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STABILISATION AND RENEGOTIATION CLAUSES IN PRODUCTION SHARING CONTRACTS: EXAMINING THE PROBLEMS AND KEY ISSUES

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ABSTRACT

OPEC's Monthly Oil Market Report (May, 2011) depicts that the price of OPEC's Reference Basket increased in April, 2011 by about $8.25 compared to March, 2011 and by $35.76 from a year earlier. The Nymex WTI and ICE Brent contracts also witnessed their highest prices since the global financial crisis of 2008. Oil producers like Nigeria are not just on the verge of a national petroleum industry 'legal revolution' in its quest to ensure maximum benefits accrue from oil and gas resource exploitation, but as overtime found itself in politically and economically unacceptable position as parties to Exploration and Production arrangements with investing Oil Companies. Russia, Venezuela, Bolivia e.t.c. have also been earmarked as producers that consistently engage in petroleum contract reviews and nationalisation to ensure petroleum arrangements yield maximum benefits for the State. Following this background and coupled with the unique attributes of Production Sharing Contracts as the preferred option for arranging upstream petroleum operations, this paper essentially seeks to examine the assertion that- *there is no absolute 'contractual security' for contracting parties*. By highlighting relevant problems and issues, especially in countries like Nigeria, it points out that contractual instruments like stabilization, renegotiation and adaptation clauses can at best guide and not freeze-up relationship and cooperation *inter vivos*, towards contractual efficiency.

1. Introduction

This paper essentially aims to examine the use and legal implications of stabilisation and renegotiation clauses in Production Sharing Contracts (PSCs) in the petroleum industry, especially as a means of guaranteeing contractual security. It identifies relevant issues and comments on problems arising from the use of these clauses in guiding the relationships of parties, especially as a contractual tool for risk management. Exploration and production (E&P) arrangements in the petroleum industry are unique for their long-term durations and 'high-risk' profiles.[2]

A principal function of long-term contracts is to facilitate trade, guard and guide relationship-specific investments of contracting parties. As it is well known, the Industry's history shows a willing disposition towards nationalisation, expropriation, breach of contract or renegotiation and review of terms. Therefore, it is important for parties to E&P arrangements to protect themselves through appropriate contractual and regulatory mechanisms, securing their investments against the changing and cyclical fortunes of oil and gas prices and related costs,[3] including legal and political risks,[4] geological, environmental and technological risks.[5]

[2] Randel Young and Richard Devine, 'Managing government renegotiation risk in international energy projects' (2009) 7, I.E.L.R. 256-258 at 256; Bede Nwete, 'To what extent can renegotiation clauses achieve stability and flexibility in petroleum development contracts?' (2006) 2, I.E.L.T.R.56-63 at 56, accessed 2/11/2010; K. Bindemann, 'Production-sharing Agreements: An Economic Analysis' O.I.E.S. (World Petroleum Market Report, Oxford) 25, 1-106 at 29 <https://www.oxfordenergy.org/pdfs/WPM25.pdf> accessed 10/11/2010

[3] Increase in demand usually leads to higher prices, upscalling investments and higher production, which in turn cause lowering of demand. Higher production over time leads to oversupply, then oversupply to lower prices, reduced investment and shrinking of supply and in-turn leads to increase in demand overtime. Unlike the regular market-based systems, higher prices do not always have the same effect on investment decisions. These economic-cycle breeds' divergent reactions from the Company or investor and State parties in E&P agreements.

[4] Olutayo Olubi, 'FG, multinationals clash over royalties' (Monday, 01 March 2010) National Daily Newspaper <http://nationaldailyngr.com/index.php?option=com_content&view=article&id=499:fg-multinationals-clash-over-royalties-&catid=126:business-news&Itemid=545> accessed 7/3/2011.

[5] Thomas W. Wälde, 'Renegotiating acquired rights in the oil and gas industries: Industry and political cycles meet the rule of law' (2008) 1(1), J. World Energy Law Bus, 55-97; Timothy Martin and J. Jay Park, Q.C, 'Global petroleum industry model contracts revisited: *Higher, faster, stronger*', , (2010) 3(1) J World Energy Law Bus, 4-43 <doi:10.1093/jwelb/jwp022>

Parties create agreements and operate based on 'incomplete information' about what 'is' or what 'will be' the effects and implications of proposed and agreed terms, within the contract's duration.[6] The problem of 'information asymmetry' also arises and once parties have become locked-in, the relationship is essentially governed by the provisions of the Agreement. As a result of inability to foresee all future contractual risks and contingencies, parties can and should specify mechanisms for reviewing the terms, as new information about relevant benefits and costs arise.[7] The adoption of these mechanisms i.e. stabilisation, renegotiation and adaptation clauses, are essentially based on the countervailing and counterpart principles of *pacta sunt servanda* (sanctity of contracts) and *clausula rebus sic stantibus* (i.e. contracts are valid as long as the underlying circumstances leading to the agreement continue to exist).[8]

From the foregoing, it becomes pertinent to ask to what extent can parties to E&P agreements leave their investments,[9] rights and obligations to the uncertainties of fate and time? Whether the future and the present are legally or relationally unmanageable by identified risk management mechanisms? Can in-depth or sophisticated drafting and documentation 'freeze-up' the 'now' and fully cater for the 'later'? In attaining contractual security and peace for parties, the rule and role of the law for risk management is embodied in stabilisation, renegotiation and adaptation clauses, Bilateral and Multilateral Investment Treaties, petroleum legislations internationalised by submission to international arbitration.[10] This paper will however focus on the stabilisation, renegotiation and adaptation clauses or agreements.

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[6] Oliver Hart and Moore, John, 'Incomplete Contracts and Renegotiation', (1988) 56(4) Econometrica, 755-785 at 755; Van Houtte, Hans, 'Changed Circumstances and Pacta Sunt Servanda', in Gaillard (ed.), Transnational Rules in International Commercial Arbitration (ICC Publ. Nr. 480, 4), Paris 1993, at 105- 123 at 107 < www.trans-lex.org/117300>

[7] Hart and Moore (Ibid); Abba Kolo and Thomas .W. Wälde, 'Renegotiation and Contract Adaptation in the International Investment Projects: Applicable Legal Principles & Industry Practices', (2003) 1(2) OGEL Journal 1-48, <http://www.ogel.org/article.asp?key=135> accessed 5/11/2010; Talal A.Q. Al-Emadi, 'Stabilization clauses in international joint venture agreements' (2010) 3, I.E.L.R., 54-63 at 54, accessed 3/11/2010.

[8] Hans Wehberg, 'Pacta Sunt Servanda' (Oct, 1959) 53(4) A.J.I.L. 775-786 <http://www.jstor.org/stable/2195750> accessed 06/11/2010; Kolo and Wälde (n7) at 2-3, 17-19; AMINOIL Arbitration Award *(Kuwait v American International Oil Co)* (1982) 21 I.L.M. 976; Joseph Nwaokoro, **'**Enforcing stabilization of international energy contracts', *(2010) January 15, 2010, J World Energy Law Bus* <doi:10.1093/jwelb/jwp027> ; Piero Bernardini, 'Stabilization and adaptation in oil and gas investments' , (2008) 1(1), J World Energy Law Bus, 98-112 <doi:10.1093/jwelb/jwn001>

[9] It can be argued that State parties are investors in land, environment and labour. It is unassailable that Host Countries bear transactional costs in these petroleum ventures.

[10] Wälde (n5) at 57.

2. Exploration and Production arrangements: Production Sharing Contracts

State parties plan to maximize wealth from hydrocarbon resources by encouraging appropriate levels of exploration and development, while the oil companies aim at building equity and maximize wealth by finding and producing oil and gas at the lowest possible cost and highest possible profit margin.[11] Amidst these divergent objectives, corporate investors in upstream petroleum operations (usually Multinational Oil Companies (MOCs)) and Host Countries (Governments, sometimes represented by National Oil Companies (NOCs)) create E&P arrangements, aimed at maximising returns on investments and resources.[12] These arrangements can be modern concessions; PSCs; Joint Venture Agreements (JVA); or service contracts.[13] It has been argued that, these arrangements are basically similar considering their practical implications or from a fiscal point of view, despite their unique philosophical and symbolic backgrounds.[14] The focus of this paper will be on PSC's.

2.1 Production Sharing Contracts: Briefly

As the holder of an acreage, oil mining lease or license the State party or NOC engages the MOC as a contractor for the purpose of carrying out petroleum exploration and production, in other to create a PSC. The discovered and produced petroleum is shared amongst parties in

[11] Center for Energy Economics (CEE), 'Terms for Upstream Projects – An Overview' Case Studies from CEE's "New Era In Oil, Gas & Power Value Creation" Programme: CEE Publications, 1991-2007, 1-9 <www.beg.utexas.edu/energyecon/new-era/case_studies/Fiscal_Terms_for_Upstream_Projects.pdf> accessed 2/4/2010.

[12] State parties or investors generally aim at public-revenue generation, socio-economic development, economic and energy security, and vertical integration, while MOCs aim at maximization of shareholder value and profits. See. Nutavoot Pongsiri, 'Partnerships in oil and gas production-sharing contracts' (2004) 17(5) I.J.P.M, 431-442 at 432 <http://www.emeraldinsight.com/journals.htm?articleid=868037&show=html> accessed 10/11/2010; Nwete (n2) at 56 and 58, accessed 2/11/2010.

[13] Michael Likosky, 'Contracting and regulatory issues in the oil and gas and metallic minerals industries' (April, 2009) 18(1) Transnational Corporations, 2-42 at 4 <http://www.unctad.org/en/docs/diaeiia20097a1_en.pdf> accessed 2/11/2010; Yinka Omorogbe, *Oil and Gas Law in Nigeria*. (M.L.B., Nigeria, 2003) 209 at 38-53.

[14] Daniel Johnston, *International Petroleum Fiscal Systems and Production Sharing Contracts*, (Pennwell Books, 1994) 325 at.39; Likosky (Ibid) at 4 and 13.

predetermined proportions and ratios.[15] Ownership of petroleum produced and *in situ* is vested in the State party until the point of 'production split' i.e. when the Contractor takes her cost (recovery) oil and share of profit oil, after royalty (oil) or income tax is deducted and paid to the State.[16] The contractor bears all the exploration risks and usually in charge of operations and management of contract area, unless the State party agrees to take up some direct participatory interests in the venture.[17] Generally, if no oil is found the contractor receives no compensation.[18] Depending on agreement between parties, PSCs are usually designed to have a lifespan of 30years i.e. 10 years for exploration and 20years for production.

A change in fiscal terms that alters the companies/contractors take or share of the net production, can imply that if oil and gas prices rise, the contractor will make huge profits without necessarily increasing their investments i.e. no additional wells drilled, no new enhanced recovery projects undertaken or well stimulations and other operational improvements.[19] Furthermore, if provisions for cost recovery is not properly crafted it can lead to unacceptable loss to one of the parties, especially the State party. For instance the 1973 Nigerian PSC with Ashland Oil Company saw an initial agreement for 50% total cost recovery per annum. After which 55% of the remaining production was allocated as Tax Oil, thus what was left for the production split between the parties was less than 25% of the gross production.[20] The local/public criticisms of this arrangement lead to a public inquiry. A full or unjustifiable cost-recovery provision will therefore delay the State party's income and benefits that otherwise would be generated by royalties or an appropriate cap on such recovery.[21] Wälde, however opines that the PSC can be viewed as a legal instrument that satisfies both the essential needs of a private investor and State

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[15] Omorogbe (n13) at 41-42; K. Bindemann (n2) at 1, 13-18.

[16] Bindemann (ibid).

[17] Ibid.

[18] Ibid.

[19] Helmut Merklein, 'Production-sharing contracts: a dying breed?' (February 3, 2010) Iraq Oil Report <http://www.iraqoilreport.com/business/economics/production-sharing-contracts-a-dying-breed-3780/> accessed 22/5/2011.

[20] See. Omorogbe (n13) at 49 – 50; Y. Omorogbe, 'Contractual Forms in the Oil and Gas Industry: the Nigerian Experience with Production Sharing Contracts' (1986) 20(3), Journal of World Trade Law, 342-349.

[21] Wälde (n5) at 55-56.

party. It gives the government the outward appearances of sovereignty and power while guaranteeing an investor's hard-core requirements (which is essentially economic and profit maximisation).

2.2 Managing Contractual Risks: Stabilisation and Renegotiation Clauses

Contractual risks (i.e. the possibility and probability of non-performance) arise due to inherent uncertainties in exploration and production operations like: discovery of new resources; probable and proven quality or quantity of reserves; economic viability of development; new technological requirements; price volatility; economic and political risks, legal and regulatory risks e.t.c. Such supervening events can lead to calls for renegotiation of agreements and claims to sanctity of contracts. Addressing these uncertainties through agreed terms and an appropriate Internal Revision and Adaptation System (IRAS) is therefore cardinal to efficiency, stability and equilibrium of parties.[22] Within the duration of a PSC, for example, trade-offs between *ex ante* commitments and flexibility *ex post*, becomes expedient in order to uphold the contractual 'efficiency'.[23] In states with high political risk and insufficient or incredible investment protection structures, investors (especially private investors) have to make their investment decision based on a pragmatic, unmitigated risk–reward balancing dependent on price, cost and profitability forecasting.[24]

A flexible fiscal regime in a PSC is usually achieved by sliding-scale systems. Such a system may trigger on production rates, thus as production rates increase, government take increases. This theoretically allows equitable terms for development of both large and small fields,[25]

[22] Ibid at 30; M. Coale, , 'Stabilization Clauses in International Petroleum Transactions' (2002) 30 Den J Int'l L &Pol'y, 217-237 at 219, accessed 2/11/2010; P.C.R. Lima, 'Possible changes in the legal framework of the Brazilian oil industry' (2009) 7 I.E.L.R., 252-255 at 253, accessed 10/11/2010.

[23] Anne Van Aaken, 'International investment law between commitment and flexibility: a contract theory analysis' (2009) 12(2) J.I.E.L., 507-538 at 1, accessed 10/11/2010.

[24] Wälde (n5) at 59

[25] Centre for Energy Economics (n11) at 7.

however practical implications shows that an increase in production does not necessarily imply increase in contractors profit share or Internal Rate of Return (IRR). Some contracts will provide flexibility through a progressive tax rate; others will tie more than one variable to a sliding scale such as cost recovery, profit oil split and royalty, water depth, cumulative production, oil prices, age or depth of the reservoir, onshore vs. offshore, R factors and the remoteness of locations e.t.c. It is opined that a truly progressive sliding-scale should be based on profitability, not production rates. It should create a situation where the government take flexes upward with increased profitability, while the contractor gets appropriate share or returns, thus curtailing the loss of revenue to the state in windfall profits.[26]

2.2.1 Stabilisation Clauses and PSCs

The basic idea behind a stabilisation clause is that it restricts the powers of the sovereign. In essence, a stabilization clause seeks to restrict the exercise of the State's legislative and administrative powers and prevents it from modifying the contractual conditions agreed with the Contractor to the latter's detriment. It reinforces the principle of the sanctity of contracts by protecting the contractor against actions of the State party**.**[27] Thus, traditional stabilisation clauses seek to address probable risks, by 'freezing' or 'neutralising' the State's regulatory powers and capacity to unilaterally change the regime and terms relied upon by the Contractor in the agreement i.e. prohibiting the application of any subsequent law or regulations by the State.[28] A variation referred to as "consistency clause", requires that any subsequently enacted law or regulation must be consistent with terms of the already concluded agreement and non-discriminatory.[29] However, contractual provisions aimed at creating stability or security against future political, legal or economic risks by providing that '*Any modifications of the terms and*

[26] Ibid at 8; Helmut Merklein (n19);

[27] Bernardini (n8) at 99.

[28] Thomas W Wälde, 'Stabilizing international investment commitments: international law versus contract interpretation' CEPMLP (CPMLP Professional Paper No. PP13, Dundee) 1-65 at 1 <http://www.dundee.ac.uk/cepmlp/infoserv/Downloads_Free/PP13.pdf>; A.D. Nwokolo, 'Is there a Legal and Functional value for the Stabilisation Clause in International Petroleum Agreements?' (2003/2004) CAR (CEPMLP Annual Review) 1-18 <http://www.dundee.ac.uk/cepmlp/car/html/car8_article27.pdf> accessed 10/11/2010.

[29] Nwokolo (n28) at 6-8.

conditions of the agreement may only be made by mutual written consent of the parties' cannot be rightly classified as a 'freezing clause' since it essentially opens the door to future discussion and renegotiations that should lead to terms mutually agreed to by the parties. The Model Exploration and Production Sharing Agreement, 1994 of Qatar (art 34.12, under the heading 'Equilibrium of the Agreement') provides that-

> "…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*…[emphasis added]"

The legal and contractual inadequacy of the 'freezing' clauses led to development of 'equilibrium' or 'balancing' stabilization clauses,[30] which requires that:

a. when a change in the law affects the economic interest of the contractor, the parties will seek to return the 'economics' of the arrangement to the *status quo ante*;[31] or
b. in the event of a legal change, the parties will negotiate to identify ways of establishing an economic equilibrium. These do not seek to prevent a change in the law by the state but rather, to address the economic impact of such a change.[32]

Thus, where a State exercises her sovereign power and changes a contract's economic and/or fiscal implications on the private investor or contractor, it should protect the economic bargain agreed to by the parties and compensate the latter accordingly.[33] Justifiably, such changes may

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[30] Peter Cameron and Graham Kellas, 'Contract and Fiscal Stability: Rhetoric and Reality' (International Conference on "Developing a Second Generation Oil and Gas Province" A.I.P.N, U.K, (14-17, September, 2008) 1-11 at 6 <http://www.dundee.ac.uk/cepmlp/gateway/files.php?file=Contract-Fiscal-Stability_311561174.pdf> accessed 2/11/2010.

[31] Nwokolo (n28) at 7-8.

[32] Cameron and Kellas (n30)

[33] Ibid.

be due to political pressure or need to increase 'government take' and revenue. By and large, a consideration of the stabilisation mechanisms as adopted in most jurisdictions reveals a gradual paradigm shift towards 'renegotiability' of terms despite the sanctity of contract notions found in both common law and civil law legal systems. Some domestic legal systems have principles invalidating a 'freezing' stabilisation clause, based on parliamentary or constitutional supremacy. Under, international law the interplay of the sanctity of contracts principle and doctrine of permanent sovereignty over natural wealth and resources, further sustained the paradigm shift.[34]

For example, due to an open-door policy to MOCs and foreign investors, the Peruvian government granted favourable terms and credits based on a new Petroleum law in 1980/81, which was repealed by a new government in 1985. These led to expropriation, renegotiation of existing PSCs and higher taxes imposed on MOCs like Belco and Occidental. *Belco rejected the new commitments, while Occidental accepted and got extensions to existing contract-duration and a new risk service contract*.[35] Also, in 2008 Repsol instituted a claim against Ecuador at ICSID over the imposition of windfall taxes on oil revenues. Consequently, a deal was struck and Repsol gave up its PSCs terms in exchange for an extension of its exploration rights and other benefits.[36] Notably, in *Parkerings-Compagniet AS v Lithuania*, the arbitral tribunal recognised 'each State's undeniable right to exercise its sovereign legislative power' and enact, modify or cancel laws but also recognised the impact of a stabilisation agreement or clause.[37] In Nigeria, 1993 PSCs are been reviewed because 'government take' paradoxically reduced when oil prices and profitability increased. Under the PSCs, MOCs had no cost recovery ceiling and the production split ratio was production-based, rather than the more pragmatic profit-based

[34] Nwokolo (n28) 10-14. The Charter of Economic Rights and Duties of States, approved by Resolution No 3281 (XXIX) of 12 December 1974 of the United Nations General Assembly. See also UN General Assembly Resolutions No 1803 (XVII) of 14 December 1962 and No 3171 (XXVIII) of 17 December 1973 affirming the permanent sovereignty of each State over its national resources. OPEC Resolution XVI.90 of 24–25 June 1968 (Declaratory Statement of Petroleum Policy in Member Countries) which, after recalling in the preamble the UN General Assembly Resolutions on ''the inalienable right of all countries to exercise permanent sovereignty over their natural resources in the interest of their natural development'' declares open to renegotiations the financial provisions of petroleum agreements resulting in excessively high net earnings 'notwithstanding any guarantee of fiscal stability'. Under public international law, States may not renounce sovereign prerogatives which are instrumental to the pursuance of fundamental public objectives.

[35] Kolo and Wälde (n7) at 7-8.

[36] Cameron and Kellas (n30) at 5.

[37] ICSID Case No. ARB/05/8, IIC 302 (2007),

sliding scale.[38] Between 2006-2008, Algeria, Ecuador and Kazakhstan introduced Windfall Profits Taxes, with the latter passing a law to allow retroactive changes to PSCs.[39]

2.2.2 Renegotiation and Adaptation

It seems justifiable that parties should have a right and duty to renegotiate obligations in long-term commercial contracts, as a result of an unforeseen and fundamental change in the underlying circumstance(s) and frustration of performance. Especially, where such would severely disrupt the original contractual equilibrium and fairness.[40] Moreover, a freezing or classic stabilization clause cannot in practical terms guarantee against the State's exercise of sovereign authority in the public interest.[41] Such clauses may however, entitle the aggrieved party to a higher amount of compensation for its violation than in the case where such a clause is absent.

Renegotiation clauses accords the parties the opportunity of salvaging an agreement that has become onerous or inefficient. Although, the tribunal in *Kuwait v. Aminoil* recognised the "*rebus sics stantibus*" principle in international petroleum investment agreements, it held on the other hand, that "an obligation to negotiate is (still) not an obligation to agree." A renegotiation and adaptation clause affords the parties with the needed stability and flexibility through the adaptation of the contract to new circumstances.[42] These mechanisms cannot be deemed efficient and fit-for-all purposes, where it fails to address changes in circumstances brought about by events outside political or legal risks, e.g. marginal discovery or price fluctuations.[43]

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[38] Egheosa Onaiwu, 'How do fluctuating oil prices affect government take under Nigeria PSC?' 2008/09 CAR (CEPMLP Annual Review) 1-23 at 6, 9-10 <http://www.dundee.ac.uk/cepmlp/gateway/files.php?file=cepmlp_car13_54_594097227.pdf> accessed 10/11/2010.

[39] Cameron and Kellas (n30) at 4.

[40] Kolo and Wälde (n7) at 7-8

[41] Prof. A.F.M. Maniruzzaman, 'The pursuit of stability in international energy investment contracts: A critical appraisal of the emerging trends' (2008) 1(2) Journal World Energy Law & Business, 121-157 at 126 accessed 2/6/2011.

[42] Nwete (n2) at 57.

Thus, adaptation clauses can provide for regular or periodic consultations between parties and revision of fundamental terms which are susceptible to change overtime, rather than just being implemented on the occasion of a change of circumstances. Furthermore, it is submitted that renegotiation clauses should not be activated when one of the parties control the supervening events. The clause should provide a neutral tribunal with appropriate criteria to guide any adaptation of the agreement.[44] Although the extent to which a third party can 'adapt' or meddle with the *consensus ad idem* of parties is also limited both under international law and national laws.

Bernardini (2008)[45] opines that a workable renegotiation clause for adaptation purposes should clearly highlight- the change of circumstances triggering the renegotiation; the effect of the change on the contract; the objective of the renegotiation; the procedure for the renegotiation; the solution in case of failure of the renegotiation process. By and large, supervening events, effect and 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 to the negotiation process.[46] Through an effective renegotiation and adaptation mechanism, parties can create a balanced Internal Adaptation System (IAS),[47] which will guarantee private investment security on the one hand and political or socio-economic acceptability for State parties on the other hand. Its structure must at least ostensibly reflect fairness and equity in the bargaining power balance at the time of negotiation and revision.

The major approaches to re-aligning contractual efficiency and established equilibrium of parties is to make the adjustment automatic or achieved in a manner stipulated in the contract so that the economic balance struck between the parties on the effective date of the contract is re-established.[48]

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[43]Ibid at 59; See. Art.34 of the Qatar Model Exploration and Production Sharing Agreement (1994) quoted in P. Bernardini, "The Renegotiation of Investment Contracts" (1998) 13 F.I.L.J. 411 at 416.

[44] John Y. Gotanda, 'Renegotiation and Adaptation Clauses in International Investment Contracts, Revisited' (2003) 36 V.J.T.L. 1461-1473 <http://works.bepress.com/cgi/viewcontent.cgi?article=1007&context=gotanda> accessed 10/11/2010.

[45] Bernardini (n8) at 103-110

[46] Ibid.

[47] See Wälde (n4).

[48] Prof. A.F.M. Maniruzzaman, 'The pursuit of stability in international energy investment contracts: A critical appraisal of the emerging trends' (2008) 1(2) Journal World Energy Law & Business, 121-157 at 127-131, accessed 2/6/2011; Peter D Cameron,

Parties can specifically provide in the contract for the manner of such adjustment or to stipulate that it should be the result of mutual agreement between the parties. A third approach is to make express provision for the parties to discuss how amendments should be made to the contract to permit economic balancing.[49] In doing this, it is crucial to provide time frames for the reviews and conditions that should trigger referral to arbitration or third party adaptation.

An example of a PSC provision that effectively allows for renegotiations of economic imbalance to a large extent is contained in the Article 16.7. of the Indian Model PSC thus-

> "…If any change in or to any Indian law, rule or regulation imposed by any central, state or local authority dealing with income tax or any other corporate tax, export/import tax, customs duty or tax imposed on petroleum or dependent upon the value of petroleum results in a *material change to the economic benefits accruing to any of the Parties after the Effective Date, the Parties to this Contract shall consult promptly to make necessary revisions and adjustments to the Contract* in order to maintain such expected economic benefits to each of the Parties as of Effective Date…[emphasis added]"[50]

However key terms like 'material change' in such provisions may be victims of misinterpretation in different contexts, especially when disputes are left to the discretion of 3rd parties or tribunals in the absence of the parties' choice of law governing the agreement or detailed and appropriate definitions. It should also be made clear whether aim of renegotiations and review is basically commercial or economic readjustment of the contract or indemnification to the affected party. Furthermore, a caveat needs to be made for an arbitral tribunal to exempt the State party from paying compensation to the contractor if the actions of the former that adversely affected the interests of the latter were taken in a state of necessity and public interests.[51] Referral to arbitration can operate as a 'safety-net' when the disputes in renegotiation spins out of control and the threat of arbitration could also be deployed ''as a means to gain leverage towards a

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'Stabilisation in Investment Contracts and Changes of Rules in Host Countries: Tools for Oil & Gas Investors' Association of International Petroleum Negotiators (AIPN), Final Report 1-116 at 31-36 <http://lba.legis.state.ak.us/sga/doc_log/2006-07-05_aipn_stabilization-cameron_final.pdf> accessed 2/6/2011

[49] Ibid.

[50] Cited in Maniruzzaman (n48) at 128.

[51] Maniruzzaman (Ibid).

negotiated settlement''.[52] Where the preferred choice of tribunal is the International Centre for Settlement of Investment Disputes (ICSID) Parties should note the distinctions between a legal or contractual dispute and conflict of interests.[53]

3. Highlighting the relevant problems: issues from Nigeria

The ownership of petroleum under a PSC arrangement by the State party and the private investor's rights as a 'contractor' implies that an inefficient contract will erode the benefits derivable by both sides on the long run and increase transaction cost(s). The private investor requires a stable and predictable framework within the lifespan of the contract, while the State party requires flexibility and capacity to meet state objectives and socio-political and economic exigencies. Essentially, States hold on to their 'inherent right' to dispose of their petroleum resources based on their national interests and objectives. They seek maximum flexibility in extracting, refining and selling these resources, in other to make the most of the current market conditions and to be able to adapt to domestic political scenarios.[54] On the other hand, MOCs or private companies (who are operating in an exceptionally long-term and capital-intensive industry) desire a reliable, consistent and transparent legal framework, in other to secure the maximum returns and profits on investments.[55] Bernhard Maier recognised a third variable in the equation of divergent interests as concerns such as energy security, environmental protection and sustainable development from the international community.[56]

[52] Ibid.

[53] There is a view that the differences of views of the parties on readjustment of the contract are merely conflicts of interest and do not qualify as 'legal disputes' under Art 25(1) of the ICSID Convention, however breach of terms and disregard of interests may lead to enforceable legal disputes.

[54] Bernhard Maier, 'How has international law dealt with the tension between sovereignty over natural resources and investor interests in the energy sector? Is there a balance?' (2010) I.E.L.R. 2010, 4, 95-109.

[55] Ibid.

[56] Ibid.

It is trite that States as sovereign entities can revise contracts unilaterally. The real issue in designing appropriate risk management mechanisms is not so much whether the host government can change the contractual relationship, but rather what is the result and implication of such regulatory action for the private investor.[57] Also, the question of whether the change amounts to a lawful or unlawful expropriation needs to be addressed. Stabilisation clauses are highly susceptible to two main limitations, i.e. the constraints imposed by the domestic legal and constitutional framework on the guarantees provided in the contract, and any exceptions required for non-fiscal matters such as the environment.[58] As Bodin opined, no state can bind itself through his own laws and no law is so sacred that it cannot be changed under the pressure of necessity. Aquinas, also argued that contracts should be performed even with regard to enemies, but, if the circumstances existing at the time of making the contract changes, non-performance of the contract is excusable.[59]

It is trite that just as the principle of sanctity of contracts is recognised by various domestic legal systems and relevant international law regimes, references to the principle of 'change of circumstances' as a ground for revising agreed terms, rights and obligations under contractual arrangements is also firmly engraved in key national legislations and regulations, international treaties and other important texts having a transnational dimension.[60] This is is not a struggle between common law positions and civil law affirmations, the two sides of the spectrum in contractual relations in the petroleum industry are now firmly recognised. Giving credence to one more than the other will by and large be determined by complete understanding of the

[57] Peter D Cameron, 'Stabilisation in Investment Contracts and Changes of Rules in Host Countries: Tools for Oil & Gas Investors' Association of International Petroleum Negotiators (AIPN), Final Report, 1-116 at 52 <http://lba.legis.state.ak.us/sga/doc_log/2006-07-05_aipn_stabilization-cameron_final.pdf> accessed 2/6/2011

[58] Peter D Cameron (ibid.) at 12-19.

[59] Wehberg (n7) at 776-777.

[60] The principle of *rebus sic stantibus*, present in many national legal systems, is also a principle of international law. This is the tenor of Article 62 of the 1969 Vienna Convention and the Law of Treaties. The general principle of *pacta sunt servanda* is set out in Article 26 of the Vienna Convention. Under the common law the sanctity of contracts principle is a fundamental rule of contractual and commercial relations, while the doctrine of "frustration of purpose" excuses performance when circumstances have changed so much that the performance required by the contract is radically different from that which was initially undertaken by the parties.

foundations of the principles and the implications of applying either to individual cases and relationships.

3.1 Prevailing issues from Nigeria

The Petroleum Industry Bill (PIB) 2008/2009 presently before the Nigerian National Assembly was drafted essentially based on the National Oil and Gas Policy 2004.[61] The Federal Government aims to carry-out the largest overhaul of the government petroleum revenue system in the last four decades through the PIB. This overhaul has four central objectives:

- to simplify the collection of government revenues;
- to cream off windfall profits in case of high oil prices;
- to collect more revenues from large profitable fields in the deep offshore waters, and
- to create Nigerian employment and business opportunities, by encouraging investment in small oil and gas fields.[62]

With a prime focus on royalties, the PIB proposes a system that percentages automatically adjust to the economic circumstances, by creating two sliding scales. One scale relates to the daily production of the oil or gas field(s). Another scale relates to the oil or gas price(s). The royalties vary in four different geographical areas: onshore, shallow offshore, deep offshore and inland basins.[63] The erstwhile Petroleum Profit Tax (PPT)[64] is split into the Corporate Income Tax (CIT) and the Nigerian Hydrocarbon Tax (NHT). The latter is not deductible in calculating the former, and is therefore a true extra tax. Also, costs that is difficult to audit, such as interest on loans will no longer be deductible under the NHT.[65]

From the perspective of the Federal Government and as discussed above, the existing PSCs before now were assessed as 'bad deals' for Nigeria, thus calls for renegotiations and reviews ,

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[61] The Policy document encapsulating the comprehensive reform agenda of the Federal Government of Nigeria which began in 2000. See Dr. Rilwanu Lukman (CFR), (KBE), 'Keynote Address by the Honourable Minister of Petroleum Resources on the Proposed Petroleum Industry Bill (PIB), Abuja, 16th July 2009, 1—16.

[62] Lukman (n61) at 6-7.

[63] Ibid.

[64] Charged Under the Petroleum Profits Tax Act Cap. P13 Laws of the Federation 2004 and in case of PSCs the Deep Offshore and Inland Basin Production Sharing Contracts Act CAP D3 Laws of the Federation of Nigeria 2004

[65] Ibid at 8.

especially based on the terms of the reforms, carried out responsively as envisaged by the PIB seems justifiable. The PIB provides that NNPC is to enter PSCs based on minimum conditions it sets including signature or production bonuses, contract areas are to be ring fenced for Cost and Profit Oil calculations, sets a cost recovery limit of 80%, it introduces a Non Recoverable Costs/Fair market Value principle e.t.c.[66] The crypto taxes in the proposed PIB include: education tax to fund industry institutions (maximum of 2% of fiscalised crude oil) and 3% of annual capital budget as contribution to the Niger Delta Development Commission (NDDC).[67] There is also a separation of oil and gas operations and activities for fiscal purposes.

Based on an incisive analysis of Company's Internal Rate of Return (IRR) under the 1993, 2000, 2005 PSC terms and PIB terms, it has been forcefully argued that at $60/bbl, only the 500 mmbbl field under 1993 terms is economic, while at $90/bbl fields larger than 100 mmbbl are economic. Also, those larger fields are economic under 2000 and 2005 terms, while interestingly no fields are economic under PIB terms.[68] This analysis can be said to be from the purview of a private investor. The foregoing developments therefore lays a foundation for very intriguing reviews and renegotiations of existing and future PSC terms going forward, because the PIB seeks to repeal the legal bedrock of the existing E&P arrangements in Nigeria.[69] It also makes a transitional and savings provision in stating that any license, lease or contract in respect of the exploration, production and development of crude oil or natural gas, granted under the Petroleum Act 1969, shall continue in force for the remainder of its duration, as if it had been issued under the PIB.

[66] Inter-Agency Project Team, 'An overview of the Petroleum Industry Bill' July 2009, 1-38 at 16-17 <www.nnpcgroup.com/Portals/0/pdf/PIBConsultativeForum.pdf>

[67] Isehunwa, S.O. and Uzoalor, E. Ifeoma, 'Evaluation of True Government Take under Fixed and Sliding Royalty Scales in Nigerian Oil Industry' (2011) 5(3) Australian Journal of Basic and Applied Sciences, 735-741 at 735 <http://www.insipub.com/ajbas/2011/735-741.pdf> accessed 2/6/2011.

[68] Wood Mackenzie Ltd., 'Global competitiveness of Nigeria's upstream fiscal terms' (Current Issues in the Nigerian Oil and Gas Industry: Focus on the Upstream Sector Lagos Business School, the Civic Centre Lagos. September, 2009) 1-36 at 7 <http://www.lbs.edu.ng/downloads/FiscalCompetitivenesstoNigeria.pdf> accessed 7/3/2011.

[69] i.e. the Petroleum Act 1969 CAP 350 Laws of the Federation 1990 and the Petroleum Production and Drilling Regulations 1969; the Petroleum Profit Tax Act; The Deep Offshore and Inland Basin Production Sharing Contracts Act 1999, CAP D3 Laws of the Federation of Nigeria 2004 (the PSC law) as amended e.t.c.

At this point, it is pertinent to consider what has been, hitherto the background to E&P arrangements, especially PSCs in Nigeria. Most PSCs have just recently begun producing after a decade of significant investments. Companies and contractors are currently in ‘cost recovery’ phase, while revenue is being generated for the government, primarily in tax oil, rather than royalty oil or profit share.[70] By the 1999 Constitution, the Nigerian National Assembly is clearly empowered to make laws for the peace, order and good government of the country. Also, the Constitution and its provisions are supreme and binding on all authorities and persons (this includes Companies registered and operating in Nigeria) in Nigeria. Any law or model of governance that is inconsistent with the Constitution is void to the extent of the inconsistency.[71] As the preferred E&P arrangement the adoption of the PSC was a policy and regulatory reaction to-

- curtail the cash calls and funding problems faced by the Federal Government in JVAs and
- the objective of opening-up the petroleum sector to foreign participation and investments.

The PSC arrangement governs the understanding between the Federal Government through NNPC and all new participants in the new inland, deep & ultra deep-water acreages.[72] The Deep Offshore and Inland Basin Production Sharing Contracts Act 1999 (as amended) (the PSC law) provides for a PPT rate of 50% (PPT rate for other E&P arrangements is 85%) and an 1nvestment Tax Credit at a flat rate of 50% of qualifying expenditure incurred wholly, exclusively and necessarily for the purposes of petroleum operations. For parties who executed PSCs after 1st July'1998, there is an Investment Tax Allowance of 50% of the qualifying expenditure.

By carrying out a cost and efficiency analysis of terms of existing E&P operation’s, economies of scale is seen in large fields in Nigeria but many small fields have unit costs of about US$20-

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[70] Ibid. at 7

[71] S4 Constitution of the Federal Republic of Nigeria, 1999
< www.nigeria-law.org/ConstitutionOfTheFederalRepublicOfNigeria.htm>

[72] Deep Offshore and Inland Basin Production Sharing Contracts Decree No 9 of 1999 Laws of the Federation of Nigeria, amended by Deep Offshore and Inland Basin Production Sharing Contracts (Amendment) Decree No 26 of 1999

$35/bbl. Also, deepwater development costs are typical of the range seen globally.[73] Furthermore, cost increases in Nigeria have been very much in line with global trends. Some peculiar issues have however inflated the costs of petroleum operations- militancy and sabotage; aging infrastructure and mature fields in the onshore and shelf; lack of basic non-oil infrastructure; building local content capacity will add to costs, but it has the potential to reduce long-term costs in the country; cost of capital – hinders the development of local companies.[74] Domestic market obligations for gas imposed on the Contractor Companies may also add to the costs and operational losses, especially where, the price of gas in the international market is higher than the government is willing to pay, for the obligatory supply.[75]

NNPC or the Oil Mining Leaseholder has the responsibility of paying all royalty, concession rentals and PPT on behalf of itself and the Contractor out of the allocated royalty oil and tax oil. The royalty rates under the PSCs vary depending on the area of the concession and are graduated on a sliding scale depending not on production, but on water depth as shown in table 1 below-

Onshore	Inland Basin[76]	Swamp/Shallow Waters	Shallow Offshore	Deep Offshore
20%	10%	0 - 100m: 18.5%	100 - 200m: 16.67%	201 - 500m: 12%
				501 - 800m: 8%
				801 - 1000m: 4%
				Over 1000m: 0%

Table 1, Source: The National Petroleum Investment Management Services (NAPIMS)

[73] Wood Mackenzie Ltd, 'Cost Drivers for the Nigerian Oil Industry and Comparison to Global Experiences' (Current Issues in the Nigerian Oil and Gas Industry: Focus on the Upstream Sector Lagos Business School, the Civic Centre September 2009 2009) 1-32 <www.lbs.edu.ng/downloads/CostDriverandComparisonstoNigeria_LBSRoundtable.pdf> accessed 3/6/2011.

[74] Ibid..

[75] Theresa O Okenabirhie, 'The domestic gas supply obligation: Is this the final solution to power failure in Nigeria? How can the government make their obligation work?' (2008/09) CAR (CEPMLP Annual Review) 1-17 <http://www.dundee.ac.uk/cepmlp/gateway/files.php?file=cepmlp_car13_65_266090310.pdf> accessed 2/6/2011. The FGN recently approved the National Gas Master plan (NGMP) which comprises the Domestic Gas supply Obligation and Gas Pricing Regulation and the Infrastructural Blueprint. The Domestic gas supply obligation is a policy that compels all producers of gas to set aside a certain percentage of their gas for strategic domestic projects like power.

[76] means any of the following Basins, namely, Anambra, Benin, Benue, Chad, Gongola, Sokoto and such other basins as may be determined, from time to time, by the Minister

The above scale and fiscal provisions clearly leave room for hidden windfall profits and loss of revenue by the State. It is opined that a scale based on both oil price and volume of production yields higher government take than those based on either volume of production or price of oil alone or water depth.[77] A look at the 2005 Nigerian Model PSC terms on renegotiation and review states that-

> "…This Contract shall not be amended or modified in any respect except by mutual consent, in writing, of the Parties…"[78]

> "….The Parties agree that *the commercial terms and conditions of this Contract are based on the existing fiscal terms in accordance with the provisions of the Deep Offshore and Inland Basin Production Sharing Contracts Act, 1999. If such fiscal terms are changed,* the Parties agree, subject to Clause 27.3, to review the terms and conditions of this Contract affected by such changes to align such terms and conditions with the fiscal terms…[emphasis added]"[79]

This model of review clauses envisages future events and changes (especially regulatory) that could affect the economic, commercial and fiscal equilibrium of parties as already agreed. Although it fails to qualify the 'change' mentioned as to whether, thus 'change' here could mean 'any change'. This is very ambiguous and could serve as a tool of confusion. The review or renegotiation also calls for alignment of terms to the changes i.e. adaptation. Also, any such review or amendment of terms must be based on a mutual consent (*consensus ad idem*) of parties in writing.

In the light of the background regulatory scenario and all that has been discussed earlier, one would expect the Parties at the final deal-making and drafting time to ensure that this part of the

[77] See. Iledare O.O., 'Fiscal Provisions in the Draft Petroleum Industry Bill (DPIB) in Nigeria: Evaluating the Impact on Offshore Economics & Take Statistics' Paper presented at the 2010 Nigeria Annual International Conference and Exhibition, July 31- August 7, Tinapa-Calabar, Nigeria. SPE #136972.

[78] Clause 26.2, Nigerian Model Production Sharing Contract 2005 (Extract) (Source: Barrows, New York)

[79] Ibid (Clause 27.1)

agreement provides- a time limit to renegotiations when 'change' occurs; the supervening 'change' should be appropriately defined and qualified to prevent misapplication and misrepresentation; the referral to arbitration if there is a failure to agree; the procedure and conditions for resolving and addressing conflict of interests before legal disputes arise; at what point will the negotiations be deemed to have broken down completely; parties shall use their best efforts and in good faith to agree on amendments and re-alignments; re-balancing or re-alignment is required when either the Contractor or private investor's position is unconscionably improved and that amendments will not in any event diminish or increase the rights or obligations of either party or parties, beyond the point of contractual equilibrium and efficiency required for meeting identified objectives.

In deference to the proposed regulatory prescriptions of the PIB, it is opined that the requirements of stability and concurrent flexibility implies that future Contracts must contain instruments that will enable the State to permit an appropriate proportion of economic rents to be recovered by the Contractor while it protects a fair and adequate share of economic, regulatory and political interests. Furthermore, where exploration risks are low and geological prospects are high, the government can capture high economic rents as well.

In a perfect market, with sufficient competition and access to information, the industry will help determine what the market can bear, and profit will be allocated accordingly. In the absence of competition, efficiency must be designed into the fiscal terms. The bottom line is the financial issue of how costs are recovered and profits divided.[80] The history of the Industry in Nigeria has shown a lack of fair and adequate competition and information asymmetry in the allocation of E&P rights and interests,[81] thus to achieve relative efficiency the Federal Government must design fiscal systems that-

- Provide a fair return to the state and private investor/contractor
- Avoid undue speculation
- Limit undue administrative burden and bottlenecks

[80] Center for Energy Economics (n11) at 1

[81] Lukman (n61) at 4-5.

- Provide flexibility and create healthy competition and market efficiency[82]

3.2 Resolving the Flexibility and concurrent Stability Crises

Holding on to a 'freezing clause' by either party to an E&P agreement, can be unjustifiable or contrary to the welfare of the state, as seen in the case of the Nigerian PSCs and the Peruvian scenario. States cannot and should not jettison sovereign prerogatives, which are cardinal and instrumental to the pursuance of essential public and socio-economic objectives. On the other hand, probable renegotiation tends to undermine the expectation of stability and 'contractual peace and security' of agreements and it could be difficult to formulate a general renegotiation clause which defines specifically when a change of circumstance is serious enough to trigger renegotiations. Therefore, instability and uncertainty can be costly for all parties.[83]

Determining the appropriate time *vis-a-vis* a supervening event is key to maintaining contractual efficiency. As Bernardini opines, such 'change' must cause a disproportionate prejudice or substantial detriment or 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.'' Generally, the principle *rebus sic stantibus* is applied with strict and narrow interpretation, since it can be regarded as a radical exception to the principle of sanctity of contracts.

Depending on *ex ante* commitments, a PSC can be said to establish a vertical principal-agent relationship or a horizontal partnership arrangement between the State party and contractor. In the former case, the State party is almost always in a stronger bargaining position within the duration of the agreement, especially once commercial discoveries are made, while in the later case, the parties remain partners with bargaining strengths and weaknesses that could fluctuate as supervening events occur, thus the need for continued cooperation in both cases cannot be overemphasised. As Wälde points out, having a smaller share in the more profitable petroleum

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[82] Ibid.

[83] Kolo and Wälde (n7) at 24. Gotanda (n40) at 1463 - 1469.

assets due to renegotiation (and cooperation) is better than being left with the options of full exit and a compensation claim requiring protracted international arbitration or legal tussle, with no guarantee of compliance with an award for the private investor or contractor.

In the quest for long-term contractual or relational efficiency and security in PSCs and E&P agreements, parties need strike the right balance between risk management and reward, by paying close attention to three key considerations: the scope and forseablity of events that triggers renegotiation; applicable law(s) and the political and legal independence the 3rd party designated to adapt the agreement where renegotiation fails; and the extent and criteria of such adaptation.[84] Finding the point of contractual 'equilibrium' or 'fairness' *inter vivos* requires critically evaluating the risks originally taken by the parties, which in this regard includes the risk of unsuccessful exploration and marginal finds, higher than expected costs, detrimental volatility of prices, political and legal insecurity. Equity and fairness in PSC terms could also be conceptualized when supervening events occur as the ratio of sharing the petroleum rent or net production as originally agreed. Thus, the production split percentages should be maintained going forward, for instance by compensation, if external events like unexpected oil price developments or more internal events like government tax measures modify that percentage and its effects on the arrangement.[85]

4. Conclusion

It is explicit that legal arguments for and against renegotiations and nationalizations occur along a spectrum. At one end, are arguments based on the principle of "sanctity of contracts" and the middle point is when parties in 'good faith' incorporate a renegotiation and adaptation clause into the contract, to deal with changes in underlying circumstances.[86] Stabilisation, renegotiation and adaptation clauses can play a *facilitative* role in stabilizing E&P arrangements such as PSCs,

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[84] Gotanda (n40) at 1472.

[85] Wälde (n5) at 80.

[86] Likosky (n13) at 22-24.

whose nature is naturally susceptible to contractual, legal, economic and political risks.[87] By and large, the contractual relationship is more important than the formal (contract) document itself and parties strive to let relationships survive if and to the extent that, this is in their interest.[88]

[87] Ibid.

[88] Kolo and Wälde (n7) at 24

LIST OF ABBREVIATIONS

1.	American Journal of International Law	A.J.I.L.
2.	Association of International Petroleum Negotiators	A.I.P.N
3.	Denver Journal of International Law and Policy	Den. J. Int'l L. & Pol'y
4.	Exploration and Production	E&P
5.	Foreign Investment law Journal	F.I.L.J.
6.	International Centre for Settlement of Investment Disputes	ICSID
7.	International Legal Materials	I.L.M.
8.	International Journal of Public Sector Management	I.J.P.M,
9.	International Energy Law & Taxation Review	I.E.L.T.R
10.	Journal of International Economic Law	J.I.E.L.
11.	Malthouse Law Books	M.L.B
12.	Nigerian National Petroleum Corporation	NNPC
13.	Oxford Institute of Energy Studies	O.I.E.S
14.	Production Sharing Contracts	PSC
15.	Vanderbilt Journal of Transnational Law	V.J.T.L.