

Resource nationalism update: Has the resource nationalism cycle turned back to the favour of IOCs?

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Since the start of the 21st century, the lack of spare capacity, the growing demand for energy together with other major political and economic developments worldwide, has progressively managed to drive up oil prices to unprecedented levels generating massive profits for international oil companies ("IOCs"). In this context, resource nationalism has resurfaced in recent years, with states imposing tougher terms on IOCs or taking greater control in their national resources, the alleged reasons being commercial, political and/or environmental considerations.

In *Venezuela*, the State required IOCs to turn over majority control of their oil projects to a State-owned company, thereby expropriating oil and gas assets; in *Russia*, certain leading operators were required to turn over majority control of their gas projects to a State-owned company; and in *Bolivia*, the State nationalised the entire industry. In Africa too, countries such as *Chad*, *Tanzania*, *Guinea* and the *Democratic Republic of Congo* have established government aligned committees to review hydrocarbons contracts. *Angola* and *Nigeria* have started to reconsider their arrangements with IOCs, *Libya* has recently announced its intention to nationalise the oil and gas industry, while *Algeria* has finally managed to enter into the first hydrocarbons contracts with IOCs, which are governed by the recently enacted hydrocarbons law that had significantly increased the State's share in hydrocarbons contracts.

The recent spate of resource nationalism is not an anomaly. History shows that states periodically seek to (re)gain control over their oil and gas resources: Following the end of the Second World War, demand for oil and gas resources increased exponentially, and the control of oil production and prices by IOCs until the 1960s triggered a cycle of increasing resource nationalism, while the 1980s were a period of low resource nationalism as non-OPEC production increased without the OPEC cartel maintaining control over production rates. Still, resource nationalism may trigger significant instability in hydrocarbons operations.

Resource nationalism can take various forms – change in the legal/regulatory framework, forced renegotiation of the hydrocarbons contract, breach of the hydrocarbons contract, unilateral modification of the hydrocarbons contract, confiscation or even expropriation or nationalisation. Resource nationalism can be implemented immediately or incrementally over a determined period of time, further to a succession of mechanisms and measures that progressively reduce or deprive the IOC from access to, control over or value of their investment¹, a concept known as indirect expropriation.

In this context, IOCs must address and monitor resource nationalism with care and appropriate tools in order to protect their investment over the performance duration of their hydrocarbons contract. Other than commercial options available, IOCs must have in mind legal means to try and pre-empt the effects of resource nationalism by the State for example by seeking to

negotiate *stability provisions* in the hydrocarbons contract and to prevent resource nationalism by the State for example by seeking to negotiate *flexibility provisions*. In cases where direct or indirect expropriation has already occurred, IOCs may be able to make a claim for *compensation* under the hydrocarbons contract and/or an international investment treaty, although in practice the route to fair and effective compensation may prove long and difficult.

Stability and flexibility provisions: pre-empting the effects of and preventing resource nationalism

Hydrocarbons contracts are negotiated on the basis of prevailing economic and financial conditions, including the legal/regulatory framework, and are expected to remain in force for significant periods of time. Stability of the contract is a key requirement given the long-term, capital intensive nature of the investment necessary for exploration, subsequent development and commercial production.

Stabilisation clauses aim at reducing risk associated with unexpected changes in the legal/regulatory framework, and their consequent impact upon the economic and financial conditions previously agreed in the long-term contract in question.

Classic stabilisation clauses which provide for a straightforward "freezing" of the legal/regulatory framework existing at the time of entering into the contract have unsurprisingly proved difficult to implement in practice. Stabilisation clauses now often include more sophisticated mechanisms, for instance provisions which allow IOCs to benefit from a change in the applicable legal/regulatory framework, or provisions which are designed to protect the investor by requiring renegotiation in the event of a detrimental change in the legal/regulatory framework.²

In this context, the most constructive approach is probably not to focus on whether states can unilaterally change the rules of the game – which rules States can legally and unilaterally change – but to focus rather on trying to pre-empt and respond creatively with the consequences of such unilateral changes, perhaps via the inclusion of specific stability mechanisms which are triggered by changes in the legal/regulatory regime and which are designed to restore the economic balance to the hydrocarbons contracts in question.³

Provided they are well-drafted, such stability

mechanisms can be an efficient way of maintaining a satisfactory degree of long-term commercial equilibrium in a changing legal/regulatory environment. A carefully drafted clause will notably include a definition of the laws/regulations to be stabilised, the determination of the changes triggering the application of the clause and a description of the consequences of a failure to reach an agreement, as well as a clear definition of the ambit of the obligation to re-negotiate.

In this respect, the enforceability of agreements to renegotiate a contract may be assessed differently depending on the applicable law of the hydrocarbons contract⁴ and the jurisdiction under which any dispute is to be heard. Common law and civil law approaches may differ in this respect. By way of example, English courts traditionally consider that, in the absence of certainty, an agreement to negotiate is legally unenforceable⁵ and that "there is no general obligation to negotiate in good faith".⁶ Meanwhile, under French law, agreements to negotiate are enforceable⁷ and parties who have agreed to renegotiate a contract must do so in good faith.⁸ The enforceability of an agreement to negotiate is limited to the duty to carry out the negotiations in good faith (an obligation *de moyens* in French law), and does not extend to any compulsion to reach binding agreement⁹ (an *obligation de résultat*).

In addition, since resource nationalism is often triggered further to the State's perception that the economic balance of the hydrocarbons contract – as it was initially agreed – has changed to the favour of the IOCs, hydrocarbons contracts should provide the necessary flexibility mechanism that allows for the economic balance to progressively and automatically adapt to changes, including not only legal/regulatory change but also any change of the economic and/or financial conditions, which may impact the economic balance of the hydrocarbons contract.

For example, allocation or revenues and/or hydrocarbons production in the context of the hydrocarbons contract could customarily depend on the level of production achieved by the IOC or on the overall profitability of operations for the IOC. Allocation could also depend in particular on crude oil prices, thereby adapting the allocation of royalty oil, crude oil and profit oil to profits generated by crude oil prices. In this context, the more IOCs generate in profits, due to high crude oil prices, the more allocation would be adjusted to share such profits with the State on a fair basis.

Provided they are well-drafted, such flexibility mechanisms can be an efficient way of maintaining a satisfactory degree of long-term commercial equilibrium in a changing economic environment. A carefully drafted clause will notably include not only the necessary sliding scales to adapt the allocation of royalty oil, crude oil and profit oil to profits generated by crude oil prices, but especially a procedure that allow such mechanism to apply automatically without the need to resort to any negotiation between the parties.

Flexibility provisions, in particular those based on crude oil prices, work both ways as they allow greater allocation of revenues and/or hydrocarbons production in the favour of the State when crude oil prices are sky high such as in the first half of 2008 and favour IOCs when crude oil prices are depressed such as in the first half of 2009.

Of course, in situations where a direct or indirect expropriation – the ultimate form of resource nationalism – has already occurred, then stability and flexibility provisions and negotiations notwithstanding, IOCs may seek to claim compensation on the basis of the hydrocarbons contract and/or international investment treaties.

Arbitration: compensating for the consequences of resources nationalism

The legislation of most African state's generally acknowledge the right of the State to expropriate, provided that such expropriation is made for public purposes, in a non discriminatory manner, and in accordance with procedures governed by law.

Most African state's legislation and investment treaties generally protect against both direct and indirect expropriation, the latter being sometimes referred to as "creeping expropriation".¹⁰ Although indirect expropriation is usually not precisely defined in African state's legislation and investment treaties, international arbitration awards indicate a number of defining factors, such as the impact of state's action on the IOC's assets,¹¹ the legitimate expectations of IOCs¹² or the purpose and proportionality of the actions taken by the state.¹³

By adopting such standards, in the oil and gas context, African state's legislation and investment treaties reconcile the conflicting principles of inviolable private property rights and of permanent sovereignty of states over their natural resources.¹⁴

In this context, the most constructive approach is probably not to focus on whether States can expropriate – since States can legally and unilaterally expropriate, assuming expropriation was implemented in accordance with applicable laws – but to focus rather on compensating for the effect of expropriation. In this respect, expropriation procedures provided in African state's legislation usually require fair compensation for the victim of expropriation, and may provide guidelines for calculating compensation. However, assuming fair compensation is not properly granted under applicable local laws where expropriation was implemented, any IOC victim of expropriation, whether direct or indirect, should assess whether there is a viable arbitration claim for compensation under the hydrocarbons contract and/or an investment treaty.¹⁵

Most bilateral¹⁶ and multilateral¹⁷ treaties generally acknowledge the right of the State to expropriate, provided that such expropriation is made for public purposes, in a non-discriminatory manner, and in accordance with procedures governed by law. For example, Article 6.1 of the 2004 United States model Bilateral Investment Treaty customarily 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 [Minimum Standard of Treatment] (1) through (3)*".

In addition, even hydrocarbons contracts sometimes acknowledge the right of the State to expropriate, provided that such expropriation is made for public purposes, in a non discriminatory manner, and in accordance with procedures governed by law. For example, Article 16.6 of an hydrocarbons contract in West Africa provides: "*Assets of the Company, including the assets contributed to the Company by its shareholders, and assets of the shareholders of the Company shall not be seized by the State by any means whatsoever, and the State hereby undertakes to neither directly or indirectly interfere with, nor to directly or indirectly restrict the rights of Company arising out of the Mining Convention and the Mining Concession, except where public policy requires it, in accordance with applicable laws and regulations*".

Such bilateral and multilateral treaties and

hydrocarbons contracts also often provide guidelines for calculating compensation. For example, Article 6.2 of the 2004 United States model Bilateral Investment Treaty provides: "*The compensation referred to in paragraph 1(c) shall: (a) be paid without delay; (b) be equivalent to the fair market value of the expropriated investment immediately before the expropriation took place ("the date of expropriation"); (c) not reflect any change in value occurring because the intended expropriation had become known earlier; and (d) be fully realisable and freely transferable.*" Similarly, Article 16.7 of the above mentioned hydrocarbons contract in West Africa provides: "*In the event of breach of Article 16.6 here above by the State, the Company and its shareholders shall receive fair compensation, which shall not be lower than the preeminent market value*".

Yet perhaps unsurprisingly, neither investment treaties nor arbitration awards have so far led to the development of any precise guidelines for property and asset valuation. Last but not least, the enforceability of arbitration awards, in particular the actual payment of compensation, may be uncertain.¹⁸ As a result, calculation and payment of fair and effective compensation has proved long and difficult in practice.

Conclusion

With the recent significant drop in oil prices in the context of the current financial crisis, there can be little doubt that a new resource nationalism cycle is beginning – yet this time who can say what it will bring?

The IEA has predicted that output from Africa's non-OPEC producers¹⁹ will stagnate over the next five years as a result of deferred investments. Therefore, Africa's non-OPEC producing countries need to maintain attractive, flexible investor friendly policies in order to make the most of the downturn. States, such as Algeria, which had toughened contract terms when oil prices were high, have realised that they must work harder to entice investors now that prices have fallen. In this context, Algeria, whose much awaited seventh licensing round had ended in disappointment in early 2009 has paid heed, apparently stating that the recently launched licensing round will offer much improved terms.

Whatever happens, it seems unlikely that resource nationalism will recede or disappear, whilst States are willing to ensure their rights of ownership to their natural resources, however, at present, it would seem that resource nationalism cycle has turned to the favour of

IOCs as States are only too aware that only investor friendly policies will attract investment. This is therefore an excellent opportunity for IOCs to negotiate and implement the above mentioned stability and flexibility provisions in anticipation of future risks of nationalism.

In the meantime, another potential safeguard against resource nationalism is for IOCs to employ a pro-active management style to detect and deal with potential problems and disputes early. Effective monitoring of a contract in performance, clear substantive analysis, rapid identification of positional strengths and weaknesses, and good strategy and timing are key to achieving the best possible protection for the investment made.

Notes:

¹ Examples of indirect expropriation include revocation of permits and/or licences, certain tax measures or environmental sanctions.

² E.g. in the contractual tax or customs provisions.

³ See "*Stabilisation in Investment Contracts and Changes of Rules in Host Countries: Tools for Oil & Gas Investors*", Peter Cameron for the Association of International Petroleum Negotiators (July 2006).

⁴ See ICC Award n°5961, JDI 1997.1051.

⁵ See *Walford v. Miles* (1992) 64 P. & C.R. 166 HL.

⁶ Per Mummery LJ in *Cobbe v. Yeomans Row Management Ltd* [2006] EWCA Civ 1139, [2006] WLR 2964, in the context of pre-contractual negotiations.

⁷ For the enforcement of an agreement to renegotiate a contract, see the decision of the Paris Court of Appeal of 28 Sept. 1976, JCP 1978. II. 18810.

⁸ Article 1134-3° of the French Civil Code provides that contracts must be performed in good faith.

⁹ This view has been expressed in arbitral case law in the context of oil and gas contracts. See *Wintershall AG and others v. Government of Qatar*, 28 ILM 795 (1989), where Qatari law was applied. The Arbitral Tribunal considered that, if there was a duty to negotiate in good faith, "*it is clear 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 the claimants*" and refers to justifiable behaviour "*under normal commercial practice*".²

¹⁰ See *Middle East Cement Shipping and Handling Co. v. Republic of Egypt*, ICSID case No. ARB/99/6, award of 12 April 2002, at no. 107.

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- ¹¹ See *Biloune v. Ghana Investments Centre*, awards 27 October 1989 and 30 June 1990; *CME Czech Republik B.V. v. Czech Republic*, UNCITRAL partial award of 13 September 2001, at no. 604; and *Impreglio S.p.A. v. Islamic Republic of Pakistan*, ICSID Case No. ARB/03/3, award of 22 April 2005, at no. 278-279.
- ¹² See *Metalclad Corp v. The United Mexican States*, ICSID Case No. ARB (AF)/97/1, award of 30 August 2000 and *Técnicas Medioambientales, Tecmed S.A. v. Mexico* (ICSID Case No. ARB(AF)/00/2), award of 29 May 2003.
- ¹³ See for example *Azurix Corp v. Argentine Republic*, ICSID Case No. ARB/01/12, award of 14 July 2006, at no. 310 -312.
- ¹⁴ This principle was affirmed by the General Assembly of the UN in its resolution 626 (VII) of 21 December 1952 and in its Resolution 1803 (XVII) of 14 December 1962.
- ¹⁵ See "*Treaty and contract in investment arbitration*", by James Crawford, *Arbitration International*, Vol. 24 No. 3 (2008), pp 351-374 for consideration of contract arbitration vs treaty arbitration.

¹⁶ For example, Article 5 of the United Kingdom - Kenya BIT (2000).

¹⁷ For example, Article 1110.1 of the NAFTA and Article 13.1 of the Energy Charter Treaty (ECT).

¹⁸ See "*Expropriation of Oil & Gas Investments: historical, legal and economic perspectives in new age of resource nationalism*", by Plexus Energy Ltd and Ince & Co. for the Association of International Petroleum Negotiators (June 2008).

¹⁹ IEA's Medium Term Oil Market Report.

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