Stabilization Clauses in Production Sharing Agreements.



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1.1. Background.

International Oil companies and host states rely on stabilization clauses for purposes of guarding their interests in the Production Sharing Agreements and to avoid any alterations in the Agreement(s) save for consent of the contracting parties. Oil & Gas Joint Venture Agreements obtain huge sums of capital investments for a long period as may be agreed by the parties and for all this, it is safe for the IOC's to enter into a contract that has stabilization clauses. The said clause prevents unilateral modification in as much as parties may agree on renegotiating clauses, which aim at protecting parties to the petroleum joint ventures by making the Agreement flexible throughout its lifetime. *See: "Stability in Petroleum Contracts; Rhetoric and reality (Lessons from the experience of selected developing countries and Economies in transition (1980-2002) DPhil thesis, University of Dundee 2005), 95.*



1.1.1 What is a Stabilization Clause?

A stabilization clause is a contractual clause inserted in an Agreement entered between a foreign investor and a state. In the investment industry, it is always in investment contracts such as concession agreements wherein a host state grants a concession as of right to an investor to develop certain projects. The general position of this clause in the petroleum contracts is that it is a type of state assurance in a regulated oil and gas contract, which ordinarily states that the conditions agreed upon in the contract between a state, and IOC, will not be negated by a state's unilateral decision through formulation of legislation or regulation. *See; Libyan American Oil Company Vs. The Government of the Libyan Arab Republic & Abdullah Al Faruque*.

1.1.1.1 Case Study: Iraqi Kurdistan Oil and Gas Contracts.

Iraq has had wide application of stabilization clauses and renegotiation clauses owing to the interests of the contracting parties I.e. the HS and the IOC's. This is due to the volatile environment on economic and political grounds. Therefore, there is use of a Production Sharing Agreement and thus the need to always review the clauses to ascertain whether they have an impact on either profit or cost oil. Due to such uncertainty and the likelihood of disputes that may arise between the contracting parties, the PSA bears the dispute resolution mechanism that may be adopted by the parties just in case of conflict. In the Iraq oil and gas industry, it is deemed fit to have stabilization clauses in their PSA such that the risk likely to be encountered by foreign companies is lowered and secondly, to create certainty of the value from the product (oil) away from economic and political dynamics. *See; Mohsin Shareef Salih and Rdhwan Salih, "Strategy of Oil Contract Negotiation" (2015) 6/9 International Journal of Business and Social Sciences.*

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1.1.2. Recourse made to Uganda.

In Uganda's Oil and Gas industry, it is one entered between the state (HS) and the International Oil Company (IOC) for purposes of activities alongside the upstream, middle stream and downstream sector. The essence of the same is to ensure that IOC's as licensees are given protection in case of change of circumstances in the near future. *See; Letco versus Liberia ICSID Case No. ARB/83/2 & Articles 10 & 12 of the Model Production Sharing Agreement on state participation and production sharing.*

Stabilization clauses are therefore, particular commitments that constitute ring fencing by the IOC's in light of the contract entered with the HS not to alter the terms of the International Petroleum Agreements by legislation or other means without the consent of the contracting party. *See; Marganta T.B, Stabilization Clauses in International Petroleum Transactions, 30 Denver J. International Law and Policy 217 (2003).*

It is on rare occasions that the contracting party will permit the alterations in the International Petroleum Agreement beyond that which was agreed by the parties . This is based on the recognition of the principle of freedom of contract between parties who are at the time of contracting are of a sober mind. *See; Printing and Numerical Registering Co. Vs. Sampson (1875) 19 Eq 462 Sir George Jessel MR.* However, due to un-foreseen circumstances, the parties can waive the same.

1.1.2.1. What is the rationale?

In essence, stabilization clauses bar a state from later alone legislating against the International Oil Company since the said companies will have negotiated a stabilization clause to freeze the laws of the state at the time of the investment when concessions are hectic. This is because clauses in re-negotiation for example in case of any change in law the government shall sit with the investor and the investor may be given tax waivers and reliefs.

In modern day, stabilization clauses do not restrain the Host State from applying amended legislation but rather outline the need for reinstatement to the prior balance of economic benefits in the event of adverse legislative changes. The clauses may be comprehensive or limited.

Significantly, stabilization clauses are a creature of contract law since the minds of the two parties aiming at achieving in respect of the projected investment meet consensus ad idem. Therefore, a contractual risk management tool aims at maintaining legal and economic equilibrium of the investment project by preventing unilateral actions of host state in exercising its sovereign powers. That notwithstanding, in absence of the said clause a state can claim a unilateral right/entitlement to waive its obligations in the contract based on principles of statehood, autonomy/sovereignty under international law since the activities in respect of extraction and production of the oil are within the HS, it shall have control and management in the circumstances. *See; Articles 1 & 2 of the UN Charter 1945; 1952 No. 626 (vii) UNGA Resolution & Article 244 of the Constitution of the Republic of Uganda.*

However, judicial decisions have stressed that the presence of a stabilization clause in a contract does not permit a state to exercise its sovereign power, it is indeed a freezing order and the same power can only be authorized on renegotiation of the PSA towards the stabilization clause. *See; International Arbitral Award, 104 J. Droit International 350 (1977) translated in 17 I.LM (1978) Texaco Overseas Petroleum Co. Vs. Libya*. The rule of law is that when there is a dispute interparty, internationalization of the contract is most appropriate to deal with the dispute at hand. This resolves the emerging control of the HS over IOC's.



In a like manner, the contracting state is bound by principles of pact sunt servanda to perform a contract subject of a stabilization clause where the same is agreed interparty. High contracting parties are therefore required to act in good faith for as long as the contract exists borrowing from the position in Articles 26 and 46 of the VCLT 1969 on the exception of fundamental change of circumstances.

Before taking up Agreements with host cost countries in the Oil & Gas sector, IOC's first conduct the required corporate and sustainable due diligence of the host country's political history and social economic status since these are the major setbacks in such contracts. The findings obtained aid the IOC to make an informed decision on whether to invest or not. Thus, whereas IOC's are interested in maximizing profit oil out of the contract, the host state is interested in accumulation and maximization of revenues, which is a desired need of the state to combat base erosion and profit shifting in respect of principles of taxation of such foreign investments. *See; Section 79 of the Income Tax Act cap 340 (As Amended) on source rules for purposes of taxation.*

It is thus key to note that the application of stabilization clauses to both developing and developed countries differ since MDC's are always at an advantage compared to LDC's and this is due to the position that the former are fast movers as compared to the later. The huge impact it has on the developing countries is the adverse effect against development in several sectors like environmental legislations, labour and human rights.

Recourse made to Production Sharing Agreement, this is the Agreement entered between the HS and IOC to trade in oil production. However, it is crux to note that a Production Sharing Agreement does not waive the Petroleum Exploration Development Act. In the circumstances, what is shared is the oil only after production after the international Oil Companies have put in the cost to explore and produce, this is simply because the state may not have the capacity to fund the oil projects.

It should be noted that there are several IOC's that have contracts with Uganda to wit; Total Energies, CNOOC among others who have contracted with Uganda. These companies do not give the HS money but they give the government part of the oil then the government determines what to do with it.



In the circumstances, many states ask the oil companies to do the marketing and selling of the oil for them where, the government simply gets a share on the oil barrels, the government will equally tax the oil companies and in such transactions, the government's share increases.

1.1.2.2 Types of Stabilization clauses.

Freezing clauses. These ordinarily preclude the host states from changing its legislation; this is an encumbrance on the Host State. In the alternative, any changes in the host state legislation subsequent to the PSA do not apply to a specific legislation. The general practice in Uganda is the primacy of the PSA terms in the event of a conflict with legislation. It therefore, follows that where there is a variance between the Agreement and the law, the Agreement shall take precedent.

Freezing clauses are classified into two that is full freezing clause and the limited freezing clause. The former clause relaxes the fiscal and non-fiscal issues where as the later aims at relaxing a particular set of legislation or legislative actions. An example of a freezing clause is when it is tailored towards tax policy. Let us by assumption take it that the stabilization clause found in an agreement is a full freezing clause the IOC would presume that it is exempted from competing with any new environmental laws enforced after the Agreement has been signed.

Conversely, a limited freezing clause, the details contained in the clause would decide whether the IOC could rely on it to evade the application of the new law. In some instances, full freezing clauses are inserted to trim down the efficacy of new laws reason being that the IOC's intend to waive the negative implications of the intended legislation.

1.1.2.2 Challenges Associated with Freezing Stabilization Clauses.

Violation of the principle of sovereignty of states. Under International law, states are independent of each other so much so that each state has control and management of its resources. The applicability of this type of stabilization is a hindrance to this doctrine as recognized under international law. In essence, a freezing stabilization clause contravenes the supremacy of the constitution of the Host state. This is because it permits chance to the IOC's to freeze the laws of HS so as to achieve their set goals in respect of the investment they would have chosen to make to achieve the results. *See; Articles 2(2) and 244 of the Constitution of the Republic of Uganda.*

Conflict of laws. Since IOC's negotiate to achieve the application of the freezing stabilization clauses there is always a dispute on what will apply in case of conflict between international law principles and domestic legislation. In such circumstances, International law can only supersede domestic legislation when the said conflict of laws raises a question of fundamental importance under Article 46 of the Vienna Convention on the Law of Treaties. From the principles of common law, one can state that such clauses oust the party's capacity to contract at free will since it puts one party in a better position than the other on a deal, that the disadvantaged party will benefit from exploration and discovery of the oil. This is a departure from the principles that have since been enunciated in contracts law; PSA is a creature of ordinary contracts.





1.1.2.4. Prohibition on Unilateral Changes.

These are commonly known as intangibility clauses. The terms of the PSA may not be modified or abrogated except with the contracting parties' natural consent. This implies the need for both parties consent in case of any changes deemed appropriate in the PSA entered between the HS and the IOC. This mode is hampered with the desire to do due diligence before the consent of any of the parties is given and it is equally time wasting since decision-making may take a long way to be made. This is because no IOC may want to enter into contract with a state before making thorough due diligence to avoid anticipatory draw back positions.

1.1.2.5. Balancing Clause.

These are commonly known as "economic stabilization clauses". They provide for automatic adjustments or negotiations to restore the initial economic balance of the PSA should legislative changes be introduced after signature. *See; Tanzania Model PSA of 2004.* Therefore, there is need as a matter of sustainable due diligence for the HS and IOC's to negotiate economic balancing clauses in a PSA to avoid adverse effects in the unforeseen circumstances in the future. This is because the petroleum industry is volatile considering the fact that there is limited or no price legislation on policies in the industry referring to Uganda as case study. In some instances where HS are interested in flexibility, they may opt for the Negotiated Economic Balancing Clause (NEBC) whose important function is to balance the competing interests of control and stability needed by both the state & the IOC. *See; J.R. Ray 'illusory Control of State Controlled Resources through Stabilization Clauses; Renegotiating Clauses May Save the Contract, (2013) 11(5) OGELI.*

1.1.2.6. Allocation of the Burden.

These clauses seek to allocate the fiscal and related burden created by a unilateral change in the law. It is common for the resultant burden to be borne by the National Oil Company or the State. *See; The Kenya's PSA where Income Tax is allocated from the share of profit hydrocarbons.* The problem with this mode is that the HS or its National Company bears high risk as compared to the IOC; the National Company has to incur huge costs to cater for any liabilities hence making it too tiresome.

1.1.3. Stabilization clauses ensure a balance in the economic value of a Production Sharing Agreement to wit;-

The position mineral resources in Uganda belong to the state who hold the same in trust of its citizens. By implication therefore, a contract entered between the state and the IOC's must create economic benefit in favour of the citizens. This has been to the contrary based on the statistics that foreign companies have the highest control in some projects like EACOP. EACOP being a limited company with shareholders; Total Energies with 62%, CNOOC with 8%, UNOOC with 15%, TCPC with 15% implying that corporations own 70% in the global north. However, the contracting obligations of the HS and IOC's is to keep the balance in the economic value of a PSA. The legislation in Uganda encourages foreign investors in the Oil & Gas industry for as long as the threshold is satisfied. It is this law among others that set in the need to work towards the economic value of a PSA where IOC's agree with HS on what clauses to insert in their Agreement to achieve the economic value.

Amidst the existence of a PSA, the debate is still looming for and against the project whereas classical economists are for the development of the project such that the country can experience the economic take off, environmental activists are against what the project is likely to cause on the environment. It is these arguments that one ought to understand the essence of IOC's and the deal they enter with the HS is to spur economic growth thus keeping the lifeline of economic value of the PSA.



IOC's always anticipate through their due diligence that there is a likelihood of change in circumstances that may force the HS to change goal posts in light of the Agreement reached however; the Agreement can be left with chance for renegotiations. Such renegotiations can settle the likelihood of the disputes.

Conclusion.

The essence of stabilization clauses is that when the IOC's enter into an International Petroleum Contract/Agreement with the HS there is a likelihood of volatility in exploration and exploitation of projects. Therefore, in the circumstances where the two contracting parties may be at hardship, it is key to focus towards achieving the economic value of a PSA through harmonization. The fact that there is always indemnification clause beyond the desire of renegotiation of the terms aiming at restoring the economic equilibrium of the parties. The parties always agree on an indemnification clause to achieve the goal towards economic value of a PSA. *See; Economic Stabilization Clause in Petroleum Production Sharing Agreement between State Oil Company of the Azerbaijan Republic and a consortium of Oil Companies.*



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