Preserving the Contractual Equilibrium of International Petroleum Contracts:

A Relational Contract Analysis

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Abstract

The viability of long-term investment contracts is dependent on the effective and efficient distribution of risk and reward between the parties, while retaining the potential for flexibility in the face of future pressures for alteration. Petroleum contracts as long-term state contracts have complex economic and legal aspects, and their performance depends upon a durable relationship between the investor, whether foreign or domestic, and the host government. Such contracts cannot be seen as discrete commercial transactions or isolated agreements. Hence, the sustained contractual relationship for petroleum transactions is based on the ability to accommodate changing expectations in changing circumstances, and on the ongoing balance and adjustment of contractual rights and obligations in changed framework.

International energy investment agreements are very vulnerable and exposed to a range of actions or inactions by public authorities (government or state agencies) which could considerably affect the profitability of a project. Amongst the principal reasons for the risk of expropriation is that the host state seeks to obtain a greater share of the return from a successful operation, by raising taxes or tightening other provisions in the investment contract without necessarily taking over ownership of the investment or to drive the investor out of business. As a result, the business relationship between the foreign oil company and host government resembles a model of an ‘obsolescing bargain’, (OBM). The thesis explores the role of the contractual equilibrium and bargaining positions and their interactions with contractual clauses in a relational model of relationship to reduce and manage risk of expropriation in international energy investment transactions. The thesis examines the classical and the relational theories of contract and their response to contractual obligations, and then suggests an adaptive contractual mechanism to maintain the equilibrium of the contract in order to protect the contracting parties’ interests and resolve disputes.
TABLE OF CONTENTS

ABSTRACT………………………………………………………………………….. 2
TABLE OF CONTENTS…………………………………………………………… 3
DECLARATION…………………………………………………………………….. 9

CHAPTER 1: Introduction……………………………………………………………...10
1.1. Argument and Approach of the Thesis……………………………………………10
1.1.1. Research Questions……………………………………………………………16
1.1.2. Reflections on Discrete Contracts, Relational Contracts, Contractual Equilibrium and Adjustment: The Role of Good Faith, the Parties’ Expectations, Justification and Significance of Adjustment and the Third Party Adaptation……………………………………….….17
1.2. Background and Context of the Thesis……………………………………………29
1.2.1. An Overview of the Petroleum Industry………………………………………29
1.3. Significance and Structure of the Research………………………………………35
CHAPTER 3: The Taking Over of the Foreign Property by the Host State in the Petroleum Industry

Introduction........................................................................................................................................99

3.1. The Host Government’s Mechanisms to Control International Oil Companies.................102

3.2. Nature of Expropriation...........................................................................................................105

3.3. Compensable Property Rights...............................................................................................109

3.3.1. Shareholder’s Rights.........................................................................................................110

3.3.2. Right of Access to the Market..........................................................................................112

3.3.3. The Limitations of The Classical Model and that Expropriation Can Only Lead to Discharge and not Adjustment.................................................................113

3.4. The Basic International Legal Requirements for a Lawful Taking........................................113

3.4.1. Public Purpose................................................................................................................115

3.4.2. Non-Discrimination.........................................................................................................120

3.4.3. Due Process of Law.........................................................................................................124

3.4.4. Compensation................................................................................................................125

3.5. Conclusion................................................................................................................................131

CHAPTER 4: Indirect Expropriation: A Method of Taking Used By Host States in the Petroleum Industry

Introduction........................................................................................................................................134

4.1. Terminology..........................................................................................................................137

4.2. The Host Government’s Devices for Indirect Expropriation.................................................139

4.2.1. A Hypothetical Example: Does the Law of Expropriation Have the Ability to Manage Imbalances Caused by Host States’ Regulatory Powers?.................................................................143

4.3. The Legal Test in Distinguishing between an Indirect Expropriation and Non-Compensable Regulatory Measures..............................................................................................144

4.3.1. The Sole Effect Doctrine..................................................................................................146

4.3.2. The Purpose Doctrine.......................................................................................................148
4.4. Case Studies

4.4.1. Case Study (I): The Energy Charter Treaty Arbitration, Yukos v. Russia

4.4.2. Case Studies (II): The NAFTA Tribunal’s Cases

4.4.3. Case Studies (III): The Iran-US Claims Tribunal’s Cases

4.5. Inadequacy of the Existing Law of Expropriation in Protecting the Parties’ Interests

4.5.1. The Role of Obsolescing Bargain and Return

4.5.2. The Significance of Implementation of the Relational Model: Maintaining the Contractual Relationship

4.5.2.1. The Advantages and the Importance of Preservation of International Petroleum Contracts

4.5.2.2. The Challenge of Determining Compensation in International Investment Arbitration: Uncertainty of Outcomes

4.5.2.2.1. Ambiguous Rules of International Law on Compensation

4.5.2.3. The Inadequacy of the Framework of Breach & Compensation in Classical Model

4.5.2.4. Problems Regarding the Ultimate Purpose of Contracting Parties under the Classical Model: An Uphill Battle for Enforcement of Arbitration in Oil & Gas Sector

4.5.3. Deficient Rules of International Law on Expropriation: Inability in Restoring the Contractual Equilibrium

4.6. Conclusion

CHAPTER 5: The Pursuit of Equilibrium in International Petroleum Transactions: The Necessity of Transactional Certainty

Introduction

5.1. Nature of Stabilisation Clauses

5.1.1. Typology of Stabilisation Clauses

5.1.1.1. Traditional Stabilisation Clauses

5.1.1.2. Modern Stabilisation Clauses

5.1.2. The Necessity of Contractual Stability in International Petroleum Transactions

5.2. Legal Validity and Efficacy of Stabilisation Clauses

5.2.1. The Effect of Stabilisation Clauses under National Law
5.2.2. The Effect of Stabilisation Clauses under International Law
5.2.2.1. Scholarly Opinion
5.2.2.2. The Contribution of International Petroleum Arbitral Awards to the Question of Legal Value of Stabilisation Clauses
5.3. Reflections on Stabilisation Clauses: Adequacy of Stabilisation Clauses
5.4. Conclusion

CHAPTER 6: The Pursuit of Equilibrium in International Petroleum Transactions: The Necessity of Contractual Flexibility

Introduction
6.1. Renegotiation and the Preservation of the Relational Equilibrium
6.2. The Renegotiation of International Petroleum Contracts with a Renegotiation Clause
6.2.1. Traditional Renegotiation Clauses
6.2.2. Modern Renegotiation Clauses
6.3. The Contractual Practice of Renegotiation
6.3.1. Renegotiation, Contractual Stability and Certainty
6.3.2. Triggering Events
6.3.3. The Extent of Contract Change and Duty of Renegotiation
6.3.4. Checklist for Drafting Renegotiation Clauses: What Should be the Content and Process of Renegotiation?
6.3.4.1. Some Principles for the Renegotiation Process
6.3.5. Failure of Renegotiation Process
6.4. The Contribution of International Petroleum Arbitral Practice to the Notion of Renegotiation
6.4.1. Coexistence of Stabilisation and Renegotiation Clauses in the Same Contract?
6.5. Conclusion

CHAPTER 7: The Contractual Flexibility and the Need for an Adaptive Mechanism for Maintaining the Equilibrium of the Contract

Introduction
AUTHOR’S DECLARATION

I declare that this thesis is my own work. It is presented to the University of York for the first time for the award of the degree of Doctor of Philosophy (PhD) in Law.
Chapter 1

Introduction

1.1. Argument and Approach of the Thesis ................................................................. 10

1.1.1. Research Questions .......................................................................................... 16

1.1.2. Reflections on Discrete Contracts, Relational Contracts, Contractual Equilibrium and Adjustment: The Role of Good Faith, the Parties’ Expectations, Justification and Significance of Adjustment and the Third Party Adaptation ........................................ 17

1.2. Background and Context of the Thesis ............................................................... 29

1.2.1. An Overview of the Petroleum Industry ......................................................... 29

1.3. Significance and Structure of the Research ...................................................... 35

1.1. Argument and Approach of the Thesis

The purpose of this research is to examine the effect of contractual techniques used in managing the risk of a host state’s interference, in maintaining the equilibrium of the contract and in protecting contracting parties’ interests. This thesis centres on the contractual equilibrium and bargaining relationships between host governments and foreign investors in the petroleum industry. It will critically analyse the law and practice in the field of petroleum by investigating the existing literature and international arbitrations. It will then examine ways to maintain contractual equilibrium in classical and relational models, the adequacy of stabilisation and renegotiation clauses in maintaining such equilibrium, and how well the law of expropriation deals with preservation of the equilibrium. In addition, it will also suggest an adaptive mechanism to protect this equilibrium against obsolescence and restore a damaged contractual balance. This thesis is not intended as a means of examining renegotiation or stabilisation clauses, and the law of expropriation but rather, discusses the existing law to evaluate whether it could adequately protect the contractual equilibrium and contracting parties’ interests. It will address available mechanisms for resolution of disputes under classical and relational models. Finally, the thesis suggests its own proposal based on relational theory to remedy the inadequacy of the existing law.

The thesis hypothesis is that the existing law is grounded in the classical model which builds on a presentiated understanding of petroleum contracts. Such an understanding treats them as a one-off bargain and creates a static framework. As a result, when contracts are concluded they become obsolete and, due to the regulatory power have, host states have the ability to alter the contract to the foreign investor’s disadvantage. When international investment law tries to remedy this problem, it ends up going too far and seriously affects the legitimate right of the
host state to deal with the natural resources. The result of this is that international investment law is now fast losing its legitimacy. For example, Latin American countries such as Bolivia, Ecuador, and Venezuela have withdrawn from the ICSID – and Argentina has threatened to withdraw – due to the lack of legitimacy.¹

The thesis argument is that in order to remedy this we need to move to a relational understanding of contracts which treats them as creating relationships rather than bargains, thus creating a dynamic framework rather than static one-off sets of rights and duties and fundamentally creating equilibrium rather than the simple determination of rights and obligations. The emphasis should not be on the preservation of the parties’ rights and obligations but on the preservation of equilibrium. This is the thrust of the thesis approach, which I will explain in greater detail in this chapter and in subsequent ones. The reason for taking this approach is to identify the problem in international investment law in order to relate the reaction against international investment law to the problem of the international legal framework and in particular, to relate the problem to the way in which this framework approaches contracts. These investment transactions are necessary and foreign investors invest remarkable amounts of capital in such transactions. As such, the legal framework cannot permit the interests of one party to be overridden. Thus, there is a need for a framework which respects the equilibrium parties have reached and works to preserve the equilibrium in the face of changing circumstances in a fair and just way. This can help to find a solution to the problem. In other words, what the thesis tries to build on in this individual chapter is why these three main pillars of existing law – the rules relating to expropriation, stabilisation and renegotiation – have failed to sustain the stability of contractual equilibrium.

The contractual clauses are intended to mitigate the risk of expropriation in the petroleum industry and reduce disruption of contractual balance. Stabilisation and renegotiation clauses are devices used as a contract-based mechanism to protect the equilibrium against the risk of expropriation, and to avoid obsolescing bargain and investment disputes. The reason for studying such clauses is their significance in the literature as the main contractual provisions to minimise the risk of expropriation.²

This study intends to examine direct and indirect expropriation in international investment, and the legal value of contractual clauses to link analysis of such clauses by a practical mechanism to prevent obsolescing bargain of relationships. Hence, this constitutes the flow of the thesis chapters: Chapter 3 (direct expropriation), Chapter 4 (indirect expropriation), Chapter 5 (stabilisation clauses), Chapter 6 (renegotiation clauses) and Chapter 7 (mandatory adjustment by the third party). In the petroleum industry, the foreign investor concludes a contract with the host government to carry out exploration and exploitation of oil and gas based on the incentives offered by the state and legal and financial arrangements inserted in international investment contract. However, obsolescing bargain could take place when investment has been made, and allocation of risk would shift gradually from the host government to the foreign investor. In this situation, the host state could obtain perceived interests from the investment but foreign investors due to the technical reason that energy projects require, need a long period to attain their expected financial profit. In this situation, the host state may assert that the original contractual legal and financial arrangement is obsolete and unilaterally change contractual framework. In a long-term relationship maintaining the equilibrium and avoiding obsolescing bargain are the underlying foundations for protection of the investment and minimisation of disputes.

The thesis aims to present an innovative approach, which brings together the OBM, dynamic equilibrium, relational contract theory and analyses how these frame the needs of the parties in petroleum contracts. This study examines the areas where the law works and discusses the law’s shortcomings. The analysis of the framework is in the second chapter and then in the next four chapters, the main legal rules, principles and doctrines that are used to deal with this area will be examined. Afterwards, according to the analysis of law and the identification of shortcomings, the thesis presents the suggested mechanism addressing the shortcomings based on going back to the core idea of the balance between flexibility and certainty and drawing upon existing practice in relation to administrative contracts and the petroleum sector.

There is growing concern in relation to regulatory intervention in fiscal, environmental, labour and commercial aspects of the petroleum industry. This type of interference emerged as the main instability factor as compliance with regulation often has financial costs for the foreign investor and may bring about economic difficulties, disequilibrium and even can result in disputes. The analysis of recent arbitral awards highlights the growing significance of contractual arrangement for management of risks, host governments interference and minimising investment disputes. Such risks may mainly be managed through a contract-based approach to protect the equilibrium against the obsolescence. The present study analyses the

international petroleum arbitral practice and critically examines effectiveness of the contractual approach aimed at maintaining the original equilibrium of the investment contract. It will reveal fundamental factors disrupting the contractual balance between the parties.

This discusses the question of how does the contractual approach provide certainty and flexibility for international petroleum investment contracts and how could prevent obsolescing bargain. Additionally, another important question is how far contractual devices are effective to prevent risk of host government interference, and contract disequilibrium.\(^3\) This mechanism attempts to distinguish the regulative measures from expropriatory measures and develop a framework of risk management strategies to manage the indirect expropriation which is the main reason for disputes in today’s world. In order to have more concentration and for the issue of time, this research will examine upstream petroleum agreements and focused on particular risks such as, direct and indirect expropriation, obsolescing bargain, and disruption of the equilibrium of the contract.

The foreign investor may face a risk that the host state could exercise its sovereign powers to regulate the energy sector. In recent years, host states use their legislative and administrative powers in more subtle methods to accrue more interests from an investment – which may reduce profitability and the value of the investment for the foreign oil company – than through direct expropriation of foreign owned property.

This study concentrates upon selected substantive law issues both outside and inside the petroleum law.\(^4\) It analyses the legal concepts, issues and problems underlying investment protection not only in doctrinal but also in functional and practical context. This research examines the relationship of foreign private investors and host governments under international petroleum investment agreements and also addresses risk factors surrounding investment contract, posing a threat to the equilibrium of the relationship. The host government interference, both direct or indirect taking of the foreign investor property, stabilisation and renegotiation clauses will be discussed. These issues are decided repeatedly under international petroleum practice.\(^5\) Contractual devices which can be used to protect the foreign investment and stabilise the contractual arrangement will be addressed. These mechanisms include stabilisation and renegotiation clauses aimed to offer a solution for certainty, flexibility and harnessing of legislative power and administrative measures of the host government to protect

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investment agreement from unilateral changes.\(^6\) Understating contractual equilibrium and bargaining positions is of great significance for evaluating the interaction and effectiveness of contractual clauses to protect the parties’ interests and avoid expropriation risk. Then, it is necessary to define risk of expropriation in order to evaluate the contractual regime for management of risks.\(^7\)

In this context for preservation of the equilibrium of contract, the present research seeks to offer a solution for disruption of equilibrium which is the fundamental reason in arising investment disputes, to regulate and keep the contractual balance on the basis of original expectations of contracting parties. It argues that the equilibrium of international petroleum investment contracts can be preserved by an efficient risk allocation system in the contract which protects the parties’ expectation of the viability of petroleum agreements and overall fairness in the contractual arrangement for the attainment of an equitable result with respect to the distribution of economic benefit between the foreign investor and the host government. The notion of equilibrium is grounded in contractual stability and flexibility of international petroleum investment agreements. It highlights the significance of maintaining a long-term relationship in the changed context. The current work seeks to minimise investment disputes and to create security and flexibility for petroleum investment contracts.

This research aims at providing a comprehensive analysis of the doctrines and case studies that are necessary for management of international petroleum transactions. The scope of the thesis is limited to the major types of political risks faced by international investors, namely, direct and indirect expropriation. The thesis examines a number of recent arbitrations under the North American Free Trade Agreement (NAFTA), and the Iran-US Claims Tribunal. The reasons for a particular focus on these Tribunals are as follows:

First, looking at two tribunals rather than a range of cases from different tribunals provides consistency. Examination of cases under two tribunals that in their contexts expropriation takes place brings about a discussion that is more concentrated. Furthermore, it is not possible due to the limitation of time and space to examine every single issues in the oil and gas sector. The thesis focused on four issues, namely, direct and indirect expropriation, stabilisation and


renegotiation clauses to discuss the relevant case law on such areas of the law as underlined by the literature.

Second, these two tribunals present a range of political contexts in which indirect expropriation arises and highlight the underlying factors motivating expropriation as we see in these cases. Several arbitral decisions and tribunals might have been selected to typify the kinds of cases that animate the ongoing debate on the function of stabilisation and renegotiation clauses, the law of expropriation and its ability on maintaining the equilibrium. This research has chosen the NAFTA Tribunal because of the richness of the Tribunal’s reasoning, its contribution to the notion of investment and investor-State arbitration and, in particular, the law of expropriation, and function of stabilisation and renegotiation clauses and relevant issues – disruption of equilibrium. This also exemplifies the evolving nature of expropriation law as it relates to balance of interests between the host state and the foreign investor.

Third, substantial amounts of international petroleum arbitrations that have discussed indirect expropriation were relevant to Iran’s nationalisation of the petroleum industry. Thus, examination of the Iran-US Claim Tribunal cases is necessary.

In this study, research methodology is primarily analytical study of the legal rules, and use of the case study to examine the application of such rules and to illustrate how the law is applied. It is an orthodox and sensible methodology. The reason for in-depth analysis is to establish the existing content of international petroleum investment law as developed by international petroleum arbitrations. In order to review the literature primary and secondary sources of materials, including, petroleum agreements, legislations and arbitral awards were examined. However, it is worth noting that due to confidentiality of petroleum investments there is a limitation in studying this area. This study examines the positions of legal issues under international and domestic laws. In order to understand the validity and effect of stabilisation and renegotiation clauses and concept of adaptation of international petroleum contracts these issues will be examined under main legal systems of the world and international law. This research has a special concentration upon awards which have been issued by the NAFTA, the ECT and the Iran-United States Claims Tribunals. The study has an in depth analysis of international cases by examination of allegations of both parties and the reasoning of the tribunal in the award.

Since the thesis critique of the law of expropriation is based upon the fact that it takes a static understating of the contract and it does not really guarantee stability, the point is this is a problem that applies to monetary remedies generally. The fact that the law quantifies the amount differently in relation to damages does not fundamentally change the thesis critique for
the law of expropriation. Thus, this research only addresses remedy for a lawful expropriation. The thesis only focuses on upstream petroleum agreements.

1.1.1. Research Questions

The main question of the thesis is to what extent does the interplay between contractual devices constitute and maintain an economic equilibrium between investors and the host state in international petroleum investment transactions? In order to answer this, we should answer whether the existing contractual regime is sufficient to deal with disruption of equilibrium and risk of expropriation or it needs to be improved. The objective is to examine weaknesses in the classical model which have led to international investment law been unable to provide a framework for stability of contractual equilibrium and looking at ways in which different framework can deal with the problem.

The present research attempts to find the answer of some related and subsidiary questions addressed hereunder or at least provide the related methods for further study to that purpose.

- **The Equilibrium of the Contract:** Does preserving equilibrium in long-term investment agreements contribute to reduction of investment disputes? What is obsolescing bargain and how does it interact with the risk of expropriation in natural resources? What factors constitute such equilibrium in a contractual relationship? What factors disrupt the equilibrium in a contractual relationship? What are the main devices to restore a damaged equilibrium? What are the characteristics of the classical model of relationship and how it deals with the contractual balance? What are the foundation and characteristics of the relational model? What is the response of contract practice to the relational model? Does the relational model provide a better framework for long-term relationships by ensuring the parties’ interests over the lifespan of the contract?

- **Taking Over of Property Rights:** What types of mechanisms are available for host states to control international oil companies in their territories, and what are the restrictions determined by international law to harness the host state’s power over foreign oil companies? What types of state intervention and control mechanisms by host states can make up an expropriation? What are the main requirements for a lawful expropriation under international law? How does the law of expropriation deal with the range of disruptions of equilibrium which take place in petroleum transactions? What is the response of the international petroleum awards to the host government’s interference? What are the property rights capable of being compensated?

- **Indirect Taking of Property Rights:** What are the differences between direct and indirect expropriation, and what is the distinguishing factor? What kinds of actions or inactions used by host states for indirect expropriation? What is the response of international
arbitral practice to indirect expropriation and damaged equilibrium? Can the law of expropriation adequately preserve the equilibrium in long-term investment contracts? How does inability of the law of compensation in protecting the parties’ interests necessitate relational model of contracting?

- **Stabilisation Clauses:** Do contractual clauses enhance the protection for the equilibrium and reduce disruption of the equilibrium in international petroleum investment transactions? Does the stabilisation clause prevent the host state from exercising sovereign powers and give the foreign investor a guarantee that host government will not change or terminate the international petroleum agreement through legislative or administrative powers? Does the stabilisation clause adequately preserve the equilibrium of the contract? Does the law pertaining to stabilisation clauses take adequate account of the dynamic character of a petroleum contract? How do international arbitrations deal with the stabilisation clause?

- **The Concept of Adjustment:** Can the notion of adjustment as we find it in domestic law and international law provide a better starting point to give effect to the relational dimension of the contract in a way that preserves the equilibrium and avoid the problem of obsolescence? How does the renegotiation clause seek to maintain the equilibrium of international petroleum investment agreements? What are the purpose and effect of the renegotiation clause? Do renegotiation clauses provide adequate assurance for the protection of the equilibrium towards inherent risks in international petroleum transactions? How does international arbitral practice deal with the dilemma of pacta sunt servanda and rebus sic stantibus? Can they coexist in a contractual relationship? What is the legal position of major legal systems of the world towards adjustment of contracts in the absence of renegotiation provisions? What is the importance of the adaptive mechanism? How does it seek to restore the equilibrium? How could the thesis proposal increase contractual flexibility and resolve disputes?

1.1.2. **Reflections on Discrete Contracts, Relational Contracts, Contractual Equilibrium and Adjustment: The Role of Good Faith, the Parties’ Expectations, Justification and Significance of Adjustment and the Third Party Adaptation**

The thesis emphasis is on a mechanism for the resolution of commercial disputes which will be written down in contractual clauses. Thus, the thesis focus is not on the magical power of clauses, including, renegotiation and stabilisation clauses. The thesis focus is on a mechanism for moving forward from disputes. It is obvious that this mechanism needs to be embodied in either contractual clauses or investment treaties. From the pragmatic point of view, it is difficult to have investment treaties.
In addition, the contractual clauses can be used by mutual agreement of the parties in a contract and therefore it is much easier than investment treaties. Consequently, the mechanism for resolving the disputes is embodied in contractual clauses that were frequently used in the petroleum industry. On this understanding of contractual relationship, such mechanism has three prongs.

The first important prong is that when the equilibrium has damaged and the dispute arose, the parties need a mechanism to manage the dispute. As discussed in chapters two and three, expropriation is a mechanism suggested by the classical model of relationship. The classical model in the event of disruption of the equilibrium does not allow for adaptation and restoration of the damaged equilibrium. The only option that this model suggests is termination of the agreement and payment of compensation. As discussed in this chapter and the following, this model could not be beneficial for contracting parties in long-term international contracts, in particular, petroleum agreements.

The second prong is the obsolescing bargain model (OBM), under which the dominant law, i.e., the classical model offers expropriation followed by compensation which is not a good mechanism for long-term contracts. Indeed, by placing the expropriation and compensation at the centre, the law has accepted the long-term contract is obsolete. In particular, the contracting parties in petroleum agreements have strong interests in maintaining the relationship over the extended time. Thus, such mechanism that was put forward by the classical model cannot cope with the problem. The thesis discussed these issues in detail in this chapter, chapter two and chapter six.

The third prong is the relational contract theory which makes the point that what actually takes place in commercial practice is that terminating the contract and payment of compensation, is not the parties’ preferred mechanism. There are other preferred mechanisms rather than the classical model approach, that contracting parties are eager to rely on. Hence, the thesis suggestion is according to the relational theory to provide flexibility, adjustment, and preservation of contractual equilibrium. The thesis does not aim to examine contractual clauses at all, and suggests a new mechanism grounded in relational model for resolving disputes. By definition, the mechanism is the process of resolving disputes.

As discussed in chapter two, the scope pursued by the parties when entering into petroleum contracts is, on the one hand, to guarantee the foreign oil company a stable flux of money in order to recover the investments made and, on the other, to provide the host country with a stable financial benefit. The achievement of such purpose necessarily implies a continuative commercial relationship between the parties. Thus, petroleum contracts are characterised by a long duration (around 20-60 years). It is, therefore, evident that such agreements are different
from the so called ‘discrete transactions’, namely, contracts that are concluded and executed in a limited lapse of time and do not require a stable relationship between the parties. For this reason, it is easier for the contractors to foresee and provide for any possible event that might affect the contract which, consequently, tends to be complete and specific. In this model of relationship the emphasis is on the provisions of the agreement that remain binding for the parties no matter what changes occur in the market over the time. In this way, the contract tends to be isolated from supervening events that will not determine any modification or adjustment of its terms (the negative or positive effects will be borne by the parties). As Professor Macneil underlined, a pure discrete transaction is characterised, amongst the other, by a limited parties’ personal involvement and communication between them, as well as by ‘short agreement process; short time between agreement and performance; short time of performance’. Moreover, this kind of contract ‘can be very complete and specific; only remote contingencies (if those) are beyond reasonable planning capacity’ (planning that ‘is entirely binding’) and does not require future cooperation. In particular, unless specifically planned and, consequently, disciplined, there are no parties’ ‘expectations about trouble in performance or among the participants’. Therefore, ‘a truly discrete exchange transaction would be entirely separate not only from all other present relations but from all past and future relations as well’ and not flexible.

However, the researcher believes that a pure discrete transaction is rare to be found in practice since a relational component is always present. As a consequence, we do not find in real life many quite discrete transactions: little personal involvement of the parties, communications largely or entirely linguistic and limited to the subject matter of transaction, the subjects of exchange consisting of an easily monetised commodity and money, little or no social or secondary exchange, and no significant past relations nor likely future relations.

Discrete contracts give emphasis on the concept of promise and on the idea that the relationship between the parties finds its sole discipline in the agreement. They tend to maximise the predictability of future risks and events at the moment of the conclusion of the contract. Consequently, in case the contract does not discipline a specific contingency or does not provide for an adaptation clause, it is assumed that the parties decided to allocate the risk on the party

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8 Discrete transactions characterised the classical and neoclassical contract law theories. For a detailed examination see chapter two.
11 This is the concept of ‘presentation of a transaction’, i.e., the restricting its expected future effects to those defined in the present. See, I. Macneil, (1978), supra note 9, 863.
negatively affected by such event. This is the approach usually adopted in international arbitration where arbitrators tend to strictly apply the principle *pacta sunt servanda*.\(^\text{12}\)

On the contrary, in a petroleum agreement, it is difficult for the parties to do the same since the long duration makes it impossible to foresee all the supervening events that can change the original market conditions on which basis the parties found a specific balance satisfying the reciprocal interests. Such contracts clearly do not fit the model of discrete transactions typical of *classical contract law* since they presuppose a relationship between the parties that lasts in time and that are characterised by investments and complexity. They can be included in the kind of contract that Professor Macneil defines as ‘*relational contracts*’. Due to their characteristics, they require flexibility and cooperation between the parties in order to *adapt* them upon the occurrence of supervening events altering their balance. An attempt to respond to such needs is made by the neoclassical contract law by recurring to some techniques (in particular, frustration and impossibility doctrines) that allow the parties to be *discharged* of their obligations without being in breach of contract when the latter is affected by supervening events that make it something different from what originally provided or impossible. However such response is *not* sufficient, and it is still based on a discrete transaction model. Indeed, relational contracts require to be *adjusted* during time instead of being *terminated* since the scope of the parties is to preserve their relationship.\(^\text{13}\)

In long-term commercial transactions the operations regulated by the parties’ agreement are simply too complex to be all encompassing and fixed at one point in time as envisaged by the classical theory. Discreteness is difficult to satisfy. There are too many considerations that cannot be finalised at the time of contracting because they depend on the occurrence of a future contingency, or because the parties – due to a lack of, or insufficient information – may be unable to make a final decision regarding some aspects of their relationship. Moreover, the passage of time might simply render the agreement incomplete. In other instance a specific aspect of the contractual content is expected to develop over the course of time. In such cases, future review of the agreement is inevitable.\(^\text{14}\)

The parties’ will, as said, is to build up and maintain a stable profitable relationship guaranteed by the *equilibrium*. Both the latter and the parties’ will and *expectations* are crystallised in the


contract that, consequently, can be deemed to represent their objective expression. More in
general, due to the fact that petroleum agreements are usually characterised by some standard
clauses, it can be said that they crystallise the expectations and will of those operating in such
market. It follows that the parties’ expectation is to adapt the petroleum contract upon the
occurrence of an unforeseen change of the market conditions that altered its equilibrium during
its life. For example, the ICC Tribunal in case No. 2291/1975, held that:

“All commercial transactions are based on the balance of the reciprocal performances
and to deny such principle would transform a commercial contract in an aleatory
contract based on speculation and hazard. There is a rule of lex mercatoria by which the
performances shall remain economically balanced and, as a consequence, in almost all
the international contracts, the price is, therefore, fixed in consideration of the
conditions existing at the moment of the conclusion of the contract and it shall vary in
light of the parameters that reflect the variations of the values of the different elements
that form the product or the performance”.  

Such expectation, and the consequent duty to adjust the agreement, find its justification on the
principle of good faith that is generally considered applicable to the execution of contracts.
Indeed, the analysis carried out above shows that such principle is recognised either by statutory
provisions or case law and scholars.

15 It can be said that the overall contract is the objectification of the parties’ will and expectations.
17 See chapter seven. In addition, see, for instance, Article 1134 of the French and Belgian Civil Codes;
Article 2 of the Swiss Civil Code; Article 1375 of the Italian Civil Code; Article 242 of the German Civil
Code; Article 313 of the German Civil Code and that entitle courts and arbitrators to adapt the contract,
contain references to the principle of good faith.

With regard to English law, it has to be noted that, although it does not expressly recognise a general
dogma of good faith, it employs other theories in order to guarantee fairness in contract or fair dealing.
In particular, courts obtain such result by means of construction and interpretation of contracts and by the
implied terms doctrine. In some cases, courts implicitly recalls the principle of good faith by referring to
(EWCA 12 October 1989) in which the Court, in describing the doctrine of frustration, held that “the
object of the doctrine was to give effect to the demands of justice, to achieve just and reasonable result, to
do what is reasonable and fair, as an expedient to escape from injustice where such would result from
enforcement of a contract in its literal terms after a significant change in circumstances”. Moreover, it has
to be noted that in a recent decision the High Court expressly recognised that in English law there is an
implied duty to perform the contract in good faith (see, Yam Seng v. International Trade, 1 Lloyd’s Rep.,
526 (EWHC (QB) 1 February 2013)); P. Ferrario, The Adaptation of Long-term Gas Sale Agreements by

Furthermore, eminent scholars hold in favour of the recognition of a general principle of good faith in
English law. See, in particular, R. Brownsword, “Positive, Negative, Neutral: the Reception of Good
Faith in English Contract Law”, in R. Brownsword, N. Hird & G. Howells (eds.), Good Faith in
Contract, (Ashgate/Dartmouth, 1999) 13, that refers to “a good faith requirements model” based on “the
standards of fair dealing already recognised in particular contracting context”; J. Wightman, “Good Faith
Contract, (Ashgate/Dartmouth, 1999) 41, that expresses a similar idea by referring to “contextual good
faith” that “derives the content of good faith from the reasonable expectations of the parties. These
It would be against the principle of *good faith* to constrain a party to keep on performing a contract that became excessively onerous and unbalanced for it. Indeed, in such case, only one party bears the consequences of the unexpected change, while the other is permitted to act opportunistically, unjustly enriching himself by taking advantage of his partner’s hardship. This is not to say that contractual parties are required to alleviate each other’s hardships. They are expected, however, not to use the hardship of others to further their own interests unjustifiably, thus undermining the joint interest of the contractual project.\(^\text{18}\)

The same consideration can be made in relation to the *termination* of the contract. Indeed, even in this case, the principle of *good faith* would be violated since the non-terminating party would be deprived of the possibility to count on a commercial relationship on which it thought it could rely for several years and, consequently, on which it based and planned its business activity by, amongst the other, spending time and money. With regard to the costs, it has to be noted that, usually, it is possible to recover the relevant investments made by the parties only after a certain number of years and that such money cannot be easily transferred and destined to other operations. Moreover, it would not be easy for the parties to find in a short time a new suitable commercial partner.

In addition, it should be emphasised that it is difficult to know to what extent potential contracting parties prepared to invest in feasibility studies and other information-generating activities to ensure that they have provided for every possible eventuality’ and that revealing the potential disruptive effect of some future eventuality is beyond the state of art and available technology.\(^\text{19}\)

Thus, in light of the specific characteristics of petroleum agreements, the *fairness* in the execution of contracts deriving from the principle of *good faith* means that the parties have to *maintain* a balanced and profitable relationship during the years as originally planned and expectations are based on norms which are widely observed in their contracting community?*, H. Collins, *The Law of Contract*, (Butterworths, 2003) 251; R. Brownsword, “Contract Law, Co-operation, and Good Faith: The Movement from Static to Dynamic Market-Individualism”, in S. Deakin & J. Michie (eds.), *Contracts, Co-operation and Competition*, (Oxford University Press, 1997) 255; R. Brownsword, “Good Faith in Contracts Revisited”, (1996) 49 C.L.P., 111; R. Zimmermann & S. Whittaker, *Good Faith in European Contract Law* (Cambridge University Press, 2000); As to international arbitration, see, ICC case No. 4761/1987, Collection of ICC Arbitral Awards 1986–1990, 519 (1987). Moreover, the recognition of good faith as a general principle of contract law finds an additional confirmation in the UNIDROIT Principles and in the PECL.

Regarding the United States, See, s. 1-304 UCC, “every contract or duty within this Act imposes an obligation of *good faith* in its performance and enforcement” and s. 205 of Restatement (Second) of Contracts “the phrase ‘good faith’ is used in a variety of contexts, and its meaning varies somewhat with the context. *Good faith* performance or enforcement of a contract emphasises faithfulness to an agreed common purpose and consistency with the justified expectations of the other party.


\(^\text{19}\) For a detailed examination see discussion of ‘Exit, Voice and Loyalty’ in chapter two; See also, Ibid, 207.
expected by them when concluding the contract. As said, without adaptation, it would not be possible to rebalance the agreement and the will of the parties would be frustrated since they could not achieve the scope pursued by means of the contract. Therefore, for these particular kinds of transactions, the execution of contracts in \textit{good faith} is the means consenting the parties to fulfil their expectations.

In other words, to execute this kind of contract in good faith means to execute it according to the parties’ will. Thus, the same idea of fairness applicable to such contracts can be deemed to overlap the parties’ expectations since both of them are represented by the maintenance of a balanced relationship over the years.

According to Professor Collins:

“The idea of reasonable expectations differs from a simple fairness criterion, for its reference is not to an independent standard of a fair price, but rather to the unexpressed intentions of the parties. But the circle becomes almost closed once it is accepted that those intentions are likely to be construed as a desire to enter a contract with reasonable balance of obligations on both sides. The best interpretation of this standard is one which takes fairness in the sense of the preservation of the balance of advantage of the contract as the unacknowledged but vital guide to interpretation.”

The adoption of a general doctrine of \textit{good faith} could, therefore, allow courts and tribunals to meet and better protect the parties’ expectations. Indeed:

“With such a principle, the courts are better equipped to respond to the varying expectations encountered in the many different contracting contexts - and, in particular, it might be argued that the courts are better able to detect co-operative dealing where it is taking place. If English contract law adopted a doctrine of good faith, it would pose questions of contractual interpretation and implication in a context, not only of background standards of fair dealing, but more immediately of the concrete expectations of the parties. Such expectations would be based as much on the way that the parties related to one another (whether they dealt with one another in an adversarial or non-adversarial manner) as on the express provisions of the agreement. As a result, English law would recover the ability to give effect to the spirit of the deal in a way that prioritised the parties’ own expectations.”

Such position was recently upheld by the case law. In particular, in a case dealing with a dispute arising out of an alleged breach of a distribution agreement, the Court, contrary to the traditional

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position adopted by English law, recognised the existence of a general implied duty to perform contracts in good faith whose content has to be determined case by case since it “is heavily dependent on context and is established through a process of construction of the contract”. However, the Court specified that, even if “its requirements are sensitive to context, the test of good faith is objective in the sense that it depends not on either party’s perception of whether particular conduct is improper but on whether in the particular context the conduct would be regarded as commercially unacceptable by reasonable and honest people”. Moreover, it was confirmed that “the strict connection between good faith and parties’ expectations since the basis of the duty of good faith is the presumed intention of the parties and meaning of their contract”.

In particular, the Court underlined the relevance of such principles with regard to contracts involving a longer term relationship between the parties which they make a substantial commitment by stating that:

“Such ‘relational’ contracts, as they are sometimes called, may require a high degree of communication, cooperation and predictable performance based on mutual trust and confidence and involve expectations of loyalty which are not legislated for in the express terms of the contract but are implicit in the parties’ understanding and necessary to give business efficacy to the arrangements. Examples of such relational contracts might include some joint venture agreements, franchise agreements and long-term distributorship agreements.”

In light of the above, in case the parties fail to find an agreement, the same principle of good faith justifies the adjustment by third party. In case the parties fail to adjust the contract by means of renegotiation, they have the right to recur to third party adaptation in order to rebalance the agreement. Indeed, why they should be deprived of a remedy that could give them the possibility to achieve the purpose pursued? The third party adaptation is, therefore, another tool, besides renegotiation, that the parties can employ in order to obtain compliance with the duty to adjust the contract (implied in the principle of good faith) and to realise their main interest, i.e., to re-establish the equilibrium necessary for the maintaining of a profitable commercial relationship. Hence, since the adaptation of petroleum agreements (by parties or third party) depends on the application of the principle of good faith to the execution of contracts, the lack of an adaptation clause or of a discipline for any supervening event that can affect the contract, does not mean that the party decided to allocate the risk to the disadvantaged party and that did not want to adjust the contract on the basis of the market’s changes.

22 See supra note 17, Yam Seng Case, paras 144, 147, 148.
23 Ibid, para 142.
In addition to the request of adjustment, a party, in case the failure of the renegotiation depended on the unfair behaviour of the other (that, for instance, refused to start the renegotiation process or refused any proposal made by the counterparty or did not propose itself any reasonable offer of modification), could claim for compensation resulting from the counterparty’s breach of the duty of good faith as including the duty to adjust the contract upon the occurrence of events altering its balance.

In this regard, one could object that the revision of contracts by a third party violates the principle of party autonomy. Nevertheless, it can be rebutted that the adaptation according to the principle of good faith is, instead, the way to comply with the principle of party autonomy. Indeed, as seen, by means of such principle it is possible to fulfil the parties’ expectations and to respect their will since they want to adjust the contract in order to keep their relationship over the years.  

Regarding the *third party adjustment*, it is true that the best solution would be the adaptation of the agreement by the parties since they know better the economic and technical reality in which they operate, as well as the issues connected to this kind of contract. However, first of all, it has to be noted that, if the parties fail to find an agreement for the adaptation of the contract, they should not be deprived of the possibility to obtain the adjustment only because a successful renegotiation is a better solution than third party adjustment. Indeed, as said, the latter is another tool for the parties to comply with their expectation and with the duty to adjust the contract provided by the principle of good faith. Therefore, it would be against such principle to deprive the parties of one of the remedies that could allow them to comply with the duty to adjust the contract and, consequently, with the possibility to maintain their relationship and to reach the scope that led them to conclude the contract.

The analysis on the recognition of the third party power to adapt contracts seems to find a support in the ‘relational contract theory’. Such doctrine, developed by some US scholars, has elaborated a model of contract that differs from that developed by classical and neoclassical theories, represented by the so-called “discrete transaction”, i.e., contracts that are concluded and executed in a limited lapse of time and that do not require a stable relationship between the parties. Such contracts maximised the predictability of future risks and events at the moment of their conclusion (presentation). Therefore, there is no room for adaptation of the agreement

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24 See, J. Perillo, *Hardship and its Impact on Contractual Obligations: A Comparative Analysis*, [http://www.cisg.law.pace.edu/cisg/biblio/perillo4.html](http://www.cisg.law.pace.edu/cisg/biblio/perillo4.html) (1996), that affirms that there is no violation of the principle of autonomy of contract since when a supervening event is unforeseen and beyond the parties’ control and it radically changes the nature of the performance, it can be deemed that the parties have never provided their consent to the execution of the contract in such situation. Therefore, without consent there is no conflict with the principle of freedom of contract and party’s autonomy.

25 See, chapter two for an extensive discussion on relational and classical theories.
upon the occurrence of unforeseen events. Indeed, it is assumed that if the parties did not set a discipline for a specific supervening circumstance, they decided that the risk has to be borne by the disadvantaged party.

However, as it was noted, this model does not fit all the different kinds of transactions that can occur in the reality and, in particular, petroleum contracts that, due to their characteristics and particular scope, presuppose the creation and preservation of a stable relationship between the parties for several years (for this reason, they are considered relational contracts). It follows that relational contracts are characterised by flexibility and require to be adapted during their life since termination is not the solution appropriate for long-term relations and does not fit the purpose pursued by the parties. In this regard, Professor Macneil underlined that when changes occur it is well to remember that we are dealing with situations where the desire is to continue the relation, not to terminate it. However, that does not mean to keep the contractual relationship as it is in spite of changes. Indeed, it was also observed that the “status quo in a dynamic society does not mean a static status quo; the status quo itself may very well be one in which changes in a certain direction are expected. If they do not come or come less than expected, then the interest-dispute-resolver is faced with a situation where the status quo calls for change, not for simply sticking to patterns now viewed as obsolete”.

Moreover, changes typically can be harmonised with the remainder of the relation only by making them consistent with the status quo. But it must be noted that if the status quo is a dynamic one moving over time in certain directions, change in accord with those patterns is essential to preserve the status quo itself.

Therefore, it could be said that it emerges the idea that adjustment is one of the characteristics of long-term contracts. They can be deemed to encompass and include their adaptation over time in order to avoid both termination and performance without modification in light of the changes occurred and affecting their balance since such remedies are in contrast with the nature of such agreements and with the purpose pursued by the parties. Starting from such principle it was affirmed that these kinds of contracts, and in particular petroleum contracts, presuppose a duty of the parties to adjust them on the basis of good faith. The compliance by the parties with the latter would meet their expectations when entered into the contract, i.e., the preservation of a long-term profitable relationship that could not be achieved without adaptation. Indeed, the

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26 The preservation of the relationship is one of the ‘relational norms’ identified by Professor Macneil as specifically applicable to relational contracts.


28 Ibid, 899.
principle of good faith “requires cooperation on the part of one party to the contract so that another party will not be deprived of his reasonable expectations”. 29

The idea of third party’s adaptation of long-term international contracts for maintaining the contractual balance is also affirmed by the ‘contractual equilibrium theory’ that also recognises that the relational model is the most appropriate for long-term agreements and aims at the preservation of a balanced relationship between the parties on the basis of the principle of good faith. 30 In particular, according to such theory, the third party determines the content of the duties of good faith and fair dealing (that rule the adjustment process) in light of the specific context in which the parties operate (surrounding circumstances). Moreover, in carrying out such task, the third party has to consider the purpose of the contract. It is affirmed the idea that, contrary to the classical contract law doctrine, in addition to contract provisions other elements have to be considered in order to determine the parties’ obligations; elements that complement the rights and duties provided by the agreement.

It seems possible to conclude that, without such adjustment, it would, indeed, be impossible to rebalance the contract and, consequently, to preserve a profitable relationship and to allow the parties to achieve the scope pursued when entering into a petroleum contract. Both termination and performance without adaptation would be against the will of the parties and the principle of good faith in the execution of the contract. For this reason, if the parties fail to adapt the contract by means of renegotiation, the third party mechanism should be allowed to do it. In order to reach its decision, the third party will have to determine whether the triggering conditions provided by the relevant case are met and, in general, whether the alteration of the contract’s balance actually occurred and was proved (it is obvious that not any economic difficulty in the performance of the contract or any non-convenient transaction could legitimate a modification of the agreement). 31 Furthermore, it was underlined, that adaptation requires the third party to interpret the contract in light of parties’ will and to evaluate the facts submitted by the parties.

Finally, it has to be noted that the above-mentioned approach is also the one adopted by international law and, namely, by the UNIDROIT Principles and the Principles of European Contract Law (PECL). In particular, Article 6.2.3 of the UNIDROIT Principles provides that:

“In case of hardship the disadvantaged party is entitled to request renegotiations. The request shall be made without undue delay and shall indicate the grounds on which it is based. (2) The request for renegotiation does not in itself entitle the disadvantaged party

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30 See, N. Nassar, supra note 18, 270-7.
31 Usually the events altering the contract balance have to be: (1) substantial; (2) unforeseen; and (3) beyond the control of the parties.
to withhold performance. (3) Upon failure to reach agreement within a reasonable time either party may resort to the court. (4) If the court finds hardship it may, if reasonable, (a) terminate the contract at a date and on terms to be fixed; or (b) adapt the contract with a view to restoring its equilibrium.”

In its turn, Article 6:111 of the PECL provides that:

“(1) A party is bound to fulfil its obligations even if performance has become more onerous, whether because the cost of performance has increased or because the value of the performance it receives has diminished.

(2) If, however, performance of the contract becomes excessively onerous because of a change of circumstances, the parties are bound to enter into negotiations with a view to adapting the contract or terminating it, provided that: (a) the change of circumstances occurred after the time of conclusion of the contract, (b) the possibility of a change of circumstances was not one which could reasonably have been taken into account at the time of conclusion of the contract, and (c) the risk of the change of circumstances is not one which, according to the contract, the party affected should be required to bear.

(3) If the parties fail to reach agreement within a reasonable period, the court may: (a) terminate the contract at a date and on terms to be determined by the court; or (b) adapt the contract in order to distribute between the parties in a just and equitable manner the losses and gains resulting from the change of circumstances. In either case, the court may award damages for the loss suffered through a party refusing to negotiate or breaking off negotiations contrary to good faith and fair dealing.”

The above-mentioned principles apply only if the contract refers to them or if arbitrators consider them as general principles of international law, and, therefore, they are applicable without the necessity of a specific reference in the contract. However, they express the need of the international business community to have, independent of what provided in the agreement, a general recognition of the third party’s power to adjust long-term contracts, when the relevant equilibrium is altered upon the occurrence of unforeseen events. Indeed, it was noted that:

“The emphasis on good faith and fair deal signals the transition to a new form of contractual morality in international business. The “all or nothing rule” of the sanctity of contract principles is being replaced by a more flexible, pragmatic approach. This approach seeks to produce results that are perceived to be just and fair and in consonance with commercial common sense. Modern commercial contract doctrine is

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33 http://www.jus.uio.no/lm/eu.contract.principles.parts.1.to.3.2002/.
developing away from the discrete model of the one-time exchange of goods and money to the co-operative and complex long-term transactions where the parties are depending to a substantial extent on the compliance of their counterparts with good faith and fair dealing as conduct-related legal standards over a long period of time.”  

1.2. Background and Context of the Thesis

Petroleum is one of the most valuable resources and the main driving force of all economies. “No other commodity, either historically or currently, can match the importance of petroleum to the world’s political and economic order”. The demand for petroleum is growing and this has increased investment into the industry. Developing countries conclude investment contracts with foreign oil companies to obtain funds, knowledge and technology required to explore for and develop natural resources, whilst investors do so seeking profits and returns. The growth of investment, however, carries with it the possibility of conflict and risks.

1.2.1. An Overview of the Petroleum Industry

It is helpful to examine the structure of the petroleum industry and its legal regime before any further discussion. It has to be underlined that this thesis is not intended to examine different petroleum agreements. The underlying idea is to discuss the significance of equilibrium in long-term agreements, in particular, petroleum agreements.

The oil and gas industry is divided into three major sectors: upstream, midstream and downstream. The upstream sector is used to refer to the search for, followed by the recovery and production of, crude oil and natural gas. This sector is also widely known as the exploration and production (E&P) sector. The upstream sector includes the search for underground or underwater oil and gas fields, the drilling of exploratory wells and, if the wells are deemed economically viable and recoverable, the operation of wells that bring crude oil and raw natural gas to the well’s surface.

35 In this research petroleum refers to oil and gas.
38 For example, India, Japan and China; OPEC, available at: http://www.opec.org/opec_web/static_files_project/media/downloads/data_graphs/MI022015.pdf
The midstream sector can include some elements of both the upstream and downstream sectors. However, the main component of midstream is the gathering system. Gathering systems are oil and natural gas storage areas where raw produced products are held until they can be transported, via pipeline, railcar or tanker truck to the refinery, where they are turned into marketable petroleum products. The downstream sector refers to the refining of crude oil, and the selling and distribution of natural gas and products that are derived from crude oil. Such products can include LPG, gasoline, jet fuel, diesel fuel, fuel oils, asphalt and petroleum coke. The downstream segment includes oil refineries, petrochemical plants, petroleum distribution outlets, retail outlets and natural gas distribution companies.41

Petroleum investment contracts vary from the old-type concession contracts to more recent types, such as joint ventures, production sharing agreements, and service contracts. Concession agreements, in particular the old type, grant and administrative authorisation to the international oil company to explore, develop and produce hydrocarbons. Concession agreements’ terms are fixed by legislation and, hence, the host state has considerable liberty to unilaterally modify the terms such as taxation and royalty. Production sharing agreements (PSAs) are widely used for exploration and development agreements between the host state and international oil companies. According to these contracts, international oil company has the rights to explore and develop the petroleum field and the investors covers all risks and exploration costs.42 Once petroleum has been produced, the exploration and production costs would be split between the host state and the foreign oil company in a way that the investor would recover its costs and both the host government and the foreign oil company benefit from the remaining petroleum.43 International petroleum contracts means those contracts concluded between international oil companies and host states and/or governmental agencies that deal with the exploration and development of oil and gas. A petroleum contract could be described as a state contract. Therefore, it differs from a standard contract in that one of the parties is generally a sovereign state or a state entity. State contract is defined as a contract made between the state or an entity of the state and a foreign national or legal person of foreign nationality, which covers upstream petroleum contracts.44 Therefore, contractual clauses for dispute management, protection of the investment and economic equilibrium of petroleum contracts are of great importance for international energy companies.

41 Ibid
There will be many parties involved in the energy industry, including: (i) host governments and their national oil companies (NOCs), such as Petronas, NIOC and Gazprom; (ii) international oil companies (IOCs), such as Chevron, BP, Total; (iii) transportation, refining companies and private banks. Amongst these many contracts between the key actors, the most important is the one between the host government and the IOC and this is the contract that will be addressed in this thesis. All of the other agreements must be consistent with and depend upon this agreement. This contract is referred to by the industry as ‘petroleum contract’ that is a contract between the host government on behalf of the nation and an international oil company that is being hosted.

The different types of petroleum investment agreements could affect the host state actions over the lifespan of a project, however, there is no doubt that the absence of appropriate contractual clauses in any type of the petroleum contract could cause difficulties, even frustrate the investment and damage the equilibrium.\(^{45}\) One could ask what will happen if the host state is unhappy with petroleum contract. The answer is that the contract will be adjusted, expropriated and/or terminated by the government. The host state’s interference would negatively affect each types of petroleum contracts. In other words, different type of petroleum contracts cannot prevent the host government from the interference where it is not satisfied with the contract. This thesis only discusses the effect of disruption of equilibrium, host states’ interference and obsolescing bargain in international petroleum transactions. The point that this research seeks to make is that these issues apply to all international petroleum investment contracts, and are not restricted to contracts of a particular type (e.g. Production Sharing Agreements or Concessions). Hence, the thesis does not need and will not concentrate upon any particular type of petroleum contracts. In order to keep the research focused and manageable, the scope of the research has been limited. The thesis will not attempt to cover the entire area of host state’s interference, petroleum contracts and contractual clauses. This research only focuses upon upstream petroleum contracts and excludes oil and gas sale agreements and pipeline contracts. In the upstream sector, the relationship is between international company and the sovereign state/state entity. Therefore, the relationship between companies that is mainly a commercial relationship and belongs to the downstream sector is not in the scope of this research.

The thesis for reasons of time and space, concentrates on most important form of the host state interference, namely, expropriation. Accordingly, this thesis will only discuss selected contractual clauses, namely, renegotiation and stabilisation clauses.

In this context, contractual mechanism helps the parties to avoid disruption of equilibrium and likely conflict. This highlights the significant role of stabilisation and renegotiation clauses that

are aimed at preserving the stability and flexibility of the contract in order maintain the contract’s balance.

Petroleum law is the law relating to exploration for, exploitation for, marketing and sale of petroleum. The focus is on government regulation, which is part of public law. Petroleum law regulates the relationship between the main actors in the industry, namely, the host state and the international oil company. This law entails the host states’ right to regulate and control natural resources and the foreign oil company’s activities by virtue of licences and regulatory measures, the international oil company’s contractual right created by relevant agreement, and international law relating to sovereignty of the state and petroleum activities and protection of foreign investment. Petroleum law is comprised of national laws and regulations of the host government such as constitution, environmental laws, tax laws, labour laws, health and safety laws and international law rules on protection of foreign investment. Upstream petroleum law addresses special concerns such as technological challenges and high risk, exploration and exploitation that requires large investments, and valuable natural resources that result in intensive government involvement and control with all aspects of the foreign oil company’s activities due to the strong public interests.

International petroleum contracts are complex, characterised by long duration and involving millions of dollars. They are often a type of state contracts in that one party is the host government46 or a state entity. Contracting parties in this type of agreement may have conflicting interests which are inherent in the nature of transactions. It has been explained that: “during the normally long duration of such contracts economic or political circumstances are likely to change. Natural resources are not renewable, and a nation, especially if it has recently emerged from a colonial past, will watch closely over the use of irreplaceable assets. These might be an imbalance in the economic equilibrium of the contract ab initio due to lack of reliable data at that time or to differences in the bargaining power or negotiating skills of the parties. External circumstances such as changes in technology and market conditions, or in the political situation within the host country, may at a later point in time make one or the other of the parties unable or unwilling to carry out its obligations under the contract”.47 As a result, management of contractual relationship and minimisation of disputes are of great significance in the industry.

Likewise, from the investors’ perspective, whilst investing in developing countries has great benefits for investors it comes with substantial risks, inter alia, risk of expropriation or more generally host state interference and taking of the foreign investor’s property rights. Host states

46 The Capital-Importing Country.
have legislative and administrative powers to control international oil companies and prioritise their own purposes. Specifically, there will be a possibility of unilateral modification of investment contracts and taking of the foreign investor’s property by the host state. Therefore, the necessity of a contractual mechanism to protect the foreign company and preclude inequities in the petroleum industry is outstanding. The host state as it has sovereignty in its jurisdiction, attempts to maximise its control over the foreign investor’s activities. Prior to making the investment, a potential foreign investor assesses all of the surrounding legal and financial circumstances to the petroleum project in order to make sure that its investment will benefit from legal certainty that is vital for a safe investment. In other words, the foreign investor seeks a stable fiscal and regulatory framework for the contract.

Foreign investors may face a wide variety of political risks that interfere with their property rights, including direct and indirect expropriation and unilateral change of the contract. The host state can arbitrarily change the laws over the life of the investment. Indirect expropriation can be in form of imposing new regulations, increasing taxes or change of the laws. These changes may result in “increased unplanned costs and legal consequences that negatively impact investments” which leads to a conflict between the host government and the international oil company.

However, foreign investors through use of contractual devices can minimise the risk of host state’s interference with their property rights. Such devices include renegotiation clause, stabilisation clause and arbitration clause. Whilst various types of petroleum investment contracts encounter different degrees of risk of host government’s interference, there is general agreement that the lack of appropriate clauses in any types of petroleum agreements can result in disequilibrium and disputes. Stabilisation clauses are intended to guarantee that host state will not unilaterally change or terminate the contract and to stabilise the contract terms. Renegotiation clauses are aimed to maintain the flexibility and stability of transactions by

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49 *Amoco Int'l Fin. Corp. v. Iran*, 15 Iran-U.S. Cl. Trib. Rep. 189-239 (1987): *The Texaco Overseas Petroleum Company v. The Libyan Government (TOPCO)* (1978) 17 ILM 3, 65; *Stebello v. Banco Totta Acroes*, 1 World Law Report 1050 (1985), for example, in this case a Portuguese state entity concluded an investment contract to build oil tankers. There was a time line for performance and in accordance with the penalty clause the late performance had to be compensated. The state owned company could not meet the deadline and had to pay compensation. However, Portuguese government intervened and changed the contract by legislative power. There was no alternative for the innocent party and it remained unpaid.  
adapting them to the changing conditions and preservation of dynamism. The renegotiation clause is a practical method to restore the original equilibrium contemplated by the parties and accommodate the contract to avoid disputes.54

As noted above, host states have sovereignty, including legislative and administrative powers. Sovereignty is the concept that states are in complete and exclusive control of all the people and property within their territory. It is the power of the host state to do everything necessary to govern itself, such as making, executing and applying laws, imposing taxes and engaging in trade. Host governments can change the law, contractual terms and bargaining position against the investor, international oil company.55 Under these circumstances, in order to establish a fair and stable framework for production and development of the industry and maximising benefits for both parties, a flexible approach to maintain the viability of the contract is needed. States try to attract more investment by offering more incentives to foreign investors. Moreover, host governments provide higher standards of investment protection, including substantive and procedural protection to promote foreign investment in their countries. In this situation, this study attempts to provide a contractual mechanism for minimisation of risk of expropriation and re-establishment of contractual equilibrium. It also enhances certainty and security of transactions.56 This will not only assist to prevent investment disputes but also can resolve the problems more quickly and cheaply.

If the parties seek to keep a long-term contact alive, their contract should be flexible and consistent with change of circumstances. Stability is of great importance in international petroleum agreements because political, legal and technical changes are inevitable over the life of petroleum agreements. In this context, instability in the contractual relationship can arise from the necessity to regulate the foreign investment in the field of petroleum. Change of economic equilibrium of contract may enable the host government to gain more revenues through a regulatory interference. The host government’s regulatory intervention in investment agreements is a major concern for international oil companies in recent times. Hence, drawing a clear line between legitimate right to regulate the industry, its extent and illegitimate interference that can result in an indirect expropriation is crucial.

After a hundred years of developing international investment law, the existing law still is not able to support stability of investment transactions with the current framework. There is rich international investment law addressing expropriation, stabilisation and renegotiation, and investment protection but does not really deal with the problem and cannot create transactional stability. The problem as will be discussed thoroughly in chapter two, is that the current law does not recognise flexibility of contracts and this will result in obsolescing bargain and disequilibrium. The existing law’s treatment with contractual relationship clearly shows that there is a problem in the way which law seeks to protect transactional stability. The thesis intends to answer this problem to improve stability and create a framework for international petroleum investment transactions.

The stabilisation clause attempts to protect the contract against any unilateral modifications and amendment which may be applied by the host state and will provide a stabilised framework for contractual rights and obligations.57 Indeed, such clauses attempt to protect the foreign company from legislative and administrative powers of the host state which may affect the contract and the foreign company's rights by future law and regulation.58 The renegotiation concept accommodates the contract with the change of circumstances and is able to reduce investment disputes.59 This study is intended to provide a comprehensive case study about international petroleum agreements, extensive analysis of the literature and makes a contribution in filling the gap caused by lack of such analysis. It will develop energy investment law and is very important for the petroleum industry and the legal community. This study will analyse current case law to illustrate the content of law in the energy industry. It is also hoped to help arbitrators and legal community by providing a better understanding of petroleum law under examination of responses to specific issues in petroleum arbitral practice.

1.3. Significance and Structure of the Research
I have explained the structure and the legal regime of the petroleum industry in the previous section. Disruption of the equilibrium which creates imbalances between rights, duties and interests of the host government and the foreign investor is the major problem in the petroleum industry. The host state reaction to disequilibrium is to interfere with the contract though regulatory measures to increase its benefits.

The host state’s interference has become more complex recently and new trends show that host states use more subtle ways for taking and shifted to indirect expropriation. There is considerable literature on expropriation, nationalisation and stabilisation clauses which mostly


59 K. Berger, (2003), supra note 7, 1347.
repeats arguments from a theoretical point of view. Nevertheless, no study has examined the issue through a diagnostic approach – identifying the problems – in a systematic way.

One important point in relation to the critique of the thesis is that it also discusses the issues from the point of views of the host government. Thus, if the law goes too far in the investor’s favour as some traditional stabilisation clauses did, it will end up taking away the ability of the host governments to exercise their legitimate power which is a problem. Hence, the thesis is not looking at the issues in a one sided way but rather examines the issues from the both sides and the balance parties reached.

The thesis explores the role of the contractual equilibrium and bargaining positions and their interactions with contractual clauses in a relational model of relationship to reduce and manage risk of expropriation in international petroleum transactions, which is completely unique and unprecedented. In other words, the existing literature has repeatedly endorsed expropriation as the main problem facing by foreign investors, and contractual clauses as a possible method for management of disputes. However, it has ended here and no studies went further. The thesis studies main causes of conflict of interests in the relationship between a host state and a foreign investor, their bargaining positions, the role of equilibrium of the contract and contractual clauses through an adaptive mechanism in a systematic way to reduce disputes. The research identifies sources and mechanism of host government for intervention and thereafter suggests the options for maintaining the contractual balance and minimisation of disputes. This research suggests a binding mechanism for adaptation of contractual relationship and resolution of disputes. This will be of great help for scholars and practitioners in the future.

This research studies international petroleum contracts through examination of bargaining relationships between the host state and the foreign investor in order to understand the contractual equilibrium. The thesis analyses two rival accounts of contract law, i.e. the classical and the relational models of contracting with regard to international petroleum agreements. The interplay between risk of expropriation and the obsolescing bargain and the role of contractual clauses in re-establishment of a damaged equilibrium in international petroleum transactions will be discussed. Such examination of the law and practice and the conceptualisation of the contractual equilibrium in international petroleum transactions, and obsolescing bargain model regarding international petroleum contracts are unprecedented.

Regarding ‘the contributions of the thesis’, it should be underlined that the thesis discusses a new framework for understanding the nature of the problem posed by disputes in petroleum contracts. This is a significant advance on the existing framework because it moves beyond presentation and is commercially more realistic, and demonstrates how existing approaches are deeply flawed as a result of their roots in a presentiated understanding. In addition, this study
demonstrates the importance of the relational contract theory both in terms of understanding the character of contracts and with regard to designing a practical framework to preserve the contractual equilibrium and maintain the contract viable. This research also discusses the relational and classical theories in the context of petroleum transactions and based on such analysis suggests a two-tier mechanism which works as a single package. Accordingly, contracting parties should adapt their contract under a relational model of contracting, and where they are unable to reach agreement to adjust the contract, a third party will adapt the contract and the decision will be binding. This mechanism provides contractual flexibility and in the second level, mandatory adjustment guarantees restoration of the contractual equilibrium in order to protect the contracting parties’ interests.

This research is segmented into eight chapters.

Chapter two examines the nature of the conflict between host states and international oil companies, bargaining positions and the interaction between obsolescing bargain and risk of expropriation. The chapter critically evaluates legal characteristics of petroleum contracts, key ingredients of the equilibrium of the contract, Obsolescing Bargain Model (OBM) and main factors disrupting the equilibrium. This chapter examines relational and classical models of relationship and their attitudes towards the contractual obligations and the response of contract law and practice to these rival theories.

Chapter three deals with the law related to expropriation and examines the basic legal requirements for a lawful expropriation and compensable property rights. The chapter set outs parameters in defining the main measures that might be taken by the host state for control of international energy projects. It provides an analytical framework for the notion of host government interference and the main risk factors in international petroleum agreements and defines taking over of foreign private property in the context of contract. In chapters three and four issues such as, host states measures to control international energy companies working within their territory (regulative measures) and distinction between indirect taking and non-compensable right of the host government to regulate the industry are examined.

In addition, an in-depth analysis of international petroleum arbitration as to the selected issues in this conflicting area will be presented. Chapter four is linked to chapter three and examines the question of what types of interference constitute indirect expropriation and also scrutinises measures used by host governments as indirect expropriation. Due to an increasing number of arbitral awards, it is of great importance to address indirect interference of host states.60

Moreover, this chapter examines international petroleum arbitrations and will also analyse some non-petroleum arbitrations to fully present the subject. The adequacy of the law in relation to expropriation as to maintaining the equilibrium will be discussed. Chapters three and four provide a framework to show the inability of classical law in preservation and restoration of equilibrium and consequently the parties’ interests.

Chapters five and six scrutinise contractual devices used to minimise associated risks in order to protect the equilibrium. Chapter five examines how far existing principles of international law are effective to preclude regulatory change of international energy projects by host governments. The present chapter also discusses doctrinal controversy about the effect of stabilisation clauses, the concept of sanctity of contract and the doctrine of mutability of contracts in international energy projects. The validity and effect of stabilisation clauses, the way such clauses manage risks of expropriation and unilateral change of the contract terms under domestic and international laws will be discussed. The fifth chapter also explores whether the stabilisation clause can adequately protect and preserve contractual equilibrium.

Chapter six deals with the concept of adaptability and renegotiation of international petroleum investment contract with such provision, the contractual practice of renegotiation, response of international arbitration to adjustment provisions and failure of renegotiation process. Chapters five and six aimed at suggesting an innovative and practical solution for management of risk through transactional stability and contractual flexibility.

Chapter six and seven examine concept of adaptation in international petroleum transactions. Such chapters address the issue that adaptability may be mutually beneficial for contracting parties provided they act in good faith and attempt to keep the flexibility of the contract to maintain the equilibrium of international petroleum agreements in the changed context. Chapter six and seven also analyse effects of renegotiation clauses through examination of petroleum arbitral awards. In addition, the interaction between principle of pacta sunt servanda (sanctity of contracts), rebus sic stantibus and theory of renegotiation will be explored. In the seventh chapter, the adjustment of international petroleum agreements in the absence of specific provisions under civil and common law systems, international law and by force majeure and


hardship clauses will be discussed. The thesis also discusses its proposal as to the idea of mandatory adjustment by the third party for international petroleum contracts in the seventh chapter.

Chapter eight is conclusion and explains in more detail the potential of the model which the thesis has created, the insights of this regarding the specific problem it has taken on and the potential it has for further research.
Chapter 3

The Taking Over of the Foreign Property by the Host State in the Petroleum Industry

Introduction

We have seen in the second chapter that the law of petroleum agreements is based on the classical model which suffers from presentation and which consequently is at best limited in its ability to deal with the obsolescing character of the bargain in petroleum transactions. This static model of relationship does not allow future adaptability and contractual flexibility in a long-term contractual relationship. As a result, the contractual balance of the contract can be damaged over time. In such a static model, equilibrium cannot be restored and it leads to the contract being terminated. This will discharge the parties. In this chapter, we now turn to the type of host state action that is at the heart of the majority of international petroleum disputes, namely, interference with the property rights of investors.

This study only examines the risk of expropriation and does not intend to address other forms of host state actions such as likely breaches of the Fair and Equitable Treatment (FET), National Treatment or Most Favoured Nation State (MFN) principles that could affect the foreign investor’s property rights. This has several reasons:

First, great importance of expropriation and its impact on the petroleum industry: as explained earlier, the main reason for international petroleum disputes is the host government interference
with the property rights of the international investor. This interference may involve direct and indirect expropriation of the foreign investor’s property that will adversely affect the profitability of the petroleum project for the international oil company.1 Expropriation has been the main problem facing petroleum investors. It took place in the 20th century, is taking place nowadays, and will take place in the future.2 However, the form of taking over has changed in this century. The issue needs to be given careful consideration in light of new trends, i.e. indirect expropriation. The sort of risks that are the subject of the thesis and can result in obsolescing bargain are expropriation whether direct or indirect.

Second, treaty-based standards: the said standards are relevant to the ambit of the protections afforded by investment treaties and not international contracts.3 The principles of FET, MFN and national treatment generated by international bilateral and multilateral treaties. Such protections are only obtained by way of express provision by treaty.4 Thus, these standards seek to protect the stability by a treaty-based mechanism and not by virtue of relying upon contract-based mechanism – that is the subject of this thesis. As a result, an important question is whether the breach that has occurred was breach of contract or breach of treaty. The treaty claims find their roots in provisions of an investment treaty, but contractual claims are founded upon contractual provisions.5 As this research has been framed from the beginning in the first and second chapters, it only examines the contractual mechanism for maintaining the equilibrium. It is not intended to discuss non-contractual mechanisms for protection of the equilibrium. Therefore, examination of the above mentioned principles as treaty-based standards are beyond the scope of this research.

In addition, the important point is that this thesis does not explore the adequacy of principles. Rather, it examines the adequacy of remedies put forward by different mechanisms under classical and relational models. As noted earlier, such mechanisms in the event of disruption of contractual equilibrium are: (i) the classical model approach, i.e., termination of the contract followed by

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compensation that is the dominant mechanism. This mechanism is not adequate for long-term contractual relations; (ii) the relational model approach that is adaptation of the contract by the parties in order to restore the equilibrium. If contracting parties would not reach an agreement, adaptation would be implemented by third party adaptation. Furthermore, the critique that compensation is inadequate and the points as to indirect expropriation is also applicable to breach of MFN and FET principles. Although this thesis has examined expropriation as a specific point, the broader issues also apply to such principles.

Finally, analysis of each type of host state interference would be a task demanding many years of research, so it is necessary to select a certain type of interference. Due to the wide variety of host state interference, this thesis will mainly focus on what, in the opinion of the legal scholars and the researcher, are the most important forms of interference in the petroleum industry. These include expropriation and termination of contract by governmental measures typically experienced by international oil companies.

In chapters three and four, the thesis discusses the law of expropriation but not for its own sake. It is not the thesis of the law of expropriation, stabilisation and renegotiation clauses. This thesis argues a different sort of remedy in petroleum contracts. The third and fourth chapters make the case for this by pointing to why the existing remedy offered by the law of expropriation is inadequate. The classical law provides two solutions in case of disruption of equilibrium making the contract unbalanced by rendering the performance of one of the parties excessively burdensome: termination of the contract or performance without adaptation to the new circumstances. In contrast, the relational theory has recognised contractual flexibility and allows for adaption in order to rebalance the contract. The thesis continues to suggest its adaptive mechanism according to relational theory in chapter seven.

In this chapter and the next, the discussion will centre on how the law of expropriation deals with the range of disruptions of equilibrium which take place in petroleum transactions. In order to study this, I will discuss how the host government’s own action becomes the source of disequilibrium and disrupts the equilibrium, and thus how expropriation itself is a disruption of the equilibrium. At the same time, expropriation, whether direct or indirect, can itself be a reaction of the host government to a perceived disruption of equilibrium. This reaction in turn is a part of a bigger picture which stems from the understanding of contract and the relationship between the parties on which the law is based.6

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I have already in chapter two established that the existing law of expropriation is built upon the classical model of contractual relationship which emphasises presentation and strictness of relationship. I have also shown that failure of presentation in such a static model will bring about taking over of the property rights in the energy projects.

The analysis in this chapter demonstrates how the classical model treats the contractual disequilibrium and will scrutinise the conditions of expropriation by which host governments seek to rebalance the relationship. The current chapter examines the different mechanisms of the host government to directly acquire the property of international oil companies and the international legal requirements for a lawful taking. Furthermore, the response of the international petroleum awards to these conflicting areas will be discussed. One of the most important trends in the petroleum sector in this century was the growth of expropriation. A significant amount of expropriations occurred in host counties in the petroleum sector.\(^7\) The concept of expropriation has been recognised by international law during the last decades.\(^8\) However, “the doctrine and case law on expropriation in international law remain somewhat unsettled. Several factors may explain why this is so. These include the diversity of interests at play, divergences in cultural, economic and legal concepts of property, different understanding of the role of the state, and a general heterogeneity in state practice.”\(^9\) In today’s business in the 21st century indirect expropriation is more common and spreads all around the world. Host governments’ interference in transactions today can take a range of forms, and may be direct or indirect. This is evident through the examination of recent international arbitral awards.\(^10\) International oil companies have filed several disputes before the international tribunals on the basis of indirect expropriation.\(^11\) The focus of the present chapter is on those forms that are taken to constitute direct expropriation. Indirect expropriation is taken up in the next chapter.

3.1. The Host Government’s Mechanisms to Control International Oil Companies

The present and the next chapters discuss the host states’ taking of foreign property, which is the most extreme form of state interference with private property. It is helpful to address a few

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examples of the host states’ mechanism to control the operations of foreign investments within their jurisdictions.

Expropriation arises from the fact that once an investment has been made, the host government has a right to control the foreign investor.12 Host governments may control foreign investment in their territory at the time of entry and also once the investment has been made, they can regulate and control the operations of the foreign investor in their jurisdiction.13

Host states have the police power to make regulatory changes. The ‘police power’ is defined as “The inherent and plenary power of a sovereign to make all laws necessary and proper to preserve the public security, order, health, morality, and justice. It is a fundamental power essential to government, and it cannot be surrendered by the legislature or irrevocably transferred away from government”.14 The government can interfere with the contract and change the contract terms or may even directly take the investment.15

Indeed, host governments exercise maximum control over international oil companies that operate in their territory and it is settled that they are authorised to control foreign oil companies at the time of entry and over the life of the energy project.16 The host government has unlimited rights to place conditions on the entry of the petroleum company into its territory. It is stated that “No international legal authority today would dispute the virtually unlimited right of a sovereign state, if it so chooses, to prescribe in what cases and under what conditions that alien would be admitted”.17

Thus, there are two main control mechanisms exercised by the host government over the international oil company: the right to control potential investment at the time of entry and the host states right to regulate and control the future operations in its territory. In addition, the host state has sovereign powers, including, legislative and administrative measures and is able to prioritise its own interests when they are in conflict with the foreign investor’s interest in the energy industry.18

This is the point that I have already made in the previous chapter that obsolescing bargain over the course of a relationship occurs and that the equilibrium of the contract can be changed by the government.

13 C. Wallace, (2002), supra note 1, 326.
17 Ibid.
18 Ibid.
The question this raises, then, is whether the law of expropriation adequately protects the legitimate expectation of the parties arising from the contractual equilibrium?

Whilst the host government has the power to force the foreign company to meet the legal requirements, it is subject to the accepted standards of international law. This right is concerned with the sovereignty of the host government and has been widely accepted. Furthermore, this right was recognised by the United Nations General Assembly Resolution, 1803 (XVII) 1962 and also has been confirmed by some international arbitrations and bilateral investment treaties. Similarly, chapter two of the Charter on Economic Rights and Duties of States has recognised the right of nationalisation and expropriation for host states. Whilst there is a controversy concerning some conditions for expropriation, mainly assessment of compensation under international law between developed and developing countries, the right of sovereign states as to expropriation and nationalisation are recognised.

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22 The United Nations General Assembly Resolution (UNGAR) 1803 (XVII) of 14 December 1962, Permanent Sovereignty Over Natural Resources.
24 Charter on Economic Rights and Duties of States (CERDS) UNGAR 3281 of 1974; “2- Each State has the right: (a) - to regulate and exercise authority over foreign investment within its national jurisdiction in accordance with its laws and regulations and in conformity with its national objectives and priorities. No State shall be compelled to grant preferential treatment to foreign investment; (b) - to regulate and supervise the activities of transnational corporations within its national jurisdiction and take measures to ensure that such activities comply with its laws, rules and regulations and conform with its economic and social policies. Transnational corporations shall not intervene in the internal affairs of a host state. Every State should, with full regard for its sovereign rights, cooperate with other States in the exercise of the right set forth in this subparagraph; (c) - to nationalise, expropriate or transfer ownership of foreign property, in which case appropriate compensation should be paid by the State adopting such measures, taking into account its relevant laws and regulations and all circumstances that the State considers pertinent. In any case where the question of compensation gives rise to a controversy, it shall be settled under the domestic law of the nationalising State and by its tribunals, unless it is freely and mutually agreed by all States concerned that other peaceful means be sought on the basis of the sovereign equality of States and in accordance with the principle of the free choice of means”.
The existence of a controversy about the calculation of compensation, however, shows that it cannot be taken for granted that the current law of expropriation adequately protects the foreign investor, or that it provides the parties with the same payoffs the original contract would have provided and, hence, maintains the contractual equilibrium. Answering this question requires us to study the practice of expropriation, as it has emerged in international investment litigation and arbitration.

International arbitral practice demonstrates that the right of sovereign states in relation to expropriation and nationalisation of private property is endorsed but it is subject to conditions. In the \textit{LIAMCO}, the sole arbitrator noted that the host state may expropriate or nationalise natural resources and it would be legal if it was accompanied with compensation for that termination.\textsuperscript{27} This pattern was followed by the tribunal in the \textit{AMINOIL} case. The tribunal held that nationalisation was a valid exercise of the right of nationalisation by Decree No.124\textsuperscript{28} and it is not discriminatory or confiscatory.\textsuperscript{29} The tribunal in the \textit{AMOCO} found that the right of expropriation for host states are unanimously accepted.\textsuperscript{30} In the case of \textit{British Petroleum v. Libya},\textsuperscript{31} the Libyan government had nationalised all properties, assets, shares and rights of BP, under the BP nationalisation law.\textsuperscript{32} Further, the tribunal recognised the right of the Libyan government to nationalise natural resources but found that the action of the Libyan government was against international law, because the basis for taking was purely a political reason. In addition, this taking was discriminatory.\textsuperscript{33} It is therefore clear that although the right of the state for nationalisation is recognised, the taking was unlawful and breached the investment contract.

As the above suggests, the trend that emerges from the practice of arbitral tribunals is to circumscribe the right of host states with specific conditions. Taking will be lawful, but only if certain requirements are met. The result is an approach in which whenever the foreign company runs against the public interest of the host country, the sovereign state may use its power to compel the international oil company to comply with the government’s stipulations and legal requirement, subject to safeguards which seek to prevent the abuse of this power. The remainder of this chapter will examine whether this approach is successful in defending the contractual equilibrium.

\textbf{3.2. Nature of Expropriation}

It is helpful to examine terminology and definitions before the main discussion. In international investment law, in relation to host government interference with the foreign private property, the

\textsuperscript{27} \textit{LIAMCO}, (1981) 20 ILM 1, 85.
\textsuperscript{29} 21 (1982) ILM 976, para.86, 1019.
\textsuperscript{30} \textit{AMOCO International Finance Corp. v. Iran}, 15 Iran-US CTR, 189, 222, para 113.
\textsuperscript{31} 53 (1974) ILR 297.
\textsuperscript{32} Ibid, 297.
\textsuperscript{33} 53 (1974) ILR 297, 354.
terms “expropriation” and “nationalisation” are used. However, international petroleum investment agreements and Bilateral Investment Treaties (BITs) do not usually offer a definition for the important concepts and terms such as expropriation and indirect expropriation and, hence, the terminology has remained blurred. Although the definitions remain controversial, their impact on the value of investment will be significant. International investment treaties only point out the risk, but interpretation must not be inconsistent with international law. Some scholars offer a definition for expropriation and distinguish expropriation and nationalisation. In Hoffman’s view, expropriation is “the outright and overt taking of property, often achieved by means of transfer of title”. Professor Brownlie elaborates upon the definition of expropriation, “the essence of matter is the deprivation by state organs of a right of property either as such, or by permanent transfer of the power of management in control”. In addition, it has been stated that, “the most meaningful distinction is that expropriation refers to the taking of one or several properties within a single area of economic activity, whereas nationalisation refers to the government’s taking of all properties within the area”. Thus, nationalisation and expropriation have the same legal nature but they differ in the scope and compensation that is usually accompanied with it.

Expropriation is defined as taking of private property by the state with the payment of compensation. It is also described as “the taking or use of property by public authority with adequate compensation”. In the AMOCO case, the tribunal presented a definition for expropriation, which is “compulsory transfer of property rights”. However, there are some cases in which the host government’s taking of property right is regarded lawful without payment of compensation. The host government as sovereign state does have sovereignty and due to this

35 Article 31 of the Vienna Convention on the Law of the Treaties, UN Doc. A/conf. 39/27 (1962); (1969) 8 ILM 679, stated that interpretation of treaties should be by considering any relevant rules of international law applicable in the relations between the parties.
38 I. Brownlie, (2003), supra note 12, 508-509.
40 K. Hober, (2003), supra note 11, 381.
42 G. Van Hecke, (1951).
43 15 Iran-US CTR 189, at p.220; Award No.310-56-3 (14 July 1987).
44 There are instances where the state taking of private property without compensation may be regarded as legitimate act. This is where the taking of property occurs as a defence measure in wartime or when the
right can take the foreign investor’s property.44 “It is undisputed that international law allows that property of nationals as well as foreign investors may be expropriated, provided that certain requirements are met.”45 There is general agreement on this point.46 However, international petroleum investment agreements are subject to the principle of Pacta Sunt Servanda (sanctity of contract), under which the host government may not expropriate the foreign investor’s property without the mutual contractual consent.47 Some other scholars have criticised this principle and asserted that it may not be absolute in long-term petroleum contracts.48

The question is to what extent, for which aims and under which conditions is expropriation justifiable. The rationale behind the expropriation is that host governments seek to improve the welfare of their nationals and maximise the economic benefits for their industries. “It contains the solution of reconciling the interests of society with those of the individuals.”49 There are two legal points of views in responding this question. From the point of view of the host governments, sovereignty of capital-importing governments may not be limited and they have full control over their natural resources.50 On the other hand, capital-exporting governments and foreign investors seek a restricted right of expropriation, due to a stable and secured return of financial interests and their legitimate expectations. In their opinion, host governments cannot expropriate a foreign investor’s property in any circumstance, and only if certain conditions are met expropriation might be done.51

Brownlie has defined nationalisation as, “the process of the taking of one or more major national resources as part of a general programme of social and economic reform.”52 In the AMOCO case, the tribunal held the following view on nationalisation “the transfer of an economic activity from private ownership to the public sector. It is realised through expropriation of the assets of an enterprise or of its capital stock, with a view to maintaining such enterprise as a going concern under the state control”.53 Nationalisation has also been defined as the transfer of property from state exercises its police power to regulate public morals, health and safety or to make private interests subservient to the general interests of the community. See, I. Brownlie, (2003), supra note 12, 509; F. Mann, “State Contracts and State Responsibility” (1960), 54 AJIL 572, 584; G. Van Hecke, (1951), supra note 40, 545.

47 Texaco arbitration, 53 ILR (1979), para.68.
48 For the full examination see the next chapters.
50 K. Hober, (2003), supra note 11, 383.
51 “Every natural or legal person is entitled to the peaceful enjoyment of his possessions. No one shall be deprived of his possessions except in the public interest and subject to the conditions provided by law and by the general principles of international law.” Article 1, the First Protocol to the European Convention; K. Hober, (2003), supra note 11, 383.
52 I. Brownlie, (2003), supra note 12, 509.
53 15 Iran-US CTR,189, 222-3; Award No.310-56-3, (14 July 1987)
private to the public sector, in the public interest, as a general programme of economic development. Expropriation is about taking property rights in individual cases but nationalisation is used as part of the economic programme of the host governments.

However, in the reality of international investments, a distinction between terms of “nationalisation” and “expropriation” does not have a great impact. As a result of host states’ interference, whether nationalisation or expropriation, the original equilibrium of the contract will be disrupted. There are different conceptual definitions which try to draw a distinction between expropriation and nationalisation, but this study uses a simpler definition for the purposes of the thesis. This thesis looks at the distinction from the point of view of the contractual equilibrium and its focus is on disruption of equilibrium by taking the investor’s property. From the perspective of disruption of equilibrium the distinction between expropriation and nationalisation does not really matter because they both reflect and create exactly the same issue: namely, they both relate to disruption of the equilibrium. The thesis takes a simpler approach which makes more sense given the context in which disputes arise.

In this study, the terms of “taking” and “expropriation” will be employed for the taking over of international investor’s property; on the basis that the doctrinal analysis of definitions is not of significance to the questions this thesis poses. It is worth noting that taking of the foreign investor’s property should be the last resort, because it will reduce the economic value of the investment, disrupt the financial return and seriously affect the property rights of international oil companies. Additionally, the host government will seek to avoid to be considered as an unattractive and threatening country for foreign investment. In order to analyse the relationship between the contractual equilibrium, dynamic bargain and expropriation, it will be fruitful to discuss international legal requirements for expropriation and the limitations of host states in exercising their rights to regulate the investment in their territory.


56 Ibid, 588. Also, due to space limitations it is not either possible or desirable to deeply discuss the definitions of the different types of state interference with property rights of investors.

3.3. Compensable Property Rights

The host government interference will affect the property rights of the international investor and thus compensation is to be paid for such affected rights by governmental measures. In order to assess the success of the law of expropriation in dealing with the issue of preserving the contractual equilibrium, it is important to discuss the concept of property. It is necessary because, in particular, property right is a core concept in expropriation. For the aim of this research, property rights in the field of petroleum and the relevant arbitral awards will be examined to determine the legal nature of property in the law of expropriation.\(^{58}\) In international law there is a general agreement on the notion of property rights.\(^{59}\) The concept of property comprises rights over things.\(^{60}\) The owner of property would have the right to dispose of the property, right to use and right to the interests of the property.\(^{61}\) The owner does not need permissions to use the property, unless it is against public policy and is banned by law.\(^{62}\) The concept of property was defined by several arbitrations in petroleum jurisprudence. In \textit{AMOCO}\(^{63}\) the tribunal held this view that property can cover tangible and intangible when interpreting Article IV of the Treaty of Amity.\(^{64}\) The Iran-US Claims Tribunal awarded that “no convincing explanation has been adduced to justify such a narrow interpretation, which is not in line with common usage of the word, nor with the express terms of the treaty protecting not only ‘property’ but also ‘interests in property’.”\(^{65}\)

In the similar vein, the arbitrator in \textit{LIAMCO} defined property rights as “rights that have a pecuniary or monetary value.”\(^{66}\) Property might be tangible or intangible and “covers all physical things, such as chattels, lands and various other things of material nature.”\(^{67}\) In the \textit{AMOCO} arbitration, the Iran-US Tribunal held that contractual rights under the Khemco agreement have economic value and can be expropriated.\(^{68}\) Hence, in light of international arbitral practice in the

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\(^{58}\) “We know property when we see it. But how can we know if an individual has lost property a right unless we really understand what property is?”, R. Higgins, “The Taking of Property by the State: Recent Developments in International Law”, (1982) 176 RDC-Collected Courses, 259, 268.


\(^{63}\) \textit{AMOCO International Finance Corp. V. Government of the Islamic Republic of Iran}, Award No. 310-56-3 (14 July 1987), 15 Iran US CTR, 189, 220.

\(^{64}\) “Property of Nationals and companies of either High Contracting Party, including interests in property, shall receive the most constant protection and security within the territories of the other High Contracting Party, in no case less than that required by international law.”

\(^{65}\) 15 Iran- US CTR, 189, 220.

\(^{66}\) 62 ILR 141, 189 (1982), Award of 12 April 1977.

\(^{67}\) 15 Iran-US CTR, 189, at p.220.

\(^{68}\) The facts will be thoroughly discussed later in this chapter. Nevertheless, for now, Khemco was an investment agreement between AMOCO International Finance Corporation and National Petrochemical
petroleum industry, contractual rights such as rights arising from contracts of concession, purchases or loans constitute property rights and those measures that have an adverse effect on which or any termination or taking over of the contractual rights must be compensated. It is evident by many international arbitrations and academic commentators. It is notable that rights which are economically significant to the investors can be expropriated. Indeed, all rights and interests having an economic content come into play, including immaterial and contractual rights. This principle is reflected in the definition of the term investment in the treaties for the protection of investments. For example, the ECT in Article 1(6) and NAFTA in Article 1139 refer not only to tangible but also to intangible property.

3.3.1. Shareholder’s Rights

It may be helpful to discuss the status of shareholders’ rights and whether they constitute property rights, and whether taking over of which will bring about to the payment of compensation. It is also worthy of note, because these rights are usually accompanied by rights such as, right to receive interests, to management and voting in the company. In the AMOCO case, the tribunal found that AMOCO’s shares in other companies were property rights and compensable. The company’s shares had financial value in the market and could be considered as property rights. In the case of Sedco three provisional managers were appointed by the government for Sediran Company, where an American investor (Sedco) had shareholder’s rights. The claimant alleged that it was deprived of attending the process of decision making and did not have control over Sediran activities. The tribunal found these circumstances as “potentially evidencing a taking”. However, the Iran-US Claims Tribunal explained its reason and held that “appointment of managers has often been regarded as a highly significant indication of expropriation because of the attendant denial of the owner’s right to manage the enterprise. When as in the instant case, the seizure of control by the appointment of temporary managers clearly ripens into outright taking

Company of Iran (NPC) to install a natural gas plant in Iran. This contract was nullified by Single Article Act after revolution in 1980.

69 “According to great array of diplomatic and judicial cases and great majority of authors, property comprises rights as well as tangible property, above all contractual rights, such as rights arising from contracts of concession, purchases, loans, etc”. J. Herz, “Expropriation of Foreign Property”, (1941) 35 Am. J. Int’L L. 243, 244-5; C. Brower & J. Brueschke, The Iran-United States Claims Tribunal (The Hague: Martinus Nijhoff Publisher, 1998), 473-5.


73 Sedco Inc. v. National Iranian Oil Company (Sedco v. Iran), 9 Iran-US CTR, 284.

74 9 Iran-US CTR 284, 277.
of title, the date of appointment presumptively should be regarded as the date of taking”. In accordance with the award, it is almost clear that those actions which adversely affect the rights of a company in the other company cannot always form taking. In this decision although the host government has deprived the foreign company of the process of making decisions and monetary fund of Sediran, the tribunal did not recognise this as an expropriation. Indeed, the governmental measure has to affect the property rights and transfer the legal title of property to the host state or the state entity.

In the Mobil Oil case, the claimants alleged that the host state had renounced the Sale and Purchase Agreement signed in 1973 and those established rights under the agreement were expropriated. The tribunal recognised that contractual rights can be the subject matter of property rights and could be therefore expropriated. In the Philips Petroleum case, the claimants alleged that their rights under the exploration and exploitation contract with the National Iranian Oil Company (NIOC), were expropriated and payment of compensation was required. The tribunal decided that financial interests are established by contractual rights and “expropriation by or attributable to a state of the property of an alien gives rise under international law to liability for compensation, and this whether the expropriation is formal or de facto and whether the property is tangible, such as real estate or a factory, or intangible, such as the contract rights in this case.”

The Iran-US Claims Tribunal in the Philips Petroleum case has endorsed that compensation is to be paid for expropriation of both tangible and intangible properties. Whereas, recognition of tangible property is not a difficult task, determination of different types of intangible properties, such as interests, economic benefits and contractual rights might be questionable. This issue is examined in petroleum jurisprudence and contractual rights were recognised as property right. However, there is no established practice yet by the international tribunals on the determination of measures that affect shareholder’s rights, which may constitute expropriation. It will therefore be helpful to take into account surrounding circumstances and a case by case approach is illustrative. In addition to direct expropriation, the government can affect property rights by

75 Ibid, 278.
76 G. Christie, “What Constitutes a Taking of Property Under International Law?”, (1962) 38 BYBIL 307, 311; However, it is an accepted principle of international law that a state is not responsible for economic injury which is due to bona fide “regulation” within the accepted police power of states. See, J. Sax, “Taking and Police Power”, (1964) 36 Yale L. J. 61-7.
77 Mobil Oil Iran, Inc. v. Iran, Award No. 311-74/76/81/150-3 (14 July 1987), 16 Iran-US CTR 3.
78 Ibid, para.73, 73.
80 Ibid,79.
81 Supra note 67, 79.
82 Ibid,75.
83 S. Friedman, (1953), supra note 20, 140-142; LIAMCO Arbitration, 62 ILR 141, 189 (1982), 189; J. Herz, (1941), supra note 69, 244-5. ; C. McLachlan, (2008), supra note 55.
various indirect methods. In this pattern, the government will reduce the economic value of the investment for the foreign investor but the legal title of property does not transfer.

3.3.2. Right of Access to the Market

The recent trend in indirect expropriation led to the emergence of a more expansive definition of property rights. The modern concept of property is “less the tangibility of things, but rather the capability of a combination of rights in a commercial and corporate setting and under a regulatory regime to earn a commercial rate of return”.

International arbitral tribunals have favoured a more expansive concept of property rights.

It could be seen in the *Pope & Talbot*. The claimant was a US company that operated softwood lumber in British Columbia to export to the United States. The Claimant alleged that the new export control regime which was in implementation of the US-Canada softwood lumber agreement “has deprived the investor of its ordinary ability to alienate its product to its traditional and natural market, -the US market- and hence expropriated its investment.” The claimant stated that it was due to the requirement that companies have to obtain export permits and the payment of fee for a certain number of board feet which is required. The respondent reasoned that the right to access a market cannot be considered as property, either tangible or intangible. However, the tribunal held that Pope & Talbot’s right to the US market was a property interest, falling within the scope of Article 1110 NAFTA. Further, the tribunal decided “Pope & Talbot’s access to the US market is an abstraction, it is, in fact, a very important part of the business of the investment. Interference with that business would necessarily have adverse effect on the property that the

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87 *Pope & Talbot*, paras, 81-86.
88 *Pope & Talbot*, para, 87.
89 *Pope & Talbot*, para, 96; Article 1110 required: “1. No Party may directly or indirectly nationalize or expropriate an investment of another Party in its territory or take a measure tantamount to nationalization or expropriation of such an investment ("expropriation"), except: (a) for a public purpose; (b) on a non-discriminatory basis;(c) in accordance with due process of law and Article 1105(1); and (d) on payment of compensation in accordance with paragraphs 2 through 6.

2. Compensation shall be equivalent to the fair market value of the expropriated investment immediately before the expropriation took place ("date of expropriation"), and shall not reflect any change in value occurring because the intended expropriation had become known earlier. Valuation criteria shall include going concern value, asset value including declared tax value of tangible property, and other criteria, as appropriate, to determine fair market value. 3. Compensation shall be paid without delay and be fully realizable.”
investor had acquired in Canada, which, of course, constitutes the investment.”\textsuperscript{90} Hence, the notion of property includes both tangible and intangible rights and such rights that were created under the contract will constitute property rights.

3.3.3. The Limitations of The Classical Model and that Expropriation Can Only Lead to Discharge and not Adjustment

I examined relational and classical theories, the OBM and problems caused by classical model in chapter two. In addition to this, I discussed the inadequacy of the classical theory and its suggested framework, i.e., termination followed by compensation in chapter four. For now, this section here links the discussion of expropriation to the underlying idea of the thesis, i.e., implementation of the relational theory and maintaining the equilibrium. The classical model in which the law of expropriation is grounded gives little room for states that need to respond to the disruption of the equilibrium. This model provides the investor larger shares of rewards and the host state smaller shares of rewards, and even if the host state seeks to respond to shifts in the equilibrium, the law of expropriation prevents the state from doing that. Moreover, in the background there is this ever-growing notion of property rights. The significance of the discussion is on the evaluative position that this study takes on the challenge of preserving the equilibrium. How do all these elements –strictness of contractual relationship, expansion of the concept of property and disruption of equilibrium- affect the law of expropriation in maintaining the contractual equilibrium? The answer is that they are grounded in a static view of rights and obligations, which looks at the contract involving a clearly defined set of rights and obligations, and tries to determine the terms on which the contract comes to an end. When the notion of property rights is expanded, it will expand the range of circumstances in which the contract is brought to an end. Expropriation can only lead to discharge and never to adjustment. I return to this point in chapter seven.

3.4. The Basic International Legal Requirements for a Lawful Taking

It is generally accepted that host governments can expropriate the foreign investor’s property but certain requirements must be fulfilled for the lawful expropriation. The question that arises, then, is whether these taken together protect the contractual equilibrium, giving the host state the freedom to react to threatened disruptions, whilst at the same time protecting the legitimate interests of the investor. This section examines this question in greater detail. The key requirements imposed by international law are that the lawful taking of property rights must be for the public purpose, non-discriminatory and with the payment of prompt, adequate and

\textsuperscript{90} Pope & Talbot, para, 98.
effective compensation.\textsuperscript{91} These conditions have been formulated in almost all BITs,\textsuperscript{92} multilateral investment treaties and international investment contracts.\textsuperscript{93} They are contained in almost all contracts and treaties to provide greater certainty.\textsuperscript{94} The distinction between lawful and unlawful expropriation which these restrictions create is important. In a lawful taking, compensation must be paid, however, in an unlawful taking damages are required. Damages will


\textsuperscript{92} The legal requirements for a lawful expropriation are incorporated in almost all BITs: Article 5 of the UK-USSR stated “except for a purpose which is in the public interest and is not discriminatory and against the payment, without delay, of prompt and effective. Such compensation shall amount to the real value of the investment expropriated immediately before the expropriation or before the impending expropriation became public knowledge, whichever is the earlier, shall be made within two months of the date of expropriation, after which interest at a normal commercial rate shall accrue until the date of payment and shall be effectively realisable and be freely transferable. The investor affected shall have a right under the law of the contracting state making the expropriation, to prompt review, by a judicial or other independent authority of that party, of his or its case and of the valuation of his or its investment in accordance with the principles set out in this paragraph.” Article 5 of the UK-USSR Agreement, cited in M. Shaw, supra note 46, 749; Article 6 of the Agreement between the Government of the Islamic Republic of Iran and the Government of the Republic of Croatia provides “(1) Investment of investors of one Contracting Party shall not be expropriated, nationalised or subjected to similar measures by other Contracting Party except for a public purpose, in accordance with due process of law in a non-discriminatory manner, and upon payment of prompt and effective compensation. (2) Such compensation shall amount to the market value of the expropriated investment immediately before the expropriation or before the impending expropriation became public knowledge. In case of delay in the payment of the compensation the host Contracting Party will pay financial compensation for the delay period from the date of entitlement of the investor to compensations to the date of payment in accordance with its law and regulations” UNCTAD Investment Instruments Online, at http://www.unctadxi.org/templates/docsearch.aspx?id=779; In a similar way Article 6(1) of the US Model BIT (2004) provides “Neither Party may expropriate or nationalise a covered investment either directly or indirectly through measures equivalent to expropriation or nationalisation (“expropriation”), except: (a) for a public purpose, (b) in a non-discriminatory manner, (c) on payment of prompt, adequate and effective compensation and; (d) in accordance with due process of law and Article 5. Article 6 (Expropriation) shall be interpreted in accordance with annexes A (customary international law) and B (Expropriation).”Article 6(1), the US Model BIT, available at http://www.state.gov/documents/organization/117601.pdf, March 2015; See also, K. Vandevelde, “The Economics of Bilateral Investment Treaties”, (2000) 41 Harv. Int’l. J., 469; G. Born, International Commercial Arbitration, (2nd ed., Transnational Publishers, 2001) 191; S. Bauhhen, “Expropriation and Environmental Regulation: The Lessons of NAFTA”, (2006) 18(2) Journal of Environmental Law 207.

\textsuperscript{93} The North American Free Trade Agreement (NAFTA), in Article 1110 (1) (a) provides “No Party may directly or indirectly nationalise or expropriate an investment of an investor of another Party in its territory or take a measure tantamount to nationalisation or expropriation of such an investment (“Expropriation”), except: (a) for a public purpose (b) on a non-discriminatory basis (c) in accordance with due process of law and Article 1105(1) (minimum standards of treatment, including fair and equitable treatment and full protection and security), and (d) on payment of compensation.”; the Energy Charter Treaty in Article 13 provides: “(1)- Investments of Investors of a Contracting Party in the Area of any other Contracting Party shall not be nationalised, expropriated or subjected to a measure or measures having effect equivalent to nationalisation or expropriation (hereinafter referred to as “Expropriation”) except where such Expropriation is: (a) for a purpose which is in the public interest; (b) not discriminatory (c) carried out under due process of law; and (d) accompanied by the payment of prompt, adequate and effective compensation.”

include loss of the future interests, earning, and loss of property, this results in more than normal compensation in a lawful taking.95 The requirements for legality under the international practice that have been shaped by arbitral awards will be examined.

### 3.4.1. Public Purpose

This requirement was first suggested by Grotius96 and has been endorsed by the United Nations General Assembly Resolution 1803, (1962) on Permanent Sovereignty over Natural Resources,97 bilateral and multilateral treaties and national legislations.98 This resolution does not establish rules in international law but it is an important factor for the development and protection of the investment in international law.99 The condition of public interest was also supported by BITs as a requirement for lawful taking.100 However, public purpose is a broad concept and international law has not provided a clear definition as of yet.101 Consequently, sovereign states determine the scope of the public purpose requirement. It is therefore, very difficult to prove that expropriation was not for the public purpose or the welfare of society.102 As a result, there are few cases, if any, where expropriation has been considered unlawful for the public purpose requirement.103

In *ADC v Hungary*,104 the tribunal found that expropriation of the claimant’s interests in the operation of a terminal at the Budapest Airport by the Hungarian government was not lawful. The tribunal held no public interest was served by depriving the claimants of their interests. In the tribunal’s opinion; “a treaty requirement for ‘public interest’ requires some genuine interest of the public. If mere reference to ‘public interest’ can magically put such interests into existence

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97 It is required that nationalisation has to be for purpose of public utility, security and natural interest. The General Assembly Resolution 1803, in Article 4 provides that “nationalisation, expropriation or requisitioning shall be based on grounds or reasons of public utility, security or the national interest which are recognised as overriding purely individual or private interests, both domestic and foreign.”
102 M. Shaw, supra note 46,571; N. Rubins, and N. Kinsella, (2005), supra note 54, 177.
103 K. Hober, (2003), supra note 11, 385.
and therefore satisfy this requirement, then this requirement would be rendered meaningless since the Tribunal can imagine no situation where this requirement would not have been met”. 105 Similarly, the tribunal in LETCO v Liberia, found that the revocation of a concession and taking the areas of concession away from LETCO were not for the public purpose. 106

Host governments usually allege that the expropriation measure is for the public purpose. There is therefore, a need for drawing a framework in determination of the sphere of public purpose. Indeed, “the question is, of course whose public interest, as determined by whom. Since international law quite patently leaves all sovereign states free to choose their own economic and social systems, the answer can be only that the test has to be the public interest of the taking state, as conclusively determined by it.” 107

Scholars have stipulated that expropriation is to be for the reason of national interests and the public utility. They have only excluded any taking for individual interest. 108 In addition, there is general agreement that governments have discretion to construe the term of public purpose. 109 The public purpose requirement is also supported by the international arbitral awards in the petroleum industry. Therefore, it would be appropriate to examine governmental action in this context, case by case to specify whether it has been carried out for the public purpose.

In the AMOCO arbitration, the tribunal decided that “an expropriation, the only purpose of which has been to avoid contractual obligations of the State or of an entity controlled by it, could not, [nevertheless] be considered as lawful under international law.” 110 Thus, it seems that expropriation of property rights to avoid performance of contractual arrangement will be unlawful, because it does not meet the public purpose requirement.

In addition, if the sole purpose of the taking of property right is a political issue, it might not fall into the scope of public purpose. In British Petroleum v Libya, the ad hoc arbitrator found that expropriation was unlawful because it was “for purely extraneous political reasons as an act of retaliation for a British foreign policy decision”. 111

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105 Ibid, para. 432, 78.
106 26 ILM 647, 665.
109 In AMOCO Case, the tribunal found that “as a result of the modern acceptance of the right to nationalise, this term (public purpose) is broadly interpreted, and the States in practice are granted extensive discretion.” 15 Iran-US CTR 189,232, para.145; J. Herz, (1941), supra note 69, A.Akinsanya, ibid, 108.
The Iran-US Claims Tribunal in the *AMOCO* case examined the issue of public purpose. The claim arose out of the Khemco Agreement, entered into on 12 July 1966 between AMOCO and the Iranian National Petrochemical Company (NPC), pursuant to which the parties agreed to make a joint venture company, Khemco, for the purpose of building and operating a plant for the production and marketing of sulphur, natural gas liquids and liquefied petroleum gas derived from natural gas. Civil unrest and events in 1978 and 1979 in Iran obstructed the operation of oil processing facilities including those of Khemco. AMOCO International then evacuated its personnel. The Special Commission in December 1980 declared that the Khemco agreement was null and void with the provision of the Single Article Act. The claimant (AMOCO) alleged it was unlawfully deprived of its 50% property interests in Khemco. AMOCO asserted that nationalisation was merely to release NPC from the contractual obligations under the Khemco agreement and, particularly, from the obligation to share the profits of the venture. Therefore, nationalisation was not valid. The tribunal then examined the public purpose requirement and found that “a precise definition of the ‘public purpose’ for which an expropriation may be lawfully decided has neither been agreed upon in international law nor even suggested, and states have been granted extensive discretion in determination of public interests.”

The tribunal also pointed out that an expropriation, the only purpose of which would have been to avoid contractual obligation of the state or of an entity controlled by it, might not be treated as lawful under international law. The tribunal then added that such expropriation would be contrary to the principle of good faith and would run counter to the well-settled rule that a state has the right to commit itself by a contract to foreign corporations. It has also generally accepted that a state has no right to expropriate a foreign concern only for financial purposes.

Further, the tribunal addressed the legality of nationalisation under the requirement of the public purpose. The tribunal found that the government’s act was for the public interest. The tribunal stated it has generally agreed that states were not entitled to expropriate for solely financial purposes. It concluded that even if financial considerations were considered in the adoption of such a decision, which would be natural, it would not be sufficient to prove that it was not taken

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112 Kharg Chemical Company Limited, a company established under the laws of Iran.
113 A company established under the laws of Iran. It is one of the respondents in AMOCO case.
114 15 Iran-US CTR. 191.
115 On 8 January 1980, the revolutionary Council of the Islamic Republic of Iran promulgated the Single Article Act concerning the nationalisation of the oil industry of Iran. The Single Article Act stated “All Oil Agreements considered by a Special Commission appointed by the Minister for oil to be contrary to the nationalisation of Iranian oil industry Act shall be annulled.” 15 Iran-US CTR. 189-205.
117 Ibid, 233.
118 15 Iran-US CTR. 189, 234.
119 15 Iran-US CTR. 189, 233.
for a public purpose.\textsuperscript{120} Indeed, every government considers financial interests while dealing with nationalisation on the grounds of public purpose. It would not therefore affect the legality of the requirement of public purpose.\textsuperscript{121}

In the AMINOIL case, the government of Kuwait decided to reduce the revenues for the oil company up to 92 percent per barrel.\textsuperscript{122} As a result, AMINOIL asked for a renegotiation with the government of Kuwait, but the parties could not reach agreement for method of the payment. The Kuwaiti government announced Decree Law No.124 that terminated concession agreement with the AMINOIL Company, declaring that all AMINOIL’s properties were nationalised and fair compensation would be paid. AMINOIL objected and alleged that nationalisation was illegal and the other side, the Kuwaiti government asserted it was legal. The main argument was whether Decree Law No.124, 1977 was a valid Act for nationalisation. The foreign oil company objected and argued that taking was unlawful because it was not for the reason of public interest.\textsuperscript{123} The foreign oil company also contended that the host government promulgated the Decree Law and terminated contractual relations which parties were negotiating. Indeed, it was issued to free the government from its contractual obligations.\textsuperscript{124}

The ad hoc arbitral tribunal examined the claimant’s contentions and stated that Decree Law No.124 was passed for a public purpose and for the completion of the government’s programme for nationalisation of the petroleum industry.\textsuperscript{125} In addition, the tribunal discussed the alleged justification for nationalisation that was only to put an end to the contractual relationship. The tribunal argued that circumstances showed it was not the case here. The Kuwaiti government sought nationalisation as a part of a general programme to take control of the entire petroleum industry.\textsuperscript{126} The tribunal also held that nationalisation for the sole purpose of termination of a contractual relationship would be unlawful.\textsuperscript{127}

However, an international petroleum arbitration considered that the requirement of public propose was not a necessary condition for a lawful nationalisation. In Libyan American Oil Company (LIAMCO) v. The Government of the Libyan Arab Republic which was concerning nationalisation of the concession rights under a petroleum concession by the government of Libya, the tribunal addressed the requirement of public purpose. The American company (Claimant), namely, the Libyan American Oil Company alleged that the government’s measures due to the lack of public

\textsuperscript{120} 15 Iran-US CTR. 189, 234.
\textsuperscript{121} S. Ganguly, (1999), supra note 95, 137.
\textsuperscript{122} Middle East Economic Survey, Vol. 18, No. 8 (13 December 1974.)
\textsuperscript{123} AMINOIL Arbitration, 24 ILM (1982) 976, para. 85, 1019.
\textsuperscript{125} 24 ILM (1982), paras. 85-86, 1019.
\textsuperscript{126} ibid, paras. 109-110,1025-6.
\textsuperscript{127} Ibid, para. 109,1025.
purpose requirement and for being politically motivated were unlawful. Despite the AMINOIL case, the sole arbitrator found that the requirement of public purpose was not met and then decided that the public purpose requirement was not necessary for a lawful nationalisation. Dr. Sobhi Mahmassani stated:

“As to the contention that the said measures were politically motivated and not in pursuance of a legitimate public purpose, it is the general opinion in international theory that the public utility principle is not a necessary requisite for the legality of nationalisation. Motives are indifferent to international law, each state being free to judge for itself what it considers useful or necessary for the public good. The object pursued by it is of no concern to third parties.” 128

In *AGIP Company v. Popular Republic of the Congo* (1979), the tribunal considered the question of public purpose. 129 In this case, the government of the Congo nationalised assets of a foreign company, named, AGIP (Brazzaville) S.A, an Italian company, which established under the Congolese law and in Congo. AGIP started its activities in the oil distribution sector in 1965. The Congolese government on January 12, 1974 by Law No.1/74 nationalised the oil distribution sector and as a consequence, all assets transferred to the Hydro-Congo State Company. However, due to signing of a protocol of agreement with the government under which AGIP undertook to sell the shares representing 50% of the company’s capital to the government of Congo, the foreign company (AGIP) was not affected by the governmental measures. In return, the Congolese government undertook to guarantee up to 50% credits and financing which granted to the company and to take the steps and parastatal organisations provided by the company. Although AGIP and the host government signed an agreement, however Hydro-Congo embarked a growing and aggressive competition with AGIP. As a result, the foreign company asked for a renegotiation, but during the renegotiations, the President of Congo decided to nationalise AGIP by order No. 6/75. AGIP challenged the validity of nationalisation that it did not satisfy the basic condition laid down by the constitution that was required for national interest. AGIP then sought to distinguish between the actions that the government performs in the general interest and those actions in the private interests. With regard to this argument, the Congolese government in the order declared that “considering that the company AGIP (Brazzaville) S.A. has ceased all commercial activities and is therefore unable to meet its obligations, and considering that this situation is seriously damaging the Congolese state as a shareholder in this company...”. Further, the tribunal rejected

128 *LIAMCO arbitration*, (1981) 20 ILM 1, 58; M. Sornarajah, (1986), supra note 96, 182. The government of Libya did not attend the proceedings; the real motive for the state’s action remained unknown. However, during that period of time, OPEC—which Libya is a member of—it started a programme to take over the sovereignty over the petroleum resources. It might have been for participation in this programme.

129 21 ILM 726 (1982).
the contention of AGIP concerning a distinction between the general interest and the private interest of the government activities as a shareholder and added, “if a state, in participating in the formation of the capital of a company, performs an act in the private sphere analogous to the action of an individual. It is nonetheless acting in the general interest of the community for which it is responsible. Thus the fact that the state that nationalise a company is a shareholder cannot alone warrant the conclusion that this step is not taken in the general interest”.  

The examination of the above-mentioned cases supports the view of the majority of scholars that the definition of public purpose has not been made clear. On this point, the arbitral awards have a prominent role in the development of unclear issues. Excluding the LIAMCO case, all other cases held that the public purpose condition required for lawful nationalisation. It is generally agreed that public purpose is one of the requirements for lawful expropriation. In petroleum jurisprudence, arbitrations did not define the condition of public purpose. In addition, all petroleum arbitral awards that were examined earlier, have not found expropriation unlawful in international law on the specific basis of the violation of the public purpose requirement. The discussion crystallised that governments have a wide discretion in the determination of the scope of public purpose. Besides, the arbitral tribunals should take into account the surrounding circumstances and all the facts pertinent to the case in determination of whether host states have met the public purpose condition.

3.4.2. Non-Discrimination

Another requirement of international law for a lawful taking is that expropriation must not be discriminatory. For the purpose of the current study, as it analyses a contractual mechanism, the principle of non-discrimination will be discussed in the framework of customary international law. It is notable that the non-discriminatory requirement has a wider meaning in international conventional law. It takes the form of two treaty standards: most favoured nation treatment (MFN) and national treatment. These two standards have each had a long history and can be found in most investment treaties. However, the latter standards are made by treaties (non-contractual mechanism), and neither is recognised as part of customary international law. Therefore, they are beyond the scope of this research and will not be discussed.  

discriminatory treatment under international law is unlawful.\textsuperscript{132} This view was supported by some bilateral and multilateral treaties\textsuperscript{133} and also awards.\textsuperscript{134} If the host government’s action has targeted foreign investors on the basis of religion or nationality, this may be classified as discrimination and expropriation will therefore be unlawful. Typically, treaties contain this requirement that expropriation shall not be with discriminatory treatment, but they do not provide a clear definition of discriminatory measures.\textsuperscript{135} There are some arguments concerning the meaning and framework of the principle of non-discrimination. It is said that when foreigners are equal with the nationals of the host government and are treated equal, then international law is not violated.\textsuperscript{136}

Despite the difficulty in presenting a comprehensive definition on discriminatory measures, we should have some criteria in determining a treatment. It might be the intention of the host state in application of that measure.\textsuperscript{137} However, it is difficult to prove it before the international tribunals. It might be useful to consider all the relevant factors and circumstances. In this connection it is said that “the principle of non-discrimination in both customary and conventional international law must be understood in the context to which it is applied. The principle has no blanket application in disregard of the factual circumstances concerned; in applying it, the judge or arbitrator must weigh cautiously all the relevant circumstances. It remains to be seen whether a future multilateral agreement on investment will clarify and settle the many issues arising in the context of non-discrimination.”\textsuperscript{138}

However, the determination of the extent of inequalities which can constitute illegal discrimination in international law is not easy. It is notable that discriminatory expropriation on the ground of ethnic, origin or nationality is not lawful.\textsuperscript{139} Arbitrary and racially motivated


\textsuperscript{133} The Energy Charter Treaty and the North American Free Trade Agreement (NAFTA).


\textsuperscript{137} M. Sornarajah, (1986), supra note 96,185.

\textsuperscript{138} A. Maniruzzaman, (1998), supra note 118, 77.

measures are unlawful and prohibited.\textsuperscript{140} Moreover, if discrimination is unreasonable it is not lawful.\textsuperscript{141} The host government’s conduct has to be in good faith to be considered lawful.\textsuperscript{142}

It has been argued that the distinction between an unlawful discrimination and a lawful action must have “an objective justification, the means employed to establish a different treatment must be proportionate to the justification for differentiation, and there is burden of proof on the party seeking to set up an exception to the equality principle.”\textsuperscript{143} However, determination of an unreasonable and unjust measure by taking into account all encompassing circumstances in each case, has to be done by the tribunal.\textsuperscript{144} The condition of non-discrimination was supported by several arbitrations. The \textit{LIAMCO} arbitration has addressed this condition. The claimant (LIAMCO) argued that nationalisation by the government of Libya had taken place because of its American corporate nationality and that those measures were used as a weapon of political retaliation against the corporate established in those countries whose politics were contrary to those of the Libyan regime.\textsuperscript{145} The tribunal then found that “it is clear and undisputed that non-discrimination is a requisite for the validity of a lawful nationalisation. That is a rule well established in international legal theory and practice. Therefore, a purely discriminatory nationalisation is illegal and wrongful.”\textsuperscript{146} The sole arbitrator then observed that “political motivation may take the shape of discrimination as a result of political retaliation”\textsuperscript{147} and also added “LIAMCO was not the first company to be nationalised, nor was the only oil company nor the only American company to be nationalised. Other companies were nationalised before it, other American and non-American companies were nationalised with it and after it, and other American companies are still operating in Libya.”\textsuperscript{148}

The arbitrator decided that the Libyan government’s measures were not discriminatory and held “the political motive was not the predominant motive for nationalisation, and that such motive per se does not constitute a sufficient proof of purely discriminatory measure.”\textsuperscript{149} It is clear that the tribunal recognised the requirement of non-discrimination as a condition for a lawful nationalisation in international law. In addition, the tribunal observed that discrimination against nationals of a specific country can be illegal. The tribunal’s award also indicated that

\textsuperscript{142} A. Maniruzzaman, (1998), supra note 118, 67.
\textsuperscript{143} I. Brownlie, (2003), supra note 12, 547.
\textsuperscript{145} \textit{LIAMCO Case}, 20 ILM (1981) 1, 59.
\textsuperscript{146} Ibid, 58-9.
\textsuperscript{147} Ibid, 58.
\textsuperscript{148} Ibid, 60.
\textsuperscript{149} Ibid, 60.
expropriation for political retaliation and purely political reasons is discriminatory and is therefore unlawful.

The *AMOCO* arbitration also discussed this requirement. In this case, AMOCO contended that expropriation of AMOCO’s property rights was discriminatory and it was therefore unlawful under international law. The claimant then argued that in another of NPC’s joint ventures, the Japanese share of a consortium, the Iran-Japan Petrochemical Company (IJPC) was not expropriated. The respondent (Iran) stated that nationalisation did not take place because of the nationality of American claimant. The Single Article Act applied to the entire oil industry, irrespective of the nationality of the foreign companies involved in this industry. Nationalisation was applied to the United States companies and non-United States companies. The reason for non-nationalisation of the Japanese company was due to exceptional circumstances. The respondent also added that “the fact that the operation of the IJPC was not closely linked with other contracts relating to the exploitation of oil fields, whereas the operations of Khemco plant was linked to the supply of gas from the oil fields operated jointly by AMOCO and NIOC pursuant to JSA.”

Therefore, the special commission did not include the contract with the IJPC among those which were nullified. The tribunal rejected the contention of discriminatory nationalisation and accepted the justification of the respondent. In addition, the tribunal stated that “discrimination is widely held as prohibited by customary international law in the field of expropriation.” Thus, the tribunal declined to find that Khemco’s expropriation was discriminatory.

A number of observations can be made based upon the above case. First, the tribunal upheld the principle of non-discrimination as a requirement for lawful expropriation. Second, the tribunal found that the host government could treat foreign companies differently, if this differentiation was justified by rational reason.

Another arbitration which dealt with the requirement of non-discrimination is the *AMINOIL* case. The tribunal considered the contention of discriminatory nationalisation based on the fact that the government’s measure had only affected AMINOIL and another foreign company operating in Kuwait was not nationalised by the Kuwaiti government. The tribunal did not accept the claimant’s contention.

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150 *AMOCO Case*, 15 Iran-US CTR 189, 232.
151 Ibid, 232.
152 Ibid, 231.
153 Ibid, 231.
154 *AMINOIL*, 21 ILM 976, 1019, para.87.
155 *AMINOIL*, 21 ILM 976, 1019, para.87.
It should be noted that the tribunal by examination of the contention of discriminatory taking supported this view that non-discrimination is a requirement of lawful taking. In addition, the tribunal through its reasoning demonstrated that different treatment with foreign companies which work in the same business, where there are “adequate reasons” for differentiation will be lawful. In sum, the tribunal found the government’s response convincing, but one aspect remained undefined. The notion of adequate reason was not clear enough. However, it seems that if differentiation in treatment with foreigners is for the requirement of public purpose, then it can be regarded as lawful.

To sum up, if the host government did not expropriate all companies in the same economic sector, it would still not be considered a discriminatory action and not therefore illegal. In other words, states may expropriate certain companies and leave the others non-expropriated. Nevertheless, this has to be supported by a reasonable justification for the different treatment. However, the arbitral practice indicates that host governments’ measures against specific foreign nationals with the aim of political retaliation are discriminatory and thus unlawful.

3.4.3. Due Process of Law

It is today generally accepted that the legality of a measure of expropriation is conditioned upon three (or four) requirements. These requirements are contained in most treaties. They are also seen to be part of customary international law. Some treaties explicitly require that the procedure of expropriation must follow principles of ‘due process’. Due process is an expression of the minimum standard under customary international law and of the requirement of fair and equitable treatment. Therefore, it is not clear whether such a clause, in the context of the rule on expropriation, adds an independent requirement for the legality of the expropriation.156 Due process of law could be seen in some international treaties such as the ECT and the NAFTA.157

In treaty-based investment law, due process is provided for in BITs. Whilst such treaties may list due process as one of the legality requirements, they usually do not define its meaning. The due process is usually understood as a requirement to provide for the decision of expropriation reviewed before an independent body.158 In addition, some BITs actually set due process somewhat apart from the public purpose, non-discrimination, and compensation requirements. Indeed, since the due process is not a substantive requirement but rather a procedural obligation in order to guarantee compliance with substantive requirements, it appears sensible to differentiate in this context. This differentiation is clearly expressed in BITs which provide that investments shall not be expropriated except for the public benefit and against compensation and that in case

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157 Article 13 (1) of the ECT; Article 1110 (1) of the NAFTA.
of expropriation “the legality of any such expropriation, nationalisation or comparable measures and the amount of compensation shall be subject to review by due process of law”.\textsuperscript{159}

In international investment contracts, the requirement would suggest that the investor for example has the right to advanced notification and a fair hearing before the expropriation takes place. Further, that the decision be taken by an unbiased official and after the passage of a reasonable period of time. Nevertheless, in UNCTAD, it is suggested that the due process requirement in international investment agreements applies \textit{after} the taking, so as to impose a requirement for some independent review of government action.\textsuperscript{160} Accordingly, that is an issue of state responsibility in general and not an issue related to expropriation as such.\textsuperscript{161}

However, there is a discussion in doctrine over whether the requirement of due process is necessary or not.\textsuperscript{162} The majority of legal jurists do not list such conditions for legality of the expropriation.\textsuperscript{163} In addition, this requirement is not mentioned in the Resolution 1803.

\textbf{3.4.4. Compensation}

There is no doubt that the exercise of the host state’s right to terminate the foreigners’ property rights must be accompanied with the payment of compensation.\textsuperscript{164} Compensation is important for both the host government and the potential investor. For the potential foreign investor, it is a decisive factor in determining whether the host country is an appropriate place for making an investment. On the other hand, for the government it is important because it may affect its economy and establish a practice for the future foreign investors. The question of compensation involves many issues. This section is not intended to address all the issues relevant to compensation. The aim of this section is to examine the host state’s duty to pay the compensation for expropriation and the effect of such payments in rebalancing the damaged equilibrium.

Foremost, it is helpful to examine the concepts of damages and compensation. Compensation or damages are understood as legal remedy. Damages are traditionally used as remedy in cases


\textsuperscript{161} Ibid.


involving an *illegal* act, including acts contrary to international law.\(^{165}\) Damages require the duty to pay for the detrimental consequences that the victim of an unlawful act has suffered.\(^{166}\) In international law, the term ‘compensation’ had been previously referred to the consequences of *lawful* exercise of sovereign rights by the state, in particular, the right to expropriate the foreign investor’s property.\(^{167}\) Nevertheless, this rigid distinction between damages and compensation has been eroded by the International Law Commission (ILC), Articles on Responsibility of States for Internationally Wrongful Acts.\(^{168}\) In the Articles on Responsibility of States for Wrongfully Acts, compensation is used to refer to a kind of reparation for *wrongful* acts of States and therefore, the definition of compensation is expanded to cover unlawful acts as well.\(^{169}\) The Commission has clearly selected a broader meaning of ‘compensation’ as including consequences of *unlawful* conduct and changed the terminology of international law.\(^{170}\) This thesis uses the term of compensation as a legal remedy to cover consequences of both lawful and unlawful conducts.

In both lawful and unlawful taking of the foreign investor’s property, the investor is entitled to compensation. However, there is a difference as to the calculation and amount of compensation.\(^{171}\) Whilst in a lawful expropriation compensation covers the actual loss, in an unlawful expropriation, compensation should cover the loss actually suffered (*damnum emergens*) plus the lost future profits (*lecrum cesans*).\(^{172}\)

There are two competing norms regarding the amount of compensation, which will be discussed below. The classical viewpoint is in the event of expropriation of foreign private property by the host government, compensation has to be paid according to international law.\(^{173}\) It has been endorsed by the United Nations General Assembly Resolution on Permanent Sovereignty over Natural Resources, 1803, (1962).\(^{174}\) Although the United Nations General Assembly Resolutions

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\(^{166}\) Ibid; M. Whiteman, *Damages in International Law*, (US Govt, Washington, 1937) 43.


\(^{169}\) Article 34, ‘Forms of Reparation’ and Article 36, ‘Compensation’.


\(^{172}\) H. Van Houtte, supra note 81, 383-4.


are not binding, rules set by resolution 1803, (by both developing and developed countries), are treated as customary international law. It has been stated:

“In such cases (of nationalisation and expropriation), the owner shall be paid appropriate compensation, in accordance with the rules in force in the State taking such measures in the exercise of its sovereignty and in accordance with international law. In any case, where the question of compensation gives rise to controversy, the national jurisdiction of the state taking such measure shall be exhausted.”

Further to decolonisation in the 1970s, the issue that compensation should be subject to domestic or international law standards was a topic of heated debate. Developing countries had the majority in the United Nations General Assembly and strongly supported this view, that the amount of compensation has to be calculated by domestic law of the host state and not international law. As a consequence, the General Assembly adopted many Resolutions such as Resolution 3171, (1973) and Resolution 3201, (1974). In Resolution 3171, it was stipulated that states are entitled to calculate the compensation by domestic law standards. The Resolution stipulated that:

“The application of the principle of nationalisation carried out by States, as an expression of their sovereignty in order to safeguard their natural resources, implies that each State is entitled to determine the amount of possible compensation and the mode of payment, and that any disputes which might arise should be settled in accordance with the national legislation of each State carrying out such measures”.

However, it has been articulated that Resolution 3171 by recalling Resolution 1803, in the preamble, has not materially changed the content of Resolution 1803. Yet, its reference to national legislations is only concerned with the procedural matters. The developing countries’ viewpoint concerning the assessment of compensation by national legislation standards was supported by Resolution 3281, (1974), the Charter of Economic Rights and Duties of States, and Resolution 3201, (1974) the Declaration on the Establishment of a New International Economic Order. Indeed, these Resolutions in their contents did not refer the question of


178 Ibid, 52.


assessment of compensation to international law standards. Despite the non-binding nature of the United Nations General Assembly Resolutions and the disagreement of developed countries with this shift, the replacement of international law standards by national legislations of the expropriating government for assessment of compensation resulted in considerable amount of uncertainties.\(^{183}\) Giving the discretion of the determination of compensation to the host government will endanger the foreign investor to incur losses. In so doing, the host state has already taken the investor’s property rights and may only consider paying loss of property regardless of full compensation. In addition, it implies that the General Assembly seeks to replace international law by domestic law of expropriating states for compensation standards.\(^{184}\)

In *Texaco Overseas Petroleum Co. And California Asiatic Oil Co. v. The Government of the Libyan Arab Republic*, the sole arbitrator examined the governing law for the assessment of compensation.\(^{185}\) He supported the customary international law nature of Resolution 1803, (1962) by referring the compensation assessment to international standards. Additionally, the arbitrator did not adopt the content of Resolutions 3281 and 3201, (1974).

He held that “it would as a practical matter rule out any recourse to international law and would confer an exclusive and unlimited competence upon the legislation and courts of the host country.”\(^{186}\) It is also worth mentioning that Resolutions 3281 and 3201, (1974) have not gained sufficient international acceptance to be regarded as customary international law and have never reappeared since they have been accepted.\(^{187}\) Therefore, they cannot be considered as customary international law.\(^{188}\) Moreover, bilateral and multilateral investment treaties, and international arbitrations did not adopt and never supported them.\(^{189}\)

Furthermore, there is a disagreement over the standards of payment of compensation and what constitutes fair compensation.\(^{190}\) There are two major approaches about the compensation requirements. First, is the ‘Hull formula’ requiring that compensation should be ‘prompt, adequate and effective’.\(^{191}\) The second approach is ‘appropriate compensation’ which requires that the host state should pay the full value of the property taken. This view is supported by

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\(^{184}\) C. Wallace, (2002), supra note 1, 988; Resolutions No. 1515 of 1960, UN Doc A/4684 (1960), para.5.

\(^{185}\) (1978) 17 ILM 27.

\(^{186}\) 17 ILM 27, (1978), para.82.


\(^{188}\) C. Wallace, (2002), supra note 1, 994.

\(^{189}\) C. Wallace, (2002), supra note 1, 994.


developing countries and is rooted in Article 4 of Resolution 1803. Although this view is not common in international investment.\textsuperscript{192}

The requirements for payment of compensation in case of taking of foreign investors’ property by the host state are introduced by the “Hull formula” which requires prompt, adequate and effective compensation. This was formulated by the former US Secretary of State, Cordell Hull in 1938 and is therefore known as the “Hull formula”. This formula for compensation was followed by several investment treaties and investment contracts.\textsuperscript{193} Almost all western States and many scholars in America and Europe supported this view that if expropriation of foreign investor’s property is with the payment of “prompt, adequate and effective” compensation, it will be lawful.\textsuperscript{194}

In addition, these requirements, “prompt, adequate, effective” are grounded in international law. Indeed, the practice and legal opinions have supported Hull’s position.\textsuperscript{195} The Energy Charter Treaty in Article 13 has also recognised the formula of prompt, adequate and effective.\textsuperscript{196} In the General Assembly Resolution 1803, the requirement of ‘appropriate’ was generally defined as, “could only mean prompt, adequate and effective compensation.”\textsuperscript{197} Additionally, the majority of the bilateral investment treaties\textsuperscript{198} and the guidelines of the World Bank have endorsed this formula. It is asserted that “appropriate compensation” is deemed appropriate if it is adequate, effective and prompt.\textsuperscript{199}

\textsuperscript{192} Ibid, 574.
\textsuperscript{194} I. Brownlie, (2003), supra note 12, 509.
\textsuperscript{196} Article 13 provides: “(1)- Investments of Investors of a Contracting Party in the Area of any other Contracting Party Shall not be nationalised, expropriated or subjected to a measure or measures having effect equivalent to nationalisation or expropriation (hereinafter referred to as “Expropriation”) except where such Expropriation is: (a) for a purpose which is in the public interest; (b) not discriminatory (c) carried out under due process of law; and (d) accompanied by the payment of prompt, adequate and effective compensation.” See also, C. Bamberge, J. Linehan & T. Waelde, “Energy Charter Treaty in 2000”, (2000) 18 JENRL 331; T. Waelde, “Arbitration in the Oil, Gas and Energy Field: Emerging Energy Charter Treaty Practice, Oil, Gas and Energy Law Intelligence”, (2003) 1 (4) OGEI 27; K. Hober, “Investment Arbitration and the Energy Charter Treaty”, (2010) 1 Journal of International Dispute Settlement 153.
\textsuperscript{199} Paragraph 2 of the Guideline IV provides that the compensation will be deemed appropriate if it is adequate, effective and prompt. Guideline IV, (1992) ILM 1363,1382.
The second view was taken in the *Chorzow factory*,\(^{200}\) the Permanent Court of International Justice, (The Tribunal) in 1928 where it was held that in a lawful expropriation, the ‘appropriate method’ for calculation of compensation “is the values of undertaking at the moment of dispossession, plus interests on the day of payment.”\(^{201}\) It also added that in an unlawful taking “reparation must, as far as possible, wipe out all the consequences of the illegal act and re-establish the situation which would, in all probability have existed if that act had not been committed.”\(^{202}\) It is notable that the tribunal did not call for adequate, prompt, and effective compensation. In addition, the tribunal stipulated that “the Cordell Hull formula no longer reflects the generally accepted international standard.”\(^{203}\)

However, several international arbitrations have endorsed the standard of “appropriate compensation” as an alternative for adequate, prompt and effective conditions. In the *AMINOIL* arbitration,\(^{204}\) the arbitral tribunal followed the General Assembly Resolution 1803 and applied appropriate compensation.\(^{205}\) The tribunal decided “the determination of the amount of an award of appropriate compensation is better carried out by means of an inquiry into all circumstances relevant to the particular case, than through abstract theoretical discussion.”\(^{206}\) In addition, in the Texaco case,\(^{207}\) the sole arbitrator argued that appropriate compensation has reflected in customary international law and would be in line with the General Assembly Resolution 1803. It is stated that the requirement of appropriate compensation is more flexible and by considering surrounding circumstances and actual conditions in each case, compensation will be determined.\(^{208}\) It is interesting that the question of compensation is still debatable. Some jurists argue that adequate, prompt and effective formula “will no longer reflect the generally accepted international standard.”\(^{209}\) Nevertheless, it is clear that in case of expropriation of foreign owned property, compensation must be paid to the foreign investor in accordance with international law standards.


\(^{201}\) *Factory at Chorzow*, 47; for setting standards of compensation which endorsed by further arbitration, see also, *Texas Overseas Petroleum Co. v. The Government of the Libyan Arab Republic*, (1973) 53 ILR 389, 337-340.

\(^{202}\) *Factory at Chorzow*, 47.


\(^{204}\) *AMINOIL arbitration*, (1982) 24 ILM 976.

\(^{205}\) ibid, 1032.

\(^{206}\) ibid, 1033.


Nonetheless, these approaches to restore the injured investor’s interests have failed. The above analysis shows that the occurrence of expropriation disturbs the equilibrium of contract and the payment of compensation cannot by itself rebalance the relationship. The key reason is the presentiated model leads to discharge and does not allow any adaptation of the relationship. The existing law does not allow adaptation and as a result, compensation as a mere solution of the classical model for a damaged equilibrium cannot deal with rebalancing the contractual equilibrium. It cannot restore the contractual positions of the parties and merely deals with the consequences of termination of the contractual relationship.

In addition, under the classical model, the relationship is fixed and all rights and obligations are determined by the parties at the time of contracting. Thus, parties are obliged to perform their commitments and once the circumstance change and the initial equilibrium is damaged, the only option which the classical model offers is to bring the contract to an end.

This is due to the static model of relationship which presentation imputes to the contract. The classical model as a whole and compensation in part, cannot therefore rebalance the equilibrium. It only frames the context in which contract is brought to an end. If the law treats each contract as being a particular relationship, then adjustment takes place within the framework of that relationship. The non-discriminatory idea, in contrast, posits that all contracts must be treated exactly the same way even if the relational understanding within each contract is very different, and thus accepts the obsolescing character which results from a presentiated model because this does not permit individual adjustment within contracts. Therefore, in relation to the main question of this chapter of how well the law of expropriation preserves the contractual equilibrium, it shows that it has failed and cannot rebalance the equilibrium at all. What it does is to work out the consequence of the equilibrium’s collapse.

3.5. Conclusion

The present chapter has sought to examine the nature of the taking of foreign owned property in the petroleum industry by the host government, in order to highlight the problems that arise out of intervention, with reference to the equilibrium of the contract. Several issues have been addressed throughout this chapter. Regardless of the definition of the terms used to describe it, the result of host states actions are significant in the petroleum industry. In practice there is no real difference in making a distinction between those terms that are used in this area, given that the impact of intervention changes the initial bargain and results in disequilibrium.

This chapter has examined how well the balance which the law strikes between permitting and restricting expropriation protects the contractual equilibrium. Expropriation of the foreign investor’s property is accepted under international law.
Nevertheless, the host government has to comply with certain conditions for a lawful expropriation. As this chapter demonstrated, the notion of property rights plays a significant role in striking this balance. It showed that this concept includes both tangible and intangible properties. Then, contractual rights were examined. It was indicated that interests, shares and shareholder’s rights are compensable property rights. This has serious implications on the equilibrium. The static view of rights and obligations which represent the classical model looks at the contract as only a set of rights and obligations and tries to determine the terms in which the contract comes to an end. As a result of expansion of the notion of property rights, the range of circumstances in which the contract is brought to an end will be expanded. This means that more contracts which could have been recused by adjustment now have come to disputes resulting in their termination.

In this chapter, the mechanisms available to the host government to control international oil companies in its jurisdiction and the last measure of control that is interference with foreign property rights were discussed.

Further, limitations that are set by international law for the exercise of the host government’s power over international petroleum companies in petroleum arbitral awards have been examined. The current chapter has established that whilst governments enjoy sovereign power to control oil companies, international law has imposed certain restrictions upon them. Expropriation should be in rare situations and only for the public interest of society. Although international investment law tried to restrict the conditions under which host states could interfere with the contract in order to rebalance the equilibrium, it was unsuccessful to maintain or restore the equilibrium in a static model of contracting. There are many situations that the injured party could not claim compensation according to the requirements of a lawful expropriation. Under the recent developments of international investment law, however, direct taking of foreign investor’s property rights is not usual and host states may take the property through more subtle methods and indirectly. The result has been the development of the law of what constitutes an indirect expropriation, and of the remedies for indirect expropriation, under the petroleum awards. The next chapter presents an in-depth analysis of indirect expropriation, and the challenges they pose for preserving the contractual equilibrium and the contractual relationship against obsolescence.
Chapter 4

Indirect Expropriation: A Method of Taking Used By Host States in the Petroleum Industry

Introduction.............................................................................................................................................. 134

4.1. Terminology...................................................................................................................................... 137

4.2. The Host Government’s Devices for Indirect Expropriation.......................................................... 139

  4.2.1. A Hypothetical Example: Does the Law of Expropriation Have the Ability to Manage Imbalances Caused by Host States’ Regulatory Powers?...................................................... 143

4.3. The Legal Test in Distinguishing between an Indirect Expropriation and Non-Compensable Regulatory Measures ............................................................................................................... 144

  4.3.1. The Sole Effect Doctrine.............................................................................................................. 146

  4.3.2. The Purpose Doctrine ................................................................................................................. 148

4.4. Case Studies ...................................................................................................................................... 152


  4.4.2. Case Studies (II): The NAFTA Tribunal’s Cases ................................................................. 157

  4.4.3. Case Studies (III): The Iran-US Claims Tribunal's Cases .................................................. 160

4.5. Inadequacy of the Existing Law of Expropriation in Protecting the Parties’ Interests ................................. 164

  4.5.1. The Role of Obsolescing Bargain and Return ........................................................................... 164

  4.5.2. The Significance of Implementation of the Relational Model: Maintaining the Contractual Relationship ................................................................................................................................. 166

    4.5.2.1. The Advantages and the Importance of Preservation of International Petroleum Contracts ................................................................................................................................. 166

    4.5.2.2. The Challenge of Determining Compensation in International Investment Arbitration: Uncertainty of Outcomes ......................................................................................................... 168

    4.5.2.2.1. Ambiguous Rules of International Law on Compensation ............................................. 169

    4.5.2.3. The Inadequacy of the Framework of Breach & Compensation in Classical Model .................................................................................................................................................. 174

    4.5.2.4. Problems Regarding the Ultimate Purpose of Contracting Parties under the Classical Model: An Uphill Battle for Enforcement of Arbitration in Oil & Gas Sector ................................................................................................................................. 176

  4.5.3. Deficient Rules of International Law on Expropriation: Inability in Restoring the Contractual Equilibrium ................................................................................................................................. 180

4.6. Conclusion ......................................................................................................................................... 183
Introduction

In the previous chapter conflicting areas of the limitations on the host state’s right for taking the foreign investor’s property, the relevant case law and the response of petroleum arbitrations to direct taking were discussed. The current chapter will continue the discussion begun in the previous chapter by examining taking of property rights in the petroleum industry. I have established that taking over, takes place where the host state does not obtain the expected benefits and through expropriation seeks to restore the equilibrium of the contract. As a result of the host government’s taking, a bigger disruption of equilibrium, which is deprivation of the foreign investor of its property rights occurs. The host state’s act for increasing its benefits against the foreign investor has detrimental effect for the investment and, hence, brings about disequilibrium. As I explained earlier, this is due to the static model of relationship that the law imputes to the contract. The current law does not allow adaptation and when the contractual equilibrium is damaged, it only provides the parties with the option of termination of the contract followed by compensation. This has nothing to do with the contractual equilibrium. Consequently, it cannot rebalance a damaged equilibrium. The response of the law to taking over has two aspects; (i) preventive measures and (ii) restorative measures.

First, the law limits the circumstances in which this larger disruption can take place, by requiring certain conditions for a lawful taking which limits the ability of the host state to lawfully expropriate the foreign investor’s property rights. In other words, the law tries to narrow down the framework in which a state could legally take over the investment. As a result, such conditions are meant to preserve the original equilibrium by mitigating the disruption. Second, where the original equilibrium is disrupted, the law attempts to restore the intent behind the contractual balance to some extent. Although the original equilibrium itself cannot be restored, the law attempts to create a new equilibrium that approaches the first as to the giving the parties the same payoffs they intended by providing for the payment of compensation.

The recent trend shows that taking of foreign property may take place not only through legislation or nationalisation but also by indirect methods that can have the same effect as direct expropriation. Host governments employ different methods for achieve what amounts to direct taking, but without acknowledging it as such, to avoid legal consequences of expropriation and then payment of compensation. The legal focus in this chapter is on shifting from the host state’s

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taking of tangible property to the new methods used indirectly by states, which may have the
same effect as direct taking in international investment law.\textsuperscript{3} Indirect methods are being used by
host governments will raise the question of what measure is tantamount to expropriation and how
strong should such methods be to form a compensable taking.\textsuperscript{4} For instance, in some indirect
takings, the foreign investor remains as the official owner, but in reality, what remains is the
empty name of ownership.\textsuperscript{5} International oil companies have filed several disputes before
international tribunals on the basis of indirect expropriation.\textsuperscript{6}

In addition, due to the enactment of numerous economic regulations, and the privatisation of
public ownership indirect expropriation has recently become more prominent.\textsuperscript{7} Hence, the current
chapter will analyse the behaviour of host states, in particular, their actions in terms of indirect
expropriation, and shed light on the relationship between expropriation and contractual
equilibrium. In order to achieve these objectives, this chapter will discuss the relevant
terminology, the measures available to host states for an indirect expropriation, distinguishing
factors as to expropriation and indirect expropriation (creeping, regulatory expropriation), and
various types of measures amounting to expropriation and also examining the response of the
petroleum arbitral practice to this particular area. This chapter will also discuss whether the
current law of expropriation can efficiently and appropriately deal with the erosion of equilibrium.

In this discussion, this chapter builds on a case study of a number of recent arbitrations under the
North American Free Trade Agreement (NAFTA) and the Iran-US Claims Tribunal. The reasons
for a particular focus on these Tribunals are as follows:

\begin{itemize}
  \item be applied as readily by the industrialised as by the developing states, the latter having in many cases
  actually learned such techniques from the more economically sophisticated industrialised nations."
  \item “With a much wider notion of proprietary rights and a much wider notion of ‘expropriatory’ or
  ‘confiscatory’ action, the relatively simple identification of a governmental ‘taking’ of a tangible property
  no longer works.” T. Waelde, “MITs (Multilateral Investment Treaties) in the Year 2000”, in Oil, Gas and
  \item C. Christie, (1961), supra note 1, 309; R. Higgins, \textit{The Taking of Property by the State: Recent
  Expropriation of Alien Property”, (1986) 1 ICISD Rev. FILJ 41.
  \item A. Mouri, \textit{The International Law of Expropriation as Reflected in the Work of the Iran-US Claims
  Foreign Investment Under International Law: Legal Aspects of Political Risk} (Dobbs Ferry, New York,
  \item “The definition of the boundary between legitimate regulation expressing inherent limitation of property
  and the state’s police powers on the one hand and excessive regulation equivalent to a full or partial
  expropriation on the other will be a major challenge for international economic lawyers.” See, T. Waelde
  and A. Kolo, “Environmental regulation, Investment Protection and ‘Regulatory taking’ in International
\end{itemize}
First, looking at two tribunals rather than a range of cases from different tribunals provides consistency. Examination of cases under two tribunals where in their contexts expropriation takes place brings about a discussion that is more concentrated.

Second, these two tribunals present a range of political contexts in which indirect expropriation arises and highlight the underlying factors motivating expropriation as we see in these cases. Several arbitral decisions and tribunals might have been selected to typify the kinds of cases that animate the ongoing debate on the function of stabilisation and renegotiation clauses, the law of expropriation and its ability on maintaining the equilibrium. This research has chosen the NAFTA because of the richness of the Tribunal’s reasoning, its contribution to the notion of investment and investor-State arbitration and, in particular, the law of expropriation, and the function of stabilisation and renegotiation clauses and relevant issues – disruption of equilibrium. This also exemplifies the evolving nature of expropriation law as it relates to the balance of interests between the host state and the foreign investor.

Third, substantial amounts of international petroleum arbitrations that have discussed indirect expropriation were relevant to Iran’s nationalisation of the petroleum industry. Thus, examination of the Iran-US Claim Tribunal cases are necessary.

This chapter will also examine an important recent case, namely, Yukos v. Russia, an ad hoc arbitration based on Energy Charter Treaty (ECT), which resulted in the largest award in the history of investor-State arbitration. This case is about expropriation and its examination highlights the deficiencies of the classical law in restoration of the equilibrium. In short, the contribution of these tribunals’ awards to international investment law and, in particular, international petroleum investment law has been significant. It is beyond doubt that these awards made significant contributions to legal thinking on a number of issues, not least in establishing the limits of protection of investment and equilibrium under the legal arrangements.8 In addition, dissatisfaction with the outcomes may also be seen as a major contributory factor in laying the foundations for a new approach, involving a kind of contract stability based on ‘equilibrium’ and contractual clauses.

4.1. Terminology

All investment treaties have a provision about expropriation. International petroleum investment agreements and BITs do not usually offer a definition of the important concepts and terms such as direct and indirect expropriation.9 ‘Indirect expropriation’, ‘regulatory’, ‘creeping’, ‘de facto’ expropriation are used interchangeably but a definition of these concepts and what kinds of governmental measures may constitute direct and indirect expropriation remains unclear. The North American Free Trade Agreement (NAFTA), in Article 1110 requires that “No party may directly or indirectly nationalise or expropriate an investment of another party in its territory or take a measure tantamount to nationalisation or expropriation of such an investment.”10 The Energy Charter Treaty under Article 13 prohibits taking measures “having effect equivalent to nationalisation or expropriation.”11 The examination of the literature and the above investment treaties indicate diversity of terms such as “de facto”, “wealth deprivation”, and “creeping expropriation” for indirect expropriation. The terms “creeping” and “de facto” are described as “whose distinguishing characteristic usually involves, at once or over time, the denial of access to, use of, or benefit from wealth processes and institutions (rather than the deprivation of wealth itself) and/or the spoliation of values other than wealth but upon which the production, conservation, distribution, and consumption of wealth totally depend”.12

Creeping expropriation is defined as a series of measures that the host government takes through which it deprives the foreign investor from property, any of them might be permissible but in total will result in expropriation with the payment of compensation.13 In an indirect expropriation the foreign private property is not seized directly.14 However, in practice the distinction is blurred, as most of de facto expropriations have both creeping and indirect aspects.15 The exercise of regulatory powers such as tax regime or environmental measures may reduce the economic value of the investor’s property without affecting the legal title. It is called “regulatory taking”. This

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10 32 ILM 289, 605 (1993); NAFTA entered into force 1 January 1994. For the full text of the convention see http://www.nafta-sec-alena.org/en/view.aspx. The same language may be found in other BITs such as UK-Ukraine BIT (1993), “having effect equivalent to nationalisation or expropriation.”
14 P. Comeaux and S. Kinsella, (1997), supra note 5, 8; R. Dolzer, (1986), supra note 4, 44.
15 Ibid, 8.
The use of other terms in investment treaties such as, ‘tantamount to expropriation’ ‘similar to’, ‘direct or indirect’ is to guarantee that creeping expropriation is referred to in the expropriation provisions. International oil companies may experience an additional risk of regulatory measures due to the nature of the oil and gas projects. These risks are surrounded in international energy investments from the beginning and over the life of the contract. The concept of regulatory risk would be examined under the definitions presented by the Organisation for Economic Cooperation and Development (OECD), and legal scholars. The OECD has introduced it as “the risk of non-payment on an export contract or project due to action taken by the importer’s host government. Such action may include intervention to prevent transfer of payments, cancellation of a license, or events that prevent the exporter from performing under the supply contract or the buyer from making payment.”

Commeuax has defined it as “the risk that laws of a country will unexpectedly change to the investor’s detriment after the investor has invested capital in the country, thereby reducing the value of individual’s investment.” In a similar vein, Boulos has specifically addressed regulatory risk in the energy industry and argued “It is the possibility that oil company investment will be expropriated, nationalised or otherwise unilaterally changed by the foreign government to the detriment of the oil company.” Under international investment law, regulatory risk might be classified in different ways. It is said that they could be firm-specific or governmental risks. The firm-specific risks are those directed as a particular company and are, by nature, discriminatory, like termination of contract. Governmental risks are those that arise from the actions of a governmental authority such as creeping expropriation. Firm-specific risks could be minimised by the insertion of certain clauses. Overall, there are different sorts of classifications of risks.

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18 The notion of “regulatory risk” has been broadened to include political risk and indirect expropriation. This is very often in state contracts and whilst a government acts as regulator, it is for the technical reason and large-scale investment and long duration of petroleum agreements.
23 Ibid, 3.
which may include, commercial risk, discriminatory regulation, political unrest, sabotage, and change of economic policy.\textsuperscript{26} International investments may face risks but the petroleum industry is particularly vulnerable. The duration of a petroleum project is long and involves large-scale investments.\textsuperscript{27} As a result, governments play an important role in the regulation of entry, of prices, of quality of services and of other aspects of investor behaviour.\textsuperscript{28} For this reason, when an investment has been made, the government’s behaviour towards the investor may begin to change into an opportunistic approach as the bargaining power shifts in favour of the host state. I have discussed the relation between expropriation and the OBM which creates incentives for the host government to engage in this type of behaviour in chapters two and three.

Nevertheless, it might be useful to briefly mention that indirect expropriation is the manifestation of the failure of presentation as an idea that attempts to bring the future to the present. The parties in the classical model of relationship by presentation and designing a contract that is strict and provides no room for flexibility seek to guarantee certainty and contractual stability. However, this attempt to preserve the original equilibrium of the contract by limiting the ability of the parties to restrict this type of behaviour has failed. As a result, the foreign investor is not well positioned to gain the expected interests.\textsuperscript{29}

To summarise, scholars and commentators employ the above-mentioned terms interchangeably and as a result, taking of property for the purpose of the current study is itself important.\textsuperscript{30} This research will therefore use them interchangeably. The host government as sovereign state does have sovereignty and due to this right can take the foreign investor’s property.\textsuperscript{31} However, it is better to focus on the result of the host state’s actions rather than defining the process per se. This is because the distinction between different types of indirect expropriatory actions is not necessarily an easy task.\textsuperscript{32}

\textbf{4.2. The Host Government’s Devices for Indirect Expropriation}

The distinction between direct and indirect expropriation is recognised by the nature of the interference with the investor’s property. The examination of international arbitrations as to direct expropriation in chapter three indicates that a compulsory transfer of the legal rights of foreign

\textsuperscript{26} Ibid, 4.
\textsuperscript{28} T. Moran, (2008), supra note 25.
\textsuperscript{29} Ibid, 4.
\textsuperscript{32} T. Waelde, (2000), supra note 12.
investor ownership to the government or to a third party by sovereign powers constitutes direct expropriation. If the governmental measures have the effect of depriving the foreign investor of the enjoyment of their property even where the legal title to the property is not affected then indirect expropriation has taken place. Such actions may result in state responsibility and if it is the case, the government is obliged to pay compensation to the foreign investor that whose property rights are affected by those measures. However, all governmental measures that affect investor’s property rights do not establish responsibility and therefore will not bring about compensation under international law. The occurrence of direct expropriation is easy to identify by exploring the existence of tangible property of the investor. Hence, it will not result in controversy. Direct expropriations will have normally taken place because of an explicit national policy measure and on a specific date. However, the identification of an indirect expropriation is very complex and depends upon the examination of the legitimate expectations of the investor concerning enjoyment of its investment.

As discussed in the previous chapter, direct taking may take place through a specific taking, nationalisation and taking of an economic sector or industry. Nonetheless, indirect taking is more complicated because of the use of sophisticated techniques, which are less obvious in terms of constituting what amounts to expropriation by the government. These techniques are recognised as compensable by the arbitral tribunals and can be in the form of excessive taxation, forced sale of alien property, management control over the investment, discriminatory administrative

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37 Ibid.


decrees, and an unreasonable interference with property rights of foreign investors.\textsuperscript{41} The host state’s method to effectuate what will amount to indirect expropriation may be in the form of a series of actions and in combination of other measures.\textsuperscript{42} Indeed, such actions are not always independent of each other and only become expropriatory if applied with other compensable techniques.\textsuperscript{43} Indirect expropriation arises from host states’ measures and may include, interference in the right of management, abusive taxation, and forced transfer of shares.\textsuperscript{44}

The aforementioned measures are not exhaustive and the host government may interfere with the property rights of the foreign investor by different actions. However, the common effect of this is to reduce the value of the investment.\textsuperscript{45} Therefore, increasing tax or abusive taxation, imposition of some restrictions on foreign investor’s rights, and changes in regulations are the most important approaches to indirect expropriation. The UNCTAD has introduced a definition for expropriation “where a measure that does not directly take property has the same impact by depriving the owner of the substantial benefits of the property.”\textsuperscript{46}

In addition, indirect expropriation has been defined as “the use of a series of measures in order to achieve a deprivation of the economic value of the investment, in this case, no individual measure in itself would amount to an expropriation.”\textsuperscript{47} Increases in tax or setting new tax regimes or environmental regulations might be described as those discriminatory and regulatory measures. For instance, different investment arbitral awards have examined the notion of abusive taxation in the energy industry. \textit{Philips Petroleum v. Iran}\textsuperscript{48}, \textit{Sedco v. Iran}\textsuperscript{49} and the \textit{Revere Copper} case are some examples.\textsuperscript{50} This trend is growing by increasing taxes, royalties, or setting new tax regimes, especially, in Latin America.

Prominent evidence of this is Venezuela, which is useful to highlight here. Mr. Hugo Chavez, the then Venezuelan President, in 2001 enacted a new hydrocarbon law that came into effect in

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\textsuperscript{42} B. Weston, (1970), supra note 11, 80.

\textsuperscript{43} C. Christie, supra note 1, 337-8.


\textsuperscript{45} K. Hober, (2003), supra note 6, 351.


\textsuperscript{47} Ibid, 42.


\textsuperscript{49} Sedco, \textit{Inc. v National Iranian Oil Co.}, 9 Iran-U.S. Claims Tribunal Reports (1985).

\textsuperscript{50} Revere Copper and Brass Inc \textit{v. Overseas Private Investment Corporation}, 56 International Law Reports 268(1978).
January 2002.\textsuperscript{51} This provided that foreign oil companies could only own less than 50 percent of capital in joint ventures in upstream projects and also increased the income tax to 50 percent instead of the former rate of 34 percent. In 2007, the Venezuelan government launched another programme for forced migration of foreign oil companies from service contract to joint venture agreements. In 2011, President Chavez, set a new tax regime for oil and gas income concerning international oil companies. “The top tax of 95 percent on exorbitant income when crude goes above $100 a barrel. It is predicted that the new tax rate will bring in between $9 billion and $16 billion this year-2011- if oil prices keep rallying.”\textsuperscript{52} Under the new regulatory arrangements, whilst the oil price rises above $70, oil companies will have to pay an 80 percent tax on revenue. When the oil price reached above $90, it would be 90 percent and a 95 percent tax will have to be paid when the price rises to $100.\textsuperscript{53} This could be unattractive for international oil companies, and because these changes were not enacted by the parliament as law, and were regulated for political reasons it may result in an indirect expropriation.

The host state may change environmental regulations over the life of petroleum projects. This can create an investment dispute.\textsuperscript{54} Indeed, the host state may change environmental regulations on a discriminatory basis to limit the petroleum investment. This change of regulation and, hence, financial balance could lead to an expropriation.\textsuperscript{55} The foreign investor’s compliance with these standards imposes extra costs to him. This could seriously affect the economic value of the investment. In this case, regulatory measures can constitute expropriation and thus compensation is required.\textsuperscript{56}

However, there is a general agreement that host states are not required to pay compensation for economic disadvantage resulting from legitimate regulation. In order to identify whether the host state’s action is compensable, it is useful to consider the host government’s action on a case-by-case basis and to define ‘taking’ according to bilateral and multilateral treaties.\textsuperscript{57} Generally, the

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\textsuperscript{51} Decree No.1510, 2 November 2001, Decree with Force of Organic Law of Hydrocarbons, Official Gazette No.37,323.
\textsuperscript{53} D. Blair, “Venezuela Downplays Oil Tax Hike”, published in Financial Times, available at \url{http://www.ft.com/cms/s/0/edca244c-701b-11e0-bea7-00144feabdc0.html#axzz1oYrMnuEx}, October 2012.
\textsuperscript{54} T. Waelde and A. Kolo, (2001), supra note 7, 819.
\textsuperscript{56} Compania Del Desarrollo De Santa Elena, S.A. v. Costa Rica, ICSID Case No. ARB/96/1, Final Award, 17 February 2000, 15 ICSID Rev. FILJ 169, 194, para 76.
\end{flushright}
growing number of environmental regulations can increase the liability of international oil companies and unpredictability.58

4.2.1. A Hypothetical Example: Does the Law of Expropriation Have the Ability to Manage Imbalances Caused by Host States’ Regulatory Powers?

According to the above discussion, expropriation includes all possible methods, which can interfere with the property rights of the foreign investor and could cover legislative and administrative measures, as well as the government’s inactions. In relation to the regulatory power of the host state, however, it is worth mentioning that although these powers are necessary, there are two potential issues with them. Firstly, they have the potential to be deliberately abused by a host state. Secondly, even when they are used for their intended purpose, they may have the effect of disrupting the contractual equilibrium because the investor ends up bearing a disproportionate amount of the burden.

Consider, for example, a situation in which an international treaty is made under which environmental rules are tightened, and because of which the government introduces new rules on how companies should comply with the new improved standards. This is because the host state is concerned about the environmental costs and its duty to protect the public interest. This can be entirely legitimate for the government to do.

However, it may have a negative impact on the equilibrium. It may damage the contractual balance because what the host state is doing is putting all the costs of the new regulatory burden on the foreign oil company. Part of the role of the law of expropriation is making the call in relation to how the new burden should be apportioned. Regarding direct expropriation, one of the reasons that direct taking may be necessary is to deal with windfalls and situations in which the host state gets a far smaller share of the profits than it expected to obtain. This is a typical situation where direct taking is used.

In this context, the way in which the host state tries to re-distribute the surplus is important. With regard to regulations, in particular environmental regulation, in essence what the state again tries to do is to re-distribute the costs of implementation. Nevertheless, the question is should all the costs be borne by the investor? Should the costs be apportioned differently? Part of the task of the law is therefore to address this. The law of indirect expropriation, however, does not do this. It has a sharp binary distinction between compensable taking and non-compensable regulation. As

a result of this binary division, arbitral tribunals have to place the government action in either category.

Nevertheless, there are situations in which the project does not turn out as expected. In this context, how can the project be brought back to equilibrium? This question, which arguably lies at the heart of the disruption, is not one the existing law of expropriation lets the tribunal ask. The relational model, in which maintaining the contractual equilibrium is the underlying principle, attempts to re-distribute the costs and burdens. Given the idea of equilibrium, the just distribution of costs and not simply assigning costs to one party is important. It shows why the law of expropriation is blind and inappropriate to preserve the contractual equilibrium. In indirect expropriation because of the way, the law is, we cannot have the discussion.

Indeed, the fact that the law categorises the host state action as compensable taking or non-compensable regulation arguably misses the point, because what the host government sometimes tries to achieve is to restore the equilibrium. Nevertheless, with this binary division, the law neither can engage in frustration of equilibrium nor distribute the burdens.

4.3. The Legal Test in Distinguishing between an Indirect Expropriation and Non-Compensable Regulatory Measures

The ability of a host state to interfere in property rights is essential for an efficient functioning of the state and, hence, it is predictable that a state has the power to so interfere. Nonetheless, the question is firstly, how to distinguish between a compensable indirect expropriation and a legitimate regulation (which is not compensable) by states and, secondly, of assessing whether the way in which the law of expropriation distinguishes between the two serves the purpose of protecting the contractual equilibrium against disruption.

As explained earlier, an indirect expropriation may take place by the host government’s interference in property and property rights of the foreign investor. Indirect expropriation does not necessarily require transfer of legal title from the international oil company to the host state. Hence, it is difficult to make a distinction between legitimate regulation and measures, which are tantamount to expropriation with the payment of compensation. It is because there is no “mechanical test” in its determination. The international arbitral tribunals and the legal scholars have not yet agreed on a perfect formula to define such measures that cross the line between a

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legitimate regulation and a compensable interference.\textsuperscript{62} It is neither feasible nor workable.\textsuperscript{63} Furthermore, international law does not present a clear and comprehensive solution to this problem.\textsuperscript{64} Although the governmental measures, which affect international oil companies’ property rights, are broad to be categorised within a formula, it will probably be best to consider the specific facts of a case, contractual terms of the investment agreement, severity of interference and other surrounding circumstances to determine whether a state’s action is tantamount to expropriation.\textsuperscript{65} To answer the question of what types of governmental measures constitute indirect expropriation, it is better to have a deep understanding by a case-by-case analysis of the measures that under international law do not give rise to responsibility and the payment of compensation.\textsuperscript{66}

The Tribunal in the ICSID case, \textit{Generation Ukraine Inc. v. Ukraine} held that the identification of an indirect expropriation depends on the specific facts of a grievance. The tribunal added that there is no mechanical test for this purpose.\textsuperscript{67} In the similar vein, “a case-by-case, fact-based inquiry” is provided by some BITs.\textsuperscript{68}

I discussed that all governmental measures would not bring about responsibility and consequently payment of compensation. Under international law, such measures that affect property rights and are not for the purpose of public health, morality or public order could be considered wrongful and compensable.\textsuperscript{69} The concept of police power of the government does not include those regulations that amount to expropriation, unless maybe in emergency or necessary situations.\textsuperscript{70} The host state’s measures such as trade restrictions, imposing taxes or where the state interference

\textsuperscript{62}“State measures that can potentially impact upon an investor’s rights in its investments are too varied to fit into a neat formula.”; J. Paulson and Z. Douglas, (2004), supra note 61, 145-6.
\textsuperscript{63} J. Paulsson & Z. Douglas, (2004), supra note 61, 145, 158.
\textsuperscript{65} J. Paulson, and Z. Douglas, (2004), supra note 61, 146.
\textsuperscript{67} \textit{Generation Ukraine Inc. v. Ukraine}, ICSID Case No. ARB/00/9, Award of 16 September 2003, (2005) 44 ILM 404, para.20-29.
is non-discriminatory, and for public purpose, do not constitute expropriation. Thus, such measures are not compensable.

Examination of the arbitral practice on indirect expropriation indicates that two different approaches were taken as to the identification of indirect expropriation. These approaches are: (i) the sole effect, and (ii) the purpose doctrine.

4.3.1. The Sole Effect Doctrine

The first approach examines the effect of state measures on the ability of the investor to enjoy its property rights. In this approach the effect of action is the determining factor to identify a taking. Indeed, this approach in specifying the border line between an indirect expropriation and a non-compensable (legitimate) regulation looks at the effect of measures and the degree of interference with an international investment project. This approach which examines the severity of those measures that affected the foreign investor is known as “sole effect” doctrine. However, “the threshold level of interference that will trigger state liability for expropriation is important.”

This question has been answered by investment arbitrations, that the interference must be substantial and deprive the foreign investor of most of the investments benefit. In addition, the deprivation must be permanent or for a substantial period of time.

In the Metalclad Corporation arbitration, the US firm (investor) had obtained permission from the government to construct and operate a facility for the disposal of hazardous waste and spent 20 million dollars for its construction. The tribunal decided that indirect expropriation had taken place. The foreign investor (American company) had obtained all required licenses for the development of a hazardous waste landfill. However, when the investment had been made the

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77 Metalclad Corp. v. United Mexican States, ICSID Case No. ARB AF/97/1, (2000), para 103.
host government began to withdraw the permissions. The tribunal held “expropriation under the NAFTA includes not only open, deliberate and acknowledged takings of property, such as outright seizure or formal or obligatory transfer of title in favour of the host state, but also covert or incidental interference with the use of property which has the effect of depriving the owner, in whole or in significant part, of the use or reasonably to be expected economic benefit of property even if not necessarily to the obvious benefit of the host state.”

Indeed, the tribunal had come to this conclusion because the host government’s measure substantially affected the international investor’s property rights and the foreign investor was no longer able to use its capital for the intended aims. The arbitrators held that it was indirect expropriation. This formula has been followed by several different arbitral tribunals in the determination of expropriation.

In the similar line of inquiry, in Tippets v. TAMS-AFFA, the new government of Iran after the revolution designated a new manager for the investment in 1979. The foreign investor filed a case for its 50% interest in a joint venture by an Iranian company before the Iran-US Claims Tribunal. The claimant alleged that the J.V did not provide him with status report of the project and did not reply to any of the claimant’s inquiries. Because the claimant could participate in the management by making decisions and signing cheques, the tribunal did not find an expropriation.

In Occidental Exploration and Production Co. v. Republic of Ecuador, the host state had refused to reimburse value added tax on purchases concerning the exploration activities of the Occidental company. The company therefore alleged that expropriation occurred. In this case, the Tribunal took the same approach as the one taken in the Metalclad. The Tribunal found that the host government’s action was in contradiction of fair and equitable treatment. Nonetheless, the tribunal decided that the host state’s action did not substantially deprive Occidental company of its financial benefits and, hence, it would not constitute indirect expropriation.

In Pope and Talbot, the US based lumber products firm filed a NAFTA claim against the Canadian government. The company asserted that Canada’s allocation of softwood export quotas violated. The Pope & Talbot alleged the host state’s action under Export Control Regime amounted to expropriation, according to Article 1110 of NAFTA. It was claimed that the host

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78 Ibid.
79 Methanex Corp. v. United States, Final Award, (3 August 2005).
83 Ibid, para. 88.
government’s measures seriously affected the ability of the company to sell products to the market in the US. However, the host state asserted that this was a non-discriminatory regulation in the sequence of the exercise of the police power and could not therefore constitute an expropriation.\footnote{Ibid.}
The Tribunal found that the host state action did not substantially interfere with the business activities of the company\footnote{Ibid, para.96.} and “the degree of interference with the investment’s operations due to the Export Control Regime does not give rise to an expropriation.”\footnote{Ibid, para.102.} The tribunal held that Article 1110 of NAFTA does not “require compensation for measures affecting property interests without regard to the magnitude or severity of that fact.”\footnote{Ibid.}

4.3.2. The Purpose Doctrine

The second approach for distinguishing between a regulative measure and an expropriatory action is to examine the intention of the host government. This is known as “purpose doctrine”.\footnote{L. Y. Fortier, and S. Drymer, “Indirect Expropriation in the Law of International Investment: I know it When I See It, Or Caveat Investor”, (2004) 19 (2) ICSID Review Foreign Investment Law Journal, 313.} This approach focuses on the purpose of the state measure but it does not ignore the effect of action on the investor. Indeed, the severity and the effect of the state measure is not the sole requirement and another condition is still required.\footnote{No one will seriously doubt that the severity of the impact upon the legal status, and the practical impact on the eminent owner’s ability to use and enjoy his property, will be a central factor in determining whether a regulatory measure effects a taking.” R. Dolzer, (2002), supra note 69, 79.} This approach considers the governmental measure and “requires weighing and balancing of factors including the purpose as well as the effect of measures.”\footnote{L. Y. Fortier, and S. Drymer, (2004), supra note 89, 313-14.} This approach has not generally been accepted by commentators and international awards, probably because it would be a difficult task to prove the intention of the host state for expropriation of the international investor’s property.\footnote{C. Schreuer, (2006), supra 31, 34.}

The arbitrators in the \textit{Tippetts} case stated that “the Tribunal does not need to determine the intent of the government of Iran, and also compensation does not depend on proof that expropriation was intentional.”\footnote{Tippetts, Abbett, McCarthy Stratton, v. TAMS-AFFA Consulting Eng’rs of Iran, 6 Iran-US CTR, (1984), para. 97.} In the \textit{Biloune v. Ghana}, the tribunal held that the intention of the host government was ambiguous. However, “the tribunal need not establish those motivations to come to a conclusion in this case”.\footnote{BILOUNE AND MARINE DRIVE COMPLEX LTD v. GHANA INVESTMENTS CENTRE AND THE GOVERNMENT OF GHANA, Award on Damages and Costs, 30 June 1990, 95 ILR 184.} Similarly, in the \textit{Philips Petroleum}, the tribunal awarded that the liability of the government for payment of compensation in the event of expropriation was not
dependent on the intention of the State.\textsuperscript{95} The tribunal in the case of \textit{S.D. Myers v. Canada} followed and applied the purpose approach and reached this conclusion “Tribunal must look at the real interest involved and the purpose and effect of the government measure.”\textsuperscript{96}

In \textit{S.D. Myers v. Canada}, the S.D. Myers, (American Company) had established a subsidiary in Canada to export PCBs (polychlorinated biphenyls) to the US for disposal. The investor claimed 20 million dollars under the NAFTA rules against the Canadian government. The claimant alleged that the imposition of export ban was a violation of Article 1110 and therefore resulted in an expropriation.\textsuperscript{97} The tribunal refused the claim of expropriation and added “Canada realised no benefits from the measures and that measure did not involve transfer of property or benefit directly to others.”\textsuperscript{98} Additionally, the tribunal noted that a taking generally requires transfer of ownership to another person. Therefore, the tribunal did not find any creeping taking and expropriation.\textsuperscript{99}

The next case in the second line of inquiry is \textit{Marvin Feldman v. Mexico}.\textsuperscript{100} The claimant, a US citizen, Mr. Marvin Feldman, had established a company under the law of Mexico and claimed that the government by exercising certain tax law to the export of tobacco products, terminated tax rebate policy for cigarette exports. The foreign investor asserted that he had made the investment based upon the tax rebate and as a result of implementing this measure he could not reach expected benefits. The investor alleged that it was against Article 1110 of the NAFTA and constituted an expropriation. The tribunal did not find an expropriation and rendered that law regulations because of regulatory powers of states are subject to modification to regulate the political and economic circumstances. The changes took place at the investors risk unless he had obtained a binding ruling from the concerned authority.\textsuperscript{101} In addition, the government action neither deprived the investor nor interfered with the investment. It also had not displaced the claimant as controlling shareholder.\textsuperscript{102} The tribunal did not find expropriation.\textsuperscript{103}

The above analysis argues two different avenues in the determination of whether a host state’s measure might be characterised as an indirect expropriation or whether it is a legitimate

\footnotesize{\textsuperscript{95} Philips Petroleum Co. Iran v. Iran, 21 Iran-U.S. CTR 79, 115.  
\textsuperscript{98} Ibid, Paras 143, 288.  
\textsuperscript{99} Ibid, Para 280.  
\textsuperscript{101} Ibid, Paras 112, 134.  
\textsuperscript{102} Ibid, Para 152.  
regulation. Albeit the sole effect approach is not a conclusive test, this approach is widely accepted. Regulatory interference and change of administrative measures might be seen all around the world. The host state seeks to establish a balance between the public interest for its people and international investor’s rights. It is therefore predictable that host governments may affect the economic benefits of the foreign investor. It could be reasonable to consider both approaches at times when the state liability for payment of compensation is in question. Several arbitral tribunals looked at the first approach that only considers the effect of action as sole factor for taking. A number of cases took the second approach, which does not deny that effect of measure is one of the main factors in making the decision, but emphasises the purpose of the measure.

However, the question is still open: what factors are important in the determination of whether or not a taking has taken place? The subjective assessment of all the relevant circumstances in every case is to be accomplished. The careful considerations of arbitrations shows that the arbitral tribunals take into account all the relevant circumstances by a fact based approach to decide whether or not an indirect expropriation occurred. Such elements, which arbitral tribunals consider are, inter alia, the disappointment of legitimate expectation caused by a governmental action, reduction of the foreign private property value, contractual rights of the foreign investors or rights established under legislation and whether the host state deprived the investor of essential benefits for which the investment was made. As well as the weight of the effect of the state measure.

One of the important factors in the determination of whether or not a taking has occurred is disappointment of legitimate expectation by the government’s measure. Examination of the arbitral cases indicates that if a governmental measure frustrates the legitimate expectation of the foreign investor that is created on the basis of a reasonable reliance on the host government’s undertakings, compensation for the affecting measure is required. Indeed, contractual commitments with the host state that will not seek to exercise its administrative or legislative

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powers to terminate or alter the contractual arrangements constitute a legitimate expectation for the investor.\textsuperscript{109}

The foreign investor makes the investment, takes the risk and brings technology into a project. Therefore, where a government’s interference has a severe impact on the project, expropriation has happened and compensation is required.\textsuperscript{110} Protection of legitimate expectation is a useful test in the determination of an indirect expropriation.\textsuperscript{111} In addition, other relevant factors like public interest and circumstances must be taken into account.\textsuperscript{112} Where the host state action breaches the agreement and deprives the investor of essential benefits which under the contractual arrangement were major reasons for the investment, it is tantamount to expropriation.\textsuperscript{113} Nevertheless, the deprivation must affect a legitimate business.\textsuperscript{114}

It is generally accepted by the arbitral tribunals and legal scholars that reduction of the investment value, \textit{per se}, will not give rise to payment of compensation.\textsuperscript{115} All investments include risks and not every problem experienced by the foreign investor can be regarded as an indirect expropriation.\textsuperscript{116} Indeed, the duty to compensate for every reduction “will render public governance almost impossible as governments will be crippled by claims for compensation.”\textsuperscript{117} It may limit the government’s right to regulate and make the state reluctant to make legitimate regulations. Hence, a threshold of the state’s interference in the foreign investor’s property rights, which can distinguish it from legitimate regulation of the economy, has to be recognised.\textsuperscript{118} The weight of the effect of a state measure on the foreign investor and the duration of the measure are the key factors in the determination of an indirect expropriation.\textsuperscript{119}

The severity of the impact on the ability of the foreign investor to enjoy and use of the investment and the legal status are important in specifying whether a regulatory action constitutes taking.\textsuperscript{120} The degree of host state interference with the property has to be substantial and restrictive to be

\textsuperscript{110} T. Waelde and A. Kolo, (2001), supra note 7, 844.
\textsuperscript{111} J. Paulson and Z. Douglas, (2004), supra note 61, 158.
\textsuperscript{113} \textit{Starrett Housing Corp. v. Iran}, 16 Iran-US CLT. Rep. 112 (1987); The tribunal in spite of lack of a formal decree of nationalisation has found that taking has resulted in deprivation of US investors of fundamental property or contracts rights.
\textsuperscript{115} R. Higgins, (1982), supra note 4, 278.
\textsuperscript{116} See, \textit{Marvin Feldman Arbitration}, para 112.
\textsuperscript{117} T. Waelde, and A. Kolo, (2001), supra note 7, 839.
\textsuperscript{118} J. Paulson and Z. Douglas, (2004), supra note 61, 147.
\textsuperscript{120} R. Dolzer, (2002), supra note 69, 79.
considered as a taking. Substantial deprivation means that the foreign investor does not have the ability to enjoy, use or dispose of the property as they would have done.

4.4. Case Studies

4.4.1. Case Study (I): The Energy Charter Treaty Arbitration, Yukos v. Russia

As suggested earlier in this chapter, the significance of the ad hoc arbitration between Yukos and Russia, which was decided according to the Energy Charter Treaty, makes it necessary for the current chapter to examine the case in greater detail.

First, it was the largest award in the history of investor-State arbitration concerning expropriation. Second, this case is proof of the law of expropriation’s (existing and dominant law) inability in preserving the equilibrium and restoring contractual balance. The classical model in which the government’s interference took place, could merely result in abrogation and deprivation of the investor of its interests. It shows that the host state’s interference leads to a larger disruption and deprivation of the oil company of reasonable interests. This case highlights the fact that was discussed in chapter two, which is that adjustment of a damaged equilibrium cannot be achieved in a fixed and strict model provided by the existing law.

Third, it highlights the significance of maintaining the contractual relationship and the way in which the relational model tries to keep the contract alive and rebalances a damaged equilibrium, i.e. adjustment. It shows that even an award of multi billion dollars cannot get the parties back to the original contractual positions that they would have been in.

Fourth, the Yukos case is the manifestation of the failure of the classical approach by providing the options of breach and compensation for protecting the parties’ interests. As explained in the second chapter, the classical model can merely provide breach of the contract once the equilibrium is disrupted. It does not allow the adjustment. The analysis of Yukos highlights that compensation

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122 In this respect ‘unreasonable interference’ standard is recognised by the Harvard Draft Convention on the International Responsibility of States for Injuries to Aliens. Article 10 of the Convention provides: 3-(a) “A taking of property includes not only an outright taking of property bust also any such unreasonable interference with the use, enjoyment, or disposal of the property as to justify an interference that the owner thereof will not be able to use, enjoy, or dispose of the property within a reasonable period of time after inception of such interference”. Reprinted in L. Sohn & R. Baxter, “Responsibility of States for Injuries to the Economic Interests of Aliens”, (1961) 55 AJIL 545, 553; Pope & Talbot Arbitration, para 102; The Iran-US Claims Tribunal has reinforced the principal of “unreasonable interference” and held that such events which unreasonably deprive the owner of fundamental ownership rights make up expropriation. See, Tippets, Abbott, McCarthy Stratton, v. TAMS-AFFA Consulting Engineers of Iran, 6 Iran-US CTR, (1984) 219, 225; (that the Tribunal wrote unreasonable interference test is sufficient to form expropriation.); G. Aldrich, (1994), supra note 1, 589; For other cases upholding this standard, see generally, Ataollah Golpira v. Islamic Republic of Iran, 2 Iran-US CLT. Rep. 171, 177; Foremost Tehran, Inc. v. Iran, 10 Iran-US CLT. Rep. 228, 244; Pope & Talbot Arbitration, para 102; Marvin Feldman Arbitration, para 152.
is not a reliable and adequate response for the protection of the parties’ interests, when the equilibrium is disrupted. There are some uncertainties concerning the valuation and standards of calculation of compensation by Tribunals under international law.¹²³ There is controversy on the method of valuation of compensation by arbitral Tribunals. In addition, the Tribunals do not award compensations for all types of interferences that negatively affect the foreign investor’s interests. For example, Yukos claimed $81 billion for compensation and $29 billion for interests, the request was rejected by the tribunal. The tribunal in the judgment awarded only $1.87 billion for compensation.¹²⁴

Finally, even after more than ten years of legal dispute before the tribunal and spending millions of dollars on legal fees and costs, the enforcement of an award of compensation against the state and state entities is problematic. In light of the tribunal's finding that the attacks against Yukos were for the sole benefit of the Russian state and the state-owned companies Rosneft and Gazprom, the claimants may be tempted to seek to enforce against these two companies, which are majority-owned by the Russian state and (while most of their assets are domestic) are also known to hold significant assets in other jurisdictions. However, enforcing against Rosneft and Gazprom will be very difficult. One major obstacle is likely to be in persuading the courts that they should pierce the corporate veil and enforce against the companies’ assets despite their separate legal personality.¹²⁵ The Yukos case will be discussed below.

In Yukos v Russia¹²⁶, the Tribunal held that whilst Russia did not explicitly expropriate Yukos, its measures had an affect equivalent to expropriation. Yukos was a company established as a joint stock company in 1993 and had operations in the petroleum industry. Yukos had three production subsidiaries, Yuganskneftegaz (YNG), Samaraneftegaz, and Tomskneft. It was the largest petroleum company in Russia and one of the world’s top ten petroleum companies in 2002. The


¹²⁴ Yukos v. Russia, Application No. 14902/04, ECHR, 15 December 2014. In addition to the more famous dispute under the Energy Charter Treaty (ECT) in Permanent Court of Arbitration in The Hague, on 23 April 2004 former Yukos management also filed claims under the Convention before the European Court of Human Rights (the ECHR). In recent development and in the case before the ECHR, on 19 January 2017 Russian Constitutional Court came to the conclusion that the decision of the European Court of Human Rights (ECHR) on compensation payment to Yukos violates the Russian Constitution and cannot be enforced. Available at http://www.cisarbitration.com/2017/01/25.

¹²⁵ It is notable that The Hague District Court ruled on 20 April 2016 to reverse a PCA tribunal’s decision against Russia to pay compensation to the former majority shareholders of Yukos Oil Company, which was once the largest oil company in Russia. Available at http://www.italaw.com/cases/1175.

¹²⁶ Yukos Universal Limited (Isle of Man) v. The Russian Federation, UNCITRAL, PCA Case No. AA 227, Final Award of 18 July 2014.

In November 2007, Yukos’ assets were nationalised and two Russian State-owned companies, Rosneft and Gazprom acquired the remaining assets. Amongst the governmental measures which allegedly violated the ECT provisions were the criminal prosecution of the company and its management. In July 2003, a series of criminal investigations were initiated by the Russian government, and it was argued on behalf of Yukos that all of these actions amounted to harassment and intimidation, that they ‘severely hampered’ the functioning of Yukos as a business. It also made up the main motive for nationalisation of Yukos’ assets.

Between July and October 2003, three key Yukos officers were arrested. Mr. Mikhail Khodorkovsky, CEO of Yukos and supporter of Russian opposition parties, Mr. Platon Lebedev, Director of the claimants Yukos Universal and Hulley, and Mr. Vasily Shakhovsky, President of Yukos-Moscow were charged of crimes of fraud, embezzlement, forgery, and tax evasion. As a result of these arrests, other high-ranking Yukos executives fled Russia.

According to Russia, the claimants were “part of a criminal enterprise engaging in a number of illegal activities, including, tax evasion, tax fraud, and schemes to avoid enforcement of tax liens”. Also, they had participated in “an illegal tax scheme designed to misuse special low-tax zones in Russia and they were aware of the illegality of the tax fraud scheme”.

According to the claimants, the respondent had imposed fines and asset freezes, VAT charges, and tax reassessment against Yukos. In addition, the Russian government annulled the merger of Yukos with Russian oil company Sibneft, threatened to revoke the licenses and forced Yukos to sell YNG, the most important production subsidiary. The claimants argued that the harassment of Yukos’ executives and these measures taken by Russia breached Article 10 (fair and equitable requirement) and resulted in an expropriation of the claimants’ investment in Yukos in violation of Article 13(1) of the ECT.

127 YUKOS Universal Limited (Isle of Man) v. The Russian Federation, UNCITRAL, PCA Case No. AA 227, Interim Award on Jurisdiction and Admissibility, 30 November 2009, paras 35-46.
128 Ibid.
129 Ibid, para 51.
130 Ibid, paras 48,49.
131 Ibid, para 52.
132 Ibid, paras 56-68.
133 YUKOS v Russia, supra note 126, Final Award, paras 62-70.
In terms of expropriation, the claimants alleged that the Russian Federation failed to satisfy any of the four requirements set out in Article 13(1) ECT.\textsuperscript{134} The expropriation was not in the public interest, it was discriminatory, and it was carried out without due process of law and not accompanied by the payment of compensation. They also added that the only plausible explanation for the Russian government was “the twin desire of dismantling the Company and transferring its assets to the State and the removal of Mr. Khodorkovsky as a potential political opponent. The result of those actions was a complete and total deprivation of the Claimants’ investment therein”\textsuperscript{135} Moreover, the claimants argued that Russia was not able to deny the total deprivation of the claimants’ investment and the transfer of title of Yukos’ property. “The respondent disaggregates its actions and argues that, when taken in isolation, each of them was, under Russian law a proper response to Yukos’ alleged conduct. While, in fact, many of those actions amounted to a gross distortion or abuse of Russian law, lawfulness under domestic law is not, in any event, the proper inquiry under Article 13(1) ECT. Under the applicable international law standards, the actions of the Russian Federation, in their totality, constitute an expropriation of the Claimants’ investments in breach of Article 13(1) ECT for which compensation is due”.\textsuperscript{136}

The Tribunal upheld the claimant’s view that Russia’s taxation measures aimed at bankrupting Yukos, were not taken in good faith. The Tribunal held that “the ECT can only apply to bona fide taxation actions, i.e., actions that are motivated for the purpose of raising general revenue for the State. By contrast, actions that are taken only ‘under the guise’ of taxation but in reality to achieve an entirely unrelated purpose - (such as the destruction of a company or the elimination of a political opponent cannot qualify for exemption from the protection standards of the ECT”.\textsuperscript{137}

Furthermore, the Tribunal examined the claimants’ reasonable expectations and held that the claimants should have expected that their tax avoidance operations might risk adverse reaction from Russian authorities. However, the claimants could not have been expected to foresee extreme actions such as tax reassessment, arrest, the forced sale of YNG, and fines. The Tribunal concluded that “the primary objective of the Russian Federation was not to collect taxes but rather to bankrupt Yukos and appropriate its valuable assets”.\textsuperscript{138} The Tribunal found that Russia had not

\textsuperscript{134} Article 13(1) requires that “Investment of Investors of a Contracting Party in the Area of any other Contracting Party shall not be nationalised, expropriated or subjected to a measure or measures having effect equivalent to nationalisation or expropriation (hereinafter referred to as “Expropriation”) except where such Expropriation is: (a) for a purpose which is in the public interest; (b) not discriminatory; (c) carried out under due process of law; and (d) accompanied by the payment of prompt, adequate, and effective compensation.”

\textsuperscript{135} Yukos v Russia, supra note 126, Final Award, paras 67-70.

\textsuperscript{136} Ibid, para 70.

\textsuperscript{137} Ibid, paras 1430-1431.

\textsuperscript{138} Ibid, paras 1578-1579.
explicitly expropriated Yukos or the holdings of its shareholders, but the measures that had been taken as to Yukos had an effect of “equivalent to nationalisation or expropriation”.

The Tribunal then discussed the basic requirements of a lawful expropriation under Article 13(1) of the ECT. In relation to the public interest condition, the Tribunal did not find that expropriation of Yukos was in the public interest. The Tribunal held that the issue whether “the destruction of Russia’s leading oil company and largest taxpayer” was in the public interest is questionable. The Tribunal added “it was in the interest of the largest State-owned oil company, Rosneft, which took over the principal assets of Yukos virtually cost-free”.

With regard to the requirement of non-discriminatory treatment, the Tribunal considered that Yukos’s treatment, compared to the treatment of other Russian oil companies which also benefited from low-tax jurisdictions might have been discriminatory. As to due process of law condition, the Tribunal did not accept that expropriation of Yukos was “carried out under due process of law” due to the harsh treatment accorded to executives and counsel of Yukos. The Tribunal concluded that “Russian courts bent to the will of Russian executive authorities to bankrupt Yukos, assign its assets to a State-controlled company, and incarcerate a man who gave signs of becoming a political competitor”.

The Tribunal then examined the requirement of payment of compensation. The Tribunal held that expropriation of Yukos was not “accompanied by the payment of prompt, adequate and effective compensation” or, in fact, any compensation at all. The Tribunal concluded that “in order for the Russian Federation to be found in breach of its treaty obligations under Article 13 of the ECT, the foregoing violations of the conditions of Article 13 more than suffice”.

The Tribunal established the liability of the respondent and held that claimants were entitled to compensation for expropriation. The Tribunal then looked at this issue whether and to what extent the compensation should be reduced as a result of the claimants’ wrongdoings according to the legal principle of contributory fault. The Tribunal found that the claimants’ abuse of low-tax jurisdictions had contributed to the prejudice they suffered and it should reduce the amount of

139 Ibid, para 1580.
140 Ibid, para 1581.
141 Ibid, para 1581.
142 Ibid, para 1582.
143 Ibid, para 1583.
144 Ibid, para 1583.
145 Ibid, para 1584.
146 Ibid, para 1594.
damages in the award. The Tribunal concluded that as a result of the claimants’ contributory fault, a 25 percent of damages should be reduced in the award.147

Finally, the Tribunal awarded that the claimants were entitled to the values of their shares, the value of the dividends that would have been paid to Yukos’ shareholders and interest on the value of the shares and dividends. Given the claimants contributed to the extent of 25 percent to the prejudice they suffered by the Russian Federation, the amount of damages to be paid to the claimants was more than fifty billion dollars.148

4.4.2. Case Studies (II): The NAFTA Tribunal’s Cases

The controversy over the meaning of expropriation is projected into the modern investment treaties. Almost all of the investment treaties contain provisions on ‘direct and indirect expropriation’ or ‘measures tantamount’, ‘similar to expropriation’ or a variety of such terms.149

The North American Free Trade Agreement, (NAFTA) in Article 1110 stated “No party may directly or indirectly nationalise or expropriate an investment of an investor of another party in its territory or take a measure tantamount to nationalisation or expropriation of such an investment ("expropriation"), except:(a) for a public purpose; (b) on a non-discriminatory basis; (c) in accordance with due process of law and Article 1105(1) (which is “treatment in accordance with international law, including fair and equitable treatment and full protection and security”); and (d) on payment of compensation.”150

Most of the bilateral investment treaties (BITs) have taken nearly the same definition for expropriation.151 Under international law and provisions of the NAFTA, expropriation with the existence of certain conditions is permitted.152.

The analysis of the NAFTA provision concerning expropriation shows that whenever the property is taken, compensation must be paid for both direct and indirect expropriation.153 In accordance with the NAFTA’s text, this requirement will be applied regardless of the method of taking or the

147 Ibid, para 1637
148 Ibid, paras 1813-1827.
149 R. Dolzer, M. Stevens, (1995), supra note 71, 99 -101; A. Lowenfeld, (2003), supra note 17, 476; The reason for incorporating terms ‘direct or indirect’ expropriation, ‘tantamount or similar to’ expropriation is to cover the so called ‘creeping expropriation’.
152 Taking of property is for public purpose, non-discriminatory and with the payment of compensation.
reason behind a taking. It also covers regulatory measures. Nevertheless, as mentioned earlier, the degree of state interference must be substantial. The NAFTA tribunals have examined several claims in relation to the host government measures, which were alleged to be expropriation. For a better understanding, this section will discuss them below.

*Pope and Talbot, Inc. v. Government of Canada,* examined the meaning of expropriation. The facts of this case were discussed earlier and now the tribunal’s discussion will be addressed. The tribunal noted that under the NAFTA provisions, the term of ‘expropriation’ means both direct and indirect expropriation. It also concluded that Article 1110 involves non-discriminatory regulation as to the exercise of government’s police power. The tribunal held that “regulations can indeed be characterised in a way that would constitute creeping expropriation. Indeed, much creeping expropriation could be conducted by regulation…” The tribunal found that there must be a substantial deprivation to regard the state act as a compensable expropriation. In addition, the tribunal added that the foreign investor’s access to the US softwood lumber market has made up the property rights, which were protected by the NAFTA. The tribunal reached the conclusion that Canada’s temporary imposition of its quota regime did not qualify as ‘substantial deprivation’.

In another case, *Feldman v. Mexico,* the claimant alleged that Mexico’s decision not to provide rebates of taxes paid by the investor for the cigarette exports from Mexico formed a creeping expropriation. The tribunal found that the legal arguments against a finding of expropriation were more persuasive. The tribunal added that Mexico had a long lasting tax policy against the operation of such businesses. The tribunal concluded that “not all government regulatory activity that makes it difficult or impossible for an investor to carry out a particular business, change in the law or change in the application of existing laws that makes it uneconomical to continue a particular business, is an expropriation under Article 1110.”

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156 Ibid, para. 96.
157 Ibid, para. 99.
158 Ibid, para. 102.
159 Ibid, para. 102.
161 Ibid, paras. 110, 111.
162 Ibid, para. 115.
163 Ibid, para. 112.
In the *S.D. Myers* arbitration, the tribunal found that an alleged wrongful export ban by the Canadian government on the export of hazardous waste generated in Canada to export to the US was not an environmentally related action but rather to protect the disposal industry of Canada from US competition. The tribunal agreed with the claimant’s contention of failure to accord fair and equitable treatment, but refused the expropriation allegation. It noted that an expropriation usually amounts to a lasting removal of the owner’s ability to make use of economic rights and deprivation that amounts to expropriation might be even temporary or partial. The border closure was temporary but the measure does not constitute an expropriation under Article 1110.

In another NAFTA’s arbitration, *Metalclad case*, the tribunal found that deprivation was substantial and stated that the deprivation of the foreign investor from operating its waste recycling facility after it had been built and the business project was fully approved by the government was a measure tantamount to expropriation in violation of Article 1110. The tribunal held this view that the host state action was deprivation of investment and had constituted expropriation.

The examination of the above arbitrations demonstrate that expropriation is made up by deprivation of the foreign investor and not by the gain for the host government. Therefore, where the host government action brings about destruction of the property, even if the state does not acquire the property in question, it will constitute expropriation. This is in line with the findings of chapter two about the OBM and the disruption of equilibrium. Whenever the parties do not gain the expected benefits or lose their interests in a relationship it will disrupt the contractual equilibrium. Nowhere in investment treaties is a regulatory measure excluded from the provisions of investment protection. Moreover, taking a regulatory measure will not justify breach of investment treaties. Whenever a regulatory activity has an adverse impact on the value of an investment it will not generally constitute expropriation. Although, it may result in state liability for the breach of other provisions such as, fair and equitable treatment and national treatment.

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165 Ibid, paras. 194-5.
166 Ibid, para. 283.
168 *Metalclad Corp. v. United Mexican States*, ICSID Case No.ARB (AF)/97/1, 30 August 2000).
169 Ibid, paras. 103-4.
170 A. Lowenfeld, (2003), supra note 17, 478.
Almost all international petroleum arbitrations that have discussed indirect expropriation were relevant to Iran’s nationalisation of the petroleum industry. In this section indirect expropriation and petroleum arbitral awards will be discussed. In this respect determination of the date of the taking in international petroleum arbitrations is crucial. Although there is a date for formal taking but the date for indirect expropriations is earlier than the date of issuance of a formal decree. The value of the investment might fluctuate over the time and it may affect the amount of compensation. In addition, the date of indirect expropriation is important for the exchange rate of currency and the date from which interests shall be assessed for the award.

In *Amoco v. Iran*, Amoco and National Petrochemical Company of Iran (NPC) concluded the ‘Khemco agreement’. They agreed to establish a joint venture on a fifty-fifty capital, (Khemco). The purpose of Khemco was to install and operate a natural gas production plant on an Iranian Island (Kharg) in the Persian Gulf. Civil unrest in Iran and the events of the Iranian revolution hampered petroleum production in late 1978. Amoco removed its expatriate personnel from Iran in late 1978. In May 1979, Amoco was informed by Iranian officials that foreign employees could not return back and NPC was ready to purchase Amoco’s share in the joint venture. The managing director of the JV informed the claimant that all sales of the petroleum products must be made by the National Iranian Oil Company (NIOC) and NPC. The Iranian minister of petroleum then informed Amoco that the Khemco agreement was nullified by the Special Commission in 1980.

The claimant alleged that its shares in Khemco were expropriated and the date of 1 August 1979 should be regarded as the date of expropriation. The tribunal observed that Amoco’s rights and interests including its shares in Khemco were expropriated through a process starting in April 1979 and had been completed by the decision of the Special Commission on 24 December 1980. The tribunal also noted that the value of the claimant’s interests shall be calculated since 31 July 1979. Judge Aldrich stated that by making this date as the date of valuation, the tribunal implicitly accepted this date as effective the date of taking. Hence, it was justified that Amoco was deprived of its property rights under the Khemco agreement. The tribunal refused the allegation that expropriation due to the absence of compensation provisions before the enactment of Single Article Act was unlawful. The tribunal by acceptance of the taking date after

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174 Ibid, paras. 182, 184.
legislation of Single Article Act (8 January 1980), considered the Act as a legal requirement for the payment of compensation which is essential for a lawful taking.\textsuperscript{177}

Another petroleum arbitration that addressed indirect expropriation is \textit{Philips Petroleum Co. Iran, v. Iran}.\textsuperscript{178} The parties signed the Joint Structure Agreement (JSA) in 1965. It was concluded between the National Iranian Oil Company (NIOC) as the “First Party” and Philips Petroleum Company Iran and a number of companies collectively referred to as the “Second Party”. The object of the JSA was exploration and exploitation of the petroleum resources of an offshore area in the Persian Gulf. Under Articles 5 and 6 of the JSA, the parties had established a joint stock operating company, namely, Iranian Marine International Oil Company (IMINCO), to carry out all operations under the JSA. The JSA in Article 6 provided that each party would have half of the stock of IMINCO and the right to appoint half of the board of directors. The second party and NIOC had the right of the oil lifted from IMINCO’s field. IMINCO ceased the production in December 1978 due to the events subsequent to the revolution and workers strikes on Lavan Island that had prevented loading of oil on tankers. When in March 1979 production started, the claimant was not permitted to lift its share of IMINCO. Further, NIOC in violation of the JSA on 11 August 1979 unilaterally removed the general manager of IMINCO and replaced him by a committee to execute the affairs of the affiliated companies.\textsuperscript{179} In addition, a sub-committee had been formed to deal with the involved companies in the JSA to terminate the existing contracts with the Second Party and to negotiate new contracts with the Second Party.\textsuperscript{180} Shortly after, in September 1979, NIOC informed the claimant that the JSA “should be regarded as terminated because events had overtaken it.”\textsuperscript{181} On 11 August 1980, the claimant had been informed that the Special Committee declared the JSA null and void.\textsuperscript{182} In determination of whether an expropriation had taken place the tribunal wrote, “expropriation by or attributable to the state of the property of an alien gives rise under international law to liabilities for compensation, and this is whether the expropriation is formal or de facto.”\textsuperscript{183} The tribunal held that Iran’s actions were consistent with the nationalisation policy of the petroleum industry.

Moreover, the tribunal argued that the effect of measures on the investor determines whether an expropriation has occurred. Therefore, expropriation does not need to be intentional to bring about the state liability. The tribunal found that Philips by a series of concrete actions had been deprived

\textsuperscript{177} Ibid, 290.
\textsuperscript{178} 21 Iran-US. CTL. Rep. 79.
\textsuperscript{179} Ibid, 95.
\textsuperscript{180} Ibid, 96.
\textsuperscript{181} Ibid, 96.
\textsuperscript{182} Ibid, 97.
\textsuperscript{183} Ibid, 106.
of its property. The tribunal also cited the *Tippetts* award to underpin its reasoning that the host state’s control may amount to expropriation under international law:

“Such a conclusion is warranted whenever events demonstrate that the owner was deprived of fundamental rights of ownership and it appears that this deprivation is not merely ephemeral a taking will found.”

The above analysis has established that the tribunal had to deal with two main issues in relation to taking. The first was when the claimant was deprived of property rights and whether a compensable taking had taken place or not. The second was determination of the date of taking. In determination of whether a taking has occurred, the tribunal had to specify whether the parties had mutually agreed to terminate the contract or whether Iran had taken the property rights. The tribunal determined the date of taking when the reasonable prospect of returning to the contractual arrangements might not be seen. The tribunal awarded compensation.

In another case, *Mobil Oil Iran, Inc. v. Iran*, the claimants were members of the group of oil companies, “The Consortium” which worked on behalf of the National Iranian Oil Company (NIOC) on the onshore Iranian oil industry. The claimants under the Sale and Purchase Agreement 1973 (SPA) had purchased crude oil from NIOC. Thereafter the revolution, NIOC on 10 March 1979 sent a letter to the consortium expressing that the NIOC considered the SPA inoperative and that expatriate personnel would be replaced. The NIOC would treat the consortium members as “prime customers”. In March 1979, the consortium responded to NIOC by sending a letter stating that the consortium wanted to “meet NIOC to reach an agreement in respect to the termination of the 1973 SPA and related arrangements”. The consortium added “the new government would deal with repayment of Members’ investment and advances and settlement of any claims of either party. Pending agreement, which we anticipate would be reached quickly, members must, of course, reserve all their rights and cannot accept the points made in the first paragraph of your letter of 10th March.”

The parties initiated negotiation but the process was suspended in November 1979. The Special Commission on 5 September 1981 repudiated the SPA and declared it void. Mobil Oil alleged that Iran had expropriated the claimant’s contractual rights established under the SPA. Further, the claimant invoked the letter of 10 March 1979 by NIOC for taking. However, the tribunal

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185 Ibid, 115.
187 Ibid, 40.
188 Ibid, 41.
189 Ibid, 41.
observed that both parties in March 1979 had mutually agreed not to revive the agreement and to start negotiation for formal termination of the agreement and settle the related issues about the termination. Accordingly, the tribunal found that the letter dated 10 March 1979 did not constitute expropriation and rejected the claimant’s allegations.\(^{190}\) Moreover, the tribunal concluded that the agreement to terminate was not unconditional. Both parties reached this agreement based on the fact that they would reconcile interests by negotiation. The tribunal added that the consortium was contractually entitled to compensation for losses that they could have expected to recover subsequent to the negotiation with NIOC.\(^{191}\)

In Sedco Inc. v. National Iranian Oil Company (NIOC),\(^ {192}\) the claimant an American drilling contractor (Sedco), owned 50% share of the Iranian Drilling Company, (Sediran) and had controlled its operation in Iran. The claimant contended that its shares in the Sediran Company were taken by a creeping expropriation. Iran promulgated the law of the Protection and Development of Iranian Industries in 1980. According to Article 1, Clause C, nationalisation of factories and companies that received substantial loans from the government and their debts exceed their net assets was permitted. On 2 August 1980, Iran by the application of Clause C of the law for the Protection and Development of Iranian Industries, transferred shares of Sedco in Sediran to the government. Iran argued “the application of Clause C cannot be regarded as a taking because Sediran was an Iranian legal entity with nothing but large amounts of debt and that Clause C is somehow to be assimilated to a law that is enacted to cover Iranian companies in state of bankruptcy.”\(^ {193}\) Additionally, Iran in November 1979 appointed three provisional directors to Sediran original administration. The claimant asserted that the actual taking of shares was earlier than the date of promulgation of this law.

The respondent argued that there was no liability for transfer of shares further to the enactment of Article 1, Clause C. Nevertheless, the tribunal did not accept this argument.\(^ {194}\) In addition, the tribunal wrote that “during the summer and early fall of 1979 Sedco was denied access to Sediran funds and deprived of its liability to participate in the management and control of Sediran, circumstances potentially evidencing a taking.”\(^ {195}\) Nevertheless, the tribunal had taken into account the other factors in finding expropriation.\(^ {196}\) The tribunal found that the appointment of a manager was a significant indication of expropriation because the owner was deprived of its right to manage the enterprise. The tribunal added that the appointment of temporary managers

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190 Mobile Oil Iran, Inc. v. Iran, 16 Iran-US CTL. Rep. 3, 43-45.
194 Ibid, 275.
195 Ibid, 277.
196 Ibid, 277.
and in consequence taking the control constituted outright taking of title and therefore the date of appointment was the date of taking.\textsuperscript{197} Furthermore, the tribunal held that the choice of the date of appointment of managers as the date of taking was because there were no prospects for Sedco to return to control Sediran and since that date, the government of Iran became “the chief architect of Sediran fortunes”.\textsuperscript{198}

To sum up, it seems where the appointment of temporary managers gives rise to deprivation of participation rights in the central and management of the company and denial of access to funds of the company, then this will result in expropriation. The arbitral tribunals examine affecting measures of shareholder’s rights, such as right to participate in the management process.

I examined the law of expropriation through a diagnostic study to identify the main weaknesses of the law of expropriation and the problems caused by interference with the investment, leading to the disruption of the equilibrium. I established through the discussion of many international arbitrations that the current law of expropriation has serious problems in re-balancing the equilibrium when an intervention occurs. The discussion in this chapter showed that the only solution that, the law tries to offer for a damaged contractual equilibrium is ending the contract and providing compensation. It could not adjust the contract and maintain it over a relationship that was intended to be long-term. The law of expropriation by providing compensation only deals with the consequences of ending the contract and does nothing to restore the contractual equilibrium.

In the following chapters, I will discuss the contractual mechanism that is recognised by international tribunals, legal scholars and practitioners in the industry. This mechanism is used for the minimisation of investment disputes in the energy industry.

\textbf{4.5. Inadequacy of the Existing Law of Expropriation in Protecting the Parties’ Interests}

\textit{4.5.1. The Role of Obsolescing Bargain and Return}

Uncertainty over the security of property rights is the essence of political risk.\textsuperscript{199} An important concern for all foreign investors is the taking over of their property rights by host governments. International oil companies always calculate the risk of expropriation. An investment can be a bargain between the oil company and the host state at the time of contracting in respect of expected interests. Nevertheless, sovereign states in the face of change of surrounding

\textsuperscript{197} Ibid, 278.
\textsuperscript{198} Ibid, 277-8.
\textsuperscript{199} N. Rubins, and N. Kinsella, (2005), supra note 75, 1-29.
in international investment arbitration. The arbitrators often have appeared to reach varying results from their calculations.\textsuperscript{239} The choice of different valuation methods may result in divergent numbers. Even if the same method is used, the experts representing each of the party would inevitably come to very different conclusions. It means that the claimant provides an estimate that is very optimistic in terms of the investment’s earnings, whilst the respondent provides a number that undervalues the property. Thus, the tribunal may end up choosing an arbitrary number in the middle of the two numbers.

With regards to interest rates the issue is that it is difficult to determine what would be a fair interest rate to award the investor, since the Chorzow Factory doctrine would require the Tribunal to \textit{speculate} what the investor would have done with the investment had it not been expropriated. Therefore, it would be hard for the Tribunal to make a determination if both sides make a compelling case. Usually what ends up happening is that an arbitrary rate would be decided with little or no reasoning.\textsuperscript{240} Some scholars however, criticise the sufficiency of the reasoning regarding valuation:

\begin{quote}
“Most tribunal awards are parsimonious in the economic detail which is presented. Whatever financial data is offered by the tribunal has been filtered through a jurist’s prism and typically is not amenable to economic analysis. The terminology is either too casual or the pieces of the financial puzzle are too few.”\textsuperscript{241}
\end{quote}

As awards in investment arbitrations are often in the millions, interest can make a significant difference and therefore should not be determined arbitrarily. In most cases, “valuation can be a sophisticated exercise going beyond the expertise of the legal profession and frequently requires specialized knowledge and skills that lawyers generally do not possess.”\textsuperscript{242} It would be problematic because if the arbitrators are not able to understand the financial reasoning behind a party’s argument, they could not produce an award that is equitable and this would therefore either over or under compensate the investor.\textsuperscript{243}

To sum up, the uncertainties involved in the determination of compensation in awards, as previously stated, would result in inequitable results for foreign investors negatively affected by the host state’s actions. Several or even a few unfair results could have devastating consequences in relation to the foreign investor, foreign investment and for the host state in general. As previously explained, the classical law and compensation that is the mere solution of this model to a damaged equilibrium, are unable to protect contracting parties’ interests, and to guarantee

\begin{footnotesize}
\begin{itemize}
\item\textsuperscript{239} \textit{Wena Hotels v. Egypt}, para 122.
\item\textsuperscript{240} For example, \textit{Siag v. Egypt}, paras 596-98.
\item\textsuperscript{242} S. Ripinsky and K. Williams, (2008), supra note 214, 190.
\item\textsuperscript{243} B. Sabahi, (2011), supra note 219, 113-135.
\end{itemize}
\end{footnotesize}
Chapter 5

The Pursuit of Equilibrium in International Petroleum Transactions: The Necessity of Transactional Certainty

Introduction

The law of expropriation represents one attempt to deal with the problem of the obsolescing character of the contractual bargain in petroleum transactions. It accepts that the host government has a lawful power to control international oil companies in its jurisdiction and that this provides the host state devices and legal instruments to ensure the priority of its purposes and interests, while there is conflict of interests between the foreign oil company and the government. It seeks to redress this by imposing conditions that must be met for expropriation to be lawful, creating a binding right to compensation on expropriation. A radically different approach is taken by stabilisation clauses, which seek to protect the investment by reducing the host state’s ability to interfere with the investor’s rights.¹ In the relationship between a sovereign state and a foreign

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investor, the stabilisation clause is an attempt to remedy imbalances that may occur when an investment was made by investors. International arbitral practice has shown that most of the cases dealing with the question of stabilisation clauses were petroleum disputes.\(^2\) The contracting parties to international investment by stabilisation clauses agree to freeze the relevant laws of the host state. Future changes in the legal and regulatory frameworks cannot therefore give rise to alteration of the contractually established arrangement. It is stated that stabilisation may refer to an attempt to avoid potential risk as to affecting the attractiveness of the project regime.\(^3\) As can be seen from the name of this clause, its role is to keep the contract stabilised and prevent changes. The host government promises to the foreign investor that it will not exercise legislative and administrative powers available to them to alter or terminate contractual arrangements.

However, the question of whether a stabilisation clause can guarantee the immutability of the project regime and effectively fetter the hands of the host state from unilateral alteration or abrogation of the contract remains open, and this is of crucial importance. Equally important is the question of whether the law pertaining to stabilisation clauses takes adequate account of the dynamic character of a petroleum contract, which as discussed in chapter two, makes it necessary for any controlling framework to incorporate an element of flexibility. These questions are the focus of this chapter.

This chapter aims to examine the question of the extent to which stabilisation clauses can protect state contracts from legislative and administrative actions. Under these circumstances, such actions that give rise to alteration can amount to unilateral termination of agreements. The present chapter will discuss various types of stabilisation clauses. It will also examine scholarly opinion and international petroleum arbitrations on the legal validity and efficacy of stabilisation clauses. In addition, the legal value and effect of these clauses under the domestic and international law will be addressed. The chapter will conclude by assessing whether, and the extent to which, stabilisation clauses contribute to maintaining the stability of the contractual equilibrium.

5.1. Nature of Stabilisation Clauses

As discussed in previous chapters, due to the unique characteristics of petroleum contracts the need for stability during the life of a project is significant. Therefore, stabilisation clauses are utilised to guarantee contractual stability and to hinder host states interference. Such clauses are included in numerous petroleum contracts to prevent the possibility of legislative or regulatory changes. An important number of long-term international contracts by containing the stabilisation

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clause aim to prevent modification of contractual rights.\textsuperscript{4} This technique guarantees that the host state would not alter the contract to encourage international oil companies to invest and has been used very often in concession contracts in the petroleum industry.\textsuperscript{5} A leading scholar has defined the stabilisation clause as “any clause contained in an agreement between a government and foreign legal entity by which the government party undertakes neither to annul the agreement nor to modify its terms either by legislation or by administrative measures”.\textsuperscript{6}

Stabilisation clauses are aimed to guarantee that future changes of laws by the host state will not result in an alteration of contractual terms. Such clauses freeze the law of the host state to preclude alteration of the project regime. It is pointed out that such a clause is an attempt “to reach a compromise between the sovereign prerogatives of the State involved and the legitimate quest of the private party for stability of status consistent with sound business judgement”.\textsuperscript{7}

The stabilisation clause is introduced to neutralise the power of the host state to affect contracts.\textsuperscript{8} It is asserted that “the foreign corporation stood at a disadvantage in any agreement it made with the host state, as the host state had the legislative power to alter any event that took place within its territory or to affect any contractual right or right to property that was located within its territory. Such a power flowed from its sovereignty. It was in the interests of the international corporation to neutralise this power”.\textsuperscript{9} Such clauses are presumed to protect the foreign investor from unilateral change of environmental, labour and other regulations, including, fiscal regime and “to prevent the destruction of the contract itself before the contract expires”.\textsuperscript{10} Professor Cameron has also offered a definition for such clauses in the field of petroleum which is “in the context of an international energy contract, the term stabilisation applies to all of the mechanisms, contractual or otherwise [legislative acts], which aim to preserve over the life of the contract the benefit of specific economic and legal conditions which the parties considered to be appropriate at the time they entered into the contract”.\textsuperscript{11}

The Iran-US Claims Tribunal has addressed the stabilisation clause and held that it is “contract language which freezes the provisions of a national system of law chosen as the law of the contract

\begin{itemize}
  \item[E. Paasivirta, “Internationalisation and Stabilisation of Contracts Versus State Sovereignty”, (1989) 60 BYIL 315.]
  \item[G. Delaume, \textit{Transnational Contracts: Applicable Law and Settlement of Disputes: Law and Practice}, Booklet 8, July 1983, 39.]
  \item[E. Paasivirta, (1989), supra note, 4, 315, 323.]
  \item[M. Sornarajah, \textit{The International Law on Foreign Investment}, (Cambridge University Press, 2004) 407.]
  \item[Ibid, 407.]
  \item[P. Cameron, (2010), supra note 1, 69.]
\end{itemize}
as of the date of the contract, in order to prevent the application to the contract of any future alterations of this system”.12

The Tribunal in AMINOIL arbitration recognised the stabilisation clause and its effect and held that: “If the contract provided that it was made for a certain period, then it would follow automatically that it could not be terminated unilaterally by either party during, or before the end of, that period, except for reasons specifically provided for elsewhere in the contract. The stabilisation clauses began to be introduced into concessionary contracts, particularly by American Companies in view of their Latin-American experiences, and for the express purpose of ensuring that concessions would run their full term, except where the case was one for which the concession itself gave a right of earlier termination”.13

5.1.1. Typology of Stabilisation Clauses

5.1.1.1. Traditional Stabilisation Clauses

There are four main types of stabilisation clauses in the international investment environment.14 The first type aims to freeze the fiscal regime and the other investment conditions alongside with applicable law to the agreement.15 It requires that law applicable to the contract will not be changed over the life of the business relationship.16 This type of stabilisation clause that is called ‘freezing’ or ‘stricto sensu’ clause provides that the law governing an agreement is the law at the time of conclusion and excludes the contract from any future changes in laws of the host government.17 The parties freeze the law governing the contract, by limiting it to the legislation of the host state on the effective date of the contract. The second type of stabilisation clause which is called ‘intangibility clause’ requires that the host state cannot unilaterally alter or abrogate the agreement. It freezes the contract rather than the law. Article 33 of the Concession Agreement between the Ruler of Abu Dhabi and Japanese Companies of 1967 contained a stabilisation clause

17 C. Curtis, “The Legal Security of Economic Development Agreements”, (1988) 29 Harv. Int’l L. J. 317, 346; M. Coale, (2002), supra note 14, 223; For example, the Concession Agreement between Iran and the Anglo Iranian Oil Company contained a stabilisation clause which reads as follows: “Concession shall not be annulled by the Government and the terms therein contained shall not be altered either by general or special legislation in the future, or by administrative measures or any other acts whatever of the executive authorities”. Cited in E. Paasivirta, supra note 4, 324.
in this type: “the mutual consent of the Ruler and the Companies shall be required to annul, or modify, the provisions of this Agreement”. 18

Another example is found in Article 18.2 of the Production Sharing Contract (1992) between the government of Yemen and a foreign investor states that “Contractor shall be solely governed by the provisions of this Agreement and the contract may be altered or amended only by the mutual agreement of the Parties”. 19

Such a clause is intended to require mutual consent of the contracting parties for alteration of contractual terms. Indeed, the first type of stabilisation clause is used to protect the foreign investor against the host state’s legislative intervention by freezing the law applicable to the agreement, but the second group of such clauses are intended to hinder unilateral change of the agreement by host state’s power of public authority. 20

The third category is called “hybrid clause” which contains both freezing and intangibility clause elements. This is an effective clause because it precludes unilateral change and destabilisation of the contract. The LIAMCO Concession Agreement contains this type of stabilisation clause:

“(1) The Government of Libya, the Commission and the appropriate provincial authorities will take all steps necessary to ensure that the Company enjoys all the rights conferred by this Concession. The contractual rights expressly created by this Concession shall not be altered except by mutual consent of the parties.

(2) This Concession shall throughout the period of its validity be construed in accordance with the Petroleum Law and Regulations in force on the date of execution of the Agreement of Amendment by which this was incorporated into this Concession Agreement. Any Amendment to or repeal of such Regulations shall not affect the contractual rights of the Company without its consent”. 21

The fourth type of such clauses provide contractual performance consistent with “good faith”. 22 This is grounded in contract theories that contracting parties should perform the contract in good faith. As discussed earlier, the requirement of good will in such clause provides that the agreement

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18 Cited in E. Paasivirta, supra note 4, 323.
19 Mayfair Production Sharing Agreement between the Ministry of Oil and Natural Resources and Yemen Mayfair Petroleum Corporation, (Al Zaydiah, Block 22, Tihama Area), 29 July 1992; P. Cameron, (2010), supra note 1, 68-80.
21 LIAMCO v. Libya, 62 ILR 170.
should not unilaterally be changed or abrogated by the host government. International law has supported this requirement in the fulfilment of obligations. These four groups of stabilisation clauses may be referred to as traditional types of stabilisation clauses. Their function is “to freeze the law of the contracting state upon the date of signature and for the duration of the contract” to neutralise the legislative and regulatory power of the host government.

5.1.1.2. Modern Stabilisation Clauses

However, the modern stabilisation clauses are intended to provide contractual stability without challenging the sovereign power of the host government. The first category is called ‘allocation of burden’ clause and provides that in the event of any changes in the legal framework of the investment contract, the clause shifts the burden of change in the fiscal regime to the state company contracting with the foreign oil company. It will transfer the additional burden on the foreign oil company to the government if there are changes to the laws. For instance, the Production Sharing Agreement of Kurdistan Regional Government (KRG) contains:

“The GOVERNMENT shall indemnify each CONTRACTOR entity upon demand against any liability to pay any taxes, duties, levies, charges, impositions or withholdings assessed or imposed upon such entity which relate to any of the exemptions granted by the GOVERNMENT under this Article 31.1”.

Another example is found in Article 36 of an Algerian Contract, which stated that “In the event of changes in the Algerian laws made after this Contract is signed, which result in a substantial reduction of the rights or increase in the obligations of one or the other Party, Sonatrach (the NOC) and Partner (the investor) will negotiate amendments to re-establish the same rights as those agreed on the date the Contract was signed”.

The second type is ‘Rebalancing’ clauses, which aim at maintaining the economic balance by virtue of a renegotiation mechanism. They provide that “if the host state adopts a measure subsequent to the conclusion of the contract (a triggering event) that is likely to have damaging consequences to the economic benefits of the original bargain for one or both of the parties, a rebalancing has to take place”. Indeed, if the economics of the project were adversely affected by the host state then the contractual terms would be re-adjusted to maintain the foreign investor in

25 Cited in P. Cameron, (2010), supra note 1, 80.
26 ibid, 80.
28 Cited in P. Cameron, (2010), supra note 1, 74-75.
the same financial position. For example, the Model Production Sharing Agreement of KRG contains:

“43.2. The obligations of the CONTRACTOR resulting from this Contract shall not be aggravated by the GOVERNMENT and the general and overall equilibrium between the Parties under this Contract shall not be affected in a substantial and lasting manner.

43.3. The GOVERNMENT guarantees to the CONTRACTOR, for the entire duration of this Contract, that it will maintain the stability of the fiscal and economic conditions of this Contract, as they result from this Contract and as they result from the laws and regulations in force on the date of signature of this Contract. The CONTRACTOR has entered into this Contract on the basis of the legal, fiscal and economic framework prevailing at the Effective Date. If, at any time after the Effective Date, there is any change in the legal, fiscal and/or economic framework under the Kurdistan Region Law or other Law applicable in the Kurdistan Region which detrimentally affects the CONTRACTOR, the terms and conditions of the Contract shall be altered so as to restore the CONTRACTOR to the same overall economic position as that which CONTRACTOR would have been in, had no such change in the legal, fiscal and/or economic framework occurred.

43.4. If the CONTRACTOR believes that its economic position has been detrimentally affected as provided in article 43.3, upon the CONTRACTOR’s written request, the Parties shall meet to agree on any necessary measures or making any appropriate amendments to the terms of this Contract with a view to re-establishing the economic equilibrium between the Parties and restoring the CONTRACTOR to the position it was in prior to the occurrence of the change having such a detrimental effect. Should the Parties be unable to agree on the merit of amending this Contract and/or any amendments to be made to this Contract within ninety (90) days of CONTRACTOR’s request (or such other period as may be agreed by the Parties), the CONTRACTOR may refer the matter in dispute to arbitration as provided in article 42.1.

43.5. Without prejudice to the generality of the foregoing, the CONTRACTOR shall be entitled to request the benefit of any future changes to the petroleum legislation or any other legislation complementing, amending or replacing it.”

Such clauses are presumed to protect the original contractual balance by a renegotiation mechanism. This will be analysed in the following chapter. The term stabilisation clause for the purpose of this study includes all types of stabilisation clauses, namely, traditional and modern.

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30 Cited in P. Cameron, (2010), supra note 1, 75-76.
types of stabilisation clauses. The re-balancing clauses that are presumed to restore economic balance between the parties are kind of renegotiation clauses and will be examined in the following chapters.

Furthermore, stabilisation clauses may be drafted in various ways. Such clauses may provide that applicable law to the agreement is the law of the host government at the time of concluding the contract and therefore future changes in laws and regulations are not applicable to it. For example, Article 17 of AMINOIL Concession Agreement 1948 provides that “The Sheikh shall not by general or special legislation or by administrative measures or by any other acts whatever annul this Agreement except as provided in Article 11. No alteration shall be made in the terms of this Agreement by either the Sheikh or the Company except in the event of Shaikh and the Company jointly agreeing that it is desirable in the interest of both parties to make certain alterations, deletions or additions to this Agreement”.

This clause prohibits future enactment that may modify contractual terms of the agreement, which have been made by mutual agreement. Stabilisation clauses may generally address externalities, which can affect the contract. They may also specifically deal with stability of labour legislation, fiscal regime in the host state and customs regimes. Modern stabilisation clauses provide that if governmental action adversely affects the economics of the project, then the contract would be re-adjusted to maintain the company in the same financial position. Whilst traditional stabilisation clauses aimed at freezing governing law and the fiscal regime of the contract, modern stabilisation clauses attempt to deal with the accommodation of change and compensation payments where governmental action is detrimental to an international oil company. In addition to stabilisation clauses international investment contracts usually contain renegotiation clauses with the aim to renegotiate certain terms, such as those affected by governmental actions.

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commodity prices or unpredictable developments. The main objective of stabilisation and renegotiation clauses is to re-establish the economic equilibrium of the contract.38

5.1.2. The Necessity of Contractual Stability in International Petroleum Transactions

International petroleum agreements are exposed to a variety of risks. They are long-term and involve large-scale capital. The energy industry, from upstream to downstream, is about risk. Thus, it is necessary to address the significance of the stabilisation clause before discussing the effect of such clauses. It is because the risk is crucial to the stability of international petroleum transactions and the role of these clauses is to maintain the stability and security of petroleum contracts.

Petroleum projects generate profit after a long period of the initial investment, which is always multi million dollars, without returns.39 The long duration of petroleum projects and the significant amounts of capital increase the economic, political and legal risks.40 Furthermore, when the investment is sunk and the risk of exploration assumed by the international oil company, the bargaining power may begin to change. At the beginning, the host state environment is investment friendly to encourage the foreign oil company to complete capital in the field of natural resources. However, thereafter the bargaining power may shift from the investor to the government. Hence, it is quite clear that the need for stability in petroleum contracts is very important.

The host state may interfere with the contractual arrangement to increase benefits from the business venture.41 Unfavourable changes may occur to an international oil company by virtue of increases in tax, amendments of regulations and the relevant laws.42 This picture can explain the importance of stability for international petroleum projects. Therefore, international oil companies use the contractual techniques, particularly, stabilisation clauses to control the future in an attempt to minimise potential risks.

However, a stabilisation clause cannot minimise all types of risks. It is mainly aimed to mitigate the risk of the host state’s interference (political risk).43 Such clauses will not minimise

41 K. Berger, (2003), supra note 40, 1349.
42 ibid, 1349.
commercial risks (price volatility), financial risks (interest rate volatility), geological risks (no economically viable deposit identified), technical risks (failure of the installations to function as envisaged), managerial risks, or natural risks (natural disasters). A stabilisation clause is an attempt “to reach a compromise between the sovereign prerogatives of the state involved and the legitimate quest of the private party for stability of status consistent with sound business judgement”.

Having discussed the nature of risks, including, change of bargaining power due to host state’s interference, and the need for stabilisation clauses. It is now useful to discuss the effects of such clauses.

5.2. Legal Validity and Efficacy of Stabilisation Clauses

Host states may interfere with contracts to terminate or unilaterally change the contractual arrangements. This interference is contrary to stabilisation provisions and may give rise to disequilibrium. In this context, therefore, liability of the government for affecting contractual rights of the foreign investor and the validity and effect of stabilisation clauses will be discussed.

The stabilisation clause addresses a conflict between “the legislative sovereignty and public interest of the state party and the long-term viability of the contractual relationship”. The legal argument in both arbitral practice and scholarly opinion under international law and the governing law will be addressed.

5.2.1. The Effect of Stabilisation Clauses under National Law

Contracting parties to an international petroleum transaction may choose the national law of the host state or international law, alternatively they may choose a blend of domestic law and general rules of law as applicable law to the contract. An examination of major legal systems of the world shows that the host state has powers to alter or terminate the contract with the foreign investor subject to the payment of compensation. Therefore, the exercise of legislative power of

47 I. Brownlie, (2003), supra note 6, 526.
the host state to abrogate the licenses or contracts applies equally to contracts with or without stabilisation provisions.\(^5\) French law has a special consideration on petroleum agreements due to the public interest, and discussed such contracts under administrative law.\(^5\) The French model has been adopted by major oil producing countries in the Middle East and Africa.\(^5\) Additionally, every host state has non-negotiable powers of regulation, and the governmental duties could not be contracted away.\(^5\) Therefore, under this model of law, if a stabilisation clause is intended or is interpreted in such a way as to limit the legislative or administrative powers of the host government it would be void.\(^5\) It is pointed out that “a contract per se cannot fetter the hands of government or the legislature, then such an effect cannot be achieved by including a stabilisation clause in the agreement”.\(^5\)

A stabilisation clause for being valid and effective must “be contained in an agreement to which the state is directly or indirectly a party”.\(^5\)

Therefore, if the private parties agree between themselves that the host government should not unilaterally change the applicable law to the agreement it is not meaningful.\(^5\) Such clauses are usually valid where the agreement is signed by the state, state entity or a component authority.\(^5\) It is also argued that contract drafting techniques cannot modify and expand the powers existing under constitutional and the other laws for the government and legislature to make commitments not to exercise their sovereign and legislative rights. Clauses renegotiated under the shadow of ultra vires and constitutional invalidity cannot generate valid rights simply by appearance or legitimate reliance on the state agency’s contracting power.\(^5\) Where the contractual guarantee is granted without proper authority it would be ultra vires.\(^5\) Hence, where a contractual guarantee by stabilisation clauses is given without proper authority international law will not uphold it.\(^5\) It is asserted that “the legality of the stabilisation clauses can only be established on the basis of a public law rule which authorises the contracting governmental party to include such clauses in the development and to be bound thereby”.\(^5\) The law applicable to the contract which might be

\(^{50}\) T. Waelde, and G. Ndi, (1996), supra note 1, 89.
\(^{51}\) S. Asante, supra note 49, 50.
\(^{54}\) P. Bernardini, (1998), supra note 37, 415.
\(^{57}\) Ibid.
\(^{58}\) W. Peter, (1995) supra note 20, 221.
\(^{59}\) T. Waelde and G. Ndi, (1996), supra note 1, 238-239.
national or international law is a major factor in the determination of the validity and effect of stabilisation clauses. This determination is one of the most complex issues in international investment law. However, on the occasions that the national law of the host state authorises insertion of stabilisation clauses and where such clauses do not limit the sovereign power of the government but indemnify the injured foreign investor, stabilisation clauses will be valid. In this context, the question is what is the point of inclusion of a stabilisation clause to an investment agreement where it is governed by the national law of a host state? In the event of host state’s interference with or termination of an investment contract this will weaken the position of the host state to attract future investment and this dishonour is part of the price that the host government pays for its action. In addition, inclusion of stabilisation clauses in the agreement will enhance the formal and political level required for intervention. Such clauses establish a significant threshold of protection for the international oil company.

Several national laws have not recognised the validity of such clauses. For example, under English law contracts may not preclude the state from carrying out essential functions to its existence. The principle states “it is not competent for the government to fetter its future executive action, which must necessarily be determined by the needs of the community when the question arises. It cannot by contract hamper its freedom of action in matters which concern the welfare of the State”. Where the domestic law of the host state is applicable law, “constitutional and legal constraints on the contractual capacity of that state may have significant legal implications for the validity and enforcement of the stabilisation clause”. The approach that has been taken by English law is also adopted by the other common law system countries.

Another example is American law, which treats permanent sovereignty as an inalienable right that cannot be waived. It is stated that “no argument can be advanced by a foreign investor that he had a legitimate expectation in the validity of such clauses negotiated in the face of a questionable legal validity to the extent that he can easily (applying due legal diligence) ascertain their invalidity under national law. Clauses negotiated under the shadow of ultra vires and

64 T. Waelde and G. Ndi, (1996), supra note 1, 239.
67 Raderakiebolaget Ampitrite v. R (1921) 3 K.B. 500, 503-504.
constitutional invalidity cannot guarantee valid rights simply by appearance or legitimate reliance on the state agency’s contracting powers”.72

Additionally, if a stabilisation clause is valid under the existing national law, it could be invalidated by the future legislation of the host state.73 Professor Waelde, stated that “nothing would prevent the national legislature from retroactively cancelling and revoking rights awarded, possibly subject to constitutional and other legal consequences (e.g. the duty to pay compensation under national law).”74 One could ask, what is the effect of a stabilisation clause under national law that is subsequently invalidated? The stabilisation clause cannot succeed in materialising the intent of the parties, under the national law to stabilise the contract.75

Hence, to guarantee the stability of the contract where such clauses are invalidated by future changes it is suggested that “to achieve the purpose of the stabilisation clause while respecting the parties’ choice of governing law, the clause should be viewed as an independent obligation governed by international law, regardless of the governing law of the contract as a whole”.76 This approach has already been adopted by arbitral tribunals as to the arbitration clause. In the AGIP case, the tribunal held that stabilisation clauses are governed by international law even when the other parts of the contract are governed by the contracting state’s law.77 This has been examined in detail in chapter five. Nevertheless, this argument is weak, because stabilisation and arbitration clauses have completely different functions. Whilst the function of a stabilisation clause is to freeze the applicable law of the contract at the time of conclusion to preclude unilateral change of the legal framework of the contract, the arbitration clause is a procedural rule for disputes. Therefore, this view is not accepted.78

The above argument can easily show why foreign investors are reluctant to choose the national law of the host state as applicable law. Over the last decades, contracting parties have chosen international law or a blend of international and national laws of host states as governing law.79 International investment contracts and, in particular, international petroleum agreements are usually governed by international law which is more favourable for international companies.

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73 Ibid
75 Ibid
76 C. Curtis, supra note 17, 347-48.
78 M. Bartels, Contractual Adaptation and Conflict Resolution: Based on Venture Contracts for Mining Projects in Developing Countries, (Kluwer Law and Taxation Publishers, 1985) 24.
5.2.2. The Effect of Stabilisation Clauses under International Law

Recent contractual practice indicates a trend to put the contract under the scope of international law by selecting international law as applicable law. This has been referred to as internationalisation or denationalisation of the contract. Such practice provides an extra legal protection in case a dispute arises between a host state and an international oil company. International law should be clearly chosen as applicable law to govern the contractual relationship. The examination of stabilisation clauses under international law mainly concentrates upon two concepts: the sovereignty of the host state and the principle of pacta sunt servanda (sanctity of contracts). I will look at these issues in the forthcoming section.

5.2.2.1. Scholarly Opinion

Firstly, the principle of sanctity of contracts will be discussed. There are various views as to the legal validity and efficacy of stabilisation clauses under international law. It is asserted that when a contract is internationalised by choosing international law as applicable law, this application of international law will apply some international principles such as pacta sunt servanda to the agreement. Thus, violation of contractual obligations by the host state will bring about international responsibility.

International oil companies when they conclude an international petroleum contract tend to internationalise the contract by the insertion of stabilisation clauses. Hence, the definition of internationalisation is relevant. However, the term of internationalisation is not defined clearly. The tribunal in Texaco case tried to define this term and held that:

“a contract between a State and an alien private person could be internationalised in the sense of being subjected to the only other legal order known to us, namely public international law. This does not mean or was ever intended to mean that the State contract should be considered to be a treaty or should be governed by public international law in the same way as transactions between States. It simply means that by exercising their right to choose the applicable legal system the parties may make public international law the object of their choice”.

are accepted and generally recognised in international practice". Therefore, it denotes that the host state seeks to retain its regulatory right on health and safety as to matters of non-fiscal regime. International law “accepts and upholds the validity of stabilisation clauses as well as the right of a sovereign nation to bind itself through the use of a stabilisation clause”.\(^{120}\)

As to stabilisation clauses there is an important question whether such clauses can effectively restrain the host state from unilateral change of the contractual arrangements. Indeed, the extent to which such clauses may guarantee the immutability of international petroleum contracts is the question. A group of commentators argue that stabilisation clauses may not effectively prevent future changes in the host state jurisdiction.\(^{121}\) They claim that stabilisation clauses may not restrain the legislative power of the host state. Nevertheless, the modern type of such clauses do not challenge sovereignty of the host state “modern stabilisation practice tends to move from per se state commitments to agreements of a much more commercial nature between foreign investors and national companies that are state-owned, partly state-owned or completely privately owned”\(^{122}\).

Another view, which is the opposite way, argues that stabilisation clauses should have a secondary protection function.\(^{123}\) In other words, such clauses provide an additional protection mechanism. The stabilisation clause is considered as “a strict yardstick for contract performance with its corresponding counterpart of legal consequences for breach of contract”.\(^{124}\) This will guarantee the performance and continuation of the contract rather than termination by the host state. Similarly, the tribunal in Parkerings case held that “by deciding to invest notwithstanding this possible instability, the Claimant took the business risk to be faced with changes of laws possibly or even likely to be detrimental to its investments. The Claimant could (and with hindsight should) have sought to protect its legitimate expectation by introducing into the investment agreement a stabilisation clause or some other provisions protecting it against unexpected and unwelcome changes”.\(^{125}\) According to the above discussion, it is fair to say that the stabilisation clause creates a legitimate expectation that the applicable law of the contract will not be altered.


\(^{121}\) T. Waelde, G. Ndi, (1996), supra note 1, 238.


\(^{125}\) Parkerings- Compagniet AS v Republic of Lithuania, ICSID Case No. ARB/05/8, para 336. Award of 11 September 2007.
concession agreement. Any amendment to or repeal of such Regulations shall not affect the contractual rights of the Company without its consent”. 158

The sole arbitrator argued that “the right of a state to nationalise is unquestionable today. It results from international customary law, established as the result of general practices considered by the international community as being the law”. 159 He then raised this issue whether the act of sovereignty that forms nationalisation authorises a state to disregard international commitments assumed by it within the framework of its sovereignty. 160 The arbitrator distinguished between foreigners and nationals of the host state in the event of nationalisation. 161 In the arbitrator’s view, nationalisation of national’s property is totally governed by domestic law of the host state. The arbitrator observed that “under these two assumptions, [concluding an internationalised agreement either by stabilising contract or choosing international law as applicable law] the state has placed itself within the international legal order to guarantee vis-à-vis the foreign contracting party a certain legal and economic status over a certain period of time”. 162 The tribunal examined the case to see whether the Libyan government had undertaken international obligations not to nationalise and interfere with the contract that prevented it from nationalisation. 163 The arbitrator found there was no difference between internationalised agreement and treaties. 164 He held that “the result is that a state cannot invoke its sovereignty to disregard commitment freely undertaken through the exercise of this same sovereignty”. 165 The sole arbitrator observed that the effect of the stabilisation clause in Article 16 was to stabilise the contractual position of the parties. Such a clause had not breached the sovereign rights of the host state and the Libyan government agreed to undertake such a commitment governed by international law. 166 It was noted that “the recognition by international law of the right to nationalise is not sufficient ground to empower a State to disregard its commitments, because the same law also recognises the power of a State to commit itself internationally, especially by accepting the inclusion of stabilisation clauses in a contract entered into with a private party”. 167 The arbitrator recognised stabilisation clauses as valid provisions with full effect.

The principle of pacta sunt servanda in the arbitrator’s view had a strict interpretation for the contractual relationship. The arbitrator concluded that: “Thus, in respect of the international law

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159 (1978) 17 ILM 3, 21, para 59.
162 Ibid.
163 (1978) 17 ILM 3, 22-23, para 64-68.
165 (1978) 17 ILM 3, 22-23, para 68.
166 (1978) 17 ILM 3, 24, para 71.
of contracts, nationalisation cannot prevail over an internationalised contract, containing stabilisation clauses, entered into between a State and a foreign private company. The situation could be different only if one were to conclude that the exercise by a State of its right to nationalise places that State on a level outside of and superior to the contract and also to the international legal order itself, and constitute an ‘act of government’ (acte de gouvernement) which is beyond the scope of any judicial redress or any criticism”.168

This strict approach in application of the principle of pacta sunt servanda for long-term contractual relationships such as petroleum agreements that usually have a 30-40 years duration might not be suitable. It is very difficult to imagine petroleum agreements that are fixed for such a long-term duration. The oil and gas industry is volatile and economic equilibrium of the contractual relationship by strict application of the pacta sunt servanda should not be ignored. In addition, the contractual stability can be achieved by other contractual devices such as renegotiation clauses with the stabilisation clause, rather than relying solely on pacta sunt servanda and ignoring equilibrium.

The arbitral tribunal in Amoco International Finance Corp. v. Government of the Islamic Republic of Iran, (AMOCO),169 also addressed stabilisation clauses. The dispute arose out of the Khemco Agreement entered into between Amoco and National Petrochemical Company (NPC) to form a joint venture company for the purpose of building and operating a plant for the production and marketing of sulphur, natural gas liquids and liquefied petroleum gas derived from natural gas. The events of the revolution hampered the operation of oil processing facilities including those of Khemco. On 24 December 1980 the Khemco agreement was declared null and void by the Special Commission according to the Single Article Act. Amoco claimed that termination of the Khemco agreement violated the stabilisation clause in the agreement. The first Article was 21 (2) of the contract that required “measures of any nature to annul or amend or modify the provisions of this agreement shall only be made possible by the mutual consent of NPC and AMOCO”.170 The contract also contained other provisions in Article 30 (2) which required that “The provisions of any current laws and regulations which may be wholly or partly inconsistent with the provisions of this agreement shall, to the extent of any such inconsistency, be of no effect in respect of the provisions of this agreement”.171

The Tribunal rejected the allegation made by Amoco and held that:

168 (1978) 17 ILM 3, 25, para 73.
169 15 Iran-US CTR 189, 222, para 113.
170 15 Iran-US CTR 189, 240, para 168.
171 15 Iran-US CTR 189, 236, para 155.
“Article 30, paragraph 2 had the effect of affirming the validity of contractual clauses inconsistent with Iranian laws and regulations. This cannot be considered as a stabilisation clause in the usual meaning of the term, however, since that term normally refers to contract language which freezes the provisions of a national system of law chosen as the law of the contract as of the date of the contract, in order to prevent the application to the contract of any future alterations of this system. Article 30, paragraph 2 applied only to provisions of any current laws and regulations existing at the time of execution of the Khemco agreement. Therefore it provided no guarantee for the future and is not a stabilisation clause”.172

The Tribunal recognised that the host state could bind itself contractually not to exercise its right to nationalise.173 Stabilisation clauses have been accepted by the Tribunal but the wording of such clause in the present case was not supported. The Tribunal added that the right to nationalise was a fundamental attribute of state sovereignty and was commonly used as an important tool of economic policy by many countries both developed and developing, and therefore could not easily be considered as surrendered.174 The Tribunal then quoted the AMINOIL case in that limitations on a state’s right to nationalise are “particularly serious undertaking which would have to be expressly stipulated for and be within the regulations governing the conclusion of state contracts; and it is to be expected that it should cover only relatively limited period”175. In addition, the Tribunal observed that although the Khemco agreement was concluded for a shorter period (35 years) than concession in AMINOIL case (60 years), however, “in economic and legal terms 35 years cannot be considered a relatively limited period”.176

Moreover, the Tribunal found that Article 21 (2) contains “a more precise meaning in so far as it prohibited changes in the provisions of the Khemco agreement by unilateral measures”.177 The Tribunal arrived at the following conclusion:

“It does not find that the Khemco agreement contains any ‘stabilisation’ clauses binding on the government. The clauses referred to by the claimant bind only the parties to the Khemco agreement namely NPC and Amoco. According to its own terms, Article 30, paragraph 2 cannot be construed as a stabilisation clause and Article 21, paragraph 2 only prohibits unilateral measures by NPC or Amoco to ‘annul, amend or modify’ the provisions of the Khemco agreement”.178

172 15 Iran-US CTR 189, 239, para 166.
173 15 Iran-US CTR 189, 243, para 179.
174 15 Iran-US CTR 189, 243, para 179.
175 15 Iran-US CTR 189, 243, para 179.
176 15 Iran-US CTR 189, 243, para 179.
177 15 Iran-US CTR 189, 240, para 170.
178 15 Iran-US CTR 189, 241, para 173.
Furthermore, the Tribunal awarded that expropriation of Iran “cannot be characterised as unlawful as a breach of a contract, since Iran, the expropriating state, was not a party to the Khemco agreement and therefore, not bound by any stabilisation clause allegedly contained therein”.\(^{179}\)

The Tribunal found that Article 21 (2) did not expressly prohibit nationalisation of the contract.

The above said analysis denotes that it is recognised that a state may bind itself contractually not to nationalise property and such clauses requiring that are only binding to the parties to the contract and not their affiliates. In addition, since limitation of sovereign rights contain serious undertaking the clause has to be clear and expressly forbidding nationalisation. Therefore, I have established that according to the case studies, there is no consensus on the legal efficacy of stabilisation clauses. However, the insertion of the stabilisation clause has had an effect on most of the discussed cases.

It should be noted that the effect of stabilisation clauses depends upon the relevant facts of each case, as well as the wording of the clauses. Even if it is difficult to achieve direct purpose of the stabilisation clauses in preventing the application of governmental changes to the petroleum contract, it would benefit the international oil company. The effect of such clauses may not be denied. Where a contract includes a stabilisation clause, this increases the amount of compensation due to unlawful breach of agreement. Therefore, even if such clauses cannot preclude nationalisation; “it may be quite significant in establishing the illegality of the action under both the contract and international law. If an expropriation is held to be unlawful under international law, perhaps because of the existence of a stabilisation clause, enhanced damages such as lost profits may be recoverable”.\(^{180}\)

5.3. Reflections on Stabilisation Clauses: Adequacy of Stabilisation Clauses

I have discussed various types of the stabilisation clauses and their efficacy under national and international law. As established above, traditional stabilisation clauses aim to neutralise the host government’s power by freezing the law of the host state on the date of contracting. It has been discussed that there is a conflict between traditional stabilisation clauses and the principle of permanent sovereignty. Additionally, according to some UN Resolutions the power of a sovereign state cannot be limited by contractual clauses.\(^{181}\)

Thus, the said conflict creates doubts regarding the legal value of these clauses. Traditional clauses are still used but they are more and more rarely to be found in investment agreements.\(^ {182}\)

\(^{179}\) 15 Iran-US CTR 189, 243-244, para 179-180.
\(^{180}\) Amoco Case, 15 Iran-US CTR 249-251, 258-259.
\(^{181}\) See the text of Resolutions above; T. Waelde, and G. Ndi, (1996), supra note 1, 261.
As a result, contractual practice has moved towards renegotiation clauses. Modern stabilisation clauses and renegotiation clauses are increasingly used in contractual practice.\textsuperscript{183} These clauses do not intend to freeze the legal system. Rather, such clauses concentrate upon the effects of host government actions to commit the government to participating in a process in which the parties have specified that adjustment must be made to restore the contractual equilibrium.\textsuperscript{184} These clauses do not seek to prevent a change in the law by the host government. Rather, they seek to address the economic impact of such a change on the bargain originally struck and to establish a framework for its preservation.\textsuperscript{185} The aim of the stabilisation clause is to ensure that the contractual terms are frozen from the time of signature over the life of the contract. However, they are not a real guarantee and cannot always prevent governments from taking unilateral actions. They are a way of framing subsequent negotiations between the investor and the host government. The stabilisation clause is a recognition of change of incentives of the state. This is what has been explained in chapter two in detail. The need for inclusion of stabilisation clauses is in fact because foreign oil companies have realised that the bargaining power shifts towards the host state over the time in such a long-term contract. The surrounding circumstances change and the host state by its police power for the public interest and in pursuit of its economic purposes could affect the investor’s interests. Such changes are foreseeable and, hence, the international oil company tries to protect the initial contractual equilibrium from unilateral changes and future interference by the host government through the insertion of a stabilisation clause in the contract.

As discussed earlier, traditional stabilisation clauses are grounded in presentation. In other words, these clauses seek to presentiate and freeze the legal system and the law of the host state which is based on the classical theories of relationship. This static model reinforces the obsolescencing character of bargain and cannot dynamically deal with changes. Modern types of stabilisation clauses might have an element of relationality in dealing with contractual relationships. As a result, some academic commentators have categorised such clauses as a type of renegotiation clause. Nevertheless, this view might be problematic. Firstly, when we look at the clause there are still strong elements of presentation. For example, an allocation of burden clause does not require re-establishment of the equilibrium, nor does it contain a balancing element. It only involves a transfer of any additional burden onto the foreign oil company in the event of change of the law. This will require the state entity to take a remedial action. It may involve payment of any additional tax or royalty from the state company’s share of the oil on behalf of the foreign oil company. Alternatively, the stabilisation clause may be in the form of the clause in the KRG PSA-discussed in the section 5.1.1.2 - which requires the host state to indemnify the foreign investor.

\textsuperscript{184} P. Cameron, AIPN, (2006), supra note 1, 68-83.
\textsuperscript{185} P. Cameron, AIPN, (2006), supra note 1, 75.
In both cases, the contract equilibrium is not restored and contracting parties have formulated a static model to deal with a dynamic framework.

Secondly, even if the scholars are correct in that it solves the problem of stabilisation clauses by abolishing such a clause which is not really a solution. This shows the failure of the static model of relationship and the classical theory. The consequence is the scholars abandon the concept of stabilisation and move going entirely towards the renegotiation. This makes the point of this thesis, that stabilisation clauses cannot be a solution because they are grounded in a static understanding.

Further, as we will see in the next chapter, renegotiation clauses also suffer from limitations. They are not rooted in a presentiated understanding of the contract but they do not impose many obligations.

I have also established that the law of expropriation is based on a static understating of contract. Once the bargain becomes obsolete, the law does not do anything to prevent it because of presentation. The contract is not dynamic and adaptation will not take place. The question here is given that stabilisation clauses have certain effects in international law will this clause fix the problems raised by the obsolescing bargain? The stabilisation clause by emphasising freezing the law and contractual terms cannot prevent the government from expropriating the foreign investor’s property. The reason behind this is that the relational character is not recognised and like presentation which freezes legal contracts, stabilisation clauses take the static model which is the different point of the same spectrum. As a result, the contractual practice has moved towards renegotiation provisions providing for balancing and restoring the equilibrium. Renegotiation clauses will be discussed in detail in the forthcoming chapters.

5.4. Conclusion

The discussion in this chapter regarding stabilisation clauses denotes that they are one of the major risk management techniques that can reduce host state’s interference with contract and property. Moreover, the stabilisation clause is very useful when disputes arise because arbitral tribunals, in practice, uphold their effectiveness in spite of different scholarly opinions as to their validity.

In the researcher’s view, the argument over the validity of the stabilisation clause should not be used to discount the ability of such clauses to ensure a project. This clause is an essential part of

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international oil companies’ methods for the management of the risk of expropriation. In addition, the stabilisation clause has an important role in international petroleum agreements and minimisation of host states’ interference. Such clauses are an attempt to reduce distortion of the equilibrium by limiting the conditions of the host states’ interference. The significance of stabilisation clauses are evident by leading scholars, the practitioners in the petroleum industry and many arbitration decisions that have confirmed their significance in the past.

Where the contract is governed by international law, stabilisation clauses can limit the host state’s right to unilaterally terminate or nationalise property. For such clauses to be valid they have to be expressly stipulated and be for a relatively limited period of time. In this chapter, traditional and modern types of stabilisation clauses and their legal value were also examined. International law recognises that the host state has full control to regulate resources and stabilisation clauses in the classic view may be in conflict with the principle of permanent sovereignty. The classical type of these clauses stipulates that the government is contractually prohibited from enacting a new law that is not consistent with the original contract. If such a new law is passed by the government, then it will not be applicable to the contract. Scholars have different opinions as to the legal validity and effect of such clauses. However, international arbitral tribunals have tended to recognise such clauses as effective and valid clauses. Thus, a foreign investor should include a stabilisation clause in the contract where the host state is a contracting party.

In addition, most international investment agreements contain stabilisation clauses to ensure stability of investment regime and to preclude arbitrary and discriminatory decisions. However, such clauses cannot be employed to impede states from implementing international commitments. There is no doubt that stabilisation clauses create legitimate expectations that must be taken into account. If the host state breaches its obligation under a stabilisation clause it will result in responsibility and damages. The arbitral tribunals approach stabilisation clauses

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193 AMINOIL, (1982) 21 ILM, 976, 1037, para 159.
by taking into account all relevant circumstances, the conduct of the parties, and reasonable expectations. However, the important issue is how to reconcile the need of the foreign investor to ensure the stability and security and the primary responsibility of the host government to pursue the public interest for the welfare of society.

The insertion of stabilisation clauses does not prevent the inherent instability in the petroleum industry. What it does do is strengthen the bargaining position of the foreign investor. The long duration that is characteristic of international petroleum contracts makes it evident that unpredictable events may take place and alter the financial balance of the contract. This disequilibrium may result in disputes and deprive both parties of benefits from the contract. The stabilisation clause, which is grounded in a static model, cannot deal with the changing circumstances and a dynamic framework. Despite the fact that stabilisation clauses recognise the possibility of change, and thus have the potential of being relational, as applied they are either grounded in a static understanding (traditional clauses) or are in effect no different from renegotiation clauses (modern clauses). The presented model of relationship in which the stabilisation clauses are rooted and in a bigger scale the classical model, lead to obsolescing bargain and distortion of the equilibrium.

Therefore, the solution for ensuring the stability and viability of such long-run agreements is to see petroleum agreements evolving. As a result of such concerns over validity and efficacy of stabilisation clauses, the incorporation of a renegotiation clause into the agreement seems appropriate. The real guarantee for transactional stability is to apply the relational model of theories. This will allow the contract to be developed and evolve. The renegotiation clause, in theory, has the possibility of serving the objective of relationality and of dealing with the problem of obsolescence, as it recognises the dynamic character of the contract. The following chapter, accordingly, examines the law and practice of renegotiation of petroleum contracts.

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194 I. Brownlie, (2003), supra note 6, 526.
Chapter 6
The Pursuit of Equilibrium in International Petroleum Transactions: The Necessity of Contractual Flexibility

Introduction

We have seen that neither expropriation nor stabilisation clauses adequately deal with the problems that cause disruption of contractual equilibrium in international petroleum transactions. We are now going to move to look at renegotiation clauses. This chapter focuses on the extent to which renegotiation clauses deal with the issues that are the central concerns of this thesis – the vulnerability of the contractual equilibrium to disruption, as well as the obsolescing character of the resulting bargain. In addition to the difficulty of preserving the contractual equilibrium under a presentiated understanding of contracts, and the role of a relational understanding of contracting.

The present chapter discusses renegotiation clauses as they currently function. The key questions posed are: do they address the problems presented by the obsolescing character of the bargain? Do they adequately preserve the contractual equilibrium? The main point to renegotiation clauses is not renegotiation as an end in itself, but as a means to the preservation of the contractual...
equilibrium. The first issue, therefore, is the purpose of the renegotiation clause. Renegotiation clauses have been created to impose an obligation upon the parties to act in good faith when a triggering event occurs.

The second relevant issue which this chapter picks up on is the effect attached to renegotiation clauses by arbitration tribunals. This includes the following questions: What does the obligation to negotiate in good faith require, in practice? What are the actual limits it imposes on self-interested action? How far is a party expected to go in sacrificing its own interests? How much regard must it have to the interests of the other party? And what is the consequence if an obligation to negotiate in good faith is breached? Then, the third issue based on the study of the effect, is the adequacy of such clauses for dealing with the problem of obsolescing bargains, and adequately embedding the element of relationality that is required for the transaction to succeed.

This thesis has framed its scope to examine merely renegotiation clauses as the main and most common type of adaptation clauses that include legal and contractual regimes in international petroleum contracts. Sliding scale royalties or profit-based royalty clauses, and quantity review clauses are component of the fiscal regime. These clauses do not deal with the change of circumstances resulting from hardship, regulatory or the government’s intervention in the legal arrangement of the contract. As a result, this research only focuses upon the most important type of adaptation clauses, namely, renegotiation clauses, whereas other types of such clauses are beyond the scope of this research.

There are several different types of royalties and some types of royalties are easier to determine than others and require much less administrative burden to verify. The notion of royalty, its calculation and typology have not been discussed in the law because these concepts are financial and more relevant to accounting. Furthermore, this research does not intend to examine renegotiation or stabilisation clauses as a clause. Such clauses were examined as a mechanism for dispute management and maintaining contractual equilibrium.

There are two main types of fiscal regimes: the concessionary system and production sharing agreements (PSA). In a concessionary system, foreign companies have rights to the oil in the ground, selling the resource provided, and compensating the government by paying a specified royalty from the subsequent sales revenues. A foreign company is also required to pay corporation tax for taking the country’s resources. PSA is one of the most common types of agreements. Under

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PSA the government as the owner of the underground resources engages a contractor or investor, usually a foreign oil company, to provide technical and financial services in an exploration and development operation. The PSA specifies the share of output products for the signatories within an agreed period of time. The foreign companies are compensated for their investment in the oil production infrastructure and the risks associated with it. The government takes an agreed share of production, as well as some royalties. Both PSA and concessionary systems require an incorporation and understanding of the impact of each of its components, such as cost recovery, tax and royalty. Royalties are an important component in a fiscal regime.

Sliding scales are defined as a scale in which a value, royalty, varies in accordance with another factor, as production, meaning that within a certain range of the factors this value is the same and as the range of the factors change the value slides into a new rate.4 There are many types of sliding scales that relate production and royalty, production and profit oil split, production and rate of return. For example, a sliding scale that relates production and royalty will have higher royalty rates as production increases, so the government will benefit from increases in production and charge lower royalty rates as production decreases, and the contractor will have an incentive to produce even with lower production rates. This feature clearly overcomes the problems faced by both the government and contractors using a single royalty value. Thus, as production increases, the government would not benefit significantly from this increase by using a single royalty value.5 Windfall profit royalties and sliding scale royalties provide for a lower royalty amount when production is lower and increase as the production increases.6 A royalty is a payment to a royalty holder by an operator and is typically based on a percentage of the minerals or petroleum products. Royalty provisions are the feature of production sharing contracts.7

The price review clause provides for the adjustment of the price formula in case the price does not reflect the actual market conditions anymore and, consequently, makes the contract unbalanced. The renegotiation clause, instead, consents to adapt the contract whose balance is altered by supervening circumstances without limitation to the price conditions. Therefore, these provisions aim to rebalance the contract in order to allow the parties to maintain their relationship for the entire duration agreed and, as a consequence, to meet their expectations. Usually these clauses set out, as a triggering event, the change of market conditions, which alters the contract’s balance and this has to be: (1) substantial; (2) unforeseen; and (3) beyond the control of the parties. Moreover, in case of price review clauses, the triggering condition can be just the passing of time.

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6 Ibid.
7 Ibid, 689.
Indeed, they can provide for periodic reviews of the price formula in order to adjust it in light of the actual market conditions. Thus, while the above mentioned clauses may only address very specific issues, however, renegotiation clauses are able to provide contractual flexibility and avoid disequilibrium. In this chapter renegotiation clauses will be discussed.

As discussed in previous chapters, when the risk of exploration is overcome and the project enters into the production phase, the host government may acquire a hostage status as to the investment (sunk investment). The host government may impose new regulations that affect the financial returns of the investment. This highlights the significance of fiscal and regulatory stability for the investment climate. Therefore, foreign oil companies seek to prevent instability and unilateral change by incorporating contractual clauses which only enable any change by mutual consent. In this context, stabilisation clauses are used to create certainty by freezing legal arrangements and renegotiation clauses serve to maintain the contract dynamic and adapt the agreement with changed circumstances. Renegotiation of contractual arrangements is very common in international petroleum investment agreements. The petroleum industry has seen many important renegotiations of contracts. Host governments may enforce renegotiation by threatening the international investor that they seek to expropriate or nationalise the resources. They pursue increasing their takings by raising prices and maximising their control over natural resources as sovereign state. The political and economic context of the petroleum investment may change and disturb the contractual equilibrium.

The political environment may be changed as a result of election or revolution. Thus, investment conditions due to the price fluctuation can be affected, where the parties are unable to adapt the contract with changes and revise the contractual obligations this will result in a legal dispute. Hence, a legal framework that provides commercial certainty and flexibility to protect and restore the position of the dissatisfied party is necessary. A renegotiation clause may provide this context. It is said that “renegotiation may become even more pronounced as companies try to find ways to negotiate contracts that provide stability, on the one hand, yet give the parties the flexibility to face the unknown, on the other”. Renegotiation clauses flexibilise the contract and maintain the financial equilibrium of the contract. This clause recognises the mutability of the contract to adapt to changes in circumstances and therefore, to reduce the risk of unilateral intervention of states

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8 For the detailed discussion of Stabilisation Clauses, see the previous chapter.
and resulting investment disputes. The renegotiation of the agreement may be initiated either where the contract contains special clauses for adjustment of the transaction or where the other contractual terms or governing law provide a triggering point for renegotiation and adaptation of the agreement.

The current chapter intends to discuss the law and practice of renegotiation of international petroleum contracts and the nature and role of renegotiation clauses in the minimisation of investment disputes. It will address the reasons for seeking to accommodate a transaction by host governments and foreign investors and examines the situations in which there is a specific provision as to renegotiation in the agreement. In addition, the response of international petroleum arbitral practice to the concept of renegotiation will be critically assessed.

6.1. Renegotiation and the Preservation of the Relational Equilibrium

The terminology that is used to define renegotiation is not particularly clear. A variety of terms such as adjustment, revision, restructuring, review, modification or adaptation are interchangeably used. A leading scholar defines renegotiation as a “common effort by the parties to adapt a contract to a new situation through a material change of its terms”. In distinction between the terms he added “renegotiation points more clearly to the procedure – the common effort of the parties- than to the result, the adaptation or restructuring of the contract”. This study will employ renegotiation for the discussion. Renegotiation is generally defined in two major groups. The first category is on the party who initiates renegotiation and the second category involves situations within which renegotiation is commenced. Under the situation-based renegotiation, three types of renegotiation, including, post-deal, intra-deal, and extra-deal renegotiation are recognised. Post-deal renegotiation is at the end of the life of the business project. Parties at the expiration of the contract may decide to renew their relationship as it is referred to as “contract renewal”. In intra-deal renegotiation which takes place over the life of the agreement, renegotiation “occurs when the agreement itself provides that, during its life at specified times or on the happening of specified events, the parties may renegotiate or review certain provisions”. Extra-deal renegotiation takes place outside of the legal framework of the original contract and is common in the petroleum industry. In this respect, it is stated that “the most difficult, stressful, and emotional renegotiations are those undertaken in apparent violation of the contract or at least in the absence of a specific clause authorising a renegotiation. These

15 Ibid, 9.
17 Ibid, 1321.
renegotiations take place ‘extra deal’, for they occur outside the framework of the existing agreement”.18

This study concentrates on intra and extra-deal renegotiations. Where the parties initiate renegotiation, it includes government-led renegotiation and investor-led renegotiation. The initiation of renegotiation by the government may take place by several means such as unilateral change of agreement and the imposition of a high tax regime to increase the state benefits from the petroleum project. They may “happen to be opportunistic, with politicians during or after an election campaign reneging on previous contracts to please their constituencies”.19 However, renegotiations initiated by governments may be reasonable to maintain the economic equilibrium between the parties.

On the other side, investors may initiate renegotiation. Renegotiations “might be shock related, when a devaluation or a recession make the operation of a given concession unsustainable it might also be opportunistic, when a firm uses its bargaining power in bilateral negotiation with the government or the regulatory agency to strike a better deal than the initially agreed one”.20 Contracting parties conclude the contract according to certain assumptions as to the business project such as labour costs, taxes, and royalties and so on. They also have expectations about the contract to benefit from the project and to maximise their own interests.21 Further to the primary negotiation for making the original agreement, and over the life of the business venture circumstances may change and alter the assumption and expectations. Therefore, renegotiation may take place from just the conclusion of an agreement to termination of an investment project. The bargaining power of the parties may vary over the life of the investment project. Renegotiation and bargaining power are linked. At the early stage of the investment life cycle, the international investor has greater bargaining strength due to technology, expertise, technical knowledge and capital in hand. However, having made the investment, the bargaining strength gradually shifts from the foreign investor to the host government. Once the investment is sunk and the foreign investor has incurred the cost of exploration and exploitation, he needs to recover the costs over time in the host government’s jurisdiction. It has been said that several factors may increase or decrease bargaining strength. Those factors are;

“The power to command resources, that is, the ability to supply what the other side needs or wants; the ability to offer opportunities, such as markets, jobs, or training; the availability of

18 Ibid, 1321.
20 Ibid, 484.
alternatives: alternative suppliers to the host society or alternative investment opportunities to the company; experience in negotiating: understanding of psychological factors and ability to operate under pressure; knowledge of one’s own and the other side’s strength and weakness; ability to accommodate to the other side’s needs and assuage their fears; use of external allies: appeals to suppliers, customers, the government of the MNC’s (Multi National Company) home country, different ministers or agencies of the host government, third parties or international bodies; use of external devices: appeal to ‘public opinion’ through news media, speeches, and public relations; ability to persuade or convince the other side of one’s good intentions and desirability as a partner; ability to demonstrate moral strength or rectitude; ability to act unilaterally: for the host government, to expropriate or to change laws and policies, for the company, to circumvent government regulations or run the business into the ground.”

Therefore, under these circumstances renegotiation of international investment contracts for repositioning of the parties is a common phenomenon. The major cause for renegotiation includes changes in legal, political or economic environments. Where the surrounding circumstances change, this brings about economic imbalance. Parties may initiate renegotiation to adapt the original contractual terms. That could also be for contractual or non-contractual causes. Non-contractual causes might be either for the events that have international origin such as the United Nations Resolutions which have a strong impact on foreign investors and provide a starting point for renegotiation or other causes such as changes in the investment climate, decolonisation or price change.

It is important to maintain the economic equilibrium between the parties otherwise it might bring about the termination of the contractual relationship. It is asserted that “the long-term nature of the contracts at issue makes them vulnerable to disruption from unforeseen events or events which the parties - for whatever reason - did not and perhaps could not deal with in the contract with sufficient time and in sufficient detail. The longer the term of an agreement and the more exposed to geological, commercial and political risks, the more it becomes vulnerable to external events. Such events can make the operation of the contract partially impracticable or, from a commercial

24 W. Stoever, supra note 22, 1.
25 M. Bartels, Contractual Adaptation and Conflict Resolution: Based on Venture Contracts for Mining Projects in Developing Countries, (Kluwer Law, 1985) 51.
26 Charter of Economic Rights and Duties of States (CERDS); Permanent Sovereignty over Natural Resources; and New International Economic Order are of those resolutions.
and financial perspective, no longer viable for one party. One consequence is for the parties to terminate the agreement or one party to withdraw.\textsuperscript{29} A change of economic conditions may make the performance of petroleum agreements onerous and disturb the financial equilibrium. Furthermore, host states may legislate or make new regulations that drastically change taxes, labour costs or environmental standards. It may create unpredictable conditions and result in instability and decreased financial return.\textsuperscript{30} It is seen that the application of new environmental regulations is one of the main risks relating to the petroleum industry.\textsuperscript{31} Indeed, it requires the international oil company to comply with the regulation and it will change the financial return for the investor.\textsuperscript{32} As a result, it may disrupt the economic equilibrium of the contract. In such occasions, renegotiation of the original contract may restore the contractual balance and reduce investment disputes.\textsuperscript{33}

The concept of renegotiation grants the flexibility and provides an opportunity to fill the gaps in the contract and make an incomplete contract complete.\textsuperscript{34} A renegotiation clause will reasonably act to maintain the contractual equilibrium.\textsuperscript{35} Such a clause “offers the parties a better consensual opportunity to maintain the benefits of the contractual relationships by adapting the contractual documents to their needs”.\textsuperscript{36} Therefore, it may retain contractual stability and restore economic balance.\textsuperscript{37}

In evaluating the necessity and effectiveness of renegotiation clauses, one question may be raised. One may ask whether the concept of renegotiation can reduce the risk of expropriation and obsolescing bargain. As discussed in chapters two and three, the academic literature upholds the view that the renegotiation of contractual terms may reduce the risk of the host government’s interference and can re-establish the financial equilibrium created by the original agreement. It is suggested that “they lessen the possibility of disputes, avoid confrontation and reduce the risk of unilateral action by the government”.\textsuperscript{38} Similarly, it has been said that the “terms of agreements become progressively out of date as economic conditions change and multinational corporations can no longer expect to freeze conditions at one point in time by iron-clad contract terms. If an

\begin{itemize}
\item \textsuperscript{29} A. Kolo and Waelde, (2000), supra note 1, 5.
\item \textsuperscript{31} Ibid, 230.
\item \textsuperscript{32} A. Boulos, “Mutuality of Interests between Companies and Governments- Myth or Fact in Energy Law”, 90 Changing Energy Markets- The Legal Consequences 3, 6 (1990) 25; T. Waelde and G. Ndi, supra note 30, 231.
\item \textsuperscript{33} Ibid, 231.
\item \textsuperscript{34} A. Kolo and T. Waelde, (2000), supra note 1, 22.
\item \textsuperscript{35} A. Kolo and T. Waelde, (2000), supra note 1, 22.
\item \textsuperscript{36} B. Nwete, “To What Extent Can Renegotiation Clauses Achieve Stability and Flexibility in Petroleum Development Contracts”, (2006) IELTR 56, 60.
\item \textsuperscript{37} J. Salacuse, (2001), supra note 10, 55.
\item \textsuperscript{38} A. El Chiati, (1987), supra note 13, 110.
\end{itemize}
investor tries to force adherence to terms that no longer reflect the hosts’ economic capability and contribution, the likelihood of an explosive confrontation and unilaterally imposed change increase”. Therefore, a renegotiation clause provides a dynamic framework “as a form of insurance against the abrupt termination of a long-term and hopefully profitable association” to maintain the contractual balance.

International investors are concerned about a change of the game’s rules which might be unilaterally in favour of the host state. It may disturb the economic equilibrium on the basis of financial expectation regarding the investment. Thus, economic, political and regulatory certainty and foreseeability would be necessary. In this respect, it is stated that “a long-term transnational agreement can only provide a basis for a viable and enduring relationship between a host government and transnational corporation if it is regarded as the broad framework of a business relationship which admits of a continuous process of accommodation and adjustment between the parties, rather than a body of fixed rights and obligations impervious to political, economic and social changes”. On the other hand, the host government needs flexibility more than stability. It has been pointed out that, “the host state which owns the minerals and enters into an agreement with the foreign investor to exploit and develop the natural resources at a time when it is not certain as to the extent, quality, and future prices of the commodity, will want the agreement to be flexible and amenable to change with changing circumstances in both the domestic and international political and economic situations. The host state is therefore more likely (but in rare cases, the foreign investor as well) to view the contract as a planning document- to be referred to and amended as the relationship progresses. The contract is therefore one, but by no means the exclusive guide for post-contractual bargaining”. The above discussion demonstrates the significance of contractual flexibility in long-term agreements for the avoidance of disruption of the equilibrium. However, in some instances host states are reluctant for adjustment. This is because they see a renegotiation clause as unduly restrictive of sovereign power. The host state could see the renegotiation clause as an inappropriate term and thus unilaterally change the agreement. In order

39 W. Stoever, supra note 22, 315-18.
44 Ibid, 404.
to fully understand the different perspectives and approaches taken by host governments and international oil companies it would be helpful to discuss the function and purpose of the contractual mechanism.

As discussed in the previous chapter, the stabilisation clause may “immunise the contract and its benefits, especially to the investor against subsequent legal and fiscal modifications after the contract has been executed”.\(^{47}\) A stabilisation clause could promote contractual stability and minimise disputes.\(^{48}\) On the other hand, the validity and legal effectiveness of its counterpart, renegotiation clause, is not in question and is widely endorsed.\(^{49}\) They are “a manifestation of the autonomy of will and as such are binding on the parties so long as they do not violate the public order as is the case, in some countries, of the monetary clauses excluding the effects of nominalism”.\(^{50}\) In other words, “unlike the traditional stabilisation clause, the renegotiation clause allows the host government to exercise its regulatory and sovereign powers by making laws or taking other steps that can affect the petroleum development contract while providing the investor with an opportunity to renegotiate the contract with a view to maintain the original financial promises and economies of the project. It thus keeps the host government’s sovereignty intact while ensuring that the financial premises upon which the investor’s contractual obligations revolve are maintained. By doing so the investor’s need for stability and predictability and the host government’s desire for a flexible and amenable contract are achieved without much rancour”.\(^{51}\) Therefore, where the financial equilibrium of the contract is disrupted a renegotiation clause may re-establish the contractual balance to continue the contractual performance.\(^{52}\)

It is well said that: “it would be idle and unproductive to pretend that the best way of resolving every issue arising out of contracts for resource development is by the rigid insistence on, application of, the original contractual terms. It would be no less idle to suggest that every issue arising out of such contracts should be resolved by changing the contractual provisions. The difficulty arises because one of the parties turns implacably hostile to the contractual terms”.\(^{53}\) Having established how the renegotiation in theory seeks to deal with the challenge of obsolescing

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\(^{47}\) B. Nwete, (2006), supra note 36, 58.
\(^{48}\) “Bilateral Investment Treaties (BITs) and Multilateral Investment Treaties (MITs) aim at facilitating foreign investment in developing and transition economies by inserting stabilisation techniques. Likewise, international investment agreements, such as those concerning the exploration or exploitation of natural resources, have included so-called ‘stabilisation’ or ‘freezing’ clauses”. G. Verhoosel, (1998), supra note 42, 453.
\(^{50}\) Ibid, 110.
\(^{51}\) B. Nwete, (2006), supra note 36, 60.
character of bargain, we move on to look at the actual practice of renegotiation clauses and how they work when the situations of renegotiations arise.

6.2. The Renegotiation of International Petroleum Contracts with a Renegotiation Clause

In this section I will discuss the purpose of renegotiation clauses, namely, what the parties seek to achieve through such clauses. The next section then explores the effect of renegotiation clauses, to consider the consequences of having renegotiation clauses. The point of incorporation of the clause into the contract is not merely facilitating renegotiation. Given the obsolescing character of bargain, it is rather an attempt to recognise the relational character of the contract as a way of overcoming disruption of the equilibrium. They expressly recognise the contractual equilibrium and seek to insert obligations of good faith and fairness into certain aspects of the parties’ dealings under the contract with the aim of preserving the equilibrium. In addition, the section discusses traditional and modern renegotiation clauses to reveal how they represent different ways of achieving it.

The long-term nature of the petroleum contracts at issue makes them vulnerable to disruption from unforeseen events or events which the parties - for whatever reason - did not and perhaps could not deal with in the contract with sufficient time and in sufficient detail. The longer the term an agreement and the more exposed to geological, commercial and political risks, the more it becomes vulnerable to external events. Such events can make the operation of the contract partially impracticable or, from a commercial and financial perspective, no longer viable for one party. One consequence of this is for the parties to terminate the agreement or for one party to withdraw. However, such complete destruction of the contract would then also destroy the contractual relationship which often would have continuing benefits for both parties. Parties can also suspend operations under the contract, which if the issues are not solved will, in many cases, equally result in the destruction of the contract.

Finally, both parties will often welcome being seen as reasonable partners with whom one can do business with, and salvaging a contractual relationship from the destructive impact of unforeseen and unregulated external events tends to contribute to the parties’ reputation as “good to do business with” in the international business community, in particular the natural resources industry. As a rule, such reputation becomes known quite rapidly in the rather narrow community of the international petroleum industry.54 According to Paulsson, “modifying the contract may be particularly vital to the success of long-term projects, with respect to which the evolution of the product market, rates of currency exchange, technological developments, politics, relative

competitive advantages, and the like, may make, it highly desirable to provide for a third party adjustment of the contract. Otherwise, the sole alternative to a negotiated solution would be the termination of the contract with a possible award of interest, and both parties may agree at the time of negotiating the contract that such an end to their association would be in the interest of neither”

Although long-term contracts, especially the international ones, tend to be exhaustive and complete in terms of disciplining future events that may occur during the contract’s life and affect the relevant equilibrium. Nevertheless, it is impossible for the parties to foresee all such circumstances. Additionally, it would not be rational to assume that the original conditions upon which this kind of agreement was concluded remain the same for its entire duration. Thus, it is necessary to characterise such contracts with a certain degree of flexibility in order to adapt their terms to changes and evolutions in the relevant market conditions. This is usually done by providing for ‘renegotiation clauses’ which aim to maintain the contract alive by restoring its balance upon the occurrence of unforeseen events altering it. In other words, the scope of such clauses is to provide the parties with a remedy different from termination of the original contract.

Long-term contracts and, in particular, petroleum contracts due to their characteristics can be considered as ‘relational contracts’, namely, contracts that aim to create and maintain over the time a stable and profitable relationship between the parties. For this reason, they need to be flexible in order to be adapted in light of the change of the market conditions that occur during their life. Therefore, parties are supposed to cooperate and adjust the contract when such events occur. Indeed, only in this way, is it possible to preserve a balanced relationship between the parties. In contrast, termination is not the solution that better suits their expectations.

It can generally be said that such provisions find their justification in the scope pursued by the parties when they entered into long-term contracts like those for petroleum agreements, and in the principle of good faith. Indeed, by means of such agreements, the parties aim to build up and maintain for several years (usually around 20-60) a relationship that satisfies the reciprocal interests and expectations. In particular, with regards to petroleum agreements, the scope is to provide, on the one hand, the investor a stable flux of money in order to recover from the huge investments made and, on the other, the host country with a stable flux of petroleum to promote the country’s economy. In consideration of such scope, upon the occurrence of supervening unforeseen events that affect the original market conditions and, consequently, the contractual equilibrium, the best solution for the parties is not the termination of the contract as

it is, but its adaptation to the new circumstances. Indeed, without the possibility to adapt the long-term contract, the will of the parties would be frustrated since they could not achieve the purpose pursued by entering into such agreements. Moreover, to deny such possibility would be contrary to the principle of good faith. As seen more in detail below, the rebalancing of the contract in order to meet the parties’ expectations is based upon the generally recognised principle that contracts have to be performed in good faith.\textsuperscript{57}

In addition, it would be contrary to such a principle to constrain the disadvantaged parties who are negatively affected by the change of circumstances, to keep on performing the original agreement or to terminate the latter. Indeed, such remedies would have negative economic effects and consequences for the parties. Moreover, in cases of termination by one of the parties, the other would be deprived of the possibility to count on a commercial relationship upon which it thought it could rely for several years and, consequently, upon which it based and planned its business activity by, amongst the other, spending a considerable amount of time and money.

Therefore, it becomes crucial to determine, in case the parties are not able to agree on the adaptation of the contract, which are the third party’s’ powers and, in particular, whether and to what extent can they modify and adjust the contractual terms in order to restore the equilibrium between the parties affected by the occurrence of unforeseen events that changed the original market conditions. In other words, it has to be understood if, in some exceptional circumstances, the third party can overcome the principle of \textit{pacta sunt servanda} in order to keep the contract in force and to avoid its termination. Indeed, as said above, the latter is not the best solution for long-term petroleum agreements in consideration of the specific scope pursued by the parties.

The aim adopted by arbitration tribunals, at the end is correct since it meets the parties’ expectations and will when entering into a long-term contract with the characteristics of a petroleum agreement, that is to maintain it alive for all the duration agreed and, consequently, to consent to its adaptation if it becomes unbalanced. In such a case, therefore, one could say that the nature, structure, scope and characteristics of a long-term petroleum agreement are better indications of the parties’ will than the choice of a procedure, as said, often made for reasons independent of the relevant provisions in terms of adjustment of contracts by arbitrators.

International investment contracts may contain a renegotiation clause to re-establish the economic equilibrium of the contract and to maintain commercial certainty and flexibility of the contractual arrangement. This clause may require renegotiation of certain terms affected by unpredictable events, government interference (change of regulations) and fundamental change of

\textsuperscript{57} Ibid.
circumstances. Such clauses are employed in international agreements more frequently in recent times. 58 For development of economic and public welfare host states began to attract foreign investment by offering competitive contractual terms and investment legislations. 59 Over the last decade the stabilisation clause is increasingly being used as “a tool in their highly motivated and competitive attempts to demonstrate a commitment to stability in their respective legislative and tax regimes”. 60 Having said the importance of adaptation of contract to the subsequent change, renegotiation clauses seem necessary. Indeed, because neither the classic force majeure nor hardship clauses offer adequate protection against an unfavourable change in the commercial balance, having a renegotiation clause in international investment agreements is essential. 61 Salacuse has argued that, “a renegotiation clause may represent such middle ground between total contractual rigidity, on the one hand, and complete relational flexibility, on the other”. 62

6.2.1. Traditional Renegotiation Clauses

Examination of the literature and existing international investment contracts indicate that ‘traditional’ and ‘modern’ types of renegotiation clauses can be seen in investment contracts. Careful examination of the wording of such clauses could be helpful in determination of the formula that is intended to “ensure greater predictability of conditions under which renegotiation may take place”. 63 Under international investment agreements, traditional renegotiation clauses are seen as; (i) general and (ii) specific renegotiation clauses.

The general renegotiation clause affects the entire substance of international investment contract and prescribes conditions under which the entire bargain may be reopened. 64 This type of renegotiation clause “explicitly sets out the aim of renegotiation of terms which most often, in the spirit of the rebus sics stantibus principle, is to restore each of the parties to their position prior to the change of the legal environment surrounding the contract”. 65 For example, Article 3.3 of the Service Contract 1979 between the Haitian State and Anschutz Overseas Corporation, provides; “it is agreed that the terms of this contract shall, upon the request of either party, be subject to renegotiation after seven years from the date pay-out or ten years after the year end in which commercial production is reached, whichever time is later-provided however, that in no event shall ‘renegotiation’ be deemed to be tantamount to termination. Rather, ‘renegotiation’ shall be

59 P. Sarcevic, Privatisation in Eastern and Central Europe, (Graham & Tortman, 1992).
64 Ibid, 416.
deemed to reflect the opportunity of the parties to adjust the economic terms and conditions of this contract to account for then local and international conditions”.66 The parties according to these clauses have a duty to renegotiate at particular points in time. As to the Haitian clause, the obligation of the parties to renegotiate embarks either at taking place a specific event or at periodic intervals.67 Therefore, time could be considered as a triggering event.

Specific renegotiation clauses refer to such clauses that determine a specific event or a particular issue for starting renegotiation.68 For example, the Petroleum Production Agreement of 1974, between the Government of Ghana and Shell Exploration and Production Company of Ghana Ltd., in Article 47 required:

“Art. 47. (b) It is hereby agreed that if during the term of this Agreement there should occur such changes in the financial and economic circumstances relating to the petroleum industry, operating conditions in Ghana and marketing conditions generally as to materially affect the fundamental economic and financial basis of this Agreement, then the provisions of this Agreement may be reviewed or renegotiated with a view to making such adjustments and modifications as may be reasonable having regard to the Operator’s capital employed and the risks incurred by him always provided that no such adjustments or modifications shall be made within 5 years after the commencement of production of petroleum in commercial quantities from the production area and that they shall have no retroactive effect”.69

This clause covered significant change of financial circumstances and clearly explained the triggering event under which the contract may be modified. It also excluded retroactive effects of contract amendment. Under the specific renegotiation clause, parties may not request renegotiation beyond the specific events. However, the general renegotiation clause “will encourage the parties to ask for renegotiation of the contract on flimsy grounds thereby jeopardising the stability of the contract”.70

6.2.2. Modern Renegotiation Clauses
Modern renegotiation clauses might be seen in three forms. (i) stipulated economic balancing, (ii) non-specified economic balancing, and (iii) negotiated economic balancing.71

70 B. Nwete, (2006), supra note 36, 60.
Stipulated economic balancing provides for an automatic amendment in the stipulated way.72

The Model Offshore Production Sharing Agreement of Pakistan points out;

“(a) The Government undertakes to uphold the fiscal stability of this Agreement and specifically guarantees that the payments to Government stipulated in Articles 6.6, 6.9, 9.1, 9.6, XIII, XXIV shall not be amended or changed with respect to the application of this Agreement. (b) Where any agency or authority of the Government imposes any tax, cess, fee, duty, levy, or other ancillary payment in addition to the guaranteed payments in article 31.1(a) as required by the laws of Pakistan other than those concerning health, safety and environmental and related matters of public interest, Government holdings shall consult with contractor on appropriate measures in order to compensate contractor for such unfavourable impacts caused by such amendments. After having quantified the unfavourable impacts, the Government holdings share of profit oil and profit gas shall be adjusted in such a manner that the overall fiscal balance is maintained”.73

This clause clearly required adjustment of contractual arrangements to maintain financial equilibrium. The modern practice shows that there has been a shift from traditional freezing clauses to a hybrid contractual mechanism including both stabilisation and renegotiation concepts.74 This modern approach is particularly related to international contracts for exploration and exploitation of natural resources.75 Since this modern approach is quite recent, the practice has not yet received much discussion in the literature or in arbitral awards. It is because legal analysis of issues concerning petroleum contracts mostly has been written in arbitral awards rendered in the past. Therefore, it projects the past practice.76 It is useful therefore to examine traditional and modern renegotiation clauses to fully understand the legal characterisation and future consequences which they create. Thus, in the next few pages, some examples of their contractual terms will be discussed.

Another type of renegotiation clause which is negotiated economic balancing, requires that parties should meet to negotiate the amendments to restore the original financial equilibrium.77
For example, an Egyptian Concession Contract 2002, provides;

“In case of changes in existing legislation or regulations applicable to the conduct of Exploration, Development and production of Petroleum, which take place after the Effective Date, and which significantly affect the economic interest of this Agreement to the detriment of CONTRACTOR or which imposes on CONTRACTOR an obligation to remit to the A.R.E (Arab Republic of Egypt) the proceeds from sales of CONTRACTOR’s Petroleum. CONTRACTOR shall notify EGPC (the National Oil Company) of the subject legislative or regulatory measure. In such case, the Parties shall negotiate possible modifications to this Agreement designed to restore the economic balance thereof which existed on the Effective Date. The Parties shall use their best efforts to agree on amendments to this Agreement within ninety (90) days from aforesaid notice. These amendments to this Agreement shall not in any event diminish or increase the rights or obligations of CONTRCATORS as these were agreed on the Effective Date. Failing agreement between Parties during the period referred to above in this Article XIX, the dispute may be submitted to arbitration, as provided in Article XXIV of this Agreement”.78

This clause requires good faith in the renegotiation process which points out that parties should apply their best efforts. It also determines the extent of amendment and has provided that parties could not reduce or increase the rights or obligations of the contractor as agreed on the effective date.

The Model Production Sharing Contract of Turkmenistan 1997 contained the following requirement;

“Where present or future laws or regulation of Turkmenistan or any requirements imposed on contractor or its subcontractors by any Turkmen authorities contain any provisions not expressly provided for under this Agreement and the implementation of which adversely affects contractor’s net economic benefits hereunder, the parties shall introduce the necessary amendments to this agreement to ensure that contactor obtains the economic results anticipated under the terms and conditions of this agreement”.79

In the similar vein, the Baku-Tbilisi-Ceyhan Host Government Agreements require:

“The State Authorities are to take all actions available to them to restore the Economic Equilibrium established under the Project Agreements if and to the extent the Economic

78 Cited in P. Cameron, AIPN, supra note 71, 31-2; A. Maniruzzaman, (2006), supra note 71, 4.
Equilibrium is disrupted or negatively affected, directly or indirectly, as a result of any change (whether the change is specific to the Project or of general application) in host government’s law (including Taxes, health, safety and the environment), including changes resulting from:

The amendment, repeal, withdrawal, termination or expiration of the host government’s law

The enactment, promulgation or issuance of the host government’s law

The interpretation or application of the host government’s law (whether by the courts, the executive or legislative authorities, or administrative or regulatory bodies);

The decisions, policies or other similar actions of judicial bodies, Tribunals and courts, the State Authorities

Jurisdictional alterations; and

The failure or refusal of judicial bodies, Tribunals and courts, and/or the State Authorities to take action, exercise authority or before the host government’s law (a “change in law”)

The foregoing obligation of the State Authorities to take all actions available to restore the Economic Equilibrium are to include the obligation to take all appropriate measures to resolve promptly by whatever means may be necessary, including by way of exemption, legislation, decree and/or other authoritative acts, any conflict or anomaly between any Project Agreement and the host government’s law”.80

The Model Exploration & Production Sharing Agreement of the State of Qatar, 1994 includes the following provision:

“Art. 34.12 Equilibrium of the Agreement: Whereas the financial position of the Contractor has been based, under the Agreement, on the laws and regulations in force at the Effective Date, it is agreed that, if any future law, decree or regulation affects Contractor’s financial position, and in particular if the customs duties exceed...percent during the term of the Agreement, both Parties shall enter into negotiations, in good faith, in order to reach an equitable solution that maintains the economic equilibrium of this Agreement. Failing to reach agreement on such equitable solution, the matter may be referred by either Party to arbitration pursuant to Article 31”. [Emphasis added].81

In respect of the third category of renegotiation clauses, namely, non-stipulated economic balancing, they do not stipulate the nature of amendment and do not mention that mutual agreement of the parties is necessary.\(^82\)

A Production Sharing Agreement between the State Oil Company of the Azerbaijan Republic and a consortium of international oil companies including AMOCO Caspian Sea Petroleum, BP, Delta Nimir Khazar, Lukoil Joint Stock Company, Turkiye Petrolleri signed on 20 September 1994, in Article 13 requires:

“The rights and interests accruing to Contractor (or its assignees) under this Agreement and its Sub-contractors under this Agreement shall not be amended, modified or reduced without the prior consent of Contractor. In the event that any Government Authority invokes any present or future law, treaty, intergovernmental agreement, decree or administrative order which contravenes the provisions of this Agreement adversely or positively affects the rights or interests of Contractor hereunder, including, but not limited to, any change in tax legislation, regulations, or administrative practice, or jurisdictional changes pertaining to the Contract Area, the terms of this Agreement shall be adjusted to re-establish the economic equilibrium of the Parties, and if the rights or interests of Contractor have been adversely affected, then the State entity shall indemnify the Contractor (and its assignees) for any disbenefit, deterioration in economic circumstances, loss or damages that ensue there from”. [Emphasis added].\(^83\)

The Production Sharing Agreement between the Vietnam National Oil and Gas Corporations of the Socialist Republic of Vietnam, LASMO Vietnam Ltd. & C. Itoh Energy Development Co., Ltd. Signed on 19 August 1992 contains the following:

“Art.17.8 Introduction of New Laws and Regulations: If after effective Date, new law(s) and/or regulation(s) are introduced in Vietnam adversely affecting CONTRACTOR’S interest, or any amendments to existing laws and/or regulation are made the Parties shall meet and consult each other and shall make the necessary changes to this Agreement to ensure that CONTRACTOR is restored to the same economic conditions which would have prevailed if the new law and/or regulation or amendment had not been introduced”.[emphasis added].\(^84\)

\(^{82}\) A. Maniruzzaman, (2006), OGEL, supra note 60, 2.


\(^{84}\) Cited in K. Berger, (2003), supra note 61, 1360.
In addition, according to the OK-Tedi Papua New Guinea Concession Agreement 1976, under clause 42, the agreement did not provide a specific triggering event and did not require a duty to renegotiate. It was simply agreement to amend the contract. It required; “The parties may from time to time by agreement in writing add to, substitute for, cancel or vary all or any of the provisions of this agreement”. 85 Also, Article 9 of the Supplementary Contract to the Concession Agreement between the State of Kuwait and the American Independent Oil Company (AMINOIL) of 28 June 1948, which was signed on 29 July 1961 required; “If, as a result of changes in the terms of concessions now in existence or as a result of the terms of concessions granted hereafter, an increase in benefits to Governments in the Middle East should come generally to be received by them, the Company shall consult with Ruler whether in the light of all relevant circumstances, including the conditions in which operations are carried out, and taking into account all payments made, any alterations in the terms of the agreements between the Ruler and the Company would be equitable to the parties”. 86

The above said clauses were some outstanding examples of renegotiation clauses in practice. The analysis of them, shows that in particular points and after certain periods of time, parties are under duty to renegotiate. Therefore, the occurrence of an event or the passing of time might be considered as a triggering event. The above mentioned clauses are obviously not exhaustive. However, they highlight the legal features of modern clauses in recent practice. Whilst the traditional stabilisation clause aims to protect foreign investors by restricting the legislative power of the government for amendment or termination of contract, the main characteristic of modern renegotiation clauses is to protect foreign investors by making the contract modelled on a flexible and amendable approach where the host state uses its power at the detriment of the foreign investor. Therefore, such clauses provide room for renegotiation where certain events take place. Examination of renegotiation clauses showed that parties by this contractual device seek to rebuild the economic balance of the agreement when it is damaged. This clause provides a dynamic framework for contractual relationships of contracting parties over the life of the agreement. In contractual practice, both government/state entity and international investors have benefited from the renegotiation clause. Contracting parties may invoke a renegotiation clause where financial balance is disrupted. 87 It will also provide a private law contract under which parties have commitments when specific conditions are satisfied to begin renegotiation. Renegotiation clauses are not of automatic application, under which parties agree to renegotiate when certain conditions are met. This poses two sets of questions as to the legal effects of a renegotiation clause. The first issue is the definition of a particular event and certain conditions which trigger a renegotiation.

86 Kuwait v. The American Independent Oil Company (AMINOIL), 21 ILM 976, 992.
The second question is about the obligation of parties during the renegotiation process. Can a party terminate the contract by failing renegotiation such as rejecting the other party’s proposal? How effective are such clauses and the process they prescribe when it comes to the protection of the legitimate expectation of the parties. The above listed questions will be discussed in the next sections.

6.3. The Contractual Practice of Renegotiation
6.3.1. Renegotiation, Contractual Stability and Certainty

There are some broad categories of circumstances that may lead to adjustment of the agreement. These are changes in conditions, either legislative and regulatory changes, or changes in economic conditions. In terms of changes in economic conditions only those that must have been beyond the control of parties and of such a nature that parties could not reasonably be expected to have taken into account at the time of contracting, would lead to adjustment. Rather than a strict application of contractual provisions, experience shows that the success of petroleum contracts lies with the mutual trust that contracting parties have in one another, together with their will to act in good faith in carrying out a project and its adjustment for their mutual interest.88

International petroleum transactions cover long time periods and deal with highly technical and financial matters and include large sums of money. Consequently, a goal sought by all sides in the negotiation process is contractual stability, which is the assurance that the terms of their contract will be respected in the future. Since the parties know that during the long time period covered by their agreement many unforeseen political, economic, regulatory, and technical circumstances may arise and drastically change the balance of benefits from what the parties contemplated at the time they originally signed their agreement. As a result, a certain degree of flexibility is a second imperative that the negotiating process should seek.89 In order to balance the stability and flexibility in a renegotiation process, one approach is that the contract authorise the parties to renegotiate the key elements of their relationship in cases where specified events or circumstances take place. The insertion of a renegotiation clause in the agreement is a wise basis for maintaining a long-term contractual relationship. Nevertheless, some traditional jurists are not willing to provide an opportunity for flexibility by virtue of the insertion of a renegotiation clause.90 Their preferred approach is to anticipate all possible future contingencies and to provide for them in the contract. This traditional approach and its reluctance for renegotiation clauses have some valid reasons. First, is the concern that renegotiation clauses are merely ‘agreements to

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agree’ and may be unenforceable.91 Second, renegotiation might increase uncertainty and risk in business transactions and offend the concept of the sanctity of contract.

Nevertheless, a specific renegotiation clause in a contract with definite terms regarding how the parties are to conduct the renegotiation process would easily meet this standard of enforceability. The required certainty would be further satisfied by specifying the precise events that give rise to the obligation to renegotiate and by specifically providing for the timing, locale, and conditions of the renegotiation process.92 In addition, the insertion of the renegotiation clause could actually contribute to transactional stability.93 For example, when significant changes in circumstances may result in severe unexpected financial hardship, a renegotiation clause may permit the parties to avoid default. The contracting parties should recognise the risk of changed circumstances and insert the conditions upon which the renegotiation process must trigger in the renegotiation clause, instead of trying to predict all eventualities.

Moreover, in long-term transactions where their success depends upon continuing cooperation, a renegotiation clause provides a middle ground between total rigidity and complete relational flexibility.94 As a result, contracting parties should recognise changed circumstances and include renegotiation provisions in the contract, and create a clear framework within which to conduct the renegotiation process. The renegotiation clause by determination of events and conditions may give stability to an arrangement whose long-term nature creates a high risk of instability.95 The renegotiation process can only be commenced once specific events stipulated in such a clause have taken place. The contracting parties in a renegotiation process cannot change the entire agreement and the extent of contract change would already have been determined by the renegotiation provisions in the contract. Thus, contractual stability will be maintained.

Finally, with regard to contractual stability and certainty of transactions in the event of a renegotiation it should be noted that the function of renegotiation clauses is limited to adjustment of the contract to the changed circumstances. They do not justify a restructuring of the entire contract. As a result, the outcome of a successful renegotiation is framed by and based upon specific conditions that were stipulated in the original contract. Consequently, one party may not seek a renegotiation to reach an unexpected result, as the entire process is controlled by specific conditions to re-balance the original contractual equilibrium. It is one of the principles for

91 Ibid.
92 J. Salacuse, (2001), supra note 89, 1510.
93 Ibid.
94 Ibid.
95 Ibid.
renegotiation that renegotiation should not result in a commercial advantage to one of the parties, but instead restore the commercial balance of the contract as to changed circumstances.  

6.3.2. Triggering Events

The conditions upon which commencement of renegotiation is based are of great importance. The criterion that must be met for triggering the renegotiation process is one of the salient features of a renegotiation clause. Indeed, the function of such clauses is primarily dependent on it. Such prerequisites should be defined in the clause to be met before renegotiation starts. Nevertheless, such prerequisites do not have a set formula that can be adopted in such clauses. According to recent petroleum arbitrations, it could be seen that contracting parties did not determine triggering events clearly and merely used some terms in the renegotiation provisions. For example, in the Atlantic Case, the events triggering the possibility for the parties to request the contract adaptation were represented only by changes in the economic conditions in the market. Moreover, such changes, as usually provided by adjustment clauses, had to be: (1) substantial, (2) beyond the parties’ control, (3) unforeseeable at the moment of the conclusion of the contract.

Long-term agreements can be affected by the occurrence of unforeseen events that change the market conditions existing at the moment of the conclusion of the agreement and representing the framework within which the parties had negotiated it and the basis on which they found the relevant balance. Such supervening events alter the contract’s equilibrium. It is important to underline that the unforeseen events taken into account in this research are those that determine changes in the original conditions and rendering the performance of the parties impossible under the relevant long-term contract or extremely burdensome and onerous. It follows that any other provision with the effect of terminating the contract in case one of the parties’ performance becomes impossible is not considered an adaptation clause. The trigger events are any changes of the market conditions that have to be: (i) substantial; (ii) unforeseen; and (iii) beyond the control of the parties. I examined the supervening events and presented some examples in section 7.3.4.

96 K. Berger, (2003), supra note 61, 1360.
98 N. Horn, (1985), supra note 14, 129.
100 The term ‘market conditions’ is meant to include not only the economic conditions characterising the market but also other conditions (political, technological, etc.) that have consequences on the market and the relevant contracts.
However, according to the nature of each contract, its duration and complexity, different approaches to determining the trigger can be found. Whereas some clauses, such as in the Ok Tedi contract, do not provide for any prerequisites to the consensus procedure, others provide for very general conditions. Each of the clauses cited in this chapter has its own conditions and criteria that have to be met before a renegotiation phase can commence.

Under Article 9 of the Supplementary Agreement of AMINOIL a review of rights and obligations of the parties is required. It obligates that in case of “an increase in benefits to governments in the Middle East and such increase should come generally to be received by them”. Where such a development takes place, still the existence of other requirements are necessary. Such change must have become general in the Middle East. It means that an empirical study to specify whether such a development has become general is required. However, it is a very difficult task where most provisions in petroleum projects are confidential.101

Other clauses contain general formulations. Article 16-6 of the Turkmenistan Model Agreement is exemplary. It links the trigger of renegotiation to the imposition of laws or regulations, the implementation of which adversely affects the contractor’s economic benefits. Of course the difficulty relates to the exact meaning of the triggering event. How could one estimate an adverse effect on the contractor’s economic benefit? Such an open-ended criterion is open to extensive interpretation and may give rise to fears of instability and frequent conflict. This is not to mean that a precise mathematical formula is required. Some of the clauses cited above were specifically worded, very precise and linked the trigger to an increase of customs or taxes. Yet, although the latter type of triggers has the advantage of being precise, such clauses are applicable only to certain aspects of the contractual relationship.

Other clauses such as the Ghana-Shell Clause mentioned above attempted to formulate a general clause with a specific trigger. The Ghana-Shell clause attempts to provide a specific trigger where there is “change in the financial and economic circumstances relating to the petroleum industry, operating conditions in Ghana and marketing conditions generally as to materially affect the fundamental economic and financial basis of this agreement”.102 Under these conditions, this clause takes a legal form close to that of a hardship clause. Where the hardship clause according to the literature serves as a generic term of adaptation, the purpose of the renegotiation clause is to make the contract dynamic and to flexibilise throughout its duration.103 The trigger corresponds to circumstances usually contemplated by hardship clauses which are similar or identical to the concept of frustration and commercial impracticability.104 These circumstances are usually of a

102 See the said clause.
general economic, financial, commercial and political nature. Although they may also be more specifically expressed. Furthermore, the contemplated event must only occur, but it must also profoundly disturb the balance of the agreement such as to place an intolerable burden on one party if performance would remain unchanged. Hardship clauses provide a starting point for renegotiation under strict conditions. Arbitrators interpret such revision clauses narrowly and clauses on other general risks below the hardship and force majeure threshold generally will not be considered. Therefore, the test that is to be met before triggering renegotiation is important and has to be carefully worded. General criteria will give rise to the doubt on the effectiveness and enforceability of such clauses. However, it is a difficult task to formulate a clause which precisely defines the triggering events and at the same time is general in style. The change in the commercial balance of the contract can barely be defined more concretely. By its complex nature, being unclear in advance and influenced by naturally volatile economic determinants, the trigger events evade a detailed definition.

Another type of renegotiation clause incorporates a determined triggering event to renegotiate. The obligation starts either after a certain lapse of time or at the occurrence of some other event such as investment recovery. It is illustrated by the following clauses:

“Not less than 4 years after the commencement of commercial production the parties shall consult together in Liberia for the purpose of considering such changes in or clarifications of this Agreement as either party deems to be appropriate”.

“The contract will be open to renegotiation on the later of the two dates:

seven years after the year the contractor has been able to recover its costs out of the 40% cost recovery portion of revenues or ten years after the first commercial production”.

Another clause evidencing this approach mentioned in section 6.2.2. is Article 16-6 of the Model Production Sharing Agreement, 1997 for Petroleum Exploration & Production of Turkmenistan. The renegotiation process described above is triggered by a pre-defined change of circumstances, the one caused by the issuance by the host State of new legislation negatively affecting the private investor’s interest.

105 Ibid.
107 A. Kolo and T. Waelde, (2000), supra note 1, 47.
The renegotiation of the agreement can be triggered at the initiative of either the host state or the investor. The clause is triggered by supervening events which are beyond the control of the parties and which negatively affect the contractual equilibrium to the detriment of either of them. A workable renegotiation clause of this kind presupposes the definition of (i) the change of circumstances triggering renegotiation; (ii) the effect of the change on the contract; (iii) the objective of the renegotiation; (iv) the procedure for renegotiation; (v) the solution in case of failure of the renegotiation process.\textsuperscript{111} In short, triggering events, as well as the objective of the renegotiation are often defined in general terms, sometimes for lack of care and some other times in order to leave greater flexibility for the negotiation process.

A change of circumstances that trigger renegotiation is the first element to be identified when drafting a renegotiation clause. However, \textit{an attempt to make an inventory of triggering events would be a fruitless exercise in view of the large variety of formulations to be found in renegotiation clauses.}\textsuperscript{112} Some renegotiation clauses include events that are not defined such as ‘a change of circumstance’ or ‘a substantial change in the circumstances existing on the date of agreement’. Some of the circumstances may be directly related to the agreement such as an intervening imbalance in the economic equilibrium, whilst others are external to the agreement, such as problems of balance of payments by the host state.\textsuperscript{113} The reference to the principle of ‘change of circumstances’ as a ground for revising the parties’ rights and obligations under their contractual arrangements is contained in international treaties. For example, the Algiers Agreement of 1981 in Article V, makes a reference to the change of circumstance as triggering renegotiation. The agreement established the Iran-US Claims Tribunal to settle disputes concerning expropriation, contractual breaches and other measures affecting US nationals’ interests in Iran following the revolution in 1979.\textsuperscript{114} Another important document is the UNIDROIT Principles of International Commercial Contracts that in chapter two, article 6.2.2 regarding hardship, defined change of circumstances as the occurrence of events fundamentally altering the equilibrium of the contract. This entitles the aggrieved party to initiate a renegotiation.\textsuperscript{115} In addition, OPEC Resolution XVI.90 of 1968, Declaratory Statement of Petroleum Policy in Member Countries, relied on the principle of change of circumstances. Renegotiation clauses are sometimes more precise in determination of triggering events to circumscribe such events triggering renegotiations. Their common feature is that the event must

\textsuperscript{112} P. Bernardini, “Stabilisation and Adaptation in Oil and Gas Investments”, Dispute Resolution in Oil and Gas Contracts Conference, Dubai, 13 November 2006.
\textsuperscript{113} Ibid.
\textsuperscript{115} UNIDROIT Principles of International Commercial Contracts (2010), UNIDROIT International Institute for the Unification of Private Law.
be beyond the control of the party invoking it to obtain relief. In other words, the event must be unforeseeable. The consequence is that if the aggrieved party could have foreseen or has caused, or contributed to cause, the event it may not claim renegotiation of the contract to its benefit.\textsuperscript{116}

Determination of whether a triggering event has taken place may bring about a conflict between the parties. Where the clause is worded vaguely and not precisely the situation is more intense. This question amounts to a legal issue arising under contract and therefore the tribunal is competent to decide on this.\textsuperscript{117} It shows that the risk is embedded in international commercial transactions. It has been said that “express language will not totally eliminate risk -there is virtually nothing that can accomplish this”\textsuperscript{118}

Another important issue is the effect of change on the agreement. Renegotiation clauses should apply only in exceptional circumstances. This requirement is defined in a variety of ways having all, the conditions that the change must be such as to cause a substantial detriment, or substantial economic imbalance to the interests of one of the parties, or to materially affect the economic and financial basis of the agreement, or the consequences and effects of which are fundamentally different to what was contemplated by the parties at the time of entering the agreement. The renegotiation clause provides that the aggrieved party may not suspend its performance, at least during the period of renegotiation as a consequences of the change of circumstances on the contract.\textsuperscript{119}

\textbf{6.3.3. The Extent of Contract Change and Duty of Renegotiation}

Renegotiation clauses often set formulations on the extent of contract change. The significance of this is rooted in the determination of the outcome that is supposed to be achieved by renegotiation. Article 17.8 of the LASMO Agreement 1992 provides a good example of an objective test as to the extent of contract change. It mandates that parties shall consult each other and make the necessary change to ensure that the contractor is restored to the same economic position which would have prevailed if the new law and/or regulation or amendment had not been introduced.\textsuperscript{120} The extent to which the agreement may be changed is often independent of the triggering event and is to be determined on the basis of the specific wording of the clause.\textsuperscript{121} Such

\textsuperscript{116} Yearbook of Commercial Arbitration, (1984), 70.
\textsuperscript{117} W. Peter, (1996), supra note 21, 34.
\textsuperscript{118} W. Fox, (1998), supra note 111, 217.
\textsuperscript{119} Ibid.
\textsuperscript{120} Art.17.8 Introduction of New Laws and Regulations: If after effective Date, new law(s) and/or regulation(s) are introduced in Vietnam adversely affecting CONTRACTOR’S interest, or any amendments to existing laws and/or regulation are made the Parties shall meet and consult each other and shall make the necessary changes to this Agreement to ensure that CONTRACTOR is restored to the same economic conditions which would have prevailed if the new law and/or regulation or amendment had not been introduced”.
\textsuperscript{121} P. Bernardini, supra note 112.
wording may be generic, adopting subjective standards such as ‘removing the unfairness’ or ‘adopting an equitable revision’ or such as to protect both parties by referring to an objective standard as ‘restoring the original contractual equilibrium’ or only the private party by making sure that it will obtain “the economic results anticipated under the terms and conditions of this Agreement.”122 In general, the meaning of a renegotiation clause cannot possibly be to let only one contracting party feel the consequences of the changed circumstances.123

The extent of contract change may be set by some tests such as exclusion of any retroactive result or indemnity of the investor for loss or damages resulting from the introduction of new regulations or laws. Over the life of an investment when a problem arises parties are required to renegotiate and discuss the possible solution.

Some of the clauses limit the extent of contract change to objective standards, such as the maintenance of the financial equilibrium or referring to subjective standards such as fairness. For example, “The Government and Contractor Shall meet to negotiate, in good faith, and agree upon the modifications which need to be made to the terms of this Agreement to restore the Contractor’s economic rights and benefits hereunder to a level equivalent to what they would have been, had such change not occurred”.124

Some scholars argued that it would be better if such a clause captures subjective standards. According to Schmitthof, it is an unnecessary fetter on the renegotiation which should aim at establishing a situation fair and equitable to both parties in the new circumstances, if the parties have to look back to the past and to adopt the equilibrium as their guiding criterion.125

In the researcher’s view, a precise interpretation of a subjective test such as ‘fairness’ requires reference to the objectives of the contract and to the intent of the contracting parties. These elements are difficult to determine. As a result, adaptation of the agreement could be facilitated by an objective test such as ‘restoring the financial balance of the parties’ obligations’ because it could be easier to quantify financial aspects of the contract than to determine what the parties should view as fair under changed circumstances.

However, there are some concerns as to the renegotiation process such as what will take place if a party does not enter into renegotiation, or if the parties are unsuccessful in agreeing an outcome. These issues will be addressed in this section. A renegotiation clause requires that when particular

122 Model Production Sharing Agreement for Turkmenistan.
123 P. Bernardini, supra note 112.
125 W. Peter, (1995), supra note 21, 244.
conditions are met parties have to renegotiate. If a party rejects to enter into renegotiation then it
is in breach of agreement and the violation of this duty could entail legal sanctions.126

Nevertheless, a party’s duty to renegotiate is not fulfilled by merely entering into renegotiations
with the other party. There are obligations imposed on the parties during the renegotiation process. However, one should not expect very clear rules. One of the widely recognised rules concerning the obligations of the parties is that contracting parties by entering into the renegotiation process should be determined to find a solution for their problems. In fact, in addition to willingness to listen to each other, they shall understand and be flexible throughout the renegotiation process to reach a compromise.127

The difficulty or inability to use precise wording in the definition of the duties of the parties in the renegotiations could have damaging results. Wording such as the use of ‘best efforts’ or ‘the parties do their utmost to reach an agreement’ leaves a great deal of unanswered questions on how the process is to be conducted by the parties and do not require them to reach an agreement on revised items.128 Nevertheless, authoritative guidance on how the parties ought to behave is available. In the AMINOIL award, the tribunal cited the International Court of Justice’s (ICJ) views on the content of an obligation to negotiate in North Sea Continental Shelf.129 The tribunal specified the general principles that ought to be observed in carrying out an obligation to negotiate.130 Those principles were: (i) good faith; (ii) a sustained upkeep of the negotiations over a period appropriate to the circumstances; (iii) an awareness of the interests of the other party; (iv) a preserving quest for an acceptable compromise.

Regarding the first principle, the parties must conduct the negotiations in good faith, regardless of whether a good faith requirement is expressly included in the renegotiation provision. If they fail to act in good faith, this will be taken into account in any arbitral proceedings that follow from any failure of the renegotiation process.131 The Aminoil tribunal in relation to the other three principles held that while an obligation to negotiate is not an obligation to agree, the obligation to negotiate exists within ‘well-defined juridical framework’ which can include fairly precise requirements.132 However, a failure to reach an agreement does not mean that the parties have failed in their duty to negotiate.

130 AMINOIL Arbitration, para 1014. 
131 P. Cameron, (2010), supra note 128, 83.
132 AMINOIL Arbitration, para 24.
In terms of the fourth principle, if the parties have an obligation to renegotiate under the agreement, provided that the triggering event has occurred, they must proceed to commence renegotiation rather than simply refer the matter to the courts instead of commencing renegotiations.\textsuperscript{133}

The function of the renegotiation clause is to accommodate the contract to the changed circumstances and not to change the whole structure of the contract.\textsuperscript{134} This is the ‘no profit no loss rule’ that is generally accepted. It requires that “the original equilibrium of the contract should be maintained and therefore neither party should be allowed to profit or forced to suffer a loss as a result of the renegotiation”.\textsuperscript{135} In addition, it should be noted that the purpose of renegotiation clauses is limited to adapting the contract to the changed circumstances and not restructuring the entire contract unless this is clearly expressed in the clause.\textsuperscript{136} Finally, timing plays a role in determining the extent to which a party has satisfied his duty to negotiate.\textsuperscript{137} However, the aforementioned rules are starting points and obligations of the parties must be determined by the wording of a renegotiation clause, the nature of risks and the nature of the contract.\textsuperscript{138}

\textbf{6.3.4. Checklist for Drafting Renegotiation Clauses: What Should be the Content and Process of Renegotiation?}

It is a difficult task for lawyers to draft renegotiation clauses that are jointly acceptable to both contracting parties. Legal scholars articulated the difficulty of designing renegotiation clauses as follows: “It is much easier to delay thinking about the future problems or to rely on more ironclad dispute settlement provisions. More importantly, it is difficult to find language that simultaneously satisfies the needs and concerns of both parties”.\textsuperscript{139} This researcher recognises this difficulty and supports the scholars’ opinion. It is not an easy task for lawyers to draft a mutually acceptable renegotiation clause in practice. Nevertheless, the parties should take reasonable time to draft the best contractual clauses.

Renegotiation provisions should not be too flexible; parties should attempt to formulate such a provision with certain elements mentioned below.\textsuperscript{140} It is well said “an open-ended approach to negotiated economic balancing however is also a high risk strategy. It should be contemplated by details and penalties for non-compliance: imposition of time limits on negotiations, recognition

\begin{footnotesize}
\textsuperscript{133} EDF Case, JCP No. 18810.
\textsuperscript{134} K. Berger, (2003), supra note 61, 1365.
\textsuperscript{135} N. Horn, (1985), supra note 14, 3, 28.
\textsuperscript{136} K. Berger, (2003), supra note 61, 1365.
\textsuperscript{137} W. Peter, (1995), supra note 21, 247.
\textsuperscript{138} K. Berger, (2003), supra note 61, 1365-66.
\textsuperscript{139} J. Otto, J. Cordes, (2002), supra note 53, Ch.5, 5.18.
\end{footnotesize}
that compensation must follow a loss or damage and resource to arbitration if the negotiations fail".  

There are some elements that need to be clearly stated in renegotiation clauses. Such clauses should address events that could trigger a renegotiation. If the parties have not determined triggering events clearly, then this may ultimately result in conflict. This is because it will be difficult to determine whether the triggering events have occurred or not. The above-mentioned clauses generally state the triggering events.

In order to start the renegotiation process, the triggering events must have taken place. Upon occurrence of triggering events, the obligation of contracting parties to renegotiate starts. In *E.D.F v. Societe Shell Francaise* case, the contract signed between a private oil company and the French national power company included a renegotiation clause. The parties agreed to renegotiate the contract “if the price of oil increased beyond a stated figure” to reset financial balance. The renegotiation clauses were triggered because the oil price went up beyond a stated figure. Nevertheless, both parties took the case to court in order to settle the dispute instead of renegotiating the original contract. The court dismissed the case and reminded the parties of their obligation to renegotiate the new oil price in order to set up a new financial balance. The court said that “it was only in the event that they could not reach an agreement that the courts consider the matter”. Thereafter, the parties went back to renegotiation and found an amicable solution for the dispute.

Provisions should make clear whether the obligation is to renegotiate or to reach an agreement. In the *AMINOIL* case, the tribunal addressed this issue in accordance with the renegotiation clauses in the Aminoil contract as follows: “An obligation to negotiate is not an obligation to agree. Yet the obligation to negotiate is not devoid of content, and when it exists within a well-defined juridical framework it can well involve fairly precise requirements”.

In a similar way, in the *Wintershall* case, it was upheld that parties by initiating renegotiation are not obliged to reach agreement. The tribunal stated that “such a duty does not include an obligation on the part of the respondent to reach agreement with respect to the proposals made by

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141 P. Cameron, AIPN (2006), supra note 60, 51.
146 Ibid, 108.
147 K. Berger, (2003), supra note 61, 1361.
the claimants”. 149 According to the Aminoil and Wintershall arbitral tribunals, there is no obligation for the parties to agree in a renegotiation. Nevertheless, if the clauses require that renegotiating parties are under obligation to reach an agreement then parties have a duty to agree. According to Bowman, renegotiation clauses should only provide for renegotiations, not for agreement on contractual adaptation. 150 The obligation of a duty to agree on contractual modifications could result in some problems. If the clause states that parties should reach an agreement at the end of the renegotiation process, this places an obligatory duty on the parties to come to an agreement and this may lead to an unfair outcome. On the other hand, if there is no obligation to reach an agreement, this may reduce the effectiveness of renegotiation clauses, because the party that has been requested to renegotiate may not take the renegotiation seriously and also may not act in good faith. In order to prevent this, the provision should stipulate that the renegotiating parties should act in good faith in the renegotiation process. 151 In that case, it can be fairly said that there might be no need to state that renegotiation has the obligation to reach an agreement. Nevertheless, a duty to negotiate in good faith does not always mean a duty to reach agreement. 152 Hence, considering the possibility of failing to reach an agreement, it seems reasonable not to have renegotiation clauses that require an obligation to reach agreement.

It has been pointed out that the “duty on one party to agree can only arise under limited circumstances when: (1) the negotiations have reached an advanced stage and all essential terms have been at least orally agreed; (2) at least partial performance has been requested and has begun; or (3) a duty to negotiate in good faith exists by virtue of a pre-existing contract and terms are offered by the other party that are-clearly and unequivocally- so commercially standard and reasonable that no reasonable party under a duty to negotiate in good faith could legitimately reject them. With regard to this latter standard, such terms must be technically sound, financially reasonable and attractive to the offeree, must provide a method to respond to changing risks, and must fall within the mainstream of similar transactions. By financially reasonable and attractive is meant that the offeree must be likely to make a profit under the terms offered, and quite importantly, is not likely to be subjected to a loss. Since a duty to agree is being imposed on a party that has not actually agreed, then a method must also be provided to respond to changing risks and market conditions so that the offeree, for example, is not subjected to a long-term fixed price contract that can potentially lead to catastrophic future loss” 153.

151 D. Bishop, (1997), supra note 126.
152 Ibid.
153 Ibid.
Furthermore, another important point to make in renegotiation clauses is what amounts to change of economic equilibrium of the contract, or when a change can be said to have taken place. This will prevent the abuse of requests for renegotiation. In cases of failure of renegotiation, the renegotiation clause should stipulate the consequence of a failure of renegotiation. The provision should set out the basic principles of the renegotiation process and expected outcomes of the renegotiation.

The contracting parties should make clear the wording of renegotiation clauses because “the parties’ obligation must necessarily be judged in accordance with the wording of each renegotiation clause”. In order to avoid potential conflict between parties, the lawyers should draft the clauses clearly. In addition, the terminologies used in the provision should be defined in the agreement. These definitions can reveal the aim of the parties, and therefore, in the event of any dispute arbitral tribunals can interpret the provision “thereby make a fair decision in relation to the dispute”.

It is worth noting that parties should draft the renegotiation clauses based on the investment conditions of each specific project, their needs and expectations. Therefore, renegotiation clauses for different investment projects may differ.

6.3.4.1. Some Principles for the Renegotiation Process

There is a generally recognised principle that the parties should consider when the renegotiation occurs. Contracting parties should invoke and conduct the renegotiation in good faith. The principle of good faith is recognised by most nations and it also has been accepted as a basis for international law. Good faith imposes upon the parties the duty to seek out an adaptation of their agreement to the new circumstances which may have occurred after its execution, in order to ensure that its performance does not cause, especially when the contract is at stake as part of a long term agreement, the ruin of one of the parties. This principle is also prevailing in international commercial law. For example, the French case law has affirmed that changes in the original economic conditions altering the contract’s equilibrium can render the agreement null and void or can give rise to a duty of cooperation and renegotiation on the basis of the principle of good faith.

155 Ibid.
157 Ibid.
159 Ibid.
161 J. O’Connor, Good Faith in International Law, (Dartmouth, 1991) 1.
faith provided by Article 1134.3. The reference to the principle of good faith with regard to the adaptation of contracts, governed by French law, was also made in international commercial arbitration. In particular, in the ICC case No. 9994/2001, a dispute arose out of a long-term license and sale agreement (governed by French law and not including an adaptation clause), concluded between a US (Defendant) and a French (Claimant) company, upon the determination of a new price asked by the Claimant in consideration of the increase of the costs of the raw material it supplied to the Defendant. Such increase was due to the more severe conditions and control imposed by a government agency in relation to collection of the human placenta of which the raw material supplied under the contract was made. The parties did not reach an agreement on the new price and upon the Defendant’s termination of the contract, the Claimant started an arbitration proceeding. The Tribunal stated that, upon the occurrence of unforeseen events altering the contract balance, the parties, according to French law, have the duty to renegotiate and adapt the contract on the basis of the principle of good faith and regardless of the existence of an adaptation clause. In addition, the arbitrators stated that such a principle is even more relevant in cases of international contracts.

In addition, in the US, the principle of commercial impracticability, to be intended as an extreme and unreasonable hardship, has been recognised by courts and the legislator. Such section, therefore, by referring to the concept of impracticability and not to impossibility, extends the cases in which a party can be excused from the performance (or from the timely performance) of its obligations since such a concept also includes situations in which the latter, upon the occurrence of unforeseen events, has become commercially unsustainable. Moreover, this provision found its justification in the principle of good faith (expressly provided by section 1–203 UCC) since it would be against the latter to ask a party to perform the contract when it has become extremely and excessively onerous (i.e., impracticable) due to supervening events changing the conditions on which the agreement was based and, consequently, altering its balance.

The law cannot operate only with specific and rigid concepts. It is very difficult to mention every single issue in detail in the contract. As a result, the approach to good faith should provide flexibility. Hence, the meaning of good faith is “aligned to that of reasonableness. However, good faith is not confined to reasonableness, but it is a way to bring in international standards.

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165 S. 1-304 UCC providing that “every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement.
167 R. Kolb, “Principles as Sources of International Law (with Special Reference to Good Faith)”, (2006) 53 (1) NILR 1, 16.
Therefore, it plays the role of a powerful standard; helping to the application in particular cases of norms in themselves too abstract to be able espouse all multifaceted features of the single cases”.\textsuperscript{168} Therefore, the concept of reasonableness is a decisive factor for understanding the principle of good faith. A reasonable conduct can be determined by taking into account all surrounding circumstances of each project and “the normative inquiry of how one should conduct himself”.\textsuperscript{169} The parties should determine what is deemed to be proper conduct.\textsuperscript{170} Thereafter, parties should try to do their best to perform contractual obligations. Understanding the concept of reasonableness could result in a reasonable behaviour in renegotiation and parties will not attempt to take advantage of the other party in the renegotiation. A common feature of any process of renegotiation is that the same should be conducted in good faith. Lack of good faith will be taken into consideration by the arbitral tribunal called upon to settle the dispute resulting from the failure of the renegotiation process.\textsuperscript{171}

According to Professor Cameron, contract drafters in the petroleum industry often use the principle of good faith to internationalise the contract. He stated that “good faith duty can act as a way of bringing international law principles into the contract and thereby defend the interests of the foreign investors”.\textsuperscript{172} The tribunal in Sapphire case noted that “this duty of good faith more often calls for the application of general principles of law, based upon reason and upon the practice of civilized countries”.\textsuperscript{173} Therefore, it is possible for the parties to renegotiate in good faith to make the contract in light of changing circumstances. The principle of good faith could result in “the less confrontational and more compromising attitude of parties to the multinational agreement”.\textsuperscript{174}

Regarding the notion of reasonableness, the Swedish legal system has some supporting and illustrating points on the above discussion. The Swedish legal system provides for the power of courts and arbitrators to intervene on contract terms in both the Contract and Arbitration Acts. In particular, Article 36 of the Contract Act (that has a procedural and mandatory nature)\textsuperscript{175} consents the adaptation of the contract in cases of supervening events changing the contractual equilibrium by providing that:

\textsuperscript{168} Ibid
\textsuperscript{170} Ibid
\textsuperscript{171} P. Bernardini, (1998), supra note 75, 415.
\textsuperscript{173} Sapphire International Petroleum Ltd., v National Iranian Oil Company, Award 15 March 1963.
“A contract term may be adjusted or held unenforceable if the term is unreasonable with respect to the contract’s contents, circumstances at the formation of the contract, subsequent events or other circumstances. If the term is of such significance that it shall otherwise be enforceable in accordance with its original terms, the contract may also be adjusted in other respects or held unenforceable in its entirety. With respect to the application of the first paragraph, special consideration shall be given to the need for protection of consumers and others who assume an inferior position in the contract relationship. The first and second paragraphs shall be given similar application to terms in other legal relationships than that of contract.”

The reference made by such provision to the concept of unreasonableness of contract terms (not only included in standard agreements but also in those negotiated between the parties) recalls the principle of good faith. Indeed, it would be against the latter to maintain a term of the agreement that upon the occurrence of an unforeseen event has become unreasonable and, as such, not compatible anymore with the new context and conditions within which the contract has to be performed. Moreover, Article 36 provides for the possibility not only to adjust a single term of the agreement but also, in case such condition is so relevant that the rest of the contract could not reasonably be enforced without changing it, to modify other terms of the agreement.

The justification of contract adjustment can be found in the principle of good faith. In particular, as seen in greater detail below, the application of such principle to the execution of contracts and, especially, long-term agreements can be deemed to imply the duty to adapt them when their balance is altered upon the occurrence of unforeseen events. To deny the adjustment would be contrary to good faith since the parties would be deprived of the possibility to reach the scope pursued by means of the contract. Indeed, without adaptation the parties could only terminate the agreement or perform it in its original terms. However, both of these remedies would frustrate the parties’ expectations (i.e., the preservation of the agreement).

A leading scholar provides a detailed guideline for the renegotiation process as follows:

1. Keeping to the negotiation framework set out by the clause,
2. Respecting the remaining provisions of the contract,
3. Having regard to the prior contractual practice between the parties,
4. Making a serious effort to reach agreement,

5. Paying attention to the interests of the other side,
6. Producing information relevant to the adaptation,
7. Showing a sincere willingness to reach a compromise,
8. Maintaining flexibility in the conduct of negotiations,
9. Searching for reasonable and appropriate adjustment solutions,
10. Making concrete and reasonable suggestions for adjustment instead of mere general declarations of willingness,
11. Avoiding rushed adjustment suggestions,
12. Giving appropriate reasons for one’s own adjustment suggestions,
13. Obtaining expert advice in difficult and complex consensus proceedings,
14. Responding promptly to adjustment offers from the other side,
15. Making an effort to maintain the price-performance relationship taking into consideration the parameters regarded as relevant by the parties,
16. Avoiding an unfair advantage or detriment to the other side (“no profit – no loss” principle),
17. Prohibition on creating established facts during negotiations except in emergency situations (ban on “escalation” strategies),
18. Maintaining efforts to reach agreement over an appropriate length of time, Avoiding unnecessary delays in the consensus proceedings.\(^{179}\)

Another important principle for the renegotiation process is that parties should follow the widely recognised principle that is ‘no profit- no loss’.\(^{180}\) According to Horn, the meaning of this rule is that “the equilibrium of the original contract should be maintained and therefore neither party should be allowed to profit or forced to suffer a loss as a result of the renegotiation”.\(^{181}\) Parties should consider the original equilibrium at the time the contract was concluded. The weighing-up of various factors will be subject to the principle of good faith and in particular the notions of fairness and reasonableness derived from this\(^{182}\). Thus, a party will be subject to fewer requirements if the opposite side also makes no moves to support the negotiation process. This follows from the idea of cooperation as a distributor of legal duties, on which most of the above mentioned obligations are based.\(^{183}\)

\(^{179}\) K. Berger, (2003), supra note 61, 1365-66.
\(^{181}\) Ibid.
\(^{182}\) N. Horn, (1985), supra note 180, 30.
\(^{183}\) Ibid.
Finally, parties should consider the outcome of an unsuccessful renegotiation before they leave the renegotiation table. There are two main outcomes of renegotiation. The first is that the parties agree to modify the original agreement. In this case, there is no problem. The second is that parties fail to reach an agreement. In this case, several possible options may arise. In the case of unsuccessful renegotiation, if the contract does not specify a different outcome, then in theory, the contract should stay as it is. Failing to agree at renegotiations may result in an impasse. Due of this, parties may suspend operations or terminate the contract or use general dispute settlement methods. The renegotiation can be used as a kind of framework for a win-win resolution. The amendments of contractual terms should be agreed between the parties and not imposed by the host government. Indeed, a new deal might be possible if the investment has been economically favourable to the investor and especially if the host country is offering new investment opportunities. As explained earlier, there is a discussion over whether the function of the renegotiation clause is ‘agreement to agree’ or ‘agreement to negotiate’. If we accept it as ‘agreement to negotiate’ in that case, “the parties not being bound in principle by anything other than an obligation to use reasonable endeavours (to negotiate in good faith) and not to achieve a particular result (to reach an agreement), there is the real risk in effect that the lack of good will of the party unaffected by the change of governing law could suffice to paralyse any adjustment of it”.

Generally speaking, the aim of the parties when they insert a renegotiation clause in an investment agreement is to support the obligation to negotiate, not a commitment to agree to new terms.

### 6.3.5. Failure of Renegotiation Process

Over the renegotiation of international transactions parties may not reach agreement to adapt the contract. In this case, it is important to know what will happen to the agreement. Will the contract be terminated and what is the obligation of the parties? Are they under commitment to reach agreement by insertion of the renegotiation clause into the contract? Can a third party intervene and adapt the agreement? Under national and international laws contracting parties do not have a duty to reach agreement and such laws do not impose liability on them. According to the unanimous international opinion, the duty in such clauses is one of best efforts to reach an agreement. Accordingly, parties must do their best to pursue successful negotiation in good faith.

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184 Ibid.
but they are not required to reach an agreement. Therefore, the duty to renegotiate could still be fulfilled even if the parties do not reach an agreement. However, the party’s refusal to agree should be based on ‘normal commercial judgement’. 

If the renegotiations were conducted in good faith and both parties have observed their obligations during the renegotiation process and the renegotiation fails, the logical consequence of failed renegotiations is that the contract will stay as it is. Under the principle of pacta sunt servanda parties are bound to fulfil their contractual obligations as has been agreed. If a party does not fulfil the contractual obligations then it is in breach of the agreement and this will give rise to compensation.

If the parties fail to reach an agreement and they do not pursue to continue their contractual relationship as it was, there are basically two types of sanctions: (i) suspension or termination of the contract; (ii) third party intervention. Regarding the first scenario, it is normally discussed in studies on hardship clauses. This sanction is not appropriate in long-term investment agreements such as petroleum contracts, where the respective interests of the parties require that they reach agreement. This is because the success of the petroleum project is crucial for the host country’s economy and also involves considerable benefit for the foreign oil company.

With respect to the second scenario, an expert or a panel of experts could be asked to issue a decision as to the failure of the parties to reach agreement and adjust the contract. The third party examines the applicable law and the renegotiation clause which determines the extent of his power and contract change. I will discuss the third party intervention in more detail, in the following chapter.

Finally, in light of the above, the researcher suggests the following renegotiation clause as a good model for drafting such clauses:

“The rights and interests accruing to Contractor (or its assignees) under this Agreement and its Sub-contractors under this Agreement shall not be amended, modified or reduced without the prior consent of Contractor. In the event that any Government authority invokes any present or future law, treaty, intergovernmental agreement, decree or administrative order which contravenes the provisions of this Agreement or adversely or positively affects the rights or interests of Contractor hereunder, including, but not limited to, any changes in tax legislation, regulations, or administrative practice, or jurisdictional changes pertaining to the Contract Area, the terms of this Agreement shall be adjusted to re-establish the economic equilibrium of the

190 K. Berger, (2003), supra note 61, 1368.
194 Ibid.
Parties, and if the rights or interests of the Contractor have been adversely affected, then the State entity shall indemnify the Contractor (and its assignees) for any disbenefit, deterioration in economic circumstances, loss or damages that ensue therefrom.”

6.4. The Contribution of International Petroleum Arbitral Practice to the Notion of Renegotiation

A number of international petroleum arbitrations have dealt with the question of renegotiation. Although the arbitral practice concerning renegotiation is not plentiful, its holdings are consistent and conclusive. This section, in line with the pattern followed so far, will attempt to examine how the concept of renegotiation has been articulated by international arbitral practice relating to the petroleum industry. International petroleum contracts need to be flexible to maintain economic viability and parties for this purpose should employ renegotiation clauses. Renegotiation provisions could adapt the contract to the changed context and guarantee to maintain the contractual equilibrium. Indeed, a renegotiation clause will “authorise changes in contracts upon the occurrence of certain events through renegotiation of the contract. The event must not only occur but it must disturb the balance of the agreement to the extent that renegotiation is necessary in the interests of fairness, equity and balance of obligation”.

Parties may employ different types of renegotiation clauses which are most suitable for their business relationship. Therefore, the wording of a clause is of great significance. Such clauses could restore economic balance which is normally used alongside the stabilisation clause. These clauses are aimed at contractual flexibility and providing a dynamic legal framework for the performance of the project. A renegotiation clause may require adaptation in the occurrence of certain events or after a period of time has lapsed. Stabilisation clauses aim to preserve the original contract and keep it unchanged over the business relationship of the parties. This clause may serve as a guarantee to protect contractual obligations against changes. A renegotiation clause intends to keep the contract dynamic and quite flexible against changed context. One question might be posed whether they can be used in the same contract. It seems that those clauses have coexistence. Indeed, the main objective of a renegotiation clause is protection against unilateral change and termination by flexibilisation of contractual arrangements, not by freezing provisions, to maintain economic balance. Although, the traditional stabilisation clause is used to freeze the legal and fiscal arrangements, a modern version of the stabilisation clause requires that

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where the new legislation is against the original investment agreement, then it may not be applied to the contract. 198 This will be discussed in greater detail in the next section.

6.4.1. Coexistence of Stabilisation and Renegotiation Clauses in the Same Contract?

Stabilisation clauses are aimed to keep the original agreement throughout the lifespan of the investment contract. 199 Accordingly, parties should not change the original contractual terms without mutual agreement. In contrast, renegotiation clauses are intended to keep the contractual relationship alive rather than the original contractual conditions. 200 Renegotiation clauses are intended to bring the parties together whenever the contractual balance is disrupted in order to re-establish the equilibrium between contracting parties. 201 Thus, the objectives of each clause is different. The relevant question here is that ‘can a stabilisation and a renegotiation clause coexist in the same contract even though their objectives are different?’ According to the literature, such clauses may stand together. It should be realised that the protection of the legitimate expectation of a foreign investor in a manner that stabilises the contractual relationship through the mechanism of stabilisation clauses represents only half of the reality. This is especially true in an industry as volatile as oil and gas. 202

The use of a renegotiation mechanism in an international investment contract may contribute to transactional stability sought by the foreign party. 203 In light of the fact that the effectiveness of stabilisation clauses may be doubtful, renegotiation clauses in contrast may offer protection against unilateral revocation or modification by the state. Under a renegotiation clause, a host state binds itself to renegotiate the contract in case of supervening circumstances instead of altering the contractual terms or its termination. Thus, the aim of such clauses is to protect the company not by freezing the contractual regulation, but conversely by making the agreement flexible and amendable throughout its duration, in case the economic circumstances of the agreement change by a sovereign act. 204 As explained in previous chapters, the objective of traditional stabilisation clauses is to freeze the applicable law, the fiscal regime and/or other important investment conditions. 205 In light of the objective, the host government is contractually prohibited from enacting legislation or regulation that is not consistent with the original investment contract. 206 The traditional approach is in direct conflict with the principle of state

200 Ibid.
201 Ibid.
203 J. Salacuse, (2001), supra note 89, 1510.
204 K. Berger, (2003), supra note 61, 1347.
206 Ibid.
sovereignty. As discussed earlier, according to international law host states have full control and power to regulate within the territory.

International companies and contract drafters realised that traditional stabilisation clauses may not be sufficient to prevent a state’s unilateral intervention. It appeared that it was crucial to develop a new clause. Due to this, contract drafters have introduced a new approach, particularly in contracts relating to natural resources investment.207 This illustrates “the ingenuity of negotiators squeezed between political risk on one side and national sovereignty on the other”.208 For a better legal appraisal of renegotiation or stabilisation clauses, there should be a harmonious reconciliation of the principle of pacta sunt servanda and rebus sic stantibus.209 It could be provided by modern renegotiation clauses. Such clauses are a hybrid provision that is a combination of a stabilisation clause with a renegotiation provision.210 The aim of such clauses is to re-establish the ‘economic equilibrium’ in investment agreements. These clauses provide certainty and flexibility together.

Baku-Tbilisi-Ceyhan Host Government Agreements (BTC HGAs) defined the ‘economic equilibrium’ as follows:

“‘Economic Equilibrium’ means the economic value to the Project Participants of the relative balance established under the Project Agreements at the applicable date between the rights, interests, exemptions, privileges, protections and other similar benefits provided or granted to such person and the concomitant burdens, costs, obligations, restrictions, conditions, and limitations agreed to be borne by such person”211

The concept of equilibrium is discussed and explained in great detail in chapter two. According to the equilibrium provisions, the occurrence of unilateral government intervention in the contractual regime results in an adaptation of the contract to restore its original equilibrium.212 In particular, in the event of unilateral government intervention, the contractual parties are under the duty to renegotiate in good faith in order to re-establish the original economic balance.213 Consequently, the modern renegotiation clauses obligate each contracting party to renegotiate. Such clauses do not challenge the sovereignty of the host government, and thus petroleum

209 Ibid.
contracts benefit from it. These clauses provide such a significant function that is to “reconcile the needs of the government and the investor by ensuring stability and flexibility through the adaptation of the petroleum contract to a change in circumstance, while at the time maintaining the economic equilibrium of the project”.  

I will now turn to the arbitral practice. The AMINOIL case is the first petroleum arbitration which addressed renegotiation. In 1974, the oil producing countries in the Middle East decided to increase their profits. Later on the OPEC announced that average government take from the operating petroleum companies would be set at $10.12 per barrel from 1 January 1975. AMINOIL was a major operating oil company and following this development requested renegotiation. The renegotiation by Kuwaiti government took place but the parties were unable to reach agreement. Then, the host state unilaterally terminated the concession contract and offered compensation. The parties referred the dispute to arbitration. The tribunal in examination of legal issues addressed clause 9 of the supplementary agreement 1961, providing consultation between the host government and AMINOIL when benefits are increased. The tribunal held that “An obligation to negotiate is not an obligation to agree. Yet the obligation to negotiate is not devoid of content, and when it exists within a well-defined juridical framework it can well involve fairly precise requirements”. Further, the tribunal added that such obligation may include certain requirements which a party ought to observe to fulfil its obligation. The tribunal found that “the general principles that ought to be observed in carrying out an obligation to negotiate, that is to say, good faith as properly to be understood” are sustained upkeep of the renegotiations over a period appropriate to the circumstances; awareness of the interests of the other party; and a preserving quest for an acceptable compromise. The tribunal held this view as to the failed renegotiation that if failure of the renegotiation could be attributed to the conduct of one party, it would be breach of contract and bring about legal responsibility.

In Mobil Oil Iran, Inc. v. Iran, the concept of renegotiation was discussed. In this case, Mobil oil and other members of the consortium entered into a Sale and Purchase Agreement (SPA) in 1973. This agreement was terminated and replaced the agreement of 1954. Mobil oil and members

216 The Arbitral Tribunal has found that three constituents may be drawn from Clause 9. First, it institutes a procedure for consultation that is more a matter of negotiation. Second, this gives rise to the right to claim the initiation and pursuit of negotiation. Third, Article 9 provides details of agreement to be reached that “had to have some noteworthy characteristics, - the agreement has to introduce, in favour of the government, changes in the previous provisions of the concession, and yet remain ‘equitable to the parties’”. AMINOIL, (1982) 21 ILM 1002-1003, para 15-24.
218 Ibid, para 70.
220 16 Iran-US Claims Tribunal 3, Award of 14 July 1987, Award No. 311-74/76/81/150-3
of consortium (claimants) alleged that Iran and the National Iranian Oil Company (NIOC) repudiated the SPA and expropriated the claimants’ contractual rights by a letter of the managing director of NIOC, dated 10 March 1979. The respondent claimed that force majeure conditions are long-time persisted and frustrated the contract by changed circumstances. It caused the termination of the agreement. Chamber three of the tribunal did not find that the SPA was terminated by way of frustration, repudiation or expropriation. The tribunal added that the parties agreed in March 1979 not to revive the agreement, then suspended by force majeure and to negotiate in view of formally terminating it and settling the issues arising from its termination. Such an agreement was subject to three main conditions spelled out in the exchange of letters of 10 and 23 March 1979. First, that NIOC would treat the consortium member companies as its prime customer under equal terms and conditions. Second, that NIOC would take over all contracts and obligations entered into by Oil Services Company of Iran (OSCO) and Iranian Oil Services Ltd. (IROS). Third, that any claims of either party would be settled through negotiations. The arbitral tribunal found at that time the SPA was suspended by force majeure and the parties agreed to terminate the SPA and renegotiate. Nevertheless, renegotiation was interrupted and never completed as a result of revolution in Iran. The tribunal examined the issue and set the rules when the arbitrators consider the legitimate expectations as to a renegotiation in good faith and restoring contractual arrangements.

The tribunal held that “The tribunal has to take into account all the relevant factual and legal circumstances of the base. Of primary concern, obviously, are the duties and obligations of both parties under the SPA and all related agreements. The agreement must be construed, not only pursuant to its initial terms, but also as to the manner in which it was performed and de facto or de jure amended during its life, up to the time it was suspended by force majeure. Each party’s record in performing the agreement so defined during the same period constitutes a second set of determinative circumstance. Finally, all such obligations, as they could be observed or foreseen at the time of March 1979 are also relevant”.

The above citation shows that the tribunal carefully examined the original contractual terms. Also, it would be used to assess the legitimate expectations of the parties to set the guideline for the tribunal to re-establish the equilibrium between the contracting parties. Further, the tribunal added that “since the tribunal, however, must assess the legitimate expectations of the parties in the negotiations initiated pursuant to the March 1979 agreement, it would be difficult indeed to consider issues which the parties had not raised in the negotiations. The fact that a party refrained from raising a specific issue in the negotiations is a strong assumption, indeed, that this party did

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221 Mobil v. Iran, 16 Iran-US Claims Tribunal 3, 54-55, para 159.
222 16 Iran-US Claims Tribunal 3, 54-55, para 161.
not expect to obtain anything on such issue”. Therefore, in assessment of legitimate expectation of the parties and deciding on restoring the balance of economic interests between the parties the contractual framework of the business relationship between the parties is important. Examination of international arbitral awards shows that parties are required to seriously engage in renegotiations with a view to reach agreement. They have a duty to renegotiate in good faith but it does not imply that parties are required to reach agreement. In addition, over the renegotiation process parties shall be flexible and understand interests of the other party to reach a reasonable solution.

Another case is *Wintershall AG et al. v. Government of Qatar.* The dispute arose out of an Exploration and Production Sharing Agreement (EPSA) entered into on 10 April 1976 between Wintershall and four other companies and the government of Qatar in substitution of an earlier concession agreement. Under this contract the government of Qatar granted the exclusive right to explore for, drill for and produce petroleum in a defined area offshore of Qatar, ‘the contract area’ to Wintershall consortium. The duration of contract was 30 years from the effective date of EPSA, 18 June 1973. (Article I of the EPSA). Under Article XI of the EPSA the claimants (Wintershall) were required to relinquish 50% of the contract area after five years but could continue to exploit the remaining 50% for a further three years. The claimants were required to relinquish an additional 20% of the contract area after eight years, leaving them with only 30% of the original area.

Furthermore, according to Article XXXV of the contract if the Wintershall consortium within eight years had not discovered crude oil in commercial quantities or economically utilisable non-associated natural gas then the government of Qatar was entitled to terminate the EPSA. If non-associated natural gas were discovered the Wintershall consortium was entitled to produce it either pursuant to the further contractual arrangements to be mutually agreed by claimants and the respondent or pursuant to the principles specified in Article XV.3 of the EPSA. The Wintershall consortium (claimants) were not able to discover crude oil in commercial quantities. However, because of a boundary dispute with Bahrain, the government of Qatar never permitted the claimant to drill in the area, identified as ‘Structure A’ that was regarded by the claimants as most likely to contain crude oil. The claimant relinquished 50% of the contract area and by letter of 3 April 1980.

Wintershall advised the respondent that they had discovered non-associated natural gas in substantial quantities in the contract area and they considered the utilisation of such gas to be

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223 16 Iran-US Claims Tribunal 3, 55, para 162.
224 16 Iran-US Claims Tribunal 3, 54, para 161; AMINOIL 21 ILM (1982) 976, 1014, para 70.
225 AMINOIL, (1982) 21 ILM 976, 1014, para 70.
The parties considered several projects for the utilisation of non-associated natural gas in the contract area and an adjacent area in which the petroleum rights were held by the Qatar General Petroleum Corporation, a corporation wholly owned by the government of Qatar. Parties continued renegotiation but could not reach agreement. The claimant alleged that the government of Qatar had breached EPSA and expropriated the claimant’s contractual rights and economic interests under the EPSA by denying claimants permission to explore for petroleum in the structure (A) area and by failing to agree with the claimant on further contractual arrangements for utilisation of the non-associated natural gas discovered by the claimant.

The arbitral tribunal decided that Qatar (the respondent) neither breached the EPSA, nor expropriated contractual rights and economic interests of Wintershall. In addition, the tribunal added that Qatar had not had a legal duty to accept proposals from Wintershall consortium as to the utilisation of the area. Furthermore, the tribunal observed that the claimant’s proposals as to the joint development were no more than offers and their acceptance was not obligatory for the respondent. Then, the tribunal examined whether under the duty to renegotiate in good faith the government of Qatar was required to accept further contractual arrangements for the development of natural gas found in the contract area. The tribunal endorsed this argument that there was such a duty to renegotiate in good faith but it does not contain an obligation for the respondent to reach agreement with respect to the proposals made by the claimant. The tribunal added that the refusal by the respondent to accept the claimant’s proposal was made in good faith and was justified under normal commercial practice. According to the view taken by the tribunal if the claimant had made a technically sound proposal falling within the meaning of normal commercial practice the tribunal would have awarded that the respondent had breached the duty to renegotiate in good faith.

6.5. Conclusion

This chapter has found that renegotiation of contracts contributes to the stability of international petroleum contracts, and does to some extent deal with the instability to which they are vulnerable. Contractual certainty and flexibility are important in international investment agreements. The necessity and importance of a certain degree of contractual flexibility to cope with the obsolescing bargain in an overall stable framework is discussed. In fact, “the stability of contracts must not be destroyed, but a necessary flexibility of contracts must be assured”. Parties should, therefore,

incorporate the renegotiation clause into international petroleum contracts to be able to maintain the equilibrium where surrounding circumstances changed.

Such clauses can, in principle, maintain the economic viability of the contract and adapt it to changes, letting parties continue their contractual performance. Contractual adjustment keeps the contract dynamic and reduces the chance of raising disputes and unilateral action by host governments. Modern renegotiation clauses may reduce the risk of unilateral change of contractual terms and indirect expropriation.\textsuperscript{232} This concept “according to which parties are under an obligation to mutually agree on the re-adjustment of their contractual relationship whenever it becomes necessary, provides another extremely useful tool for conflict avoidance”.\textsuperscript{233} They have benefits for both the host states and international investors in times of economic recession or price volatility. In relation to adjustment when parties formulate renegotiation provisions they are required to clearly determine starting points, renegotiation process and the extent of contract change through the renegotiation procedure.

However, it has been shown that renegotiation clauses cannot adequately deal with the disruption of equilibrium. According to renegotiation clauses, the only duty is that parties must do their best for a successful renegotiation in good faith. As a result, once the parties have made their best effort they will have no further obligation. The renegotiation process ends here and it does not restore a disrupted equilibrium. Whilst such clauses are, therefore, a promising attempt, they are not enough. The international petroleum agreement need a binding mechanism which is capable of restoring a disrupted equilibrium even when the parties cannot reach an agreement to salvage the relationship. Thus, the next chapter looks at a binding mechanism through which parties seek to maintain their relationship where the equilibrium is disrupted.

To sum up, a renegotiation clause is aimed to provide the parties with contractual flexibility and a certain degree of stability for performance of contractual commitments over their relationship. However, due to its inadequacy in restoring the equilibrium, the adjustment mechanism needs enhancement. I will thus discuss this mechanism in the next chapter.

Chapter 7

The Contractual Flexibility and the Need for an Adaptive Mechanism for Maintaining the Equilibrium of the Contract

Introduction

This thesis has thus far examined stabilisation and renegotiation clauses, as well as expropriation and how well they can function to preserve the contractual equilibrium. As this discussion has indicated, the key challenge is therefore, maintaining the equilibrium which current law and mechanisms are unable to preserve, in order to protect the interests of both parties. Against this background, this chapter is looking at the core question of a balance between pacta sunt servanda – representing stability – and rebus sic stantibus – representing flexibility – and a binding mechanism to give effect to that balance. The existing mechanisms have not worked to strike the

Introduction

7.1. The Concept of Renegotiation and Obsolescing Bargain

7.2. Transactional Stability & Contractual Flexibility: Pacta Sunt Servanda & Rebus Sic Stantibus in International Petroleum Transactions

7.3. The Adjustment of International Petroleum Agreements without Renegotiation

7.3.1. Civil Law

7.3.2. Common Law

7.3.3. The Position of International Law

7.3.4. Force Majeure, Hardship Clauses and International Petroleum Contracts

7.4. The Thesis Proposal: Mandatory Adjustment by the Third Party

7.4.1. The Content and the Procedure for Third Party Mechanism: Model Clause

7.4.1.1. Essential Elements of an Expert Clause: Some Principles

7.4.1.2. Is there any Restriction on the Types of Disputes Referred to ED?

7.4.1.3. Jurisdiction

7.4.1.4. The Qualifications of the Expert Tribunal

7.4.1.5. The Requirement for Joint Applications

7.4.1.6. Criteria for the Experts’ Suitability

7.4.1.7. The Final and Binding Decision: The Procedure

7.4.1.8. Expert Determination in Practice: Advantages, Disadvantages, Remarks and Additional Examples

7.5. Conclusion

7.1. The Concept of Renegotiation and Obsolescing Bargain

7.2. Transactional Stability & Contractual Flexibility: Pacta Sunt Servanda & Rebus Sic Stantibus in International Petroleum Transactions

7.3. The Adjustment of International Petroleum Agreements without Renegotiation

7.3.1. Civil Law

7.3.2. Common Law

7.3.3. The Position of International Law

7.3.4. Force Majeure, Hardship Clauses and International Petroleum Contracts

7.4. The Thesis Proposal: Mandatory Adjustment by the Third Party

7.4.1. The Content and the Procedure for Third Party Mechanism: Model Clause

7.4.1.1. Essential Elements of an Expert Clause: Some Principles

7.4.1.2. Is there any Restriction on the Types of Disputes Referred to ED?

7.4.1.3. Jurisdiction

7.4.1.4. The Qualifications of the Expert Tribunal

7.4.1.5. The Requirement for Joint Applications

7.4.1.6. Criteria for the Experts’ Suitability

7.4.1.7. The Final and Binding Decision: The Procedure

7.4.1.8. Expert Determination in Practice: Advantages, Disadvantages, Remarks and Additional Examples

7.5. Conclusion

Introduction

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balance. I will look at what the problem is and attempt to come up with an adaptive mechanism which has roots in existing practice but which could be better structured.

In this chapter, I will explore a mechanism which is new in the context of petroleum contracts, namely, *mandatory* adjustment. I will suggest a completely different and innovative approach which does not exist at all. In the petroleum industry parties currently may use a mechanism such as expert determination to resolve their disputes. Nevertheless, the mechanism suggested by this thesis has two phases, is mandatory and works as a single package. The thesis proposal is a two-tier mechanism. Once contracting parties have attempted to rebalance the damaged equilibrium by virtue of a renegotiation clause, if they were not able to reach agreement the second stage is initiated. In this case, after a failed renegotiation the thesis suggests that the contract refers the matter to the third party in order to adapt the contract with the new circumstances. This mechanism as an integrated package provides mandatory adjustment by a third party that would be final and binding for the contracting parties. The proposed mechanism works under the framework of the relational model which recognises the dynamic relational aspect of contracts. The third party for adaptation of the contract does not need any further consent as the parties have agreed to a two-tier mandatory mechanism. This mechanism would benefit from the concept of ‘expert determination’ in the second phase of the approach.

This mechanism is not a panacea. The present chapter discussed in great detail the proposed mechanism and addressed its potential problems. Nevertheless, it does a better job of addressing these problems which have been identified than the existing law does. The problems which the suggested mechanism is aimed at dealing with are: (i) obsolescing character of bargain, (ii) disruption of contractual equilibrium and, (iii) strictness and rigidity of the contract as only a set of rights and duties. This will seek to provide a mandatory solution which is grounded in a relational understanding to keep the parties’ interests in balance and the contractual relationship evolving. The lack of legitimacy and sufficient expertise of the third party are the potential vulnerabilities that this mechanism could have. I will turn to this discussion later in the chapter.

This chapter examines the rebus sic stantibus doctrine, the possibility of adjustment of international petroleum contracts in the absence of a renegotiation clause, the position of major legal systems of the world and international law, adaptation through force majeure and hardship clauses and the idea of mandatory adjustment. The effectiveness of renegotiation clauses, the relation between the principle of pacta sunt servanda and rebus sic stantibus. As well as the extent to which parties can expect adaptation through renegotiation by examination of renegotiation theory in scholarly literature will be discussed.

The chapter also picks up the following questions: What is mandatory adjustment capable of doing, and what are its limits? Having discussed the underlying factors causing the disruption of
the equilibrium, is this an appropriate mechanism for oil and gas contracts? What sort of panel or tribunal will we need to deal with the task of adjustment?

In a long-term relationship, circumstances can change and significantly alter expectations of the parties. It can make performance of the agreement onerous or partially or completely impossible. In this situation, the contract should be adjusted according to the parties’ intention to ensure continuation of the relationship. I have already examined the idea of presentiation, static model of relationship and its failure in long-term contracts in chapter two. In long-term agreements parties have limited ability to anticipate all the events in the future and thus cannot foresee contingencies in the contract. The existence of a mechanism, therefore, which adapts rights and obligations of the parties over time, is necessary. This chapter proposes an adaptive contractual mechanism in order to maintain the contract equilibrium. In a relational model, a long-term agreement is a preliminary source of the relationship which is subject of continuing adaptation of the parties’ relationship.

Contractual flexibility of the relationship is implicit terms of the contract. In addition, in a long-term relation obsolescing bargain takes place and as a result the bargaining position of the parties may change. Consequently, the host state may interfere with the agreement which creates risk of expropriation. Thus, the renegotiation process can maintain the viability of the contractual relationship. The necessity of contractual flexibility in long-term agreements is reflected by mutual interests of the parties and commercial necessity. This thesis proposes that renegotiation should be made even in the absence of a clause. This is foreseen by the United Nations Draft Code of Conduct on Transnational Corporations adopted in 1986 which requires:

“Contracts between Government and transnational corporation should be negotiated and implemented in good faith. In such contracts, especially long-term ones, revision or renegotiation clauses should normally be included. In the absence of such clauses and where there has been a fundamental change of the circumstances on which the contract was based, TNCs, acting in good faith, shall/should cooperate with Governments for review or renegotiation of such contracts”.

The current chapter also continues the discussion from chapter four and distinguishes between two different frameworks of breach and adaptation. The chapter explores the need for an adaptive mechanism rather than simply a better law of expropriation. The reason is that there are many

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circumstances where adaptation is a better remedy than termination. A major issue with the law currently is that it drives in the direction of discharge – to put an end to the contract - without sufficiently considering adaptation in order to maintain the relationship of the contract. Renegotiation clauses seek to provide contractual flexibility and adjustment. However, as we have seen they have a very limited effect. Such clauses can work where the parties do their best in good faith and do not require the parties to reach agreement. Thus, once the parties have tried to find a solution they have no further obligation. This is based on cooperation of the parties.

7.1. The Concept of Renegotiation and Obsolescing Bargain

Petroleum contracts are very vulnerable to disruption because the original bargain would become obsolete over time. Given the power of the state, there is not much to restrain the power to make the bargain obsolete. As this thesis has argued, part of the reason is that the relational character of the parties’ transaction is not fully recognised. The legal framework of the contracted is grounded in a presentiated understanding of the contract. In the legal view, everything for which the parties wish to provide should be foreseen and incorporated into the contract; the consequence is that all situations, whether foreseen or unforeseen, are dealt with through the contractual framework and through legal rules which assume the basic adequacy of the contractual framework.

The result is that the contract is governed by a framework which is static and cannot dynamically deal with changes. This classical model of contracting thus reinforces the obsolescing character of the bargain. The law of expropriation is based on a static understating of contract. Once the bargain becomes obsolete, the law does not do anything to prevent the obsolescence, because of its presentiated understanding of contracting and only permitting discharge. The contract is not a dynamic instrument, and adaptation will not therefore take place through the law, nor will the law actively encourage the adaptation of the contract. The presentiated bargain has become obsolete, and the law’s efforts will therefore be directed towards providing compensation for the loss of the bargain.

The alternative approach, on which the relational contract theory is premised, is based on the idea of the contract as creating equilibrium, rather than a static framework. The contractual equilibrium is dynamic and hence exhibits resilience in the face of changing circumstances. The parties’ contract is seen as creating a framework for such adaptation, rather than being a fully presentiated instrument. In principle, stabilisation and renegotiation clauses can accommodate such a dynamic approach for contracting. They could be able to avoid getting stuck to presentation of the contract. However, as it is shown, stabilisation and renegotiation clauses in practice have a limited effect where there is not a cooperative behaviour between the parties.
Renegotiation clauses only require the parties to do their best to find a solution and do not require
the parties to reach an agreement. Once the parties have tried to reach an agreement in good faith,
they have no further obligation. Thus, they cannot adequately deal with erosion of the equilibrium.

7.2. Transactional Stability & Contractual Flexibility: Pacta Sunt Servanda & Rebus Sic Stantibus in International Petroleum Transactions

The role of stability in international petroleum transactions is crucial. International oil companies
are aware that host governments through different methods may control the business venture.
Therefore, international oil companies seek a reasonable degree of certainty with regards to the
financial and regulatory regime.3 The balance between transactional stability and flexibility
through adaptation is necessary. Renegotiation clauses are one type of adaptation but we need a
form of adaptation that has the certainty of pacta sunt servanda - which renegotiation clauses do
not have - and flexibility of renegotiation clauses.

International petroleum agreements usually contain the stabilisation clause to restrict the
regulatory power of the host state to unilaterally change or terminate the contract.4 However,
certain questions arise here for consideration. What is the necessity to have a mechanism for
adjustment and what types of benefits could it bring to the agreement? As discussed in the
previous chapters, stabilisation clauses are used to provide a stable framework for operating the
business venture and obtaining certainty from the host state and public agency. However, such
clauses cannot always grant the international oil company adequate protection. Sometimes, host
states use their power to modify contractual equilibrium in their own interest as the guardian of
the public interest. In addition, stabilisation clauses may be in conflict with the host government’s
sovereignty.5 Thus, the use of stabilisation clauses might be problematic in long-term petroleum
transactions, as such transactions contain both public and private law factors as discussed in
chapter two.6

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3 T. Waelde, “Revision of Transnational Investment Agreements in the Natural Resources Sector”, (1978)
10 Law. Of Am. (currently University of Miami Inter-American Law Review) 265; T. Waelde and G. Ndi,
“Stabilising International Investment Commitments: International Law Versus Contract Interpretation”,
the Relevance of a Multilateral Investment Guarantee Scheme”, (1987), 21 Int’l Law, 671; T. Waelde,
4 C. Wallace, The Multinational Enterprise and Legal Control: Host State Sovereignty in an Era of
“Renegotiation and Contract Adaptation in International Investment Projects” (2000) 1 J. World Inv. &
in the Arbitration Process”, (1986) 1 ICSID Rev. FILJ 257, 262-3; A. Redfern and M. Hunter, Law and
Somarajah, The Pursuit of Nationalised Property, (Dordrecht, Lancaster, Nijhoff, 1986) 3-51; P.
6 A. Maniruzzaman, “The New Generation of Energy and Natural Resources Development Agreements:
The problem arises where the state gives supremacy over the contractual commitments created under the petroleum contract and seeks to alter the agreement. It is said that in the exercise of sovereign power if the government breaches the contract it does not automatically give rise to liability. Nonetheless, according to another point of view taken by some scholars, breach of state contract in exercise of sovereignty per se will result in state liability. The legal protection of the agreement from unilateral change by the host state is not completely satisfactory and in some occasions its effectiveness is doubtful. Thus, the foreign investor seeks to improve the contractual protection by other contractual devices.

International petroleum contracts cover a very long duration for exploration and production phases. Therefore, they require the commitment of huge capital which considerably increases associated risks and makes the petroleum industry volatile. Foreign oil companies make a risk-reward assessment as to the regulatory and fiscal regime of the host country to decide whether or not to commit their capital. The foreign investor considers the petroleum project based on the legitimate expectations about rate of return, taxation and labour costs and other financial charges in the host country. International petroleum contracts are exposed to future events for a long time, the impact of which on the agreement is not easy to be predicted. The weaknesses of stabilisation clauses discussed in Chapter five reflect the fact that an emphasis on preserving the terms of the bargain (rather than the underlying equilibrium) cannot guarantee the viability of the contract.

As discussed earlier, petroleum contracts are not isolated and discrete. They are a type of relational agreement and cannot be presented. Therefore, any changes in the industry will have an impact on the economics of the project. When considerable changes in the original expectation of the parties takes place, such fundamental changes will affect the financial return for the parties. Under such circumstances parties seek to revise the contractual arrangement. These issues thus highlight the role of adaptability. Some commentators assert that “it is idle to freeze the position of the parties for long periods to conditions that become so out of date. Either parties will include renegotiation provisions in their contracts or they will act as if they were there”. Furthermore, in long-term investment agreements the pressure for change is high and host governments either in developing or developed countries may seek renegotiation even where applicable law or the
contract do not provide a ground for such renegotiation. The host government may improve environmental regulations by setting new regulations. This legitimate right for enhancement of environmental standards by national or international standards is one of the foreign oil company’s concerns. Compliance with enhanced regulation and new environmental standards will increase costs for the foreign investor. As a result, the economic viability of the business project may require an adjustment. Renegotiation will serve as a device for adapting the agreement and reducing the risk of dispute and confrontation.

When the host state and the foreign oil company conclude an agreement the extent and future prices of petroleum are usually unknown. Hence, if the parties have a flexible approach on agreement they can later adapt the contract to the changed political, economic, commercial situations. Indeed, insertion of adaptation provisions in the petroleum contract will contribute to transactional stability. If the efficacy of the stabilisation clause is doubtful, an adaptation mechanism may provide protection against unilateral modification or termination of the agreement. It has been stated that “a major source of conflict between host governments of developing countries and transnational corporations derives from the preoccupation of transnational corporations with stability and predictability in contractual relations on the one hand, and the demand of host governments for a more flexible contractual regime on the other”. In fact, the host government under the adaptation mechanism binds itself not to unilaterally alter or revoke the contract in case of changed circumstances and to adjust the agreement. Therefore, unlike the existing law which can only offer renegotiation and stabilisation clauses which provides certainty by freezing contractual regulation, the adjustment mechanism protects the contract by flexibilisation contractual arrangements throughout the duration of the contract against unilateral alteration by a sovereign act. The contractual adjustment is thus more in line with the nature of

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private law governing the contractual relationship between the parties. It will therefore result in compensation to restore the contractual equilibrium where alteration of regulations and laws disturb the equilibrium.19

Where adjustment is sought, the reluctant party may invoke the principle of pacta sunt servanda or sanctity of contract requiring that agreement of the parties to a contract must be observed.20 On the other hand, the seeking party can invoke the principle of rebus sic stantibus or changed circumstances for initiating adaptation.21 However, as discussed in detail in chapters two and five, the principle of sanctity of contract is not absolute.22 It is grounded in classical contract theory of freedom of contract.23 According to this theory, contract is made of free will of the parties.24 It is stated that “this principle of free contract, which was the legal encapsulation of laissez-faire and the mainstay of industrialisation, worked on the basis that everyone had complete freedom of choice in determining who they would contract with, on what terms, and that oppressive bargains could be avoided by simply finding someone else to make the bargain with”.25 For the strict application of this principle to the short-term contracts and to the agreements equal contractual parties might be suitable.26

This principle is widely recognised as a general principle of law.27 However, the extent to which this principle might be applicable to international petroleum contracts is of great significance. The legal nature of international petroleum agreements is different from normal commercial contracts. International petroleum agreements are concluded between unequal parties who are the state or state entity and the international oil company.28 Due to the nature of international petroleum contracts which require large scale capital, technology and are complex, it might not be possible to predict and manage all possibilities at the time of contracting.29 In other words, “the parties know that during the long-term period covered by their agreement, many unforeseen political, economic, regulatory and technical circumstances may arise to drastically change the balance of

28 A. Maniruzzaman, (1992), supra note 22, 141.
benefits from the project that the parties contemplated at the time that they signed the project agreement". 30 Therefore, it seems that insisting on the original contractual arrangement and reliance on the principle of sanctity of contract does not lead to a fair outcome. 31 Capital exporting countries argue that international investment agreements and international treaties are in the same category and therefore they will be subject to the principle of pacta sunt servanda. 32

However, it is very difficult to support this argument. It is noted that “one important fact that in case of treaties between sovereign states, there is a mutual surrender of sovereignty does not exist in case of investment agreement”. 33 According to this argument, the legal consequence is that the host state cannot change or terminate the agreements made with foreigners. 34 Hence, the legal consequence of this argument that international investment contracts and international agreements are the same is that governments cannot exercise sovereign power because it is widely agreed that treaties “cannot be impaired by unilateral decisions”. 35

As discussed in previous chapters, the principle of pacta sunt servanda is a classic theory based on the free will of the parties. However, “this extreme freedom of contract come to be abused by parties with greater bargaining power and thus provoked both legislative and judicial interventions for striking a better balance”. 36 As the will theory came to be abused by parties with greater bargaining power, it has been replaced by an ‘objective theory of contract’. The aim of the objective theory is that contracts can be modified by states or their courts on grounds of equity. 37 In recent years, host governments have intervened in contracts to regulate contractual terms by legislative and administrative means. With the role of governments in regulation of the economy, it could be fair to say that the principle of sanctity of contracts is eroded. 38 According to Professor Waelde, in natural resources, agreements made with a foreign investor, the host government due to its sovereignty could unilaterally change or terminate the contract. 39

As we have seen in the fifth chapter, the principle of permanent sovereignty over natural resources forms a part of jus cogens of international law and therefore the principle of pacta sunt servanda does not have any impact on investment agreements between a foreign investor and a host government. 40 Under the Vienna Convention on the Law of Treaties “if a new peremptory norm

37 Ibid; S. Asante, supra (1979), note 17, 402.
38 M. Somarajah, (1986), supra note 5,110; see the discussion of theories in chapter two.
of general international law emerges, any existing treaty which is in conflict with that norm becomes void and terminates”. In line with the commentators supporting the view that the principle of permanent sovereignty over natural resources forms a part of jus cogens of international law, Article 64 of the Convention has upheld that view. However, it is opposed by some international arbitration and has not been accepted as jus cogens. In addition, the arbitrator in Texaco noted such resolutions have “no binding force and carry no obligations for the Member States”.  

The United Nations General Assembly Resolution 1803 (1962) on Permanent Sovereignty over Natural Resources states “foreign investment agreements freely entered into by, or between, sovereign states shall be observed in good faith…” Thus, it does not deny that there is a rule of international law which requires that a state has the duty to respect contracts freely entered into with a foreign party. This means the rule should not be understood in the traditional sense of pacta sunt servanda. Therefore, the argument that the principle of pacta sunt servanda is overridden by the principle of permanent sovereignty over natural resources is weak. Nevertheless, it affirms that the application of the principle of pacta sunt servanda is not absolute. 

It has been argued that under no legal system (municipal or international) has the principle of pacta sunt servanda been found to be absolute. One commentator stated that “the French doctrine of improvidence, the corresponding doctrine of Wegfall der Geschäftsgrundlage in German law and the concept of good faith in other civilian systems, all provide for the revision of contracts in appropriate cases by reference to objective criteria not traceable to the will of the parties”.

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42 The Tribunal in AMOCO case observed that “the quoted rule, [however], must not be equated with the principle pacta sunt servanda often invoked by claimants in international arbitrations. To do so would suggest that sovereign states are bound by contracts with private parties exactly as they are bound by treaties with other sovereign states. This would be completely devoid of any foundation in law or equity and would go much further than any state has ever permitted in its own domestic law. In no system of law are private interests permitted to prevail over duly established public interest, making impossible actions required for the public good. Rather, private parties who contract with a government are only entitled to fair compensation when measures of public policy are implemented at the expense of their contract rights. No justification exists for a different treatment of foreign private interests. To insist on complete immunity from requirements of economic policy of the government concerned would be the most certain way to cause the repudiation of the quoted rule”. Award No. 310-56-3 of 14 July 1987, 15 Iran-US Claims Tribunal, 189, 242-3, para 178.
43 Texaco Overseas Petroleum Co. California Asiatic Oil Co. v Libyan Arab Republic, (1977) 17 ILM 1, 11-12, para 83.
45 A. Maniruzzaman, “State Contracts”, supra note 22, 143.
Furthermore, as discussed in chapter two, the classical contract theory of relationship emphasises ‘discreteness’ (a one-off transaction between the parties) and ‘presentiation’ (a detailed contract stipulating all the parties’ expectations and remedies for breach).

“A discrete contract applies more to businessmen operating locally in a stable environment. Hence, the market place paradigm applicable to a ‘one-time’, discrete transaction is not applicable to a long-term (relational) or contract which spans over 10-20 years. In such a continuous or relational contract, the signed agreement is basically viewed as a framework for future cooperation between the parties. And since the contract hardly deals exhaustively with the parties’ rights and obligations, it should be flexible enough if it is to sail through the storm and waves of the uncertain future”.

In this context, the principle of rebus sic stantibus which is generally recognised under international law provides room for amendment and adaptation of agreements where circumstances change fundamentally. Under international law, the Vienna Convention on the Law of Treaties (1969) has recognised both principles of pacta sunt servanda in Article 26 and its counterpart rebus sic stantibus (change of circumstance) in Article 62. Contracting parties to international investment contracts should understand each other’s demands in good faith. Neither the principle of sanctity of contract nor rebus sic stantibus shall be applied to all circumstances. Parties should critically weigh these equal principles towards each other. Both principles are equal and parties in case of fundamental change of circumstance should seek to adapt the contract through a renegotiation in good faith to re-establish the contractual equilibrium. This research

49 S. Asante, (1979), supra note 17, 406.
50 Article 26 of the Convention on the Law of Treaties requires “Pacta Sunt Servanda. Every treaty in force is binding upon the parties to it and must be performed by them in good faith”. Article 62 of the Convention provides that “Fundamental Change of Circumstances. 1-A Fundamental change of circumstances which has occurred with regard to those existing at the time of the conclusion of a treaty, and which was not foreseen by the parties, may not be invoked as a ground for terminating or withdrawing from the treaty unless: (a) the existence of those circumstances constituted an essential basis of the consent of the parties to be bound by the treaty; and (b) the effect of the change is radically to transform the extent of obligations still to be performed under the treaty. 2- A fundamental change of circumstance may not be invoked as a ground for terminating or withdrawing from a treaty: (a) if the treaty establishes a boundary; or (b) if the fundamental change is the result of a breach by the party invoking it either of an obligation under the treaty or of any other international obligation owed to any other party to the treaty. 3- If, under the foregoing paragraphs, a party may invoke a fundamental change of circumstances as a ground for terminating or withdrawing from a treaty it may also invoke the change as a ground for suspending the operation of the treaty”. The Convention is available at http://untreaty.un.org/ilc/texts/instruments/english/conventions/1_1_1969.pdf.
suggests concentrating upon a functional analysis of the causes of the inherent instability of these contracts.\(^{52}\)

Additionally, where the parties to the business venture come to conclude a contract from different a culture that may have completely different understandings of business transaction adjustment could be helpful.\(^{53}\) For example, Asians and Westerners have utterly different business styles. Westerners, particularly Anglo Saxons, often see “the transaction as set in the concrete of a lengthy and detailed contract, without the possibility of modification”\(^{54}\) and they might place “high value on the sanctity of a contract and on the predictability or certainty that comes from knowing exactly what commitments they have made”.\(^{55}\) In contrast, Asians view business transactions in the relationship between the contracting parties\(^{56}\) and they seek to avoid conflict to maintain a durable relationship. They “may have a less legalistic background and may view a formally negotiated agreement as merely a step in an ongoing process of accommodation and agreement seeking”.\(^{57}\) Under this culture a businessman who is a party to a contract assumes that the long-run relationship contains an implied principle for adapting and adjustment of the relationship when it undergoes fundamental changes.\(^{58}\) In this case, this thesis would say that it is wise to incorporate a renegotiation clause into the contract to narrow down the gaps between the parties to satisfy them by offering a middle ground. Indeed, a long-term contract needs cooperation and renegotiation clauses by standing in the middle between total contractual rigidity and complete relational flexibility.\(^{59}\) Therefore, a renegotiation clause does have a facilitative role in stabilising international petroleum transactions whose nature produces a high risk of instability.

I have established that the contractual equilibrium and its maintenance is the most important part of international petroleum investment agreements.\(^{60}\) International investment contracts should provide amendment and adaptation of contractual terms if the economic equilibrium of the contract is damaged.\(^{61}\) It will guarantee dynamism of the contract and maintain the agreement economically viable. The adjustment is seen as an essential part of the contractual relationship in long-term investment transactions which is indeed a mechanism for preserving relationality, overcoming the OBM, and maintaining the contractual equilibrium.

\(^{52}\) S. Asante, (1979), supra note 17, 407.
\(^{53}\) J. Salacuse, (2001), supra note 1, 1514.
\(^{54}\) Ibid, 1515.
\(^{58}\) J. Salacuse, (2001), supra note 1, 1515.
\(^{60}\) M. Sornarajah, “Supremacy”, supra note 26, 104.
\(^{61}\) Ibid, 100.
7.3. The Adjustment of International Petroleum Agreements without Renegotiation Provisions

In case of change of equilibrium of the contract and where there is no explicit mechanism for renegotiation of the agreement, it can only be made through applicable law or other contractual terms. Indeed, these may provide a triggering point for renegotiation of the agreement to adapt it to the changed circumstances. This section discusses those routes and analyses various scenarios in pursuing adjustment of the contract in the absence of an explicit mechanism.

The question of applicable law for petroleum agreements is very important because it will determine the conditions under which a contracting party is entitled to the contract change. The governing law will also frame the legal consequences of failed renegotiation and liability of the party where the failed renegotiation is attributed to a party. This section is intended to discuss whether and under which conditions a party in an international petroleum investment may find a triggering point to initiate renegotiation of contract where there is not an explicit provision by agreement. In accordance with the universally known and widely accepted principle of party autonomy the contracting parties may choose the law they presume appropriate for their contract. However, where the parties choose national law some issues such as compensation or taking over of foreign private property are subject to international law rules to determine the state liability. Parties can also choose international law to apply to their contract. In addition, the parties may choose a combined approach made of national, international law and general principles of law or sometimes with reference to practices in international petroleum transactions. These occasions may pose difficulty for arbitrators where they try to identify the applicable rules. In such circumstances “arbitrators have a natural tendency to select those principles which are international and are seen as a reflection of an international consensus, while they are likely to disregard principles of national law which are inconsistent with generally recognised principles of international law. This preference reflects the natural preference of international arbitral tribunals for internationally recognised principles”. For the aim of this chapter to identify the context of generally recognised legal principles referred to in petroleum contracts, the response of the major legal systems to the question of adaptability of long-term international investment

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64 A. Redfern & M. Hunter, (2009), supra note 5, 100; Texaco Overseas, supra note 45, 11.


contracts between a state or state entity and a foreign investor will be examined. Furthermore, adjustment of long-term international petroleum contracts under international law will be discussed.

7.3.1. Civil Law
French law is grounded in the principle of sanctity of contract and this principle has been strictly upheld by courts. Discharge from contractual commitments is restricted only to impossibility, mainly by reason of force majeure. In the traditional view, force majeure is an unpredictable, irresistible event which makes the performance of the contract impossible. Additionally, the event must not arise from either party’s fault. This is grounded in good faith and is articulated in the French Civil Code, Articles 1134 and 1135. In French case law, changed circumstances are not sufficient grounds for relief from contract performance. It is stated that “no factor of time or equity can authorise a judge to modify the positions of the parties”.

There is a very interesting point in respect of the distinction between discharge and adjustment. The point really is that in some cases it is appropriate to bring the contract to an end (discharge) because the relationship is irretrievably damaged. However, there are many cases in which the contract can be salvaged and kept alive through adjustment. The law currently does not let scholars even ask this question: should the contract be ended or is it better to adjust it and keep it alive? There is simply no way of even asking this question and there is no practical way of adjusting the contract to keep it alive. The entire law centres on the binary understanding and either goes back to the original rights and duties – requiring the parties to abide by these commitments – or brings the contract to an end and provides for compensation. Neither of these focuses on the equilibrium. In contrast, adjustment concentrates upon the equilibrium rather than the rights and duties. It asks what adjustment can be made to bring the rights and duties of the parties back into the position that keeps the contract in equilibrium. That shows the significance of this distinction. Likewise, force majeure only allows discharge, not adjustment. Imprevision allows adjustment of contracts made with the state or state entity. Thus, administrative contracts can be adjusted, even if the private contract cannot – which is not important for the purpose of the thesis at all, as all the issues which I have raised in chapter two and here in this chapter are due to the fact that the contract involves a state party on one side i.e. an administrative agreement. The thesis is not intended to discuss whether rebus sic stantibus and pacta sunt servanda should

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70 Article 1134 provides that “Agreements lawfully entered into take the place of the law for those who have made them. They may be revoked by mutual consent, or for causes authorized by law. They must be performed in good faith”. Article 1135 requires that “Agreements are binding not only as to what is therein expressed, but also as to all the consequences which equity, usage or statute give to the obligation according to its nature”. See also, N. Nassar, (1995), supra note 21, 196-8; W. Peter, (1995), supra note 12, 188.
lead to a broad power of adjustment in private contracts; it is not an issue which I will consider here at all. The thesis only considers their role in administrative contracts. French and German laws permit that and it is the reason that I examine them in this section.

French law has also developed a doctrine as to administrative contracts which are concluded with public institutions or the government. The doctrine of *imprevision* empowers the courts to revise the provisions of a contract as they might become excessive and exorbitant due to the advent of extraordinary circumstances.\(^{71}\) Under this doctrine courts may adapt the contract where the economic equilibrium by unpredictable change of circumstances is seriously disrupted (adjustment and not discharge).

The doctrine of *imprevision* applies where the economic equilibrium of the contract by an unforeseen change of circumstances – unrelated to the activity of the host government- is damaged. The Conseil d'Etat in the key case of *Gaz de Bordeaux*, stated that “the basis of imprevision in administrative contracts is the need to ensure continuity of public service” and “just as the Company cannot not argue that it should not be required to bear any increase in the price ... it would be totally excessive if it is admitted that such increases are to be considered a normal business risk; on the contrary, it is necessary to find a solution that puts an end to temporary difficulties, taking into account both the general interest ... and the special conditions that do not allow the contract to operate normally ...; to this end it is necessary to decide, on the one hand, that the Company is required to provide the concession service and, on the other hand, that during this period it must bear only that part of the adverse consequences that a reasonable interpretation of the contract allows”.\(^{72}\) In this case, a private contractor signed a contract to the gas for the city of Bordeaux. However, he as a result of the unprecedented rise in coal prices asked for equitable adjustment. This was granted because his ruin might have disrupted the gas supply for the city. The Conseil d'Etat has set out the elements of the circumstances that permit adjustment of administrative contracts. The event must be unforeseeable and external to the parties, exceed all reasonable expectations and result in a profound unbalancing of the contract. The key point of the French administrative law doctrine is that the private contractor has a right to an indemnity from the state or its enterprise if it establishes both that the difficulties encountered were exceptional and unforeseeable and that they upset the financial equilibrium of the contract. This doctrine has important implications on petroleum contracts because they will

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\(^{71}\) *The Libyan American Oil Company (LIAMCO), v. the Government of the Libyan Arab Republic*, (1981) 20 ILM 1, 73.

be concluded with state or state entities. This provides for adjustment in international petroleum contracts. It will allow termination of the contract only where the event is final and irremediable. 73

German law is grounded in the principle of sanctity of contracts. However, it recognises relief from contractual performance where performance is impossible without fault on either side. German courts have formulated a doctrine on revision of contract which allows for adjustment of the contract when the transaction’s foundation has collapsed. This doctrine is called ‘Wegfall der Geschäftsgrundlage’ or the doctrine of the foundation of transactions. The situations in which according to this doctrine, relief from contract performance is permitted are three grounds: (a) cases where the purpose of the contract cannot be fulfilled because of the occurrence of subsequent unforeseen events; (b) cases where the performance has become impracticable or where the value of the counter-performance has significantly changed; (c) mistake in shared basic assumptions. This doctrine is based on the concept of good faith. 74

German case law explained the doctrine as “the common representation of both contracting parties at the time of signing of the contract, or the representations of one party which have been perceived and implicitly accepted by the other party, with regard to the existence or future occurrence of circumstances upon which the intention for contracting of both parties is based. The basis of the transaction may be missing if the parties were, at the signing of the contract, in mutual error with regard to a major condition for the transaction; it may have lapsed if the circumstances, after the signing of the contract, changed unexpectedly or in a way which was not anticipated.” The contract may only be adapted within these restrictive conditions. Under this doctrine the contract can be adapted or terminated where “uncontrollable change in the circumstances surrounding the contract that leads to a fundamental disequilibrium in the contract and puts an undue burden on the party who had not anticipated and accepted that risk in the contracts”. 75

However, courts do not revise the contract for mere change in onerousness or risk of the agreement which freely has been concluded. Section 313 of BGB requires the main pillars of the doctrine of the foundation of transactions. It empowers the courts to step in and change the

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contract terms where they think it is necessary to correct a disturbance of the foundation. The section under the title of ‘interference with the basis of the transaction’ requires that:

“(1) If circumstances which became the basis of a contract have significantly changed since the contract was entered into and if the parties would not have entered into the contract or would have entered into it with different contents if they had foreseen this change, adaptation of the contract may be demanded to the extent that, taking account of all the circumstances of the specific case, in particular the contractual or statutory distribution of risk, one of the parties cannot reasonably be expected to uphold the contract without alteration. (2) It is equivalent to a change of circumstances if material conceptions that have become the basis of the contract are found to be incorrect. (3) If adaptation of the contract is not possible or one party cannot reasonably be expected to accept it, the disadvantaged party may revoke the contract. In the case of continuing obligations, the right to terminate takes the place of the right to revoke.”

The test for defining the foundation of the transaction is the essential assumptions of the parties which contemplate the parties’ expectations. Where the foundation of the transaction is disrupted, an adaptation of the contract is required. If such an adjustment process is not possible, the disadvantaged party could withdraw from the contract. Therefore, the disadvantaged party has a right to adapt the contract terms or in exceptional cases, terminate the contract. The contractual risk allocation is therefore is key ingredient to the doctrine. According to the principle of pacta sunt servanda the subsequent change of the contract must be restricted to the extreme cases. Thus, where one party cannot be asked to bear the risk of a subsequent change of events or to bear the risk of certain assumptions on which the contract is grounded, the doctrine of the foundation of contract permits adjustment.

“The decisive issue is the extent to which the equivalence between the mutual performances of the parties has been disturbed. It is assumed that contracts provide basically for the equivalence of performances. If this equivalence has been profoundly disturbed by unforeseen circumstances, the contract may be adapted to the changed circumstances”. Consequently, in case of the collapse of the foundations of the contract, parties are under duty to negotiate in good faith to adapt the agreement. In addition, in certain cases courts may adapt the contract. Adaptation may only be granted if the balance between performance and counter-performance has been so profoundly disturbed that the limitation of the reasonably assumed risk has been exceeded and the interest of the disadvantaged party is no longer safeguarded at all.

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76 Section 313, German Civil Code (BGB), (2002).
7.3.2. Common Law

Under English law the traditional position is that the contract is absolute and parties must perform the contract even where most of the circumstances are changed and the agreement is burdensome. English law gives courts a limited power to discharge, and no power to adapt. Moreover, there is no duty under common law on the parties to renegotiate contractual terms nor do the courts have the power to adjust the contract and adapt it to the changed circumstances. Nonetheless, the courts in a number of cases made a party free from obligation under the concept of ‘frustration’. When the contract performance physically or legally becomes impossible or when the performance is possible but only in a very difficult manner from that originally contemplated without fault on either party, then frustration has taken place. Indeed, “a contract is said to be frustrated when a supervening event occurs which so fundamentally affects the performance of the contract that in the eyes of the law the contract comes to an end and both parties are discharged from any duty to perform”. It should be emphasised that the effect of frustration is the termination of the contract, and the court has no power to adapt the contractual terms to the changed circumstances. The English courts interpret the doctrine of frustration very narrowly and they rarely apply this. It is said that “the English doctrine of frustration as currently applied is too strict and narrow to produce that degree of adjustment which the commercial community would regard as fair”. However, English courts in numerous cases have recognised contractual terms providing flexibility to enable parties to adapt the contract to change of circumstances. The foreseeability plays a significant role in commercial risk allocation and the text of the contract can require instructions for adaptation of the contract terms in the event of a substantial change in the economic environment. One commentator has noted “the narrowness of the doctrine of frustration does not act as a barrier to the parties themselves inserting into their contracts a range of clauses which will enable them to adapt their contract to meet changing conditions. A wide range of devices are available to contracting parties to enable them to adjust or suspend the

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82 P. Atiyah, An Introduction to the Law of Contract, (Oxford, Clarendon, 1995) 229-44; Also, for example see the leading case Krell v. Henry, in which a party was discharged from paying, because there was frustration of the purpose of the contract (rooms had been rented to view a procession which was cancelled due to the King's illness). [1903] LR 2 KB 740.
87 W. Park, (2015), supra note 81, 89-90.
contract in the light of unforeseen events”. Similarly, it is stated that; “the general principle is that the parties are free to stipulate those events that are to be considered as frustrating the contract, or as entitling one party or the other to an adjustment of the terms, and if the parties fail to do so the law will not intervene”. 89

The US practice proposes a more flexible approach to the situation where circumstances change. It is referred to as ‘commercial impracticability’ which is mentioned in section 268 (2) of the Restatement (Second) of Contracts and section 2-615 of the Uniform Commercial Code. Relief from contractual commitments may be sought under the doctrine of impracticability, where excessively burdened performance such as severe shortage of raw material or unpredictable shutdowns of major sources of supply has taken place. Parties may also request renegotiation. 91

In addition, courts under American law which recognises a narrow ground for relief from unpredictable onerous contractual obligations have adjusted contractual terms where at the time of conclusion of contract the change was unforeseeable or where holding the party to continued operation of the agreement may have given rise to bankruptcy. Under the US law, renegotiation of long-run contracts in case of extreme unforeseeable onerous events is recognised. 93

The above discussion has established that major legal systems of the world have widely recognised the principle of pacta sunt servanda or sanctity of contracts in stricto sense. 94 Nonetheless, where the fundamental purpose of the contract does not exist anymore, the contract will no longer be valid and comes to an end (discharge, rather than adjustment). The point to be made is that the principle of sanctity of contract is not absolute. The legal position of legal systems where the contract as a result of drastic change of circumstance becomes onerous which disturbs the original equilibrium is different. Under the US practice, the concept of renegotiability when the contract becomes onerous for a party is recognised. In addition, it has been accepted in all civil law countries and it becomes more prominent when a party is a government or a state body. Under English law, courts have shown that they rarely interfere with the contractual terms and tend to uphold the validity of contract. 95

94 Z. Kronfol, Protection of Foreign Investment: A Study in International Law, (Leiden, 1972) 82.
7.3.3. The Position of International Law

As suggested earlier, I look at various contexts in which mandatory adjustment is used and investigate to see if we can draw on those contexts to structure a system of mandatory adjustment for international petroleum contracts. I have established the various types of rules of mandatory adjustment which currently exist, in domestic law but also in international law. Thus, I look at the use of mandatory adjustment in another legal system of law and try to explore whether the use of which as a basis to create a new mechanism for international petroleum transactions is feasible.

Under international law, the principle of rebus sic stantibus or change of circumstances is widely accepted. This principle will govern all contracts even where they do not contain a specific clause. The Vienna Convention on the Law of Treaties, 1969 has recognised change of circumstances. According to the treaty provisions the legal effect of change of circumstances is that the disadvantaged party subject to the procedure which is articulated in Article 65, may request renegotiation or withdrawal from obligations. However, this Article does have a limited application only in exceptional circumstances. It has been worded carefully to avoid uncertainties on the sanctity of international contracts as provided by Article 26 of the treaty. Furthermore, this position is supported by the International Court of Justice (ICJ) which stated; “a fundamental change of circumstances must have been unforeseen; the existence of circumstance at the time of the Treaty’s conclusion must have constituted an essential basis of the parties to be bound of the Treaty”. The tribunal held that, “the negative and conditional wording of Article 62 of the Vienna Convention on the law of Treaties is a clear indication moreover that the ability of Treaty relations requires that the plea of fundamental change of circumstances be applied only in

96 N. Horn, (1985), supra note 51, 25; I. Brownlie, (2003), supra note 7, 620; N. Nassar, (1995), supra note 21, 200-205; “The principle that a treaty is subject to an implied condition that if circumstances are substantially different from those obtaining when it was concluded, then a party to the treaty is entitled to be released from it”. OED Online. Oxford University Press.
98 Article 62 of the Convention provides: “Fundamental Change of Circumstances. 1-A Fundamental change of circumstances which has occurred with regard to those existing at the time of the conclusion of a treaty, and which was not foreseen by the parties, may not be invoked as a ground for terminating or withdrawing from the treaty unless: (a) the existence of those circumstances constituted an essential basis of the consent of the parties to be bound by the treaty; and (b) the effect of the change is radically to transform the extent of obligations still to be performed under the treaty. 2- A fundamental change of circumstance may not be invoked as a ground for terminating or withdrawing from a treaty: (a) if the treaty establishes a boundary; or (b) if the fundamental change is the result of a breach by the party invoking it either of an obligation under the treaty or of any other international obligation owed to any other party to the treaty. 3- If, under the foregoing paragraphs, a party may invoke a fundamental change of circumstances as a ground for terminating or withdrawing from a treaty it may also invoke the change as a ground for suspending the operation of the treaty”. The Convention is available at http://untreaty.un.org/ilc/texts/instruments/english/conventions/1_1_1969.pdf.
100 Article 26 of the Convention on the Law of Treaties requires “Pacta Sunt Servanda. Every treaty in force is binding upon the parties to it and must be performed by them in good faith”. See also, N. Horn, (1985), supra note 51, 25.
exceptional circumstances.” According to Article 1 of the Vienna Convention, this convention is only applicable to inter-states treaties. However, it is asserted that “Article 62 is a strong argument for the existence of a general legal principle which might also be relevant to transnational contracts with or between private parties”. Moreover, it has been suggested that there is an obligation to renegotiate where the original contractual equilibrium which was made at the time of conclusion is disrupted by fundamental change of circumstances. Therefore, parties may request renegotiation of international commercial contracts. This legal point of view was held based on the United Nations General Assembly Resolutions. In addition, the United Nations Economic and Social Council (ECOSOC) draft Code of Conduct on Transnational Corporations in Article 5 has stated that transnational corporations should renegotiate with governments where the conditions upon which the contract was based have fundamentally changed. Even where there is no relevant clause to require so.

However, under international law there is no consensus on whether there is a duty of renegotiation of international contracts. On the one hand, developing countries argue that the principle of sanctity of contracts is overridden by permanent sovereignty of host governments over natural resources. Indeed, such contracts upon which economic development and public welfare were based are important for public interests. In contrast, developed countries emphasise the protection of the foreign investor and sanctity of contract. They argue that “insistence of developed countries on the sanctity of contracts did at no point explicitly or implicitly reject the application of contract law concepts such as change of circumstance, but it rejected the developing countries’ claim to a right to unilaterally change, revoke or coerce the renegotiation of a contract on the grounds of sovereignty and new economic policy alone.”

The above examination shows that it is not clear whether in instances where international investment contracts concluded with governments have undergone fundamental changes in surrounding circumstances, there is a duty of renegotiation or not. Thus, the position of international law on such situations is controversial and blurred.

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102 Ibid, para 104.
103 Article 1 of the Convention requires “The Present Convention applies to treaties between States”.
7.3.4. Force Majeure, Hardship Clauses and International Petroleum Contracts

In the absence of express provisions relating to renegotiation of contract when a party insists on renegotiation of agreement it might be sought either by the hardship concept of international contract law or force majeure clause incorporated into the contract.\(^{110}\) Force majeure and hardship clauses are employed to minimise the damage that may be incurred by one of the contracting parties over the performance of contract in changed circumstances.\(^{111}\) For the purpose of this section two points will be discussed. First, the legal nature and concept of such clauses and the second, the extent to which such clauses can be used for triggering renegotiation.

A force majeure clause in the traditional sense is used for unavoidable and unforeseeable events which are beyond the control of the parties.\(^{112}\) It will only include events of fundamental character which give rise to permanent or temporary obstruction that are excuses from the performance of contract.\(^{113}\) These clauses are aimed at dealing with unforeseeable events that make the performance of the contract temporarily or permanently impossible. In the petroleum industry, force majeure provisions are used in two different ways. First, they may be included in the petroleum contract but the legal definition and consequences are determined by the given applicable law.\(^{114}\) The second is that parties define the concept of force majeure and prescribe types of events which constitute a valid excuse in the contract. Thus, the parties do not refer the definition to the governing law.\(^{115}\) Force majeure provisions where the fulfilment of contract becomes extremely onerous or impossible usually provide for termination of the agreement. Hence, under the traditional sense it does not restore the contractual equilibrium.\(^{116}\)

However, force majeure clauses in current use have less strict conditions for taking place. They also provide for suspension, although not termination of agreement. The consequences of a force majeure event are dependent upon the contractual provisions. However, it generally only postpones the performance of contractual obligations.\(^{117}\) Termination of contract is only for exceptional circumstances when the event continues for a significant amount of time.\(^{118}\)

\(^{110}\) K. Berger, (2003), supra note 18, 1350.
\(^{113}\) N. Horn, (1985), supra note 51, 131.
\(^{118}\) K. Blinn, (2009), supra note 114, 292.
that the party whose performance is delayed is entitled to an extension of time for performance.\textsuperscript{119} Such clauses contain a duty to make the best efforts to overcome the force majeure events by renegotiation.\textsuperscript{120} Force majeure clauses usually define events which constitute force majeure and the means by which their impact can be minimised to maintain the relationship.\textsuperscript{121} Although such clauses primarily address the non-performance of the agreement and the liability arises out of this, where the supervening events cause temporary impossibility they provide contract adaptation.

\textsuperscript{119} J. Smith & A. Behrman, (2015), supra note 117, 120.
\textsuperscript{120} W. Peter, (1995), supra note 12, 236.
\textsuperscript{121} Liquefied Natural Gas Sales Agreement, concluded between Japanese and Canadian parties in 1982, under Article XIII defines the force majeure events as follows:

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“Article XIII- FORCE MAJURE- 13.1:
Excuse for Non-Performance. In the event that any party to this Agreement is rendered unable, wholly or in part, by force majeure to carry out its obligations under this Agreement, such party shall give notice by telex or telegraph to the other parties to this Agreement in the English language setting forth the full particulars of such force majeure and the estimated duration thereof as soon as possible after the occurrence of said force majeure. Upon the giving of such notice the obligations of such party, insofar as they are affected by such force majeure, shall be suspended, except for the obligations to make payments hereunder, during the continuance of any inability so caused, but for no longer period, and such cause shall so far as possible be remedied with reasonable dispatch. The party claiming force majeure shall exercise reasonable efforts to mitigate the effects of such force majeure on the performance of its obligations under this agreement.

13.2: Meaning of Force Majeure. The term “Force Majeure” as employed herein shall mean any event beyond the reasonable control of the parties hereto, including without limitation, acts of God; forces of nature; perils of the sea; shipwrecks; collisions; stranding; bursting of boilers; breakage of shafts; acts of the public enemy; wars; blockades; civil wars; insurrections; strikes; lockouts or differences with workmen; riots; disorders; quarantines; epidemics; landslides; lightning; earthquakes; atmospheric disturbance; typhoons; tornadoes; fires; storms or storm warning; floods; subsidence or washouts; soil erosion; arrests; restraints of government or judicial body (including Canadian or Japanese, federal, provincial, prefecture or local) including restraints in the form of orders, rules or regulations asserting authority to prohibit performance of this Agreement other than the obligations to remit payments under this Agreement; civil disturbances; explosions; inability to obtain natural gas supply; acts, orders, requests, requisitions, directives, diversions; embargoes, import or export restrictions, priorities, or expropriations of government or governmental authorities; interferences by civil or military authorities, legal or de facto, whether purporting to act under some constitution, decree, law or otherwise, inability to obtain necessary materials or supplies; serious accidental damage; and without limitation by enumeration, any other cause or causes (whether of the kind enumerated or otherwise) not reasonably within the control of the party claiming force majeure. It is understood and agreed that the settlement of strikes or differences with employees shall be entirely within the discretion of the party having the difficulty. Notwithstanding the foregoing, both buyers and seller shall make reasonable efforts so that the supply of LNG shall not be interrupted due to strike, lockout or other industrial disturbance.

13.5: Subject to Arbitration. In the event of a dispute between the parties hereto as to the validity of a claim of force majeure, the dispute shall be resolved in accordance with the provisions of article XVIII. The party asserting the claim of force majeure shall have the burden of proving that the circumstances constitute valid grounds of force majeure under this article XIII and that such party has exercised reasonable efforts to remedy the cause of any alleged force majeure condition.

However, hardship clauses primarily address adaptation of the agreement by re-establishment of the contractual balance.122

A recent model clause in AIPN Model International Joint Operating Agreement in Article 1.1 defines force majeure as “those circumstances beyond the reasonable control of the Party concerned”. The Model Agreement in Article 16 as to force majeure requires that:

“If as a result of Force Majeure any Party is rendered unable, wholly or in part, to carry out its obligations under this Agreement, other than the obligation to pay any amounts due or to furnish Security, then the obligations of the Party giving such notice, so far as and to the extent that obligations are affected by such Force Majeure, shall be suspended during the continuance of any inability so caused and for such reasonable period afterwards as may be necessary for the Party to put itself in the same position that it occupied before the Force Majeure, but for no longer period. The Party claiming Force Majeure shall notify the other Parties of the Force Majeure within a reasonable time after the occurrence of the facts relied on and shall keep all Parties informed of all significant developments. Such notice shall give reasonably full particulars of the Force Majeure and also estimate the period of time that the Party will probably require to remedy the Force Majeure. The affected Party shall use all reasonable diligence to remove or overcome the Force Majeure situation as quickly as possible in an economic manner but shall not be obligated to settle any labour dispute except on terms acceptable to it, and all such disputes shall be handled within the sole discretion of the affected Party.”123

Once supervening events take place, the force majeure obligates the parties to cooperate, and make their best efforts to overcome and mitigate the consequences of such events in order to find an equitable outcome. The force majeure clause may require suspension of performance where the performance of the contract is temporarily impossible, adaptation and adjustment of the contract according to the force majeure circumstances and finally termination of the contract where the force majeure events are permanent.124 The force majeure clause plays an important role in petroleum contracts where there is no renegotiation provision. Modern petroleum contracts contain force majeure clauses which promote flexibility through obligating parties to renegotiate, adapt the contractual terms and continue their relationship instead of abrupt termination and discharging obligations.125

Hardship clauses were not used in international contracts for exploration and exploitation of oil. However, hardship clauses are usually used in international investment contracts and natural gas sales contracts. A hardship clause is employed for the situations in which the performance of contract is possible but is extremely burdensome, when “the burden posed on one party has reached the ‘limit of sacrifice’”.

A leading scholar has noted the factors that need to be available for an event to be considered as a hardship event. First, the event must be outside the control of the parties. Thus, the event must not result from a failure or default of the claiming party. Second, it must be of fundamental character to damage the equilibrium of the contract and third, it must be completely uncontemplated and unpredictable. In fact, hardship clauses are similar to force majeure clauses except that they do not contemplate situations which will terminate the contract. Hardship clauses provide for adjustment of the contractual commitments to re-establish the equilibrium which has been disrupted by change of circumstances. In addition, it has been stated that they are a “specific type of renegotiation clause, which only apply in situations similar to force majeure”. Therefore, the underlying idea behind the hardship clause is adaptation of the contract rather than termination of the relationship.

Hardship clauses operate when the situation fundamentally changes the original equilibrium of the contract and makes the performance of the contract burdensome for the disadvantaged party. Such clauses always require a duty of renegotiation on the parties. The legal effect of the hardship clauses is adjustment of the contract terms to restore the damaged equilibrium of the contract. The hardship situation may be caused by financial, legal, political, technical, economic factors that seriously and adversely affect a party. The fundamental alteration of the equilibrium of the contract has two manifestations. First, a substantial increase in the cost of performance for the

disadvantaged party who performs his obligations. Second, a substantial decrease in the value of the performance received by one party.137

A good example of a hardship clause which is used in the contract for Sale of Natural Gas is as follows:

“Hardship: when entering into this Agreement the parties contemplate that the effects and/or consequences of this Agreement will not result in economic conditions which are substantial hardship to any of them; provided that they will act in accordance with sound marketing and efficient operating practices. They therefore agree on the following:

a) Substantial hardship shall mean if at any time or from time to time during the term of this Agreement without default of the party concerned there is the occurrence of an intervening event or change of circumstances beyond said party’s control when acting as a reasonable and prudent operator such that the consequences and effects of which are fundamentally different from what was contemplated by the parties at the time of entering into this agreement (such as, without limitation, the economic consequences and effects of a novel economically available source of energy), which consequences and effects place said party in the situation that then and for the foreseeable future all annual cost (including, without limitation, depreciation and interest) associated with or related to the processed gas which is the subject of this agreement exceed the annual proceeds derived from the sale of said gas. Notwithstanding the effect of other relieving or adjusting provisions of request the other for a meeting to determine if said occurrence has happened and if so to agree upon what, if any, adjustment in the price then in force under this agreement and/or other terms and conditions thereof is justified in the circumstances unfairness to the parties to alleviate said consequences and effects of said occurrence. Price control by the Government of the state of the relevant buyer(s) affecting the price of natural gas in the market shall not be considered to constitute substantial hardship”.138

As discussed earlier, international petroleum contracts are concluded between a state or state agency and an international oil company. One question that may be posed here is whether such state entities are able to rely on force majeure or hardship clauses for the events that are caused by the host government’s interference with the contract to cope with the circumstances or to ask for adjustment of contract. The principle of the separation between state and state entity is widely accepted.139 The renegotiation of separate legal personality of such entities in all times will put

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138 K. Blinn, (2009), supra note 114, 297.
contracts with state-controlled enterprises at risk. Therefore, the state entity will particularly be able to claim to be released from contractual commitments by relying on force majeure even for such events caused by its own government. However, it is a starting point and there are situations in which the principle of separation is not accepted as a defence. It is observed that “the starting point will have to be the principle that the separation between the state enterprise and the state is respected and that therefore normally acts of public authority by the state have to be accepted as an excusing case of force majeure…if the contract itself stipulates that the state enterprise is to be considered responsible for certain acts of state, no force majeure can be claimed if such an act of state then actually occurs”.

Force majeure invocation subsequent to interference of the government is not recognised for the state enterprise in many arbitral awards. Yet, a fact based inquiry on the basis of all relevant circumstances for the final award is required. In international petroleum investment contracts, force majeure and hardship clauses in theory provide a triggering point to restore the economic equilibrium of the contract where circumstances changed. It may bring about flexibility and may guarantee contract performance. Yet, the principle of sanctity of contract is a general rule for performance of contractual obligations. Force majeure clauses are used to accommodate the contract with unpredictable, fundamental change of circumstances. They involve acts of God that may make the performance of the contract temporarily or permanently impossible and also cover the change of economic equilibrium of the contract.

Hardship clauses are used when the performance of the contract becomes extremely burdensome. Therefore, such clauses are not intended to allow parties to seek relief because the contract simply becomes onerous, or where it is a bad bargain. It is stated that “in a contract, each party accepts a certain number of risks and cannot free itself from its obligations if a certain risk materialises. The mere fact that the risk falls heavily on one of the parties, is, as yet, not a valid argument for a variation of the contract”. This argument has been endorsed by international arbitral awards. It is presumed that parties to a contract are knowledgeable about the transaction and are aware of the risks which may be posed by such transactions. The international arbitral tribunals interpret silence of the parties on possible contingency as a concise decision to take the

risk. This principle has been widely accepted and serves as a standard for distribution of risk in the contract.146

7.4. The Thesis Proposal: Mandatory Adjustment by the Third Party

This section explores adjustment and limits of renegotiation in international petroleum transactions and proposes a mechanism of mandatory adjustment. In petroleum transactions where the commerciality of the project is not viable or the equilibrium of the contract is damaged, parties by renegotiation seek to restore the contractual balance. In many cases, parties sought renegotiation to maintain the relationship and their reputation in the international investment environment.147 Renegotiation of the contract occurs after concluding the agreement, when the parties have increased transactional understanding, mutual interests and the petroleum project is operational. In order to achieve a favourable outcome, parties should act in good faith and cooperate. The good faith is the main requirement of renegotiation. As the renegotiation process with a lack of good faith and in a confrontational manner cannot lead the parties to achieve a reasonable solution.148

I have shown that the underlying idea behind the renegotiation is dynamic stability. Renegotiation finds its legal ground in the contract terms and where the agreement does not include such provisions, renegotiation can be triggered either where applicable law permits it or where triggering events take place. Hence, the thesis proposal merely encourages parties to incorporate renegotiation clauses in their contract and should not be meant as a duty to renegotiate is implied in every contract. The duty of renegotiation of long-term agreements in good faith even where the contract does not contain explicit provisions is derived from interdependence of the parties and economic rationality of cooperation and performance of the agreement rather than a breakdown.149 However, I should emphasise that incorporation of renegotiation clauses into the contract creates a clear framework for adaptation and serves as a mechanism for the allocation of risk. Renegotiation provisions are recognition of future changes in the relationship of the parties over time. This can avoid contractual disequilibrium and initiation of arbitration process that is very costly. However, the adjustment clauses cannot overcome the limits of the renegotiation procedure and are unable to create a relational mechanism which does not suffer from the weaknesses of the renegotiation clauses.

I have already discussed that the renegotiation clause does not require the parties to reach an agreement. It only obligates the parties to do their best efforts to reach an equitable solution. It is underscored by the tribunal that “an obligation to negotiate is not an obligation to agree”. 150 Nevertheless, this thesis argues that the obligation of the parties to make their best efforts is a legal obligation which needs to be defined, therefore it is necessary to now define it. In the renegotiation process, the best efforts of the parties means considering needs and interests of the other party, commitment and seriousness to the negotiation, flexibility and good faith are thus required.151

If a party refused to renegotiate where the contract contains explicit provisions, it will be breach of the contract because it is a legal obligation and compensation is required. On the other hand, a failed renegotiation which has been conducted in good faith does not create liability, unless it is proved that a party has not behaved in good faith.152

In case of failure of renegotiation where the parties conducted a renegotiation in good faith, two scenarios can possibly arise:

First, the contract can be silent about the consequences of a failed renegotiation, in this situation the contract remains unchanged and the original contractual terms are effective because no new agreement has been reached. Second, where the parties have not reached an agreement, the renegotiation clause can refer the matter to the third party for adaptation. The third party can be an arbitral tribunal, expert, court or a panel of experts. The renegotiation clause determines the power of the third party as to the adaptation of the agreement. It is undisputable that a contract can be adapted according to the parties’ intention, commercial usage and background of their relationship by the third party.153 The third party’s decision is binding and final.154

The proposed approach by this thesis suggests two tiers. Firstly, the parties should renegotiate and adapt the contract according to the requirements of the clause. Secondly, in case of failure of a renegotiation, a panel of three experts, not only from lawyers, but broader composed of an economist, an engineer and a lawyer will look at the surrounding circumstances to deal with the conflict of interests, against the background of the contractual equilibrium that the parties sought to achieve in their original transaction. The panel’s decision will be final and binding.

150 AMINOIL Award, (1982) 24 ILM 976.
However, before I discuss the mechanism further, an important issue arises here in relation to the legitimacy of the tribunal. One may pose the question that the proposed panel is a huge erosion of the host government’s sovereignty which is usually for the interests of developed countries – investors and thus against the interests of developing countries – host governments that is illegitimate. Such tribunals enjoy low legitimacy and for example, like the ICSID which is running into trouble with many developing countries in Latin America withdraw from the Washington Convention (1965). How can the mechanism guarantee the interests of both parties, maintain legitimacy and respond to that threat? There are international arbitral bodies which have significant legitimacy. The Permanent Court of Arbitration, and the United Nations Tribunals for the Law of the Sea are classic examples. Developing countries do not see the tribunal biased against them and indeed, it is not biased against them. They happily engage with the process and initiate the cases. In contrast, it is very difficult to find cases initiated by developing countries under the ICSID.

The way in which the Permanent Court of Arbitration (PCA) works could guarantee the interests of both parties. It has legitimacy and developing countries use it all the time. They trust it and expect the tribunal to uphold their interests and in practice, the tribunal does. The point is that such a mechanism must be entrusted to a tribunal of that type to ensure that it does not become yet another source of contention where it is about the evolution of genuine norms. It is feasible because it has already been made in relation to the Permanent Court of Arbitration and the Convention on the Law of the Sea. Part of the reason that ICSID and other international tribunals are not popular amongst developing countries is because such tribunals are grounded in a strongly presentiated understanding. If they move away from the classical model that makes a binary division and does not take into account of the parties’ interests in restoring the equilibrium, towards a more relational understanding, the tribunal can reach legitimacy. This means that the countries have a very limited room to manoeuvre to defend their public interests. Whereas, a dynamic relational model of contractual relationship, can provide sufficient room for host countries to strike a balance between the public and private interests. The discussion of this section is not only about change of tribunals but also about changes to international investment law itself. There is a need to take the law away from the very presentiated understanding it currently has. We need a shift towards a more relational understanding of contract, and the parties’ obligations. As a result, host countries will have enough power to defend the public interest of their citizens. Indeed, the relational model looks at the interests of both contracting parties.

These bodies show that there is nothing about intrinsic to international tribunals that denies them legitimacy. In this regard, examination of French and German laws is important because it shows according to the legal rules and case law it can be done in a way that protects the interests of the public body.
Hence, the point is taking adequate account of the interests of developing countries. What will guarantee that the tribunal takes account of the issue? The approach to guarantee the interests of both contracting parties has two aspects. First, there are tribunals which do take account of interests of developing countries because the law is properly structured in a way that contractual equilibrium, the parties’ expectation and future relationship matter. Secondly, once the tribunal moves away from the presentiated understanding of the contract to a more properly structured relational approach to adjustment, this can overcome the issues with legitimacy.

The thesis solution is that the adjustment mechanism should be anchored in that type of approach, rather than existing investment law in relation to expropriation and stabilisation, which is already somewhat poisoned. Then this would be a much better way of preserving the contractual equilibrium in a way that respects the interests of both parties. International investment law as it stands lacks legitimacy but the thesis solution will have far greater legitimacy than international investment law has because the thesis anchors it in an understanding of the contract and a basic existing legal position that respects the interests of both parties and in institutions like the PCA that have international legitimacy. It has to be underlined that the legitimacy of the third party mechanism does not come from the relational model. The legitimacy of this mechanism comes from the third party mechanism. Indeed, it is legitimate based on the fact that it was created in a legitimate way. The fact that third party mechanism is grounded in the relational model does not increase the legitimacy. The thesis in this chapter cited the precedents to show that it is possible to have a legitimate third party mechanism.

The contract adaptation by the third party is foreseen by certain institutions, such as the ICSID and the ICC and they have developed rules and facilities to carry out the contract adaptation.155 This approach is also upheld by arbitral practice. For example, the tribunal in AMINOIL held that “there can be no doubt that, speaking generally, a tribunal cannot substitute itself for the parties in order to modify a contract, unless that right is conferred upon it by law or by the express consent of the parties. For that, the consent of both parties would be necessary”.156 Thus, express consent of the parties in the agreement for adaptation and modification of the contract by the third party is required. In addition, the other side of the point is that once such consent has been given, the tribunal can – and in practice not infrequently does – exercise them to adjust contracts.157

Another example in support of third party adaptation can be seen in the Atlantic LNG project where the passage of time brought changes in economic conditions that affected the use and value

155 J. Salacuse, (2001), supra note 1, 1517.
156 AMINOIL Award, (1982) 21 ILM, 976, 1015-16,
157 See also, P. Bernardini, (1998), supra note 5, 421.
of the commodity and distorted the parties’ original bargain. The parties have expressly agreed in the contract that the arbitrator can adapt the contract in case of failure of the renegotiation. In respect of revision of the price formula when the circumstance changes, Section 8.5 of the Contract provides that: “If at any time either party considers that economic circumstances in Spain beyond the control of the parties, while exercising due diligence, have substantially changed as compared to what it reasonably expected when entering into this contract and the contract price resulting from application of the original price formula does not reflect the value of Natural Gas in the Buyer’s end user market, then such party may request that the parties should enter into negotiations to determine whether or not such changed circumstances exist and justify a revision of the contract price and, if so, to seek agreement on a fair and equitable revision.” If the parties cannot reach an agreement on a new formula within six months, and renegotiation failed either party could ask the arbitral tribunal to adapt the contract according to the criteria set out in the contract.

I have discussed in chapter six that the parties have no obligation to reach agreement. In other words, a failure to agree is not a breach of contract. The subject matter of adaptation may be: (i) technical questions, as can be defined by designs, estimates of quantities, quality requirement, or etc; (ii) values like the value of a certain portion of work, cost estimates, market price; (iii) contractual terms such as time for delivery, manner of payments, and other duties of contracting parties.

Third party intervention may have the following functions as to the contract: (i) filling gaps in the contract such as determining the time for delivery of materials, determining the technical design; (ii) changing the contract such as making changes to quality standards to adapt the work, e.g. to newly discovered subsoil conditions, changing a price, postponing the time for completion of the project; (iii) clarification of ambiguities such as questions regarding contractual duties. In reality the distinction between gap-filling, modification, and clarifying is not clear. Sometimes the parties may disagree on whether there is an actual gap to be filled or, alternatively, whether the decision to be made by the third party constitutes a modification or merely a clarification of the meaning and contents of an existing clause.

The need for wide use of independent experts as to complex projects is reflected in the practice of petroleum companies. In the context of third party intervention, the third party has to make

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159 W. Park, (2015), supra note 81, 92.
160 Ibid, 92-3.
161 Ibid.
162 Ibid.
163 Ibid.
a number of decisions such as adapting the contract to unknown or changed circumstances. The practical requirements for effecting third party intervention are manifold. First, the third party’s power should be broad enough to allow necessary flexibility. Second, the decision must be quick and binding if it is to bring about a quick and solid settlement of a dispute. Where the parties included a renegotiation clause aimed at making it possible to adapt their contract to changing circumstances tending to upset the original contractual equilibrium, the third party’s intervention can then remedy any lack of agreement by the parties on the nature or extent of the modification to be made. Adaptation of contract is called for by a contract which is complete but becomes incomplete due to a change in circumstances.

As discussed earlier, an adjustment clause – a clause which refers things to a third party has gone beyond a traditional renegotiation clause and can be a middle ground between total contractual rigidity and complete relational flexibility. It has shown that the third party adaptation of petroleum agreements in practice can be through the renegotiation clause which refers the matter to the third party, where the parties failed to reach an agreement. This research argues that the third party should examine whether the renegotiation process has been made according to its conditions, adapt and amend the contractual terms and thus determine the rights and obligations of the parties in light of the past conduct of the parties. According to the thesis proposal, the panel should seek to restore the equilibrium of the contract through assessment of the extent of risk and loss incurred by either party to distribute the loss and allocate risks. In order to re-establish the equilibrium, the panel can change the contractual terms and determine the amount of damages payable to the injured parties. In practice, it has been foreseen and there are petroleum contracts referring the failed renegotiation to an expert or a panel as third party to adapt the agreement. For example, the Turkmenistan PSA 1998, in Article 27.2 states that should the parties fail to arrive to an agreement, the parties shall refer the matter to the expert. However, all other disputes regarding breach of the contract, interpretation and validity must still be settled by the arbitral tribunal.

7.4.1. The Content and the Procedure for Third Party Mechanism: Model Clause

The third party may conduct the proceedings as he considers appropriate, taking into account, the circumstances of the case, the need for a speedy settlement, and the express wishes of the parties. Such procedural discretion allows the third party intervener to play an active part. He may take every appropriate step to sort out matters, to soften any positions and to identify common grounds. The exact manner of the third party intervener’s assistance will vary from one case to another and

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164 Ibid.
depend, in particular, on the wishes of the parties. For example, the third party will be guided by the renegotiation clause, principles of objectivity, fairness and justice, giving consideration to, among other things, the rights and obligations of the parties, the usages of the trade concerned and the circumstances surrounding the dispute, including any previous business practice between the parties.¹⁶⁷ These guidelines make it clear that he does not have to follow strictly provisions of any substantive law. There are special reasons for having a panel of experts. For example, in a complex project such as petroleum projects, parties might wish to have a number of different experts who understand and can explain the economics and the law.

The main advantage of third party adaptation materialises when the proceedings are amicable, speedy and inexpensive. The best approach is to provide for simple and informal procedures, as done by the UNCITRAL Conciliation Rules. In cases where the parties’ disputes concern the renegotiation and adaptation of the contract, the third party mechanism can have advantages. Expert determination (ED), as an instrument for dispute resolution has been used by the oil and gas industries in various ways and has for long been crystallized by the English courts.¹⁶⁸ ED can be defined as “a means by which the parties to a contract jointly instruct a third party to decide an issue between them”.¹⁶⁹ A good example is Article 37.3 of the Iraq Model Production Oil Field Technical Service Contract (2009), which provides that disputes arising between the parties (with respect to relevant technical matters) may, at the election of either party be referred to an independent expert for determination.¹⁷⁰

37.2. “The Parties shall endeavour to settle amicably any dispute arising out of or in connection with or in relation to this Contract or any provision or agreement related thereto. Where no such settlement is reached within 30 days of the date when one Party notifies the other Party of the Dispute, then the matter may, as appropriate, be referred by the Parties to their senior management for resolution. Where no such settlement is reached within 30 days of such referral to management, any Party to the Dispute may refer the matter, as appropriate, to an independent expert.

37.3. If any dispute arises between the Parties with respect to relevant technical matters or adaptation of the contract, such dispute may be referred to an independent expert for determination. Such expert shall be agreed upon by the Parties to the Dispute and shall be willing to undertake such evaluation, and shall be independent, shall not be originated from, or have been at any time a citizen of, the country in which any of the Parties to Dispute is organised, and shall have no interest in or relation to either Party or with any

¹⁶⁸ Ibid.
the entities constituting the Parties and shall be qualified by education, experience, and training to evaluate the matter in Dispute. The Expert shall render its decision within one month following the Expert’s formal acceptance of its appointment, or within such further time as the Parties may agree in writing. The costs of the Expert determination shall be shared equally by the Parties.”

Accordingly, the ED clause made provisions regarding Expert’s appointment and cost, neutrality, qualification, and decision timeframe. Contracting parties need to decide the basis of appointment for the independent third party since some commercial contractual issues such as adjustment of the agreement are more suitable for determination by a third party acting as expert rather than an arbitrator. It follows that ED is widely used in the oil and gas industry as a dispute resolution mechanism where the issue is primarily technical or commercial in nature. The oil and gas industry is an international market with those involved potentially having assets scattered in many different countries. Petroleum contracts are long term in their nature, involving multiple stakeholders, and can be particularly complex, both technically and legally. Contractual disputes can cost oil and gas companies millions of dollars, not only in terms of their profits but also in terms of damages incurred to reputation and the potential for ruining future joint ventures. In electing ED as the primary method of dispute resolution, the Iraqi government sought to avoid such consequences by adaptation of the contract.

An Australian judge, has highlighted the benefits of using ED and held “on a practical level, ED has apparently been attractive, largely because it is less expensive and speedier, avoids the rigours of the application of the rules of evidence and procedure and offers a finality which avoids delays, potential re-hearing and appeals, which is particularly suitable where the parties may have a continuing relationship”. The principle applies to both the oil and gas industry and many other sectors where ED is popularly in use. However, this is not to say with absolute certainty that ED is a panacea, as issues such as; enforcement, complexity, immunity and the challenge of ED’s decisions have made the election of ED as a method of dispute resolution a crucial or even critical choice for the parties to the contract.

The experts decision binds the parties and unless the ED agreement provides otherwise, under the common law an ED can only be challenged on the grounds of fraud, bias or that the expert has

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171 Ibid.
174 The Heart Research Institute Ltd v Psiron Ltd [2002] NSWSC 646, 86.
answered the wrong question or has otherwise materially departed from his or her instructions.176 In highly technical and complex industries such as oil and gas, a panel of suitably qualified experts is more likely to produce a reliable answer to the parties’ needs than arbitrators or a judge.177

In addition, a major key to the third party mechanism (panel of experts) is speed. “one cannot suspend drilling operations while the lawyers get to work on arguing the dispute but an expert can make a decision in minutes (if required) or days/weeks as appropriate”.178 Hence, whereas “arbitration can be, and too often is slow and expensive”,179 the same cannot purely be said of a third party mechanism, particularly, where the test or formula to be applied is clear (adjustment of the contract) and the question contractual or technical.180

Additionally, the third party mechanism is confidential. This is in the interests of companies, both in respect to future investors, the preservation of important trade secrets and public opinion, to be perceived as credible. Additionally, the proceedings are normally informal and flexible.181 The general view is that third party mechanism offers a faster, lower-cost alternative to arbitration in many commercial circumstances, offering a legally binding decision almost impervious to challenge.182 This is true of its attractiveness and suitability to the oil and gas industry. It is therefore submitted that, the UK law of ED (particularly that of England and Wales) is well developed, with a line of leading authorities establishing its bases (although the law is all common law, there being no relevant statute) and defining its limit.

Apportioning costs and entitlements in an oil or gas field is often necessary to settle matters between the participants in unitised projects.183 In a unitised project, parties having differing interests in two or more different areas agree that a field underlying their respective tracts should be developed and produced as one project. The exact proportions in which oil and gas is present in the respective tracts become fully apparent only as wells are drilled during the course of operations. Sometimes the issue is not the amount of oil but rather the amount of recoverable reserves, in which case prediction of costs and prices well into the future becomes necessary, and issues of economics are as important as those of geology. By a process known as re-determination of equities, the parties agree that the proportion which their respective stakes bear to one another

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180 J. Williams, (2008), supra note 175, 225.
181 Ibid.
182 Ibid.
183 D. Daintith, United Kingdom Oil and Gas Law, (Sweet & Maxwell,) 115.
is to be reassessed after a certain period, or at periodic intervals. If the parties are unable to agree on the precise application of the method of calculation to the information derived from the drilling and production, the dispute may be referred by agreement to an expert to determine.¹⁸⁴

The court has heard a series of cases on expert determination in recent years. There were two cases on completed re-determinations in unitisation contracts. In both cases the method of re-determination used by the experts was challenged on the grounds of mistakes in relation to interpretation of the agreement. The court’s investigations were very extensive in both of these judgments.¹⁸⁵

In order to make the discussion more clear, it is useful to present an example. The most common form of expert involvement is in unitisation contract, and the determination of tract participation. The appointed expert is required to rule on matters in dispute. The UK Court of Appeal in the case of *Arco British Limited et al v Sun Oil (Britain) Limited et al* relating to the first redetermination of equity for the Balmoral Field, UK North Sea, examined expert determination. The expert redetermination conducted by Gaffney, Cline & Associates Limited had increased the claimant’s tract participation at a time when low commodity prices coupled with historically high development costs meant that an increase in equity resulted in a back-adjusted loss of revenue of around £50 million in 1988 currency. Therefore, the claimant sought to reduce its tract participation. To this end, the claimant contended that the expert had deviated from implicitly prescribed technical procedures in the agreement by not tying seismic survey data to well control data. The court decided that the paragraph in question could not be read as implying exclusivity because that would have placed an undue constraint on the expert by forcing him to ignore other pertinent data that would normally be taken into account.¹⁸⁶

The court held: “While it cannot be said that it would be unreasonable for the parties to the agreement to have decided to impose the constraint, in the absence of their indicating that this is what they required I consider it would be wrong to infer such a constraint which could result in the expert being prevented from coming to a decision which he regarded as being the correct decision on all the data available”.¹⁸⁷

Accordingly, an important aspect of the expert’s assignment is that the expert is required to make a determination. This means that he should start with a (possibly agreed) database of petroleum geoscience and engineering data and determine tract participation by following the technical

¹⁸⁴ Ibid.
¹⁸⁷ Ibid.
procedures contained in the contract. In the event that no technical procedures are prescribed, the expert is required to follow good international petroleum practice in delivering a decision. In either case, the deliverable is an absolute tract participation and the expert must disclose his workings for verification purposes. All the expert’s work has to be auditable and replicable.\textsuperscript{188} The parties are strictly only able to rebut the expert’s initial decision where there is a manifest error, i.e. an error that is so obvious that it cannot be a matter of opinion, or where there is evidence of breach of contract, fraud or conflict of interest.

Provision for expert determination in an unitisation contract is usually embodied within Agreement. The key is to achieve a balance between under-prescription, which leaves too many matters open for dispute, and over-prescription, which can give rise to unworkable procedures when more becomes known about the character of the constituent reservoir(s) of the subject oil or gas field.

7.4.1.1. Essential Elements of an Expert Clause: Some Principles

Expert clauses should contain the items in this list.

1- The issue to be determined
2- The experts’ qualifications
3- The duty to act as an expert
4- How the expert is to be appointed
5- That the experts tribunal’s decision will be final and binding
6- Provisions for awarding the costs between the parties
7- Procedure for the actual reference, and
8- Time lines

In addition, regarding the implied terms in an expert clause, as a contract law concept, implied terms underpin the law of expert determination, because some basic terms are not spelt out, namely, that the parties would not accept a final decision intended to have a binding effect when that decision was vitiated by dishonesty, partiality or mistake.\textsuperscript{189} Dishonesty and partiality are never mentioned in expert clauses as factors whose presence the parties agree would be sufficient to upset a decision, as they are so obvious and a term may therefore be implied. Where the expert must act independently, there is an implied term that the parties will not seek to interfere with the expert’s independence.\textsuperscript{190} Furthermore, in one case it was held to be an implied term that the

\textsuperscript{188} Ibid.
\textsuperscript{190} Minister Trust Ltd. v. Traps Tractors Ltd, (1954) 1 W.L.R. 963, 975.
expert should act lawfully and fairly, hence, an unfair determination was invalid.\textsuperscript{191} Most contracts contain an implied term that the parties will cooperate with each other in the performance of the contract, and this will apply to a clause providing for expert determination.\textsuperscript{192}

\textbf{7.4.1.2. Is there any Restriction on the Types of Disputes Referred to ED?}

An expert determination clause is an agreement between the parties that the specified disputes shall be determined by an expert. There is nothing unusual about such a provision and parties are held to their bargain if they agree to such a clause. Neither is there anything unusual about the clause providing that the expert's decision shall be ‘final and binding’ or ‘conclusive’, and provisions such as that do not oust the jurisdiction of the Court. The effect of the clause is to make the decision of the expert final and binding, providing the matters referred to him are ones which the agreement contemplates. All disputes will entail issues which concern any one of, or a combination of, fact, law (including contractual interpretation) or technical issues. In principle, there is no reason why any of these issues or a combination of them could not be determined by an expert. Considerable care is required when formulating the scope of the issue to be decided by the expert. The validity of an expert determination may be challenged where the expert is required to decide a technical question but, in so doing, it is necessary for the expert to form a view as to the correct contractual interpretation of the relevant clauses.\textsuperscript{193}

The ability to set aside an expert determination is dependent on whether or not the expert has carried out the task which he or she was contractually required to undertake. If the expert has carried out that task, the fact that errors were made or the expert took irrelevant matters into account does not render the determination challengeable. On the other hand, if the expert has not performed the task contractually conferred on him or her, but rather performed some different task, or carried out his or her task in a way not within the contractual contemplation of the parties, objectively ascertained, then the determination will be liable to be set aside.\textsuperscript{194}

\textbf{7.4.1.3. Jurisdiction}

The word ‘jurisdiction’ is used to describe the nature and scope of the expert’s task. It is therefore an important issue to be determined. The expert clause is the first part of a contract to look at to find out what the expert’s task is, but the expert clause has to be read in the context of the whole contract to discover its full meaning. An expert clause should not be read in isolation from the


\textsuperscript{193} AGL Victoria Pty Ltd v SPI Networks (Gas) Pty Ltd (2006) 244 CLR 305.

\textsuperscript{194} Ibid.
performance of obligations of the parties, the commercial purpose of the agreement and contractual background of the parties.

The task of the experts, the issue to be determined and the manner in which it is to be performed are, obviously, central questions. Ambiguity and uncertainty about them can promote disputes that prevent the operation of the third party clause. Some clauses state that disputes may be referred to an expert, others suggest that they shall be referred to an expert. The latter is suggested.

Where the parties have entrusted the power of a decision to an expert, the extent of the expert’s jurisdiction depends upon the contractual terms. It should be noted that each agreement depends on its own terms, read in its own context, and little assistance can be gained from other cases decided in relation to different contracts.\(^{195}\)

Expert determination is not a type of legal proceedings like litigation which has a formal and highly regulated structure, nor does it have machinery for its supervision by judges as does arbitration.\(^{196}\) The expert clause in the parties’ contract is the only document to have a decisive effect and then only if it lays down the procedure in detail, which many do not. Whatever procedure is followed it must be ensured that the expert has a copy of the contract incorporating the expert clause and the basic information about the issue the expert is to decide and between whom it is to be decided.

**7.4.1.4. The Qualifications of the Expert Tribunal**

The clauses establish conclusively what qualifications the experts are supposed to have. It is therefore important to provide for this in the third party clause. For example, according to the thesis’ proposal, the experts’ tribunal should be lawyer, technical expert and economist.

**7.4.1.5. The Requirement for Joint Applications**

Difficulties sometimes arise when one of the parties refuses to join the other party to appoint an expert. This can be avoided by a provision enabling either one of the parties to apply independently.

Referring issues to a named individual is not advisable unless a dispute has already arisen. The reason for this is that some time may pass after the making of the original contract containing the reference to the specifically named individual. By the time a dispute arises that individual may have died, retired or be unavailable or may simply refuse to conduct as an expert.\(^{197}\)

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\(^{197}\) Ibid, 520.
However, professional qualifications are usually stipulated. The qualification may be membership of a particular professional certificate or academic degree. The expert may also be required to have relevant experience.

7.4.1.6. Criteria for the Experts’ Suitability
The criteria needs to be specific, but not so as to limit the availability of experts. A clause which says no more than, the expert is to be ‘suitably qualified’ can provide material for a wasteful argument if a dispute arises. The expert clause may lay down criteria for the experts’ suitability. Where there is a matter of education, training and experience it is best to specify an academic degree, professional certificate or membership of a professional body.

7.4.1.7. The Final and Binding Decision: The Procedure
Expert determination results in a binding result. If a procedure set out in a contract does not necessarily lead to a binding result, the system is not expert determination. Expert clauses commonly provide that the decision will be ‘final and binding’, and it is in the interests of the parties. ‘Final’ means that the decision is not subject to review and ‘binding’ means that the parties are obliged to comply with the decision. Thus, insertion of both terms will preclude subsequent arguments.198

It is not common to specify a particular form for the decision. If a form is specified and not followed, the decision may be invalid, depending on the nature and degree of the departure from the specified form.

The implied duty to cooperate ought to make it unnecessary to stipulate that the parties are to provide the expert with all information and documents required. In addition, some expert clauses require that the expert is to make a decision by a particular date. These provisions are included to encourage speed, which is generally desirable.

7.4.1.8. Expert Determination in Practice: Advantages, Disadvantages, Remarks and Additional Examples
Expert determination has the following advantages as compared to other methods of dispute resolution, in particular arbitration and litigation:

1- It allows the appointment of an expert who is familiar with the technical issues. This gives confidence to disputants that decisions would be reached based on the individual's knowledge - who is expert of the field.

2- It is usually cheaper, quicker and less formal than arbitration or litigation. Along with that it comes up with an added benefit of being less formal than the mentioned two methods of dispute resolution.

3- It helps parties to maintain business relationships, as it is confidential and less adversarial than litigation or arbitration. It gives flexibility to oil and gas disputants to choose their own set of rules and regulations.

4- The expert's decision is normally final and binding because, unless the parties provide otherwise, the decision can only be challenged on limited grounds.

It has been discussed above that ED has its own problems. There are some other issues regarding ED:199

1- The outcome of expert determination cannot be easily challenged and there is very narrow margin of it being appealed other than fraud and manifest error.

2- This method is usually used to determine the technical and financial side of disputes without any interpretation of law.

3- The expert or umpire concludes the outcome based on his own findings and there are no rules for natural justice or due process to be followed.

4- The ED process is not easily enforceable until there is a bilateral agreement between international disputants.

The main drawback is that ED does not provide the cross-border enforceability benefit of the New York Convention 1958, and judgments are not enforceable across borders.200 However, ED offers a far faster, lower-cost alternative to arbitration in many commercial circumstances, offering a legally binding decision almost impervious to challenge.201 ED offers a number of pitfalls but these are easily avoided by: (i) leaving as much of the procedural matters to the ED as possible; (ii) seeking unreasoned determinations; and (iii) otherwise structuring the ED to minimise the possibility of challenge. It is easily possible to carry out an ED in a £100 million dispute in 30 days for less than £50,000.202

The procedure is normally dictated by the terms of the original agreement made between the parties, incorporating the expert's terms of reference.

The following points should be covered:

1- Matters in dispute should be identified at the outset;

199 Ibid, 525.
201 Ibid.
202 Ibid.
2- Certainty should be provided in relation to the time at which the issues for decision have to be finalised. This will prevent parties from introducing new issues once the determination is in progress;

3- Although neither party will have the burden of proving its case before the expert, the terms of reference should make it clear that the expert is required to make his decision on the basis of all the material before him;

4- Scope of the expert's function – does this extend to deciding issues involving how the contract itself is constructed?203

In addition to the model ED clause mentioned above, according to the leading academic scholars and practitioners, an ED clause could be drafted as follows:

“If the parties are unable to agree on adjustment of the contract in accordance with the provisions of renegotiation, either party may request that the matter be referred for decision to a panel of experts (Panel). If, and to the extent that, any such dispute or difference has not been settled pursuant to the renegotiation within 60 days of the commencement of the renegotiation, it shall, upon the filing of the request for expert determination by either party, be referred to the panel of experts. The Panel of experts includes a law professor, an engineer and an economist to adapt the contract according to the provisions mentioned in the contract, the relationship background and the parties’ interests. The Panel shall attempt to agree with the Parties upon the procedure and timetable to be followed in the expert determination. The Panel shall deliver its decision within 60 days. If and to the extent that any such matters cannot be agreed, the Panel may in its sole discretion adopt such procedures and timetables as it shall consider appropriate and these shall be binding on the parties.”204

The issue can also be referred to a panel of experts appointed by the President of Association of International Petroleum Negotiators (AIPN).

“In the event that any dispute arising out of or in connection with reaching agreement on renegotiation and adjustment of the contract, the parties agree that determination of experts shall be conducted expeditiously by the parties to the dispute. The party desiring an expert determination shall give the other party to the dispute written notice of the request for such determination. If the parties to the dispute are unable to agree upon an expert within 10 days after receipt of the notice of request for an expert determination, then, upon the request of any of the parties to the dispute the President of Association of


204 Ibid.
International Petroleum Negotiators (AIPN) shall appoint such experts and shall administer such expert determination through the ICC’s Rules for Expertise. All parties agree to cooperate fully in expeditious conduct of such expert determination and to provide the expert with access to all facilities, documents and information. The panel of experts shall endeavour to resolve the dispute (adapt the contract to the changed circumstances) within 30 days after the appointment, taking into account the circumstances requiring an expeditious resolution of the matter in dispute. The experts’ decision shall be final and binding on the parties to the dispute.205

The third party adaptation which is proposed by this study implies intervention of an institution or a person to adapt the contract to the changed circumstances. It is the essential idea of hardship clauses, renegotiation clauses, ICC Adaptation Rules, and the UNCITRAL Conciliation Rules which provide for the intervention of a third party.206 The ICC Rules on the Regulation of Contractual Relations (ICC Adaptation Rules) 1978 provide for a procedure for the binding contract adjustment by the third party.207 It provides that in the event of hardship, parties should renegotiate to adapt the contract. Failing an agreement within 90 days, each party is entitled to refer the case to the ICC Standing Committee to obtain the appointment of a third party. The third party decides what revision is needed and the decision is binding.208 The third party’s decision “is inserted into the contract and is binding on the parties as the contract”.209 In addition, the UNCITRAL Conciliation Rules 1980 have provided a set of rules that conciliation serves as a means for renegotiation of the contract.210 Contractual third party intervention is more flexible and speedy and these features are the advantage of this approach. The decision of the third party intervener is part of the management of complex long-term contracts.211

Institutional arbitration rules, usually, are silent on the issue of the third party’s powers to adapt the contract. The same approach is adopted by the UNCITRAL Arbitration Rules. However, in some cases, arbitration institutions provide for specific rules for the adaptation of contracts separate and distinct from those regarding arbitration proceedings. Such solution clearly denotes

211 N. Horn, (1985), supra note 208, 140-1.
the idea that the adjustment of contracts is not considered as traditional arbitration and, consequently, is not part of the judicial task of arbitrators.

This approach, for instance, is adopted by the Belgian Centre for Arbitration and Mediation (CEPANI), which provides for Adaptation of Contracts Rules. In particular, Article 1 establishes that such rules apply only if the parties “have so agreed with a specific clause” and if they “wish to have recourse to a third person whose mission shall be to complete the contract on items unforeseen by them, or to adapt their common intent to new situations”. The third appointed party issues a written recommendation or a decision that is binding for the parties but that does not constitute a judicial decision or an arbitral award. In light of analysis of such rules, it is evident that the clause and the procedure for referring the dispute to the third party for adaptation should be flexible and does not need to be too precise.

The legal analysis of contract adaptability by a third party under common law and civil law legal systems will show that the civil law system is more lenient than common law towards the adaptation of contract. In German law, where the requirements of a collapse of the foundation of the transaction (Wegfall der Geschäftsgrundlage) are met, the arbitrator similar to a court can adapt the agreement. In French law, courts can intervene in an administrative contract either through the parties’ reference or in order to ensure fairness to maintain the contract continuation in the event of changes of circumstance under force majeure doctrine. English law has taken a restrictive approach about the courts power to adapt the contract. The courts are not called upon to write the contract for the parties and decide about the future cooperation of the parties. The courts usually excuse the parties from the contract performance, however, they have no power to adjust or adapt the contractual terms. The adjustment of long-term contracts in the event of commercial impracticability is permitted in the US legal system to avoid injustice in the contractual relationship. Under German Civil Code (BGB), Section 317 provides that the parties can empower a third person to determine the contractual performance. If the parties do not provide guidance on how the third person should reach the decision, such a clause is not valid.

213 A. Al Faruque, (2006), supra note 166, 3.
219 Sections 317-319 of German Civil Code; N. Horn, supra note 51, 184; Section 317 requires that “(1) Where specification of performance is left to a third party, then in case of doubt it is to be assumed that the specification is to be made at the reasonably exercised discretion of the third party. (2) If the specification
The present study proposes that international petroleum transactions as a long-term relationship need a panel of experts including, independent technical consultants to decide about complex technical projects. The adapted contract is an enforceable agreement because parties have agreed to the result of third party intervention.

The thesis proposal is supported by international practice. The inclusion of a renegotiation clause combined with a provision calling for the third party adaptation where the parties are not able to find an equitable solution can contribute to the transactional stability and ultimately reduce the likelihood of a dispute. According to the ICSID convention, under Article 25(1) an arbitral tribunal cannot adapt the contract, because only legal disputes are arbitrable under the convention. Nevertheless, if the parties fail to agree about the revision of a contract, their disagreement gives rise to a legal dispute as it concerns rights and obligations of the parties.

In addition to the above-mentioned examples of rules and laws that reflect current practice, another example in which the proposed contractual mechanism is echoed is in the UNIDROIT and PECL Principles. For example, the UNIDROIT Principles have provided a framework for contract adaptation by a third party where the parties’ renegotiation in the event of hardship failed. In the event of a hardship, the disadvantaged party may request a renegotiation to modify the terms of contract in light of the changed circumstances. In this regard, the arbitration tribunal in the ICC Case No. 10351/2001 expressly referred to the principle of good faith as a principle that is generally applicable to international contracts and that implies the duty of the parties to adapt the agreement in order to rebalance it, upon the occurrence of unforeseen events altering its equilibrium. If the parties fail to reach an agreement, the principles permit either party to call for a third party to adapt the contract with a view to restoring its equilibrium or terminate the contract. The arbitrators held that the obligation to execute contracts in good faith, in addition to be provided by the applicable law, is a general principle of international contract law (being provided by Article 1.7 of the UNIDROIT Principles) and that, according to such obligation, the parties have to adjust the contract in order to rebalance it when the original conditions change.
If a substantial change that was not predicted at the time of execution takes place in the circumstances on which the agreement was based so that a party suffers or is foreseen to suffer substantial hardship, which is likely to continue, arising from that change, then the parties shall immediately consult and make mutually acceptable revision of the terms and conditions appropriate to alleviate or eliminate the hardship, in a spirit of mutual understanding and cooperation.

An accurate definition of the principle of hardship and a description of the relevant triggering conditions are provided by both the International Institute for the Unification of Private Law Principles of International Commercial Contracts (UNIDROIT Principles) and the Principles of European Contract Law (PECL). In particular, Articles 6.2.1 and 6.2.2 of the UNIDROIT Principles provide that:

“There is hardship where the occurrence of events fundamentally alters the equilibrium of the contract either because the cost of a party’s performance has increased or because the value of the performance a party receives has diminished, and (a) the events occur or become known to the disadvantaged party after the conclusion of the contract; (b) the events could not reasonably have been taken into account by the disadvantaged party at the time of the conclusion of the contract; (c) the events are beyond the control of the disadvantaged party; and (d) the risk of the events was not assumed by the disadvantaged party.”

In its turn, Article 6:111 of the PECL provides that:

“(1) A party is bound to fulfil its obligations even if performance has become more onerous, whether because the cost of performance has increased or because the value of the performance it receives has diminished. (2) If, however, performance of the contract becomes excessively onerous because of a change of circumstances, the parties are bound to enter into negotiations with a view to adapting the contract or terminating it, provided that: (a) the change of circumstances occurred after the time of conclusion of the contract, (b) the possibility of a change of circumstances was not one which could reasonably have been taken into account at the time of conclusion of the contract, and (c) the risk of the change of circumstances is not one which, according to the contract, the party affected should be required to bear.”

The aim of the hardship clause is to rebalance the contract in order for the parties to maintain their relationship instead of terminating it and, even in this case, parties usually referred to the principle of good faith. Therefore, hardship clauses also provide for the renegotiation between

the parties upon the occurrence of the hardship event. Article 6.2.3 of the UNIDROIT Principles and Article 6:111, paragraph 3, of the PECL, provide that upon the failure of the renegotiation, it is possible for the parties to resort to courts that can terminate the contract or adapt it in order to rebalance it. Finally, it has to be underlined that the extent of hardship provisions in the petroleum industry is not limited to the revision of the price but is broader and can regard any contract condition. Due to this general application, usually such clauses do not provide for specific parameters on how to adjust the contract, as, instead, it often happens in price review clauses.

The ICC International Court of Arbitration in *Andersen Consulting Business Unit Member Firms v Arthur Andersen Business Unit*, applied the UNIDROIT Principles and decided the case. Andersen Consulting Business Unit (hereinafter ACBU) and Arthur Andersen Business Unit (hereinafter AABU) were two business units of the Andersen Worldwide Organisation (hereinafter AWO). AWO, set up in 1977 was a network of more than 140 member firms operating in over 75 countries and linked to each other through Member Firm Interfirm Agreements (hereinafter MFIFAs). Member firms of AWO practiced accounting, audit and consulting services. In 1989 after restructuring member firms’ practice, AABU conducted audit and tax and other financial advisory services and ACBU systems integration and other consulting services. Nevertheless, relationships between the two business units constantly deteriorated. On the one hand, AABU member firms, increasingly conducted consulting business, began developing their own consulting practices; on the other, ACBU member firms complained that such behaviour constituted undue interference with their own professional practices. They tried to avoid overlapping activities but it was unsuccessful. Consequently, in 1997 ACBU member firms filed a request for arbitration before the ICC International Court of Arbitration.

According to the claimants, the respondents by expanding consulting practices and failure of coordination in relation to the activities of the member firms and implementation of guidelines had fundamentally breached the inter-firms agreement. Respondents rejected the claim of breach and argued that the claimants behaved in bad faith for having filed the request for arbitration instead of following the procedure in case of controversy required by the MFIFAs. According to the arbitration clause, the tribunal is not bound to apply the substantive law of any jurisdiction, but must use the agreement policy and decide on the basis of general principle of equity. The ICC tribunal held that “the UNIDROIT Principles of International Commercial Contracts are a reliable source of international commercial law in international arbitration that have enjoyed universal

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227 Ibid.
228 Ibid.
230 Ibid
acceptance and, moreover, are at the heart of those most fundamental notions which have consistently been applied in arbitral practice”.  

The tribunal found that AABU member firms competed with ACBU member firms, but such conduct did not constitute a breach of the obligation under the MFIFAs. It held that “AABU by disrupting Claimants’ business opportunities and hiring away their personnel, may have breached their implicit obligation to cooperate and to pursue their professional practice in accordance with the principle of good faith and fair dealing which is inherent in international contracts and expressly stated in Article 1.7 of the UNIDROIT Principles”. The tribunal finally, rejected the claimants request for US $ 100 million in damages but held that with the termination of the MFIFAs the claimants lose their right to use the Andersen name. Nevertheless, the tribunal allowed the claimants a reasonable period of time to adjust to the new situation after which the claimants had to cease use of the Andersen name. The tribunal added that it is a well-established rule of law that a fundamental breach of a contract gives the aggrieved party the right to terminate the contractual relationship. This general rule is reflected in the MFIFAs which provide that the effect of a material breach thereto entitles the wronged party to terminate its MFIFA. Under the UNIDROIT Principles of International Commercial Contracts, a party may terminate a contract when the failure of the other party to perform an obligation under the contract amounts to a fundamental non-performance. The consequence of termination is to release the parties from their obligation to effect and to receive further performance. Consequently, the claimants were released from all of their obligations to the AABU under the MFIFAs as of the date that the award was notified to the parties.

The short discussion of Arthur Andersen arbitration demonstrates that the tribunal applied the good faith and adjustment rules under the UNIDROIT Principles to basically create a fair outcome which was a good settlement agreement. It provides for an orderly dissolution of partnership, joint intellectual property rights and the use of trademarks over the transitional period. These issues have been done through application of the tribunal’s power and by use of such principles. It shows how tribunals actually use their power in a way that adequately recognises the dynamic character of the contract and they are able to defend the equilibrium. Also, the tribunals use their power wisely to maintain the contractual balance to place the parties in the position in which equilibrium is restored.

The thesis mechanism maintains the contractual relationship and will not interject unpredictability into the contract and reduces the cost of the contract. It is stated that; “In so doing the court will

231 ibid  
232 Ibid  
233 UNIDROIT Principles of International Commercial Contracts, Articles 7.3.1(1) and 7.3.5(1).  
seek to make a fair distribution of the losses between the parties. This may or may not, depending on the nature of the hardship, involve price adaptation. However, if it does, the adaptation will not necessarily reflect in full the loss entailed by the change in circumstances, since the court will, for instance, have to consider the extent to which one of the parties has taken a risk and the extent to which the party entitled to receive a performance may still benefit from that performance.” 235

According to the proposed contractual approach, since the decision of the panel is final, renegotiation provisions should clearly define the scope of power of the panel and explicitly set out the conditions regarding the extent of adaptation according to good faith to maintain the contractual balance and find an equitable solution. In addition, given the very long duration of petroleum agreements, the third party should adjust the contract with objectivity to reach the purpose of the contract consistent with the parties’ intention mirrored in the contract terms. The panel should restore the equilibrium according to the intention of the parties, original agreement and the background of the relationship.

As discussed above, a mechanism which provides for renegotiation of the contractual terms in the event of disruption of the equilibrium and if the renegotiation process fails refers the case to a panel of three experts, including a lawyer, an independent technical consultant and an economist can avoid the conflict and minimise investment disputes. Through the mechanism, the panel should seek to restore the equilibrium and determine the rights and obligations of the parties according to the changed circumstances. The third party’s power should be subject to some principles such as maintaining equilibrium and fairness and should be the last resort.

7.5. Conclusion
This chapter has found that the generally accepted principle of sanctity of contract or pacta sunt servanda is widely recognised under international law and major legal systems. This principle is not absolute and under specific conditions and exceptional circumstances the contract may be adapted to the changed circumstances. It is also established that force majeure and hardship clauses were used to enhance flexibility in the contract and provide a triggering point for renegotiation. However, force majeure and hardship clauses may not be employed against all unfavourable changes in the equilibrium of contract or bad bargain.

Recognition of the need for adaptation of long-term contracts through a relational model can ensure the dynamic evolution of the parties’ relationship. The renegotiation clause is seen as an effective instrument for maintaining the equilibrium of the contract by virtue of flexibilisation and stabilisation of transactions. Such clauses reinforce the mutability of the agreement, promote

235 UNIDROIT Principles, Article 6.2 (3), comment 7, p. 221.
stability and create a balance between sanctity of contract and the need for operating the contract and fairness. The classical model of relationship focuses on the presentation, sanctity of contract and performance of the contract in a static model of relationship which may result in an unfair outcome or termination of the relationship. Nevertheless, the renegotiation clause in a relational model can promote the contract flexibility and alleviate the strength of the static model and sanctity of contract to seek a *fair and reasonable outcome*.

As discussed above, given the long duration of petroleum agreements, the huge investment, long payback period and the limited foreseeability of the parties concerning potential future events, contractual flexibility and adjustment are vital to keep the contract consistent with the future contingencies.236 The legal discussion as to contractual mechanism of contract adaptation by the third party is part of the legal debate of two competing principles of pacta sunt servanda and rebus sic stantibus which I have already discussed in detail.

A balance between flexibility and certainty should be struck. The current trend is to confer a *broad competence for contract adaptation* on the third party which is consistent with pragmatism and commercial necessity.237 The contract adaption by consent of the parties is also in line with the party autonomy and sanctity of contract.

The thesis in this chapter suggested its proposal for adjustment of contractual relationships by virtue of the mandatory adaptation by the third party. Additionally, the content, procedure, advantages, disadvantages and model clause for such mechanism were presented. The proposed approach by this thesis suggests two tiers. Firstly, the parties should renegotiate and adapt the contract according to the requirements of the clause. Secondly, in case of failure of a renegotiation, a panel of three experts, not only from lawyers, but broader composed of an economist, an engineer and a lawyer will look at the surrounding circumstances to deal with the conflict of interests, against the background of the contractual equilibrium that the parties sought to achieve in their original transaction. The practical requirements for effecting third party intervention are manifold. First, the third party’s power should be broad enough to allow necessary flexibility. Second, the decision must be quick and binding if it is to bring about a quick and solid settlement of a dispute.

However, the adaptation process requires the cooperation of the parties to reach an equitable outcome. If the parties are unable to reach agreement in order to adapt the contract with changed circumstances, the third party intervention is an effective mechanism to preserve the agreement’s

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financial viability. The third party mechanism is not a panacea. However, as this thesis has made clear, it is an attempt to restore the contractual equilibrium and to avoid the problems caused by the classical model. The third party intervention where contracting parties have agreed that the panel’s decision would be final and binding could practically maintain the relationship in a multi-million dollar project and adjust the contract in the parties’ interests. The panel’s decision would be according to the background of the parties’ relationship, their intent, and provisions of renegotiation. This approach can be an alternative to dispute resolution by avoiding costly disputes.
Chapter 8: Conclusion

This thesis sought to explore how well the existing law deals with the preservation of the equilibrium, and attempted to suggest an adaptive mechanism to protect the equilibrium against the obsolescence and restore the damaged contractual equilibrium. This research focused upon preserving equilibrium of the contract, the interplay between risk of the host government’s interference with the foreign investor’s property rights (expropriation) and the obsolescing bargain (erosion of bargaining power) and their impact on the equilibrium of international petroleum investment agreements.

In addition, it analysed the role of certain contractual clauses in managing the risk of expropriation as an attempt to maintain the contractual equilibrium to protect the parties’ interests. The thesis provides a comprehensive analysis of the equilibrium of the contract, obsolescing bargain of power and risk of expropriation as a factor disrupting the contractual equilibrium according to the examination of contractual theories and arbitral practice. This research aims at suggesting a distinct analysis of the contractual equilibrium by rejecting the existing contract law theory. This study particularly concentrates upon the importance of maintaining contractual equilibrium for minimising international investment disputes. The research seeks to investigate whether the existing law has been able to preserve stability of contractual equilibrium in long-term relationships.

The thesis for this objective scrutinised two rival accounts of law, namely, the classical and relational theories to discuss the extent to which they can cope with the obsolescing bargain and erosion of the equilibrium. The current study examined the success of contractual mechanism in the preservation of the equilibrium and the way in which contractual devices work. Then, the study analysed the role of such mechanism in minimising investment disputes by examination of contract practice and international arbitrations.

It examined practice of international petroleum arbitrations and the response of this practice to the substantive law in the field of petroleum. It is throughout the study discussed that there is no unity of opinion within scholars regarding the selected substantive law issues. However, the law in this area is progressed and later tribunals learned from their precedents. Thus, tribunals have come to more realistic decisions by taking balanced and sophisticated approaches. The international arbitral practice and development of substantive law in international petroleum transactions are important to lawyers, arbitrators, contract drafters, scholars, international oil companies and host states to plan for unfavourable events that could change the original equilibrium of the contract to avoid contractual imbalances and disputes. It could also help the tribunals and contracting parties in the interpretation of the contractual terms and to promote future negotiations for business projects between host governments and foreign investors.
In this chapter, the researcher seeks to conclude some important points in evaluation of contractual mechanism in mitigating risk of taking over and contractual imbalances. This will not repeat all findings and conclusions that have been made in previous chapters.

This thesis found that international petroleum transactions are vulnerable. The government or state agency is a contracting party and has sovereign power to alter the arrangements which contractually agreed to. The project would be implemented within the host state territory. Thus, in order to minimise the obsolescing bargain and as a result alteration of contract, contractual devices for protection of the parties’ interests and maintaining the equilibrium are necessary. The recent developments in the energy industry revealed that host countries have considerably shifted from direct expropriation to indirect expropriation through more subtle methods to change the equilibrium in the foreign investor’s disadvantage. The examination of the academic literature and cases indicate that host governments employ different methods including increasing taxes, change of foreign exchange control and setting new environmental regulations to unilaterally alter the contractual terms. As discussed earlier in chapters two and three, this is the host state’s response under in the classical model to restore a damaged equilibrium. Since the classical model of contracting does not allow for adaptation, host states interfere with petroleum contracts. This is the main reason for the major problem in the petroleum industry, i.e. expropriation.

In international petroleum investment transactions, contractual techniques are widely used to mitigate the risk of contractual disequilibrium. Because of the obsolescing character of bargain, contractual stability and transactional certainty are more important than normal commercial contracts. As noted earlier, the stabilisation clause cannot offer full and absolute protection. However, breach of such clauses makes expropriation unlawful and would increase amount of compensation. Thus, in order to maintain the contract financially viable over the life of the petroleum contract as a long-term relationship, contractual arrangement should be well designed and contain a mechanism to re-establish the equilibrium between the parties. Additionally, another factor is contractual flexibility and the ability of adapting to changing conditions. Indeed, adjustment is necessary for long-term and complex investment agreements to restore the economic balance between the contracting parties according to the original terms.

In this context, the renegotiation clause can be an effective technique to decrease occurrence of agreement change by host states and to avoid conflict. Such clauses could offer a middle point between contractual flexibility and stability. Hence, this blend approach which contains both stability and flexibility in international petroleum agreements is the most effective tool. This reveals the significance of interaction between contracting parties and how they are interdependent to implement the project. This mechanism would be an appropriate device to distribute the economic profits between the host country and the international oil company. In addition, this could maintain the
equilibrium of the contract. This approach would therefore decrease the possibility of occurrence of indirect expropriations that could take place by host states’ intervention.

The contractual mechanism that has been discussed in this research could reduce the risk of the host government’s interference with the foreign investor’s property rights and avoid conflicts. Contractual devices could not completely prevent resource nationalism or exercise of sovereign power. Thus, they cannot entirely eliminate the risk of expropriation and disequilibrium. Nevertheless, breach of such clauses will make the government action unlawful and will substantially increase the amount of compensation. The analysis of the academic literature and practice in international petroleum investments showed a trend towards indirect expropriation in recent time. Hence, the role of such clauses in minimising and management of such risk is outstanding. It is notable that contractual mechanism neither can entirely remove the risk of indirect expropriation nor may completely limit the sovereign power of the host state. However, insertion of such clauses in a contract maintains a balance between the international oil company and the host government’s interests. This could manage and reduce the risk of interference with the investor’s property rights and alteration of contractual balance.

It has established in chapters three to six, the significance of the role of contractual devices in international petroleum transactions.

It was discussed throughout this research that in order to reduce the risk of host state interference and disruption of equilibrium, contracting parties should conclude a fair balanced contract containing provisions providing economic interests for both parties. The application of fairness and good faith in a long-term contractual relationship in a high-risk industry like the petroleum industry could be seen as a solution that allocates risks and rewards. This approach would establish a mutual balance between the host government and the foreign oil company’s interests. Finally, there are other investment protection mechanisms which may enhance protection. They are as supplement not alternative to contractual devices such as BITs, MITs and insurance. However, it should be mentioned that in case that contractual clauses cannot completely prevent the risk of expropriation they will increase amount of compensation. In case of failure of adjustment of the contract, the thesis proposal is mandatory adjustment which the parties have already agreed to. The outcome of third party adjustment will be binding for the parties and is a solution for maintaining the relationship when the parties were unable to reach an agreement.

In chapter two the legal nature of international petroleum contracts, the OBM, relational and classical theories of contracting and the relevant law and practice were discussed. This chapter scrutinised whether petroleum agreements were articulated by strict contractual terms or by flexible legal norms to adapt to changes. According to the classical contract law, contract adjustment is inefficient and unnecessary for allocation of resources and does not have any benefit to society. This will improve certainty and trust not only in the contractual relationship between the parties but also in international
The principle of pacta sunt servanda is respected but it is not absolute and there is a major shift to relationality by elements of relational theory.

Additionally, the chapter addressed the principle of sanctity of contract and its implications under the classical and the relational contract theories. The contractual equilibrium is defined by attaching significant weight to the role of surrounding circumstances. It includes circumstances at the time of contracting and those encompassed the contract over the contractual relationship. International tribunals use surrounding context to define contractual commitments and to enforce good faith in the relationship of the contracting parties. International arbitrations have widely recognised the role of surrounding circumstances and obsolescing bargain to define the contractual content. The Iran-US Claims Tribunal in many cases has clearly rejected the argument that the principle of pacta sunt servanda is a rule that per se is sufficient to define contractual commitments. It has considered the subsequent conduct of the contracting parties as one of the elements that determine contractual content. Consequently, the classical model and the way in which the law attempts to foresee and finalise every single issue at the time of contracting with no further adaptation in the future, would not protect the parties’ interest.

It was underlined that the contractual relationship operates in an evolving context and not in vacuum. Thus, adaptation of the contract for maintaining the equilibrium would preserve reasonable expectations of the contracting parties. Despite the classical theory of relationship defining contractual content by intention of the contracting parties and formalistic rules, the relational contract theory determines the contractual relationship in light of surrounding circumstances and what is appropriate, rational and reasonable in that context. In long-term contractual relationships which are subject to changes contracts and contained terms are not the exclusive source of contractual commitments. Nevertheless, the surrounding context and conduct of the parties would define the context of relationship. The second chapter has also discussed the factors which constitute and disturb the equilibrium, and the response of contract law and arbitral practice to the relational understanding of contract.

Chapters three and four addressed direct and indirect expropriation. The interference of the host state with the foreign investor’s property is the main reason for arising disputes. These chapters examined direct and indirect taking of foreign investor’s property to investigate how well the law of expropriation deals with the preservation of contractual equilibrium in long-term contracts. It has been addressed that the claim of expropriation can be established whenever what was taken constitutes property rights capable of being compensated. The examination of petroleum arbitrations revealed that the notion of property includes contractual rights, company’s shares, and tangible and intangible property rights. Thus, taking measures that substantially affect or alter such rights could constitute

expropriation and would be compensable. The response of the arbitral practice to such conflicting areas and the extent to which the host government can interfere with the foreign investor’s property to control the energy industry were also examined. It demonstrated that in modern times arbitral tribunals take an expansive approach in defining property rights. In addition, it is confirmed by international arbitrations that management rights and involvement in the process of making decisions for a company are not always independent property rights capable of being expropriated. However, the tribunal can employ them as a factor for deciding the exact date of expropriation.

Additionally, chapter three looked at the control mechanism available to host state over international oil companies operating within its jurisdiction. It has been endorsed by international arbitral practice that host states have the right to control the operation of international oil companies over the life of business in their territory. However, the exercise of this right and taking over of foreign-owned property shall be lawful. The certain requirements for a lawful taking have been widely recognised by arbitral tribunals. The taking over of the property must be for public purpose, on a non-discriminatory basis and with the payment of compensation. The chapter demonstrated the response of petroleum arbitral practice to these basic requirements and discussed the conflict arises out of the relevant arguments. Excluding of LIAMCO arbitration, all arbitrations have endorsed the public purpose requirement as a condition for a lawful taking. International petroleum arbitrations indicate that taking over of foreign investor’s property for purely financial purposes or to avoid contractual commitments or for political reasons will be contrary to the public purpose requirement and are therefore unlawful. However, the host state may expropriate property of one investor and leaves the other intact. This could be non-discriminatory and lawful as long as the government action is justified. In addition, the third requirement for a lawful taking, namely, compensation was discussed. The examination of scholarly opinion and arbitral practice show that taking of property must be compensated and international law sets out limitations for host governments to exercise their rights to control and regulate operation of international oil companies.

In chapter four the question of indirect expropriation, the distinction between direct and indirect expropriation, legitimate regulation and its distinguishing factors from indirect taking were discussed. The measures that may affect property rights which are not considered wrongful and do not result in liability and compensation payment examined. Such measures that fall into the category of the police power of the host government will not give rise to liability. The areas of conflict that may arise out of this argument have examined.

In addition, two main approaches under the scholarly opinion and arbitral practice in the assessment of host government’s actions were discussed. The first approach emphasises the effect of host state’s measures on the foreign investor to enjoy and use the property. Other approach recognises the effect of host state’s measure but the purpose of the host state in taking such measure is the major factor in
determining whether or not expropriation has taken place. The first approach is widely supported by scholarly writings and arbitral awards. In determination of expropriation, international tribunals initiate a fact-based scrutiny and in this process, the governmental action must have substantially deprived the foreign investor of its ownership rights.

The measure must affect the ability of the investor in the enjoyment and use of property and if it partially affects the property it would not amount to expropriation. The legitimate expectation of the foreign investor is another significant factor that its deprivation by the host state could result in an expropriation. The legitimate expectations reflect the host state’s obligations to the international oil company and the foreign investor’s reliance on such undertakings that have motivated the oil company to take the risk and bring the capital and technology to the host state’s jurisdiction. Thus, disappointment of the legitimate expectation is a breach and would amount to an expropriation.

The analysis of the arbitral practice shows that deprivation of the foreign investor is the main criterion in determining expropriation. Therefore, even when the host state’s measure does not bring gain but affect the foreign investor’s property right it amounts to an expropriation. Most of petroleum arbitral awards were decided by the Iran-US Claims Tribunal. The tribunal’s practice is in line with international law principle that in the application of a bona fide regulation, the occurrence of economic injury to the foreign oil company would not give rise to liability. Governmental measures affecting the shareholder’s rights would not amount to expropriation per se. However, if such measures are accompanied by other governmental actions and their effects together are to deprive the foreign investor and to take the control of business venture, then it will be an expropriation. The careful consideration of petroleum arbitral practice also demonstrated that the effect of the host state’s measures on the international oil company is the key factor in establishing an expropriation.

In addition, chapter four discussed the adequacy of the law of expropriation and compensation in preserving the equilibrium and, thus, protecting contracting parties’ interests. The significance of the preservation of the contractual equilibrium, and contractual relationships were examined. Further, theoretical and practical problems regarding termination of contract, instead of maintaining the contract discussed. The challenge of determination of compensation in international investment law under the classical model of contracting were addressed. It underlined the vitality of the preservation of contracts, and the contractual equilibrium in the relational model of contracting. This chapter also picked up the ultimate purpose of the contracting parties under the classical model, namely, enforcement of an award. The analysis of case law established the inadequacy of the existing law in maintaining the contractual equilibrium and underlined necessity of the preservation of contractual relationships. The research followed the discussion and revealed that enforcement of awards against the host states, in the field of oil and gas would be problematic. Consequently, this would be very costly and sometimes after decades, the injured party has not been compensated.
Chapter five studied contractual stability, legal value of stabilisation clauses and the effect of such requirements on international petroleum contracts. The significance of contractual stability in international petroleum contracts has discussed throughout the chapter and it has been shown that such clauses are aimed to guarantee that host government will not use its power as sovereign state to alter or terminate the contract. For examination of legal value of stabilisation clauses this chapter discussed their legal validity and effectiveness under scholarly writings, international arbitral practice and applicable law. The examination of scholarly writings demonstrated that there was a controversy between legal scholars. Where domestic law of the host state is applicable law then stabilisation clauses could not limit the legislative and administrative powers of a sovereign state. Thus, the question of legal validity and effect of such clauses would not arise.

In case that national law of the host state is governing law if the government’s actions give rise to denial of justice or where the action is wrongful, it would lead to international liability. This easily can explain that why international oil companies are reluctant to place their contractual relationship under provisions of host state’s domestic law. The chapter has also examined the response of international petroleum arbitrations to the question of legal validity and effectiveness of these clauses. It was shown that there are two legal viewpoints in arbitral decisions on the legal nature of stabilisation clauses. In a number of decisions, arbitrators have given full effect to such clauses but in other cases tribunals have subjected their validity and effects to certain requirements and their effects have been limited. The incorporation of stabilisation clauses into a petroleum agreement could hinder the unilateral change or termination of contractual relationship.

However, the host state still holds sovereign rights to legislate to regulate the economic, energy industry and to set new regulations to guarantee public interest. Such clauses cannot completely remove inherent instability and would not guarantee a complete protection in this volatile industry. Stabilisation clauses for being effective have to be drafted clearly and only cover a limited period of time. The analysis of international petroleum arbitral awards showed that stabilisation clauses could strengthen the contractual position of the international oil company but they cannot be used as a full protection mechanism against taking of property rights by the host state.

The analysis of international arbitral practice and scholarly opinion in this research demonstrated that contractual clauses could not completely protect the equilibrium against external contingency or host states’ sovereign powers. Such techniques cannot guarantee the transactional stability for long-term international petroleum agreements. Hence, such clauses do not advocate contractual certainty for contracting parties and this study proposed renegotiation techniques to promote transactional stability and decrease inherent uncertainty in international petroleum contracts.

Chapters six and seven are interrelated. In these chapters, theories of renegotiation and the question of how contract adjustment could promote contractual stability were discussed. The chapter examined
adjustment of international petroleum agreements in the presence of renegotiation clauses, traditional and modern renegotiation clauses, the practice of adjustment and international arbitral awards. The chapter then explored the situation where the contract includes a renegotiation clause and examined renegotiation clauses in international petroleum agreements. The triggering events, the duty of renegotiation, checklist for drafting renegotiation clauses, principles for the renegotiation process and the extent to which a contract could be adjusted by a renegotiation clause have been addressed. Further, the chapter discussed the response of international petroleum arbitrations to renegotiation of contractual relationships. In chapter seven, the interplay between principles of pacta sunt servanda and rebus sic stantibus, and adjustment of contracts in the absence of specific provisions were examined.

In addition, the chapter studied hardship and force majeure clauses and their positions in relation to adjustment of contractual relationship. Hardship and force majeure clauses are aimed at adjusting the contract in the event of unpredictable fundamental changes in the surrounding context of the contract. Hardship events take place when performance of the contract becomes extremely onerous. The force majeure event happens when the contract implementation temporarily or permanently becomes impossible, because of acts of god. The mere disruption of contractual equilibrium will not constitute force majeure. Thus, contracting parties cannot rely on force majeure or hardship clauses for bad bargain or contractual disequilibrium that could take place over the contractual relationship. They can seek relief for contractual imbalances where there is an explicit provision for renegotiation. The analysis of international arbitral awards and scholarly opinion has endorsed it.

Examination of the arbitral practice in the field of petroleum, demonstrated that the contract adjustment and renegotiation are widely recognised. The requirements for the renegotiation process were discussed and set out in some petroleum awards. The tribunal in AMINOIL arbitration argued that contracting parties must renegotiate in good faith and this requires awareness of the interests of the other party, sustained upkeep of the renegotiations over a period of time appropriate to the circumstances, and a preserving quest for an acceptable compromise. The duty of renegotiation does not obligate contracting parties to reach an agreement. Failed renegotiation could be breach of contract if it can be attributed to one party’s conduct. However, one party’s refusal to the latter party’s proposal will not constitute a breach of duty of renegotiation as long as it is justified by normal commercial practice and made in good faith. The adjustment should restore contractual equilibrium that has been damaged and should also take into account other contractual terms and reasonable expectations of the parties for this aim.

The thesis hypothesis which the existing law is grounded in a classical model that builds on a presentiated understanding of petroleum contracts, treating them as a one-off bargain and creates a static framework was discussed. It was demonstrated that due to the presentiated understanding of agreements when contracts are concluded they become obsolete and host states due to the regulatory power have the ability to alter the contract in the foreign investor’s disadvantage. The entire classical
model does not lead to adjustment and only reinforces the parties’ rights and duties and will therefore result in a breach. As a result, the law of expropriation and stabilisation clauses cannot preserve stability of contractual equilibrium in long-term relationships. The thesis in chapter seven proposed and discussed its mandatory mechanism for adjustment of contracts. The content and procedure for third party mechanism, its problems and model clauses were discussed. The proposed mechanism by this thesis suggests two tiers. First, the parties should renegotiate and adapt the contract according to the requirements of the clause. Secondly, in the event of failure of a renegotiation, a panel of three experts, not only from lawyers, but broader composed of an economist, an engineer and a lawyer will look at the surrounding circumstances to deal with the conflict of interests, against the background of the contractual equilibrium that the parties sought to achieve in their original transaction. The panel’s decision will be final and binding. The thesis proposal seeks an adjustment of contract with the parties in the first level. Then, in order to resolve the dispute and avoid termination of the contract suggests mandatory adaptation by a panel of experts. This package of renegotiation and mandatory adjustment under a relational model of contracting – which is new in this sense – would protect the contracting parties’ interests. Consequently, this mechanism would restore a damaged equilibrium. As noted earlier, this mechanism is not a panacea, but at least is an attempt based on reality in order to protect the contractual equilibrium and resolves disputes.

The thesis has established a solid foundation for further researches regarding management of international investment disputes. The study has also established a new theoretical framework in which bargaining power relationships and the source of conflict in the host government and the foreign investor relationship were analysed. The new theoretical model can systematically examine the risk of expropriation, the interplay with the contractual clauses, the concept of obsolescing bargain, and the disrupted equilibrium of the contract which may lead to disputes. I have established that the contractual clauses can minimise the risk of expropriation and restore the equilibrium which improve transactional stability and flexibility. In case of failure of renegotiation, the third party adjustment can preserve the equilibrium. The thesis solution is that the adjustment mechanism should be anchored in the approach which respects interest of both parties, rather than existing investment law in relation to expropriation and stabilisation which is already somewhat poisoned. Then there will be a much better way of preserving the contractual equilibrium.

Finally, the research does not intend to be exhaustive nor cover all the relevant issues as to the management of international petroleum contracts. Nevertheless, this research can be used in the examination of the areas which were not studied in this research but need further studies. For example, the law of compensation, the assessment and limiting compensation, the response of international petroleum arbitral awards and force majeure clauses as a renegotiation tool, are of the questions which may be raised.
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<td>AIPN</td>
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<td>BIT</td>
<td>Bilateral Investment Treaty</td>
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<td>BP</td>
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<td>Cam. L. Rev.</td>
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<td>CEPMLP</td>
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<td>CERDS</td>
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<td>Colum. J. Transnat’l L.</td>
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<td>Abbreviation</td>
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<td>EU</td>
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<td>FDI</td>
<td>Foreign Direct Investment</td>
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<td>HGAs</td>
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<td>IBA</td>
<td>International Bar Association</td>
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<td>Ibid</td>
<td>The same (Ibidem)</td>
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<td>ICC</td>
<td>International Chamber of Commerce</td>
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<td>ICJ</td>
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<td>International Oil Company</td>
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<td>JBL</td>
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<td>Journal of Contract Law</td>
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<td>JENRL</td>
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J.I.B.L Journal of International Banking Law
J. Int’l L. and Economics Journal of International Law and Economics
J. World Inv. & Trade Journal of World Investment and Trade
Law & Pol’y Int’l Bus Law and Policy in International Business
LCIA London Court of International Arbitration
Louisiana L. Rev. Louisiana Law Review
MIGA Multilateral Investment Guarantee Agency
NAFTA North American Free Trade Agreement
NOC National Oil Company
OECD Organisation for Economic Cooperation and Development
OGEL Oil, Gas & Energy Law
OPEC Organisation of the Petroleum Exporting Countries
OUP Oxford University Press
Para Paragraph
PSA Production Sharing Agreement
PSC Production Sharing Contract
Supra Above
European J. Int’l. L The European Journal of International Law
UK United Kingdom of Great Britain and Northern Ireland
UN United Nations
UNCITRAL United Nations Conference on International Trade Law
UNCTAD United Nations Conference on Trade and Development
UNIDROIT International Institute for the Unification of Private Law
Uniform L. Rev.  Uniform Law Review
US  United States of America
Vand. J. Transnat’l L.  Vanderbilt Journal of Transnational Law
Va. J. Int’l L.  Virginia Journal of International Law
YCA  Yearbook of Commercial Arbitration
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