produce. Incentives to refrain from environmental damage could be sewn into the renegotiation clause.

---

31 Ibid
Environmental incentives could be achieved by weighting the R factor in favour of the state, by X%, upon the occurrence of Y number of violations of state’s environmental regulatory regime, refusal or delay inremedying a spill or environmentally hazardous circumstance. The weighted percentage would have to be temporally limited and tied directly to the incident. For example, after the third violation of state’s regulatory regime the R factor is to be weighted in favour of the state by X% for a term of Z months, this time could be tolled until such time that compliance is achieved with state’s environmental regulations with optional arbitration to ensure the state does not unreasonably withhold a compliance status. Of course, the parties would need to pay close attention to an integration of good faith into such a provision.

III. CONCLUSION

The renegotiation clause could be an answer to control problems resulting from a PSA being ineffective due to change in circumstances or significant price fluctuations in the hydrocarbon market. Renegotiation clauses are not simple solutions and there is a danger in utilizing them that correlates to the care in crafting the provisions. Care must be taken during the negotiation and drafting of the renegotiation clause because premature negotiations or a lack of precision may lead to an ineffective clause that required additional funds to create and fails to provide a mechanism or guidance for altering the agreement to mutually satisfactory terms. However, a well-crafted renegotiation clause, or section of clauses, permits the diametric interests to ensure that they will maintain the original, or at least equitable, control from the original negotiations throughout the term of the PSA.
The renegotiation clause has the potential to play a role in various incentives. States should recognise these roles and be prepared to plan, negotiate and implement these incentives equitably to benefit fully from the renegotiation clause. Once states recognise and utilise the benefits from the renegotiation clause, then state control should be enhanced. The enhanced state control will also benefit private interests in adding a layer of stability because the state will no longer need to feel backed into the proverbial corner.