

**An Evaluation Of Contractual Clauses Used To Mitigate
Risks In Long Term Oil And Gas Agreements**

By

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ABSTRACT

Long term contracting features prominently in the increasingly volatile and uncertain oil and gas industry. The extensive duration of oil and gas agreements makes them vulnerable to an array of risks. These risks are generally mitigated through contractual clauses. Despite the widespread use of these clauses, it is argued that the literature fails to engage in a holistic examination of some of these contractual clauses. This thesis examines the legal and functional effectiveness of six selected clauses. It examines whether each of the selected clauses is fit for purpose and the challenges to its effectiveness. It offers recommendations on how its effectiveness may be enhanced.

This research is the first piece of work that examines the legal and practical effectiveness of commonly used risk mitigation clauses throughout the lifecycle of long term oil and gas agreements. It makes a contribution to knowledge by distinguishing the differences and overlaps in the different types of clause, so as to sharpen analysis of their precise functions and the challenges that may defeat their operation.

In assessing effectiveness, the thesis focuses on the approach in English law, although it also considers the position in some other jurisdictions.

DEDICATION

To my Lord and Saviour Jesus Christ, for I have come this far by faith.

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‘Thanks be to God who always causes me to triumph in His name’.

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List of Abbreviations

AACQ	Adjusted annual contract quantity
ACQ	Annual contract quantity
AIPN	Association of International Petroleum Negotiators
AMPLA	Australian Mining & Petroleum Law Association
BIT	Bilateral investment treaty
BP	British Petroleum
CD	Commercial discovery
CJV	Contractual joint venture
CoP	Cessation of production
DCG	Decommissioning
DRD	Decommissioning relief deeds
DSA	Decommissioning security agreement
EJV	Equity joint venture
GBA	Gas balancing agreement
GSA	Gas sales agreement
HCA	High Court of Australia
HS	Host state
IOC	International oil company
JV	Joint venture
JOA	Joint operating agreement
JOP	Joint operating party

LNG	Liquified natural gas
LoC	Letter of Credit
LOTGA	Long term gas agreement
LOTOGA	Long term oil and gas agreement
MCC	Modern concession contract
MEC	Modern equilibrium clause
MIT	Multilateral investment treaty
NOC	National oil company
NPC	Net Present Cost
NPV	Net Present Value
OGUK	Oil & Gas UK
OPCOM	Operating Committee
OPEC	Organisation of petroleum exporting countries
PSA	Producing sharing agreement
PSC	Producing sharing contract
PSNR	Permanent sovereignty over natural resources
RC	Renegotiation clause
RSC	Risk service contract
SC	Stabilisation clause
TAP	Tax adjustment provision
ToP	Take or Pay
UKSC	United Kingdom Supreme Court
UOA	Unit operating agreement

CHAPTER 1

GENERAL INTRODUCTION

Introduction

The oil and gas industry is a multi-trillion dollar industry.¹ In most producing states this industry plays a key role in economic development. Generally, states exploit oil and gas through contracts with international oil and gas companies (hereafter IOCs). These contracts are usually long term. IOCs also enter into other long term oil and gas contracts, such as joint ventures. IOCs would seek to reduce the risks in long term contracts through general risk mitigation measures such as research and due diligence on host state and reliance on protection available under treaty (BIT and MIT). However, concerns about the effectiveness of these measures have led IOCs to seek additional protection from risks through the inclusion of certain contractual clauses. This thesis seeks to evaluate the effectiveness of contractual clauses used by IOCs to mitigate risks in agreements between host states and IOCs, IOC to IOC, as well as IOC and buyers. The thesis focuses on risk mitigation from the perspective of the IOC as this is the party faced with the greatest financial risk throughout the duration of the long term oil and gas agreement.

¹ Marc Hammerson, *Upstream Oil and Gas: Cases, Materials and Commentary* (Globe Law and Business 2011) 31; Nicholas Antonas and Marc Hammerson, 'Introduction to UK petroleum law and practice' in Marc Hammerson and Nicholas Antonas (eds), *Oil and Gas Decommissioning: Law, Policy and Comparative Practice* (2nd edn, Globe Law and Business 2016) 46.

Despite the various types of long term oil and gas agreements, the thesis will discuss only the three main ones.² The first is the initial oil and gas agreement between a host state and a private company (generally an IOC), in the form of a concession, licence, production sharing contract, or service contract.³ The second agreement would be between various IOCs, typically in the form of a joint venture to exploit oil and gas resources subject to the initial agreement with the state. The third agreement discussed is between an IOC seller of gas and a buyer, in the form of long term gas sales agreements.

All three agreements are referred to as long term oil and gas agreements (hereafter LOTOGAs) because of their extensive duration. For instance, a licence between a host state and an IOC would typically last around thirty years.⁴ Any joint venture between IOCs could also last the same period if it begins concurrently with the licence. Depending on its structure, a long term sales agreement could cover the entire production phase of the contract area; this may be around 15-20 years.⁵ The extensive duration of LOTOGAs leaves an IOC vulnerable to a myriad of risks, some of which it may seek to mitigate through contractual clauses.

² An example of another type of long term oil and gas agreement is a transportation agreement.

³ These are discussed in chapter 2.

⁴ It is common for host states to separate an oil and gas licence or contract pertaining to exploration and production into three phases. For example, in the UK, production licences generally run for three consecutive periods or terms. The initial term is for exploration, the second term would be appraisal and development, and the third term is intended for production. Under the Traditional Seaward Production Licence, the initial term was four years, the second term was also four years and the third term was for 18 years. The Seaward Production Licence (Traditional, Promote and Frontier types) has been replaced by the Offshore Innovate Licences. One feature of the latter is that it offers greater flexibility in the durations of the Initial and Second Terms. Oil & Gas Authority UK, 'Licensing regime' <<http://www.gov.uk/guidance/oil-and-gas-petroleum-licensing-guidance>>; <<https://www.ogauthority.co.uk/regulatory-framework/>>; <<https://www.ogauthority.co.uk/licensing-consents/types-of-licence/>>; <<http://www.legislation.gov.uk/ukxi/2014/1686/schedule/2/made>>; Oil & Gas Authority, 'Licence applications' <<https://www.ogauthority.co.uk/licensing-consents/licensing-system/licence-applications/>>; <https://itportal.ogauthority.co.uk/web_files/recent_licences/licences/P1722.pdf> accessed 08 November 2018.

⁵ *ibid.*

1.1. Contractual risk mitigation by the international oil and gas company

In its agreement with the host state, the IOC would seek to limit the adverse consequences of direct actions of the state, such as expropriation, unilateral change of contract or forced renegotiation, through a stabilisation clause (hereafter SC). Yet, the SC has its limitations. The duration of a LOTOGA exposes the IOC to the risk that the economic equilibrium of the agreement may be adversely affected by political, economic, legal or other changes within the host state. The inclusion of a renegotiation clause (hereafter RC) can help to adjust this equilibrium within contractually recognised limits.

Even with the SC and the RC, in order to further reduce its exposure under its contract with the host state, an IOC may enter into a joint venture (hereafter JV) with other IOCs. The JV is a financial risk reducing mechanism as it shares all the risks of the venture between joint venturers according to predetermined interests. However, it carries its own risks. In a JV, the primary obligation of each joint venturer is to make a financial contribution towards the cost of operations. There is a risk that at any period, any party may be unable to meet its financial obligations. This would constitute a default. The general position is that the financial liability of the defaulting party would fall on the non-defaulting parties of the JV.⁶ To mitigate this and other JV risks, IOCs would normally seek to include a number of contractual clauses in the JV

⁶ As an example, the Norway Model Joint Operating Agreement 2013 (Agreement concerning petroleum activities- Attachment A Joint Operating Agreement), Article 9 provides that, '[i]f a Party does not comply with his obligation to make payments pursuant to Articles 7 or 8, the amounts which are not paid shall be advanced by the non-defaulting Parties in accordance with their Participating Interest'. Also, in some cases, the joint venture could provide that the failure of a non-defaulting party to cover a defaulting party's cash shortfall according to its percentage interest would itself constitute a default. An example of this is in the Denmark Model Joint Operating Agreement 2014, Article 11.1 (d). It provides that, '...failure by any Party to make such payments shall likewise and with the same results render that Party in default'.

agreement. These include the forfeiture clause, gas balancing agreement and decommissioning security agreement.

Additionally, the IOC will seek to mitigate risks and uncertainties in long term sales agreements. The Take or Pay clause is a common contractual method used to reduce financial risks in a sales agreement between an IOC seller and a buyer.

1.2. The selected clauses

Although numerous risk mitigation clauses could be discussed, six clauses pursuing a common aim have been selected for this study. This common aim is to protect the IOC from risks which have the greatest financial impact on the three types of LOTOGA identified above. Also, a linking factor is that some of the clauses are susceptible to challenge under the penalty rule. Additionally, a significant justification for the selected clauses is that these clauses have been identified in the literature as the most commonly used to reduce risks and uncertainties. The stabilisation and renegotiation clauses have been cited as the most common contractual methods of mitigating political risks in a LOTOGA.⁷ The forfeiture clause (hereafter FC) is a common default remedy in joint operating agreements; this is evidenced by its inclusion in numerous Model Oil and Gas Joint Operating Agreements.⁸ The gas

⁷ Martin Bartels, *Contractual Adaptation and Conflict Resolution: Based on venture contracts for mining projects in developing countries* (Kluwer Law 1985); Wolfgang Peter, *Arbitration and Renegotiation of International Investment Agreements* (Second Revised and Enlarged edn, Kluwer Law International 1995); Kaj Hobér, 'Ownership of the Oil and Gas Resources in the Caspian Sea: Problems and Solutions - International Arbitration and Contractual Clauses' (2009) 4 *Oil, Gas & Energy Law Intelligence* (OGEL) <www.ogel.org> accessed 23 November 2017; Mustapha Erkan, *International Energy Investment Law: Stability through Contractual Clauses* (Kluwer Law 2011) 10.

⁸ Examples are contained in the: Model JOA Greenland 2008-11.3.3, Model Service Contract Iraq 2010- Addendum One Heads of JOA, Clause 7.2, AIPN Model JOA 2012- Article 8.4.D.1, Model JOA for Licence Denmark 2014- Article 11.3.3, Model PSC Kenya 2015- Appendix C 6.9-6.10. See also Eduardo G Pereira, 'Protection against Default in Long Term Petroleum Joint Ventures' (May 2012) The Oxford Institute for Energy Studies, WPM 47. 1, 4 <https://www.oxfordenergy.org/wpcms/wp-content/uploads/2012/05/WPM_47.pdf> accessed 10 November 2017.

balancing agreement (hereafter GBA) is unique to the gas industry. It is the only contractual agreement relating to balancing in gas agreements exploited through a JV. Thus, a discussion on its effectiveness as a contractual method of risk mitigation is highly appropriate. The Take or Pay (hereafter ToP) clause is a common contractual method of reducing financial risks in gas sales agreements.⁹ Lastly, the decommissioning security agreement (hereafter DSA) is a common contractual method used to mitigate financial risks in LOTOGAs exploited through a JV.¹⁰

The thesis will not discuss certain other clauses that are also commonly used by IOCs to mitigate risks in LOTOGAs, such as indemnity and dispute resolution clauses, as there is a host of literature on their effectiveness.¹¹

⁹ See Ben Holland and Philip Spencer Ashley, 'Enforceability of Take-or-Pay Provisions in English Law Contracts (2008) 26 (4) Journal of Energy & Natural Resources Law 610, 610; Efe U Azaino, 'Natural gas contracts: Do take or pay clauses fall foul of the rule against penalties?' (May 2012) 1, 1-2 <https://www.academia.edu/10666060/Natural_Gas_Contracts_Do_Take_Or_Pay_Clauses_Fall_Foul_of_The_Rule_Against_Penalties> accessed 17 March 2017; Daniel R Rogers and Merrick J White, 'Key considerations in energy take-or-pay contracts' (Lexology: King and Spalding LLP, April 2013) <<http://www.lexology.com/library/detail.aspx?g=abec95b0-aec8-4c88-8bcb-f3e8a0ef451f>> accessed 19 May 2017; Anthony Papamatheos, 'Take or Pay Arrangements in Energy Supply: Contracting Out of the Penalty Conundrum' (2015) AMPLA Yearbook 474, 474-476.

¹⁰ The DSA is used to ensure that guaranteed funds will be available to cover decommissioning costs. See Department of Energy and Climate Change, 'Guidance Notes: Decommissioning of Offshore Oil and Gas Installations and Pipelines under the Petroleum Act 1998' (March 2011) 1, 115 <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/69754/Guidance_Notes_v6_07.01.2013.pdf> accessed 20 March 2017; Scott C Styles, 'Joint Operating Agreements' in Gordon G and others (eds), *Oil and Gas Law: Current Practice and Emerging Trends* (2nd edn, Dundee University Press 2011) 407.

¹¹ See Stephen Myron Schwebel, *International Arbitration: three salient problems* (Cambridge University Press 1987); Judy Clark, 'International arbitration' (2004) 102(18) Oil and Gas Journal Tulsa; David R. Haigh, 'Disputes: Injunction, Multi-Party, Specific Performance, Forfeiture & Arbitrability' (2007) 5(2) OGEL <www.ogel.org.uk> accessed 11 May 2017; Mustapha Erkan, *International Energy Investment Law: Stability through Contractual Clauses* (Kluwer Law 2011); A.F.M Maniruzzaman, 'The Issue of Resource Nationalism: Risk Engineering and Dispute Management in the Oil and Gas Industry' (2012) 10 (3) OGEL <www.ogel.org.uk> accessed 11 May 2017; Herfried Wöss and others, *Damages in international arbitration under complex long-term contracts* (Oxford University Press 2014); Gary B. Born, *International Commercial Arbitration* (2nd edn, Kluwer Law International 2014); Garry B. Born, *International Arbitration: Cases and Materials* (2nd edn, Kluwer Law International 2015); Nigel Blackaby and others, *Redfern and Hunter on International Arbitration* (6th edn, Oxford University Press 2015).

Also, an important risk mitigation clause which will not be discussed is force majeure.¹² The force majeure clause is a contractual defence which frees a party from performing a particular obligation of the contract due to circumstances beyond its control.¹³ However, the thesis's focus is on clauses through which an IOC seeks to ensure the performance of a contractual obligation by another party, or through which the IOC is guaranteed a stipulated remedy in the case of non-performance. Therefore, a discussion of the force majeure clause does not fit with the overall direction of the thesis.

1.3. Objective of the thesis

The approach in notable scholarly works on risk mitigation is to focus on risks and uncertainties which arise as a result of the involvement of a state party in a LOTOGA. A popular book on risk mitigation in LOTOGAs is by Mustapha Erkan.¹⁴ This book focuses on political risks created because of the involvement of a state party, and evaluates how IOCs can protect their investment through contractual clauses. A similar book by Peter Cameron explores stability based on contract and treaty.¹⁵ Both books only consider risk mitigation clauses (stabilisation, renegotiation, choice of law and alternative dispute resolution clauses) in contracts between host states and IOCs.

¹² For a discussion see Christoph Brunner, *Force Majeure and Hardship under General Contract Principles: Exemption for Non-Performance in International Arbitration* (Kluwer Law International 2008).

¹³ International Chamber of Commerce (ICC) Force Majeure Clause 2003, ICC Hardship Clause 2003 <<http://store.iccwbo.org/t/ICC%20Force%20Majeure%20Hardship%20Clause>> accessed 01 November 2017. It also frees the party claiming force majeure from any liability in damages or under any contractual remedy for breach, for as long as the impeding event continues. International Chamber of Commerce (ICC) Force Majeure Clause 2003, Paragraph 4, 5 and 6.

¹⁴ Mustapha Erkan, *International Energy Investment Law: Stability through Contractual Clauses* (Kluwer Law 2011).

¹⁵ Peter D Cameron, *International Energy Investment Law: The Pursuit of Stability* (Oxford University Press 2010).

There is no discussion on how contractual clauses can be used to create stability and reduce risks in agreements between IOCs involved in a long term oil and gas JV or between an IOC seller and a buyer of oil or gas. The benefit of these authors' approach is that the discussion is streamlined, focusing on contractual clauses to mitigate risks created by a state party. However, the demerit is that such an approach is one-sided and does not engage in a holistic analysis of risks which affect the IOC, only some of which are the result of state action. For example, the majority of complex and costly LOTOGAs are exploited through JVs.¹⁶ Thus, the IOC is faced with risks arising from other joint venturers as well as the state party. To this writer's knowledge, there is no major academic work (apart from general discussions on JV provisions) focused on assessing the effectiveness of contractual clauses used to mitigate risks and uncertainties in collaborative endeavours between IOCs involved in a LOTOGA. A more recent book by Pereira and Zahari comes close to an assessment of risk mitigation clauses in joint ventures, however, it only examines default provisions in joint operating agreements.¹⁷ It does not consider other crucial risk mitigation clauses such as the GBA, ToP or DSA, which are triggered by non-default events. Furthermore, it is surprising that there is no book (to the best of the writer's knowledge) that provides an assessment of common contractual clauses used to mitigate risks during the life of a LOTOGA, from exploration to decommissioning.¹⁸

¹⁶ Christopher Duval and others, *International Petroleum Exploration and Exploitation Agreements: Legal, Economic and Policy Aspects* (2nd edn, Barrows Company 2009) 285.

¹⁷ Eduardo G Pereira and Wan M Zulhafiz Wan Zahari (eds), *Joint Operating Agreement: Applicability and Enforcement of Default Provisions* (Rocky Mountain Mineral Law Foundation 2018).

¹⁸ The five stages of a LOTOGA are: exploration; appraisal; development; production and decommissioning. The stabilisation, renegotiation and forfeiture clause can be used from the exploration to the production phase. The gas balancing agreement and Take or Pay clause are used during the production phase. The decommissioning security agreement is used to cover funds for the decommissioning stage.

This thesis seeks to fill this gap by providing an assessment of risk mitigation clauses in the lifecycle of LOTOGAs.

This approach offers a fresh perspective to the discourse in that it seeks to distinguish the variation and overlaps in the different types of clause, to sharpen analysis of their precise functions and to evaluate the possible challenges to which the clauses may be vulnerable. As an example, a common factor between three of the selected clauses (FC, GBA and ToP clause) is that they are all susceptible to challenge under the penalty rule. A group assessment is central to understanding how each clause links to the other and any broad implications on the LOTOGA.

1.4. Research questions

The thesis seeks to examine the selected clauses from two perspectives: legal and functional effectiveness. The first test of effectiveness is to explore the vulnerability of each clause to legal challenge. The second test is one of functional effectiveness. This considers whether the clause can fulfil its commercial purpose. In the assessment of each clause, the principal question is whether the clause is effective in mitigating risks in LOTOGAs. The thesis asks three main questions:

1. What is the commercial purpose of the clause?
2. Is the clause effective to achieve its commercial purpose? This involves a discussion of the possible legal challenges.
3. How can the effectiveness of the clause be enhanced?

1.5. Methodology

The thesis adopts a doctrinal approach, analysing primary and secondary sources available from libraries, as well as online materials. Primary sources include legislation, case law, real oil and gas agreements and model contracts. The focus of the research is on English law. However, sources from other jurisdictions have been considered where relevant. Secondary sources include major academic books and journals, as well as legal commentaries. There is a contextual analysis of the problem, using didactic reasoning. The effectiveness of each clause is assessed through a tripartite process: what the clause is intended to achieve (the design of the clause); what are the legal and practical challenges affecting how it can fulfil the intended function; how those challenges can be overcome so as to give each clause greater effectiveness.

1.6. Structure of the thesis

The thesis is in two main parts. Part one focuses on contractual methods used to reduce risks and uncertainties in LOTOGAs between host states and IOCs. This discussion spans over chapter 4 and 5. Part two addresses contractual risk mitigation between IOCs working together on a long term oil and gas joint venture. This is in chapter 6, 7 and 9. Chapter 8 considers risk mitigation in the relationship between an IOC seller and a buyer of gas.

Chapter 1 of the thesis begins with a general introduction.

Chapter 2 contains an introduction to long term oil and gas agreements.

Chapter 3 explains the risks faced by IOCs in LOTOGAs.

Chapter 4 is focused on the stabilisation clause. It explores the legal and practical effectiveness of the SC.

Chapter 5 evaluates how the renegotiation clause can be used to reduce risks and uncertainties in LOTOGAs.

Chapter 6 examines the forfeiture clause in joint ventures, particularly the joint operating agreement. It considers whether a forfeiture clause is legally enforceable under the penalty rule, applying guidance from *Makdessi v Cavendish Square Holdings BV*.¹⁹

Chapter 7 is on the gas balancing agreement (GBA). This chapter assesses the effectiveness of the GBA in gas arrangements where multiple parties have rights to production.

Chapter 8 discusses the Take or Pay (ToP) clause. The chapter analyses whether the ToP provision is legally enforceable or whether it contravenes the rule against penalties. It also considers the reasonable endeavours obligation of the ToP seller.

Chapter 9 is on the decommissioning security agreement (DSA). The focus is on assessing the effectiveness of the DSA, looking at its response to the financial risks of decommissioning where the field has been exploited through a joint venture.

Chapter 10 provides some recommendations and conclusions.

¹⁹ [2015] UKSC 67, [2015] 3 WLR 1373 (SC).

CHAPTER 2

AN INTRODUCTION TO LONG TERM OIL AND GAS AGREEMENTS

Introduction

Prior to assessing the effectiveness of the selected clauses, it is necessary to provide a background on LOTOGAs, the various types explored in the thesis, the rights created and the nature of the relationship between the contracting parties. In so doing, this chapter discusses the legal and commercial arrangements between host states and IOCs, between IOC-IOC in a JV, and between an IOC seller and a buyer, in a long term sales agreement. This context may be helpful in understanding how each of the selected clauses fit in LOTOGAs.

2.1. The long term oil and gas agreement between host states and international oil companies

There are four main types of LOTOGA used in the relationship between IOCs and host states. These are: the concession, licence, production sharing contract and risk service contract. Arguably, there is a fifth type – referred to as a hybrid contract – which combines several features of the four main types.¹

¹ China has used a hybrid oil and gas contract which is at its core a joint venture, but also has features of the PSC. Zhiguo Gao, *International Petroleum Contracts: Current Trends and New Directions* (Graham Trotman Ltd 1994) 143; Jin Xiong, Yan Zhao and George Zhao, 'Oil and gas regulation in China: overview' (Thomas Reuters Practical Law: King & Wood Mallesons, 01 October 2014) <[https://uk.practicallaw.thomsonreuters.com/3-525-3038?transitionType=Default&contextData=\(sc.Default\)&firstPage=true&bhcp=1](https://uk.practicallaw.thomsonreuters.com/3-525-3038?transitionType=Default&contextData=(sc.Default)&firstPage=true&bhcp=1)> accessed 06 September 2017.

i. Concession

Historically, a concession is the conferring by a state to an IOC the exclusive rights to explore and exploit oil and gas over a large acreage and for a period of between 60 to 75 years.² The concessionaire is given proprietary rights over resources, as well as absolute decision making powers.³ In return the state would receive a nominal payment through a lump sum or instalments.⁴ It would also receive royalty payment – agreed in absolute terms or based on the volume of oil or gas extracted.⁵

Over time, particularly after decolonisation, governments became discontented with the terms of the traditional concession and sought to regain sovereignty over natural resources, as well as to secure participation in operations and increased fiscal payments.⁶ This gave rise to the modern concession contract (hereafter MCC). This agreement is similar to the traditional concession in terms of its legal structure, but it is a more favourable agreement for the state. The duration of the MCC is around 38 years.⁷ Also, the state receives increased revenue, more in line with the value of the

² Ernest E Smith and others, *Materials on International Petroleum Transactions* (Rocky Mountain Mineral Law Foundation 2010) 442. The first petroleum concession was granted by Persia in 1901 to a British entrepreneur William D'Arcy.

³ *ibid* 31.

⁴ Zhiguo Gao, *International Petroleum Contracts: Current Trends and New Directions* (Graham Trotman Ltd 1994) 13-15; Muthucumaraswamy Sornarajah, *The Settlement of Foreign Investment Disputes* (Kluwer Law International, 2000) 44; Ernest E Smith and others, *Materials on International Petroleum Transactions* (Rocky Mountain Mineral Law Foundation 2010) 31.

⁵ *ibid*.

⁶ Zhiguo Gao, *International Petroleum Contracts: Current Trends and New Directions* (Graham Trotman Ltd 1994) 14.

⁷ *ibid* 53. For instance, in a comparison of the Thailand traditional and modern concession contracts, Gao found that the traditional concession was for a duration of 75 years, whilst the modern concession was for 38 years. The modern concession also included two renewals of 4 and 10 years each. The maximum period was thus 48 years. The area of the traditional concession was 35,000 km whilst the area under the modern concession was 10,436km.

resource. For example, in the Thai MCC,⁸ besides the royalty payment, the government receives several ‘special advantages’ from the IOC. These include a signature bonus, annual bonus, and scholarships.⁹ More importantly, the MCC leaves some scope for state participation in the LOTOGA.¹⁰

Yet, despite these changes, the political and historical narrative that accompanies the concession mars its use in many postcolonial states. Such states are likely to prefer other forms of LOTOGAs, one of which is the licence.

ii. Licence

A licence is an agreement through which the licensee is granted exclusive or non-exclusive¹¹ rights over a defined area for a limited period of time (generally about thirty years).¹² In return, the state receives specified fiscal payments.¹³ Aside from having a more politically acceptable title, the licence is essentially a MCC in terms of

⁸ Whilst retaining the MCC, in 2017, the Thai government introduced production sharing contracts, as well as service contracts. Steve Potter, ‘Thailand introduces production sharing and service contracts to promote upstream oil and gas investment’ (Out-Law, 14 July 2017) <<https://www.out-law.com/en/articles/2017/july/thailand-introduces-production-sharing-and-service-contracts-to-promote-upstream-oil-and-gas-investment/>> accessed 06 February 2018.

⁹ Zhiguo Gao, *International Petroleum Contracts: Current Trends and New Directions* (Graham Trotman Ltd 1994) 37-39.

¹⁰ Peter D. Cameron and Michael C. Stanley, *Oil, Gas, and Mining: A Sourcebook for Understanding the Extractive Industries* (World Bank Group 2017) 75-77.

¹¹ In this context, ‘exclusive’ can have two meanings. Firstly, it can relate to the breakdown of oil and gas operations. An exclusive licence in terms of operations means that the licensee has sole right to exploration and exploitation within the licence area. Secondly, exclusive can relate to the number of participants on the block. Here, an exclusive licence provides that the state would not offer parts of the block to other companies. Rather, the licensee would be the sole company operating on the block. Under the traditional concession, the concessionaire would have exclusive rights in relation to operation, as well as being the only participant on the block.

¹² Jubilee Easo, ‘Licences, Concessions, Production sharing agreements and Service contracts’ in Geoffrey Picton-Tuberville (ed), *Oil and Gas: A Practical Handbook* (Globe Law and Business 2009) 29-32.

¹³ For example, in the UK, the revenue from oil and gas consists of offshore corporation tax (this includes ‘ring fence’ corporation tax and the supplementary charge) and petroleum revenue tax. Oil and Gas Authority, ‘Taxation Overview’ <<https://www.ogauthority.co.uk/exploration-production/taxation/overview/>> accessed 26 January 2019.

its structure. In fact, some texts refer to both alike.¹⁴ The licence is used in the United Kingdom, as well as in some developing states formerly under colonial rule. Examples include Morocco, Namibia,¹⁵ and The Gambia.¹⁶

iii. Production sharing contract

The end of the colonial period inspired a sense of nationalism¹⁷ in newly independent states who sought to assert their position in the international economic order.¹⁸ One way to bring this about was for these countries to have permanent sovereignty over natural resources (hereafter PSNR). The idea of PSNR emerged from debates at the United Nations, which gave way to various resolutions; most significant of these is the General Assembly resolution 1803 (XVII).¹⁹ This culminated in the Charter of Economic Rights and Duties of States.²⁰ There is no comprehensive definition of sovereignty in the UN General Assembly resolutions. However, the underlying principle is that it covers the right to explore for hydrocarbons, with host states

¹⁴ See Zhiguo Gao, *International Petroleum Contracts: Current Trends and New Directions* (Graham Trotman Ltd 1994) 29; Peter D. Cameron and Michael C. Stanley, *Oil, Gas, and Mining: A Sourcebook for Understanding the Extractive Industries* (World Bank Group 2017) 75-77; Gas Strategies, 'Industry Glossary' <<http://www.gasstrategies.com/industry-glossary#C>> accessed 04 January 2017.

¹⁵ See Ministry of Mines and Energy, 'Petroleum Upstream' <<http://www.mme.gov.na/petroleum/upstream/>> accessed 17 March 2018.

¹⁶ Berwin Leighton Paisner, 'Unlocking The Gambia's Potential: Legislative Petroleum Framework in The Gambia' (2017) <<http://www.mop.gov.gm/sites/default/files/PowerPoint%20%20-%20The%20Gambia%20Legislative%20Framework%20%2858769244v4%20Legal%29.pdf>>; <<http://www.mop.gov.gm/pgpp>> accessed 17 March 2018. Morocco and South Africa also use the licence.

¹⁷ 'Nationalism is a condition of mind, feeling, or sentiment of a group of people living in a well-defined geographical area, speaking a common language, possessing a literature in which the aspirations of the nation have been expressed, being attached to common traditions, and, in some cases, having a common religion'. Louis L Snyder (ed), *The Dynamic of Nationalism: Readings in its Meaning and Development* (D. Van Nostrand Company 1964) 2.

¹⁸ Nico Schrijver, *Sovereignty over natural resources: Balancing rights and duties* (Cambridge University Press 1997) 1; Muthucumaraswamy Sornarajah, *The International Law on Foreign Investment* (4th edn, Cambridge University Press 2017) 1-2.

¹⁹ General Assembly resolution 1803 (XVII) of 14 December 1962, 'Permanent sovereignty over natural resources' <http://legal.un.org/avl/ha/ga_1803/ga_1803.html> accessed 05 February 2018.

²⁰ General Assembly Resolution 3281 (XXIX) of 12 December 1974 'Charter of Economic Rights and Duties of States' <<http://www.un-documents.net/a29r3281.htm>> accessed 05 February 2018.

becoming owners of any resources found.²¹ It also includes: the right to use and dispose of resources; the right to regain control at the end of the concession; the right to compensation for any damage to the environment or geology; and the right to expropriate the resource.²²

Nevertheless, after the UN resolutions on PSNR were adopted, these governments were faced with the reality that they needed foreign investment. The production sharing contract (hereafter PSC) (also known as the production sharing agreement- PSA), an innovation by Indonesia, emerged as a compromise.²³ The main features of the PSC are that the state retains sovereignty over resources and hires the IOC as a contractor to carry out oil and gas activities.²⁴ The IOC bears all the risks of exploration. Where there is a commercial discovery, the IOC is allowed to recover its costs from a specified percentage (generally around 40%) of monthly production, known as 'cost oil'.²⁵ The remaining production is split in predetermined percentages between the state and IOC as 'profit oil'. In terms of the fiscal package, there is no royalty payment since the state remains the owner of resources. However, it is usual for the IOC to pay the state a signature bonus, and production bonuses where

²¹ Sangwani Patrick Ng'ambi, 'Permanent Sovereignty Over Natural Resources and the Sanctity of Contracts, From the Angle of *Lucrum Cessans*' (2015) 12(2) *Loyola University Chicago International Law Review* 153, 154.

²² *ibid* 154-172; For a general discussion on permanent sovereignty over natural resources, see Nico Schrijver, *Sovereignty over natural resources: Balancing rights and duties* (Cambridge University Press 1997). Expropriation is a highly controversial area of investment law. It involves measures by the state which deprive the investor of the full benefit of its investment.

²³ Muthucumaraswamy Sornarajah, *The International Law on Foreign Investment* (3rd edn, Cambridge University Press 2010) 74.

²⁴ *ibid* 144.

²⁵ Zhiguo Gao, *International Petroleum Contracts: Current Trends and New Directions* (Graham Trotman Ltd 1994) 66; Anthony Jennings, *Oil and Gas Exploration Contracts* (2nd edn, Sweet & Maxwell 2008) 16.

production reaches certain levels over a period of time.²⁶ The PSC is common in developing countries such as Indonesia,²⁷ Malaysia, Nigeria and Equatorial Guinea.²⁸

iv. Service contract

Although used in two forms, risk and non-risk,²⁹ this thesis is concerned with the risk service contract (hereafter RSC).

In a RSC, the IOC takes on all the risks of exploration in the hope that it will make a commercial discovery of oil or gas.³⁰ Where there is a commercial discovery, the IOC will continue to provide technical services in the capacity of a contractor, and receives remuneration in cash or in oil.³¹ Iraq uses a RSC (known as a technical service contract) where the IOC is paid a fixed fee per barrel (remuneration fee); its operating costs are also recovered through the remuneration fee which is taxed at

²⁶ Zhiguo Gao, *International Petroleum Contracts: Current Trends and New Directions* (Graham Trotman Ltd 1994) 76.

²⁷ In 2017, there were changes to the Indonesian Energy Law. Regulation 8 replaces the usual cost recovery mechanism with a system where the contractor receives a gross split of production from the beginning of operations. For more on this, see Sean Prior, Nathan Dodd and Rod Brown, 'Indonesia: Indonesia Briefing: Latest Changes In Energy Law (Part 2)' (Mondaq: Mayer Brown, 09 March 2017) <<http://www.mondaq.com/x/575504/Oil+Gas+Electricity/Indonesia+Briefing+Latest+Changes+in+Energy+Law+Part+2>> accessed 27 January 2018.

²⁸ Sani Saidu, 'A Comparative Analysis of Production Sharing Contracts of Selected Developing Countries: Nigeria, Indonesia, Malaysia and Equatorial Guinea' (2014) 2(2) *Journal of Finance and Accounting* 34-40.

²⁹ In a non-risk service contract, the state takes on the risks (financial and otherwise) of exploration and exploitation. The state hires the contractor to carry out specific oil and gas operations. In return, the contractor receives an agreed fee, whether there is a discovery or not. This payment may be in cash or in kind. The latter is typically preferred by IOCs as it gives them access to oil/gas. The non-risk service contract is typically used where the state requires a particular technical skill or specialism in oil and gas operations, one which cannot be performed by its NOC. The thesis is not concerned with this type of agreement since the state (not the IOC) is the party bearing the risks of oil and gas operations. For more on the non-risk service contract, see Anthony Jennings, *Oil and Gas Exploration Contracts* (2nd edn, Sweet & Maxwell 2008) 20, 38.

³⁰ This is the case in the concession, licence and production sharing contract.

³¹ Anthony Jennings, *Oil and Gas Exploration Contracts* (2nd edn, Sweet & Maxwell 2008) 20.

35%.³² There may also be agreement for a state entity to take over operations from the IOC at the production phase.³³ The RSC gives the state a great degree of control over its natural resources, but for IOCs it is the least attractive form of LOTOGA, particularly because there is no guaranteed access to oil or gas.

Overall, the predominant difference in the types of LOTOGA described above lies in the degree of control exercised by the host state over the IOC, the IOC's access to oil and gas, and the amount of risk borne by the IOC.³⁴ In negotiating the specific terms of the LOTOGA, be it a licence or contract, the IOC would seek the inclusion of contractual clauses which reduce risks. Where the LOTOGA concerns a large area and/or complex operations, the IOC would also consider mitigating its risks (particularly financial risks) through collaboration with other IOCs. Typically, this would be in the form of a joint venture, with the joint venture itself being a type of LOTOGA where it is running alongside a licence or contract granted by the state.

2.2. Joint venture in a long term oil and gas agreement

The exploration and exploitation of oil and gas requires significant financial and non-financial resources. In many instances, an oil and gas project can require hundreds of

³² See Reed Smith LLP, 'Iraq oil and gas regime - part II' (Lexology: Reed Smith LLP, 04 June 2013) <<https://www.lexology.com/library/detail.aspx?g=6c78b845-a73f-4554-be26-6ce88d79cea3>>; Luay J. Al-Khateen, 'Iraq's crazy goings on' (Petroleum Economist, 14 November 2017) <<http://www.petroleum-economist.com/articles/upstream/exploration-production/2017/iraqs-crazy-goings-on>> accessed 15 November 2017. The 2006 Iraqi Constitution, Article 111 states that, 'Oil and gas are owned by all the people of Iraq in all the regions and governorates'. This has been interpreted as a constitutional restriction on the PSC since that allows IOCs to 'own' oil and gas. Therefore, the technical service contract remains the only alternative since the IOC does not own oil and gas resources. However, it must be noted that the semi-autonomous Kurdistan region of northern Iraq uses the PSC.

³³Anthony Jennings, *Oil and Gas Exploration Contracts* (2nd edn, Sweet & Maxwell 2008) 20.

³⁴ Jubilee Easo, 'Licences, Concessions, Production sharing agreements and Service contracts' in Geoffrey Picton-Tuberville (ed), *Oil and Gas: A Practical Handbook* (Globe Law and Business 2009) 28.

millions of pounds, as well as specific technical expertise.³⁵ Therefore, an IOC would seek to reduce the risks associated with such a project by entering into a JVs with other parties, mainly IOCs. IOCs also enter into JVs with national oil companies (hereafter NOCs). However, in some cases, the IOCs would bear the NOC's share of costs during the exploration period, before a commercial discovery.³⁶ In contrast, IOCs working collaboratively on a JV are required to bear their participating percentage of all risks associated with exploration and exploitation. For this reason, the discussion on the JV will focus on IOCs.

Whilst not all LOTOGAs are developed through JVs, the majority of large and complex oil and gas projects are developed through JVs.³⁷ For an IOC, the chief purpose of entering into a JV is to reduce risks. The JV allows each participant to spread resources over several rather than one large project.³⁸ Additionally, the combination of technical skills and expertise allows IOCs to learn from each other. Furthermore, the JV has a strategic advantage where the state grants the licence or

³⁵ Ernest E Smith and others, *Materials on International Petroleum Transactions* (Rocky Mountain Mineral Law Foundation 2010) 526.

³⁶ For example, the Model Joint Operating Agreement for Licence No... for Exploration and Exploitation of Hydrocarbons in an Open Door Area in Greenland (Government of Greenland, Bureau of Minerals and Petroleum (April 2008) Article 2.4.1 provides that, 'The Percentage Interest of NUNAOIL shall be subject to the provisions of Article 12 of the Licence. *NUNAOIL's share of the costs, expenses, obligations and liabilities referred to in Article 2.2 (a) shall, without prejudice and subject to Article 7.7.9, be borne by the other Parties as set forth in Sections 12.02 and 12.04 of the Licence. Such bearing by the other Parties of NUNAOIL's share of costs, expenses, obligations and liabilities is referred to in this Agreement as a "carry" of NUNAOIL...*'. (emphasis added) <https://www.govmin.gl/images/stories/petroleum/exploration_exploitation/opendoor/model_joa_open_door.pdf> accessed 19 October 2017. See also Ernest E Smith and others, *Materials on International Petroleum Transactions* (Rocky Mountain Mineral Law Foundation 2010) 492. Christopher Duval and others., *International Petroleum Exploration and Exploitation Agreements: Legal, Economic and Policy Aspects* (2nd edn, Barrows Company 2009) 285.

³⁷ Christopher Duval and others., *International Petroleum Exploration and Exploitation Agreements: Legal, Economic and Policy Aspects* (2nd edn, Barrows Company 2009) 285.

³⁸ Peter Roberts, *Joint Operating Agreements: A Practical Guide* (3rd edn, Globe Business Publishing 2015) 19.

contract through a process of competitive bidding. By combining strengths, expertise and resources, IOCs increase their chances of having a successful bid.³⁹

IOCs can enter into a JV prior to or after acquiring an oil and gas right from a host state. The JV may be a contractual or equity joint venture.⁴⁰ An equity JV (EJV) requires the parties to create a JV company where each party owns an agreed percentage of shares, with a right to dividends.⁴¹ In contrast, in a contractual JV (CJV) there is no separate JV company but simply a contract through which each party owns an agreed percentage of oil and gas production. As such, where allowed by the host state, the CJV is preferred by IOCs because of the direct access to oil and gas. Reference to the JV throughout the thesis is to the CJV because this is more commonly used than the EJV.

Although there are several types of JVs, the thesis' discussion on JVs is focused on the joint operating agreement and the unitisation agreement. This is because these agreements involve significant risks and financial contributions from IOCs and are directly relevant to the discussion on some of the selected clauses, such as the FC, GBA and DSA.

³⁹ Charez Golvala, 'Upstream joint ventures-bidding and operating agreements' in Picton-Tuberville G (ed), *Oil and Gas: A Practical Handbook* (Globe Law and Business 2009) 42.

⁴⁰ The equity joint venture is also commonly referred to as the incorporated joint venture; the contractual joint venture as the unincorporated joint venture. See Peter Roberts, *Joint Operating Agreements: A Practical Guide* (3rd edn, Globe Business Publishing 2015) 27-28.

⁴¹ Peter Roberts, *Joint Operating Agreements: A Practical Guide* (2nd edn, Globe Law and Business 2012) 22-24. The IOC nominated as Operator in an EJV would be responsible for carrying out exploration and exploitation activities. Upon production, the joint venture company would generally be solely responsible for marketing oil and gas, having no obligation to market to either the IOCs or NOC.

i. Joint operating agreement

The joint operating agreement (hereafter JOA) is by far the most common type of JV used by IOCs.⁴² This form of agreement is entered into in respect of a licence or contract area explored and/or exploited by multiple IOCs working collaboratively. The JOA is the legal instrument which sets out the rights and duties of each party according to their undivided participating interest in the underlying licence or contract,⁴³ discussed in section 2.1 above. The principal role of a JOA is to specify how oil and gas operations which are required under the licence or contract with the host state would be performed as between joint venturers.⁴⁴ The JOA controls the horizontal relationship between the IOCs, whilst the underlying licence or contract controls the vertical relationship between the state and IOCs.⁴⁵

The structure of a JOA is that it is made up of an Operator and non-operating parties. The Operator would be responsible for preparing and fulfilling all the work obligations to the state, under the licence or contract.⁴⁶ The non-operating parties have a duty to make cash contributions according to their participating interest, as well as approve work programmes and budgets presented by the Operator. The duty to make cash contributions also applies to the Operator. Each party has a right to a share of

⁴² A. Timothy Martin, 'Model Contracts: A Survey of the Global Petroleum Industry' (2004) 22 *Journal of Energy and Natural Resources Law* 281, 291; Eduardo G Pereira and Wan M Zulhafiz Wan Zahari (eds), *Joint Operating Agreement: Applicability and Enforcement of Default Provisions* (Rocky Mountain Mineral Law Foundation 2018) xxi.

⁴³ Christopher Duval and others, *International Petroleum Exploration and Exploitation Agreements: Legal, Economic and Policy Aspects* (2nd edn, Barrows Company 2009) 285.

⁴⁴ Peter Roberts, *Joint Operating Agreements: A Practical Guide* (2nd edn, Globe Law and Business 2012) 14.

⁴⁵ Scott Crichton Styles, 'Joint Operating Agreements' in Gordon G, Paterson J and Usenmez E (eds), *UK Oil and Gas Law: Current Practice and Emerging Trends Volume II: Commercial and Contract Law Issues* (3rd edn, Edinburgh University Press 2018) 20.

⁴⁶ *ibid* 32-33.

production according to its participating interest. The success of the JOA is largely dependent on all joint venturers making timely financial contributions when the Operator issues a cash-call. Where any party defaults on a cash-call, the general position is that the liability for the shortfall would fall on the remaining joint venturers.⁴⁷ In some JVs, the failure of a non-defaulting party to cover a defaulting party's cash shortfall according to its percentage interest would itself constitute a default.⁴⁸ Thus, it becomes apparent that although one of the main purposes of a JV is to reduce risks, it could itself be a source of financial risk. This risk can be minimised by using contractual mechanisms such as FCs, discussed in Chapter 6 below.

ii. Unitisation agreement

In contrast to a JOA which is in respect of a single contract area, unitisation is the joint development of an oil and gas reservoir which extends across multiple contract areas.⁴⁹ Typically, unitisation is necessary where different contract areas subject to separate licences or contracts with the state share a common reservoir.⁵⁰ Considering the complex geology and migratory nature of oil and gas, the act of splitting areas of land into separate contract areas or blocks is purely artificial. The state would not

⁴⁷ As an example, the Norway Model Joint Operating Agreement Concerning Petroleum Activities-(Attachment A) 2013, Article 9 provides that- 'If a Party does not comply with his obligation to make payments pursuant to Articles 7 or 8, the amounts which are not paid shall be advanced by the non-defaulting Parties in accordance with their Participating interest...'

⁴⁸ An example of this is in the Denmark Model Joint Operating Agreement 2014, Article 11.1 (d). It provides that, '...[F]ailure by any Party to make such payments shall likewise and with the same results render that Party in default'.

⁴⁹ The concept of unitisation is from the USA, although it has been adopted in other jurisdictions, the UK included. See Rod Chooramun, 'Unitisation- The Oil and Gas Industry's Solution to One of Geology's Many Conundrums' Notes From The Field - An English Law Perspective On The Oil & Gas Market (Andrew Skurth, August 2014) <<https://www.andrewskurth.com/insights-1133.html>> accessed 10th February 2016; Peter Roberts, *Joint Operating Agreements: A Practical Guide* (3rd ed, Globe Business Publishing 2015) 317-328.

⁵⁰ Danielle Beggs and Justyna Bremen, 'Unitisation and unitisation agreements' in Geoffrey Picton-Tuberville (ed), *Oil and Gas: A Practical Handbook* (Globe Law and Business 2009) 57.

know whether or not a reservoir crosses several blocks until oil and gas operations begin in the area.⁵¹

Where there is no unitisation, the various companies with separate licences or contracts would be drilling aggressively, so as to capture⁵² maximum resource. Aggressive drilling causes environmental damage and could also lead to any company capturing more resource than it is entitled to. Additionally, aggressive drilling may mean that the reservoir is not exploited in the most efficient method. Ultimately, this could reduce the volume of oil or gas recoverable from the common reservoir.⁵³

Unitisation is used to secure the most efficient production and maximum recovery of oil and gas from a shared reservoir.⁵⁴ The companies working together would agree upon a unit operating agreement. This will govern the relationship between the various companies (referred to as each group) and set out the rights and duties of each group, in respect of the performance of obligations to the state under the licence or contract.⁵⁵ It will also govern daily operations. Each group will have a

⁵¹ It is also possible that a reservoir crosses the boundary of two states. In such a case, cross-border unitisation would be necessary. This is beyond the scope of the thesis.

⁵² Prior to unitisation legislation in the USA, the rule of capture applied. See Rod Chooramun, 'Unitisation- The Oil and Gas Industry's Solution to One of Geology's Many Conundrums' Notes From The Field - An English Law Perspective On The Oil & Gas Market (Andrew Skurth, August 2014) <<https://www.andrewskurth.com/insights-1133.html>> accessed 10th February 2016.

⁵³ Danielle Beggs and Justyna Bremen, 'Unitisation and unitisation agreements' in Geoffrey Picton-Tuberville (ed), *Oil and Gas: A Practical Handbook* (Globe Law and Business 2009) 57; Ernest E Smith and others, *Materials on International Petroleum Transactions* (Rocky Mountain Mineral Law Foundation 2010) 627.

⁵⁴ For more on Unitisation see Ernest E Smith and others, *Materials on International Petroleum Transactions* (Rocky Mountain Mineral Law Foundation 2010) 627-646; Marc Hammerson, *Upstream Oil and Gas: Cases, Materials and Commentary* (Globe Law and Business 2011) 251-292; Peter Roberts, *Joint Operating Agreements: A Practical Guide* (3rd ed, Globe Business Publishing 2015) 317-328.

⁵⁵ Ernest E Smith and others, *Materials on International Petroleum Transactions* (Rocky Mountain Mineral Law Foundation 2010) 636-645.

unit interest (also known as tract participations/unit equity⁵⁶) which determines respective rights and duties. The primary duty of each group is to make a cash contribution according to its unit interest. In return, each group also receives a percentage of production based on its unit interest.⁵⁷ One of the groups will be designated as the unit Operator and is responsible for carrying out oil and gas activities.⁵⁸ All groups will have a seat on an operating committee and have voting rights based on unit interest.⁵⁹ Where there are multiple members in a group, the rights and duties of the group are split between its members according to individual participating interest. For instance, if group A has a unit interest of 40%, and group A is made up of two members, each having a 50% interest in the underlying licence or contract, each member will bear 20% of the costs of unitisation, and also be entitled to 20% of production. The Operator can only fulfil its work obligations to the state where all parties make timely financial contributions. Consequently, the unit operating

⁵⁶ Danielle Beggs and Justyna Bremen, 'Unitisation and unitisation agreements' in Geoffrey Picton-Tuberville (ed), *Oil and Gas: A Practical Handbook* (Globe Law and Business 2009) 63.

⁵⁷ At the beginning of unitised operations, little will be known about the characteristics of the reservoir and the percentage of total production flowing from each group's portion of the field. As a result, the initial unit interest of each group is decided through an estimation of the hydrocarbons in the shared reservoir, as at the time unitised operations begin. The parties must agree on the method through which the initial interest will be calculated. Parties would seek an estimation that most represents the reality, since financial liability, access to production and voting powers are all tied to unit interest. The method of estimation may include calculating the 'stock tank oil originally in place' (STOOIP)* or 'reserve estimation'**. However, in order to gain a more accurate estimation of unit interest, there will be a redetermination study during the production stage, when there is more information about the reservoir. Danielle Beggs and Justyna Bremen, 'Unitisation and unitisation agreements' in Geoffrey Picton-Tuberville (ed), *Oil and Gas: A Practical Handbook* (Globe Law and Business 2009) 64. *STOOIP calculates the total amount of petroleum in the reservoir before production commences. However, the amount of petroleum recoverable may be lower than the total amount in the reservoir. **Reserve estimation calculates the amount of hydrocarbons expected to be commercially produced. Rod Chooramun, 'Unitisation- The Oil and Gas Industry's Solution to One of Geology's Many Conundrums' Notes From The Field - An English Law Perspective On The Oil & Gas Market (Andrew Skurth, August 2014) <<https://www.andrewskurth.com/insights-1133.html>; <<http://documents.lexology.com/279fe7de-a081-4b57-84ea-8821421812f4.pdf>>> accessed 10th February 2016.

⁵⁸ There will be a criteria guiding the selection of the Unit Operator.

⁵⁹ Bernard Taverne, *Petroleum, Industry and Governments: A Study of the Involvement of Industry and Governments in the Production and Use of Petroleum* (2nd edn, Wolters Kluwer 2008) 375-385.

agreement will have strict provisions to address the risk of default. One of these could be through the forfeiture of the defaulting party/group's interest.⁶⁰ The FC is discussed in Chapter 6 of this thesis.

2.3. Long term oil and gas sales agreement between international oil and gas companies and buyers

Another type of LOTOGA (involving an IOC) also discussed in this thesis is the long term sales agreement including a ToP clause.

Given the significant investment involved in the exploration and exploitation of oil and gas, an IOC would seek to dispose of oil or gas production in a way which guarantees it a steady and stable income. It does so by means of common long term sales agreements, such as depletion contracts and supply contracts. In a depletion contract,⁶¹ the buyer commits to purchase gas from a particular reservoir, field or well until it is no longer economical for the seller to continue production.⁶² In a supply

⁶⁰ As an example, a Ghana Unitization and Unit Operating Agreement 2009*, Article 10.8A provides that if a default is not remedied within thirty days, at any time thereafter until the Defaulting Party or Defaulting Group has cured its defaults:

‘(1) Any Contributing Party or group of Contributing Parties holding individually or collectively a Unit Interest (as increased pursuant to Article 10.6(B)(1)) of at least fifty percent (50%) *shall have the option, exercisable in its discretion, to require that the Defaulting Party or Defaulting Group withdraw from this Agreement and Transfer all of its Project Interests* (in the case of a Defaulting Group, only that Project Interest attributable to the Contract with respect to which it is in default), as described in Article 10.8(B); and (2) Any Contributing Party or group of Contributing Parties holding individually or collectively a Unit Interest (as increased pursuant to Article 10.6(B)(1)) of at least fifty percent (50%) shall have the option, exercisable in its discretion, to require that the Defaulting Party or Defaulting Group offer to sell all of its Project Interests (in the case of a Defaulting Group, only that Project Interest attributable to the Contract with respect to which it is in default) to any Contributing Parties wishing to purchase such interests, as described in Article 10.8(C)’. (emphasis added).

* Unitization and Unit Operating Agreement 2009 between Ghana National Petroleum Corporation (1) Tullow Ghana Limited (2) Kosmos Energy Ghana HC (3) Anadarko WCTP Company (4) Sabre Oil & Gas Holdings Limited (5) EO Group Limited (6), covering The Jubilee Field Unit located offshore the Republic of Ghana <<http://www.resourcecontracts.org/contract/ocds-591adf-0771447862/view#/pdf>> accessed 17 March 2018.

⁶¹ ‘A depletion contract is a production sales contract in which the sale volumes are essentially governed by the performance characteristics of the particular gas field’. Gas Strategies- Industry Glossaries <<http://www.gasstrategies.com/industry-glossary>> accessed 26 January 2019.

⁶² Daniel O’Neil, ‘Gas sale and purchase agreements’ in Picton-Tuberville G (ed), *Oil and Gas: A Practical Handbook* (Globe Law and Business 2009) 138.

contract, the seller commits to supply to the buyer agreed volumes of gas over a specified period.⁶³ In either case, the sales agreement can include a ToP clause.⁶⁴

The ToP clause provides that the buyer should pay for specified contractual volumes at specified periods, irrespective of whether it takes delivery of such volumes. This guarantees the seller a secure source of income. The thesis examines the ToP clause in Chapter 8.

⁶³ Ernest E Smith and others, *Materials on International Petroleum Transactions* (Rocky Mountain Mineral Law Foundation 2010) 1052; Daniel R. Rogers and David Y. Phua, 'Project Development and Finance LNG- Asia: Re-examining the Take-or-Pay Obligation in LNG Sale and Purchase Agreements' (Lexology: King and Spalding LLP, November 2015) <<http://www.lexology.com/library/detail.aspx?g=a55fc12f-9eef-4353-8d59-b9016aa3f5f3>> accessed 19 May 2017; Gas Strategies- Industry Glossaries <<http://www.gasstrategies.com/industry-glossary>> accessed 26 January 2019.

⁶⁴ For example, in *Total Gas Marketing Limited v. ARCO British Limited and Others* [1998] UKHL 22, 2 Lloyd's Rep 209, the gas sales agreement was structured as a 'buyer's nominated' depletion contract, with the buyer required to Take or Pay for an annual minimum quantity of gas.

Conclusion

This chapter has discussed the four main types of LOTOGAs between host states and IOCs. It has also assessed LOTOGAs in the forms of JVs between IOCs. These various forms of LOTOGAs pose various risks to the IOC. In LOTOGAs with host states, the IOC is faced with political risks because of the state's sovereign power which it can use to affect the LOTOGA. Yet, the level of political risks will depend on the type of state as well as the form of LOTOGA. For instance, a RSC is arguably a more risky form of LOTOGA than a licence because of the level of state involvement in the contract, as well as the underlying sense of nationalism in states which use the RSC. Therefore, the IOC would seek to protect the LOTOGA from adverse state action through as many means as possible. One of this is through the inclusion of stabilisation and renegotiation clauses, discussed in Chapters 4 and 5 below.

Although IOCs enter into JVs in order to reduce the risks arising under the licence or contract, this chapter indicated the inherent risks of JVs. Some of these risks are commonly addressed through the FC, GBA and DSA. The thesis discusses these clauses in Chapters 6, 7 and 9 respectively.

The last form of LOTOGA discussed in this chapter is the long term sales agreement, particularly in relation to the ToP clause which is used to guarantee the seller a steady and stable income. The dynamics of this agreement are assessed in Chapter 8 of the thesis.

The next chapter considers some of the risks that accompany the various forms of LOTOGAs and the implications for IOCs.

CHAPTER 3

RISKS IN LONG TERM OIL AND GAS AGREEMENTS: AN EXPLANATION OF COMMON RISKS FACED BY INTERNATIONAL OIL AND GAS COMPANIES

Introduction

The purpose of this chapter is to explain the risks faced by IOCs which may be mitigated by the clauses discussed in Chapters 4-9 of the thesis. Despite the various risks which an IOC could encounter throughout the lifecycle of a LOTOGA, this chapter's focus is on the risks which an IOC can contractually mitigate.¹ The discussion is in two parts. The first part considers risks arising in LOTOGAs between host states and IOCs. The second part explores risks in the other two forms of LOTOGAs: JVs between IOCs, and long term gas sales agreements.

LOTOGAs between host states and IOCs are long term and highly cash intensive. The mixture of long duration and high costs opens LOTOGAs to a number of vulnerabilities. Firstly, the longer the life of a LOTOGA, the more vulnerable it is to unilateral amendment by the state. Over time, the government which agreed to the original terms may become dissatisfied or discontented with those terms, due to economic and/or political changes in the state. It may seek to amend certain terms. Also, there could be a regime change and a new government may seek to alter the terms of the LOTOGA, according to its manifesto or aspirations for the oil and gas

¹ It is impossible to expect an IOC to control and mitigate every form of risk as there are external parties and factors whose actions can impact the LOTOGA; these are outside the control of the IOC and in some cases, the host state. An example is the risk of terrorism or the kidnapping of foreign workers. In such instance, neither the host state or the IOC can directly control this risk by contract.

industry. Secondly, nothing remains the same in any industry, particularly one as volatile as the oil and gas industry. As such, the longer the duration of the contract, the more vulnerable the IOC is to market changes which could increase the cost of oil and gas operations. This increase in costs raises the financial risks in a JV as any party may be unable to meet up with its financial obligations. This is discussed in section 3.3 on counter party risks.

3.1. Political Risk

It has been argued that the most significant risk in a LOTOGA is political risk.² Yet, it is the financial consequences of political risk that matter most to IOCs. Wälde and Ndi indicate that political risk is the occurrence of events in the political sector of a country which negatively affect normal business operations and reduce the level of profitability.³

² Ernest E Smith and others, *Materials on International Petroleum Transactions* (Rocky Mountain Mineral Law Foundation 2010) 284-327; Peter D Cameron, *International Energy Investment Law: The Pursuit of Stability* (Oxford University Press 2010) 61; Arve Throvik, 'Political risk in large projects' in Thomas J Dimitroff (ed), *Risk and Energy Infrastructure: Cross-border dimensions* (Globe Law and Business 2011) 33-50; Mustapha Erkan, *International Energy Investment Law: Stability through Contractual Clauses* (Kluwer Law 2011) 5; Fabio Solimene, 'Political risk in the oil and gas industry and legal tools for mitigation' (2014) 2 I.E.L.R 81, 82-85.

³ Thomas W Wälde and George Ndi, 'Stabilizing International Investment Commitments: International Law Versus Contract Interpretation' (1996) 31 Tex. Int'l L. J. 215, 232. A similar definition is adopted by investopedia, where it states that 'Political risk is the risk that an investment's returns could suffer as a return of political changes or instability in a country'. Investopedia, 'Political risk' <www.investopedia.com/terms/p/politicalrisk.asp> accessed 19th January 2016. However, Throvik defines political risk as '...consisting of any actions taken by legitimate or illegitimate political groups or authorities that cause an important project to be cancelled, stopped, seriously delayed or significantly altered in scope'. Throvik's definition correctly envisages that political risk is not always due to political action or limited to instability in a country. A country may have a very stable system of governance yet still have a level of political risk. Arve Throvik, 'Political risk in large projects' in Thomas J Dimitroff (ed), *Risk and Energy Infrastructure: Cross-border dimensions* (Globe Law and Business 2011) 34.

Political risk can affect a LOTOGA in three main areas.⁴ The first is through forced renegotiation. This is the risk that the host state may demand a renegotiation of the contract despite guarantees and stipulations in the agreement to enforce the stability of the contract.⁵ Although the IOC would have no contractual obligation to renegotiate in the absence of a RC, the refusal of the investor to renegotiate could lead to delay tactics by the state which could jeopardise operations. Furthermore, where the state requests or demands renegotiation at the stage of operations where the IOC has sunk considerable costs into the LOTOGA with strong financial prospects and is yet to recoup such costs, the bargaining power would be in favour of the state and the IOC may feel compelled to renegotiate. This is known as the obsolescing bargain.⁶ The IOC would seek to mitigate the risk of forced renegotiation through the inclusion of a renegotiation clause, which is discussed in Chapter 5 of the thesis.

Secondly, political risk can affect a LOTOGA through unilateral change of contract. This is the risk that the state as a sovereign authority may amend or affect the terms of the contract without the consent of the IOC. An example (albeit not a LOTOGA) of unilateral change of contract in respect of taxation is *Revere Copper v*

⁴ Ernest E Smith and others, *Materials on International Petroleum Transactions* (Rocky Mountain Mineral Law Foundation 2010) 284-327; Peter D Cameron, *International Energy Investment Law: The Pursuit of Stability* (Oxford University Press 2010) 61; Arve Throvik, 'Political risk in large projects' in Thomas J Dimitroff (ed), *Risk and Energy Infrastructure: Cross-border dimensions* (Globe Law and Business 2011) 33-50; Mustapha Erkan, *International Energy Investment Law: Stability through Contractual Clauses* (Kluwer Law 2011) 5; Fabio Solimene, 'Political risk in the oil and gas industry and legal tools for mitigation' (2014) 2 I.E.L.R 81, 82-85.

⁵ Mustapha Erkan, *International Energy Investment Law: Stability through Contractual Clauses* (Kluwer Law 2011) 181.

⁶ This is the interaction between an IOC and a host state, where the initial bargain favours the IOC but where, over time as the IOC's fixed assets in the country increase, the bargaining power shifts to the government. See Deardorff's Glossary of International Economics, *Obsolescing bargain model*. <<http://www-personal.umich.edu/~alandear/glossary/o.html>> accessed 06 February 2016. However, the relevance of the obsolescing bargain in the relationship between IOC and host states has been disputed in recent times. See Ravi Ramamurti, 'The Obsolescing 'Bargaining Model'? MNC-Host Developing Country Relations Revisited' (2001) 32(1) Journal of International Business Studies 23-39.

US Overseas Private Investment Corporation.⁷ In this case, amongst other issues, there was an agreement between the government of Jamaica and a local subsidiary (RJA) of the investor which fixed the amount of taxes and royalties payable by RJA for twenty-five years. However, seven years after the agreement, the newly elected government drastically increased the financial contributions payable by RJA, forcing RJA to cease trading shortly afterwards. This case demonstrates that despite specific guarantees from a state, an investor could still be exposed to political risk, although the state may have to pay compensation to the investor in such an instance.⁸ A unilateral change of contract by a state could also amount to indirect expropriation. This was the position successfully claimed by the investor in the above case. The SC, discussed in Chapter 4, may be used to reduce the risks of unilateral change of contract.

More generally, the IOC is also faced with political and legal risk where the state enacts laws or regulations which are detrimental to the interests of IOCs. For instance, in 2010 the Ecuadorian government sought to increase state control over the

⁷ *Revere Copper v US Overseas Private Investment Corporation (OPIC)*, Award, 24 August 1978, 17 ILM (1978) 1321; 56 ILR (1980) 258.

⁸ ICSID awards indicate that the state is liable to pay compensation where there has been a 'taking' (expropriation) of an investment, contrary to express guarantees by the state. See *Middle East Cement Shipping v Egypt*, Award, 12 April 2002, 7 ICSID Reports 178, para 107. However, ICSID awards also demonstrate that the state is not liable to pay such compensation where the measure/s affecting the investor is of general application in a particular industry and is carried out in the course of enforcing governmental regulatory powers or as is the case in the USA 'police power' of the state. The arbitral tribunal in *Feldman v Mexico*, Award 16 December 2002, 7 ICSID Reports 341, para 103 stated that '...governments must be free to act in the broader public interest through protection of the environment, new or modified tax regimes...and the like. Reasonable governmental regulation of this type cannot be achieved if any business that is adversely affected may seek compensation, and it is safe to say that customary international law recognises this'. A similar position is adopted by the arbitral tribunals in *SD Myers v Canada*, First Partial Award, 13 November 2000, 8 ICSID Reports 18; *Methanex v United States*, Award, 3 August 2005, 44 ILM (2005)1345; *Saluka v Czech Republic*, Partial Award, 17 March 2006, 15 ICSID Reports 274. In contrast, the ICSID tribunal in *Santa Elena v Costa Rica*, Case No. ARB/96/1, Award 17 February 2000, para 72 stated that '...where property is expropriated, even for environmental purposes, whether domestic or international, the state's obligation to pay compensation remains'. Other tribunals have sought to adopt a balancing of interest between the state's right to act in the public interest and the protection of the investor's rights. See the tribunal in *Azurix v Argentina*, Award, 14 July 2006, 14 ICSID Reports 374, para 310, 311; *LG&E v Argentina*, Decision on Liability, 3 October 2006, 21 ICSID Review-FILJ (2006) 203.

oil sector.⁹ Political and legal risks are commonly mitigated through the SC. A discussion of this is contained in Chapter 4.

The third area of political risk is expropriation. There is consensus amongst writers on stability in oil and gas agreements that the greatest risk to an oil and gas investment is expropriation,¹⁰ particularly the indirect kind.¹¹ Direct expropriation involves the outright taking of an investment or obligatory transfer of title in favour of the host state.¹² For example, in 2012 there was a direct expropriation by Argentina of the 51% interest of the Spanish oil company Repsol in the state owned oil company YPF.¹³ Indirect expropriation has been described as ‘...measures ... taken by a state

⁹ Under a new law, ‘...the current production-sharing agreements will be replaced by flat fee service contracts. The Ecuadorean state will own 100% of the oil and gas produced’. This political change would have been a major blow for IOCs operating in Ecuador as the flat fee means that IOCs no longer have access to oil or gas. Also, it is unlikely that the flat fee would guarantee the profits IOCs sought to recover from the investment. Seven IOCs refused to accept the new contract and pulled out of Ecuador. BBC News, ‘Ecuador increasing state control over oil sector’ (27 July 2010) <<http://www.bbc.co.uk/news/world-latin-america-10772445>> accessed 14 June 2016. The seven IOCs are U.S. Bellwether, the mixed-capital consortiums Gran Colombia and Petróleo Amazónico, Brazil’s Petrobras, the U.S.-based EDC, South Korea’s Canada Grande and China’s CNPC. Gonzalo Ortiz, ‘ECUADOR: Seven Foreign Oil Companies to Pull Out’ (Inter Press Service, 25 January 2011) <<http://www.ipsnews.net/2011/01/ecuador-seven-foreign-oil-companies-to-pull-out/>> accessed 11 May 2018; Paul Ruiz, ‘Ecuador Begins Rainforest Drilling In Effort To Avoid Venezuela’s Fate’ (The Fuse, 08 September 2016) <<http://energyfuse.org/ecuador-begins-rainforest-drilling-effort-avoid-venezuelas-fate/>> accessed 11 May 2018.

¹⁰ Mustapha Erkan, *International Energy Investment Law: Stability through Contractual Clauses* (Kluwer Law 2011) 49. Erkan’s survey on expropriation indicated that a majority of oil and gas practitioners were of the view that oil and gas investors faced a greater risk of expropriation today than in the past. See also Muthucumaraswamy Sornarajah, *The International Law on Foreign Investment* (3rd edn, Cambridge University Press 2010) 99, 207-208; Peter D Cameron, *International Energy Investment Law: The Pursuit of Stability* (Oxford University Press 2010) 61; Fabio Solimene, ‘Political risk in the oil and gas industry and legal tools for mitigation’ (2014) 2 I.E.L.R 81,82-85.

¹¹ Erkan indicates that direct expropriations are less common, as host states would most likely avoid creating a negative impression as this could affect the prospect of attracting investment. To this end, Erkan opines that the state would rather use measures which amount to creeping or indirect expropriation. Mustapha Erkan, *International Energy Investment Law: Stability through Contractual Clauses* (Kluwer Law 2011) 31.

¹² *Metalclad v Mexico*, Award, 30 August 2000, 5 ICSID Reports 212; 16 ICSID Review-FILJ (2001) 168, para 103.

¹³ In 2013 the parties reached an agreement for Argentina to pay REPSOL \$5bn. See Fredrik Erixon and Lisa Brandt, ‘The Expropriation of Repsol YPF, and the Case for Improved Investment Protection Accords’ (European Centre for International Political Economy (ECIPE), 2013) <<http://ecipe.org/app/uploads/2014/12/PB8.pdf>> accessed 09 June 2016; Tracy Rucinski, Andres González and Kevin Gray, ‘Spain’s Repsol agrees to \$5 billion settlement with Argentina over YPF’ (Reuters, 25 February 2014) <<http://www.reuters.com/article/us-repsol-argentina-idUSBREA1O1LJ20140225>> accessed 09 June 2016.

the effect of which is to deprive the investor of the use and benefit of his investment even though he may retain nominal ownership of the respective rights...'.¹⁴ Thus, the state may not appropriate the investment outright, but its action would have the effect of taking the investment. Expropriation is the most severe interference on the IOC's investment by the state.¹⁵ IOCs can address the risks of expropriation through a SC as well as a RC. These clauses are discussed in Chapters 4 and 5 respectively.

3.2. Market/Economic Risk

Oil and gas companies are faced with the risk of financial volatility. This can arise from inflation within the host country, exchange rate volatility and most of all, unexpected reductions in the price of oil and gas. Although fluctuations in price, exchange rate and the like affect virtually all international contracts, the impact of these factors on LOTOGAs could be more significant, due to the amount of investment sunk into an oil and gas project and the duration of the project. The cost estimate of a project may also soar significantly.¹⁶

Also, a decline in oil prices is a market risk that could have severe implications on the budget and profit margins of an IOC. In 2016, Krauss commented that, 'Earnings are down for companies that made record profits in recent years, leading

¹⁴ *Middle East Cement Shipping and Handling Co. v Egypt Award*, 12 April 2002 7 ICSID Reports 178, para 107.

¹⁵ Rudolph Dolzer and Christoph Schreuer, *Principles of International Investment Law* (2nd edn, Oxford University Press 2012) 98.

¹⁶ For example, a 'mega' natural-gas project in Australia, called Gorgon, which was jointly owned by Chevron, Exxon and Shell was initially cost estimated at around \$29billion. This later increased by 45% to \$54 billion. Some of the reasons for the increase were put down to shortages of skilled labour due to fierce competition, design complexities, higher cost of materials, cyclones and the fact that the project was taking place in a very remote location. Daniel Gilbert and Justin Scheck, 'Big Oil Companies Struggle to Justify Soaring Project Costs' (The Wall Street Journal, January 2014) <<http://www.wsj.com/articles/SB10001424052702303277704579348332283819314>> accessed 03 March 2016.

them to decommission more than two-thirds of their rigs and sharply cut investment in exploration and production'.¹⁷ The decline in profit was attributed to the plunging oil prices which had fallen by 70 percent since June 2014.¹⁸ In May 2018, the Brent¹⁹ crude price rose to \$77.17 a barrel for the first time in three and a half years. However, by December 2018 it had fallen to under \$60 a barrel.²⁰ Nine months later, (17 September 2019), the price rose to \$69 a barrel following an attack on Saudi Arabian oil facilities.²¹ This volatility in price affects the market risk IOCs are exposed to. For instance, there is a risk that when oil prices are high the state may want to renegotiate the LOTOGA so as to secure increased revenue. However, where the price is depressed over a sustained period, the IOC would have less profit and may

¹⁷ Clifford Krauss, 'Oil prices: What's behind the drop? Simple Economics' (The New York Times, 12 January 2015 <<https://www.nytimes.com/2015/01/13/business/energy-environment/oil-prices.html>> accessed 05 October 2018.

¹⁸ *ibid.*

¹⁹ Brent crude oil is a global benchmark. The other global benchmarks for crude oil are US West Texas Intermediate and Dubai crude. See <<https://oilprice.com/Energy/Oil-Prices/Is-WTI-Overtaking-Brent-As-The-Biggest-Global-Benchmark.html>>; <<https://www.theice.com/global-crudes>>; <<https://www.globalpetrolprices.com/articles/22/>>; <<http://markets.businessinsider.com/commodities/oil-price>> accessed 11 May 2018.

²⁰ <<https://www.bloomberg.com/energy>>; <<https://markets.businessinsider.com/commodities/oil-price/usd?type=brent>> accessed 20 December 2018.

²¹ This was the '...biggest one-day percentage gain since the contract began trading in 1988'. Sheela Tobben, 'Oil Prices Jump Most on Record After Saudi Arabia Strike' (15 September 2019) <<https://www.bloomberg.com/news/articles/2019-09-15/oil-prices-jump-19-after-attack-cuts-saudi-arabian-supplies>> accessed 19 September 2019; BBC News, 'Oil prices soar after attacks on Saudi facilities' (17 September 2019) <<https://www.bbc.co.uk/news/business-49710820>> accessed 19 September 2019.

want to renegotiate.²² The inclusion of a relevant RC could mitigate economic/market risk. A discussion of the RC is contained in Chapter 5 of the thesis.

3.3. Counter party risks

Where the LOTOGA is exploited through a JV, the IOC is also faced with JV related risks. The assessment of risks in the JV will be limited to the JOA (although such risks – albeit on a larger scale – will also apply to unitisation agreements) because this is the most common form of JV in LOTOGAs.²³ Additionally, the JOA is directly relevant to the discussion of the FC, GBA and DSA in Chapters 6, 7 and 9.

The most significant risk of a JV for an IOC is the risk of default. In a JOA, the primary obligation of each joint operating party is to fund oil and gas operations according to its participating interest in the project.²⁴ IOCs are faced with the risk that at any time any party to the JOA may be unable to fund its share of costs. This event – default – could produce a range of consequences including the collapse of the JOA and the loss of the licence or contract. JOAs commonly mitigate the risk of default through the FC, which is examined in detail in Chapter 6 below.

²² For example, on 10 June 2016 Erin Energy sought a revision of certain fiscal terms from the Ghana Ministry of Petroleum, in light of global oil price decline. The Ministry's response (via a letter dated 23rd June 2016) was that this required a renegotiation of fiscal terms. This suggests that there may not have been a relevant RC, else the company would have sought to exercise its contractual right to renegotiate. Although this writer is unaware of whether the agreement went on to be renegotiated, the example illustrates the impact of fiscal changes on an oil and gas company. Erin Energy Ghana Limited, GNPC Exploration and Production Company Limited, Base Energy Limited, Ghana National Petroleum Corporation, Expanded Shallow Water Tano, Extension Agreement, 2016 (23 June 2016) <<http://www.resourcecontracts.org/contract/ocds-591adf-2009529955/view#/pdf>> accessed 05 April 2018. (Erin Energy is the Operator of the project).

²³ A. Timothy Martin, 'Model Contracts: A Survey of the Global Petroleum Industry' (2004) 22 *Journal of Energy and Natural Resources Law* 281, 291; Marc Hammerson, *Upstream Oil and Gas: Cases, Materials and Commentary* (Globe Law and Business 2011) 174; Eduardo G Pereira and Wan M Zulhafiz Wan Zahari (eds), *Joint Operating Agreement: Applicability and Enforcement of Default Provisions* (Rocky Mountain Mineral Law Foundation 2018) xxi.

²⁴ Peter Roberts, *Joint Operating Agreements: A Practical Guide* (2nd edn, Globe Law and Business 2012) 187.

More generally, in a long term gas agreement where parties to a JV are marketing gas independently of each other, at any period there is an uncertainty that any party may be unable to take all its share of production. This uncertainty can be contractually addressed through a GBA, which is fully analysed in Chapter 7.

Further on in the lifecycle of the LOTOGA is the long term sales agreement. Given the duration of LOTOGAs and the financial obligations that come with it, an IOC would seek to ensure a steady and stable income from the sale of oil or gas. In the absence of this, the IOC is faced with the risk that it may be unable to meet its financial obligations under the LOTOGA, as well as meet any loan repayment obligations. A common way for IOCs to limit financial risk is through the inclusion of a ToP clause in a long term sales agreement. The ToP clause is examined in detail in Chapter 8.

At the final cycle of the LOTOGA is decommissioning. In a JV, there is a risk that there may be insufficient funds to cover the costs of decommissioning. This can happen where any JV party becomes insolvent or financially unstable and can no longer meet their financial obligations for decommissioning. The financial risk of decommissioning can be mitigated through a DSA, discussed in Chapter 9 of the thesis.

Conclusion

This chapter has discussed the main risks of a LOTOGA for an IOC. It assessed political, market/economic risks in LOTOGAs between an IOC and a host state. These forms of risk arise because of the sovereign position of the state which may be used to adversely affect the LOTOGA. However, in some cases, the changes to the LOTOGA is not state interference, but rather economic changes. IOCs seek to mitigate these forms of risks through the inclusion of a stabilisation and RC, which are examined in Chapters 4 and 5 below.

The risks inherent in JVs were also discussed. In JVs, the most significant risk for an IOC is financial risk. IOCs would seek to reduce the level of financial risk they are exposed to through the inclusion of various contractual clauses. Some of these include the FC which targets the risk of default, as well as the DSA which seeks to limit financial risks. The chapter also discussed the risks of uncertainty in long term gas agreements subject to a JV and the relevance of the GBA.

Finally, the chapter considered the nature of financial risks in long term sales agreements and how an IOC can use the ToP clause to limit this risk.

The next chapter begins with a discussion on the first selected clause, the SC.

CHAPTER 4

THE STABILISATION CLAUSE

Introduction

This chapter considers the pursuit of stability through the SC and the challenges which can prevent it from fulfilling its intended purpose. It is argued that the SC is unable to prevent the risks of unilateral change of contract or expropriation because of the sovereign position of the state. Some academic writers adopt a pragmatic view of the SC, arguing that although it cannot prevent unilateral change of contract or expropriation, it has an economic benefit. These writers have argued that the presence of a relevant SC increases the compensation payable to the IOC. This chapter questions the degree to which the SC influences compensation and argues that the inclusion of a formula for calculating damages where there is a breach of the SC will enhance the value of the SC ('SC damages provision').

Section 4.1 contains an assessment of the varying definitions of the SC, and the implications thereof. Section 4.2 briefly explores the history of the SC and some of its primary benefits. The next section (4.3) examines the types of SC. Going on from this, section 4.4 evaluates the legal validity of the SC. In section 4.5, the practical effectiveness of the SC is assessed. After this, the final section recommends the inclusion of a 'SC damages provision'.

4.1. Definitions of the stabilisation clause

The literature on the SC provides two different explanations of the same clause. This writer distinguishes these as the protectionist and preventative views. The protectionist view defines the SC as intended to protect the investor from actions of the state which have an adverse effect on the agreement. As an example, Cameron defines a SC as ‘a contractual assurance of negotiated terms against future legal or regulatory changes, providing legal and fiscal stability’.¹ Faruque also defines the SC as ‘a legal mechanism for the protection of foreign investors from state intervention in a petroleum and mineral resource development project through legislative or administrative measures’.² According to this view, the SC is not ascribed with the power to prevent state intervention; rather its aim is to protect the investor from state intervention. This protection could be in the form of compensation.

In contrast, the preventative view regards the restriction on the powers of the state as fundamental to the protection of the investor. It frames its definition of the SC as having a ‘fettering’ effect on the sovereign powers of the state, in regards to it making legislative or regulatory changes which affect the LOTOGA. To cite Brownlie’s definition, a SC is:

Any clause contained in an agreement between a government and a foreign legal entity by which the government party undertakes neither to annul the agreement nor to modify its terms, either by legislative or by administrative measures.³

¹ Peter D Cameron, *International Energy Investment Law: The Pursuit of Stability* (Oxford University Press 2010) 60.

² Abdullah Faruque, ‘Validity and Efficacy of Stabilisation Clauses: Legal Protection vs. Functional Value’ (2006) 23(4) *Journal of International Arbitration* 317, 318.

³ Iain Brownlie, *Principles of Public International Law* (6th edn, Oxford University Press 2003) 550.

Similarly, Coale defines a SC as, ‘a specific commitment by the foreign country not to alter the terms of the agreement, by legislation or other means, without the consent of the contracting party’.⁴ In this case, the SC maintains stability by imposing a duty on the state to negotiate the terms, hence preventing unilateral variation. Both writers take a preventative view as their definitions involve a negative imperative on the state, albeit that Coale envisages a more flexible type of SC, where modification is permissible upon mutual consent.

Although the protectionist and preventative definitions are related, one interpretative difficulty with SCs is whether they should be viewed as predominantly protectionist rather than preventative; that is, more focused on the protection of the investment than on fettering the powers of the state. The significance of the distinction between the protectionist and preventative views turns on the degree of effectiveness ascribed to a SC. For instance, according to the preventative view, a SC which is intended to fetter the powers of the state but fails to achieve this would be deemed ineffective. Yet, under a protectionist view, the clause would be deemed effective if it results in some form of compensation for the investor, though it is unable to fetter the state’s powers. When examined through the eyes of contract law, one might argue that the preventative view looks at the SC as a primary obligation which the state is required to perform, whilst the protectionist view looks at the SC as conferring both primary and secondary obligations so that the state is required to pay compensation in the event of non-performance.

⁴ Margarita T.B Coale, ‘Stabilization Clauses In international Petroleum Transactions’ (2001-2002) 30 *Denver Journal of International Law & Policy* 217, 222. See also Michelle Flores, ‘A Practical Approach to Allocating Environmental Liability and Stabilizing Foreign Investment in the Energy Sectors of Developing Countries’ (2001) 12 *Colorado Journal of Int’l Env’tl Law and Policy* 141, 159-61.

In this writer's view, the preventative definition or view is preferable for IOCs as it limits the risk of state interference with the LOTOGA, thereby enhancing stability of terms. However, it is difficult to enforce. The benefit of the protectionist view is that it envisages changes to the LOTOGA and specifies an appropriate remedy. This remedy is in keeping with the commercial purpose of a SC.

4.2. The pursuit of contractual stability through the stabilisation clause

Following nationalisations in the Soviet Union, Latin America and the Middle East in the early 1920s, investors in foreign countries began to include SCs in investment agreements from the late 1920s until the mid-1940s.⁵ However, the early 1960s marked a decline in nationalisations and thus the need for the SC in investment contracts was reduced. This time period marked an increase in the use of treaties as a mechanism through which to protect investments⁶ and a decline in the use of SCs. The SC later re-emerged as a contractual tool for reducing political risks, following the rise of new methods of expropriation, in particular indirect expropriation.⁷ IOCs have sought to address both direct and indirect forms of expropriation through various forms of SC.

This thesis has identified two primary benefits of a SC which may explain its continued use, despite challenges to its legal and practical effectiveness. The first primary benefit is that it gives the IOC a legal claim against the state where the state changes/affects the LOTOGA contrary to the SC – a claim which so often translates to

⁵ Mustapha Erkan, *International Energy Investment Law: Stability through Contractual Clauses* (Kluwer Law 2011) 35.

⁶ *ibid* 35-44.

⁷ *ibid* 59.

compensation for the IOC. From a practical standpoint, the state has the power to do whatsoever it chooses, regardless of a SC. It is argued that what an IOC really wants through the inclusion of a SC is to change the negotiating playing field between it and the state. That is, the IOC recognises that the state can make a unilateral change of contract contrary to the SC, but it wants some leverage through which it can enter into negotiations with the state where there is such change. The SC gives the IOC leverage over the state. In the absence of a SC, the IOC has no claim against the state because there is no breach of contract. The benefit of a SC is demonstrated in the decision of *Sergei Pauschok, CISC Golden East Company, CJSC Vostokneftegaz Company v The Republic of Mongolia*,⁸ which concerned the application of a windfall profit tax of 68 percent. The tribunal held:

In the absence of such a stability agreement in favor of GEM, Claimants have not succeeded in establishing that they had legitimate expectations that they would not be exposed to significant tax increases in the future.⁹

Therefore, the investor's claim was dismissed. By contrast, where there is an effective SC, the IOC can recover compensation. This is illustrated by the decision in *Burlington Resources Inc v Ecuador*¹⁰ which concerned a 99% windfall profit tax. Although the tribunal held that the effect of the tax did not constitute expropriation, it found that the steps taken to enforce the measure were contrary to the SC and expropriatory; thus the state was required to pay compensation to the IOC.¹¹

⁸ Award on Jurisdiction and Liability, 28 April 2011.

⁹ Award on Jurisdiction and Liability, 28 April 2011, para 302.

¹⁰ ICSID No ARB/08/5, Decision on Liability of 14 December 2012.

¹¹ *Burlington Resources Inc. v. Ecuador*, ICSID No ARB/08/5, Decision on Liability of 14 December 2012, para 546.

The second primary benefit of a SC is that its inclusion means that the IOC has been given an additional guarantee of stability, thus creating a legitimate expectation. It has been argued that the inclusion of a relevant SC increases the amount of compensation payable to the IOC in the event of expropriation.¹² Nevertheless, there is little discussion in the literature on the exact measure of additional compensation. In this writer's view, the second benefit of the SC can be enhanced by stipulating the amount of compensation payable by the state if it breaches the SC – thereby quantifying the economic value of the SC. This would be a form of liquidated damages clause.

4.3. Types of stabilisation clause

Academic writers have assessed that there are four types of SC: freezing clause; intangibility or inviolability clause; risk allocation clause; and economic rebalancing clause.¹³

There are major differences between SCs, such that a broad reference to the SC should not be taken to cover all types of SC. In order to evaluate the legal and practical effectiveness of the SC, it is necessary to clarify the different types of SC, and their intended functions. For example, the freezing clause is the most controversial form of SC (for reasons explained below); as such, the challenges to its effectiveness are more severe than those facing the other types of SC.

¹² *ibid.*

¹³ Peter D Cameron, *International Energy Investment Law: The Pursuit of Stability* (Oxford University Press 2010) 61; Rudolph Dolzer and Christopher Schreuer, *Principles of International Investment Law* (2nd edn, Oxford University Press 2012) 83.

*i. Freezing clause*¹⁴

This type of clause seeks to prevent the host state from changing its laws in relation to the agreement.¹⁵ More specifically, it may provide that any change in the legislative or regulatory regime of the host state will not affect the LOTOGA.¹⁶ An example of a freezing clause is found in a Liberian agreement. In relation to the taxation regime, Article XIX Section 9, stipulates amongst other issues:

...[A]ny amendments, additions, revisions, modifications... to the Tax Corpus made after the Amendment Effective Date shall not be applicable to the Concessionaire. Furthermore, any future amendment...to any Law (other than the Tax Corpus) applicable to the Concessionaire...that would have the effect of imposing an additional or higher tax...will not apply to the Concessionaire...¹⁷

Another example is from a Suriname Production Sharing Contract 2011 which provides:

A Contractor,..., shall be subject to Income Tax pursuant to the rates applicable on the date that the petroleum agreement enters into force. In case the tax rates are adjusted, such adjustment shall not be applicable to the Contractor and shall have no influence on his liability to pay taxes pursuant to the Income Tax Law of 1922.¹⁸

¹⁴ *ibid* 70.

¹⁵ *ibid*.

¹⁶ Muthucumaraswamy Sornarajah, *The International Law on Foreign Investment* (4th edn, Cambridge University Press 2017) 330.

¹⁷ The Mineral Development Agreement between the Government of the Republic of Liberia and Mittal Steel Holdings NV dated 17th August 2005, and the Amendment thereto dated 28 December 2006. Cited in Peter D Cameron, *International Energy Investment Law: The Pursuit of Stability* (Oxford University Press 2010) 70-71. See also Global Witness, 'Heavy Mittal? A State within a State: The inequitable Mineral Development Agreement between the Government of Liberia and Mittal Steel Holdings NV' (October 2006) <https://www.globalwitness.org/sites/default/files/pdfs/mittal_steel_en_oct_2006_high_res.pdf> at page 30 accessed 09 April 2016.

¹⁸ Production Sharing Contract For Petroleum Exploration, Development and Production relating to Block 45 Offshore Suriname Between Staatsolie Maatschappij Suriname N.V. and Kosmos Energy Suriname 2011, Article 18.4.1

The freezing clause is the most restrictive type of SC. It has severe implications on the principle of state sovereignty, as it seeks to restrain the sovereign powers of the state to amend or enact legislation affecting the agreement.¹⁹ This is demonstrated by the public outcry that resulted from, amongst other issues,²⁰ the far reaching powers of the SC in the original²¹ Mittal Steel²² (now Arcelor Mittal) agreement with the Liberian government in 2005.²³ Here, the SC had the potential to compromise the state's sovereign right to regulate on human rights, taxation and environmental obligations of the foreign party.²⁴

Although freezing clauses are less frequently used in modern LOTOGAs,²⁵ a 2009 study²⁶ which reviewed 76 investment contracts and 12 model contracts found

¹⁹ Peter D Cameron, *International Energy Investment Law: The Pursuit of Stability* (Oxford University Press 2010) 70.

²⁰ The most contentious issue in the agreement was that the company was given total power to set the price of iron ore. See Global Witness, 'Update on the Renegotiation of the Mineral Development Agreement between Mittal Steel and the Government of Liberia' (August 2007) <https://www.globalwitness.org/sites/default/files/pdfs/mittal_steel_update_en_aug_07.pdf> accessed 12 March 2016.

²¹ The agreement was modified on the 28th of December 2006. See, Global Witness, 'Update on the Renegotiation of the Mineral Development Agreement between Mittal Steel and the Government of Liberia' (August 2007) <https://www.globalwitness.org/sites/default/files/pdfs/mittal_steel_update_en_aug_07.pdf> accessed 12 March 2016.

²² The Mineral Development Agreement between the Government of the Republic of Liberia and Mittal Steel Holdings NV dated 17th August 2005, and the Amendment thereto dated 28 December 2006.

²³ Annalise Nelson, 'Investments in the deep freeze? Stabilization clauses in investment contracts' (Kluwer Arbitration blog, November 2011) <<http://kluwerarbitrationblog.com/2011/11/09/investments-in-the-deep-freeze-stabilization-clauses-in-investment-contracts/>> accessed 05 March 2016. See also Global Witness, 'Update on the Renegotiation of the Mineral Development Agreement between Mittal Steel and the Government of Liberia' (August 2007) <https://www.globalwitness.org/sites/default/files/pdfs/mittal_steel_update_en_aug_07.pdf> accessed 12 March 2016.

²⁴ Global Witness, 'Update on the Renegotiation of the Mineral Development Agreement between Mittal Steel and the Government of Liberia' (August 2007) <https://www.globalwitness.org/sites/default/files/pdfs/mittal_steel_update_en_aug_07.pdf> accessed 12 March 2016.

²⁵ This may be because states who previously consented to such forms of SC are now more economically developed and refuse to consent to such forms of SC. Also, it could be because history has demonstrated that the freezing SC has little or no practical effectiveness since the state has the legislative, administrative and regulatory ability to pass legislation which affects the LOTOGA, contrary to the SC.

²⁶ This study was conducted under the aegis of the Special Representative of the Secretary-General for business and human rights (SRSG) and the International Finance Corporation (IFC).

that freezing SCs still feature in modern investment contracts in parts of Africa (Sub-Saharan and Northern), Eastern and Southern Europe, Central Asia, and the Middle East.²⁷

*ii. Intangibility/ Inviolability clause*²⁸

This type of SC prevents any unilateral change to the contract without the consent of the contracting parties.²⁹ A characteristic feature is that it provides that should there be any changes to the contract, it must be subject to the mutual consent of the contracting parties.³⁰ For example, the Mozambique Model PSC provides that ‘the government will not without the agreement of the contractor exercise its legislative authority to amend or modify the provisions of this agreement...’.³¹

Nevertheless, despite the fact that an intangibility clause is more flexible than a freezing clause, it has practical challenges. Consent is easy to come by when the contracting parties are on good terms, but when the contractual relationship has been damaged, consent can become elusive. Where a state seeks to materially affect the terms of the agreement to the detriment of the IOC, the IOC may not give its consent.

²⁷ Andrea Shemberg, ‘Stabilization Clauses and Human Rights: A research project conducted for IFC and the United Nations Special Representative of the Secretary-General on Business and Human Rights’ (May 27, 2009) 1, 17 <<http://www.ifc.org/wps/wcm/connect/9feb5b00488555eab8c4fa6a6515bb18/Stabilization%2BPaper.pdf?MOD=AJPERES&CACHEID=9feb5b00488555eab8c4fa6a6515bb18>> accessed 05 June 2019 (IFC is the International Financial Corporation World Bank Group); Katja Gehne and Romulo Brillo, ‘Stabilization Clauses in International Investment Law: Beyond Balancing and Fair and Equitable Treatment’ (May 2017) 143 Institute of Economic Law Transnational Economic Law Research Center (TELC) School of Law, Martin Luther University Halle-Wittenberg 5, 10 <<http://telc.jura.uni-halle.de/sites/default/files/BeitraegeTWR/Heft%20143.pdf>> accessed 05 June 2019.

²⁸ Rudolph Dolzer and Christoph Schreuer, *Principles of International Investment Law* (2nd edn, Oxford University Press 2012) 83.

²⁹ Peter D Cameron, *International Energy Investment Law: The Pursuit of Stability* (Oxford University Press 2010) 74.

³⁰ *ibid.*

³¹ The Mozambique Model Production Sharing Contract 2001, Article 30(7)(d) & (e).

This can sour the relationship between both parties, with the state unilaterally altering the agreement in breach of the SC.

Nonetheless, the benefit of this type of SC is that it correctly envisages that things may change within the host state or even externally, thereby affecting the LOTOGA. It gives the contracting parties the opportunity to keep the contract alive where both parties are willing.

*iii. Risk allocation clause*³²

This clause provides that where there has been a unilateral change of law which affects the legal framework of the original agreement, the burden created by the change will be shifted from the IOC.³³ Generally, where the NOC³⁴ is a contractual party to the LOTOGA (eg, joint venturer), the NOC will be required to bear the burden created by the change in law, thereby ensuring that the IOC's rights and duties under the contract remain unaffected.³⁵ As an example, Article 31.1 of the Model PSA of Kurdistan provides that:

The GOVERNMENT shall indemnify each CONTRACTOR entity upon demand against any liability to pay any taxes, duties...or withholdings assessed or imposed upon such entity which relate to any of the exemptions granted by the GOVERNMENT.³⁶

³² R. Doak Bishop, James Crawford and W. Michael Reisman, *Foreign Investment Disputes: Cases, Materials and Commentary* (2nd edn, Kluwer Law International 2014) 254.

³³ *ibid.*

³⁴ Although the majority of NOCs are owned by the state, some NOCs have some private ownership. For the purpose of this thesis, the reference to a NOC refers to those which are entirely state-owned.

³⁵ Peter D Cameron, *International Energy Investment Law: The Pursuit of Stability* (Oxford University Press 2010) 80.

³⁶ Model Production Sharing Agreement of the Kurdistan Regional Government of Iraq 2007 <http://www.krg.org/uploads/documents/KRG%20Model%20PSC_2007_09_06_h14m3s46.pdf>; <http://mnr.krg.org/images/pdfs/KRG_Model_PSC_production_sharing_contract_20071112.pdf> accessed 22 February 2018.

The risk allocation SC may serve the needs of a state which is committed to maintaining a stable contractual environment for the IOC but seeks increased flexibility to make legal and regulatory changes as necessary, which may affect the agreement, subject to it compensating the IOC. This type of SC is arguably a ‘watered down’ version when compared to the freezing SC. Nonetheless, from a legal and practical viewpoint, it is perhaps more beneficial to IOCs since it correctly envisages changes to the LOTOGA and provides how such changes might be addressed as between the contracting parties. Nevertheless, it is anticipated that this type of SC may not be commonly used in practice because the majority of NOCs or indeed the state would not want to take on this financial burden. However, the advantage of this type of SC for an IOC is that there is more likelihood that the state would as far as is practicable ensure the stability of the agreement, so as to avoid creating a financial burden on itself or any of its appointed entities.

iv. Economic rebalancing³⁷ clause

This type of clause does not seek to prohibit the host state from enacting law which affects the terms of the LOTOGA; rather it provides that where a sovereign action of the state affects the economic equilibrium of the LOTOGA for the IOC, a readjustment will occur.³⁸ This means that where an action of the state adversely affects the expected financial gain of the IOC there will be a readjustment of the contract to reflect a position that is more economically just for the IOC. An example of this is found in Article 43.3 of the Kurdistan Model PSA which provides:

³⁷ Peter D Cameron, *International Energy Investment Law: The Pursuit of Stability* (Oxford University Press 2010) 74.

³⁸ *ibid* 75.

... If, at any time after the Effective Date, there is any change in the legal, fiscal and/or economic framework...which detrimentally affects the CONTRACTOR, the terms and conditions of the CONTRACT shall be altered so as to restore the contractor to the same overall economic position as that which CONTRACTOR would have been in, had no such change in the legal, fiscal and/or economic framework occurred.³⁹

Also, in the Cameroon Model PSC 2015, Article 9.2.2.1, the state guarantees the stability of the economic regime of the LOTOGA under the conditions set forth in a SC (Article 29).⁴⁰ The SC provides that where there is a legislative or regulatory change which significantly affects the economic equilibrium of the contract to the detriment of the contractor, the contractor is to provide written notification to the Minister in charge of hydrocarbons.⁴¹ The result of this notification is that the concerned provision no longer affects the contract or where it does, the contract will be readjusted. The Minister can either:

³⁹ Model Production Sharing Agreement of the Kurdistan Regional Government of Iraq 2007 <http://www.krg.org/uploads/documents/KRG%20Model%20PSC_2007_09_06_h14m3s46.pdf>; <http://mnr.krg.org/images/pdfs/KRG_Model_PSC_production_sharing_contract_20071112.pdf> accessed 22 February 2018.

⁴⁰ Model Production Sharing Contract Between The Republic of Cameroon and The Holder March 2015, Article 29 <<http://www.resourcecontracts.org/search?q=model+production+sharing+contract&order=desc&sortby=year>; http://www.resourcecontracts.org/search?q=&country%5B%5D=cm&resource%5B%5D=Hydrocarbons&language%5B%5D=en&document_type%5B%5D=Model+Contract> accessed 11 March 2018.

⁴¹ ‘In the event of a change in the provisions of Title VI of the Petroleum Code, or more generally of any of the provisions of the Petroleum Legislation and of the provisions of the texts to which the Petroleum Code refers for the application of the said Title VI, or of the annual finance law, which takes place after the Effective Date and which would affect in a significant manner the economic equilibrium of this Contract to the detriment of the CONTRACTOR, the CONTRACTOR may, within two (2) months from the written notification to CONTRACTOR of the legislative or regulatory measure in question, send to the Minister in charge of Hydrocarbons written notification stating that the legislative or regulatory change in question would have a significant detrimental effect on CONTRACTOR’s economic equilibrium as guaranteed pursuant to Article 9.2.2.1 of this Contract. Said notification shall also set forth the CONTRACTOR’s justifications.’ Model Production Sharing Contract Between The Republic of Cameroon and The Holder March 2015, Article 29.1 <<http://www.resourcecontracts.org/search?q=model+production+sharing+contract&order=desc&sortby=year>; http://www.resourcecontracts.org/search?q=&country%5B%5D=cm&resource%5B%5D=Hydrocarbons&language%5B%5D=en&document_type%5B%5D=Model+Contract> accessed 11 March 2018. Article 29.2 further describes, that a “significant” modification is that which has the effect of reducing the CONTRACTOR’s economic benefits resulting from this Contract.

Accept in writing the reasons of the CONTRACTOR and make arrangements so that *the legislative or regulatory provision in question no longer applies to the CONTRACTOR* nor to any entity comprising CONTRACTOR;⁴² or If the Minister in charge of Hydrocarbons cannot make arrangements as provided for in Article 29.3.1 above, the Parties shall endeavour to make such *readjustments to the Contract as to reestablish the economic equilibrium of the Contract* as it had been agreed to on the Effective Date, taking into account the new legislative or regulatory provision referred to in the notice.⁴³

Where the result of rebalancing is that the change in law (eg, increased tax) will not affect the IOC, the state suffers a financial loss in the sense that it will not gain extra benefits (increased tax) from the IOC.

In the economic rebalancing SC, the manner of restoring the economic equilibrium may be expressly provided in the agreement or the parties may have to renegotiate (see Cameroon example above). The most efficient and effective drafting of the clause would provide the method of readjustment, or at least the conditions and expectations of the renegotiation process. This is because the less room there is for uncertainty, the greater will be the stability of the LOTOGA. However, drafting a clause with such specificities may not always be possible because the state may be unwilling to commit to such terms.⁴⁴ This is because such a commitment would confine the state to the exact manner of readjustment prescribed in the text.

⁴² Model Production Sharing Contract Between The Republic of Cameroon and The Holder March 2015, Article 29.3.1 <<http://www.resourcecontracts.org/search?q=model+production+sharing+contract&order=desc&sortby=year>; http://www.resourcecontracts.org/search?q=&country%5B%5D=cm&resource%5B%5D=Hydrocarbons&language%5B%5D=en&document_type%5B%5D=Model+Contract> accessed 11 March 2018 (emphasis added). Note that under Article 29.3.2, the Minister of Hydrocarbons may reject the Contractor's justifications.

⁴³ *ibid*, Article 29.4 (emphasis added). It further provides that, 'The Parties shall make their best efforts to agree upon revisions to be made to the Contract within ninety (90) Days as from the notification of the rejection of the above- mentioned request of the CONTRACTOR. The revisions to be made to the Contract may not in any event diminish the rights or increase the obligations of the CONTRACTOR as had been agreed to as of the Effective Date.'

⁴⁴ Peter D Cameron, *International Energy Investment Law: The Pursuit of Stability* (Oxford University Press 2010) 75.

Conclusion on the types of stabilisation clause

Overall, the practical advantage of the economic rebalancing SC is that it does not conflict with state sovereignty. Also, it adapts to changes in a LOTOGA and ensures an appropriate economic return for both contracting parties. Despite this, this type of clause has the potential to create more uncertainties if the text is not clear on the degree of economic imbalance to necessitate a readjustment or the manner of readjustment.

The last two types of SC discussed are modern forms, whilst the previous two are traditional SCs. The freezing SC is the only clause that takes the ‘preventative’ rationale – the other three types of SC deal with the consequences of the changes made by the state, thus they are ‘protectionist’. A LOTOGA may include one or more types of SC, each applying to a different section of the agreement, depending on the functions the contracting parties want the clause to achieve.⁴⁵

Despite the differences in the various types of SCs, the main contention surrounding the SC is the question of its effectiveness against the risk of unilateral change of contract and expropriation. Although modern forms of SC do not conflict with state sovereignty, there is still the question of whether they are effective in mitigating the risk of unilateral change of contract and expropriation. In a hypothetical scenario, a risk allocation SC could provide that the NOC would bear the financial burden for the increase in the tax rate. Yet, in challenging economic and

⁴⁵ Cameron notes that a recent Ecuadorean PSC contains a hybrid SC. The applicable law at the time the contract is made is frozen (freezing clause), any changes to the contract must have the consent of the contracting parties (intangibility clause) and where an amendment to the taxation regime occurs, there is an adjustment of production sharing percentages (economic rebalancing clause). Peter D Cameron, *International Energy Investment Law: The Pursuit of Stability* (Oxford University Press 2010) 79-81.

political situations, the NOC may refuse to take this burden or it may simply be unable to afford to pay the difference where it is cash-strapped. In such a case, the SC would lack practical effectiveness.

Yet, traditional SCs are even more questionable. Where the state commits to freeze the law applicable to the LOTOGA (see sample freezing clause above), but enacts legislation which affects the LOTOGA, how can the IOC compel the state to honour its commitments through the SC? The state may seek to use the defence of state sovereignty to frustrate the claim of the IOC. Traditional SCs are still in existence⁴⁶ so the issue of their enforceability and effectiveness is still a live issue. The following section considers the doctrine of state sovereignty and its effect on the legal and practical effectiveness of the SC.

4.4. The legal validity of the stabilisation clause under the principle of state sovereignty

A central concern of this chapter is to enquire into two questions: one, whether the SC is legally valid and therefore legally effective; and two, whether the SC has any practical effectiveness. If the SC is legally valid, this means it can legally bind the state, therefore, it is legally effective. Despite this, legal effectiveness does not translate to practical effectiveness. The latter is judged by the ability of the SC to prevent the state from carrying out actions contrary to the SC. Prior to addressing

⁴⁶Andrea Shemberg, 'Stabilization Clauses and Human Rights: A research project conducted for IFC and the United Nations Special Representative of the Secretary-General on Business and Human Rights' (May 27, 2009) 1, 17 <<http://www.ifc.org/wps/wcm/connect/9feb5b00488555eab8c4fa6a6515bb18/Stabilization%2BPaper.pdf?MOD=AJPERES&CACHEID=9feb5b00488555eab8c4fa6a6515bb18>> accessed 05 June 2019; Katja Gehne and Romulo Brillo, 'Stabilization Clauses in International Investment Law: Beyond Balancing and Fair and Equitable Treatment' (May 2017) 143 Institute of Economic Law Transnational Economic Law Research Center (TELC) School of Law, Martin Luther University Halle-Wittenberg 5, 10 <<http://telc.jura.uni-halle.de/sites/default/files/BeitraegeTWR/Heft%20143.pdf>> accessed 05 June 2019.

practical effectiveness in section 4.5 below, this section considers the question of the SC's legal validity under national and international law.

International law seeks to promote the interests of the international community and therefore interferes in the affairs of states, whereas states seek to maintain a degree of autonomy from international law. Consequently, states have used the doctrine of state sovereignty as a shield against the intrusion of international law.⁴⁷ Host states have often disputed the validity of a SC under the notion of state sovereignty.⁴⁸ Therefore, IOCs would generally seek to include international law as the governing law of the LOTOGA.⁴⁹ This allows IOCs to argue that the contract has been 'internationalised'.⁵⁰ The essence of 'internationalisation' is to ensure that the LOTOGA is not solely governed by the legal order of the state, but also governed by

⁴⁷ Robert McCorquodale and Martin Dixon, *Cases and Materials on International Law* (4th edn, Oxford University Press 2003) 104.

⁴⁸ *Texaco v Libyan Arab Republic* (TOPCO), Award, (1977) 53 I.L.R. 389; *The Government of the State of Kuwait v American Independent Oil Co*, Award, 24 March 1982 (1982) 21 ILM 976, para 90; *AGIP Co. v Popular Republic of Congo*, (1982) ICSID Case No. ARB/77/1, 21 ILM. 726.

⁴⁹ An example of the inclusion of international law in a LOTOGA is found in the *Texaco v Libyan Arab Republic* (TOPCO), Award, (1977) 53 I.L.R. 389- 14 Deeds of Concession were signed between 1955 and 1966. Governing law (Clause 28) provides, 'Concession shall be governed by and interpreted in accordance with the principles of law of Libya common to the principles of international law and in the absence of such common principles then by and in accordance with the general principles of law, including such of those principles as may have been applied by international tribunals.' For a discussion on internationalisation, see J. NNA Emeka, 'Anchoring Stabilization Clauses in International Petroleum Contracts' 42(4) *The International Lawyer* (WINTER 2008)1317, 1318, 1326; Julien Cantegreil, 'The Audacity of the *Texaco/Calasiatic* Award: René-Jean Dupuy and the Internationalization of Foreign Investment Law' 22 *European Journal of International Law* (2011) 441-458.

⁵⁰ The argument of internationalisation of the contract was also made in the notable case of *The Government of the State of Kuwait v American Independent Oil Co*, Award 24 March 1982 (1982) 21 ILM 976, 94-97, 102; Mustapha Erkan, *International Energy Investment Law: Stability through Contractual Clauses* (Kluwer Law 2011) 113-116. See also Juha Kuusi, *The Host State and the Transnational Corporation: An Analysis of Legal Relationships* (Saxon House, 1979) 87-88. In contrast, Sornarajah has argued against the notion of internationalisation of contract. For a discussion, see Muthucumaraswamy Sornarajah, 'The Myth of International Contract Law' (1981) 15 *Journal of World Trade Law* 187; *The Pursuit of Nationalized Property* ((Martinus Nijhoff, The Hague 1986); *International Commercial Arbitration: The Problem of State Contracts* (Longman 1990); *Law of International Joint Ventures* (Longman 1992); *The International Law on Foreign Investment* (1st to 3rd eds, Cambridge University Press 1994, 2004, 2010); *Resistance and Change in the International Law on Foreign Investment* (Cambridge University Press 2015).

international law. This is a useful advantage, particularly where national law conflicts with international law.

4.4.1. *Validity under national law*

Where the contracting parties have exclusively chosen the law of the host state as the governing law of the LOTOGA,⁵¹ or where that law is applied by an arbitral tribunal for lack of choice by the parties, the validity of a SC would first be tested under national law. The constitution of a state may prevent its government from entering into stabilisation agreements. For example, under the English principle of parliamentary sovereignty,⁵² ‘[t]he legislature is not bound by its own legislation’,⁵³ neither can one parliament bind the next.⁵⁴ Therefore, a clause restricting the powers of the legislature would be invalid in the United Kingdom. Australia, Brazil, Canada, Norway, and Saudi Arabia are other examples of states which do not offer stabilisation guarantees.⁵⁵

⁵¹ Generally, the host state would typically prefer that its domestic law be the applicable law of the contract, rather than that of another state, thereby allowing it to retain control over the agreement. Erkan opines that the majority of oil and gas agreements are subject to host state law as the governing law of the contract, albeit that most of these agreements would also include international law as the governing law. The latter has been the position over the last twenty years. See Mustapha Erkan, *International Energy Investment Law: Stability through Contractual Clauses* (Kluwer Law 2011) 110-113, 223.

⁵² According to AV Dicey, ‘The principle of parliamentary sovereignty means neither more nor less than this: namely, that Parliament thus defined has, under the English constitution, the right to make or unmake any law whatever; and, further, that no person or body is recognised by the law of England as having the right to oversee or set aside the legislation of Parliament’. AV Dicey, *The Law of the Constitution* (Macmillan 1885) 39. See also Hilaire Barnett, *Constitutional & Administrative Law* (11th edn, Routledge 2016) 120.

⁵³ Muthucumaraswamy Sornarajah, *The International Law on Foreign Investment* (3rd edn, Cambridge University Press 2010) 282.

⁵⁴ Parliamentary sovereignty, <<http://www.parliament.uk/about/how/sovereignty/>> accessed 10 August 2018. See also AV Dicey, *The Law of the Constitution* (Macmillan 1885) 39.

⁵⁵ Peter Cameron, ‘Stabilisation in Investment Contracts and Changes of Rules in Host Countries: Tools for Oil & Gas Investors’ (2006) Association of International Petroleum Negotiators (AIPN) (Final Report) 1, 13,17 <<http://www.rmmlf.org/Istanbul/4-Stabilisation-Paper.pdf>> accessed 23 May 2018.

Curiously, decommissioning relief deeds (DRD) issued by the UK government have some semblance to the stabilisation clause because by committing not to amend the amount of tax relief under the agreement, the DRD is in effect a stabilisation guarantee in respect of tax relief for DCG costs. This is discussed in chapter 9 of the thesis.

4.4.2. *Validity under international law*

Under international law, state sovereignty denotes ‘the international independence of a state, combined with the right and power of regulating its internal affairs without foreign dictation’.⁵⁶ This relates to the right of a state to engage in whatsoever policies within its own borders as it deems fit.⁵⁷

Following on from this is the right of a state to PSNR. This is set out as a principle of international law in resolution 1803 (General Assembly) of the United Nations.⁵⁸ The principles in this resolution concern the exploration, development and disposition of natural resources, nationalization and expropriation, foreign investment, and other related issues. Resolution 1803 culminated in the Charter of Economic Rights and Duties of States.⁵⁹ The fundamental importance of PSNR is that the

⁵⁶ Henry Campbell Black, *Black's Law Dictionary* (6th edn, West 1990). For other definitions see also Hilary Charlesworth and Christine Chinkin, *The Boundaries of International Law: A Feminist Analysis* (Manchester University Press 2002) 124-134; Ian Brownlie, *Principles of Public International Law* (6th edn, Oxford University Press 2003) 287-289; Robert McCorquodale and Martin Dixon, *Cases and Materials on International Law* (4th edn, Oxford University Press 2003) 104, 234.

⁵⁷ Johan D van der Vyver, ‘Sovereignty and Human Rights in Constitutional and International Law’ (1991) 5 *Emory International Law Review* 321, 392 (citing Richard Lillich).

⁵⁸ General Assembly Resolution 1803 (XVII) of 14 December 1962, ‘Permanent sovereignty over natural resources’ <http://legal.un.org/avl/ha/ga_1803/ga_1803.html> accessed 05 June 2018. ‘Resolution 1803 (XVII) provides that States and international organizations shall strictly and conscientiously respect the sovereignty of peoples and nations over their natural wealth and resources in accordance with the Charter of the United Nations and the principles contained in the resolution’.

⁵⁹ General Assembly Resolution 3281 (XXIX) of 12 December 1974, ‘Charter of Economic Rights and Duties of States’ <<http://www.un-documents.net/a29r3281.htm>> accessed 05 February 2018. This Charter is generally viewed as a part of customary international law.

sovereignty of a state extends to natural resources found within its borders. Thus, it may nationalise or expropriate an investment, provided compensation is paid to the investor (IOC).⁶⁰

The principle of PSNR is so fundamental that one school of thought has argued that SCs are invalid because a state cannot ‘contract away’ its sovereignty.⁶¹ The views of those belonging to this school of thought are best summarised in the words of Aréchaga,⁶² who writes that:

The concept of permanent sovereignty signifies that the territorial State never loses its legal capacity to change the status or the method of exploitation of [natural] resources, regardless of any arrangements that may have been made for their exploitation and administration.⁶³

Omorogbe further contends that stabilisation laws or clauses are legally valueless because they ‘...cannot bind the legislative body from enacting any other law which in any way alters or amends the terms contained therein’.⁶⁴

⁶⁰ For a further discussion on PSNR, see Ricardo Pereira and Orla Gough, ‘Permanent Sovereignty Over Natural Resources in the 21st Century: Natural Resource Governance and the Right to Self-determination of Indigenous Peoples under International Law’ (2013) 452-470 <<http://www5.austlii.edu.au/au/journals/MelbJIL/2013/15.pdf>> accessed 05 June 2018; Sangwani Patrick Ng’ambi, ‘Permanent Sovereignty Over Natural Resources and the Sanctity of Contracts, From the Angle of *Lucrum Cessans*’ (2015) 12(2) *Loyola University Chicago International Law Review* 153-172.

⁶¹ See Angelo P. Sereni, *International Economic Institutions and the Municipal Law of States*’ (1959) 96 *Collected Courses of the Hague Academy of International Law* 210, 210; F.V. Garcia-Amador, ‘The Proposed New International Economic Order: A New Approach to the Law Governing Nationalization and Compensation’ (1980) 12 *U. Miami Journal of International Law* 1, 17-24; Rosalyn Higgins, ‘The Taking of Property by the State: Recent Developments in International Law’ 176 *Collected Courses of the Hague Academy of International Law* (1982) 233, 235; Muthucumaraswamy Sornarajah, *The Pursuit of Nationalized Property* (Martinus Nijhoff, The Hague 1986) 126; Ian Brownlie, *Principles of Public International Law* (6th edn, Oxford University Press 2003) 526.

⁶² Eduardo Jiménez Aréchaga held the seat of the President of the International Court of Justice between 1976-1979. *International Court of Justice: All Members* <<http://www.icj-cij.org/court/index.php?p1=1&p2=2&p3=2>> accessed 07 April 2016.

⁶³ Eduardo Jiménez de Aréchaga, ‘State Responsibility for the Nationalization of Foreign Owned Property’ (1978) 11 *N.Y.U.J Int’l L. & Poly* 179,179-180.

⁶⁴ Yinka Omorogbe, ‘Law and Investor Protection in the Nigerian Natural Gas Industry’ (1996) 14 *Journal of Energy & Natural Resources Law* 179,189.

However, another school of thought argues that the principle of PSNR has existed since 1962,⁶⁵ and this has not stopped states from consenting to SCs.⁶⁶ Whilst this is a valid point, the continued use of SCs does not necessarily confer legal validity; an unfair term may feature heavily in contracts but that does not mean it is valid. Nonetheless, one might argue that the prevalence of SCs in investment contracts is an indication of state practice which ought to translate into customary international law. Yet, such an express view on the status of SCs as forming part of customary international law has not been consistently made – either in the literature or in arbitral awards. Nevertheless, there are clear decisions where the validity of the SC has been upheld. For example, in the *Texaco v Libyan Arab Republic (TOPCO)*⁶⁷ award, the sole arbitrator stated that a state can enter into international commitments in its discretionary competence: ‘...the result is that a State cannot invoke its sovereignty to disregard commitments freely undertaken through the exercise of this same sovereignty...’.⁶⁸ In principle, this means that state sovereignty does not invalidate SCs – the state cannot ‘eat its cake and have it too.’ Similarly, the arbitral tribunal in *AGIP Co. v Popular Republic of Congo*⁶⁹ held that ‘[s]tabilisation clauses

⁶⁵ See Resolution 1803 by the General Assembly of the United Nations which sets down the right of permanent sovereignty over natural resources as a principle of international law. <<http://www.ohchr.org/EN/ProfessionalInterest/Pages/NaturalResources.aspx>> accessed 02 April 2016.

⁶⁶ Abdullah Faruque, ‘Validity and Efficacy of Stabilisation Clauses: Legal Protection vs. Functional Value’ (2006) 23(4) *Journal of International Arbitration* 317, 323.

⁶⁷ *Texaco v Libyan Arab Republic (TOPCO)*, Award, (1977) 53 I.L.R. 389.

⁶⁸ *Texaco v Libyan Arab Republic (TOPCO)*, Award, (1977) 53 I.L.R. 389. The sole arbitrator awarded specific performance after determining that there has been an expropriation. This is in contrast to the general position which is to award damages. The sole arbitrator in that case found that ‘...restitutio in integrum is an appropriate remedy under the Libyan Civil Code and Muslim law, and cited the Chorzow Factory case as applying the rule of restitutio in integrum.’ R. Doak Bishop, *International Arbitration of Petroleum Disputes: The Development of a Lex Petrolea*, XXIII Y.B. COM. ARB. 1131 (1998) 1173. However, the order proved impossible to enforce in the face of opposition from the state.

⁶⁹ *AGIP Co. v Popular Republic of Congo*, (1982) ICSID Case No. ARB/77/1, 21 ILM. 726.

freely accepted by the Government do not affect the principle of its sovereign legislative and regulatory powers...'.⁷⁰

Also, in *ES Summit Generation Limited v Republic of Hungary*,⁷¹ the arbitral tribunal's comments on the SC reflects a favourable view on its validity. The case concerned long term power purchase agreements (PPAs). Political debate regarding the profits of certain power generators, coupled with an investigation from the European Commission on State Aid, led to the reintroduction of an administrative price regime (from fixed to flexible tariffs) for power generation.⁷² The claimant alleged that this change violated the terms of its PPAs. It argued that this price regime had an adverse impact on the investment and was in breach of Hungary's obligations under the Energy Charter Treaty. The tribunal rejected the claim, and observed that, '...no specific commitments were made by Hungary that could limit its sovereign right to change its law (such as a stability clause) or that could legitimately have made the investor believe that no change in the law would occur'.⁷³ This indicates that in the tribunal's view, a SC would have had some effect – although it is not an admission that the SC would have prevented Hungary from changing the law. Another favourable view on the validity of the SC is seen in *Revere Copper v US Overseas*

⁷⁰ *ibid* para 86.

⁷¹ Award, ICSID Case No ARB/07/22, 23 September 2010.

⁷² Hungary argued that the reintroduction of the administrative pricing was necessary under EU law. It is useful to note that the Energy Charter Treaty was the applicable law, as well as the applicable rules and principles of international law.

⁷³ *ES Summit Generation Limited v Republic of Hungary*, Award, ICSID Case No ARB/07/22, 23 September 2010, para 9.3.31.

Private Investment Corporation,⁷⁴ where the tribunal held that the tax SC was internationally binding, and any action to the contrary constituted a breach.⁷⁵

Additionally, in *CMS Gas Transmission Company v. Argentina*,⁷⁶ the tribunal indicated that, ‘...the stabilisation ensured a right that the Claimant can properly invoke’.⁷⁷ Furthermore, in *Parkerings–Compagniet AS v Lithuania*,⁷⁸ the tribunal made comments which support the validity of a SC. It stated that:

It is each State’s undeniable right and privilege to exercise its sovereign legislative power. A State has the right to enact, modify or cancel a law at its own discretion. *Save for the existence of an agreement, in the form of a stabilisation clause or otherwise*, there is nothing objectionable about the amendment brought to the regulatory framework existing at the time an investor made its investment...⁷⁹

Although the views of the arbitrators in the above cases cannot be taken as conclusive evidence on the validity of the SC, nevertheless, they provide a starting point on how the validity of the SC should be viewed. Also, the continued use of SCs in state contracts appears to support their validity, albeit not conclusively. Furthermore, this writer argues that a SC should be viewed through the eyes of contract, besides the doctrine of state sovereignty. From a freedom of contract view, states have the power and ability to choose to limit their sovereignty in the interest of attracting investment. Therefore, states consenting to SCs are contractually bound to honour the terms of the

⁷⁴ Award, 24 August 1978, 17 ILM (1978) 1321; 56 ILR (1980) 258.

⁷⁵ *ibid* at 1345.

⁷⁶ Award, ICSID Case No ARB/01/8, 12 May 2005, IIC 65 (2005).

⁷⁷ *ibid* at para 151. Unfortunately, the tribunal failed to quantify the value of compensation specifically for the presence of the SCs.

⁷⁸ Award, ICSID Case No ARB/05/8, 11 September 2007.

⁷⁹ *ibid* at para 332 (emphasis added).

clause. Where the state does not wish to comply, it may choose to breach the contract and pay damages.

For these reasons, the thesis proceeds with the view that a SC is valid, and thus legally effective since it has legal power to bind the state. Despite this, the state as a sovereign party is able to amend or affect the LOTOGA, contrary to the SC. This raises the question of whether a SC has any practical effectiveness.

4.5. An assessment of the practical effectiveness of the stabilisation clause

The main question regarding the practical effectiveness of a SC in mitigating political risk could best be phrased as, ‘What options are open to the IOC if the state acts in breach of the SC?’

From a practical standpoint, a SC cannot prevent the state from doing as it chooses. Where a state is determined to expropriate or amend the terms of the LOTOGA, its sovereign position gives it the power to disregard the SC (subject to paying compensation). More so, an award of specific performance in favour of the IOC would be no more than an empty victory for the IOC since there is no means of enforcing such an award. For example, although the sole arbitrator awarded specific performance in *Texaco v Libyan Arab Republic (TOPCO)*⁸⁰ the order proved impossible to enforce in the face of opposition from the state.⁸¹ Therefore, the practical limitation on the effectiveness of the SC is its greatest weakness.

Omukoro cites the example of Venezuela, arguing that a review of its dealings with IOCs indicates that the presence of SCs in contracts makes no difference when

⁸⁰ Award, (1977) 53 I.L.R. 389.

⁸¹ The parties reached a settlement later on.

its national interests are at stake.⁸² Also, in reflecting upon the role of a SC (however drafted), Sornarajah opines that its main purpose is to prevent the application of changes to the agreement.⁸³ However, he notes that:

As a matter of constitutional theory, a stabilisation clause may not be able to achieve what it sets out to do. It may not serve as anything more than a comforter to the foreign investor, who may derive some security from the belief that there is a promise secured from the state not to apply its future legislation to the contract.⁸⁴

Nwaokoror concurs with this view, adding that the SC provides, ‘...little more than psychological comfort...’.⁸⁵ Irrespective of these views, the inclusion of a SC in a LOTOGA does have a practical advantage for an IOC.⁸⁶ Realistically, where there is a dispute between the state and an IOC, the lawyers of the state would advise the state about the added advantage of the SC for the investor and the implications before an arbitral tribunal. In assessing the functions of a SC, Cameron indicates that it can operate as a bargaining chip for the investor should a dispute arise between it and the

⁸² Dickson Ebikabowei Omukoro, ‘Examining Contractual Stability Measures in Light of Emerging Risks: Revisiting the Stabilisation Clause Debate’ (2012-2015) 24 Sri Lanka Journal of International Law 85, 95. For a further discussion see, T.J Pate, ‘Evaluating Stabilization Clauses in Venezuela’s Strategic Association Agreements for Heavy-Crude Extraction in the Orinoco Belt: The Return of a Forgotten Contractual Risk Reduction Mechanism for the Petroleum Industry’ (2009) 7(3) OGEL 1-43 <www.ogel.org> accessed 14 May 2018; Elizabeth Eljuri and Clovis Trevino, ‘Political Risk Management in Light of Venezuela’s Partial Nationalisation of the Oil Field Service Sector’ (2010) 28 Journal of Energy & Natural Resources Law 375-402.

⁸³ Muthucumaraswamy Sornarajah, *The International Law on Foreign Investment* (4th edn, Cambridge University Press 2017) 331.

⁸⁴ *ibid.*

⁸⁵ Joseph Nwaokoro, ‘Enforcing stabilization of international energy contracts’ (2010) 2 (1) Journal of World Energy Law & Business 103,103. Nwaokoro also adds that the SC it creates a false sense of security for IOCs who view that it is a guarantee of contractual stability.

⁸⁶ For example, its inclusion in a long term contract will help to reduce the amount of premium to be paid on insurance. See Dickson Ebikabowei Omukoro, ‘Examining Contractual Stability Measures in Light of Emerging Risks: Revisiting the Stabilisation Clause Debate’ (2012-2015) 24 Sri Lanka Journal of International Law 85,101.

host state.⁸⁷ He argues that a SC ‘...greatly improves the investor’s bargaining position’.⁸⁸ This is another protective view of the SC. Cameron’s view is that a state may be encouraged to reach a settlement with the investor due to the inclusion of a SC in the agreement. As an example, in 1974 the government of Jamaica entered into mining agreements which included SCs. The government subsequently imposed a production levy on bauxite, leading to discontentment by the companies.⁸⁹ A number of these companies commenced arbitration against the Jamaican government.⁹⁰ However, the parties found common ground and the agreements were renegotiated in 1979. In commenting on this case, Kolo and Wälde⁹¹ attribute the resolution of the dispute to the fact that the companies commenced arbitration, thereby compelling the state to reach a reasonable compromise. They comment thus: ‘...resort to international arbitration or its threat may induce the parties to negotiate under the “shadow” of law’.⁹²

⁸⁷ Peter D Cameron, *International Energy Investment Law: The Pursuit of Stability* (Oxford University Press 2010) 61. See also Wolfgang Peter, *Arbitration and Renegotiation of International Investment Agreements* (Second Revised and Enlarged edn, Kluwer Law International 1995) 225.

⁸⁸ Peter D Cameron, *International Energy Investment Law: The Pursuit of Stability* (Oxford University Press 2010) 425.

⁸⁹ Abba Kolo and Thomas Wälde, ‘Renegotiation and Contract Renegotiation in International Investment Projects: Applicable Legal Principles and Industry Practices’ (2000) 1(5) *Journal of World Investment & Trade* 5, 14

⁹⁰ *Alcoa Minerals of Jamaica Incorporation v Government of Jamaica* (1976) 17 *Harvard International Law Journal* 90.

⁹¹ Abba Kolo and Thomas Wälde, ‘Renegotiation and Contract Adaptation in International Investment Projects: Applicable Legal Principles and Industry Practices’ (2000) 1(5) *Journal of World Investment & Trade* 5, 14.

⁹² *ibid.*

Another view on the SC is that it can lead to increased compensation for the IOC.⁹³ The thesis refers to this as the compensation theory. For example, Arécheaga asserts that:

An anticipated cancellation in violation of such a contractual stipulation (stabilisation clause) would give rise to a special right to compensation; the amount of the indemnity would have to be much higher than in the normal cases because the existence of such a clause is a most pertinent condition which must be taken into account in determining the appropriate compensation...⁹⁴

The ‘cancellation’ referred to above can either be an act of expropriation or nationalisation since both are actions which cancel the contract. It is only in this context that one can argue that the IOC should receive increased compensation than it would have if there was no SC. This is because the IOC has a claim to compensation for expropriation or nationalisation under international law, absent of any SC.⁹⁵ Therefore, where there is a SC prohibiting expropriation and the state breaches this, the IOC ought to receive compensation which reflects its legitimate expectation of stability under the SC. Consequently, a tribunal has to determine the calculation for compensation – be it for the value of the investment, lost profits, or both. The tribunal would consider the inclusion of a SC when calculating damages – this is part of the

⁹³ Eduardo Jiménez de Aréchaga, ‘State Responsibility for the Nationalisation of Foreign owned Property’ (1978) 11 *New York University Journal of International Law and Politics* 179, 192; Subrata Roy Chowdhury, ‘Permanent Sovereignty and its Impact on Stabilisation Clauses, Standards of Compensation and Patterns of Development Co-operation’ in Kamal Hossain and Subrata Roy Chowdhury (eds), *Permanent Sovereignty over Natural Resources in International Law: Law and Practice* (Frances Pinter 1984) 42, 57–71; Muthucumaraswamy Sornarajah, *The Settlement of Foreign Investment Disputes* (Kluwer Law International, 2000) 50-51; Wolfgang Peter, *Arbitration and Renegotiation of International Investment Agreements* (Second Revised and Enlarged edn, Kluwer Law International 1995) 225; Peter D Cameron, *International Energy Investment Law: The Pursuit of Stability* (Oxford University Press 2010) 61.

⁹⁴ Eduardo Jiménez de Aréchaga, ‘State Responsibility for the Nationalisation of Foreign owned Property’ (1978) 11 *New York University Journal of International Law and Politics* 179, 192.

⁹⁵ Martin Dixon, *Textbook on International Law* (6th edn, Oxford University Press 2007) 264-270; Peter D Cameron, *International Energy Investment Law: The Pursuit of Stability* (Oxford University Press 2010) 81.

economic benefit of a SC. Sornarajah further notes that, '[t]he tendency of international arbitral tribunals has been to apply the best method possible to achieve the highest amount of compensation in the event of the breach of the stabilisation clause'.⁹⁶

Similarly, in assessing the value of a SC in the context of expropriation, Professor Wälde expresses that:

...If one would ignore the existence of a stabilisation clause for compensation purposes and allow expropriation with normal compensation, the added presence of the stabilisation commitment would have no effect. The current view seems to be that stabilisation clauses have to be interpreted cautiously in terms of restricting government powers of expropriation; if they should be interpreted as to prohibit expropriation, the solution could be to apply in addition to expropriation-compensation analysis a model of damages for breach of contract and award to claimant the higher of the two values if different. In other words, the presence of stabilisation clauses should make factors legitimate part of the 'equitable considerations' tribunals can apply within the valuation range left to them by the divergence of the various approaches. A stabilisation clause is essentially a risk allocation clause. It would be true to this vocation of the clause to make by way of valuation (i.e. discount rate), the government bears a higher degree of the risk that it would have to be otherwise...⁹⁷

This writer agrees. The calculation of compensation for an expropriation or nationalisation where there is a relevant SC should be higher than where there is no SC. By providing a SC, the state makes an additional promise to maintain a certain level of legal stability, thereby increasing the IOC's legitimate expectation of stability. However, absent of expropriation or nationalisation (i.e. where the state simply amends/affects the LOTOGA, contrary to a SC), there would be no 'special right of

⁹⁶ Maniruzzaman A.F.M, 'Damages for Breach of Stabilisation Clauses in International Investment Law: Where we do stand today?' (2007) 11 & 12(23) *International Energy Law & Taxation Review* 246, 251.

⁹⁷ Thomas Walde, 'Remedies and Compensation in International Investment Law' (2005) 2(5) *Transnational Dispute Management* 1, 68-69.

compensation' since violation of the SC is the breach of contract which gives right to compensation. There is no basis for why the compensation has to be 'special'.

Additionally, although some views on the SC in arbitral awards reflect a consciousness of their beneficial nature, these awards are not always clear on the value (in economic terms) it added to the level of compensation. Professor Maniruzzaman reflects thus:

In various international arbitration cases where the breach of a stabilisation clause was in issue, no quantification of damages, specifically for such breach, in the total quantum of compensation awarded by the tribunal can be discerned. Either the tribunal characterised the nationalisation of foreign investment in violation of the classic stabilisation clause as unlawful and exceptionally awarded *restitutio in integrum* as in *Texaco v Libya*,⁶ or in other cases characterised government interferences with contract in any form as lawful and resorted to a method that led to the highest possible amount of compensation as the fair market value of the property.⁹⁸

This is not to say that the SC has no impact on the scale of compensation; rather, that its impact remains unclear. A notable decision relating to a SC is *The Government of the State of Kuwait v American Independent Oil Co* (hereafter *Aminoil*).⁹⁹ This concerned a concession of sixty years granted in 1948 with a SC which prevented unilateral amendment of the agreement. Following an agreed formula of government 'take' by OPEC, Kuwait sought to increase its royalty take but Aminoil did not consent. Thus, in 1977 Kuwait nationalised the concession with the intention of paying fair compensation. The arbitral tribunal rejected the view that the presence of

⁹⁸ Maniruzzaman A.F.M, 'Damages for Breach of Stabilisation Clauses in International Investment Law: Where we do stand today?' (2007) 11 & 12(23) *International Energy Law & Taxation Review* 246, 249.

⁹⁹ (1982) 21 ILM. 976.

the SCs made the nationalisation unlawful,¹⁰⁰ but noted that the SCs reinforced the necessity for ‘proper indemnification’ to the company in the event of nationalisation.¹⁰¹ In referring to the SCs, the tribunal noted that, ‘...[t]hese clauses created for the concessionaire a legitimate expectation that must be taken into account’.¹⁰² Although Aminoil’s aim was to obtain a ‘reasonable rate of return’ on its investment,¹⁰³ changes that took place over the years meant that ‘...Aminoil had come to accept the principle of a moderate estimate of profits, and that it was this that constituted its legitimate expectation.’¹⁰⁴ In calculating the amount owed to Aminoil, the tribunal stated that this was:

...made up of the values of the various components of the undertaking separately considered, and of the undertaking itself considered as an organic totality - or going concern - therefore as a unified whole, the value of which is greater than that of its component parts, and which must also take account of the *legitimate expectations of the owners*.¹⁰⁵

The significance of the SCs is that, the tribunal acknowledged that they provided Aminoil a certain legitimate expectation. This legitimate expectation to a reasonable rate of return (‘moderate estimate of profits’) was included in the calculation of damages. The tribunal set this as \$10 million per year; with a sum total of

¹⁰⁰ *The Government of the State of Kuwait v American Independent Oil Co (AMINOIL)* (1982) 21 ILM. 976, para 102 and 104. Notably, Sir Gerald Fitzmaurice gave a separate opinion, indicating that the essence of the SCs were to prevent nationalisation and not simply to secure monetary compensation. It was his view that the SCs prohibited nationalisation, and as such, the nationalisation was unlawful. This separate opinion is contained in page 1043-1053. However, the view of the majority was that the nationalisation was lawful.

¹⁰¹ *The Government of the State of Kuwait v American Independent Oil Co (AMINOIL)* (1982) 21 ILM. 976, para 96.

¹⁰² *ibid* at para 159.

¹⁰³ *ibid* at para 160.

¹⁰⁴ *ibid* at para 161.

¹⁰⁵ *ibid* at para 178 (1) (emphasis added).

\$29,652,000 from 1975-1977.¹⁰⁶ However, this sum was also ‘deductible against the total profits going to Aminoil in those three years’.¹⁰⁷ (The total amount awarded to Aminoil was a fraction of the amount claimed.¹⁰⁸)

Also, in the case of *AGIP Co. v People’s Republic of Congo* (hereafter AGIP),¹⁰⁹ there was a SC¹¹⁰ whereby the government committed ‘...not to apply certain laws and decrees as well as “any other subsequent law or decree that aims to alter the Company’s status as a limited liability corporation in private law” ’¹¹¹ to the concession. The government did otherwise. However, short of finding that the nationalisation was unlawful because of the presence of the SC, the tribunal found that the nationalisation of the investor’s interests amounted to a repudiation of the SC.¹¹² AGIP sought compensation for the nationalisation of the company, as well as damages for losses resulting from the failure of the government to perform its contractual obligations.¹¹³ The tribunal awarded both (full compensation).¹¹⁴ It held that:

¹⁰⁶ The tribunal awarded a rate of return of \$8,852 million for 261 days out of 365 in 1977. The annual amount from 1975 to 1977 was increased by 10% per annum to take account of inflation. *The Government of the State of Kuwait v American Independent Oil Co (AMINOIL)* (1982) 21 ILM. 976, para 176 (2).

¹⁰⁷ *The Government of the State of Kuwait v American Independent Oil Co (AMINOIL)* (1982) 21 ILM. 976, para 176 (2).

¹⁰⁸ A sum total of \$206,041,000 was awarded for Aminoil’s investment. However, its liabilities to the government were calculated as \$123,041,00. After subtracting this, the balance due to Aminoil was thus \$83,000,000. The tribunal awarded compound interest as it set interest at 7.5%, and also added 10% to take account for inflation. This resulted in a final award of \$179, 750, 764 (see para 179). Aminoil had made a claim for over \$600,000,000, as well as interest.

¹⁰⁹ (1982) ICSID Case No. ARB/77/1, 21 ILM. 726.

¹¹⁰ This was referred to in the document as a stability provision.

¹¹¹ Article 4 and 11 of the Protocol Agreement. (1982) ICSID Case No. ARB/77/1, 21 ILM. 726, para 69-70.

¹¹² *ibid.*

¹¹³ *AGIP Co. v People’s Republic of Congo* (1982) ICSID Case No. ARB/77/1, 21 ILM. 726, para 95.

¹¹⁴ *ibid* at para 99, 102-109.

- ii. ...The Government is obliged to pay AGIP as damages:
 - (A) for non-recovery of commercial debts
 - Lit 202,807, 838 (Annexes 50 and 52)
 - US\$333,297.76 (Annex 56)
 - F 968,071.86 (Annexes 54 and 58)
 - (B) for payments made by AGIP as guarantor
 - F 16,688,388 (Annexes 61, 63, 65 and 67)
 - (C) for 50% of the shares of the company
 - F 2,800,000
 - (D) for lucrum cessans
 - F 3...

Although one may argue that the tribunal's decision to award full compensation was due to the presence of the SC, this does not suggest that such compensation would be unavailable in an expropriation claim absent a SC. Each case is different: as such, the circumstances of a case may lead to an award of full compensation. However, what the decisions above do confirm on the SC is that a tribunal would be likely to award a higher figure in favour of the claimant, in a case of expropriation or nationalisation where there is a SC prohibiting either of these acts. This is because the SC provides the IOC a legitimate expectation, and such expectation is compensable. This was the position in the *Aminoil* decision above. Where there is a breach of a SC (in the absence of expropriation or nationalisation), the IOC's claim is simply for breach of contract. The SC cannot provide any form of enhanced or increased compensation.

Given the concerns on the practical effectiveness of the SC, the next section explores one method through which the SC may be given greater effectiveness, or at least greater force.

4.6. Damages provision for breach of a stabilisation clause

This section argues that the compensation theory of the SC can be strengthened where the LOTOGA specifies the amount of damages applicable in the event of a breach of contract. If the effectiveness of the SC is reduced to compensation, it is necessary for the SC to include a provision on the calculation of damages in the event of a breach of the SC. In commenting on the SC, Cameron notes that ‘a freezing clause may define the damages in the event of the state’s breach’.¹¹⁵ This thesis seeks to expand on Cameron’s idea and further argues that all forms of SC (not just the freezing SC) should expressly define how damages will be calculated. There are three benefits to this approach. Firstly, it will serve to dissuade the state from contractual breach, as the state will have to consider the significant amount of damages it has committed itself to pay in the event of a breach. Thus, the state will have to consider whether it is commercially more efficient to breach the SC or to honour its terms. Secondly, such a provision will avoid the contentious process that often accompanies the calculation of damages where there is a breach of the SC. There may, however, be claims that the provision is a penalty (this issue is addressed below). Thirdly, where the dispute proceeds to arbitration, the tribunal will already have the agreed formula for the calculation of damages, thereby saving a lot of time.

However, the damages clause presents some challenges too. First, it is anticipated that there will be instances where states may be unwilling to consent to an express provision which regulates the amount of damages for a breach of the SC. In such cases, an IOC must evaluate the risks and benefits of the LOTOGA, and

¹¹⁵ Peter D Cameron, *International Energy Investment Law: The Pursuit of Stability* (Oxford University Press 2010) 70.

determine whether it is willing to invest without such a provision. It must be noted that there are countries with high political risks where the state does not give stabilisation guarantees, yet IOCs continue to invest (eg, Brazil). The potential rewards of the investment means that IOCs may take on the LOTOGA even without a SC, if the profits outweigh the risks. For instance, Brazil has no history of expropriations in the oil and gas industry so IOCs would consider that it is low risk.

Nevertheless, where there is no opposition by the state to an express provision on damages – either because it is desperate for investment or because it is committed to abide by the SC – IOCs should consider the inclusion of a thoroughly calculated ‘SC damages provision’ as a matter of priority. The SC may be unable to prevent expropriation or unilateral change of contract; however, a SC damages provision will strengthen the value of the SC by ensuring that the IOC is duly compensated in the event of a breach.

Secondly, even where the state consents, a damages provision is at risk of engaging the penalty rule. In a contract governed by English law, a provision interpreted as a penalty is unenforceable. In *Cavendish Square Holdings BV v Talal El Makdessi*,¹¹⁶ the UKSC concluded that only provisions enlivened by a breach of contract come within the penalty rule.¹¹⁷ Therefore, one way to mitigate the risk of a challenge under the penalty rule is for IOCs to construct the provision in a way that does not limit the state from contractual amendment. The framing of the provision would provide that the state has the freedom to amend the LOTOGA even though

¹¹⁶ *Cavendish Square Holdings BV v Talal El Makdessi* [2015] UKSC 67, [2015] 3 WLR 1373 (SC).

¹¹⁷ The UKSC rejected the Australian position where a provision not triggered by a contractual breach could engage the penalty rule. *Cavendish Square Holdings BV v Talal El Makdessi* [2015] UKSC 67, [2015] 3 WLR 1373 (SC) [42] (Lord Sumption and Lord Neuberger SCJJ (with whom Lord Carnwath SCJ agreed)). The UKSC held that the Australian approach was inconsistent with established English authority and uncertain in the scope of its application.

there is a SC; however, it has to pay a specified amount to the IOC for exercising such freedom. Where the primary obligation is put in either-or terms, this is likely to avoid the penalty rule because the rule only applies to provisions triggered by a breach of contract. However, this would not be enough to avoid engaging the penalty rule in jurisdictions like Australia where the penalty rule can apply to provisions not enlivened by a breach of contract.¹¹⁸ In this case, the provision will only be enforceable if it is neither unconscionable nor extravagant, in comparison with the greatest loss the innocent party has suffered from the failure of the defaulting party to fulfil a primary stipulation.¹¹⁹ Yet, even where the LOTOGA is governed by English law, IOCs must ensure a robust protection of the provision by ensuring it serves a legitimate interest, and that it is neither unconscionable nor exorbitant.

This thesis suggests a damages provision along the following lines:

The state commits itself to ensure stable investment conditions for the IOC. Where legal, political or economic conditions compel the state to alter or affect the economic equilibrium of the LOTOGA through legislative, regulatory or other measures, the state reserves the right to effect such changes. Pursuant to this, the IOC is to receive full financial compensation for the economic detriment of the change to the investment conditions on the LOTOGA and consequently the IOC. This compensation is payable no later than 120 days from the first date the economic equilibrium of the LOTOGA was altered or affected by state action.

¹¹⁸ *Andrews v Australia and New Zealand Banking Group Ltd* [2012] HCA 30, 247 CLR 205. For a discussion, see chapter 6 of thesis, section 6.3.2.1.i. The Australian court's approach to the doctrine of penalties was reaffirmed in *Paciocco v Australia and New Zealand Banking Group Limited* [2016] HCA 28.

¹¹⁹ *ibid.*

Conclusion

The chief contention to the legal and practical effectiveness of a SC is the principle of state sovereignty, in particular PSNR. The discussion concluded that the SC has legal validity (albeit open to question), but limited practical effectiveness.

This chapter submitted that despite arguments that a SC can lead to increased compensation for an IOC, this is not necessarily the case. A significant benefit of a relevant SC in the case of a unilateral change of contract is that it gives the IOC a claim against the state. However, the SC is not providing any increased compensation, but simply a right to compensation – where there is no SC, there is no breach of contract. In the case of expropriation or nationalisation where there is a relevant SC, there is arbitral practice reflecting that the inclusion of a SC is taken into account in the calculation of damages (*Aminoil* and *AGIP*). The chapter recommended that the economic benefit of a SC can be enhanced through a ‘SC damages provision’, with a sample clause provided. This provision will likely motivate host governments to operate within the contract, or at least to strongly consider the financial implications of doing otherwise. More so, it provides a foundation for the calculation of damages by an arbitral tribunal. Stipulating the amount of compensation payable by the state in the event of a SC breach quantifies the economic value of the SC. However, it was also argued that such a provision may engage the penalty rule. It has been recommended that such a provision is framed in such a way that it is not triggered in response to a breach. The state should be given the choice to comply with the SC or to do otherwise. The choice to do otherwise is what triggers the stipulated payment, although the state’s decision to act is not classified as a breach of contract.

Framing the provision in such a manner is likely to avoid the penalty rule under English law, albeit that it will not avoid the rule under Australian law since the penalty rule there applies to provisions not triggered by a breach of contract. In such a case, the onus is on IOCs to ensure the provision is not unconscionable or extravagant, in comparison with the greatest loss the innocent party has suffered from the failure of the defaulting party to fulfil a primary stipulation. In contracts governed by English law, IOCs should also ensure that there is a legitimate interest for the imposition of the provision, and that the provision is neither unconscionable nor exorbitant, in the event that the provision is deemed to engage the penalty rule.

Finally, despite the attractions of a SC, it is no guarantee of contractual stability. LOTOGAs by their nature go through much change throughout the life of the contract; in this context both the IOC and host state must be willing to compromise and strike a balance between rigidity and flexibility. Such a balance can be achieved through the combination of stabilisation and RCs, the latter is discussed in the next chapter.

CHAPTER 5

THE RENEGOTIATION CLAUSE

Introduction

This chapter examines the extent to which a RC can be used in a LOTOGA to mitigate the risks of changing circumstances which have an adverse financial impact on the IOC. The thesis' assessment of RCs indicates that RCs are commonly used to address changes in the fiscal regime of the contract. Depending on its terms, a RC can open the door for either the state or IOC to renegotiate the LOTOGA. The chapter focuses on where the IOC is the party seeking renegotiation. This is primarily because there is little discussion in the literature on IOC-led renegotiation.

This chapter: (a) assesses how RCs can benefit IOCs; (b) evaluates the effectiveness of the RC as a contractual method of risk mitigation in LOTOGAs;¹ (c) evaluates whether the RC is more effective than a SC in reducing the risk of unilateral change of contract by the state in a LOTOGA. Further, the chapter significantly extends the analysis of RCs by prominent writers such as Cameron,² Sornarajah,³

¹ This chapter does not discuss the renegotiation process as this has been discussed in major academic texts. For a discussion on the renegotiation process, See Jeswald W Salacuse, 'Renegotiating International Project Agreements' (2000) 24(4) *Fordham International Law Journal* 1319-1370; Klaus Peter Berger, 'Renegotiation and Adaptation of International Investment Contracts: The Role of Contract Drafters and Arbitrators' (2004) 2(4) *Oil, Gas & Energy Law Intelligence (OGEL)* 1, 1-10 <www.ogel.org> accessed 09 May 2016; Piero Bernardini, 'Stabilization and adaptation in oil and gas investments' (2008) 1(1) *Journal of World Energy Law & Business* 98-112.

² Peter D Cameron, *International Energy Investment Law: The Pursuit of Stability* (Oxford University Press 2010) 83-88, 422.

³ Muthucumaraswamy Sornarajah, 'Supremacy of the Renegotiation Clause in International Contract' (1988) 5(2) *Journal of International Arbitration* 97- 114.

Kolo,⁴ Wälde⁵ and others,⁶ by looking at how political systems in host states could affect the effectiveness of the RC. The extended analysis is beneficial because it provides insight into how systems of governance may impact upon contractual methods of risk mitigation. This assessment will aid IOCs in deciding whether to include a RC in a LOTOGA, depending on the political system of the host state. The hypothesis indicates that the RC is likely to be a more effective form of risk mitigation in all three systems of governance considered, than the SC.

The discussion begins with a brief assessment on the nature of renegotiation.

5.1. The nature of renegotiation

One dictionary definition of renegotiation is that it means, ‘to negotiate again; (as for more money...) specifically: to adjust a government project price in order to eliminate or recover excessive profits’.⁷ However, renegotiation is not always premised on the recovery of excessive profits, rather it may be because changes to the economic, legal or political environment no longer make the contractual terms commercially viable

⁴ Abba Kolo and Thomas Wälde, ‘Renegotiation and Contract Adaptation in International Investment Projects: Applicable Legal Principles and Industry Practices’ (2000) 1 (1) *Journal of World Investment and Trade* 5-57.

⁵ *ibid.*

⁶ Such as Yinka Omorogbe, *The Oil and Gas Industry Exploration & Production Contracts* (Malthouse Press Limited 1997) 104-107; Jeswald W Salacuse, ‘Renegotiating International Project Agreements’ (2000) 24(4) *Fordham International Law Journal* 1319-1370; Muthucumaraswamy Sornarajah, *The Settlement of Foreign Investment Disputes* (Kluwer Law International, 2000); Jeswald W Salacuse, ‘Renegotiating International Business Transactions: the Continuing Struggle of Life Against Form’ (2001) 35 *International Lawyer* 1507-1542; Klaus Peter Berger, ‘Renegotiation and Adaptation of International Investment Contracts: The Role of Contract Drafters and Arbitrators’ (2004) 2(4) *Oil, Gas & Energy Law Intelligence (OGEL)* 1-33 <<https://www-ogel-org.ezproxid.bham.ac.uk/article.asp?key=1573>> accessed 09 May 2016; Zeyad A. Al Qurashi, ‘Renegotiation of International Petroleum Agreements’ (2005) 22(4) *Journal of International Arbitration* 261-300; Piero Bernardini, ‘Stabilization and adaptation in oil and gas investments’ (2008) 1(1) *Journal of World Energy Law & Business* 98, 101-105.

⁷ ‘renegotiate, r’ (Merriam Webster’s Dictionary Online) <<http://www.merriam-webster.com/dictionary/renegotiate>> accessed 23 April 2016. See also ‘renegotiate, r’ (*OED Online*, OUP 2019) <<https://www-oed-com.ezproxye.bham.ac.uk/view/Entry/162417?redirectedFrom=RENEGOTIATE&>> accessed 21 September 2019.

for one party. Renegotiation is common in LOTOGAs.⁸ A report by Stodder and Orr indicated that, ‘...[a]pproximately half of all long-term infrastructure investment contracts end up being renegotiated...’.⁹

Three forms of renegotiation are identified in the literature. These are; post-deal, intra-deal and extra-deal renegotiation.¹⁰ Post-deal¹¹ renegotiation occurs at the expiration of the original contract where the parties seek to renew the contract.¹² Extra-deal¹³ renegotiation occurs where the contract does not make provision for renegotiation, yet one of the contracting parties is seeking renegotiation.¹⁴ Intra-deal¹⁵ renegotiation takes place during the life of the contract where there is an express

⁸ Stephan Kröll, ‘The Renegotiation and Adaptation of Investment Contracts’ (2004) 2 (1) OGE 1, 1 <www.ogel.org.uk> accessed 23 May 2018; Jeswald W Salacuse, ‘Renegotiating International Project Agreements’ (2000) 24(4) Fordham International Law Journal 1319, 1319.

⁹ Collaboratory for Research on Global Projects (Report prepared by- S.M.M Stodder and R.J Orr), ‘Understanding Renegotiation and Dispute Resolution Experience in Foreign Infrastructure Investment’ Proceedings of the 2nd General Counsels’ Roundtable (2006) 7 Journal of World Investment & Trade 805, 806.

¹⁰ Jeswald W Salacuse, ‘Renegotiating International Project Agreements’ (2000) 24(4) Fordham International Law Journal 1319, 1319; International Trade Forum Magazine, ‘Contract Renegotiations: The Neglected Phase of the Process’ (2001) Issue 1 <<http://www.tradeforum.org/Contract-Renegotiations/>> accessed 13 June 2016; Stephan Kröll, ‘The Renegotiation and Adaptation of Investment Contracts’ (2004) 2 (1) OGE 1, 1 <www.ogel.org.uk> accessed 23 May 2018; Jeswald W Salacuse, *Seven Secrets for Negotiating with Government: How to Deal with Local, State, National, or Foreign Governments--and Come Out Ahead* (AMACOM 2008) 165; Mustapha Erkan, *International Energy Investment Law: Stability through Contractual Clauses* (Kluwer Law 2011) 150-151.

¹¹ Jeswald W Salacuse, *Seven Secrets for Negotiating with Government: How to Deal with Local, State, National, or Foreign Governments--and Come Out Ahead* (AMACOM 2008) 165.

¹² Mustapha Erkan, *International Energy Investment Law: Stability through Contractual Clauses* (Kluwer Law 2011) 150-151; International Trade Forum Magazine, ‘Contract Renegotiations: The Neglected Phase of the Process’ (2001) Issue 1 <<http://www.tradeforum.org/Contract-Renegotiations/>> accessed 13 June 2016.

¹³ International Trade Forum Magazine, ‘Contract Renegotiations: The Neglected Phase of the Process’ (2001) Issue 1 <<http://www.tradeforum.org/Contract-Renegotiations/>> accessed 13 June 2016; Jeswald W Salacuse, ‘Renegotiating International Project Agreements’ (2000) 24(4) Fordham International Law Journal 1319, 1321.

¹⁴ Mustapha Erkan, *International Energy Investment Law: Stability through Contractual Clauses* (Kluwer Law 2011) 150-151.

¹⁵ Jeswald W Salacuse, ‘Renegotiating International Project Agreements’ (2000) 24(4) Fordham International Law Journal 1319, 1321.

provision for renegotiation through a RC. This chapter is concerned with intra-deal renegotiation.

A RC facilitates the reopening of some or all of the contractual terms of an agreement. The reopening of terms would generally serve the interest of one party over the other, although a RC may be framed to serve the interests of both parties. The reopening of terms through a RC may reduce the stability of the contract as some of the original terms of the agreement would be amended following a successful renegotiation. On this basis, Peter argues that the inclusion of the RC in LOTOGAs is not beneficial to the pursuit of stability because it increases uncertainty.¹⁶ However, given the extensive duration of LOTOGAs, it is unrealistic to expect that the original terms of the agreement would always be preserved, particularly in the face of material changes which significantly affect the economic equilibrium of the agreement.¹⁷

The inclusion of a RC indicates that the LOTOGA is expected to be a changing entity, not fixed at the point of its inception. It also raises the expectation that changes in the contracting environment are not at one or other party's risk, but will allow the contract balance of risk/profitability to be reconsidered.

¹⁶ Wolfgang Peter, *Arbitration and Renegotiation of International Investment Agreements* (Second Revised and Enlarged edn, Kluwer Law International 1995) 125.

¹⁷ Although there may be LOTOGAs where the original terms of the agreement are maintained throughout the life of the contract.

It is relevant to note that the validity of the RC is not in question.¹⁸ It is ‘...a manifestation of the autonomy of the will of the parties’;¹⁹ thus it is enforceable, provided it does not contravene the public order.

5.2. The purpose of a renegotiation clause

According to Horn, renegotiation reflects a common effort by the contracting parties to adapt the agreement to a new situation through a material change of terms.²⁰ Although parties can renegotiate without a RC (extra-deal), a RC provides the legal basis for the amendment of the agreement, where specified events lead to an economic imbalance in the agreement.²¹ This economic imbalance would generally be to the detriment of one or more contracting parties (where there are multiple parties). For Qurashi, the role of a RC is to ‘...protect the foreign party by making the contract flexible and dynamic throughout its duration in order to adapt to changes in circumstances and more particularly to re-establish the contractual equilibrium of the transaction’.²² Typically, such a provision would concern fixed or automatic adaptations of the contract, usually in regards to the fiscal package, or it would specify aspects of the contract which are open to amendment in terms of rights and

¹⁸ Ahmed Z El Chiati, *Protection of Investment in the Context of Petroleum Agreements* (1987) 204 RECUEIL DES COURS/Collected courses of The Hague Academy of International Law 1, 110; Zeyad A. Al Qurashi, ‘Renegotiation of International Petroleum Agreements’ (2005) 22(4) *Journal of International Arbitration* 261, 270-274, 277, 300.

¹⁹ Ahmed Z El Chiati, *Protection of Investment in the Context of Petroleum Agreements* (1987) 204 RECUEIL DES COURS/Collected courses of The Hague Academy of International Law 1, 110.

²⁰ Norbert Horn, ‘The Concept of Adaptation and Renegotiation in the Law of the Transnational Commercial Contracts’ in Norbert Horn (ed), *Adaptation and Renegotiation of Contracts in International Trade and Finance* (Kluwer Law and Taxation 1985) 9.

²¹ Haya Rashed Al Khalifa, ‘Negotiating and Arbitrating against Government Entities’ (2003) 19(5) *Construction Law Journal* 258, 266.

²² Zeyad A. Al Qurashi, ‘Renegotiation of International Petroleum Agreements’ (2005) 22(4) *Journal of International Arbitration* 261, 261.

duties.²³ For example, a concession agreement between the State of Kuwait and Aminoil in 1961 stipulated that:

[I]f as a result of changes in the terms of concessions now in existence... an increase in benefits to Governments in the Middle East should come generally to be received by them, the Company shall consult with the Ruler whether in the light of all relevant circumstances..., any alterations in the terms of the agreements between the Ruler and the Company would be equitable to the parties.²⁴

The aim of this RC is to ensure that the agreement remains commercially attractive for the investor, although it is not clear what is the risk it seeks to protect the investor against. Also, the language of this clause is vague, as it does not specify the exact form of ‘benefits’ which must accrue to the state, nor its amount, in order to trigger the renegotiation. Presumably this vagueness is deliberate, so a wide variety of circumstances may be captured by the RC. However, such vagueness can lead to uncertainty.

Nevertheless, RCs with such vague terms are less frequently seen in modern LOTOGAs. This is because many host states, at least in some developing countries, now take on a more involved role in LOTOGAs than they did during traditional concessions. This could be through requiring the IOC to enter into joint ventures with the NOC, coupled with the use of PSCs,²⁵ and RSCs.²⁶ The inclusion of RCs with vague clauses in old LOTOGAs is likely because the parties did not think they needed a contract clause to deal with renegotiation, and could rely on the other party’s

²³ *ibid.*

²⁴ Concession Agreement between the State of Kuwait and The American Independent Oil Company (AMINOIL) 1948, as amended by the Supplementary Agreement of 1961, Article 9. <http://www.biiicl.org/files/3938_1982_kuwait_v_aminoil.pdf> accessed 7th April 2016.

²⁵ For a discussion on the PSC, see chapter 2, section 2.1.iii.

²⁶ For a discussion on the RSC, see chapter 2, section 2.1.iv.

cooperation and self-interest to enter into renegotiations. Yet, cooperation would be harder to come by where the parties are at loggerheads and there is no framework for renegotiation. The RC creates an expectation of cooperation when the need for change arises in LOTOGAs which are particularly susceptible to sharp changes in the contracting environment.

A RC can mitigate the impact of economic factors which have a material adverse effect on the economic equilibrium of the LOTOGA for an IOC. This could be where the IOC experiences severe geological challenges with the contract area which result in it expending more than the anticipated costs in the exploration and exploitative process. An example of this is the 1989 agreement between the government of Colombia and British Petroleum (BP) for the exploration and development of petroleum in the Piedemonte region. Although the contract terms had been structured for oil, more natural gas than condensate was discovered.²⁷ Also, there were difficult geological conditions.²⁸ Consequently, the original contract terms were no longer favourable to BP and it sought an extra-deal renegotiation of the agreement in 1994. Following a renegotiation process of four years (due to political pressure faced by the Colombian government) the parties reached a compromise for the production of condensate to be counted as gas.²⁹ This was because the contract did not envisage and make allowance for the possibility that gas rather than oil would be

²⁷ Generally, condensate occurs in association with natural gas. Condensate is one of the lightest crude oil. Because it is a light oil, it undergoes less refining processes than conventional crude oil. This makes it a more economical resource. Wintershall, 'How fossil fuels move the world- Condensate' <<https://www.wintershall.com/crude-oil-natural-gas/condensate.html>> accessed 03 May 2018; Schlumberger, 'Oilfield Glossary- Condensate' <<http://www.glossary.oilfield.slb.com/Terms/c/condensate.aspx>> accessed 03 May 2018.

²⁸ Abba Kolo and Thomas Wälde, 'Renegotiation and Contract Adaptation in International Investment Projects: Applicable Legal Principles and Industry Practices' (2000) 1(1) *Journal of World Investment and Trade* 5, 18.

²⁹ *ibid.*

discovered, and, under Colombian law, ‘...parties to a contract cannot be prejudiced by an omission in their contract’.³⁰ Although this case concerned an extra-deal renegotiation, it serves to illustrate how economic factors can adversely affect an IOC.

One might argue that the fact that renegotiation was possible in the BP case indicates that a RC is not that important in practice. However, this would be inaccurate. The fact that BP were successful in renegotiating extra-deal does not mean that another IOC would have the same success. Each case is unique. Thus, a prudent IOC should not rely on the presumption that the state will concede to renegotiation, even where there is a commercial imperative. A RC avoids or at least reduces the contentious process of arbitration or litigation, as well as the challenges which can accompany extra-deal renegotiation.

Although a RC also raises issues of its own regarding interpretation, such challenges can be mitigated through efficient and effective drafting. In the BP case, the absence of a RC led to a four-year renegotiation process, no doubt costing BP a lot of time and money which could otherwise have been invested into the project. In hindsight, if the contract had included a RC which specified a time limit on renegotiation, the Colombian government would have been compelled to renegotiate within the time limit or risk contractual adjustment by an expert, if that was the specified or default position in the RC. Nevertheless, the inclusion of a time limit may not always be beneficial, as it can lead to rushed negotiations. This is unlikely to result in a renegotiated agreement. In drafting the RC, parties should agree upon

³⁰ Abba Kolo and Thomas Wälde, ‘Renegotiation and Contract Adaptation in International Investment Projects: Applicable Legal Principles and Industry Practices’ (2000) 1(1) *Journal of World Investment and Trade* 5, 19.

reasonable time limits, taking account of the issues to be negotiated, rather than a blank time limit for all areas of the contract subject to renegotiation.

The RC is not a panacea to avert risks, nor does it guarantee successful renegotiations. However, its inclusion in a LOTOGA is very helpful as it provides contractual grounds for the negotiation process. Section 5.4 will discuss the arguments in favour of a RC, but prior to that, the next section explores the different types of RC.

5.3. Types of renegotiation clause

A RC can be general or specific. The former relates to the agreement at large, while the latter concerns a specific part (such as the fiscal regime) of the agreement. For instance, a specific RC could relate to the price of raw materials under the contract. It could provide that the trigger event for renegotiation is where there is a 40% increase in the price of raw materials. The trigger event is the specified economic change which must occur and affect the agreement in the specified manner.³¹ The trigger could also be a timeline, such as every five years during the contract. An example of a general RC is found in a Papua New Guinea concession agreement, which states that, ‘...the parties may from time to time by agreement in writing add to, substitute for, cancel or vary all or any of the provisions of this Agreement’.³² This does not appear to be a RC at first sight because it does not state that the parties have to renegotiate; it just provides that they can vary the agreement at any time. However, because it

³¹ Klaus Peter Berger, ‘Renegotiation and Adaptation of International Investment Contracts: The Role of Contract Drafters and Arbitrators’ (2004) 2(4) Oil, Gas & Energy Law Intelligence (OGEL) 1, 15 <www.ogel.org> accessed 09 May 2016.

³² ‘OK-Tedi’ Copper Agreement between the State of Papua New Guinea and Dampier Mining Corporation Limited 1976, Clause 42. Cited in Mustapha Erkan, *International Energy Investment Law: Stability through Contractual Clauses* (Kluwer Law 2011) 200.

indicates that the parties (and not one party) can vary the agreement, this variation would require some form of renegotiation between the parties. A more specific form of the RC is contained in a Model Qatar PSA which states:

Whereas the financial position of the Contractor has been based,..., on the laws and regulations in force at the Effective Date, it is agreed that, if any future law, decree or regulation affects Contractor's financial position, and in particular if the customs duties exceed...percent during the term of the Agreement, both Parties shall enter into negotiations, in good faith, in order to reach an equitable solution that maintains the economic equilibrium of this Agreement. Failing to reach agreement on such equitable solution, the matter may be referred by either Party to arbitration pursuant to Article 31.³³

This RC makes clear that the specific trigger is a future law or regulation affecting the contractor's financial position, and increasing custom duties by a specified percentage. However, it is not so specific as to state the degree of effect on the contractor's financial position. This RC pursues a similar objective as that in the Aminoil agreement, which is to ensure contractual equity. Both the Aminoil and Qatar RCs are framed in favour of the investor. In contrast, the Papua New Guinea RC is framed to benefit either of the contracting parties.

The specific RC is more commonly used in modern oil and gas agreements.³⁴

The type of RC used in a LOTOGA is central to whether it is able to mitigate the risk of unilateral change of contract and expropriation. Consequently, the RC must be

³³ Qatar Model Exploration and Production Sharing Agreement of 1994, Article 34.12. Cited in Klaus Peter Berger, 'Renegotiation and Adaptation of International Investment Contracts: The Role of Contract Drafters and Arbitrators' (2004) 2(4) Oil, Gas & Energy Law Intelligence (OGEL) 1, 13 <www.ogel.org> accessed 09 May 2016.

³⁴ This is because of the difficulties in constructing a general RC which is able to define the degree of economic imbalance to trigger renegotiation. Klaus Peter Berger, 'Renegotiation and Adaptation of International Investment Contracts: The Role of Contract Drafters and Arbitrators' (2004) 2(4) Oil, Gas & Energy Law Intelligence (OGEL) 1, 16 <www.ogel.org> accessed 09 May 2016. However, the lack of specificity in a general RC may be beneficial. As is commonly said, 'the devil is in the details', thus where a clause is too specific, its application may be too limited and thereby prove unhelpful to the contracting parties.

properly framed (not too general and not too specific) so that it is able to respond to material changes which affect the economic equilibrium of the LOTOGA.

5.4. What are the arguments in favour of a renegotiation clause?

Chapter 3 of the thesis discussed the impact of political and economic risks on a LOTOGA, and consequently on an IOC. This thesis argues that, contrary to other views,³⁵ the RC is a useful contractual method of mitigating the risks of unilateral change of contract and expropriation, thereby contributing to the stability of a LOTOGA.

Although other writers in favour of a RC have mentioned some of its benefits, chief of which is that it can promote the stability of a long term investment agreement,³⁶ these benefits are not so clearly enumerated. The thesis collates these benefits and provides a more robust explanation for why the RC should be included as

³⁵ For example, Erkan states that, '[r]enegotiation clauses are out of favour with IOCs because IOCs believe that after investments start, bargaining power shifts in favour of the state'. Mustapha Erkan, *International Energy Investment Law: Stability through Contractual Clauses* (Kluwer Law 2011) 193. Also, Peter indicates that investors consider that RCs reduce contract stability. Wolfgang Peter, *Arbitration and Renegotiation of International Investment Agreements* (Second Revised and Enlarged edn, Kluwer Law International 1995) 240.

³⁶ See S.K.B Asante, 'Stability of Contractual Relations in the Transnational Investment Process' (1979) 28 Int'l and Comp.L.Q. 401; Muthucumaraswamy Sornarajah, 'Supremacy of the Renegotiation Clause in International Contract' (1988) 5(2) Journal of International Arbitration, Kluwer Law international 97-114; Yinka Omorogbe, *The Oil and Gas Industry Exploration & Production Contracts* (Malthouse Press Limited 1997) 104-107; Jeswald W Salacuse, 'Renegotiating International Project Agreements' (2000) 24(4) Fordham International Law Journal 1319, 1329-1330; Muthucumaraswamy Sornarajah, *The Settlement of Foreign Investment Disputes* (Kluwer Law International 2000) 53-55; Jeswald W Salacuse, 'Renegotiating International Business Transactions: the Continuing Struggle of Life Against Form' (2001) 35 International Lawyer 1507, 1514; Klaus Peter Berger, 'Renegotiation and Adaptation of International Investment Contracts: The Role of Contract Drafters and Arbitrators' (2004) 2(4) Oil, Gas & Energy Law Intelligence (OGEL) 1, 14 <www.ogel.org> accessed 09 May 2016; Zeyad A. Al Qurashi, 'Renegotiation of International Petroleum Agreements' (2005) 22(4) Journal of International Arbitration 261, 261, 264-267, Bede Nwete, 'To what extent can renegotiation clauses achieve stability and flexibility in petroleum development contracts?' (2006) 2 International Energy Law & Taxation Review 56, 60; Piero Bernardini, 'Stabilization and adaptation in oil and gas investments' (2008) 1(1) Journal of World Energy Law & Business 98, 101-102; Mustapha Erkan, *International Energy Investment Law: Stability through Contractual Clauses* (Kluwer Law 2011) 194; Tade Oyewunmi, 'Stabilisation and Renegotiation Clauses In Production Sharing Contracts: Examining the Problems and Key Issues' (2011) 9(6) OGEL 1, 11, 22-23 <www-ogel.org> accessed 09 May 2016.

an essential contractual method of risk mitigation in LOTOGAs. Five arguments will be made in favour of the RC.

Some writers indicate that IOCs question the utility of the RC. However, it is submitted that these questions are open to doubt. For instance, Peter notes that international investors (IOCs) often consider that RCs reduce contract stability.³⁷ This is presumably because they raise the spectre of change and the expectation that the contract will have to be negotiated again in the future. Yet, the idea of legal instability due to the inclusion of a RC is arguably limited to the case where the construction of a RC leads to more uncertainty, and/or a contracting party is not operating in good faith when seeking renegotiation. Similarly, in commenting on the potential pitfalls of a RC, Salacuse states that its presence, ‘...creates a risk that one of the parties will use a renegotiation clause as a lever to force changes in provisions that, strictly speaking, are not open to revision’.³⁸ Whilst this will be true in some contexts, it will not always be the case. This assertion is supported by the fact that Salacuse goes on to state that, a RC ‘...may actually contribute to transactional stability in certain situations’.³⁹ Moreover, even without the inclusion of a RC, a state party can use its sovereign position as a lever to force contractual changes. In this context, the inclusion of a RC will aid renegotiation, although it is not a guarantee of successful renegotiation. That success is to a large extent dependent on a properly drafted RC, as well as both parties operating in good faith, motivated by a joint desire to continue with the LOTOGA.

Additionally, Qurashi argues that:

³⁷ Wolfgang Peter, *Arbitration and Renegotiation of International Investment Agreements* (Second Revised and Enlarged edn, Kluwer Law International 1995) 240.

³⁸ Jeswald W Salacuse, ‘Renegotiating International Project Agreements’ (2000) 24(4) *Fordham International Law Journal* 1319,1329.

³⁹ *ibid.*

The major concern of the foreign investor is not with the renegotiation clause *per se*, but rather with the fear that flexibility created by the insertion of the renegotiation clause could be used by the state to alter key investment conditions to its advantage.⁴⁰

Although this writer agrees with the premise of this statement, it argues that this is an irrational fear, since the state can only use a RC to its advantage if the RC has been structured to favour the state. More so, many RCs are structured to favour the IOC. Furthermore, IOCs holding to this view fail to consider that there may be legitimate economic, legal or political changes requiring changes to the LOTOGA. In such a case, the inclusion of a RC provides a framework for renegotiation. More importantly, IOCs in fear of flexibility may find themselves in delicate situations where they require the LOTOGA to respond flexibly to changed circumstances which affect the IOC's interest.⁴¹

According to Stoeber, western lawyers are wary of RCs because they affect the certainty of the contract and offend western concepts of contractual sanctity.⁴² Most IOCs are from western societies, with legal representatives from western states. It could be argued that the negative perception of RCs by western lawyers has been transferred to IOCs. However, this perception fails to take account of the fact that some producing states have a contractual culture which may not be in line with western concepts of sanctity. IOCs must pay attention to the contractual culture of the host state so as to avoid an unrealistic reliance on contractual risk mitigation,

⁴⁰ Zeyad A. Al Qurashi, 'Renegotiation of International Petroleum Agreements' (2005) 22(4) *Journal of International Arbitration* 261, 266.

⁴¹ Recall the BP-Colombia example and the Gorgon project which moved from a cost estimate of \$29 billion to actual costs of \$54 billion.

⁴² William A Stoeber, *Renegotiations in International Business Transactions: The Process of Dispute Resolution between Multinational Investors and Host Societies* (Lexington Books 1981) 27.

particularly in states where the contractual relationship is equally as important as the LOTOGA itself.

Furthermore, IOCs and others concerned that a RC may undermine stability should note that the stability of the LOTOGA is not at stake since the requirement to renegotiate is, at most, a best efforts obligation⁴³ – it is not a requirement to agree.⁴⁴

Despite the concerns about the RC, the thesis argues that it is a useful contractual method of risk mitigation which IOCs should include in their LOTOGAs with host states. The discussion now turns to the five arguments in favour of a RC.

The first argument is that a RC avoids the uncertainties and contentions which can accompany extra-deal renegotiations, particularly where the other party (state) is

⁴³ Klaus Peter Berger, 'Renegotiation and Adaptation of International Investment Contracts: The Role of Contract Drafters and Arbitrators' (2004) 2(4) Oil, Gas & Energy Law Intelligence (OGEL) 1, 21 <www.ogel.org> accessed 09 May 2016. This obligation is binding under English law. A 'best efforts' obligation can be likened to an obligation of 'reasonable endeavours'. The latter has been held to mean the same as 'best endeavours'. See *Jet2.com Limited v Blackpool Airport Limited* [2011] EWHC 1529, para 36. The decision in this case was upheld by the Court of Appeal - *Jet2.com Limited v Blackpool Airport Limited v Jet2.com Limited* [2012] EWCA Civ 417. A reasonable endeavours obligation is an undertaking by a contracting party to use reasonable efforts to bring about an event or to perform an action. See Edwin Peel, *Treitel on the Law of Contract* (14th edn, Sweet & Maxwell/Thomson Reuters 2015) 2-104-107. See also The UNIDROIT Principles of International Commercial Contracts 2016, Article 5.1.4 (2) which refers to the Duty of best efforts: 'To the extent that an obligation of a party involves a duty of best efforts in the performance of an activity, that party is bound to make such efforts as would be made by a reasonable person of the same kind in the same circumstances'. <<https://www.unidroit.org/english/principles/contracts/principles2016/principles2016-e.pdf>> accessed 10 May 2018.

⁴⁴ *The Government of the State of Kuwait v American Independent Oil Co (AMINOIL)*, (1982) 21 ILM. 976, 1004 [24]. Admittedly, the lack of a requirement to agree can lead to uncertainty and could delay the performance of the contract where the parties reach a stalemate and are unable to agree the best way forward. Indeed, it has been argued that '...renegotiation clauses are merely "agreements to agree" and, therefore, may be invalid and unenforceable under the law of many countries'. J W Carter, 'The Renegotiation of Contracts' (1999) 13 *Journal of Contract Law* 185, 188; Leon E Trakman and Kunal Sharma, 'The binding force of agreements to negotiate in good faith' (2014) 73(3) *Cambridge Law Journal* 598, 598. However, this is where the importance of linking an arbitration clause with the RC comes in. Where the parties are unable to agree, the RC may expressly give power to an arbitral tribunal to adjust the contract where there is a dispute on contractual adjustment. This serves to reduce the risk of uncertainty, should the parties fail to agree. This was the position stipulated in the earlier discussed Model Qatar Production Sharing Agreement, Article 34.12 in section 5.3 above.

not in favour of renegotiation.⁴⁵ Where there is a RC, it will stipulate which changes will give rise to renegotiation and the trigger event that must occur. Even where the RC does not address the circumstances for which the IOC may seek renegotiation, the inclusion of a RC serves to indicate that the parties have contemplated some form of changes to the agreement. To maximise the benefit of a RC, IOCs must focus on its effective drafting; this will mitigate problems relating to interpretation, enforcement, cooperation and remedy.

Critics of the RC may argue that where there is a commercial imperative to renegotiate, this is enough to compel renegotiation even in the absence of a RC. This view has two failings. Firstly, it assumes that both parties will have a shared interest in renegotiating. Whilst this could be the case, there will be instances where the other party is seeking to escape the contract and as such, is unlikely to view renegotiation as a commercial imperative. Secondly, even where there is a commercial imperative, one party will generally have more to benefit from renegotiation; this could lead to opportunism from the other party since there is no contractual framework for renegotiation. A RC avoids, or at least reduces, both problems.

Although the inclusion of a RC does not translate to successful renegotiations, one method of possibly enhancing the benefit of a RC is to include a good faith

⁴⁵ Jeswald W Salacuse, 'Renegotiating Existing Agreements: How to Deal with "Life Struggling Against Form"' (2001) 17(4) *Negotiation Journal* 311, 313; Zeyad A. Al Qurashi, 'Renegotiation of International Petroleum Agreements' (2005) 22(4) *Journal of International Arbitration* 261, 265. The forced renegotiation of petroleum concession agreements between states and IOCs in the 1960s and 1970s is an example of extra-deal renegotiation. These were state-led, with many of these cases revolving around the Organisation of Petroleum Exporting Countries (OPEC).

obligation in negotiations.⁴⁶ An example of this is contained in a Qatar Model PSA.⁴⁷ However, English law does not recognise a general duty for contractual parties to act in good faith, either during negotiations or in the performance of the contract.⁴⁸ This is because of the difficulties in quantifying good faith, the resulting uncertainty, and the recognition that contracting parties are allowed to seek to pursue their own commercial interest.⁴⁹ An express agreement to negotiate in good faith also faces challenges with enforcement because it could be difficult to know when the duty has been breached or what constitutes bad faith.⁵⁰ More importantly, it is generally

⁴⁶ Good faith is typically described as promoting loyalty, honesty or fidelity to the contract. Jeannie Marie Paterson, 'Good Faith Duties in Contract Performance' (2014) 14(2) Oxford University Commonwealth Law Journal 283, 285, 292.

⁴⁷ 'Whereas the financial position of the Contractor has been based,..., on the laws and regulations in force at the Effective Date, it is agreed that, if any future law, decree or regulation affects Contractor's financial position, and in particular if the customs duties exceed...percent during the term of the Agreement, both Parties shall enter into negotiations, **in good faith**, in order to reach an equitable solution that maintains the economic equilibrium of this Agreement. Failing to reach agreement on such equitable solution, the matter may be referred by either Party to arbitration pursuant to Article 31'. Qatar Model Exploration and Production Sharing Agreement of 1994, Article 34.12. Cited in Klaus Peter Berger, 'Renegotiation and Adaptation of International Investment Contracts: The Role of Contract Drafters and Arbitrators' (2004) 2(4) Oil, Gas & Energy Law Intelligence (OGEL) 1, 13 <www.ogel.org> accessed 09 May 2016 (emphasis added).

⁴⁸ *Walford v Miles* [1992] 2 AC 128; Hugh G Beale (ed), *Chitty on Contracts* Volume I: General Principles (31st edn, Sweet & Maxwell 2012) para 1-039. See also Pedro Barasnevicius Quagliato, 'The duty to negotiate in good faith' (2008) 50(5) International Journal of Law and Management 213, 213; Jeannie Marie Paterson, 'Good Faith Duties in Contract Performance' (2014) 14(2) Oxford University Commonwealth Law Journal 283, 285; Ronnie King and others, 'A leap of faith - the meaning of good faith in commercial contracts' (Ashurt, 09 February 2017) <<https://www.ashurst.com/en/news-and-insights/legal-updates/a-leap-of-faith---the-meaning-of-good-faith-in-commercial-contracts/>> accessed 04 July 2018; Chris Parker, Gregg Rowan and Nick Pantlin, 'How far can you act in your own self-interest? The role of good faith in commercial contracts' (Herbert Smith Freehills: Contract Disputes Practical Guide February 2016, Issue 4) <<http://hsfnotes.com/litigation/wp-content/uploads/sites/7/2016/01/Contract-disputes-practical-guides-4-Good-faith.pdf>> accessed 16 July 2018. However, there is such a general duty in France, Germany, the Netherlands, as well as the US, Canada and Australia. In English law, duties of good faith can arise in consumer contracts as well as other contexts, but these are different from commercial contracts and as such will not be discussed.

⁴⁹ *Walford v Miles* [1992] 2 AC 128; *Bates v Post Office Ltd* (No. 3) [2019] EWHC 606 (QB); Ronnie King and others, 'A leap of faith - the meaning of good faith in commercial contracts' (Ashurt, 09 February 2017) <<https://www.ashurst.com/en/news-and-insights/legal-updates/a-leap-of-faith---the-meaning-of-good-faith-in-commercial-contracts/>> accessed 04 July 2018; Chris Parker, Gregg Rowan and Nick Pantlin, 'How far can you act in your own self-interest? The role of good faith in commercial contracts' (Herbert Smith Freehills: Contract Disputes Practical Guide February 2016, Issue 4) <<http://hsfnotes.com/litigation/wp-content/uploads/sites/7/2016/01/Contract-disputes-practical-guides-4-Good-faith.pdf>> accessed 16 July 2018.

⁵⁰ *ibid.*

difficult to hold states to a duty of good faith because there is no international caselaw where a state has been found to breach a duty of good faith.

Notwithstanding, it may be possible for the good faith obligation to be given a concrete meaning by the contract context. An example is a long-term agreement requiring close cooperation on both sides, relational contracts.⁵¹ In *Bates v Post Office LTD*,⁵² the judge set out nine tests for determining whether a contract was relational.

These are:

1. There must be no specific express terms in the contract that prevents a duty of good faith being implied into the contract.
2. The contract will be a long-term one, with the mutual intention of the parties being that there will be a long-term relationship.
3. The parties must intend that their respective roles be performed with integrity, and with fidelity to their bargain.
4. The parties will be committed to collaborating with one another in the performance of the contract.
5. The spirits and objectives of their venture may not be capable of being expressed exhaustively in a written contract.
6. They will each repose trust and confidence in one another, but of a different kind to that involved in fiduciary relationships.
7. The contract in question will involve a high degree of communication, co-operation and predictable performance based on mutual trust and confidence, and expectations of loyalty.
8. There may be a degree of significant investment by one party (or both) in the venture. This significant investment may be, in some cases, more accurately described as substantial financial commitment.
9. Exclusivity of the relationship may also be present.⁵³

In the absence of an express term prohibiting an implied duty of good faith, it is argued that a LOTOGA between a state and an IOC-IOC will have most of the characteristics listed (1-9) above. This is because: it is long term (2); it requires

⁵¹ *Yam Seng Pte Ltd v International Trade Corp Ltd* [2013] EWHC 111. Yam Seng determined that there was some scope to imply a term of good faith in some circumstances. Also, in *Bates v Post Office Ltd* (No. 3) [2019] EWHC 606 (QB), it was held that English caselaw supports the concept that a doctrine of good faith should apply to 'relational contracts'.

⁵² (No. 3) [2019] EWHC 606 (QB).

⁵³ *Bates v Post Office Ltd* (No. 3) [2019] EWHC 606 (QB) [725].

integrity and collaboration between the parties in the performance of operations (3 and 4); the duration and complexity of a LOTOGA means it is not possible to exhaust its spirits and objectives in a written contract (5); both parties require a level of trust and confidence in each other in regards to payment, performance and general conduct (6); in order for operations to proceed smoothly, there will be a high level of communication and co-operation between the parties, as well as an expectation of predictable performance (7) and, there is significant financial investment on the part of the IOC (8). Finally, although there may not be an exclusive relationship between the state and the IOC, this is not detrimental to the argument that the LOTOGA is a relational contract. In providing this non-exhaustive list, the judge expressed that ‘... many of these characteristics will be found to be present where a contract is a relational one’.⁵⁴ A LOTOGA between a state and an IOC has almost all of the characteristics listed. Therefore, this writer argues that it is a relational contract, in which case, an implied duty of good faith may apply.

However, the complexity of LOTOGAs and the sophistication of the contracting parties are arguments which go against an implied duty of good faith and support an expressly defined duty of good faith. If the parties intend to have such a duty in the LOTOGA, it should be clearly expressed in the written contract. An express duty of good faith is more likely to be upheld by a court than an implied duty of good faith.

⁵⁴ *ibid* [726].

Additionally, in *Petromec Inc v Petroleo Brasileiro SA Petrobras*,⁵⁵ obiter comments from the Court of Appeal indicated that an express obligation to negotiate in good faith may be enforceable in some instances.⁵⁶ The case concerned an agreement to negotiate in good faith on the cost of an upgrade to an offshore oil platform. It was held that the dispute could be assessed objectively, and the court could identify the possible result of negotiations in good faith, even in the absence of agreement by the parties. The court could objectively determine the extra costs of the upgrade.⁵⁷

Although IOCs would still be faced with the problem of proving that a state was acting in bad faith during negotiations, the inclusion of a good faith obligation with an objective criteria may assist the IOC's claim that the obligation is enforceable. Furthermore, despite the practical limitations of the good faith obligation, it is better to include it in the LOTOGA as its inclusion may encourage state compliance. States will be cautious to avoid acting in a manner which could be described as bad faith if or when a dispute proceeds to arbitration. More importantly, where such an agreement

⁵⁵ [2005] EWCA Civ 891.

⁵⁶ The court commented that, 'It would be a strong thing to declare unenforceable a clause into which the parties have deliberately and expressly entered'. *Petromec Inc v Petroleo Brasileiro SA Petrobras* [2005] EWCA Civ 891 [121] (Longmore LJ).

⁵⁷ This was quite different to obligations of good faith concerning 'agreements to agree' the terms of further agreements. This was the position in two subsequent cases, where it was held that the express requirements to negotiate in good faith did not give rise to enforceable obligations. *Barbudev v Eurocom Cable Management Bulgaria EOOD* [2012] EWCA Civ 548 and *Charles Shaker v Vistajet Group Holdings SA* [2012] EWHC 1329 (Comm). The relevant clause in *Barbudev* was contained in a side letter. It provided, 'in consideration for you agreeing to enter into the Proposed Transaction ... the Purchaser hereby agrees that ... we shall offer you the opportunity to invest in the Purchaser on the terms to be agreed between us which shall be set out in the Investment Agreement and we agree to negotiate the Investment Agreement in good faith with you'. The Court of Appeal held that this amounted to an 'agreement to agree', and it was thus unenforceable. In *Shaker*, the relevant term was in a letter of intent concerning a potential transaction concerning the purchase and operation of an aircraft. It stated, 'In the event that the Guarantor, Seller and Buyer, despite the exercise of their good faith and reasonable endeavours, fail to reach agreement, execute and deliver the Transaction Documents on or before the Cut-Off Date...the Guarantor shall within five (5) business days following the Cut-Off Date refund the Deposit to the Buyer's nominated account'. The Court held that this provision lacked an objective criteria, as such it was unenforceable.

to negotiate is recognised, failure to negotiate can be regarded as a breach giving rise to damages.

It is recommended that the good faith obligation attached to the RC should define what the parties intend for the obligation to mean, the scope of the obligation, some of the actions which parties are to take or refrain from during negotiations, and clearly defined means of discharging the obligation. This will help in advancing an argument that the provision does not fail for uncertainty. In the context of a LOTOGA, an example of this could be where a state resisting a renegotiated agreement is required to provide proof that it has engaged in a financial impact assessment, taking into account its legitimate interests and that of the IOC. The state is not required to sacrifice its own commercial interests,⁵⁸ yet it must also consider the interests of the IOC. This writer accepts that the recommendation to provide proof could potentially be a complex process; however, such a proviso (or something similar) would give more force to the RC as states are likely to take the negotiation process seriously, being less likely to act flippantly or in bad faith.

The thesis suggests a good faith obligation along the following lines:

Where the renegotiation clause is triggered, the contracting parties agree to renegotiate in good faith, with the primary purpose of arriving at a renegotiated agreement which maintains the economic equilibrium of this Agreement. Actions indicative of good faith include, but not limited to, full engagement in renegotiations, evidence-based consideration of how the trigger event has affected the economic equilibrium of the LOTOGA, the use of experienced and well-advised negotiators, timely consideration of relevant factors, clear evidence of reasonable compromise on the issue or issues renegotiated e.t.c. Where renegotiations are unsuccessful, the party resisting a renegotiated agreement must provide an impact

⁵⁸ See *Gold Group Properties Ltd v BDW Trading Ltd* [2010] EWHC 1632; Chris Parker, Gregg Rowan and Nick Pantlin, 'How far can you act in your own self-interest? The role of good faith in commercial contracts' (Herbert Smith Freehills: Contract Disputes Practical Guide February 2016, Issue 4) <<http://hsfnotes.com/litigation/wp-content/uploads/sites/7/2016/01/Contract-disputes-practical-guides-4-Good-faith.pdf>> accessed 16 July 2018.

assessment which proves that it has reasonably considered the legitimate interests of the other party seeking renegotiation, and that acquiescence to the form of renegotiation sought would amount to a disproportionate sacrifice of its own commercial interests.

This proviso is likely to deter the state from acting in bad faith or deliberately disregarding the interests of the IOC.

Additionally, it would be useful to include time-limits so that the renegotiation process is not protracted. However, this writer earlier noted⁵⁹ that time-limits must be applied cautiously; to aid rather than rush negotiations. Rushed negotiations are unlikely to yield a renegotiated agreement.

The second argument is that an IOC can benefit from the inclusion of a RC where the state, due to economic, political and/or legal reasons, seeks unilaterally to amend the contract or expropriate the investment. In such a case, where there is no RC, there is nothing explicitly restricting the state from carrying out such adverse action, unless there is a SC.

Although the state is required to abide by the principles of international investment law (such as due process or non-discrimination) since the LOTOGA is an international investment, the application of public international law principles depends on whether the agreement has been subjected to these principles. For example, international law recognises and accepts that a state has the right to expropriate an investment.⁶⁰ However, a lawful expropriation must follow the

⁵⁹ See section 5.2 above.

⁶⁰ See United Nations Charter of Economic Rights and Duties of States Resolution 3281 (1975); A.F.M Maniruzzaman, 'Expropriation of Alien Property and the Principle of Non-Discrimination in International Law of Foreign Investment: An Overview' (1998) 8 *Journal of Transnational Law and Policy* 57-77; Ernest E Smith and others, *Materials on International Petroleum Transactions* (Rocky Mountain Mineral Law Foundation 2010) 286-296; Muthucumaraswamy Sornarajah, *The International Law on Foreign Investment* (3rd edn, Cambridge University Press 2010) 375; Rudolph Dolzer and Christopher Schreuer, *Principles of International Investment Law* (2nd edn, Oxford University Press 2012) 98-129.

principles of due process, be non-discriminatory, carried out for a public purpose,⁶¹ and followed by compensation to the investor.⁶² The application of these principles can also depend on whether there is an applicable treaty between the host state and the home state of the IOC. Yet, there is a degree of uncertainty about the application of the principles from international law or treaty. For instance, the LOTOGA may not qualify for protection under a relevant treaty because the IOC does not meet the criteria of 'nationality'.⁶³ The uncertainty surrounding the application of international law principles makes the SC appear as a better form of protection against unilateral change of contract and/or expropriation. However, the discussion in chapter 4 indicated that the SC is unable to actually prevent the state from affecting the contract, or from unilateral amendment or expropriation. In contrast, irrespective of any challenges to the effectiveness of a RC, where there is a relevant RC, the state has a contractual obligation to first renegotiate with the IOC before carrying out such action. Although renegotiation could increase the financial costs of the project (at least from the IOC's perspective), the RC seeks to ensure that the state and the IOC

⁶¹ 'Nationalization, expropriation or requisitioning shall be based on grounds or reasons of public utility, security or the national interest which are recognized as overriding purely individual or private interests, both domestic and foreign. In such cases the owner shall be paid appropriate compensation, in accordance with the rules in force in the State taking such measures in the exercise of its sovereignty and in accordance with international law...' General Assembly Resolution 1803 (XVII) of 14 December 1962, 'Permanent sovereignty over natural resources' Article 4 <http://legal.un.org/avl/ha/ga_1803/ga_1803.html> accessed 05 June 2018. See also R. Doak Bishop, James Crawford and W. Michael Reisman, *Foreign Investment Disputes: Cases, Materials and Commentary* (2nd edn, Kluwer Law International 2014) 14-15.

⁶² *ibid*; Rudolph Dolzer and Christopher Schreuer, *Principles of International Investment Law* (2nd edn, Oxford University Press 2012) 100.

⁶³ The standards of protection guaranteed in a treaty (bilateral or multilateral) can only be enjoyed by nationals of the state parties to the treaty. The determination of corporate nationality can be quite complex. The treaty would indicate the criteria for determining corporate nationality. Generally, this would relate to the place of incorporation of the business or the main seat of the business. Some treaties also require a controlling interest of nationals to establish corporate nationality- see for example the Bilateral Investment Treaty between Moldova and the United States 1994, and the Bilateral Investment Treaty between Ecuador and France 1994. The variations in the determination of nationality create some degree of uncertainty as to whether the investment (LOTOGA) will be protected. Rudolph Dolzer and Christopher Schreuer, *Principles of International Investment Law* (2nd edn, Oxford University Press 2012) 44-49.

have the opportunity to discuss the realities facing the LOTOGA before things reach crisis level and end in either unilateral change of contract or expropriation.⁶⁴

The third argument is that states may be more willing to comply with a RC than a SC because it does not challenge state sovereignty. A RC is by nature different to the SC because it seeks to accommodate change rather than prevent it. Suppose a LOTOGA includes a tax SC whereby the tax rate is fixed at 10%. The state later increases the tax rate to 20% and applies this increase to the LOTOGA. This increase is a breach of the SC. However, the LOTOGA also includes a RC, which is triggered by the change in the tax rate. In this case, the SC has failed to prevent change, but it has triggered the RC. The benefit of the RC is that it creates an opportunity for the parties to negotiate an appropriate middle ground.

The success of operations is dependent not only on the skill and expertise of the IOC, but also on the ability of the contracting parties to maintain a good working relationship. This is not to suggest that party relationships are more important than contractual terms, but rather that both are equally important.

The fourth argument is that a RC may have the psychological effect of making it easier to commence dialogue over other possible changes to the agreement. By envisaging changes to one or more areas of the LOTOGA, the RC sets the idea that the contract is intended to be flexible and responsive to changes. Therefore, where other areas of the LOTOGA not covered by a RC are adversely affected by changes, the IOC may find it easier to request extra-deal renegotiation because other areas of the contract are subject to renegotiation. Furthermore, where the parties have previously engaged in renegotiation due to the inclusion of a RC, a familiarity is

⁶⁴ Modern SCs which include renegotiate would also achieve this objective.

created in the working relationship, such that it is easier to engage in other renegotiations. Yet, this does not mean that the state will accede to extra-deal renegotiations.

The fifth argument in favour of a RC is that it gives the IOC power to bring the state to the negotiating table. This is related to bargaining power. Where there is a change in the law which adversely affects the LOTOGA, without a RC an IOC would be at the mercy of the state. This is particularly the case where the IOC requires renegotiation at a time when the bargaining power favours the state. One can define bargaining power as the ability to exert influence over another during negotiations by virtue of an advantage. In this context, the IOC's initial advantage is that it is bringing investment into the state; therefore, it will typically have a stronger bargaining power than the state during the early stages of the LOTOGA (see graph below).⁶⁵ This is because the state does not possess all the cards; it has no certainty about a commercial discovery, or whether its national oil company (if any) will acquire the expertise to operate the investment.⁶⁶ However, upon a sizeable commercial discovery the bargaining power shifts in favour of the state (this is illustrated in the graph below). As development and production progress, both parties have a vested interest in the success of operations, as well as having much to lose. Arguably, the IOC has more to lose because of its financial investment. Therefore, the state would acquire more bargaining strength as the IOC sinks more costs into the project, since the IOC would

⁶⁵ For a detailed summary of the factors which affect bargaining strength, see William A Stoeber, *Renegotiations in International Business Transactions: The Process of Dispute Resolution between Multinational Investors and Host Societies* (Lexington Books 1981) 10.

⁶⁶ *ibid.*

need to yield a sufficient return to cover its costs and also make a profit (see graph below). This is known as the obsolescing bargain.⁶⁷

At this stage, without a RC, the IOC would find it very difficult to get the state to consent to extra-deal renegotiation because it no longer has the economic bargaining power to force the state to the negotiating table. In contrast, even in the absence of a RC, the state has the ability to bring the IOC to the renegotiation table, because it has the power to adversely affect the LOTOGA through legislative and/or administrative changes (regardless of a SC). As an example, in *The Government of the State of Kuwait v American Independent Oil Co*⁶⁸ (hereafter *Aminoil*) a concession of sixty years was granted in 1948; the agreement included a SC which sought to prevent the state from unilaterally amending the agreement. The parties amended the concession twice in 1961 and 1973, both changes resulting in an increase in government 'take'. However, following an agreed formula of government 'take' by OPEC, Kuwait sought to increase its royalty take but *Aminoil* did not consent. Due to this, Kuwait nationalised the concession in 1977. Although Kuwait paid compensation, this case demonstrates the severe effects on an investment when a state elects to carry out an action in the exercise of its sovereignty. It reflects an advantage which the state as a sovereign power has over an IOC. Most importantly, this case indicates the importance of including a RC; if there had been a relevant RC in the

⁶⁷ This is the interaction between an IOC and a host state, where the initial bargain favours the IOC but over time as the IOC's fixed assets in the country increase, the bargaining power shifts to the government. See Deardorff's Glossary of International Economics, Obsolescing bargain model. <<http://www-personal.umich.edu/~alandear/glossary/o.html>> accessed 06 February 2016. However, the relevance of the obsolescing bargain in the relationship between IOC and host states has been disputed. See Ravi Ramamurti, 'The Obsolescing 'Bargaining Model'? MNC-Host Developing Country Relations Revisited' (2001) 32(1) *Journal of International Business Studies* 23-29. Nevertheless, Cameron argues that the obsolescing bargain remains relevant in the energy sector. See Peter D Cameron, 'Stabilization and the impact of changing patterns of energy investment' (2017) 10 *Journal of World Energy Law and Business* 389, 392.

⁶⁸ (1982) 21 ILM. 976.

agreement, the state would have been under an obligation to renegotiate the agreement before carrying out such a nationalisation.⁶⁹

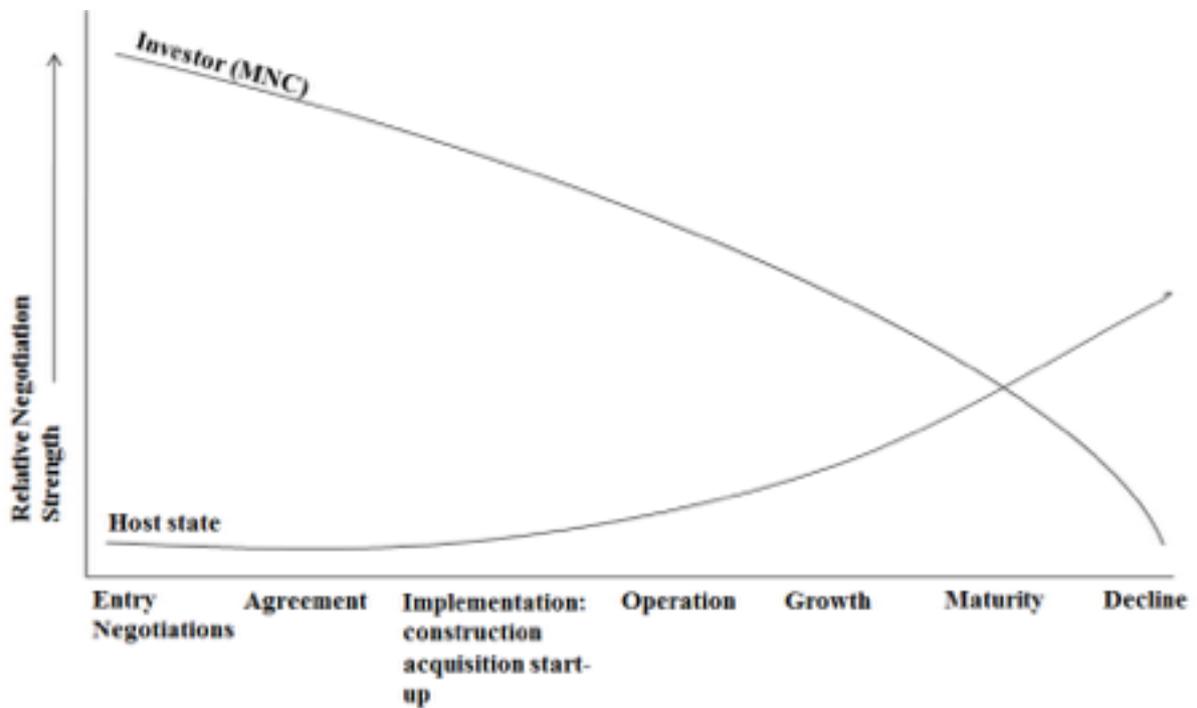
Therefore, to avoid placing themselves in such a precarious position, it is prudent for IOCs to include a RC in the LOTOGA. A RC gives the IOC power to bring the state to the negotiating table.⁷⁰

The graph below illustrates the shift in the bargaining power of both parties throughout the life of the project.

⁶⁹ Whether such renegotiation is successful or not is another matter.

⁷⁰ Yet, the typical position on bargaining power and timing may not apply where the project encounters severe complications, say in the geology of the reservoir. In such a case, the state may be willing to renegotiate (extra-deal) to the advantage of the IOC in view of the difficulty in commissioning a different IOC to take on a complex project.

Figure 1. Changes in Negotiating Strength of Investor and Host Country over the Project Life Cycle



Source: Stoever W.A, 'Renegotiations'⁷¹

MNC- Multinational corporation

⁷¹ William A Stoever, *Renegotiations in International Business Transactions: The Process of Dispute Resolution between Multinational Investors and Host Societies* (Lexington Books 1981) 9-11.

Finally, the inclusion of modern SCs (risk allocation and economic rebalancing) in LOTOGAs is an acceptance of the reality that, for such agreements to survive, provisions must be made to accommodate certain changed circumstances which adversely affect the contract. These modern forms of SC are useful in accommodating changed circumstances because they have an element of flexibility. The previous chapter noted that apart from the freezing SC, the other forms of SC envisage some form of renegotiation between the contracting parties. Therefore, this poses the question: what distinguishes a RC from a SC? A SC targets unilateral change of contract by the state, as well as expropriation. Although a RC can also address these risks, it is targeted at a broad range of changes which affect the LOTOGA, such as a persistent decline in oil prices. Depending on how the RC is framed, the IOC may be able to seek a renegotiation of fiscal terms with the state so as to adjust the economic equilibrium of the LOTOGA. A SC cannot assist an IOC in such circumstances because the state has not changed/affected the contract. The advantage of the RC over modern forms of SC is that it can mitigate the risks of changes which affect the LOTOGA, even where the change is not the result of state action. Additionally, the RC is more flexible.

Further, both the economic rebalancing and risk allocation SC would specify the best future course of action to take when specified circumstances occur. This could be through requiring the NOC to take on the burden created by changed circumstances or to require the state to adjust the agreement in order to restore the economic balance. Yet, in practice, neither of the specified options might be entirely appropriate or possible when the specified circumstances arise in the future. Although the intangibility SC also requires the state to seek the consent of the IOC before amending

the contract, the state may find grounds on which it could argue that the IOC unreasonably withheld its consent. Moreover, the requirement to seek consent may not always translate to extensive renegotiation, as in the case of a RC. Furthermore, where the state is seeking to alter the LOTOGA due to nationalistic persuasions, the requirement to seek the consent of an IOC may be considered an affront to the sovereignty of the state. A RC is likely to be viewed more amicably.

It is recommended that IOCs should not exclude a RC for fear that it may threaten the stability of the agreement. Rather, IOCs should focus on the effective drafting of the RC, so that it facilitates the survival and efficient performance of the contract, without jeopardising stability or creating more uncertainties.⁷²

5.5. Can a renegotiation clause complement a stabilisation clause?

The main argument against the RC in LOTOGAs is that it can undermine the stability of the agreement. The discussion in the previous section has endeavoured to show that a RC can mitigate the risks of unilateral change of contract and expropriation in LOTOGAs, thereby contributing to the stability of the LOTOGA. By suggesting that changes in the environment (eg, economy, geology of the field) will lead to changes in the agreement, not its entire abandonment – the RC attempts to keep the relationship going. This section contributes to the central argument of the chapter by demonstrating the complementary role of the RC with the SC. The ability of these clauses to work in harmony reveals that the RC is not a threat to stability, but an aid.

⁷² For a discussion on the construction of the renegotiation clause, see Klaus Peter Berger, 'Renegotiation and Adaptation of International Investment Contracts: The Role of Contract Drafters and Arbitrators' (2004) 2(4) Oil, Gas & Energy Law Intelligence (OGEL) 1, 13-16 <www.ogel.org> accessed 09 May 2016; Zeyad A. Al Qurashi, 'Renegotiation of International Petroleum Agreements' (2005) 22(4) Journal of International Arbitration 261, 288-291; Piero Bernardini, 'Stabilization and adaptation in oil and gas investments' (2008) 1(1) Journal of World Energy Law & Business 98-112.

Al Qurashi indicates that the protection of foreign investment in a way that stabilises the contractual relationship through a SC ‘...represents only half of the reality’.⁷³ Although Al Qurashi does not specify what the ‘other half’ is, his discussion points to the fact that despite attempts at stabilisation, the LOTOGA is fraught with uncertainties, such as marginal finds, oil prices etc.⁷⁴ This writer agrees and adds that, the other half of investment protection involves maintaining the contractual relationship in the face of changes which affect the original terms of the LOTOGA. It has been argued by writers such as Salacuse,⁷⁵ Asante,⁷⁶ Sornarajah,⁷⁷ and others⁷⁸ that a RC can actually contribute to the stability of a long term agreement. Thus, if it contributes to stability, it is by nature complementary to a SC. However, this complementary nature is not so clearly expressed in the literature, rather it must be teased out. This thesis provides a more robust explanation.

⁷³ Zeyad A. Al Qurashi, ‘Renegotiation of International Petroleum Agreements’ (2005) 22(4) *Journal of International Arbitration* 261, 264.

⁷⁴ *ibid* 264-265.

⁷⁵ Jeswald W Salacuse, ‘Renegotiating International Project Agreements’ (2000) 24(4) *Fordham International Law Journal* 1319, 1329.

⁷⁶ S.K.B Asante, ‘Stability of Contractual Relations in the Transnational Investment Process’ (1979) 28 *Int’l and Comp.L.Q.* 401, 401.

⁷⁷ Muthucumaraswamy Sornarajah, ‘Supremacy of the Renegotiation Clause in International Contract’ (1988) 5(2) *Journal of International Arbitration*, *Kluwer Law international* 97-114.

⁷⁸ See Zeyad A. Al Qurashi, ‘Renegotiation of International Petroleum Agreements’ (2005) 22(4) *Journal of International Arbitration* 261, 261, 264-267, Bede Nwete, ‘To what extent can renegotiation clauses achieve stability and flexibility in petroleum development contracts?’ (2006) 2 *International Energy Law & Taxation Review* 56, 60; Piero Bernardini, ‘Stabilization and adaptation in oil and gas investments’ (2008) 1(1) *Journal of World Energy Law & Business* 98, 101-102; Mustapha Erkan, *International Energy Investment Law: Stability through Contractual Clauses* (Kluwer Law 2011) 194; Tade Oyewunmi, ‘Stabilisation and Renegotiation Clauses In Production Sharing Contracts: Examining the Problems and Key Issues’ (2011) 9(6) *OGEL* 1, 11, 22-23 <www.ogel.org> accessed 09 May 2016.

5.5.1. The interaction between the renegotiation and stabilisation clause

‘Stabilisation’ conveys the sense that something is unlikely to change.⁷⁹ Therefore, one might assume that SCs do not envisage change. However, this is not necessarily the case. In preserving the bargained-for benefits of the LOTOGA, the SC actually has some interaction with renegotiation, even in contracts which do not include a RC. The two modern SCs discussed previously in chapter 4 (risk allocation and economic rebalancing clause⁸⁰) envisage some form of renegotiation. Sornarajah has argued that these are not SCs in the strict sense.⁸¹ This is true, because the true purpose of a SC is to preserve the original terms of the LOTOGA, rather than serve as a means through which the terms of the contract may be reopened. Despite this, it is argued that one of the traditional forms of SC (intangibility SC also discussed in chapter 4⁸²), which requires consent from the IOC before the state can amend the agreement actually envisages some form of renegotiation. In protecting its interest, an IOC may request renegotiation with the state before consenting to a significant change of contract. In view of this, it is clear that the stabilisation and RCs are not always mutually exclusive in LOTOGAs.

Additionally, Bernardini indicates the compatibility of both clauses by stating:

As an alternative to or in combination with a stabilization clause, the adaptation/renegotiation clause may offer both parties protection against

⁷⁹ For some general definitions, see <<https://dictionary.cambridge.org/dictionary/english/stabilize>>; <<https://www.thefreedictionary.com/stabilisation>>; <<http://lexicon.ft.com/Term?term=stabilisation>>; accessed 08 May 2018.

⁸⁰ For a discussion of these clauses, see chapter 4, section 4.3, iii and iv.

⁸¹ Muthucumaraswamy Sornarajah, *The International Law on Foreign Investment* (4th edn, Cambridge University Press 2017) 331.

⁸² See chapter 4 of the thesis, section 4.3, ii.

the hardship caused to either of them by a change of those circumstances which were present at the time of the conclusion of the agreement.⁸³

The importance of stability for IOCs involved in LOTOGAs cannot be overstated, in the light of the significant financial risk. However, a LOTOGA operates in the real world, a world affected by changes within and outside the host state. An attempt to totally insulate the LOTOGA from such changes may be counter-productive, particularly at a time when the IOC requires some flexibility in the terms of the LOTOGA. A combination of the stabilisation and RC in a LOTOGA is likely to better secure the financial interests of an IOC than reliance on a SC alone. The presence of a SC offers the IOC some degree of stability and an additional guarantee from the state that it is committed to preserving the original terms of the agreement. Yet, there is no guarantee that the state will not expropriate or unilaterally amend the terms of the LOTOGA. Although a RC cannot preclude a state from carrying out either of these actions, the inclusion of a relevant RC mandates dialogue. Such dialogue may be central to preventing adverse changes by the state.

The compatibility of the stabilisation and RC is further explored in the discussion of the modern RC.

5.5.2. The modern renegotiation or equilibrium clause

This section seeks to show that a modern RC is an alternative form of risk mitigation, apart from the SC and the RC. The decision to include or exclude it in a LOTOGA is a question of whether it will be effective or not. This may depend on the political

⁸³ Piero Bernardini, 'Stabilization and adaptation in oil and gas investments' (2008) 1(1) *Journal of World Energy Law & Business* 98, 101-102.

system in the host state. This point will be discussed in section 5.5.3 after the assessment of the modern RC.

The modern RC or equilibrium clause is a clause that combines a SC and RC.⁸⁴ The primary purpose of this clause is to maintain the economic equilibrium in a long term agreement.⁸⁵ An equilibrium clause seeks to reconcile the needs of the host state and the IOC by ensuring contractual stability and flexibility through the modification of the LOTOGA in order to adapt it to changed circumstances, so as to preserve the economic equilibrium of the agreement.⁸⁶

Economic equilibrium essentially means the economic bargain struck by the contracting parties at the commencement of the agreement. The Baku-Tbilisi-Ceyhan Host Government Agreements (BTC- HGAs) defines it in the following way:

“Economic Equilibrium” means the economic value to the Project Participants of the relative balance established under the Project Agreements at the applicable date between the rights, interests, exemptions, privileges, protections and other similar benefits provided or granted to such Person and the concomitant burdens, costs, obligations, restrictions, conditions and limitations agreed to be borne by such Person.⁸⁷

Alexander indicates that the modern RC/equilibrium clause can be divided into three categories: stipulated economic balancing; non-specified economic balancing;

⁸⁴ Thomas W. Wälde and George Ndi, ‘Stabilising International Investment Commitments: International Law Versus Contract Interpretation’ (1996) 31 *Tex. Int’l L. J.* 215, 265.

⁸⁵ Mustapha Erkan, *International Energy Investment Law: Stability through Contractual Clauses* (Kluwer Law 2011) 198.

⁸⁶ Bede Nwete, ‘To what extent can renegotiation clauses achieve stability and flexibility in petroleum development contracts?’ (2006) 2 *International Energy Law & Taxation Review* 56, 59.

⁸⁷ Appendix 1, The Georgian HGA; Appendix 1, The Turkish HGA; Appendix 1, The Azeri HGA, cited in A.F.M Maniruzzaman, ‘International Energy Contracts and Cross-Border Pipeline Projects: Stabilization, Renegotiation and Economic Balancing in Changed Circumstances - Some Recent Trends’ (2006) 4(4) *Oil, Gas & Energy Law Intelligence (OGEL)* 1, 12 <<https://www.ogel.org/article.asp?key=2289>> accessed 10 May 2016.

and negotiated economic balancing.⁸⁸ The first provides that contractual amendment occurs automatically according to the manner stipulated in the agreement.⁸⁹ This could be through reducing the percentage of government take of petroleum in a PSC where an additional or increased tax measure is imposed on the IOC. In the second, neither the nature nor the specific method of readjustment is stipulated in the agreement, but the effect of the readjustment will be to reestablish the economic bargain of the agreement.⁹⁰ An example of this is contained in a Suriname PSC 2011 which provides:

If any additional impositions of, or changes in the existing Tax, Royalty, Applicable Law, ...in Suriname, from and after the Signing Date, which are not of a general nature and not applicable to the general public, have the effect of adversely impacting the rights and exemptions of Contractor or adversely impacting Contractor's economic benefit in the Contract, the economic terms of the Contract shall be modified in order to maintain the economic equilibrium of this Contract so that Contractor shall receive the same economic benefit as before such imposition or change.⁹¹

⁸⁸ Frank C. Alexander, Jr., 'The Three Pillars of Security of Investment Under PSCs and Other Host Government Contracts' Chapter 7 in *Institute for Energy Law of the Centre for American and International Law's Fifty-Fourth Annual Institute on Oil and Gas Law* (Publication 640, Release 54), (Lexis Nexis Mathew Bender 2003) Sec. 7.03[1], 7.19; A.F.M Maniruzzaman, 'International Energy Contracts and Cross-Border Pipeline Projects: Stabilization, Renegotiation and Economic Balancing in Changed Circumstances - Some Recent Trends' (2006) 4(4) *Oil, Gas & Energy Law Intelligence (OGEL)* 1, 1-2 <<https://www.ogel.org/article.asp?key=2289>> accessed 10 May 2016; Elizabeth Eljuri and Clovis Trevino, 'Political Risk Management in Light of Venezuela's Partial Nationalisation of the Oil Field Service Sector' (2010) 28 *Journal of Energy and Natural Resources Law* 375, 388.

⁸⁹ Frank C. Alexander, Jr., 'The Three Pillars of Security of Investment Under PSCs and Other Host Government Contracts' Chapter 7 in *Institute for Energy Law of the Centre for American and International Law's Fifty-Fourth Annual Institute on Oil and Gas Law* (Publication 640, Release 54), (Lexis Nexis Mathew Bender 2003) Sec. 7.19.

⁹⁰ *ibid.*

⁹¹ Production Sharing Contract For Petroleum Exploration, Development and Production relating to Block 45 Offshore Suriname Between Staatsolie Maatschappij Suriname N.V. and Kosmos Energy Suriname 2011, Article 18.4.2 <<http://www.resourcecontracts.org/contract/ocds-591adf-8649797663/view#/pdf>> accessed 06 April 2018.

Also, where there is a NOC involved in the agreement, the NOC may be required to indemnify the IOC against any economic disadvantage or loss suffered as a result of a change in law or regulations affecting the agreement.⁹²

In the third and final category, where an action of the state adversely affects the original economic equilibrium of the agreement, the parties have an obligation to discuss the manner of the amendment necessary to restore the economic equilibrium.⁹³ For example, a Kurdistan PSC 2011 provides that:

The GOVERNMENT guarantees to the CONTRACTOR, for the entire duration of this Contract, that it will maintain the stability of the legal, fiscal and economic conditions of this Contract...If, at any time after the Effective Date, there is any change in the legal, fiscal and/or economic framework... which detrimentally affects the CONTRACTOR,... the terms and conditions of the Contract shall be altered so as to restore the CONTRACTOR, ... to the same overall economic position... as that which such Person would have been in, had no such change in the legal, fiscal and/or economic framework occurred.⁹⁴

⁹² An example of this is found in an Azeri Production Sharing Contract. It provides that: 'The rights and interests accruing to Contractor (or its assignees) under this Agreement and its Sub-contractors under this Agreement shall not be amended, modified or reduced without the prior consent of Contractor. In the event that any Governmental Authority invokes any present or future law, treaty, intergovernmental agreement, decree or administrative order which contravenes the provisions of this Agreement or adversely or positively affects the rights or interests of Contractor hereunder, including, but not limited to, any changes in tax legislation, regulations, or administrative practice, the terms of this Agreement shall be adjusted to re-establish the economic equilibrium of the Parties, and if the rights or interests of Contractor have been adversely affected, the SOCAR shall indemnify the Contractor (and its assignees) for any disbenefit, deterioration in economic circumstances, loss or damages that ensue therefrom. SOCAR shall within the limits of its authority use its reasonable lawful endeavors to ensure that the appropriate Governmental Authorities will take appropriate measures to resolve promptly in accordance with the foregoing principles any conflict or anomaly between all such treaty, intergovernmental agreement, law, decree or administrative order and this Agreement.' Agreement dated 19 April 1999 on the Exploration Development and Production sharing for the Block including the Padar Area and the Adjacent Prospective Structures in the Azerbaijan Republic between the State Oil Company of Azerbaijan and Kura Valley Development Company Ltd. And Socar Oil Affiliate (Azerbaijan), Barrows, (Article 24.2). [Cited in A.F.M Maniruzzaman, 'International Energy Contracts and Cross-Border Pipeline Projects: Stabilization, Renegotiation and Economic Balancing in Changed Circumstances - Some Recent Trends' (2006) 4(4) Oil, Gas & Energy Law Intelligence (OGEL) 1, 3 <<https://www.ogel.org/article.asp?key=2289>> accessed 10 May 2016].

⁹³ Frank C. Alexander, Jr., 'The Three Pillars of Security of Investment Under PSCs and Other Host Government Contracts' Chapter 7 in *Institute for Energy Law of the Centre for American and International Law's Fifty-Fourth Annual Institute on Oil and Gas Law* (Publication 640, Release 54), (Lexis Nexis Mathew Bender 2003) Sec. 7.19.

⁹⁴ Production Sharing Contract Garmian Block Kurdistan Region Between The Kurdistan Regional Government of Iraq And Westernzagros Limited 2011, Article 43.3 <<http://www.resourcecontracts.org/contract/ocds-591adf-9205170350/view#/pdf>> accessed 06 April 2018.

As to the mode of rebalancing, Article 43.4 of the same agreement provides that, ‘...[T]he Parties shall meet to agree on any necessary measures or making any appropriate amendments to the terms of this Contract to re-establishing the equilibrium between the Parties’.⁹⁵ This envisages that there will be negotiation between the parties as to the mode of rebalancing.⁹⁶

Overall, the modern RC is reminiscent of an economic rebalancing SC which allows a readjustment of the agreement where an action of the state adversely affects the anticipated financial gain of the IOC. The benefit of a modern RC is that it does not challenge the sovereignty of the state, but rather seeks to maintain the original economic bargain which the contracting parties struck at the commencement of the agreement.

On the one hand, the principle of state sovereignty consistently undermines the effectiveness of a SC. On the other hand, the RC faces criticism about creating uncertainty in the LOTOGA, although this thesis has argued otherwise. The modern RC is an alternative form of contractual risk mitigation which attempts to combine the best of the SC and RC, by balancing the interests of the IOC and those of the state. Yet, this does not indicate that the modern RC would be more effective than the SC or

⁹⁵ *ibid* Article 43.4.

⁹⁶ Another example is an Egyptian concession agreement of 2002. It provides that: ‘In case of changes in existing legislation or regulations applicable to the conduct of Exploration, Development and Production of petroleum, which take place after the Effective Date, and which significantly affect the economic interest of this Agreement to the detriment of CONTRACTOR or which imposes on CONTRACTOR an obligation to remit to the A.R.E. the proceeds from sales of CONTRACTOR’s Petroleum, CONTRACTOR shall notify FGPC of the subject legislative and regulatory measure. In such case, the Parties shall negotiate possible modifications to this Agreement designed to restore the economic balance thereof which existed on the Effective Date’. Concession Agreement of 2002 for Petroleum Exploration and Exploitation between Egypt & Egyptian General Petroleum Corporation & Dover Investments Limited (East Wadi Araba Area Gulf of Suez), Barrows, (Article XIX). [Cited in A.F.M Maniruzzaman, ‘International Energy Contracts and Cross-Border Pipeline Projects: Stabilization, Renegotiation and Economic Balancing in Changed Circumstances - Some Recent Trends’ (2006) 4(4) Oil, Gas & Energy Law Intelligence (OGEL) 1,4 <<https://www.ogel.org/article.asp?key=2289>> accessed 10 May 2016.

RC. The thesis argues that a significant factor which can affect the effectiveness of all three clauses (SC, RC and modern RC) is the political system in the host state.

5.5.3. How the system of governance in the host state can affect the effectiveness of the stabilisation, renegotiation and modern renegotiation clause

The central argument made in this section is that the effectiveness of a SC, RC or modern RC in a LOTOGA may depend on the political system of the host state. Three systems of governance will be assessed. These have been identified in the literature as: dysfunctional societies; authoritarian regimes and western-style democracies.⁹⁷

i. Dysfunctional states

Generally, this is a political system where the central authority is unable to exercise adequate control over society and the legislative system is undermined and compromised by local, regional, religious and cultural differences.⁹⁸ The main problem in such societies is the lack of stability and security.⁹⁹ This can have adverse effects on a LOTOGA. Kuang identifies Somalia and Afghanistan as examples of dysfunctional states.¹⁰⁰ According to a global report, both states also have very high risks of expropriation.¹⁰¹

⁹⁷ Arve Throvik, 'Political risk in large projects' in Thomas J Dimitroff (ed), *Risk and Energy Infrastructure: Cross-border dimensions* (Globe Law and Business 2011) 35.

⁹⁸ *ibid* 36.

⁹⁹ *ibid*.

¹⁰⁰ Cliff Kuang, 'Infographic of the Day: The World's Most Dysfunctional Countries, Ranked' (21 June 2010) <<http://www.fastcompany.com/1662264/infographic-day-worlds-most-dysfunctional-countries-ranked>> accessed 06 July 2016.

¹⁰¹ The Global Economy, 'Expropriation Risk- country rankings' <https://www.theglobaleconomy.com/rankings/Expropriation_risk/> accessed 23 May 2018.

Also, pertinent to the issue at hand is the doctrine of separation of powers.¹⁰² This exists to prevent the concentration of power in government, which so often leads to dictatorship.¹⁰³ In dysfunctional states, although there may be a separation of power in the constitution, the degree to which this is followed, if at all, is limited.¹⁰⁴ The lack of adherence to this could be a reflection of the dysfunction occurring in the system. Further, dysfunctional societies tend to have corrupt governments with little or no adherence to the rule of law. Such societies tend to have ineffective systems of redress. Thus, based on this classification, many developing countries have an element of dysfunction.

Therefore, it is argued that a dysfunctional state may be unable to honour its commitment to a SC. Where there is corruption in government, the needs of the individuals in power are placed above the needs of the people or the IOC, regardless of the commitment to the SC. Thus, if a government is unwilling or unable to govern efficiently and in the best interests of its citizens, it is unlikely to restrain itself from breaching the SC if it serves its personal interests. Therefore, there is little or no value in the inclusion of SCs since the likelihood of state compliance is relatively low. A deterrent against breach of the SC is the knowledge that the state will be liable to pay lump sum damages at arbitration. Yet, in a scenario where the current government has doubts about remaining in office (where an election is imminent), it may be undeterred about the prospect of paying damages since it may not be in power at the

¹⁰² The three arms of government are the legislative, executive and judiciary. See John Locke, *Second Treatise on Civil Government* (1690) Chapter XII. This is not to say that these three institutions are entirely separate, rather that there is a clear distinction between all bodies. A reasonable amount of cooperation is necessary and expected from all institutions.

¹⁰³ 'Power tends to corrupt and absolute power corrupts absolutely...' John Emerich Edward Dalberg Acton, first Baron Acton (1834–1902).

¹⁰⁴ According to the Nigerian constitution, the doctrine of separation of powers exists. The 1999 Constitution of the Federal Republic of Nigeria, Chapter 5, 6 and 7.

time a tribunal awards damages. However, where the government will be in power at the time of an award, the prospect of lump sum damages may serve to deter a breach of the traditional or modern SC in some cases (arguably, the same can be said of a government in a stable democracy). The SC would be an effective method of risk mitigation against such governments.

Although there will be variations in each dysfunctional state, such that some may be more compliant than others, the SC will not always be the most effective contractual method of mitigating uncertainties. Dysfunctional states are susceptible to sudden changes in government, with the new government refusing to honour a SC or stabilised elements of a modern RC. Therefore, the RC is likely to be the most effective of the three clauses because of its flexibility. The RC creates the opportunity for both parties to engage in dialogue. Such dialogue may not necessarily dissuade the state from carrying out a unilateral change of contract or expropriation, but there is a chance that dialogue may lead to successful renegotiation, or at least allow the parties to find common ground.

Although corrupt governments are unlikely to abide by stringent contractual obligations which limit their regulatory and legislative powers, there remains a motivation to continue the LOTOGA because it is a source of state income, albeit that such funds may be siphoned by corrupt officials. In a sense, the enforcement of the LOTOGA is also attributable to the effectiveness of non-legal norms (keeping the money flowing in) not necessarily because of what the contract says. Thus, provided the IOC is still benefitting from the LOTOGA, both it and the state have a common goal (continued operations) and can seek to reach an agreement through dialogue.

In an investor-state dispute which proceeds to arbitration, it has been indicated that the inclusion of a SC has a practical effect, part of which is to influence the amount of compensation.¹⁰⁵ Therefore, a SC is likely to favour an IOC at arbitration. Indeed, it may persuade the state to settle the dispute before arbitration. Yet, a RC will also have the same benefit for an IOC at arbitration, particularly where the state has not complied with the RC. The state will be liable to pay damages (likely calculated on the basis of the original contract terms) to the IOC where it has failed to engage in renegotiations.¹⁰⁶ The terms of the RC must be clear on what constitutes such failure, be it non-involvement, meagre efforts or otherwise.

ii. Authoritarian regimes

An authoritarian system of government is one where the leader stands above the rule of law¹⁰⁷ and denies democratic freedoms.¹⁰⁸ It is sometimes described as an autocratic, totalitarian system or a military regime.¹⁰⁹ Hague and Harrop indicate that China's political system is deeply authoritarian, '...the party is above the law because the party makes the law'.¹¹⁰ Such regimes are characterised by the lack of popular

¹⁰⁵ For an earlier discussion, see Chapter 4, section 4.5.

¹⁰⁶ Also, the RC may provide that a third party expert adapts the contract where the parties are unable to agree on the manner of adaptation, and/or where there has been a failure to renegotiate. See Stephan Kröll, 'The Renegotiation and Adaptation of Investment Contracts' (2004) 2(1) OGEL 1,13 <www.ogel.org.uk> accessed 23 May 2018; Zeyad A. Al Qurashi, 'Renegotiation of International Petroleum Agreements' (2005) 22(4) Journal of International Arbitration 26, 292.

¹⁰⁷ Such as, freedom of expression, freedom to oppose the government and freedom of assembly. Rod Hague and Martin Harrop, *Comparative Government and Politics: An Introduction* (5th edn, Palgrave 2001) 14.

¹⁰⁸ Frank Bealey, *The Blackwell Dictionary of Political Science: A User's Guide to Its Terms* (Blackwell Publishers 1999) 21.

¹⁰⁹ *ibid.* Also, Hague and Harrop classify all forms of non-democracy under the broad category of authoritarian rule. Rod Hague and Martin Harrop, *Comparative Government and Politics: An Introduction* (5th edn, Palgrave 2001) 15.

¹¹⁰ Rod Hague and Martin Harrop, *Comparative Government and Politics: An Introduction* (5th edn, Palgrave 2001) 44.

assent, having instead one political party or individual controlling access to office.¹¹¹

Other examples include North Korea, Syria, Chad¹¹² and Saudi Arabia.¹¹³

An important factor which affects the SC and the LOTOGA as a whole is that, where there is a supreme leader as is the case in North Korea, this individual is free to change his/her perspective on foreign investment. Thus, the stability of the LOTOGA and the effectiveness of the SC may lie in the balance, according to the will of often unpredictable leaders. Throvik also indicates that from the perspective of an IOC, the biggest political risk facing a LOTOGA in authoritarian regimes is corruption.¹¹⁴ Corruption in these regimes occurs on a larger scale than in dysfunctional societies whose main risk is instability and insecurity.¹¹⁵

¹¹¹ Arve Throvik, 'Political risk in large projects' in Thomas J Dimitroff (ed), *Risk and Energy Infrastructure: Cross-border dimensions* (Globe Law and Business 2011) 38.

¹¹² The Economist Intelligence Unit, 'The Economist Intelligence Unit's Democracy Index-167 countries scored on a scale of 0 to 10 based on 60 indicators' (2017) <<https://infographics.economist.com/2018/DemocracyIndex/>> accessed 08 May 2018. (The Democracy Index is based on five categories: electoral process and pluralism; civil liberties; the functioning of government; political participation; and political culture).

¹¹³ *ibid.* In Saudi Arabia, some of the largest oil reserves are not offered to IOCs, therefore companies like Total, Shell, and ExxonMobil have only been involved in some technical service agreements, technical studies, and Research and Development. Consequently, these types of contracts do not require a SC as the IOC is not taking on the same financial risks as it would in a LOTOGA. Saudi Arabia is more open to IOCs in its gas sector. In 2017, it began talks with IOCs (BP, Chevron and Eni) in relation to partnerships on gas developments. In this context, the IOC would be more concerned about stability of terms. APICORP Energy Research, 'IOCs heading in different directions in MENA' (2017) 2(4) Arab Petroleum Investment Corporation <http://www.apicorp-arabia.com/Research/EnergyResearch/2017/APICORP_EnergyResearch_V02N04_Jan2017.pdf> accessed 23 May 2018; Interfax Global Energy, 'Saudi Arabia in talks with IOCs on gas investments' (11 April 2017) <<http://interfaxenergy.com/gasdaily/article/25447/saudi-arabia-in-talks-with-iocs-on-gas-investments>>; Ron Bousso, Dmitry Zhdannikov and Rania El Gamal, 'Exclusive: Saudis, oil majors discuss gas investments ahead of giant IPO' (Reuters, 11 April 2017) <<https://uk.reuters.com/article/us-saudi-aramco-gas-exclusive/exclusive-saudis-oil-majors-discuss-gas-investments-ahead-of-giant-ipo-idUKKBN17D0JY>> accessed 23 May 2018.

¹¹⁴ Arve Throvik, 'Political risk in large projects' in Thomas J Dimitroff (ed), *Risk and Energy Infrastructure: Cross-border dimensions* (Globe Law and Business 2011) 38.

¹¹⁵ *ibid.*

Despite the negative effects of corruption, the IOC's greatest concern is the risk of expropriation. The Credendo Group¹¹⁶ published a global report based on the risk of expropriation between 2013-2016. Ecuador, Iraq, Syria and Venezuela were ranked amongst those with the highest risk of expropriation (a ranking of 7 is high, 1 is low – these states scored seven. North Korea scored six).¹¹⁷ Rich comments that, expropriation is the most common concern for Chinese investors operating in North Korea.¹¹⁸ It is interesting that North Korea and Syria are also classified as having an authoritarian system of governance.¹¹⁹ There may be some correlation between the system of governance and the risk of expropriation.¹²⁰

There is of course the question of whether an authoritarian state will consent to SCs. It is argued that an authoritarian government can consent to a SC if it deems it

¹¹⁶ 'Credendo is a European credit insurance group that is present all over the continent and active in all segments of trade credit and political risk insurance, providing a range of products that cover risks worldwide'. <<https://www.credendo.com/about>> accessed 23 May 2018.

¹¹⁷ The Global Economy, 'Expropriation Risk- country rankings' <https://www.theglobaleconomy.com/rankings/Expropriation_risk/> accessed 23 May 2018.

¹¹⁸ Timothy S Rich, 'Prospects dim for Chinese investment push in North Korea' (Nikkei Asian Review, 01 April 2017) <<https://asia.nikkei.com/Economy/Prospects-dim-for-Chinese-investment-push-in-North-Korea>> accessed 23 May 2018.

¹¹⁹ The Economist Intelligence Unit, 'The Economist Intelligence Unit's Democracy Index-167 countries scored on a scale of 0 to 10 based on 60 indicators' (2017) <<https://infographics.economist.com/2018/DemocracyIndex/>> accessed 08 May 2018. (The Democracy Index is based on five categories: electoral process and pluralism; civil liberties; the functioning of government; political participation; and political culture).

¹²⁰ However, Saudi Arabia (an authoritarian state) scored three, a mid to average ranking on the risk of expropriation. In 2015, a report on the investment climate in Saudi Arabia was produced by the US Department of State. It indicated: 'The Embassy is not aware of the SAG* ever having expropriated property from foreign investors without adequate compensation. There have been no expropriating actions in the recent past or policy shifts that would suggest there the SAG will initiate such actions in the near future. Some small to medium-sized foreign investors, however, have complained that their investment licenses have been cancelled without justification, causing them to forfeit their investments'. United States of America, Department of States, 'Saudi Arabia Investment Climate Statement 2015' 1,9 <<https://www.state.gov/documents/organization/241938.pdf>> accessed 23 May 2018. This statement, along with the Credendo expropriation ranking (3 out of 7) indicates that the Saudi Arabian government is not hostile to foreign investors. Nevertheless, IOCs may still prefer to include a SC (where possible) in LOTOGAs in case things go wrong, or simply for peace of mind.

The Global Economy, 'Expropriation Risk- country rankings' <https://www.theglobaleconomy.com/rankings/Expropriation_risk/> accessed 23 May 2018.

* Saudi Arabia Government.

necessary to secure the investment, although the terms of the SC are likely to be stringent.¹²¹ Sotonye cites the SCs granted by the late General Sani Abacha during his military regime in Nigeria as an example of this.¹²²

More generally, it is argued that authoritarian regimes would be less likely to agree to the inclusion of a SC, as it seeks to limit the state's ability to unilaterally amend or affect the LOTOGA. However, in the hypothetical scenario that the state consents to a SC, what would be the attitude of the state to the SC? Although one cannot say with certainty what perspective the state would take on the SC, it appears reasonable to suggest that, since authoritarian regimes have little or no regard for the rule of law or other features of liberal democracies, one can expect that the state will not respect the sanctity of contract or the SC. A feature of authoritarian regimes is that the individual or political party in power is the law and can make and unmake laws and guarantees as it deems fit. Thus, the SC can only be effective as long as the government deems the terms of the LOTOGA to be beneficial.

Therefore, a SC would be the least effective method of mitigating against political risks and uncertainties in LOTOGAs in authoritarian states. Nevertheless, IOCs may still include a SC (where possible) as a relevant SC would give an IOC a claim against the state where there has been a breach of contract. Realistically, an IOC operating in an authoritarian state will want to tread carefully, so as not to risk

¹²¹ Sotonye argues that corrupt and/or dictatorial regimes appear more likely to grant the most stringent forms of stabilisation clauses'. Frank Sotonye, 'Stabilisation clauses and sustainable development in developing countries' Unpublished PhD Thesis, University of Nottingham 2014, 1,117.

¹²² Nigerian Liquefied Natural Gas (Fiscal Incentives Guarantees and Assurances) (Amendment) Act 1993 (Hereafter 'NLNG Act'). The Act was originally enacted as a military decree in 1993 but, it is now deemed to be an Act. Under the clauses, the government commits not to alter the fiscal regime governing the project without the prior written agreement of the IOCs (Para 2 to second schedule). Frank Sotonye, 'Stabilisation clauses and sustainable development in developing countries' Unpublished PhD Thesis, University of Nottingham 2014, 1,126.

agitating the state. Such agitation would have negative consequences on any other investments the IOC may have in the state.

Modern RCs which combine elements of stabilisation and renegotiation are less restrictive than traditional SCs; therefore, the state could be more open to this type of clause. However, the IOC remains largely at the mercy of an autocratic leader who may go on to amend unilaterally the stabilised elements of the LOTOGA. Although an IOC would prefer an immutable guarantee of stability, perhaps the best it can hope for in such states is an opportunity to enter into dialogue before changes occur to the LOTOGA.

IOCs must properly measure the risks of operating in authoritarian regimes and be open to renegotiation. The RC is likely to be the most effective form of mitigation against political risk.

iii. Western-style democracies

The key features of these states is that they are generally defined by market capitalism, pluralism,¹²³ free movement of goods, market and services, a well developed society with a strong adherence to the rule of law, separation of powers, transparency and very limited corruption in government.¹²⁴ The UK and USA are classic western democracies; both scored one on the Global Economy expropriation ranking, meaning they have very low risks of expropriation.¹²⁵ Yet, this does not mean

¹²³ 'A liberal democratic State allows different agents to operate freely in the market as entrepreneurs and traders, and does not itself seek to appropriate the means of production'. Yves Mény and Andrew Knapp, *Government and Politics in Western Europe: Britain, France, Italy, Germany* (3rd edn, Oxford University Press 1998) 3.

¹²⁴ Arve Throvik, 'Political risk in large projects' in Thomas J Dimitroff (ed), *Risk and Energy Infrastructure: Cross-border dimensions* (Globe Law and Business 2011) 41-42.

¹²⁵ The Global Economy, 'Expropriation Risk- country rankings' <https://www.theglobaleconomy.com/rankings/Expropriation_risk/> accessed 23 May 2018.

that there is legislative stability. Instead, '[t]he UK has long been a textbook example of fiscal instability. Since the establishment of the UKCS tax system in 1975, the regime has been repeatedly reviewed and many amendments applied'.¹²⁶ An example of this is the increase in supplementary charge in the wake of record crude prices.¹²⁷ Nevertheless, such incidents are not always unfavourable to IOCs: in an attempt to boost the oil industry during low oil prices, the UK 2015 budget included a reduction in tax burden.¹²⁸

The key features (listed above) of these states render them likely to comply with a SC and to view the SC as beneficial to the rights of an IOC. States practising a form of western democracy will be prone to operate within the contract and respect the SC. Therefore, a SC will be an effective contractual method of mitigating against political risks.

Where the constitution of the state does not permit the inclusion of a SC in the LOTOGA, an IOC still has a legitimate expectation that the state will comply with the contract. Therefore, the RC and modern RC will also be effective against political risks in such states.

¹²⁶ Mario Mansour and Carole Nakle, 'Fiscal Stabilization in Oil and Gas Contracts: Evidence and Implications' (2016) 37 *The Oxford Institute for Energy Studies* 1, 9 <<https://www.oxfordenergy.org/wpcms/wp-content/uploads/2016/02/Fiscal-Stabilization-in-Oil-and-Gas-Contracts-SP-37.pdf>> accessed 24 May 2018.

¹²⁷ The supplementary charge (SC) is an additional charge on a company's ring-fenced profits (but with no deduction for finance costs). Office for Budget Responsibility, 'Oil and Gas Revenues' <<http://obr.uk/forecasts-in-depth/tax-by-tax-spend-by-spend/oil-and-gas-revenues/>> accessed 05 February 2018; BBC News, 'Brown doubles North Sea oil tax' (05 December 2005) <<http://news.bbc.co.uk/1/hi/business/4500540.stm>> accessed 24 May 2018.

¹²⁸ There was a revision of the supplementary charge, reducing it from 20% to 10%, as well as petroleum revenue tax been set at zero from the 1st of January 2016. 'Petroleum revenue tax is a 'field-based' tax charged on the profits arising from individual oil and gas fields that were approved for development before 16 March 1993. However, it has not been abolished so that losses (such as losses arising from decommissioning PRT-liable fields) can be carried back against past PRT payments. PRT was deductible as an expense in computing profits chargeable to RFCT and SC'. Office for Budget Responsibility, 'Oil and Gas Revenues' <<http://obr.uk/forecasts-in-depth/tax-by-tax-spend-by-spend/oil-and-gas-revenues/>> accessed 05 February 2018.

More generally, states will also fall into the category of ‘developed’ or ‘developing’, according to their economic, social and political development.¹²⁹ Typically, dysfunctional societies are classified under developing states whilst western-style democracies generally fall under the category of developed states. Where the constitution of a developed state allows its government to agree to a SC,¹³⁰ the perspective of the state to the SC is more liberal and in line with traditional doctrines of sanctity of contract. In this cases, the SC, RC and modern RC would all be effective methods of mitigating against political risks.

Also, many developed states tend to adopt a hands-off approach after signing a LOTOGA. This is linked to the fact that these types of states are amenable to the principle of freedom of contract and free markets as wealth creators. Further, such states have effective court systems through which IOCs can pursue the enforcement of the LOTOGA or, at least, damages.

Additionally, Jensen submits that in developed states, there is a greater understanding and respect of property rights, which has an influence on how the state deals with the investment rights of an IOC.¹³¹ This is a relevant point, but, in this writer’s view, it is not a greater understanding of property rights that restrains governments in developed states in their dealings with IOCs. Rather, it is a reflection

¹²⁹ The World Economic Situation and Prospects (WESP) 2014 classifies all countries broadly into three groups: economies in transition, developed economies, and developing economies. United Nations, ‘World Economic Situation and Prospects’ (2014) 1, 143 <http://www.un.org/en/development/desa/policy/wesp/wesp_current/2014wesp_country_classification.pdf> accessed 08 May 2018; United Nations, ‘World Economic Situation and Prospects’ (2017) <https://www.un.org/development/desa/dpad/wp-content/uploads/sites/45/publication/2017wesp_full_en.pdf> accessed 08 May 2018.

¹³⁰ The constitution of some developed states (For example, the United Kingdom) precludes its government from giving stabilisation guarantees.

¹³¹ Nathan Jensen, ‘Political Risk, Democratic Institutions, and Foreign Direct Investment’ (2008) 70(4) *The Journal of Politics* 1040-1052.

of the fact that these states abide with the rule of law, and also that the state's economic wealth is not tied to the oil and gas sector.

It has been argued that SCs are often rampant in LTOGAs with developing countries because such states are in need of economic development and are more willing to grant the IOC an additional guarantee of stability, in return for investment.¹³² Whilst this may have some element of truth, what is the attitude of the state in upholding its commitment to the SC? It is argued that the perspective of developing states in relation to the SC will generally depend on two main issues: the rule of law and the country's economic dependence on its oil and gas industry.¹³³

A key feature of corruption is that there is a blatant disregard for the rule of law. According to an international NGO¹³⁴ Transparency International, '[c]orruption is the abuse of entrusted power for private gain'.¹³⁵ In this author's view, where there is a deliberate abuse of power, it is because those engaging in it have no regard for the rule of law – rampant corruption is the result of the system of governance.

In developing states where corruption runs deep in some or all areas of government, there is a sense that the main goal of state officials would be to make the maximum personal financial gain from the LTOGA. In December 2017, Ecuador's

¹³² Evaristus Oshionebo, 'Stabilization Clauses In Natural Resource Extraction Contracts: Legal, Economic And Social Implications For Developing Countries' (2010) 10 *Asper Rev. Int'l Bus. & Trade Law* 1, 20.

¹³³ Some of the world economies dependent on oil revenue include Saudi Arabia, Iraq, Algeria, Azerbaijan, Kuwait, Libya, Sudan, Ghana, Angola and Venezuela. See Rosamund Hutt, 'Which economies are most reliant on oil?' (World Economic Forum, 10 May 2016) <<https://www.weforum.org/agenda/2016/05/which-economies-are-most-reliant-on-oil/>> accessed 30 August 2017; International Monetary Fund, 'Economic Diversification in Oil-Exporting Arab Countries - Annual Meeting of Arab Ministers of Finance' (April 2016) <<https://www.imf.org/external/np/pp/eng/2016/042916.pdf>> accessed 30 August 2017.

¹³⁴ Non-governmental organisation.

¹³⁵ Transparency International, 'What is Corruption?' <<https://www.transparency.org/what-is-corruption>> accessed 23 May 2018.

Vice President Jorge Glas was sentenced to six years in jail after he was found guilty of receiving bribes in exchange for giving out state contracts to a Brazilian construction company (Odebrecht).¹³⁶

The operation of a SC would deny corrupt officials personal 'benefit', hence these officials would seek to exert pressure on the state or its representatives to disregard the SC. In such states where political corruption is rife, the perspective of corrupt officials would be that the SC hinders economic benefit for the state and so it should not be respected. Also, for many developing states with an oil and gas industry, economic development is often largely dependent on this industry, despite the fact that the state may have other natural resources.¹³⁷ Therefore, to honour the commitments under the SC may deny the state (particularly corrupt officials) maximum economic benefits.¹³⁸

Additionally, where the system of governance is dysfunctional, nationalistic persuasions may affect the state's perspective on the SC. At the commencement of the

¹³⁶ The Odebrecht scandal has spread to 14 countries, which include Brazil, Colombia and Peru. There are investigations into allegations that bribes were paid to top state officials to secure government contracts. In Brazil, the former CEO of the state-owned NOC (Petrobras) was sentenced to 11 years in jail after he was found guilty of accepting bribes from Odebrecht. The Independent, 'Ecuador's Vice President Jorge Glas imprisoned as corruption investigation gets underway' (03 October 2017) <<https://www.independent.co.uk/news/world/americas/ecuador-vice-president-jorge-glas-arrested-jailed-corruption-bribery-investigation-odebrecht-supreme-a7980691.html>>; Reuters, 'Odebrecht scandal: Ecuador vice-president given six years' jail' (The Guardian, 14 December 2017) <<https://www.theguardian.com/world/2017/dec/14/odebrecht-scandal-ecuador-vice-president-given-six-years-jail>> accessed 22 May 2018; Anthony Faiola, 'The corruption scandal started in Brazil. Now it's wreaking havoc in Peru' (The Washington Post, 23 January 2018) <https://www.washingtonpost.com/world/the_americas/the-corruption-scandal-started-in-brazil-now-its-wreaking-havoc-in-peru/2018/01/23/0f9bc4ca-fad2-11e7-9b5d-bbf0da31214d_story.html?noredirect=on&utm_term=.0372460c7ad2>; Linda Pressly, 'The largest foreign bribery case in history' (BBC News, 22 April 2018) <<http://www.bbc.co.uk/news/business-43825294>> accessed 22 May 2018; Reuters, 'Ex-Petrobras CEO Bendine convicted of corruption in Brazil' (Reuters, 07 March 2018) <<https://www.reuters.com/article/us-brazil-corruption-bendine/ex-petrobras-ceo-bendine-convicted-of-corruption-in-brazil-idUSKCN1GJ37B>> accessed 22 May 2018.

¹³⁷ For example, the African continent is rich in natural resources such as cobalt, uranium and agricultural produce, yet much of these resources are under-explored, choosing instead to focus on oil and gas. See African Natural Resources Center (ANRC) <<http://www.afdb.org/en/topics-and-sectors/initiatives-partnerships/african-natural-resources-center-anrc/>> accessed 03 July 2016.

¹³⁸ Rachel L. Wellhausen, 'Investor-State Disputes: When Can Governments Break Contracts?' (2015) 59(2) Journal of Conflict Resolution 239, 242.

LOTOGA, the state may not hold nationalistic persuasions but later change its position because of political pressure arising from nationalistic groups. For example, in 2017 the Indonesian government had to draft a new oil and gas law because in 2012 a nationalistic group successfully challenged (at the Constitutional Court) the 2001 Oil and Gas Law on the basis that supervisory powers should rest with the state and not an independent authority.¹³⁹ The draft version of the new law had been indicated to have nationalistic persuasions because it aimed to protect national control over oil and gas production.¹⁴⁰ Fortunately, these nationalistic sentiments were not incorporated into the new law.¹⁴¹

A notable point is in relation to a legal tradition in Latin American states¹⁴² called the Calvo doctrine.¹⁴³ This was developed by the Argentinian jurist Carlos Calvo and, at its core, it provides that foreign investors should not seek diplomatic

¹³⁹ Charles Balls and others, 'Indonesia's New Draft Oil and Gas Law' (Mondaq: Reed Smith, April 2015) <http://www.mondaq.com/article.asp?article_id=391416&signup=true> accessed 14 May 2016. Updated version (February 2016) <<http://www.mondaq.com/x/414574/Oil+Gas+Electricity/UPDATE+Indonesias+New+Draft+Oil+Gas+Law>> accessed 14 May 2016.

¹⁴⁰ *ibid.*

¹⁴¹ Sean Prior, Nathan Dodd and Rod Brown, 'Indonesia: Indonesia Briefing: Latest Changes In Energy Law (Part 1)' (Mondaq: Mayer Brown, 03 March 2017) <<http://www.mondaq.com/x/573020/Renewables/Indonesia+Briefing+Latest+Changes+In+Energy+Law+Part+1>> accessed 11 June 2017; Sean Prior, Nathan Dodd and Rod Brown, 'Indonesia: Indonesia Briefing: Latest Changes In Energy Law (Part 2)' (Mondaq: Mayer Brown, 09 March 2017) <<http://www.mondaq.com/x/575504/Oil+Gas+Electricity/Indonesia+Briefing+Latest+Changes+in+Energy+Law+Part+2>> accessed 11 June 2017; Benjamin McQuhae, Alex Cull and Darren Murphy, 'Indonesia: Indonesia's New Gross Split Production Sharing Contracts For The Oil & Gas Industry' (Mondaq: Jones Day, 8 February 2017) <<http://www.mondaq.com/x/566378/Oil+Gas+Electricity/Indonesias+New+Gross+Split+Production+Sharing+Contracts+For+The+Oil+Gas+Industry>> accessed 11 June 2017. See also Justin Tan, 'Indonesia: Key Considerations For Foreign Investors In The Indonesian Power Sector' (Mondaq: Clyde & Co, 9 February 2018) <<http://www.mondaq.com/x/672336/Renewables/Key+Considerations+For+Foreign+Investors+In+The+Indonesian+Power+Sector>> accessed 31 March 2018. However, under the new law, there are practical considerations for IOCs in relation to cost recovery.

¹⁴² Such as Bolivia, Ecuador, Mexico, Peru and Venezuela.

¹⁴³ This is a corollary of the Calvo Clause. For a discussion, see Manuel R. Garcia-Mora, 'The Calvo Clause in Latin American Constitutions and International Law' (1950) 33(4) *Marquette Law Review* 205-219.

protection from their home state when operating in the host state.¹⁴⁴ Rather, in the event of a dispute, the IOC has to resort to local remedies (jurisdiction of local courts) as must other local investors.¹⁴⁵ The principle is thus opposed to a SC which seeks to confer on a foreign investor (IOC) an additional protection unavailable to local companies. Presently, for the most part, the Calvo doctrine is no longer in operation in Latin America states, but it ‘...re-emerges from time to time, under different forms, whenever political circumstances would seem to warrant that revival’.¹⁴⁶ Therefore, although Latin American states may include SCs in LOTOGAs, IOCs should not be complacent about its operation as another political revolution may revive the Calvo doctrine. Although the essence of the Calvo doctrine is to resist diplomatic protection for IOCs, it can also affect the state’s perspective on the SC, as this seeks to provide an additional benefit to the IOC.

Latin America has had an uncomfortable history with IOCs. In May 2006, the Bolivian President (Evo Morales) nationalised oil and gas assets.¹⁴⁷ Also, in 2006, Ecuador seized an oil field controlled by an IOC (US-based Occidental).¹⁴⁸ A year later, the IOC ConocoPhillips had its investment expropriated by the Venezuelan

¹⁴⁴ Manuel R. Garcia-Mora, ‘The Calvo Clause in Latin American Constitutions and International Law’ (1950) 33(4) *Marquette Law Review* 205-219; Zhiguo Gao, *International Petroleum Contracts: Current Trends and New Directions* (Graham Trotman Ltd 1994) 133-134.

¹⁴⁵ *ibid.*

¹⁴⁶ Patrick Juillard, ‘Calvo Doctrine/Calvo Clause’ in Max Planck Encyclopedia of Public International Law (online edition) January 2007 <<http://opil.ouplaw.com/view/10.1093/law:epil/9780199231690/law-9780199231690-e689>> accessed 03 July 2016.

¹⁴⁷ Vlado Vivoda, ‘Resource Nationalism, Bargaining and International Oil Companies: Challenges and Change in the New Millennium’ (2009) 14 *New Political Economy* 517, 520 -521.

¹⁴⁸ *ibid.*

government of Hugo Chavez, following nationalisation of the oil and gas sector.¹⁴⁹ In 2018, an arbitration tribunal found in favour of ConocoPhillips for \$2bn.¹⁵⁰ Yet, not all Latin American states are the same. Brazil does not offer stabilisation guarantees in its petroleum regime,¹⁵¹ although its Civil Law Code contains economic equilibrium clauses.¹⁵² Brazil has only one bilateral investment treaty in force,¹⁵³ yet there has been no expropriation in the petroleum sector.¹⁵⁴ This illustrates that although states may have a certain system of governance or be subject to negative ‘labelling’ because of their region, each state must be taken on its own merits. Though the discussion has

¹⁴⁹ Justin Jacobs, ‘ConocoPhillips judgement piles pressure on Venezuela's PdV’ (Petroleum Economist, 27 April 2018) <<http://www.petroleum-economist.com/articles/politics-economics/south-central-america/2018/conocophillips-judgement-piles-pressure-on-venezuelas-pdv>> accessed 23 May 2018.

¹⁵⁰ Reuters, ‘Conoco sues to enforce \$2 billion award that Venezuela scorns’ (Reuters, 26 April 2018) <<https://www.reuters.com/article/us-venezuela-conocophillips-reaction/conoco-sues-to-enforce-2-billion-award-that-venezuela-scorns-idUSKBN1HX2LU>> accessed 23 May 2018. It is worthy of note that the award given was less than 10 percent of what ConocoPhillips originally sought.

¹⁵¹ Peter Cameron, ‘Stabilisation in Investment Contracts and Changes of Rules in Host Countries: Tools for Oil & Gas Investors’ (2006) Association of International Petroleum Negotiators (AIPN) (Final Report) 1, 27 <<http://www.rmmlf.org/Istanbul/4-Stabilisation-Paper.pdf>> accessed 23 May 2018; Mario Mansour and Carole Nakle, ‘Fiscal Stabilization in Oil and Gas Contracts: Evidence and Implications’ (2016) 37 The Oxford Institute for Energy Studies 1, 35 <<https://www.oxfordenergy.org/wpcms/wp-content/uploads/2016/02/Fiscal-Stabilization-in-Oil-and-Gas-Contracts-SP-37.pdf>> accessed 24 May 2018.

¹⁵² ‘Article 478 of the Brazilian Civil Code determines the right of termination, in case one of the parties undergoes extreme impacts derived from extraordinary and unpredictable events, which also bring extreme advantage to the unaffected party. Article 479, however, allows the unaffected party to avoid termination if it accepts to equitably modify the contract conditions. Article 480 goes even further, allowing the affected party to impose a modification (scope reduction, for example) in case it undertakes excessive burden’. Fernando Marcondes and others, ‘Construction- Brazil’ (Latin Lawyer, 19 July 2017) <<https://latinlawyer.com/jurisdiction/1004561/brazil>> accessed 24 May 2018.

¹⁵³ Nancy A. Welsh, Andrea K. Schneider and Kathryn Rimpfel, ‘Using the Theories of Exit, Voice, Loyalty, and Procedural Justice to Reconceptualize Brazil’s Rejection of Bilateral Investment Treaties’ (2014) 45 Washington University Journal of Law & Policy (New Directions in Global Dispute Resolution) 105-143 <https://openscholarship.wustl.edu/cgi/viewcontent.cgi?referer=https://www.google.co.uk/&httpsredir=1&article=1816&context=law_journal_law_policy>; Investment Policy Hub, ‘Brazil’ <<http://investmentpolicyhub.unctad.org/IIA/CountryBits/27>> accessed 08 October 2019. Brazil has signed several BITs but only the BIT with Angola is in force. <<http://investmentpolicyhub.unctad.org/IIA/CountryBits/27#iiaInnerMenu>> accessed 08 October 2019.

¹⁵⁴ The Brazilian Constitution 1988 (Title II Chapter 1, Article XXIV, XXV) restricts expropriation without compensation. Nancy A. Welsh, Andrea K. Schneider and Kathryn Rimpfel, ‘Using the Theories of Exit, Voice, Loyalty, and Procedural Justice to Reconceptualize Brazil’s Rejection of Bilateral Investment Treaties’ (2014) 45 Washington University Journal of Law & Policy (New Directions in Global Dispute Resolution) 105,130 <https://openscholarship.wustl.edu/cgi/viewcontent.cgi?referer=https://www.google.co.uk/&httpsredir=1&article=1816&context=law_journal_law_policy> accessed 24 May 2018.

argued that the prevailing political climate/system of governance in the host state can have an influence on the effectiveness of the SC, RC and modern RC, the context of a state's history of dealings with foreign investors must not be ignored.

When operating in states with a strong history of nationalism, it is argued that a RC may be more effective than a SC or modern RC, because it is the least challenging to state sovereignty. In states with long histories of expropriation and/or unilateral change of contract, the SC would be most effective, provided it is allowed in the constitution. Yet, the effectiveness of the SC may be limited in the face of strong nationalistic sentiments in the state. In this sense, it would be prudent to include a SC as well as a RC; the modern RC would offer the 'best of both worlds'.

A conclusion on the impact of systems of government

This thesis postulates that the RC would generally be effective in all three systems of governance discussed, because of its flexibility and the fact that it does not conflict with state sovereignty. However, the hypothesis relating to the impact of systems of governance would require further research.

It has been argued that the RC would be more effective in dysfunctional states than the modern RC or SC. The RC is also likely to be effective in authoritarian states, as these states are unlikely to consent to a SC or even abide by it. Although the modern RC is less restrictive than the SC, the stabilised terms may be subject to change at the will of an autocratic leader.

It was posited that any of the three clauses would be effective in western-style democracies. This is because such states generally operate within the contract and

respect contractual terms. In this case, an IOC's choice of clause should be closely tied to prevailing issues within the state, i.e. political, legal, economic context.

Finally, no two states are the same, regardless of the political category into which they fall. The relevance of systems of governance should be one of many factors taken into consideration before selecting any of the three clauses. Although there is no harm in including a SC in a LOTOGA, it is recommended that IOCs adequately consider the system of governance in the host state and evaluate which of the three clauses (SC, RC or modern RC) would be most effective in mitigating risks and uncertainties.

Conclusion

The discussion in this chapter demonstrates that a RC can mitigate the risks of changes which affect the LOTOGA, as well as unilateral change of contract and expropriation in LOTOGAs, thereby contributing to the stability of the LOTOGA. In so doing, the chapter provided a more robust explanation for why the RC should be included as an essential contractual method of risk mitigation in LOTOGAs. The five arguments advanced in favour of a RC prove that IOCs have much to benefit from the inclusion of a RC in a LOTOGA.

The discussion recommended that the RC should include an express obligation of good faith during renegotiations; the requirement of good faith provides a basis for the conduct of parties during renegotiations. This will strengthen the value of the RC.

Also, it was argued that the system of governance in the host state can affect the effectiveness of the SC, RC or modern RC. Arguments have been advanced for which clause would likely be most effective in different political systems. It has been recommended that IOCs assess the system of governance in the state and determine which of the three clauses would be most effective in mitigating the risks of unilateral change of contract and/or expropriation.

Additionally, the discussion on the modern RC demonstrated that it is possible to balance stability and flexibility in the pursuit of certainty, with the SC and RC being compatible rather than mutually exclusive. The RC and SC are compatible because, to a limited extent, they serve the same function, to reduce the risk of unilateral change of contract and expropriation.

Furthermore, this chapter has argued that IOCs holding on to sanctity of contract may find themselves in situations where economic changes (such as oil price) are unfavourable and it becomes essential for the fiscal terms of the LOTOGA to be revised so as to readjust the economic equilibrium of the contract. Whilst sanctity of contract is desirable in a LOTOGA, it must not be immutable because the contract exists in a real world, a world affected by unexpected internal and external changes.

The key to having a better appreciation of the RC is to understand that total rigidity is unrealistic in a LOTOGA, where the success and effective operation of the project depends not only on the skill and expertise of the IOC, but also on the ability of the IOC and state to work together as allies for the duration of the agreement.

The RC is not a 'free for all' clause as, realistically, it would not cover every single change which adversely affects the LOTOGA. The onus is on contract drafters to structure the triggering conditions of the contracts in such a manner that maintains a reasonable degree of flexibility, but without compromising the level of stability and certainty required for the LOTOGA.

The chapter made an argument for the inclusion of time-limits in the RC, so that the renegotiation process is not drawn out due to bad faith. Yet, time-limits must be applied cautiously to avoid rushed negotiations which are unlikely to result in a renegotiated agreement.

Lastly, a LOTOGA between a state and IOC requires some degree of compromise. The agreement may begin favourably but as time goes by, circumstances can change and be unfavourable to either party, thus the parties must decide whether to renegotiate and find common ground for progress or to terminate the agreement.

This compromise introduces flexibility into the LOTOGA, it need not jeopardise a reasonable expectation of stability.

The next chapter begins with an assessment of risk mitigation between IOCs, looking at the forfeiture clause.

CHAPTER 6

FORFEITURE CLAUSES IN OIL AND GAS JOINT OPERATING AGREEMENTS

Introduction

The signing of a licence or contract is the beginning of contractual relations between the state and an IOC. This relationship was the focus of the discussion in chapters 4 and 5. In many cases, particularly large and complex operations, that licence or contract would be exploited through a joint venture between IOCs.¹ This chapter seeks to assess the legal and practical effectiveness of the forfeiture clause (hereafter FC) as used between IOCs in the JOA, which is a type of JV agreement. The assessment of the FC will be based solely on the JOA because it is the most common form of JV in LOTOGAs.² Limitations of space prevent a discussion of the FC in other types of JV.

Although the JOA³ is a mechanism through which IOCs can reduce risks in a LOTOGA, it is not without risks of its own. The risk that any party may fail to keep up with its financial obligations under the JOA is one of the most significant risks in a JOA.

¹ Where there is a NOC, this company may also be involved in the joint venture. This is common in joint operating agreements, albeit that the NOC would usually join the venture after the exploration stage is over. This ensures that the state is not bearing any risks or costs prior to a commercial discovery of oil and/or gas.

² A. Timothy Martin, 'Model Contracts: A Survey of the Global Petroleum Industry' (2004) 22 *Journal of Energy and Natural Resources Law* 281, 291; Marc Hammerson, *Upstream Oil and Gas: Cases, Materials and Commentary* (Globe Law and Business 2011) 174; Eduardo G Pereira and Wan M Zulhafiz Wan Zahari (eds), *Joint Operating Agreement: Applicability and Enforcement of Default Provisions* (Rocky Mountain Mineral Law Foundation 2018) xxi.

³ The JOA described in this thesis refers to the contractual (also known as non-incorporated) joint venture where parties have legal and beneficial rights to oil and gas.

The general structure of a JOA is that each party has a duty to make timely cash contributions according to the size of its interest in the agreement.⁴ Typically, the joint operating parties (hereafter JOPs) will conduct due diligence checks on each other to ensure that all parties to the venture are financially sound and of good reputation. However, given the importance of cash flow in a JOA, the parties will seek to incorporate various provisions into the agreement which will deal with financial default. The forfeiture provision is a principal remedy for default in several Model JOAs worldwide.⁵

Forfeiture provisions have been the subject of debate for many years.⁶ The principal debate concerns whether these provisions should be unenforceable under the penalty rule.⁷ In common law jurisdictions⁸ it is settled that any contractual term interpreted as a penalty clause is unenforceable. This rule exists in English law⁹ which

⁴ Scott Crichton Styles, 'Joint Operating Agreements' in Gordon G, Paterson J and Usenmez E (eds), *UK Oil and Gas Law: Current Practice and Emerging Trends Volume II: Commercial and Contract Law Issues* (3rd edn, Edinburgh University Press 2018) 51. The structure of a JOA was discussed in chapter 2, section 2.2.i.

⁵ Eduardo G Pereira, 'Protection against Default in Long Term Petroleum Joint Ventures' (May 2012) The Oxford Institute for Energy Studies, WPM 47. 1, 4 <https://www.oxfordenergy.org/wpcms/wp-content/uploads/2012/05/WPM_47.pdf> accessed 10 August 2016. Examples are contained in the: Model JOA Greenland 2008-11.3.3, Model Service Contract Iraq 2010-Addendum One – Heads of JOA, Clause 7.2, AIPN Model JOA 2012- Article 8.4.D.1, Model JOA for Licence Denmark 2014- Article 11.3.3, Model PSC Kenya 2015-Appendix C 6.9-6.10

⁶ Andrew Kurth and Peter Roberts, 'Forfeiture clauses in JOAs - new law, old problems. Notes from the Field - An English Law perspective on the Oil and Gas Market' (2014) <http://www.lexology.com/library/detail.aspx?g=804288f2-970d-419f-bbf3-a2d965bd3f16&utm_source=lexology+Daily+Newsfeed&utm_medium=HTML+email> accessed 10th August 2016.

⁷ *Jobson v Johnson* [1989] 1 WLR 1026; *Cavendish Square Holdings BV v Talal El Makdessi* [2015] UKSC 67, [2015] 3 WLR 1373 (SC).

⁸ Some of which include England, Wales and Northern Ireland.

⁹ In England, the penalty rule has '...existed since the 16th century and can be traced back to the same period in Scotland'. William W McBryde, *The Law of Contract in Scotland* (3rd edn, Thomson 2007) paras 22-148.

is the main jurisdiction of the thesis;¹⁰ it is also found in other common law jurisdictions.¹¹ The debate around forfeiture provisions arises because, in terms of key features they have certain similarities with penalty clauses. The chief feature is that the provision is activated upon a breach of contract and in response to the breach. This has led to uncertainty as to whether forfeiture provisions will also be rendered unenforceable. In contrast, in most civil law jurisdictions, such as Belgium, Denmark, France and Germany, contractual penalties are generally enforceable, albeit that the amount required of the breaching party may be reduced where the court deems it excessive.¹²

¹⁰ English law is ranked as one of the top choice of law in international commercial contracts. This may be because English law has gained greater international familiarity than the laws of other jurisdictions. This is the case where IOCs are able to choose the governing law of the contract. See Peter Roberts, *Petroleum Contracts: English Law and Practice* (Oxford University Press 2013) 3; Aaron M. Cooper and Flavio Inocencio, 'Forfeiture, Buy-Out Provision, and Enforceability Under English Law After The Makdessi Decision' in Eduardo G Pereira and Wan M Zulhafiz Wan Zahari (eds), *Joint Operating Agreement: Applicability and Enforcement of Default Provisions* (Rocky Mountain Mineral Law Foundation 2018) 123. See also Geoff Hewitt, 'The AIPN Model Form International Operating Agreement 2002' (2003) 11 *International Energy Law and Taxation Review* 309-311.

¹¹ For example in Australia, Canada and Ireland. The recent Australian position on the penalty rule is a departure from the English position as it provides amongst others, that a provision can be a penalty even if it is triggered by a breach of contract. This position has been widely criticised. See Anthony Gray, 'Contractual Penalties in Australian Law after Andrews: An Opportunity Missed' (2013) 18 *Deakin Law Review* 1-26; Edwin Peel 'The Rule against Penalties' (2013) 129 *LQR* 152-157; J W Carter and others, 'Contractual Penalties: Resurrecting the Equitable Jurisdiction' (2013) 30 *Journal of Contract Law* 99-132; Sirko Harder 'The Relevance of Breach to the Applicability of the Rule against Penalties' (2013) 30 *JCL* 52-69; Jessica Palmer, 'Implications of the new rule against penalties' (2016) 47 *Victoria University of Wellington Law Review* 305, 314 <<http://www.nzlii.org/nz/journals/VUWLawRw/2016/17.pdf>> accessed 07 December 2017.

In Canada, the position on the penalty rule is unsettled, and lacks judicial consensus. For a discussion, see Paul-Erik Veel, 'Penalty clauses in Canadian contract law.' (2008) 66 *U.T.Fac. L.Rev* 229. This paper is also available at <<https://www.thefreelibrary.com/Penalty+clauses+in+Canadian+contract+law.-a0192388342>> accessed 12 June 2019.

¹² Other examples include, China, Italy, Norway, Netherlands, Russia, Spain, Sweden and Switzerland. J. Frank McKenna, 'Liquidated damages and penalty clauses: a civil law versus common law comparison' (Lexology: Reed Smith LLP, 12 May 2008) <<https://www.lexology.com/library/detail.aspx?g=d413e9e1-6489-439e-82b9-246779648efb>> accessed 12 June 2019; Ignacio Marín García, 'Enforcement of penalty clauses in civil and common law: A puzzle to be solved by the contracting parties' (2012 Spring/Summer) 5(1) *European Journal of Legal Studies* 95, 96 <<http://www.ejls.eu/10/127UK.htm>> accessed 11th August 2016; Elia Lardi, Triebold Claudius and Simon Oats, 'Liquidated damages or contractual penalty: Under Swiss Law' (Eversheds, January 2015) <<https://www.eversheds.com/documents/services/construction/Construction-briefing-Jan-15.pdf>> accessed 11 August 2016.

Although there is a view that the revised penalty test laid down by the Supreme Court in *Cavendish Square Holdings BV v Talal El Makdessi*¹³ (hereafter *Makdessi*) makes it more likely that forfeiture provisions in oil and gas JVs will be enforceable,¹⁴ this thesis argues that this is not necessarily the case.¹⁵

The discussion is divided into three main sections. Section 6.1 looks at the problem of default in JOAs and the contractual responses to this risk. In Section 6.2, the issue of forfeiture and the FC in JOAs are addressed. Section 6.3 discusses the enforceability of the forfeiture provision, looking at the possible challenges to enforcement. The last section considers how IOCs can safeguard the forfeiture provision.

6.1. The risks of IOCs defaulting on their financial obligations

Earlier in chapter 2 of the thesis, the structure of a JOA was discussed.¹⁶ Under this structure, the JOA authorises the Operator to issue periodic cash calls based on the

¹³ [2015] UKSC 67, [2015] 3 WLR 1373 (SC). Makdessi was the respondent, Cavendish was the appellant.

¹⁴ See David Lewis and others, 'Enforcement of JOA forfeiture provisions following the Supreme Court decision in *Cavendish Square Holdings B.V. v. Makdessi* [2015] UKSC 67' (Clifford Chance, November 2015) <https://www.cliffordchance.com/briefings/2015/11/enforcement_of_joaforfeitureprovision.html> accessed 03 August 2016; Segun Osuntokun, Tim Sumner, Lisa Allenden, 'Oil & Gas JOA Defaults: Enforcing Forfeiture Clauses after the Cavendish Square Decision' (Berwin Leighton Paisner, February 2016) <http://www.blplaw.com/media/how-can-we-help-you/finance/Oil_Gas_JOA_Defaults_-_Enforcing_forefeiture_clauses_after_the_Cavendish_Square_Decision.pdf> accessed 09 February 2018; William Day, 'A Pyrrhic victory for the doctrine against penalties: *Makdessi v Cavendish Square Holding BV*' (Case comment) (2016) *Journal of Business Law* 115, 127; Scott Crichton Styles, 'Joint Operating Agreements' in Gordon G, Paterson J and Usenmez E (eds), *UK Oil and Gas Law: Current Practice and Emerging Trends Volume II: Commercial and Contract Law Issues* (3rd ed, Edinburgh University Press 2018) 60.

¹⁵ The thesis will not assess the pre-*Makdessi* position because its focus is on the current *Makdessi* test. Pre-*Makdessi*, penalty provisions were assessed under the four stage test provided by Lord Dunedin in *Dunlop Pneumatic Tyre co. Ltd v New Garage and Motor co. Ltd*. [1915] AC 79. The four stage test was provided at para 86-87.

¹⁶ See Section 2.2.i.

approved budget programme.¹⁷ The cash call will be to the Operator itself and all JOPs in accordance with individual participating interest in the LOTOGA.¹⁸ The cash call¹⁹ will trigger a deadline for performance by all parties, with the failure to perform being treated as a default²⁰ and in breach of the agreement.²¹ IOCs are all too aware of the ramifications of default and would try to avoid this as far as possible; yet, default remains a major risk in JOAs.

This thesis has identified two main reasons why IOCs default on their financial obligations. Firstly, an IOC could find itself in financial difficulty due to economic factors affecting the industry, chief of which is the price of oil. The profitability of a LOTOGA for an IOC is largely dependent on oil prices. Where the price is high, profits increase so far as the risks do not increase. The depressed price of oil in recent years had a negative effect on the financial position of many IOCs, with a 2016 report by Deloitte²² indicating that, '[r]oughly a third of oil producers are at high risk of

¹⁷ *ibid.*

¹⁸ Greg Gordon and others (eds), *Oil and Gas Law: Current Practice and Emerging Trends* (2nd edn, Dundee University Press 2011) 365. Although it is possible for the Operator to elect to cover all financial obligations and claim it retrospectively from non-operators. This is less common because of the financial burden and risk taken on the Operator. This chapter considers JOAs where financial contributions are paid according to the cash call.

¹⁹ 'Cash Call means the Percentage Share of funds required to be paid by a Participant from time to time in accordance with this agreement to finance Joint Expenditure'. AMPLA Model Petroleum Exploration JOA 2011, 1.1 Definitions.

²⁰ Examples include: Ghana* JOA 2010 Article 8.1; AIPN Model JOA 2012, Article 8.1A. Default can also extend to situations where a party persistently makes late payment. See AIPN Model JOA 2012, Article 8.4.D- Optional provision – Expedited forfeiture for subsequent default.

*Joint Operating Agreement Kosmos Energy Ghana HC (1) The E.O Group (2) Operating Agreement in Respect of West Cape Three Points Block Offshore Ghana <www.ogel.org> accessed 15th August 2016.

²¹ For example, in the AMPLA Model Petroleum Exploration JOA 2011- Definitions 1.1: '[d]efault Event means a Breach Default Event or an Unpaid Monies Default Event'. A '[d]efaulting Participant means a Participant which has committed a **breach of this agreement**, whether as an Unpaid Monies Default Event or a Breach Default Event or to which (or to an Affiliate of which) a Breach Default Event relates'. (emphasis added).

²² The report was based on a review of over 500 publicly traded oil and natural gas exploration and production companies around the world.

slipping into bankruptcy this year as low commodity prices crimp their access to cash and ability to cut debt...'.²³ For an IOC facing financial decline or at worst the risk of bankruptcy, it is likely to default in an existing JOA.²⁴

Secondly, an IOC could default if the LOTOGA is no longer economically viable. This may be because the project has encountered unexpected risks, such as excessive complications during exploration or just general difficulties arising from the geology of the contract area.²⁵ Where this occurs during the early stages of the project, an IOC may be tempted to cut its losses and avoid sinking further costs into the JOA. Clearly, this would have financial implications, as non-breaching parties would generally have the right to bring a claim against the breaching party for non-payment.

In both areas discussed above, timing plays a significant role in whether default occurs or is avoided. It is suggested that default is more likely to occur during the

²³ Ernest Scheyder, 'High risk of bankruptcy for one-third of oil firms: Deloitte' (16 February 2016) <<http://www.reuters.com/article/us-usa-shale-bankruptcy-idUSKCN0VP006>> accessed 13 August 2016.

²⁴ Where this is the case, IOCs party to JOAs which contain traditional forfeiture provisions (without compensation) must prepare themselves. Additionally, in an economic decline, IOCs with several investments will focus available finances on the most attractive investments. In relation to smaller IOCs, Roberts argues that, '[t]he aggregation of their commitments across a portfolio of projects could be a stretch and so they might apply some selective ordering to how (or indeed whether) they choose to meet all of those obligations'. Peter Roberts, 'Fault-lines in the joint operating agreement: forfeiture' (2008) 7 I.E.L.R 274, 274. Therefore, in the scenario where an IOC is party to two separate JOAs, one facing high risks and the other low risks, it is commercially prudent for the IOC to prioritise its financial obligations in the latter and find other means of meeting its obligations in the more risky JOA.

²⁵ A possible example is the 1989 agreement between the government of Colombia and British Petroleum (BP) for the exploration and development of petroleum in the Piedemonte region. Amongst other issues, the Operator encountered difficult geological conditions in the field, leading it to seek an extra-deal renegotiation of the agreement in 1994. The state consented to the renegotiation. Although there were no indications that BP was going to default on its obligations, it seems reasonable to suggest that both it and the state would have considered the possibility of this occurring if operations continued to experience difficulty. Abba Kolo and Thomas Wälde, 'Renegotiation and Contract Adaptation in International Investment Projects: Applicable Legal Principles and Industry Practices' (2000) 1 (1) *Journal of World Investment Trade* 5, 18.

exploration stage of operations and the period during which the field reaches maturity.²⁶

In recognition of the reality that default constitutes a real threat in a JOA, several provisions are used to deal with default.

6.1.1. Contractual responses to the risk of default

There are a range of contractual responses used to deal with default. Forfeiture is the ultimate sanction²⁷ and will be discussed at length. Prior to this, other types of contractual responses are considered. The purpose of the discussion on the alternative clauses is to show that they are not as effective as the FC. Additionally, in determining whether the FC is a penalty, it may be a relevant question whether suitable alternatives to the FC could have been used to achieve the same purpose.

²⁶ At the stage of exploration, an IOC has no certainty of recovering its investment, it can simply hope that there will be a commercial discovery of oil/gas. During this period, if there are persistent complications and difficulties, a JOP becomes less motivated to remain in the JOA. However, where a commercial discovery has been made and operations are in the development stage, the likelihood of default is reduced because each JOP knows that there is a high probability of recouping its investment. As operations proceed to the production stage, default is least likely to occur because each JOP would be receiving a percentage of production, which it can sell to cover its financial obligations. The final stage of operations is the decommissioning (hereafter DCG) phase when reserves become depleted. The possibility of default is increased at this stage because the field is generating little or no income and instead requires the parties to make significant financial contributions. At this stage, a party may deliberately default. The consequences of default typically include denying the defaulting party access to hydrocarbons. Yet, where the field is mature, it would be generating little or no hydrocarbons and thus the denial of access to lift hydrocarbons becomes an ineffective deterrent. In reducing the overwhelming financial burden that arises at the DCG stage, a JOA may make provision for DCG security. Peter Roberts, *Petroleum Contracts: English Law and Practice* (Oxford University Press 2013) 177-178. This requires all the JOP to make cash contributions or provide alternative forms of security (eg, letter of credit) towards DCG, far before the field reaches maturity. The decommissioning security agreement is discussed in chapter 9.

²⁷ Aaron M. Cooper and Flavio Inocencio, 'Forfeiture, Buy-Out Provision, and Enforceability Under English Law After The Makdessi Decision' in Eduardo G Pereira and Wan M Zulhafiz Wan Zahari (eds), *Joint Operating Agreement: Applicability and Enforcement of Default Provisions* (Rocky Mountain Mineral Law Foundation 2018) 127.

The most widely used default provisions in oil and gas JOAs are: buy-out; mortgage or lien over interest; withering option; and forfeiture of the participating interest of the breaching party.²⁸

i. Buy-out

A buy-out provision allows innocent parties to purchase the interest of a party which fails to meet its financial obligations and remedy such breach by the expiry of the grace period.²⁹ An example is contained in the AIPN Model JOA 2012.³⁰ Under the buy-out alternative, the innocent parties acquiring the interest can specify in the option notice an appraised value for such interest. The breaching party can accept this amount or refer the matter to an independent expert for valuation of the participating interest. The expert is to determine the value of the interest based on the fair market value, less the following: the total amount in default; the cost of the expert's determination; and a specified percentage of the fair market value of the defaulting party's participating interest (the discount).³¹ It has been argued that, where the value of the buy-out option is not carefully determined, it is possible for an action to arise

²⁸ One of the other options include collateral. The JOA may prescribe some form of collateral from each party prior to forming the joint venture. The value of the collateral will determine whether it is a sufficient method of addressing a default of financial obligations. Collateral may prove to be insufficient where the liabilities of the breaching party exceed the value of its collateral. Also, where the parties can draw on collateral, it operates only a temporary remedy. This is because collateral will eventually run out and the breaching party will simply fall back into default, unless it has resolved its financial difficulties. See Peter Roberts, *Joint Operating Agreements: A Practical Guide* (2nd edn, Globe Law and Business 2012) 45; Peter Roberts, *Joint Operating Agreements: A Practical Guide* (3rd edn, Globe Business Publishing 2015) 218.

²⁹ Buy-out provisions are contained in: OGUK JOA 2009 Clause 17.7; AMPLA Model Petroleum Exploration JOA 2011 Section 16.1; AIPN Model JOA 2012 Section 8.4(D2)&(F); Model JOA Norway 2013 Article 9.3.

³⁰ Article 8.4F provides that- 'In connection with the option set out in Article 8.4.D.2 each Party grants to each of the other Parties the right and option to acquire (the "Buy-Out Option") under Article 8.4.F.1 all of its Participating Interest for the consideration determined under Article 8.4.F.2 (the "Buy-Out Price") and paid under Article 8.4.F.3'.

³¹ Article 8.4.F.2(a)(b)(c) AIPN Model JOA 2012.

on whether the discount amounts to a penalty.³² However, in *Makdessi* (soon to be discussed), the Supreme Court concluded that the loss of some of the payments for the business after a breach was not a penalty based on the construction of the contract. It held that ‘...[t]he clause is in reality a price adjustment clause. Although the occasion for its operation is a breach of contract, it is in no sense a secondary provision’.³³ Therefore, based on this reasoning, it is anticipated that a buy-out option would likely be viewed in the same or similar light to a price adjustment clause since ‘the discount’ readjusts the price payable to the defaulting party. If so, the buy-out provision would be interpreted as a primary obligation, thus avoiding the penalty rule. Nevertheless, the decision would rest on the construction of the contract. Where the provision is challenged as a penalty and the two stage *Makdessi* test is applied, the amount of the discount would be relevant in assessing whether it is exorbitant or unconscionable.³⁴ In illustrating the difficulties with the buy-out provision, particularly the discount, the discussion considers the case of *CRA v New Zealand Goldfields Investments and Claremont Petroleum*³⁵ (hereafter *CRA*). This concerned a mining licence subject to a JV. There was a provision for the breaching party to transfer its interests to the remaining joint venturers at a 5% discount to the market price. The Supreme Court of

³² Aaron M. Cooper and Flavio Inocencio, ‘Forfeiture, Buy-Out Provision, and Enforceability Under English Law After The Makdessi Decision’ in Eduardo G Pereira and Wan M Zulhafiz Wan Zahari (eds), *Joint Operating Agreement: Applicability and Enforcement of Default Provisions* (Rocky Mountain Mineral Law Foundation 2018) 128; Peter Roberts, ‘Fault-lines in the joint operating agreement: forfeiture’ (2008) 7 I.E.L.R 274, 276; Eduardo G Pereira, ‘Protection against Default in Long Term Petroleum Joint Ventures’ (May 2012) The Oxford Institute for Energy Studies, WPM 47. 1, 11 <https://www.oxfordenergy.org/wpcms/wp-content/uploads/2012/05/WPM_47.pdf> accessed 17 October 2016.

³³ *Cavendish Square Holdings BV v Talal El Makdessi* [2015] UKSC 67, [2015] 3 WLR 1373 (SC) [74] (Lord Neuberger and Lord Sumption SCJJ). Therefore, the rule against penalties could not apply. A majority of 4 held clause 5.1 (withholding clause) to be a primary obligation, whilst the remaining three opted not to decide.

³⁴ Exorbitance or unconscionability is the third stage of the *Makdessi* test in determining whether a clause is penal. The three stage test is discussed below at section 6.3.2.1(i-iii).

³⁵ (1989) VR 873.

Victoria held that the discount was not a penalty because it was not extravagant and its purpose was to allow the survival of joint venture operations (the primary obligation issue did not arise). This purpose was held to amount to a sufficient commercial justification for the discounted price.

Nevertheless, in the light of a possible challenge to the discount amount, the buy-out option is not a suitable alternative to a FC as it is also vulnerable to challenge under the penalty rule. The main issue with the FC is the contention to its enforceability. Consequently, a provision which is subject to the same challenge cannot reasonably be used as an alternative. IOCs would want a degree of certainty that any provision which would replace the FC would avoid the penalty net, as well as effectively deal with the problem of default. It is submitted that the buy-out option fails to do this.

ii. Mortgage or lien over interest

The mortgage option allows each contracting party to grant a mortgage interest on its participating interest in the JOA to other JOPs. In the event of a default, the innocent parties can sell the breaching party's interest to a third party or any member of the JOA. A lien over interest operates similarly to the mortgage option. It will usually be the Operator who enforces the lien over the breaching party's interest.³⁶ To aid this process, the JOA may prescribe that each party appoint the other parties to the venture as its attorney, for the purposes of carrying out the transfer of forfeited interest.³⁷ In

³⁶ Where the Operator is the defaulting party, the JOA would specify how the default provisions should be applied. For a discussion, see Eduardo G Pereira and David Sweeney, 'Operator's Default' in Eduardo G Pereira and Wan M Zulhafiz Wan Zahari (eds), *Joint Operating Agreement: Applicability and Enforcement of Default Provisions* (Rocky Mountain Mineral Law Foundation 2018) 51-61.

³⁷ Peter Roberts, 'Fault-lines in the joint operating agreement: forfeiture' (2008) 7 I.E.L.R 274, 275. It is crucial that parties complete all relevant host state regulation pertaining to the registration of the mortgage or lien. Otherwise, the lien or mortgage may be ineffective.

both options, once the interest is sold, the default amount is recovered from the sale of the breaching party's interest.³⁸ Any excess from the proceeds will pass on to the breaching party. Although this option is similar to the buy-out provision discussed above, it may have more severe consequences for the breaching party. For example, where the value of the breaching party's interest only covers the amount in default, this would leave the breaching party with no compensation. In such case, the breaching party would be stripped of its interest without compensation. This form of sale would be no different from the traditional forfeiture, which is uncompensated. Consequently, the breaching party may challenge the enforcement of this option on the basis that it ought to be interpreted as an unenforceable penalty. The success of such challenge would be dependent on the construction of the clause, as well as whether the innocent parties can demonstrate that there is a legitimate interest in enforcing the sale, and that such sale is neither exorbitant nor unconscionable. It is submitted that this option is not a suitable alternative to forfeiture because it could also face legal challenge under the penalty rule. The limitations with the two options so far discussed have led to the inclusion of the withering option as a default remedy.

iii. Withering option

This is a less restrictive variant of the forfeiture provision. It provides that the breaching party will only forfeit part of its interest based on the amount owed and the amount contributed to the JV before the default event.³⁹ The JOA would specify the

³⁸ See for example, The Canadian Association of Petroleum Landmen Model Form Operating Procedure, Section 5.05B (g). However, such sale is only possible as per the conditions of the LOTOGA and the JOA.

³⁹ Peter Roberts, *Joint Operating Agreements: A Practical Guide* (3rd ed, Globe Business Publishing 2015) 232.

formula which the withering interest is to be calculated. Where default occurs during the early stages of operation, the defaulting party would not have made significant contributions. Therefore, where it defaults during a capital intensive period of operations (eg, development or production phase), the amount owed may exceed its total contributions. In such instance, the withering interest calculation could result in the forfeiture of the breaching party's entire interest.⁴⁰ However, where default occurs during the later stages of operations, the calculation could result in the loss of only some of the breaching party's participating interest, as it would have already made significant contributions. The AIPN Model JOA 2012 includes a withering option which calculates how much of the projected total cost for approved development plans have been made by the breaching party and then reduces its interest accordingly.⁴¹ Yet, this option may allow a party to commit a deliberate breach so as to reduce its participating interest where it faces financial difficulties. Overall, depending on the formula for calculation,⁴² the withering option may lead to total

⁴⁰ This could be the case where default occurs during the early stages of joint operations and the parties have yet to make significant contributions.

⁴¹ Article 8.4.G. For a further discussion on the withering option see, Peter Roberts, *Joint Operating Agreements: A Practical Guide* (3rd ed, Globe Business Publishing 2015) 232-236.

⁴² For example, the AIPN Model JOA 2012, Article 8.4.G.2 provides that: 'The Withering Interest shall be determined based on the following formula: [**Withering price x Default factor x DPPI**]

DPETC

Where:

"Withering Price" means the amount equal to DPETC less DPACP.

"DPETC" means the Defaulting Party's Participating Interest share of the Estimated Total Costs.

"DPACP" means the aggregate costs paid by the Defaulting Party regarding the applicable Development Plan before the date of the Cash Call giving rise to the default.

"Default Factor" means:

1.25, if less than twenty-five percent (25%) of the Estimated Total Costs have been expended by the Parties;

1.20, if at least twenty-five percent (25%) but less than fifty percent (50%) of the Estimated Total Costs have been expended by the Parties;

1.15, if at least fifty percent (50%) but less than seventy-five percent (75%) of the Estimated Total Costs have been expended by the Parties; or

1.10, if at least seventy five percent (75%) of the Estimated Total Costs have been expended by the Parties'.

"DPPI" means the Defaulting Party's Participating Interest as of the due date of the Cash Call giving rise to the default (expressed as a percentage).' (emphasis added).

forfeiture of interest, in which case, it is not an alternative to a forfeiture provision. However, if the calculation results in partial forfeiture, the withering option could operate as a less restrictive alternative to total forfeiture. Nevertheless, allowing the breaching party to retain a measure of its interest may expose the remaining JOPs to future financial risk if that party is in serious financial difficulty. This would also put the JOA at risk. Additionally, the withering option involves quite a complex and likely lengthy process, which may unnecessarily hinder ongoing operations.

The inadequacy of the above options in dealing with default is the major factor which drives parties to use the forfeiture provision despite contentions on enforcement.

6.2. Forfeiture

The FC is regarded as the last resort where the breaching party still retains its participating interest and has yet to remedy its breach at the end of a grace period. At the end of the grace period, where default remains, the forfeiture provision will be triggered, if contained in the JOA.⁴³

6.2.1. What is a forfeiture?

The definitions of forfeiture often describe an act involving the loss of property or monies as a penalty for wrongdoing.⁴⁴ In Dr Johnson's Dictionary, to forfeit is, 'to

⁴³ Peter Roberts, *Joint Operating Agreements: A Practical Guide* (3rd ed, Globe Business Publishing 2015) 223.

⁴⁴ 'forfeit, f' (Oxford Dictionaries Online) <<http://www.oxforddictionaries.com/definition/english/forfeit>> accessed 2nd August 2016. The Oxford English Dictionary defines 'forfeit' as something, 'that has been lost or has to be given up as the penalty of a crime or fault or breach of engagement'. 'forfeit, f' (*OED Online*, OUP 2019) <<https://www-oed-com.ezproxye.bham.ac.uk/view/Entry/73278?result=2&rskey=IFEIXt&>> accessed 21 September 2019.

lose by some breach of condition'. The Imperial Dictionary provides a definition in regard to property and describes forfeiture as 'a loss of the right to possess'.⁴⁵

In the context of commercial contracts, a FC can involve the loss of future payment or the retention of monies paid.⁴⁶ It can also have the effect of reacquiring property from the breaching party, in favour of the non-breaching contractual party.⁴⁷ As the FC is only triggered after the breaching party has failed to cure/remedy its breach within the grace period (generally sixty days),⁴⁸ it is possible for the breaching party to remedy its breach before the forfeiture provision is implemented. However, where it is unable to cure its breach, it will likely seek to assign its interests, or

⁴⁵ As quoted in *Re Sumner's Settled Estates* [1911] 1 Ch 315 [319] (Eve J).

⁴⁶ In *Makdessi*, clause 5.1 and clause 5.6 meant that the defaulting party was to lose the right to receive future payments, as well as lose the value of the goodwill of the business. *Cavendish Square Holdings BV v Talal El Makdessi* [2015] UKSC 67, [2015] 3 WLR 1373 (SC) [55].

⁴⁷ *Jobson v Johnson* [1989] 1 WLR 1026, 1026-1027. This case involved the retransfer of shares by the defaulting party.

⁴⁸ This would be between 30 to 60 days. Mozambique Draft Joint Operating Agreement (March 2006) Article 8.4 (D) stipulates a grace period of 30 days; OGUK Model JOA 2009, Clause 17.6.1- 60 days (or 30 during the exploration stage); JOA Danish 2014, Article 11.3.3- 60 days; The Model JOA Norway 2013 (Article 9.3) is more forbearing with the breaching party by providing a grace period of three months.

withdraw from the JOA where possible, so as to avoid the disrepute of forfeiture.⁴⁹

It is relevant to mention that a voluntary withdrawal by the defaulting party is different from a forced transfer of interest following default. The latter comes within the scope of a forfeiture and could be challenged as unenforceable under the penalty rule.⁵⁰ Whereas, in a voluntary transfer/withdrawal without compensation, the defaulting party is unlikely to dispute the enforceability of the withdrawal provision, since it freely made such transfer of interest.

Given the contentions surrounding the forfeiture provision, it is useful to have a list which elucidates the chief features of a forfeiture. Also, provisions which pertain to forfeiture may not always be labelled as such. Thus, a list which stipulates the elements of a forfeiture is crucial as it will assist in a determination of whether an impugned provision is a forfeiture in its substance. More so, a clear identification of these key features will aid discussions on enforcement.

⁴⁹ These factors may explain the dearth of case law on forfeiture provisions in oil and gas JOA. However, in some cases, the defaulting party may decide not to remedy its default. This would leave the remaining JOPs with no option than to exercise the relevant default remedy under the JOA. For example, in November 2015 the Norwegian oil company Noreco (UK subsidiary) defaulted on a cash-call under the Huntington JOA. It did not remedy the default within the specified 45 days, leading the remaining joint venturers to issue a formal notice to acquire its 20% participating interests for no consideration, in accordance with the provisions of the JOA (forfeiture rights). Offshore Energy Today, 'Noreco set to lose Huntington stake' (02 November 2015) <<http://www.offshoreenergytoday.com/noreco-set-to-lose-huntington-stake/>> accessed 11 November 2017; Norwegian Energy Company ASA, 'Noreco Annual Report 2015' <http://www.noreco.com/Global/Annual_report_2015_Group.pdf> 1, 84 accessed 11 November 2017; Offshore Energy Today, 'Noreco exits Huntington Field (UK)' (11 January 2016) <<http://www.offshoreenergytoday.com/noreco-exits-huntington-field-uk/>> accessed 11 November 2017. In December 2016, Noreco (one of the remaining three joint venturers) entered into an agreement with Premier Oil to transfer its 20% participating interest. Another joint venturer (Iona Energy) became insolvent in 2016, leading to an increase in Premier oil's total participating interest. See Offshore Energy Today, 'Iona Energy goes into administration' (07 January 2016) <<http://www.offshoreenergytoday.com/iona-energy-goes-into-administration/>> accessed 11 November 2017. energy-pedia news, 'UK: Noreco transfers interest in Huntington licence to Premier Oil' (19 December 2016) <<https://www.energy-pedia.com/news/united-kingdom/noreco-transfers-interest-in-huntington-licence-to-premier-oil-169428>> accessed 11 November 2017; Premier Oil, 'Proposed acquisition of the EPUK Group Circular to Shareholders and Notice of General Meeting' (25 April 2016) <<http://www.premier-oil.com/premieroil/dlibrary/panda/Eva-FINAL-CIRCULAR.pdf>> accessed 11 November 2017.

⁵⁰ 'A forced transfer for no consideration or for a consideration which does not reflect the value of the asset transferred may constitute a penalty within the scope of the penalty doctrine'. *Cavendish Square Holdings BV v Talal El Makdessi* [2015] UKSC 67, [2015] 3 WLR 1373 (SC) [183].

6.2.2. Key features of a forfeiture clause

There is no single rule or doctrine against contractual forfeiture, although there are means of exercising control over them (such as relief against forfeiture, or applying the penalty rule).⁵¹

In assessing the current position of English law on forfeiture, it is submitted that for a provision to be regarded as a FC four features must be present.

Firstly, the provision is triggered in response to a breach of contract.⁵² Secondly, the defaulting party will lose the right to that which is ‘forfeited’ in perpetuity.⁵³ Thirdly, the non-defaulting party directly benefits from the loss, either by acquiring that which is forfeited or by having the right to transfer it to a nominated individual/entity.⁵⁴ Lastly, the provision is inserted as a security to compel performance or where performance does not occur, to give the innocent party a right to abstain from future performance – the innocent party’s performance being contingent on that of the defaulting party.⁵⁵

The four features identified above will assist in the determination of whether a provision is a forfeiture in substance, even though it might not be labelled as such in the agreement. It is the effect of the provision that matters, rather than its title or form.

In examining how the FC appears in the JOA, two samples are detailed below.

⁵¹ The forfeiture rule in English law relates to wills and the laws of succession. The Forfeiture Act 1982, section 2. A discussion on that rule is outside the scope of the thesis.

⁵² See *B.I.C.C v Burndy Corp*, [1985] Ch 232; *Jobson v Johnson* [1989] 1 WLR 1026; *Cavendish Square Holdings BV v Talal El Makdessi* [2015] UKSC 67, [2015] 3 WLR 1373 (SC).

⁵³ *ibid.*

⁵⁴ *ibid.*

⁵⁵ *Cavendish Square Holdings BV v Talal El Makdessi* [2015] UKSC 67, [2015] 3 WLR 1373 (SC).

Sample Forfeiture Clauses

1. *AIPN Model JOA 2012*

Article 8.4.D If a Defaulting Party fails to fully remedy all its defaults by the thirtieth (30th) Day of the Default Period,

Optional Provision, choose Option if desired – Expedited Forfeiture for Subsequent Default

or by the fifteenth (15th) Day of the corresponding Default Period of any subsequent default occurring within twelve (12) Months of the preceding default,

then, without prejudice to any other rights available to each non-defaulting Party to recover its portion of the Total Amount in Default, at any time afterwards until the Defaulting Party has cured its defaults:

8.4.D.1 any non-defaulting Party shall have the option, exercisable in its discretion at any time, to require that the Defaulting Party offer to completely withdraw from this Agreement and assign all of its Participating Interest, as described in Article 8.4.E; and/or...⁵⁶

The reference to forfeiture is in the optional provision for subsequent default.

2. *Model JOA for Licence Denmark 2014, Article 11.2 and Article 11.3.3*

The Defaulting Party shall have the right to remedy the default at any time prior to forfeiture, as hereinafter provided, by payment in full to the Operator or, if the Non-Defaulting Parties have paid any amounts under Section 11.1 (d), the Non-Defaulting Parties, in proportion to the amounts so paid by them, of all amounts in respect of which the Defaulting Party is in default together with interest thereon calculated at the rate of five per cent (5%) above the Cost of Funds Rate from and including the due date for payment of such amounts until the actual date of payment.⁵⁷

In the event that the default continues for more than sixty (60) days then each of the Non-Defaulting Parties shall have the right to claim forfeiture and to acquire, by notice to the other Parties given within thirty (30) days after such period of sixty (60) days, the interest of the Defaulting Party in the Licence and in and under this Agreement ("Defaulted Interest") or, if more than one (1) Non-Defaulting Party exercises such right, its proportionate share of the interest of the Defaulting Party in the Licence and in and under this Agreement, such share being the

⁵⁶ AIPN Model JOA 2012, Article 8.4.D.1 (emphasis added).

⁵⁷ Model JOA for Licence Denmark 2014, Article 11.2.

proportion in which its Percentage Interest bears to the total Percentage Interests of such Non-Defaulting Parties...⁵⁸

In assessing the certainty or perhaps uncertainty of IOCs in using the forfeiture provision as a default remedy, the next section considers the attitude of the courts towards FCs.

6.3. Possible challenges against forfeiture

Presently, where a forfeiture provision is triggered, the breaching party against whom the provision is applied can seek to challenge the enforceability of the provision from three positions. The first challenge is to the procedural process of the forfeiture provision; this includes events leading up to forfeiture. The second is to argue that the provision is an unenforceable penalty. The third is to argue that even if it is not a penalty, the provision is one over which the court can grant relief against forfeiture.

6.3.1. *Whether the prescribed process was followed*

The JOA would set out the procedure for issuing and responding to cash-calls,⁵⁹ time limits,⁶⁰ conditions relevant to forfeiture,⁶¹ and the acquisition of the breaching party's interest by the non-defaulting party.⁶² Where there has been a failure to follow any of these conditions and the forfeiture provision is applied against a breaching party, that party can challenge the lawfulness of the forfeiture. Where the court finds that the

⁵⁸ *ibid*, Article 11.3.3.

⁵⁹ See for example- AIPN Model JOA 2012, Article 3.3C. 'Cash Call means any request for the Parties to advance their respective Participating Interest shares of estimated cash requirements for the next Calendar Month's Joint Operations in accordance with an approved Work Program and Budget'. AIPN Model JOA 2012, Definitions.

⁶⁰ For example - Model JOA for Licence Denmark 2014, Article 11.1(a)(b)(c)(d).

⁶¹ *ibid*, Article 11.3.3.

⁶² *ibid*, Article 11.3.4.

condition has not been satisfied or that the procedure in question has not been followed, this may invalidate the forfeiture altogether.

In a Canadian case, *Amneet Holdings Ltd. v 79548 Manitoba Ltd. et al.*,⁶³ the failure to meet cash-call demands led to the forfeiture of interests in the JV. This concerned a JV over a shopping mall and the forfeiture of the claimant's interest upon defaulting on its cash-call. The JV parties reached an agreement to contribute additional cash into the project in order to pay down the mortgage principal, leading to an extension of the mortgage and avoid the mortgagee taking adverse action. This additional cash contribution was made through a cash-call. The claimant argued that this cash-call was invalid and thus the forfeiture was invalid. It also sought relief against forfeiture. Its position was based principally on the argument that the agreement between the parties was an investment in a corporation and not a JV, thus the proceedings for the cash-call should be governed by the Corporations Act. At first instance and on appeal, it was held that the investment agreement was a JV and, more importantly, that the cash-call and the resulting forfeiture were both in line with the process set out in the agreement. In upholding the decision, the Court of Appeal held that, if proper notice is given in accordance with the JV agreement, failure to meet the cash-call would result in the forfeiture of interest.⁶⁴ The court did not engage in a thorough discussion of the forfeiture provision since what was in question was the procedure surrounding the cash-call. However, what is clear here is that a forfeiture provision can be challenged if the procedure set out for forfeiture is not followed. Where the challenge is successful, the parties must decide whether to follow the

⁶³ (2004) CarswellMan 84; (2004) MBCA 32.

⁶⁴ *Amneet Holdings Ltd. v 79548 Manitoba Ltd. et al* (2004) CarswellMan 84; (2004) MBCA 32 [32].

correct procedure or if the financial default has been remedied by this time, the parties may elect to continue with operations as normal.

The Australian Court also took a similar approach in *Empire Oil Company Ltd and ERM Gas v Wharf Resources*,⁶⁵ which concerned a JOA over a petroleum permit. There was a provision that a party who failed to meet its cash-call demand could be deemed to have given a notice of withdrawal from the JV. The defendant defaulted over three cash-calls and the claimants executed transfers, deeds of assignment and the like, so as to give effect to the deemed withdrawal. The claimants sought a declaration from the court to declare that defendant was a defaulting party and therefore withdrawn from the JOA, as well as a declaration approving the transfers and assignment of the defaulting party's interest to the claimants. The defendant argued that the Operator (*Empire*) was not authorised to issue the cash-call because a separate Production JOA was needed to govern that phase of operations. Notably, the defendant did not appear at trial, thus the court could only consider the defences it had previously filed in its pleadings through its solicitors. The key issue considered by the court was whether the stipulated procedure for the cash-calls were followed. The court found that this was satisfied and held that there had been a deemed withdrawal of the breaching party through its default and that such withdrawal was valid and effective, according to the JOA.⁶⁶ The decision illustrates that where there is a challenge to the procedural process of the forfeiture, the court will look to the terms of the agreement and follow the specified guidance in the JOA.

⁶⁵ (2014) WASC 179.

⁶⁶ *Empire Oil Company Ltd and ERM Gas v Wharf Resources* (2014) WASC 179 [61].

A recent English case on the issue is *Pan Petroleum AJE Limited v (1) Yinka Folawiyo Petroleum Co Ltd and Others*.⁶⁷ This concerned a JOA to develop oilfields in Nigeria. A dispute arose concerning the validity of two cash-calls. Pan Petroleum (the alleged defaulter) failed to pay a cash-call, but successfully made an application for an interim injunction (pending arbitration proceedings) to prevent the non-defaulting parties from exercising remedies under the JOA. Pan Petroleum succeeded in its argument that the disputed cash-call had not been issued in accordance with the JOA. The High Court ruled in its favour and this decision was upheld by the Court of Appeal. This decision demonstrates how an unlawful procedure may delay or frustrate non-defaulting parties from exercising default remedies (such as forfeiture) under the JOA.

Where the court does not find any procedural irregularity which invalidates the default remedy, the breaching party can challenge that the provision is a penalty and therefore unenforceable.

6.3.2. *Whether the forfeiture clause is a penalty*

At the time of writing, there is no English decision which analyses the interpretation of FCs within the oil and gas JOA context. The leading case on the operation of the common law penalty rule (as applicable to forfeiture) in English law is *Cavendish Square Holdings BV v Talal El Makdessi*⁶⁸ (*Makdessi*). This was not related to a LOTOGA, rather it concerned the sale of majority shares in an advertising company.

⁶⁷ *Pan Petroleum AJE Limited v (1) Yinka Folawiyo Petroleum Co Ltd*; (2) *YFP Deepwater Co Ltd*; (3) *EER (Colobus) Nigeria Ltd*; (4) *Newage Exploration Nigeria Ltd*; and (5) *PR Oil & Gas Nigeria Ltd* [2017] EWCA Civ 1525.

⁶⁸ *Cavendish Square Holdings BV v Talal El Makdessi* [2015] UKSC 67, [2015] 3 WLR 1373 (SC); [2012] EWHC 3582 (Comm).

There were two clauses (5.1 and 5.6) in issue. One provided that the seller (Makdessi) would lose the rights to any further instalments if it breached the non-compete clauses included in the agreement.⁶⁹ The second provided that the buyer (Cavendish) could purchase the remaining shares at a substantially reduced price, which would exclude the value of the goodwill of the business. The legal question was whether these two clauses were penalties and thus unenforceable. At first instance, the judge concluded that although on the construction of the FC it was challengeable as a penalty, it would not be interpreted as such because it had a legitimate commercial purpose. The purpose was to adjust the consideration due to the seller following its breach.⁷⁰ On the contrary, the Court of Appeal held that the forfeiture provision was an unenforceable penalty because its main purpose was to deter a contractual breach⁷¹ and so it could not be commercially justifiable. The Supreme Court concluded that, as a matter of construction, neither clause was a penalty and so the penalty rule was not engaged. Thus, both clauses were enforceable.⁷² Although numerous commentaries on this decision link it to forfeiture provisions in oil and gas JOA,⁷³ in actual fact, very little was made about forfeiture in the appeal. The focus was on whether either clause 5.1

⁶⁹ The Supreme Court held that ‘...[t]he clause is in reality a price adjustment clause. Although the occasion for its operation is a breach of contract, it is in no sense a secondary provision.’ *Cavendish Square Holdings BV v Talal El Makdessi* [2015] UKSC 67, [2015] 3 WLR 1373 (SC) [74] (Lord Neuberger and Lord Sumption SCJJ). Therefore, the rule against penalties could not apply. A majority of 4 held clause 5.1 to be a primary obligation, whilst the remaining three opted not to decide.

⁷⁰ *Cavendish Square Holdings BV v Talal Makdessi* [2012] EWHC 3582 [51].

⁷¹ *Cavendish Square Holdings BV v Talal Makdessi* [2013] EWCA Civ 1539 [120-123].

⁷² *Cavendish Square Holdings BV v Talal El Makdessi* [2015] UKSC 67, [2015] 3 WLR 1373 (SC) [88].

⁷³ See Judith Aldersey-Williams and others, ‘Default clauses in joint operating agreements: recent guidance from the English courts’ (2016) 1 I.E.L.R 36-57; Adam Dann and others, ‘Oil & Gas JOA Defaults: Enforcing Forfeiture Clauses after the Cavendish Square Decision’ (Brewin Leighton Paisner, February 2016) <<https://www.bclplaw.com/en-GB/index.html>> accessed 02 August 2016; Mark Stefanini and David Smith, ‘JOA Defaults: Enforcing Forfeiture Clauses Following the UK Supreme Court’s Cavendish v Makdessi Decision’ (Mayer Brown, 20 June 2016) <<https://www.mayerbrown.com/joa-defaults-enforcing-forfeiture-clauses-following-the-uk-supreme-courts-cavendish-v-makdessi-decision-06-20-2016/>> accessed 02 August 2016.

or 5.6 amounted to an unenforceable penalty. The general view in several commentaries is that an English court may likely enforce forfeiture provisions in oil and gas JOAs following the decision of the Supreme Court in *Makdessi*.⁷⁴ It is submitted that such a view is far too optimistic. Rather, given the difficulties which accompany the primary/secondary divide as laid down in the revised penalty test, there is little certainty on how a court might interpret forfeiture provisions in JOAs. It is submitted that the best means of ensuring that the FC will be enforced is for IOCs to focus on the construction of the FC, as well as ensuring it satisfies the conditions laid down in *Makdessi*. These will be discussed below.

Overall, what the *Makdessi* decision does make clear is that FCs are in principle subject to the rule against penalties. Lord Neuberger and Lord Sumption SCJJ (with whom Lord Carnwath SCJ agreed) established the ‘*Makdessi* test’⁷⁵ to be applied in deciding whether a provision is a penalty, moving on from the four stage test laid down by Lord Dunedin in *Dunlop Pneumatic*,⁷⁶ or the defence of commercial justification applied in earlier cases.⁷⁷ The main part of what Lord Neuberger and Lord Sumption SCJJ described as the ‘true test’ is the reference to whether the sum or

⁷⁴ See David Lewis and others, ‘Enforcement of JOA forfeiture provisions following the Supreme Court decision in *Cavendish Square Holdings B.V. v. Makdessi* [2015] UKSC 67’ (Clifford Chance, November 2015) <https://www.cliffordchance.com/briefings/2015/11/enforcement_of_joaforfeitureprovision.html> accessed 03 August 2016; Segun Osuntokun, Tim Sumner, Lisa Allenden, ‘Oil & Gas JOA Defaults: Enforcing Forfeiture Clauses after the Cavendish Square Decision’ (Berwin Leighton Paisner, February 2016) <http://www.blplaw.com/media/how-can-we-help-you/finance/Oil_Gas_JOA_Defaults_-_Enforcing_forefeiture_clauses_after_the_Cavendish_Square_Decision.pdf> accessed 09 February 2018; William Day, ‘A Pyrrhic victory for the doctrine against penalties: *Makdessi v Cavendish Square Holding BV*’ (Case comment) (2016) *Journal of Business Law* 115, 127.

⁷⁵ *Cavendish Square Holdings BV v Talal El Makdessi* [2015] UKSC 67, [2015] 3 WLR 1373 (SC), para 32.

⁷⁶ *Dunlop Pneumatic Tyre co. Ltd v New Garage and Motor co. Ltd* [1915] AC 79, page 87. This test was to distinguish whether a provision was a penalty or a liquidated damages provision.

⁷⁷ *Scandinavian Trading Tanker co. AB. v Flota Petrolera Ecuatoriana* (The *Scaptrade*) [1983] 2 AC 694, [1983] 3 WLR 203 (HL); *Lordsvale Finance v Bank of Zambia* [1996] QB 752; *Cavendish Square Holdings BV v Talal El Makdessi* [2012] EWHC 3582 Comm.

remedy is ‘...out of all proportion to any legitimate interest of the innocent party...’.⁷⁸

Lord Hodge’s test asks whether the provision is exorbitant or unconscionable when viewed against the innocent party’s interest in the performance of the contract.⁷⁹ These two tests are essentially the same, save for the reference to ‘secondary obligation’ by Lord Neuberger and Lord Sumption SCJJ.⁸⁰ The true test will be referred to throughout the thesis as the *Makdessi* test. It states:

The true test is whether the impugned provision is a secondary obligation which imposes a detriment on the contract breaker out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation. The innocent party can have no proper interest in simply punishing the defaulter. His interest is in the performance or in some appropriate alternative to performance...⁸¹

6.3.2.1. *Makdessi and the implications for forfeiture provisions in JOAs*

The true test has two parts. The first is a construction test which asks whether the provision is a primary or secondary obligation. If it is a secondary obligation, the second part of the test is to assess two issues: one, whether the innocent party/parties have a legitimate interest for the imposition of the provision on the defaulting party; and two, whether the provision is unconscionable or exorbitant when viewed against the legitimate interest of the innocent party.

⁷⁸ *Cavendish Square Holdings BV v Talal El Makdessi* [2015] UKSC 67, [2015] 3 WLR 1373 (SC) [32] (Lord Neuberger and Lord Sumption SCJJ) (with whom Lord Carnwath SCJ agreed).

⁷⁹ The test by Lord Hodge (para 255) and Lord Mance SCJJ (para 152) is essentially the same. Lord Toulson SCJ endorsed Lord Hodge’s test, Lord Clarke SCJ agreed with Lord Mance and Lord Hodge SCJJ.

⁸⁰ Lord Hope D, ‘The Law on Penalties – A Wasted Opportunity?’ (2016) 33 *Journal of Contract Law* 93-107. *ibid*; Judith Aldersey-Williams and others, ‘Default clauses in joint operating agreements: recent guidance from the English courts’ (2016) 1 *I.E.L.R.* 36, 43. The Law Reporter also cites the true test- [2015] WLR(D) 439.

⁸¹ *Cavendish Square Holdings BV v Talal El Makdessi* [2015] UKSC 67, [2015] 3 WLR 1373 (SC) [32] (Lord Neuberger and Lord Sumption SCJJ) (with whom Lord Carnwath SCJ agreed).

i. Construction test: Primary/ Secondary obligation divide

This thesis has reservations about the primary/secondary divide and proposes a number of alternatives. This is on account of the difficulties which can accompany the determination of whether a provision is indeed a primary or secondary obligation. In 2016, the Scottish Law Commission provided a brief summary of the history of the distinction between primary and secondary obligations in English law.⁸² Citing Birks, it noted:

An obligation is secondary or remedial when the event by which it is triggered is the breach of another, pre-existing obligation. Obligations born of such events stand in a fixed temporal and logical relationship to the anterior obligations which they protect. They are dependent and subsequent. That explains ‘secondary’. By contrast primary obligations are those which lack these properties. The events which bring them into being are not breaches of other obligations. Consequently they neither suppose the anterior existence of, nor function as remedies for, any other obligation.⁸³

Arguably, this explanation is of limited significance as it does not help to distinguish whether the impugned clauses in *Makdessi* were indeed primary, contingent primary or secondary obligations. Its usefulness is limited to relatively straightforward clauses where it is less complicated to separate primary and secondary obligations. For example, a clause might provide that party A has to pay party B a specified amount if party A fails to fulfil a particular obligation within a certain period of time. The obligation to pay could be regarded as a secondary obligation because it is triggered in breach of the duty to perform a specified obligation (the primary obligation). However, this will not always be the case. In *Makdessi*, the provision (clause 5.6)

⁸² Scottish Law Commission, *Review of Contract Law: Discussion Paper on Penalty Clauses* (Scot Law Com No 126, 2016) 1, 27 <https://www.scotlawcom.gov.uk/files/1314/8049/7097/Discussion_Paper_on_Penalty_Clauses_DP_No_162.pdf> accessed 22 June 2018.

⁸³ *ibid* 27. Peter Birks, ‘Obligations: One Tier or Two?’ in P G Stein and A D E Lewis (eds) *Studies in Justinian’s Institutes in memory of J A C Thomas* (Sweet & Maxwell 1983) 21.

which led to the loss of the goodwill of the business following a breach of the restrictive covenant was interpreted as a primary obligation by a majority of 4 to 3. Lord Neuberger and Lord Sumption SCJJ reasoned that the FC was a primary obligation because it gave the buyers the option to purchase shares for distinct commercial reasons.⁸⁴ In addition, Lord Carnwath and Lord Mance SCJJ also interpreted the provision as a primary obligation.⁸⁵ However, this writer is not convinced of this reasoning since the buyer's right to acquire the shares excluding the value of their goodwill was a direct result of the seller's breach. A primary purpose of the FC was to serve as a deterrent against breach – the failure to perform is what triggered the FC. In the writer's view, the FC should have been interpreted as a secondary obligation, although it had a legitimate interest. This argument is in line with Lord Hodge's reasoning that the FC was a secondary obligation because its purpose was to deter the seller from breaching the restrictive covenants.⁸⁶ Lord Clarke and Lord Toulson SCJJ were also in agreement with Lord Hodge SCJ in relation to the interpretation of the FC as a secondary obligation,⁸⁷ albeit that neither of the two Lords delivered a separate reasoning on this. This decision does reflect the difficult

⁸⁴ *Cavendish Square Holdings BV v Talal El Makdessi* [2015] UKSC 67, [2015] 3 WLR 1373 (SC) [83] (Lord Neuberger and Lord Sumption SCJJ).

⁸⁵ Lord Carnwath SCJ agreed with the assessment of the forfeiture provision as a primary obligation (at para 83). Lord Mance SCJ also held that the forfeiture provision was a primary obligation '... clause 5.6 must be viewed in nature and impact as a composite whole as well as in context. It operates as an element in a mechanism provided by clauses 5 and 11.2 for bringing to an end the continuing relationship between WPP and a defaulting shareholder. Although triggered by default, it amounts, like clause 5.1, to a reshaping of the parties' primary relationship.' *Cavendish Square Holdings BV v Talal El Makdessi* [2015] UKSC 67, [2015] 3 WLR 1373 (SC) [183].

⁸⁶ *Cavendish Square Holdings BV v Talal El Makdessi* [2015] UKSC 67, [2015] 3 WLR 1373 (SC) [280].

⁸⁷ Lord Clarke did not deliver a separate judgment on the forfeiture clause as a secondary obligation, rather he pointed to Lord Hodge's brief reasoning at para 280. Lord Toulson agreed with the reasoning of Lord Mance and Lord Hodge, dissenting only in part on *ParkingEye*. See para 292-316.

interpretative questions that can arise in the determination of primary or secondary obligations.

Further illustrating the difficulties with the primary/secondary divide, and consequently the penalty point, are two conflicting decisions post *Makdessi*, noted in the Scottish Law Commission 2018 Report on Penalty clauses.⁸⁸ The first is *Gray v Others v Braid Group Holdings Limited*⁸⁹ (hereafter *Gray*) (Scottish decision) which concerned a ‘bad leaver’ clause in a company’s Articles of Association. According to this clause, a shareholder who had engaged in bribery was required to sell its shares at par value not market value, leading to an undervalue of over £18 million. An Extra Division held unanimously that the clause was not a primary or conditional primary obligation. This was because the only instance in which a ‘Bad Leaver’ could be compelled to transfer his shares at a lower price (subscription price) was where it had engaged in fraud or gross misconduct, which constituted a breach of contract.⁹⁰ This meant that it was a secondary obligation. However, according to a majority, it was not an unenforceable penalty. Lord Menzies (with whom Lord Brodie agreed⁹¹) reasoned that the fraud or gross misconduct constituted the breach of the primary obligation, with the transfer of shares provision being the secondary obligation.⁹² In

⁸⁸ Scottish Law Commission, *Report on Review of Contract Law: Formation, Interpretation, Remedies for Breach, and Penalty Clauses* (Scot Law Com No 252, 2018) <https://www.scotlawcom.gov.uk/files/1115/2222/5222/Report_on_Review_of_Contract_Law_-_Formation_Interpretation_Remedies_for_Breach_and_Penalty_Clauses_Report_No_252.pdf> accessed 17 June 2018.

⁸⁹ [2016] CSIH 68, 2016 SLT 1003.

⁹⁰ *Gray v Others v Braid Group Holdings Limited* [2016] CSIH 68, 2016 SLT 1003.

⁹¹ *ibid* para 106.

⁹² *ibid* para 82 (Lord Menzies).

differentiating the transfer provision (Article 6.8.2.2) from clause 5.1 (loss of goodwill) in *Makdessi*, Lord Menzies noted that, the *Makdessi* clause:

...reflected to a large extent goodwill was being sold by way of instalment payments, and during the course of those instalments steps were taken by the seller which might reduce the value of the goodwill and therefore reduce the price...⁹³

In contrast, the transfer clause in *Gray* was ‘...a mechanism for determining the consequences of a subsequent default, which may occur many years later...’.⁹⁴

Although Lord Malcolm (the third judge in the Extra Division) did not directly express whether the bad leaver provisions were a primary or secondary provision, his comments indicate that he favoured that it was a secondary obligation,⁹⁵ and that such obligations were a ‘...legitimate and proportionate response to the issues and problems likely to arise if and when circumstances justified their implementation’.⁹⁶

The claimant tried to appeal to the UK Supreme Court, but leave was denied.

The second case is *Richards and Purves v IP Solutions Group Ltd*,⁹⁷ (hereafter *Purves*) (English decision) which also concerned a ‘bad leaver’ who was required to retransfer shares at £1. In contrast to the previous case (*Gray*) the Judge (May J) held that the clause was ‘more akin to a primary obligation agreed between parties for distinct commercial reasons to do with a shareholder leaving the Company’.⁹⁸ In a brief reference on the penalty issue and transfer provision in *Makdessi*, May J noted

⁹³ *ibid.*

⁹⁴ *ibid.*

⁹⁵ *ibid* para 114-126. (Lord Malcolm).

⁹⁶ *ibid* para 125 (Lord Malcolm).

⁹⁷ [2016] EWHC 1835 (QB).

⁹⁸ *Richards and Purves v IP Solutions Group Ltd* [2016] EWHC 1835 (QB). Also known as *Richards Anor v IP Solutions Group Ltd* [2016] EWHC 1835 (QB).

that, '[i]t turns on the construction of the particular provision in the context of the agreement or agreements as a whole.'⁹⁹ May J also reasoned that the transfer provision in *Makdessi*:

...appears to have been part of a single agreement which included provisions dealing with Mr Makdessi's continuing obligations as a seller',¹⁰⁰ whilst the transfer provision in *Richards* was '...located in a separate document, being the Articles of Association of the Company adopted by special resolution at the time of the investment.'¹⁰¹

The Judge did not comment on whether this formed the interpretation of why the transfer provision in *Richards* was a primary obligation, rather than a secondary obligation.

Whilst it is accepted that the construction of a provision can affect whether it is deemed to be a primary or secondary obligation, the two decisions are still conflicting. In this writer's view, it is difficult to understand the distinguishing factor which made one clause a secondary obligation, and the other a primary obligation. It is interesting to note that May J held that even if the bad leaver clause were held to be a secondary provision, it was not a penalty since it was not unconscionable.¹⁰²

These decisions highlight this writer's concerns about the uncertainty of the construction part of the *Makdessi* test. IOCs cannot be certain of the court's position to a forfeiture provision; thus it is crucial to ensure that the clause has a clear legitimate expectation, one which is neither unconscionable nor exorbitant.

⁹⁹ *ibid* para 84.

¹⁰⁰ *ibid*.

¹⁰¹ *ibid*.

¹⁰² *Richards and Purves v IP Solutions Group Ltd* [2016] EWHC 1835 (QB) [85].

In mitigating the difficulty of the primary/secondary obligation divide, one could argue that the construction test of the penalty rule ought to be reframed. Presently, where it is determined that a provision is a primary obligation, there need not be any further enquiry and the clause is enforceable. One alternative is for the abolition of the primary/secondary obligation divide solely in oil and gas JOAs, due to their unique structure which makes them distinct from other commercial agreements. But this writer would dismiss this argument on the basis that oil and gas JOAs are not so unique as to warrant such an exemption in the law relating to penalty clauses. The second argument is against the application of the primary/secondary obligation divide in the context of all forfeiture provisions. Yet, the objection to this proposal is that it would create a floodgate of litigation/arbitration, because every clause that appears to deter breach of contract could potentially be subject to the penalty rule. Such an approach would be an unnecessary interference with freedom of contract and would actually create further uncertainty; as such, it is an unsuitable alternative. More importantly, this approach does not help IOCs seeking to enforce a FC because it opens the clause to more scrutiny even if it is drafted to look like a primary obligation.

The argument for the reframing of the construction test is somewhat along the approach of the Australian court, although this was rejected by the UK Supreme Court (hereafter UKSC) in *Makdessi*.¹⁰³ The approach of the Australian court in relation to the penalty rule was the same as that of the English court. However, the High Court of Australia (hereafter HCA) departed from this in the case of *Andrews v Australia and*

¹⁰³ *Cavendish Square Holdings BV v Talal El Makdessi* [2015] UKSC 67, [2015] 3 WLR 1373 (SC) [42] (Lord Sumption and Lord Neuberger SCJJ) (with whom Lord Carnwath SCJ agreed) .

*New Zealand Banking Group Ltd*¹⁰⁴ (hereafter *Andrews*). This was a class action concerning bank charges payable by the customer where a cheque bounced or where the customer went over its available funds or overdraft limit, although there had been no breach of contract. The decision can be summarised in four points. Firstly, the court held that it has equitable jurisdiction to relieve a sufficiently onerous provision, whether or not such provision is triggered by a contractual breach.¹⁰⁵ Secondly, the penalty rule in the common law is different from the test in equity.¹⁰⁶ Thirdly, the penalty rule in common law can only apply to a provision enlivened by a breach of contract, whilst the penalty rule in equity can apply to provisions not triggered by a contractual breach. The Australian approach thus widens the scope of the penalty rule to cover primary obligations. Lastly, where there is no breach of contract, the penalty rule in equity can apply provided that the challenged provision is a collateral stipulation which imposes an additional detriment on the defaulting party, in the nature of a security, for the purpose (in terrorem) of satisfying a primary stipulation.¹⁰⁷ Nevertheless, at common law and in equity, the challenged provision will not be interpreted as an unenforceable penalty unless it is unconscionable or

¹⁰⁴ [2012] HCA 30, 247 CLR 205. The Australian court's approach to the doctrine of penalties was reaffirmed in *Paciocco v Australia and New Zealand Banking Group Limited* [2016] HCA 28. The case also concerned bank charges - the High Court of Australia held that the late payment fees by the bank did not constitute a penalty, neither were the fees unconscionable or unfair under the relevant statutory provisions.

¹⁰⁵ Such provision would be triggered following the failure to perform an obligation, although this failure need not be regarded as a breach of contract.

¹⁰⁶ The court indicated that there is an equitable form of the penalty rule. *Andrews v Australia and New Zealand Banking Group Ltd* [2012] HCA 30, 247 CLR 205 [41], [45].

¹⁰⁷ *Andrews v Australia and New Zealand Banking Group Ltd* [2012] HCA 30, 247 CLR 205 [10], [45].

extravagant, in comparison with the greatest loss the innocent party has suffered from the failure of the defaulting party to fulfil a primary stipulation.¹⁰⁸

The HCA provided an historical background to demonstrate that there is a role (albeit limited) for equity in granting relief from penalties.¹⁰⁹ It argued that there is no need for a breach of contract before equity can intervene, since its intervention is based on the availability of compensation.¹¹⁰ However, the UKSC argued that the equitable jurisdiction to relieve against penalties was linked to defeasible bonds, where a breach of contract was necessary.¹¹¹ Also, it argued that if there was a separate equitable jurisdiction to relieve against penalties wider than the common law jurisdiction, there is no trace in the authorities since the fusion of law and equity.¹¹² The decision of the HCA to apply the penalty rule to provisions not triggered by a breach of contract was rejected by the UKSC in *Makdessi*,¹¹³ which held that the decision involved ‘...a radical departure from the previous understanding of the law...’.¹¹⁴ This ‘radical departure’ is one of the arguments against the decision in

¹⁰⁸ *Andrews v Australia and New Zealand Banking Group Ltd* [2012] HCA 30, 247 CLR 205; *Paciocco v Australia and New Zealand Banking Group Limited* [2016] HCA 28.

¹⁰⁹ *Paciocco v Australia and New Zealand Banking Group Limited* [2016] HCA 28 [18]-[25].

¹¹⁰ *ibid.*

¹¹¹ *Cavendish Square Holdings BV v Talal El Makdessi* [2015] UKSC 67, [2015] 3 WLR 1373 (SC) [42] (Lord Sumption and Lord Neuberger SCJJ) (with whom Lord Carnwath SCJ agreed).

¹¹² *ibid.*

¹¹³ *ibid.* The UKSC held that the Australian approach was inconsistent with established English authority and uncertain in the scope of its application.

¹¹⁴ *Cavendish Square Holdings BV v Talal El Makdessi* [2015] UKSC 67, [2015] 3 WLR 1373 (SC) [41] (Lord Sumption and Lord Neuberger SCJJ) (with whom Lord Carnwath SCJ agreed).

Andrews.¹¹⁵ Nevertheless, in the subsequent case of *Paciocco v Australia and New Zealand Banking Group Limited*,¹¹⁶ which also concerned bank charges, the HCA confirmed the *Andrews* decision. It held that ‘...equitable relief against penalties had not been subsumed into the common law rule and that the rule against penalties was not limited to cases arising out of a breach of contract’.¹¹⁷ Although the HCA did not respond to criticism of *Andrews* by the UKSC, nor critique the UKSC’s approach, it held that:

There is need to respond only to the statement in *Cavendish* that *Andrews* involved “a radical departure from the previous understanding of the law”. To the extent that the statement refers to the common law of Australia, the statement is wrong and appears to be based on a misunderstanding of *Andrews*.¹¹⁸ (The reference to *Cavendish* is to *Makdessi*.)

According to Gageler J’s reasoning, *Andrews* did not disturb the previous law of Australia in relation to the penalty clause. The position in Australia prior to and post *Andrews* is that a provision imposing a penalty is unenforceable at common law without the discretionary intervention of equity.¹¹⁹ The decision in *Andrews* merely asserted and reinforced that there is a separate equitable jurisdiction to relief against penalties. Additionally, Gageler J also reasoned that, the fusion of the administration

¹¹⁵ See Anthony Gray, ‘Contractual Penalties in Australian Law after *Andrews*: An Opportunity Missed’ (2013) 18 *Deakin Law Review* 1-26; Edwin Peel ‘The Rule against Penalties’ (2013) 129 *LQR* 152-157; J W Carter and others, ‘Contractual Penalties: Resurrecting the Equitable Jurisdiction’ (2013) 30 *Journal of Contract Law* 99-132; Sirko Harder ‘The Relevance of Breach to the Applicability of the Rule against Penalties’ (2013) 30 *JCL* 52-69; Jessica Palmer, ‘Implications of the new rule against penalties’ (2016) 47 *Victoria University of Wellington Law Review* 305, 314 <<http://www.nzlii.org/nz/journals/VUWLawRw/2016/17.pdf>> accessed 07 December 2017. Some of these writers argue that the Australian approach has been strongly criticised precisely because it did not provide a sufficient justification (or thorough analysis) for widening the scope of the penalty rule, or indeed for why it departed from previous Australian and United Kingdom case law.

¹¹⁶ [2016] HCA 28.

¹¹⁷ *Paciocco v Australia and New Zealand Banking Group Limited* [2016] HCA 28 [4].

¹¹⁸ *ibid* [121] (Gageler J).

¹¹⁹ *ibid* 122.

of law and equity under the Australian Judicature system did not indicate that the separate equitable jurisdiction had been subsumed into the common law, neither did it mean that it had been abolished.¹²⁰

Despite the criticisms¹²¹ of the Australian approach, one is somewhat sympathetic to it as the HCA sought to remove the rigidity of the penalty rule by extending its application, thereby making it less formalistic and ‘...less capable of avoidance by ingenious drafting’.¹²² Nevertheless, this thesis cannot support the Australian approach as it renders FCs more vulnerable to controls on penalty clauses. It is also in danger of opening the floodgates whereby any provision can be challenged as a penalty. This process would negatively affect operations, create significant uncertainty, as well as waste time and resources. If such an approach were to be followed in the UK, IOCs would have even less certainty about the enforcement of a forfeiture provision.

The primary versus secondary obligation divide: A double-edged sword

On one hand, the uncertainty created by the primary/secondary obligation divide may lead to litigation or challenges to the FC. On the other hand, the presence of the divide guarantees an additional level of protection for non-defaulting IOCs. This is because defaulting parties looking to challenge the FC may be deterred by the prospect that the

¹²⁰ *Paciocco v Australia and New Zealand Banking Group Limited* [2016] HCA 28 [123] (Gageler J). Furthermore, it held that, ‘...the significance of Andrews lies in its explanation of the conception of a penalty as a punishment for non-observance of a contractual stipulation, in its explanation of that conception of a penalty as a continuation of the conception which originated in equity, and in its endorsement of the description of the speech of Lord Dunedin in *Dunlop* as the “product of centuries of equity jurisprudence’ . *ibid* [127].

¹²¹ Anthony Gray and others (n115).

¹²² Mr Bloch QC, who appeared for Mr Makdessi on the first appeal recommended that the court adopt this approach, but this view was rejected. *Cavendish Square Holdings BV v Talal El Makdessi* [2015] UKSC 67, [2015] 3 WLR 1373 (SC) [40].

provision could be interpreted as a primary obligation, thereby avoiding the penalty rule and being enforceable. In such a case, the defaulting party would have to bear the legal costs of the non-defaulting party/parties. Although there is the possibility that the provision could be interpreted as a secondary obligation (thus engaging the penalty test), defaulting parties already in financial difficulty may not want to risk this alternative. Therefore, the primary/secondary divide may reduce the risk that forfeiture provisions could be challenged as unenforceable penalties. This position is favourable to IOCs who wish to ensure that the forfeiture provision is an enforceable contractual method of mitigating the financial risks of a JOA.

Is the forfeiture clause in oil and gas JOAs imposing a primary or secondary obligation?

On the topic of breach, it is useful to mention that in the context of a JOA, the failure to meet the cash-call may not always be referred to as a breach of contract.¹²³ The AMPLA Model Exploration JOA 2011 refers to a defaulting participant as, ‘a participant which has committed a breach of this agreement, whether as an Unpaid Monies Default Event or a Breach Default Event...’.¹²⁴ In contrast, the definition of a defaulting party in the AIPN Model JOA 2012 (Article 8.1.A) only refers to the defaulting party as being, ‘[a]ny Party that fails to pay when due its share of Joint Account charges (including Cash Calls and interest)...’. Although there is no

¹²³ The JOAs listed do not refer to the failure to meet the cash-call as a breach of contract, rather the reference is to the ‘defaulting party’. See Model JOA Greenland 2008; Ghana Joint Operating Agreement 2010- Joint Operating Agreement Kosmos Energy Ghana HC (1) The E.O Group (2) Operating Agreement in Respect of West Cape Three Points Block Offshore Ghana, Clause 3.3 (C) [Accessed at OGEL 15th August 2016]; the AIPN Model JOA 2012; Model Joint Operating Agreement Concerning Petroleum Activities Norway 2013; Model JOA for Licence Denmark 2014.

¹²⁴ AMPLA Model Petroleum Exploration JOA 2011, Definitions 1.1.

reference to a breach of contract in the AIPN Model JOA,¹²⁵ it is argued here that the failure to comply with an obligation of the contract is a breach of contract. This would bring the FC within the net of the penalty rule since the provision is triggered in response to a breach. However, it could also be argued that Article 8.1.A above is an example of a primary obligation wherein the failure of a party to pay leads to other specified actions or consequences. In this sense, one could argue that the terms are permissive.

Although one cannot say with absolute certainty whether a forfeiture provision in an oil and gas JOA would be a secondary obligation, it is suggested that the general structure of many forfeiture provisions in JOAs are in the form of a secondary obligation. The forfeiture provision does not provide the cash shortfall, but by removing the financially unstable party, it allows the innocent parties to proceed with greater financial security and also gives these parties the opportunity to increase their participating interest by acquiring the forfeited interest, with the accompanying benefits, albeit with increased risk. It must be noted that *Makdessi* did not concern a JOA but a mergers and acquisition transaction, therefore the view of the majority in interpreting the forfeiture provision as a primary obligation is unlikely to apply in the context of JOAs. The structure of oil and gas JOAs as earlier discussed in section 6.1 is unique, in that the stability and survival of operations is greatly dependent on a steady cash flow and the replacement of a party in financial difficulty with a more financially reliable party. As a matter of ‘business common sense’/reasonable expectations in the industry, the joint operating party’s primary obligation is to pay

¹²⁵ It may be that the drafters of the AIPN Model JOA sought to produce a Model contract which would be least open to conflict, with a view that parties could add or deduct from the text as they deem fit.

when required. Therefore, by nature, a forfeiture provision is not imposing an obligation but is rather a consequence for the failure to fulfil a duty. As such, it is more of a secondary than primary obligation. Thus, it is hard to conceive how a FC in an oil and gas JOA could be regarded as a primary obligation, since its purpose is to mitigate the results of the failure to meet a cash-call.

Nevertheless, where the forfeiture provision is interpreted as a secondary obligation, it will be examined under the *Makdessi* test. It will be recalled that the two parts of the test are: one, the provision serves a legitimate expectation; two, its application is not unconscionable/exorbitant.

ii. Makdessi test: Legitimate Interest

According to the *Makdessi* test, where a forfeiture provision is interpreted as a secondary obligation, the second stage is to test whether it serves a legitimate interest. The test considers the purpose for the inclusion of a provision; assessing whether the party to whom the provision benefits has a proper interest for its inclusion, and that, the interest goes beyond merely ‘...punishing the defaulting party’.¹²⁶ In a JOA, the innocent parties must have a legitimate interest in the enforcement of the primary obligation, which is, the duty of the defaulting party to timely meet its cash-call. This asks two questions: when is an interest legitimate; and what are the commercial justifications for the inclusion of a forfeiture provision in an oil and gas JOA?

¹²⁶ *Cavendish Square Holdings BV v Talal El Makdessi* [2015] UKSC 67, [2015] 3 WLR 1373 (SC) [32] (Lord Neuberger and Lord Sumpton SCJJ) (with whom Lord Carnwath SCJ agreed).

Part of the history of the legitimate interest test can be traced to the famous case of *White and Carter (Councils) LTD v McGregor*.¹²⁷ This concerned a three year contract for the display of the defendant's advertisements on bins supplied by the claimant. On the day the contract was agreed, the defendant wrote to cancel the advertisements and repudiate the contract, claiming that his representative had misunderstood his wishes. The claimant (advertising contractors) refused the cancellation and continued with the contract. The defendant declined to pay the due amount, leading to the advertising contractors suing for the full payment. The court held that the claimant was entitled to full payment, and was not obliged to accept McGregor's repudiation and sue for damages. Lord Reid notably reasoned as follows:

It may well be that, if it can be shown that a person has no legitimate interest, financial or otherwise, in performing the contract rather than claiming damages, he ought not to be allowed to saddle the other party with an additional burden with no benefit to himself. If a party has no interest to enforce a stipulation, he cannot in general enforce it...¹²⁸

Lord Reid's quote was incorporated into the *Makdessi* test,¹²⁹ and a court faced with the interpretation of a forfeiture provision is required to assess whether the clause serves a legitimate interest¹³⁰ which goes beyond merely compensating the innocent party. The issue is that the payment appears to exceed the claimant's loss, which is valid provided there is a legitimate interest in encouraging performance (rather than breach).

¹²⁷ [1962] AC 413.

¹²⁸ *ibid* at page 431.

¹²⁹ The 'true test' of a penalty- *Cavendish Square Holdings BV v Talal El Makdessi* [2015] UKSC 67, [2015] 3 WLR 1373 (SC) [32] (Lord Neuberger and Lord Sumption SCJJ) (with whom Lord Carnwath SCJ agreed).

¹³⁰ The legitimate interest test is also used in an assessment of when gain-based or restitutionary damages might be ordered.

In safeguarding the FC, the priority should be on making abundantly clear what the legitimate expectations of the parties are as at the time of entering into the contract. Given the structure of a JOA as earlier discussed, it will be relatively straightforward for the innocent parties to demonstrate that all joint venturers have a legitimate interest in ensuring that each party contributes its share of the cash-call, since the survival of the JOA and underlying licence or contract is dependent on steady and timely cash flow. The primary obligation to make financial contributions is at the heart of the JOA; without it, the agreement would collapse. It is recommended that the JOA state the implications of default on all parties, the life of the JOA and the underlying licence or contract. The JOA should not be structured in a way that assumes or presumes that a court is already aware of the implications of default, rather it should state such implications explicitly where possible.

What is the commercial justification for the inclusion of a forfeiture provision? The inclusion of a forfeiture provision (arguably a secondary provision) is a means through which the survival of the JOA is guaranteed, in the event that any party defaults on its financial obligations. The essence of the forfeiture provision is to divest the breaching party of its interest in the JOA and to pass on such interest to a more financially stable JOP. The main commercial justifications for forfeiture provisions in oil and gas JOAs are: certainty of cash flow to ensure stability of operations, safeguarding the investment of non-breaching parties, the need to meet strict time limits for work obligations to the state, reputational risk for parties if operations are delayed¹³¹ or if the JOA collapses, psychological fear of repeated default and, most

¹³¹ Adam Dann and others, 'Oil & Gas JOA Defaults: Enforcing Forfeiture Clauses after the Cavendish Square Decision' (Brewin Leighton Paisner, February 2016) <<https://www.bclplaw.com/en-GB/index.html>> accessed 02 August 2016.

importantly, the survival of the joint venture and underlying licence or contract. The survival of the joint venture through the cash-call is so fundamental that an innocent party can become a defaulting party if it fails to cover the defaulting party's cash contributions according to its participating interest.¹³² Also, the fact that the forfeiture provision applies indiscriminately to any defaulting party highlights the dependence of the JOA on regular and timely cash contributions.¹³³ These justifications must be spelt clearly throughout the JOA and especially in the forfeiture provision.

Based on the above, it is argued that the innocent parties in a JOA have a legitimate interest in enforcing the primary obligation for each party to meet the cash-call, as well as strong commercial justifications for the inclusion of the forfeiture provision where financial default occurs. In the context of JOAs, this limb of the *Makdessi* test is perhaps the least complicated and one where non-defaulting parties can show ample evidence that there is a legitimate interest in enforcing performance of the primary obligation (cash-call).

Although doubtful, in the event that a forfeiture provision interpreted as a secondary obligation is held to lack a legitimate interest, it would have failed the first limb of the *Makdessi* test; the second and last part is to assess whether the obligation imposed by the FC is exorbitant/unconscionable.

¹³² An example of this is provided in the Model JOA for Licence Denmark 2014, Article 11.1 (d).

¹³³ Adam Dann and others, 'Oil & Gas JOA Defaults: Enforcing Forfeiture Clauses after the Cavendish Square Decision' (Brewin Leighton Paisner, February 2016) <<https://www.belplaw.com/en-GB/index.html>> accessed 02 August 2016.

iii. Makdessi test: Exorbitance or Unconscionability

The last limb of the test is that the provision must not be exorbitant or unconscionable.¹³⁴ However, what do either of these words mean and how are they judged? In phrasing the *Makdessi* test, their Lordships reasoned that the provision must not impose ‘...a detriment on the contract-breaker out of all *proportion* to any legitimate interest of the innocent party in the enforcement of the primary obligation...’.¹³⁵ The reference to ‘proportion’ provides some guidance as to how to determine exorbitance and unconscionability. Therefore, proportionality is the key through which to assess whether the provision was excessive to the legitimate interest of the innocent parties. Proportionality can be defined as doing only what is necessary for or in the achievement of a aim – that the action is not ‘out of all proportion’¹³⁶ to the harm suffered.

In a JOA, the court will look at the legitimate interest of the innocent parties in respect of contractual performance by the defaulting party.¹³⁷ It will then adopt a balancing exercise by weighing this expectation against the remedy of forfeiture,

¹³⁴ This is actually the first limb of the four stage test laid down by Lord Dunedin in *Dunlop Pneumatic Tyre co. Ltd v New Garage and Motor co. Ltd* [1915] AC 79, 87.

¹³⁵ *Cavendish Square Holdings BV v Talal El Makdesii* [2015] UKSC 67, [2015] 3 WLR 1373 (SC) [32] (Lord Neuberger and Lord Sumption SCJJ) (with whom Lord Carnwath SCJ agreed) (emphasis added).

¹³⁶ In assessing penalty, the Scottish Commission opined that, ‘[i]t may be that “exorbitant” or “out of all proportion” (but not “disproportionate”) would best capture what is looked for’. Scottish Law Commission, *Report on Review of Contract Law: Formation, Interpretation, Remedies for Breach, and Penalty Clauses* (Scot Law Com No 252, 2018) 1, 220 <https://www.scotlawcom.gov.uk/files/1115/2222/5222/Report_on_Review_of_Contract_Law_-_Formation_Interpretation_Remedies_for_Breach_and_Penalty_Clauses_Report_No_252.pdf> accessed 17 June 2018.

¹³⁷ This is assessed as at the time when the contract was entered into. Adam Dann and others, ‘Oil & Gas JOA Defaults: Enforcing Forfeiture Clauses after the Cavendish Square Decision’ (Brewin Leighton Paisner, February 2016) <<https://www.bclplaw.com/en-GB/index.html>> accessed 02 August 2016.

asking this question, is this remedy exorbitant or unconscionable? Or rather, is this remedy proportional to the interest protected?

At the time of entering into the JOA, the innocent parties would have had a legitimate expectation that the defaulting party would meet all its cash-calls whilst it remained a party to the JOA, so as to ensure timely operations and the survival of the JOA. In the event that this was no longer possible, the innocent parties would have reasonably expected a more financially stable JOP to take over the defaulting party's interest at the end of the grace period. Thus, in terms of the court assessing the legitimate interest of the innocent parties as at the time the contract was entered into, it is argued that there should be a presumption in favour of enforcing forfeiture, unless the measure of its application is out of all proportion. This can be assessed by looking at whether forfeiture was an excessive remedy.¹³⁸ One of the factors the court may consider is whether there was a less restrictive alternative to forfeiture. Such alternatives include buy-out, mortgage or lien over interest and withering option; these were earlier discussed and found to be inadequate in dealing with default.¹³⁹ Moreover, these options may also raise challenges on enforcement.¹⁴⁰

The assessment of proportionality should take note of what is common to oil and gas JOAs. Market norms may be used to determine what is reasonable, and thus

¹³⁸ Their Lordships in *Makdessi* made reference to phrases such as 'excessive' and 'grossly high' in their terminology relating to disproportionality. *Cavendish Square Holdings BV v Talal El Makdessi* [2015] UKSC 67, [2015] 3 WLR 1373 (SC) [164], [265].

¹³⁹ See section 6.1.1 above.

¹⁴⁰ *ibid.*

proportional in the context.¹⁴¹ Forfeiture is commonly used to secure performance of the primary obligation (cash-call); this should support the view that it is neither exorbitant or disproportionate. In *ParkingEye Limited v Beavis* (hereafter *ParkingEye*),¹⁴² an appeal heard by the Supreme Court on the same day as *Makdessi*. It was concluded there that, on the construction of the relevant contract, the penalty rule was engaged because the car park did not suffer a loss where a customer overstayed, but that the car park (management) had a legitimate interest for the imposition of the £85 ‘penalty fee’ for overstaying. Thus, the clause pertaining to the fine was enforceable. The defendant presented evidence indicating that there was a parking industry norm to impose charges for overstaying; this assisted in the argument that the fine was proportionate.¹⁴³ However, the innocent parties must be ready to defend an argument that the move from traditional forfeiture to options such as buy-out (albeit at a discount) and withering option is also evidence that there is some consensus that forfeiture is viewed as disproportionate. The buy-out and withering option still pursue the same aims as the forfeiture provision; that is, the continued stability and survival of the JOA. These alternatives do not reflect different legitimate interests of the innocent parties, rather the use of such options are more likely motivated by precautionary reasoning. That is, JOPs may use the withering option or buy-out model because they are uncertain about the enforcement of traditional forfeiture provisions, and thus, view the alternatives as less likely to offend the

¹⁴¹ Scottish Law Commission, *Report on Review of Contract Law: Formation, Interpretation, Remedies for Breach, and Penalty Clauses* (Scot Law Com No 252, 2018) 1, 189 <https://www.scotlawcom.gov.uk/files/1115/2222/5222/Report_on_Review_of_Contract_Law_-_Formation_Interpretation_Remedies_for_Breach_and_Penalty_Clauses_Report_No_252.pdf> accessed 17 June 2018.

¹⁴² [2015] UKSC 67.

¹⁴³ See Judith Aldersey-Williams and others, ‘Default clauses in joint operating agreements: recent guidance from the English courts’ (2016) 1 I.E.L.R 36, 48.

penalty rule.¹⁴⁴ Yet, these alternatives also come with uncertainties for the innocent parties. The withering option involves a complex calculation which can lead to disputes, thereby stagnating the process. Similarly, the buy-out option requires expert determination if the appraised value offered by an innocent party/parties is not accepted by the defaulting party. This can unnecessarily prolong the process and affect steady operations, especially if the issue remains unresolved by the next cash-call. In the interests of certainty, the parties would prefer a one-off form of remedy to deal with default.

In a JOA, the aim pursued through the use of the forfeiture remedy is the survival of the agreement. This is through transferring the interest of a struggling financial party to a more stable financial party. As such, it is arguably proportionate since the value of the JOA and underlying licence or contract would exceed any loss suffered by the defaulting party who suffers a forfeiture because this party only has a percentage of the whole interest. Yet, if innocent parties still retain the right to sue for damages for breach, as well as to claim costs from the defaulting party in relation to approved work programs, this would amount to a double jeopardy and could raise concerns as to disproportionality.¹⁴⁵ According to Aldersey-Williams, there is a possibility that ‘...the value of any forfeited asset might be taken into account in reducing a sum due from a defaulting participant (i.e. the sum in default might be abated by hydrocarbons forfeited’.¹⁴⁶ It is suggested that the structuring of forfeiture provisions in a manner which avoids or at least reduces the extent of the double

¹⁴⁴ The maxim, better to be safe than sorry, springs to mind.

¹⁴⁵ Judith Aldersey-Williams and others, ‘Default clauses in joint operating agreements: recent guidance from the English courts’ (2016) 1 I.E.L.R 36, 45-46.

¹⁴⁶ *ibid* 46.

jeopardy would assist the innocent parties in demonstrating that the provision is proportionate to the interest protected. This thesis suggests the inclusion of a proviso along the following lines:

Following the application of the forfeiture provision, the innocent parties agree not to pursue any claim against the breaching party for damages at common law. The defaulting party must however satisfy its obligations in relation to decommissioning.

Where there may be other losses, not made good by the forfeiture, but consequent on the breaching party not making the cash-call, the provision may indicate that the breaching party be required to cover this loss, or a percentage of it. Nevertheless, the requirement to cover this loss does again raise the issue of double jeopardy. The parties have to consider the benefit and detriment of adding this requirement in the provision, and consider the likelihood of such additional loss arising.

Overall, forfeiture provisions in oil and gas JOAs can be challenged under the penalty rule. However, for the reasons given above, it is submitted that they would likely be interpreted similarly to *ParkingEye*.¹⁴⁷ That is, although the provision is a secondary obligation which plainly engages the penalty rule, it is not a penalty because it has a legitimate interest which goes beyond merely claiming damages for a breach of contract and it is one which is not out of proportion to the interests of the innocent parties at the time of entering into the contract.¹⁴⁸

A forfeiture provision which is found to lack a legitimate interest, and which is exorbitant or unconscionable, would be an unenforceable penalty under the

¹⁴⁷ *ParkingEye Limited v Beavis* [2015] UKSC 67.

¹⁴⁸ *ibid* at para 99-101.

application of *Makdessi*.¹⁴⁹ However, where the provision passes the *Makdessi* test, the provision would be enforceable. In this case, the last avenue of escape is for the defaulting party to seek relief against forfeiture.

6.3.3. Relief against forfeiture

A forfeiture provision which is not interpreted as a penalty clause is enforceable. However, based on the common law, the courts have limited jurisdiction to grant equitable relief from forfeiture in certain situations.¹⁵⁰ In the prominent case of *Shiloh Spinners v Harding*,¹⁵¹ (hereafter *Shiloh Spinners*) Lord Wilberforce gave specific circumstances in which equity could grant relief from forfeiture. This includes fraud, surprise, mistake, accident, as well as a situation where the defaulting party was ready to pay the amount for which the forfeiture provision was triggered, including interest. *Shiloh Spinners*¹⁵² concerned the right of re-entry over leased property where there had been non-performance of certain obligations by an assignee. The claimants sought possession of the premises while the defendants resisted the right of re-entry and sought relief against forfeiture. The House of Lords held that the court had discretion to grant relief in limited cases, where appropriate, provided the object of the contract and the essence of the forfeiture provision is to secure monetary payment.¹⁵³ Also,

¹⁴⁹ In which case the innocent party would have to rely on its common law remedies for contractual breach, whatever that might be (or simply reach an agreement with the defaulting party). Scottish Law Commission, *Report on Review of Contract Law: Formation, Interpretation, Remedies for Breach, and Penalty Clauses* (Scot Law Com No 252, 2018) 1, 223 <https://www.scotlawcom.gov.uk/files/1115/2222/5222/Report_on_Review_of_Contract_Law_-_Formation_Interpretation_Remedies_for_Breach_and_Penalty_Clauses_Report_No_252.pdf> accessed 17 June 2018.

¹⁵⁰ Edwin Peel, *Treitel on The Law of Contract* (14th edn, Sweet & Maxwell/Thomson Reuters 2015) 1000-1003; Sarah Worthington, 'Penalty Clauses' in Graham Virgo and Sarah Worthington (eds), *Commercial Remedies: Resolving Controversies* (Cambridge University Press 2017) 384-385.

¹⁵¹ *Shiloh Spinners Ltd. v Harding* [1973] AC 691, 722D -723F.

¹⁵² *Shiloh Spinners Ltd. v Harding* [1973] AC 691.

¹⁵³ *ibid* at 722B.

where the purpose of the contract can be achieved (eg, payment of money) if the matter comes before a court, and the forfeiture provision was added as a security to ensure the production of that result.¹⁵⁴ Where the agreement containing the forfeiture provision comes within this ambit, the court will also consider whether the rights in the agreement are possessory or proprietary.

The decision of the House of Lords in the *Scandinavian Trading Tanker co. AB. v Flota Petrolera Ecuatoriana*¹⁵⁵ (hereafter *The Scaptrade*) limited relief from forfeiture to contracts concerning the transfer or creation of possessory or proprietary rights.¹⁵⁶ This decision was followed by the Court of Appeal in *BICC v Burndy*¹⁵⁷ (hereafter *BICC*), where the claim for relief from forfeiture in respect of an assignment of patent rights was successful.

Where a court considers that it has jurisdiction to grant relief from forfeiture in an agreement pertaining to proprietary or possessory rights, it must then decide the form of relief to grant to the breaching party. This can be in the form of granting a time extension for that party to cure its breach, making an order for the return of the

¹⁵⁴ *ibid* at 723G.

¹⁵⁵ *Scandinavian Trading Tanker co. AB. v Flota Petrolera Ecuatoriana (The Scaptrade)* [1983] 2 AC 694, [1983] 3 WLR 203 (HL).

¹⁵⁶ The *Scaptrade* concerned a contract for the hire of a vessel on a time charter. The charterer failed to pay hire on time, upon which the owner withdrew the vessel. The charterer sought relief from the termination of the time charter. The court declined to grant such relief, mainly on the basis that it did not have jurisdiction in respect of a contract of services such as a time charter. Lord Diplock added that there were practical reasons of legal policy for declining to create jurisdiction in this area of contracts. One of such considerations was the notorious volatility of the freight market. Lord Diplock, with whom the other four Lordships agreed, concluded that relief was not available in respect of contractual rights and could only be granted in respect of possessory or proprietary rights, in addition to interests in land, such as mortgages. *Scandinavian Trading Tanker co. AB. v Flota Petrolera Ecuatoriana (The Scaptrade)* [1983] 2 AC 694, [1983] 3 WLR 203 (HL) 702C, 703E. See also *Cukurova Finance International Ltd v Alfa Telecom Turkey Ltd* [2013] UKPC 20, [2015] 2 WLR 875.

¹⁵⁷ *BICC Plc v Burndy Corp* [1985] Ch 232, [1985] 2 WLR 132 [252A] (Dillon LJ).

forfeited interest, or more creatively, to scale down the forfeiture, so that the innocent party is not over-compensated.¹⁵⁸

In the context of a JOA, the question arises whether rights existing in the JOA are contractual, possessory or proprietary. The nature of rights conferred by the state would determine the rights existing in the agreement. Chapter 2 of the thesis discussed the four main types of LOTOGA used in the relationship between IOCs and host states: the concession, licence, PSC and RSC. In a traditional concession, the concessionaire is given proprietary rights over resources.¹⁵⁹ Following the grant of the concession or any licence or contract which confers proprietary rights, the JOA would be modelled on this agreement. In such case, the natural course of things should be that the JOA also confers proprietary rights on all JOPs. However, this may not always be the case. Where an IOC becomes a JOP post the grant of the licence or contract, the structure of the contract may be that the party is only granted contractual and not proprietary rights. The final decision would be dependent on the agreement with the state and any conditions which affect a subsequent JOA, as well as the agreement between JOPs.

Nevertheless, even where the underlying licence or contract only confers contractual rights, there is an argument that a non-proprietary right could still be possessory in nature. This is based on the recent decision of the High Court in *General Motors UK Limited v The Manchester Ship Canal Company Limited*.¹⁶⁰ The

¹⁵⁸ *Jobson v Johnson* [1989] 1 WLR 1026, 1037, 1045-1046. [Option 1- the court could sell the shares and pay the innocent party its actual loss, with the excess paid to the breaching party. Option 2- the court could enforce the retransfer of shares provided their value did not exceed the loss suffered by the innocent party.]

¹⁵⁹ Ernest E Smith and others, *Materials on International Petroleum Transactions* (Rocky Mountain Mineral Law Foundation 2010) 31.

¹⁶⁰ [2016] EWHC 2960 (Ch).

case concerned a licence in perpetuity which granted the claimant the right to discharge surface water through the defendant's land. The claimant failed to make its annual payment, leading to a forfeiture of the licence according to the terms of the agreement. The judge held that although the licence did not concern proprietary rights, it could not be described as pertaining to purely contractual rights because the licence was in perpetuity.¹⁶¹ On this basis, as well as the fact that there were no commercial policy reasons (as in the *Scaptrade*¹⁶²), the judge granted relief from forfeiture, albeit with some hesitation.¹⁶³ The Court of Appeal held that the licence did in fact confer a possessory, albeit not proprietary interest.¹⁶⁴

In the LOTOGA context, the contract area (land) subject to the agreement will dispense nearly all its hydrocarbons during the life of the contract, such that there is little or no benefit left, unless secondary or tertiary recovery is carried out. Perpetuity relates to lasting forever; with forever relating to the life-term or scope in which something continues to exist. It could be argued that because the life of the field as a hydrocarbon reservoir is over when it is no longer producing commercial quantities (irrespective that the contract may be for 20-30 years), it could be viewed as life-term. This is combined with the fact that the IOC may have exclusive rights to the use,

¹⁶¹ *ibid* para 88.

¹⁶² *Scandinavian Trading Tanker co. AB. v Flota Petrolera Ecuatoriana* (The *Scaptrade*) [1983] 2 AC 694; [1983] 3 WLR 203 (HL). The volatility of the freight market was a policy consideration mitigating against the jurisdiction to grant relief.

¹⁶³ *General Motors UK Limited v The Manchester Ship Canal Company Limited* [2016] EWHC 2960 (Ch) [97].

¹⁶⁴ *The Manchester Ship Canal Company Limited v Vauxhall Motors Limited* (formerly General Motors UK Limited) [2018] EWCA Civ 110. The Appeal Court confirmed that the equitable right to relief from forfeiture only applies to proprietary or possessory interests (at para 49). However, it found that the facts of the case indicated that '...the rights granted by the Licence were possessory in nature and thus opened the way to the exercise of the equitable jurisdiction to grant relief against forfeiture'. (at para 68).

management and repair of the acreage.¹⁶⁵ Therefore, there is arguably some scope for contractual rights having a possessory nature. If so, it may be possible for relief to extend to LOTOGAs which have some possessory character even though they are subject to a contractual right. Nevertheless, it is not enough that the LOTOGA confers rights which could be described as ‘close to possessory’; it must be either a possessory or proprietary interest in order for relief to apply.¹⁶⁶

Going forward, this chapter will proceed on the basis that relief against forfeiture is in principle available over interests in a JOA, particularly where the underlying licence or contract confers proprietary rights and these rights extend to the JOA. The discussion proceeds to examine how relief from forfeiture might apply in oil and gas JOAs.

In a JOA, the object of the agreement and of the inclusion of the right to forfeit is essentially to secure the payment of money. Therefore, following *Shiloh Spinners*,¹⁶⁷ relief from forfeiture is available in oil and gas JOAs which are proprietary or possessory in nature. Nonetheless, the English courts have been

¹⁶⁵ In deciding that the licence conferred possessory rights, the Appeal Court held that: ‘...the Licence cast upon Vauxhall the responsibility for the physical construction of the infrastructure and the sole primary responsibility for its maintenance and repair. It did not reserve to MSCC any rights to use the infrastructure or (except in case of default by Vauxhall) to carry out works to it. Those rights over the physical property, coupled with its physical characteristics and the clear intention that Vauxhall would be the only entity able to use and maintain it, amount, in my judgment, to a sufficient degree of physical custody and control of the infrastructure (although not of the soil in which it was placed), having regard to the nature of the property and the manner in which property of that character is commonly enjoyed. Vauxhall plainly intended to exercise those rights (and fulfil those responsibilities) on its own behalf and for its own benefit. The combination of those elements means that the rights granted by the Licence were possessory in nature and thus opened the way to the exercise of the equitable jurisdiction to grant relief against forfeiture. *The Manchester Ship Canal Company Limited v Vauxhall Motors Limited* (formerly General Motors UK Limited) [2018] EWCA Civ 110 [68].’

¹⁶⁶ The Appeal Court held that the High Court judge should not have extended the boundaries of relief to cover interests which were ‘close to possessory’ as this was a position divergent from precedent. *The Manchester Ship Canal Company Limited v Vauxhall Motors Limited* (formerly General Motors UK Limited) [2018] EWCA Civ 110 [51].

¹⁶⁷ *Shiloh Spinners Ltd. v Harding* [1973] AC 691, 722, 723G.

cautious in granting relief against forfeiture in commercial contracts where time has an impact on the contract or where timeous performance is an essential part of the contract. In *Union Eagle Ltd v Golden Achievement Ltd*,¹⁶⁸ Lord Hoffman stated that, ‘...in many forms of transaction it is of great importance that if something happens for which the contract has made express provision, the parties should know with certainty that the terms of the contract will be enforced’.¹⁶⁹ Also, in *Total Gas Marketing Ltd v Arco British Ltd & Ors*,¹⁷⁰ the contract for the supply of gas included a ToP provision, along with a requirement that the sellers become a party to the allocation agreement at the delivery terminal. The sellers failed to fulfil this condition by the first delivery date and the buyers terminated the agreement. The House of Lords found that the requirement to join the allocation agreement was a contingent condition and thus the failure to fulfil this meant that the buyers had a right to terminate the agreement. This is a strict approach when viewed that it was a long term contract and a more flexible approach would have been to allow the seller to join the allocation agreement, thereby preserving the contract. Nevertheless, one cannot help but concur that there is a pressing need for certainty in commercial contracts, most especially in an oil and gas JOA where there are millions of pounds at stake. It is not

¹⁶⁸ [1997] AC 514. The contract concerned the purchase of a flat in which there was a stipulation that time was of the essence. The buyer paid the initial 10% deposit but its solicitors were ten minutes late in tendering the purchase price. The vendor went on to rescind the contract, leading to a forfeiture of the deposit as stipulated in the contract. The buyer sought specific performance (which would lead also to relief against forfeiture of its deposit) but the Hong Kong Court of Appeal and the Privy Council declined to grant relief against forfeiture. This hardline approach is likely a result of the stipulation that time was of the essence, which would have alerted the purchaser to be wary. The failure of the purchaser to abide by the strict time limits in the absence of supervening circumstances meant that the court was not obliged to intervene on its behalf. Furthermore, the court acknowledged the pressing need for certainty in commercial transactions.

¹⁶⁹ *Union Eagle Ltd v Golden Achievement Ltd* [1997] AC 514, 519C.

¹⁷⁰ [1998] UKHL 22, 2 Lloyd’s Rep. 209

uncommon for JOAs to expressly state that time is of the essence. A 2010 Ghana JOA specifies:

Each Party shall pay when due, in accordance with the Accounting Procedure, its Participating Interest share of Joint Account expenses, including cash advances and interest, accrued pursuant to this Agreement. The Parties agree that time is of the essence for payments owing under this Agreement...¹⁷¹

Where such stipulation is made, the court may refrain from exercising its discretion to grant relief. Nevertheless, it is argued that even where there is no such stipulation, the structure of an oil and gas JOA is one in which time is of the essence.¹⁷² The Operator is required to perform the minimum work obligations under the underlying licence or contract within a strict time limit; such performance is only possible where JOPs make timely cash contributions. On this basis, timely performance could be regarded as an implied condition of the JOA.

Yet, it could also be argued that time is not strictly of the essence in JOAs because, if it were, there ought not to be a grace period during which the defaulting party is given time to cure its default. This argument has merit since the grace period appears to suggest that the JOA is not strictly dependent on timely performance. However, the merit of this argument may be dispelled by taking consideration of the fact that the innocent parties have to cover the default quickly; this reflects that time is of the essence. In fact, timely performance is so essential that an innocent party could

¹⁷¹ Ghana Joint Operating Agreement 2010- Joint Operating Agreement Kosmos Energy Ghana HC (1) The E.O Group (2) Operating Agreement in Respect of West Cape Three Points Block Offshore Ghana, Clause 3.3 (C) [Accessed at OGEL 15th August 2016].

¹⁷² In understanding the principle of time being of the essence, it has been said that, '[b]roadly speaking time will be considered of the essence in mercantile contracts'. *Bunge Corp. v Tradax Export S.A.* [1981] 1 WLR 711, 740. The JOA is a specific form of mercantile contract in which time is fundamental to performance.

itself become a breaching party for failing to contribute towards the shortfall.¹⁷³

Therefore, the same commercial considerations broadly construed in mercantile sale of goods contracts also apply to JOAs.

The court will assess whether to grant relief against forfeiture looking at the period from when default occurred; this is in contrast to reviewing the time from when the contract was entered into when assessing whether the clause is a penalty.¹⁷⁴ In a JOA, the stage of operations where default occurs is relevant. The effect of a successful plea for relief could be to grant the breaching party more time to cure its breach,¹⁷⁵ thereby postponing the forfeiture to a later date if the breach remains uncured, or to ‘scale down’ the forfeiture. The latter was the approach taken by the court in *Jobson*¹⁷⁶ although the UKSC in *Makdessi*¹⁷⁷ criticised it as unorthodox if the provision was treated as a forfeiture, and wrong in principle if the provision was treated as a penalty case.¹⁷⁸ Notably, following the UKSC decision in *Makdessi*, there

¹⁷³ An example of this is contained in the Model Denmark JOA 2014, Article 11.1.d.

¹⁷⁴ *BICC Plc v Burndy Corp* [1985] Ch 232, [1985] 2 WLR 132; *Makdessi v Cavendish Square Holdings BV* [2015] UKSC 67, [2015] 3 WLR 1373 (SC) [227] (Lord Hodge SCJ).

¹⁷⁵ *BICC Plc v Burndy Corp* [1985] Ch 232, [1985] 2 WLR 132.

¹⁷⁶ *Jobson v Johnson* [1989] 1 WLR 1026.

¹⁷⁷ *Cavendish Square Holdings BV v Talal El Makdessi* [2015] UKSC 67, [2015] 3 WLR 1373 (SC) [87] (Lord Neuberger and Lord Sumption SCJJ) (with whom Lord Carnwath SCJ agreed).

¹⁷⁸ The essence of scaling down the forfeiture is to reduce its severity and achieve a fair commercial result where the court reasons that total forfeiture would be disproportionate. This was the position taken by the Court of Appeal in *Jobson*, albeit that the court applied this in its assessment of the provision as a penalty clause rather than under the notion of granting relief against forfeiture. This decision has received mixed judicial treatment. In particular, Lord Neuberger and Lord Sumption SCJJ in *Cavendish Square Holdings BV v Talal El Makdessi* [2015] UKSC 67, [2015] 3 WLR 1373 (SC) [87] held that the scaling down remedy applied to the forfeiture was not appropriate in the context of the rule on penalties. Rather, this remedy ought to have been applied in the context of equitable relief. See also Judith Aldersey-Williams and others, ‘Default clauses in joint operating agreements: recent guidance from the English courts’ (2016) 1 I.E.L.R 36, 51-53.

is no longer a judicial power to modify a penal clause.¹⁷⁹ The clause is either enforceable or it is not.

However, where the clause is not penal and the defaulting party applies for relief to scale down the forfeiture, the innocent parties could argue that it is not appropriate in the context of a JOA because it amounts to rewriting the forfeiture provision. Innocent parties can seek to avoid the scaling down remedy by demonstrating that the interests of the defaulting party from the period of breach have been taken into account and that the forfeiture reflects a fair commercial result. Targeted forfeiture provisions which apply to different stages of operation provide the means of demonstrating this, and they are discussed below. This is in contrast to broad forfeiture provisions which apply in the same manner throughout all stages of operation.

6.4. Safeguarding forfeiture provisions

The lack of caselaw on forfeiture provisions in oil and gas JOAs makes it difficult to be entirely certain about the enforceability of forfeiture provisions. The discussion above illustrates this uncertainty. This section therefore seeks to advance some guidance as to how IOCs can better structure forfeiture provisions in JOAs to avoid non-enforcement under the penalty rule.

Traditional forfeiture provisions are most contentious in relation to the rule on penalties. This is because such provisions do not prescribe that the defaulting party receive any compensation for its forfeited interest. An example is the forfeiture

¹⁷⁹ The Scottish Commission notes that such a judicial modifying power exists in Scots law, both at common law and in statute, albeit that the statutory power is limited to penalties in support of an obligation to pay money. Scottish Law Commission, *Review of Contract Law: Discussion Paper on Penalty Clauses* (Scot Law Com No 126, 2016) 1, 42 <https://www.scotlawcom.gov.uk/files/1314/8049/7097/Discussion_Paper_on_Penalty_Clauses_DP_No_162.pdf> accessed 22 June 2018.

alternative in the AIPN Model JOA.¹⁸⁰ Therefore, in order to safeguard and promote the enforcement of the forfeiture provision, IOCs must anticipate that the court may be concerned by the presence or absence of compensation for the forfeited interest. It is therefore suggested that FCs should provide for the payment of some form of compensation.

6.4.1. Forfeiture and compensation: What is unconscionable?

The stages in the lifecycle of an oil and gas JOA are: exploration, appraisal, development, production and decommissioning.¹⁸¹ The assessment of unconscionableness is primarily for the benefit of the defaulting party, with the innocent parties who acquired the forfeited interest having to defend their acquisition. The effect of forfeiture on a defaulting party depends on how much capital it has invested into the project and the prospects of the project.

It is suggested that the JOA uses specific forfeiture provisions depending on the stage of operations. That is, there should be a forfeiture provision which targets default at each phase of the JOA, rather than a blanket forfeiture. This is because the legitimate interest of JOPs at the time of entering into the contract is also dependent on its stage of operations. For example, at the exploration and development stage, there is a legitimate interest that all parties make timeous contributions. This interest also remains at the production stage albeit in a slightly different manner. The parties have a commercial purpose that if such contributions are not made, the hydrocarbon

¹⁸⁰ The AIPN Model JOA 2012 provides four options to deal with default: forfeiture, buy-out, withering interest and mortgage and security interest (encumbrance). The forfeiture option (Article 8.4.D.1) does not refer to compensation of the defaulting party. It merely provides that if after 30 days of default, the defaulting party has not remedied its default, '[t]hen any non-defaulting Party shall have the option, exercisable in its discretion at any time, to require that the Defaulting Party offer to completely withdraw from this Agreement and assign all of its Participating Interest, as described in Article 8.4.E'.

¹⁸¹ A party can join the JOA during any of these stages.

allocation of the defaulting party can be sold and used to cover its financial obligations.

The discussion that follows explains forfeiture in each phase of operations, putting forward recommended forfeiture provisions for the various phases.

i. Forfeiture at the exploration stage

At the exploration stage, IOCs have no certainty as to whether they will make a commercial discovery and thereby reap a return on their investment. Therefore, where default leads to the forfeiture of interest, the defaulting party would not have suffered a greater loss because there may never be a commercial discovery. The innocent parties who acquire the forfeited interest have not acquired a benefit but merely increased risk since there is no certainty of a return, although they also acquire the chance of greater return if there is a commercial discovery. In the former, it is arguable that it is not unconscionable for the non-defaulting parties to acquire the forfeited interest without compensation since they are in fact doing themselves a disservice by acquiring greater risks without certainty of benefits, though with a chance of profits. In the event that there is no commercial discovery, the defaulting party has suffered no loss and so no unconscionability exists. Yet, a forfeited interest acquired freely may yield great returns in the future where there is a commercial discovery. If ever there is a commercial discovery, the defaulting party cannot claim compensation retrospectively, in the same manner that the innocent parties cannot make a claim from it for the additional loss of investment if there were no commercial discovery.

This writer will propose sample forfeiture provisions which are more likely to be enforceable if challenged under the *Makdessi* test.

Where a financial default remains uncured at the last day of the grace period, the defaulting party will forfeit its participating interest in the JOA.

Following such forfeiture at the exploration phase prior to a commercial discovery, an innocent party or parties is to acquire the forfeited interest freely according to its respective participating interest in the joint venture.

The benefit of such a provision is that it takes account of the fact that the defaulting party would not have invested significant capital prior to a commercial discovery. As such, the forfeiture of interest for no compensation is not unconscionable when weighed against the risks and benefits for the innocent parties in acquiring the forfeited interest. Where default occurs after a commercial discovery, there is an argument that the defaulting party should receive compensation for its forfeited interest.

ii. Forfeiture at the appraisal stage

This is the stage after a commercial discovery has been ascertained and the parties have to make an appraisal of the discovery before agreeing on a development programme.

A similar approach for dealing with default at the exploration stage can also be applied here, since both stages are pre-development, which is the most cash intensive phase of operations. The recommended forfeiture provision above also applies here, although with the additional proviso:

In the interests of a fair commercial result, it is agreed that the defaulting party will receive ——% of its total cash-call contributions in cash within six months from the date of the commercial discovery. The remaining —— % deduction from the total cash-call invested is accepted by all

parties to be a concession for the additional risks borne by the innocent parties.

In reaching an agreement on the percentage to be paid to the defaulting party, the parties must balance all the competing interests. The defaulting party's interest will be in recouping all its investment, particularly because it has lost the opportunity to make profits. In contrast, the innocent parties' interest will be to calculate the repayment figure to a percentage that takes account of the fact that the default put the JOA in jeopardy and also the additional risks that the innocent parties will have to bear, albeit that there will be increased returns.

In the appraisal phase and further stages in the LOTOGA, the writer has recommended payment of a percentage of the total cash contributions of the defaulting party, rather than payment of a percentage of the defaulting party's interest. This is for two reasons. One, the value of the interest will likely exceed the cash amount paid by the defaulting party, thereby placing a greater financial burden on the innocent party/parties. Secondly, the reference to a percentage of total cash contributions will avoid the challenges that arise in the valuation of interest.

iii. Forfeiture at the development and production stage

There is a lot of overlap in the development and production stages. Reference will be made to this section when discussing forfeiture at the production stage.

The defaulting party would have made significant contributions and thus where a court enquires as to the fairness of the forfeiture provision, it will likely consider whether adequate compensation is paid in recognition of the defaulting party's total

contributions.¹⁸² The calculation of compensation at this stage must be most delicate; an amount too high will disfavour the innocent parties and an amount too low may face challenges as to the exorbitance of the remedy.

For default at the development or production stage, the forfeiture provision should consider that any defaulting party will suffer a greater loss than at the exploration stage and so, the calculation of compensation for its forfeited interest should take into consideration its increased investment in the JOA. The fact that there is already a commercial discovery is good ground for the defaulting party to argue that it should have the right to retain some of its participating interest. There is a valid argument that the innocent parties should not be allowed to profit in excess where they have not taken additional risks. Similarly, the defaulting party should not be allowed to retain all its interest because its default put the JOA at risk and its financial stability is still in question. The JOA can also make provision for repeated defaults such that the defaulting party can only retain a smaller percentage of its interest. Any repeated default would not cause the same level of financial instability to the JOA (as in the first default) if the defaulting party already has a reduced interest. A suggested provision reads:

Where a financial default remains uncured at the last day of the grace period, the defaulting party will forfeit 30% of its participating interest in the JOA. The innocent parties who acquire the forfeited interest must pay the defaulting party a total of 14.5% of its total cash-call contributions (at the date of forfeiture) in a once and final cash payment within six months of forfeiture, or in kind at the date of first production. This amount is payable in accordance with the participating interest acquired by each innocent party. (The failure of the innocent parties to comply accordingly will lead to the defaulting party reacquiring an additional 5% of its interest.)

¹⁸² Geoff Hewitt, 'Default on the UKCS and the law on penalties - has anything changed?' (2016) 1 *International Energy Law Review* 5, 7.

The non-payment of the remaining 15.5% of the defaulting party's cash contributions is accepted by all parties to be a concession for the additional risks borne by the innocent parties.

The above provision has been structured in such a way as to demonstrate to a court that the interests of the defaulting party have been balanced with the interests of the innocent parties and that of the JOA. It was already discussed that timely cash contributions are vital to the success of any JOA, as well as central to meeting work obligations to the host state. Any default places the JOA at risk. Therefore, it is essential that the financial stability of the JOA is prioritised above the need of individual joint venturers. The defaulting party should not be allowed to retain all of its interest because its default has already put the JOA at risk. The impact of its repeated default (if any) would be mitigated by the fact that it already has a reduced interest. The provision seeks to show to a court that the provision is neither exorbitant nor unconscionable since the defaulting party will still retain 70% of its interest, as well as receive repayment of 14.5% of its cash contributions.

iv. Forfeiture at the production stage

The effect of forfeiture at this stage is similar to the development stage (see above).

Forfeiture Provision For Production Phase

Where a financial default remains uncured at the last day of the grace period, the defaulting party will forfeit 40% of its participating interest in the JOA.

The innocent parties who acquire the defaulting party's interest must pay the defaulting party 23% of its total cash contributions in a once and final cash payment within six months of forfeiture, or in kind within three months of forfeiture. (The failure of the innocent parties to comply accordingly will lead to the defaulting party reacquiring an additional 6% of its interest.)

The non-payment of the remaining 17% of the defaulting party's cash contributions is accepted by all parties to be a concession for the additional risks borne by the innocent parties.

One may question why the provision recommended an increase of forfeited interest at the production stage. At the production phase, each party should be able to cover its cash-call with proceeds from the sale of its percentage of production. The fact that a party is unable to do so is evidence of serious financial (or marketing) difficulty, in which case its interest should be further reduced to protect the integrity of the JOA.

v. Forfeiture at the decommissioning stage

Where default occurs at the stage where the field is maturing (just before DCG), acquiring the interest of the breaching party is a burden not a benefit. It is posited that the value of the forfeited interest would be relatively low at this stage and thus the defaulting party ought not to be compensated for its forfeited interest. This is because the field would be producing little or nothing and, as such, the interest is worth very little. At this phase, the defaulting party may in fact be agreeable to forfeiture because it means it need no longer contribute towards any cash-call (save for its percentage of DCG liabilities¹⁸³). Overall, oil and gas JOAs are likely to face few or no challenges on the enforceability of forfeiture provisions at the DCG phase. However, this would

¹⁸³ The liabilities of a party may remain even after it has withdrawn from the JOA, either voluntarily or through forfeiture. An example of this is contained in the Model JOA for Licence Denmark 2014, section 11.3.4 — 'Any forfeiture and acquisition of the interest of the Defaulting Party in the Licence and in and under this Agreement shall be: (a) subject to any necessary consent of the Danish Energy Agency; (b) without prejudice to any other rights of each Party other than the Defaulting Party; (c) so forfeited and acquired free of any charges and encumbrances; (d) effective as of the date of default; and (e) *subject to the Defaulting Party remaining liable and obligated for its share of all net costs and obligations that in any way relate to the abandonment of Joint Operations* or a sole risk project in which the Defaulting Party participated. Said share shall be determined in the manner set forth in Section 10.2.7; and the Defaulting Party shall promptly join in such actions as may be necessary or desirable to obtain any necessary consent of the Danish Energy Agency and shall execute and deliver any and all documents necessary to effect any such forfeiture and acquisition' (emphasis added).

depend on the exact period during DCG and whether the field is at all producing hydrocarbons.

It is argued that forfeiture at the DCG stage would not serve any commercial purpose because the JOA is about to wind up and, therefore, neither its stability nor survival are at stake. Nonetheless, should the JOA seek to include a forfeiture provision, it could be phrased along the following lines:

Where default occurs towards the end of the life of the reservoir and the defaulting party fails to cure its default by the last day of the grace period, it shall be deemed to have withdrawn from the agreement, subject to its remaining liabilities under the agreement. The Operator shall lift such party's allocation of hydrocarbons if the field is still producing (albeit nearly depleted) and shall sell this at arm's length. After such sale and upon a deduction of associated costs including the amount in default, the Operator shall credit any excess monies towards the defaulting party's decommissioning liabilities.

For the reasons stated in this discussion, it is anticipated that the forfeiture provision is unlikely to be challenged at the DCG phase.

All the above stipulations have been structured in ways which take account of the commitment and investment each party has made, whilst maintaining the survival of the JOA. It is anticipated that these forfeiture provisions which are more specific to each stage of operation will demonstrate to a court that the legitimate interests of the non-defaulting parties, the survival of the JOA and the rights of the defaulting party have been appropriately considered. As such, if the provision is challenged as a unenforceable penalty, it is unlikely to be viewed as unconscionable or exorbitant.

This chapter will now reach a conclusion.

Conclusion

IOCs are advised not to sit too comfortably following the decision in *Makdessi*. It has been argued that the difficulties which accompany the primary/secondary divide mean there is no certainty as to whether a forfeiture provision in a JOA will be interpreted as a primary or secondary obligation. Nevertheless, it has been submitted that forfeiture provisions in JOAs are likely to be interpreted as a secondary obligation. Although IOCs may seek to draft the FC as a primary obligation, the likelihood of the court interpreting it as such is slim. The chapter has demonstrated that the prudent approach for IOCs seeking to rely on forfeiture provisions is to focus on ensuring that the provision has a clear legitimate interest, and is neither exorbitant nor unconscionable. Where this is satisfied, the provision will be enforceable. It is against this background that there is a reasonable degree of certainty that forfeiture provisions in oil and gas JOAs will be enforced by an English Court.

The chapter has argued that targeted forfeiture provisions which are specific to each stage of operations stand a better chance of enforcement under the penalty test. This is also applicable to instances where the challenge as to a penalty fails but the breaching party applies for relief against forfeiture. In such cases, the court will make its determination by looking at the period from when default occurs, not the time the contract was entered into. It is in this assessment that the stage of operations where default occurs is most relevant. Where the innocent parties seek to defend the claim for relief, they will likely have a better chance at this by demonstrating that the targeted forfeiture provision has taken into account the interests of the breaching party and the value of its investments at the period of default. Broad forfeiture provisions which apply throughout all the stages of operation will struggle to show that the

interests of the breaching party have been properly considered since this party will suffer the same fate at any phase of operations.

Also, the discussion has highlighted that IOCs must consider the procedure/process leading to forfeiture. The forfeiture provision itself may be airtight but the manner in which the defaulting party comes to forfeit its interest is also relevant. The approach of the English court in *Pan Petroleum AJE Limited v (1) Yinka Folawiyo Petroleum Co Ltd and Others*¹⁸⁴ makes this clear. Although a provision may have a legitimate interest and is neither unconscionable or exorbitant, failure to abide by procedure in issuing cash-calls may be a ground for relief against forfeiture.¹⁸⁵ The chapter argued that relief against forfeiture is in principle available over interests in a JOA, particularly where the underlying licence or contract confers proprietary rights and these rights extend to the JOA (even though it is prima facie a contractual right).

All in all, IOCs must remain sensitive to changes in the industry. The oil and gas industry has witnessed the introduction of less draconian alternatives to forfeiture, an example of which is the withering option. Nevertheless, it was argued that the withering option may simply be postponing the inevitable (total forfeiture), where the defaulting party remains in financial difficulty. The attraction of the forfeiture provision is that it provides a final solution that allows the JOPs to move on in the certainty and security that their legitimate interests in the agreement are protected and the JOA can proceed smoothly. The targeted forfeiture provisions stipulated above at the different stages of operation will allow IOCs to continue to utilise the forfeiture

¹⁸⁴ *Pan Petroleum AJE Limited v (1) Yinka Folawiyo Petroleum Co Ltd; (2) YFP Deepwater Co Ltd; (3) EER (Colobus) Nigeria Ltd; (4) Newage Exploration Nigeria Ltd; and (5) PR Oil & Gas Nigeria Ltd* [2017] EWCA Civ 1525.

¹⁸⁵ David Perks, 'Court declares effective withdrawal following default' (Gadens, 30 May 2014) <<http://www.gadens.com/publications/Pages/Court-declares-effective-withdrawal-following-default.aspx>> accessed 3rd August 2016.

provision but in a manner that reduces challenges to enforcement. In this writer's view, the recommended provisions are a better alternative to the withering option for three main reasons. Firstly, the targeted FC at development and production phase specifies the maximum interest the defaulting party would be required to forfeit (30 or 40% respectively). In contrast, depending on the formula and the period when default occurs, the withering option may lead to a higher loss than this. Secondly, the withering option does not provide the defaulting party any financial compensation for its forfeited interest, whereas the targeted FCs recommended for appraisal to production phases offer financial compensation. This is an indication that the interests of the defaulting party have been properly considered. Thirdly, the recommended provisions for the development and production phase further consider the interest of the defaulting party by giving it the opportunity to recover more of its forfeited interest where the innocent parties do not comply with the conditions of the provision. Overall, the recommended forfeiture provisions balance the risks and rewards of the forfeited interest between the innocent and defaulting parties.

Lastly, IOCs must bear in mind that the JOA is a commercial as well as relational arrangement. Parties must strive to make reasonable compromises which maintain the integrity of the JOA but also consider the position of a defaulting party. This is more so the case where an economic crisis affects the oil and gas industry and any party may find itself in default. The grace period already extended to defaulting parties is a good start to secure the relational dimension of the JOA, but arguably, more specific forfeiture provisions as illustrated in the provisions above would do more to secure the interests of all parties and also avoid the contentions on enforceability of the forfeiture provision. Ultimately, the essence of the forfeiture provision is to secure

the survival of the JOA; it is not a mechanism by which the non-defaulting parties seek to profit from the misfortune of the defaulting party, albeit that this may result incidentally.

CHAPTER 7

GAS BALANCING AGREEMENTS

Introduction

This chapter seeks to evaluate the effectiveness of the GBA as a contractual mechanism used to reduce risks and uncertainties in long term gas agreements. The GBA is used in a JV (eg, JOA) where there are multiple parties with rights to the gas produced. Each of these parties would have the right to lift gas according to individual participating interests (ownership share) in the JV. However, any of these parties could experience marketing or storage difficulties, thereby being unable to take some or all of its share of gas at a particular time. To accommodate this, the GBA will indicate the circumstances where if one (or more) party is unable to take its share of gas, another party is allowed to take more than its share of gas at that time. This creates an imbalance of gas, with the GBA also specifying the method and process through which the imbalance of gas is to be corrected.

The GBA is beneficial in JV agreements because it enables the smooth running of operations where a party is unable to lift all its share of gas. Nevertheless, in order for the GBA to be effective, it must first be legally enforceable. Depending on the wording of the particular GBA, a party could suffer irrecoverable loss of gas volumes, thereby raising the possibility of a challenge that the provision is an unenforceable penalty, or a claim for relief on the basis that the provision is a forfeiture. This chapter examines both positions and how this affects the overall effectiveness of the GBA.

In comparison to the other contractual clauses discussed in this thesis, the GBA is the least controversial. As such, there is a scarcity of literature or decisions on its application, leading to an assumption that the GBA is a safe and effective contractual method for the mitigation of risks in long term gas agreements. However, this assumption may no longer be secure in view of the recent UKSC decision in *Cavendish Square Holdings BV v Talal El Makdessi*¹ (hereafter *Makdessi*). In the light of that decision, would an English court now regard a provision in a GBA leading to the loss of gas volumes as an unenforceable penalty? The guidelines provided in *Makdessi* require a consideration of whether the GBA is a primary or secondary obligation, as well as the application of a two stage test. Academic writers have so far failed to consider whether a GBA leading to the forfeiture of gas volumes is a primary or secondary obligation. This is examined in this chapter. Where the impugned provision of the GBA is a secondary obligation, the two stage *Makdessi* test will be applied, with the provision being interpreted as a penalty if it lacks a legitimate expectation and is also unconscionable or exorbitant.

The discussion begins with a discussion of the commercial context of the GBA. It goes on to look at its nature, function, the rights and obligations it confers, and the expectations under the GBA. Following this, the challenges to the GBA under the penalty rule are considered. Finally, the chapter considers how the effectiveness of the GBA can be enhanced.

¹ [2015] UKSC 67, [2015] 3 WLR 1373 (SC).

7.1. The commercial context

Due to the physical properties of gas (natural gaseous state), its exploitation is exceedingly complex, more so than crude oil. Aside from the fact that its development is highly capital intensive, the gas producer must have in place stable storage, transportation and sales arrangements.² These arrangements are also necessary in oil contracts, but not on the same scale. Unlike gas, oil can be transported through cargo vessels or pipelines, although the latter is less frequently used in the offshore sector.³ There is also a spot market for oil which enables trading to be fast paced and on a short term basis.⁴ In contrast, because of the volume to liquid ratio of natural gas, pipelines are the primary method of transportation.⁵ These pipeline arrangements take years to complete and require substantial upfront investment.

The difficulties which accompany the transportation of gas have given rise to an increase in liquified natural gas (LNG). LNG is gas that has been converted to liquid by intense cooling under pressure (-162°C).⁶ The cooling process reduces the volume of the gas to 1/600.⁷ Upon arriving at its destination, LNG is returned back to its gaseous state through the process of re-gasification.⁸

² Marc Hammerson, *Upstream Oil and Gas: Cases, Materials and Commentary* (Globe Law and Business 2011) 294.

³ *ibid.*

⁴ Paul Griffin (ed), *Liquified Natural Gas: The Law and Business of LNG* (2nd edn, Globe Law and Business 2012) 66.

⁵ Marc Hammerson, *Upstream Oil and Gas: Cases, Materials and Commentary* (Globe Law and Business 2011) 293-294.

⁶ Shell Global, 'Liquified Natural Gas' <<http://www.shell.com/energy-and-innovation/natural-gas/liquefied-natural-gas-lng.html>> accessed 18 August 2018.

⁷ *ibid.* The advantages of LNG are that it is non-toxic, it will not ignite in its liquid state, and it is easier to store and transport.

⁸ Ernest E Smith and others, *Materials on International Petroleum Transactions* (Rocky Mountain Mineral Law Foundation 2010) 1067.

For these reasons, a developer of natural gas must identify a market and buyers prior to development because gas (in contrast to oil) does not have a readily available market or buyers. Yet, even with the best laid plans, a seller of gas may sometimes find itself unable to market or store all its production share in a particular contract period. It would thus nominate and lift a lesser quantity of gas than its share. This is where the GBA comes in.

7.2. The nature of the gas balancing agreement

The GBA is an agreement in which multiple owners of a gas block or field indicate how production will be balanced where any party takes less or more than its share of production.⁹

Generally, the GBA is used in two types of transactions. The first is where there is a JOA. Here, the parties to the GBA would be comprised of all the members of the JOA who have joined the GBA (see diagram 1 below). The second transaction is where there is a unitisation project (see diagram 2 below). Unitisation is the joint development of an oil or gas field where the field has been broken down into several contract blocks/areas by the state.¹⁰ Some of these contract areas could be subject to a JOA, such that the unitisation project has numerous JOAs attached to it. A unit operating agreement (UOA) will govern the relationship between the various companies party to the unitisation project. Each block would be referred to as a unit.

⁹ Tomás Lanardonne, ‘ “Cash-or-Gas”: The Quest for Balancing the Imbalance’ (2016) 9 *Revista Argentina de Derecho de la Energía, Hidrocarburos y Minería*, mayo-julio de 1-35.

¹⁰ Danielle Beggs and Justyna Bremen, ‘Unitisation and unitisation agreements’ in Geoffrey Picton-Tuberville (ed), *Oil and Gas: A Practical Handbook* (Globe Law and Business 2009) 57-58. For an earlier discussion, see chapter 2, section 2.2.ii of the thesis.

All of the parties to the UOA would be expected to join the GBA by a specified deadline.

Diagram 1: Transactions in which the GBA is used

A. Joint Operating Agreement

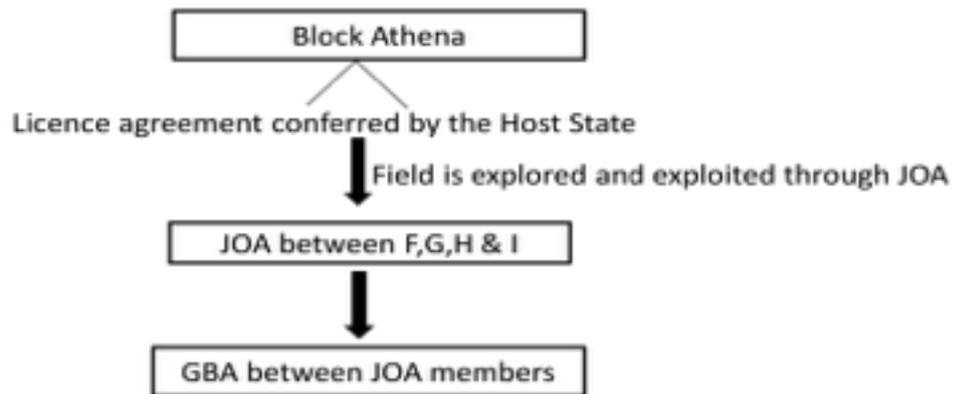
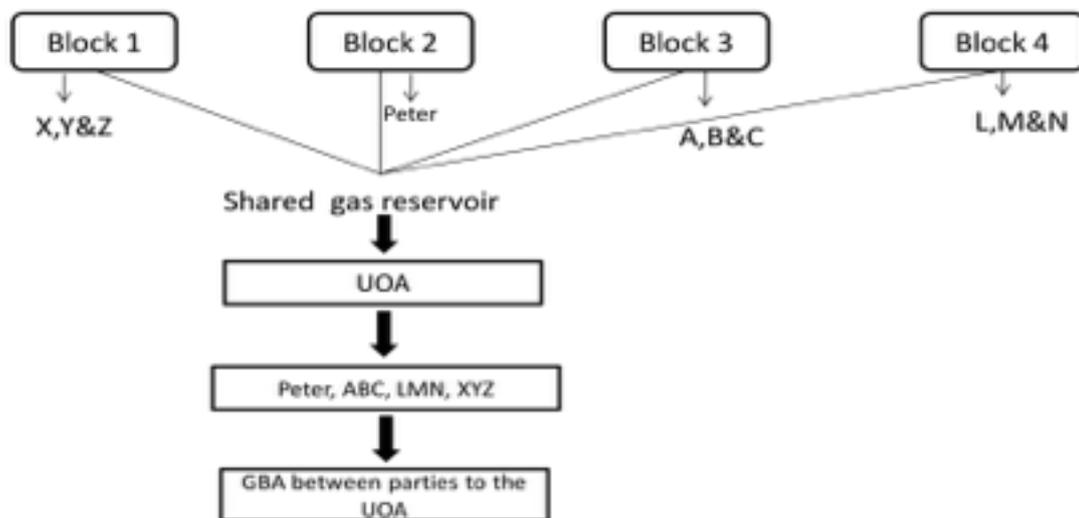


Diagram 2

B. Unitisation Project



Where the GBA is used alongside an operating agreement, it would sit under the operating agreement (JOA or UOA) and both agreements must be consistent with each other – where there is a conflict the parties must indicate which agreement would prevail. Generally, during each nomination period, each party or unit would be entitled to an allocation of gas production equal to its interest as set out in the operating agreement. The GBA's focus is on the lifting and balancing of gas, leaving other issues pertaining to the JV at large to be covered by the relevant operating agreement. The main issues commonly covered in the GBA are in relation to nominations and deliveries procedure, lifting entitlements, under-lifting, over-lifting, form of balancing,¹¹ the balancing area,¹² and the period during which the gas imbalance must be restored. Where there is a time limit on recovery, the GBA will indicate whether failure to recover will lead to a loss of the owed volumes of gas.¹³

7.3. Function of the gas balancing agreement

Parties to a JV may decide not to agree to a GBA and simply regulate their affairs through the JOA. However, this comes with additional challenges because the provisions of the JOA in relation to gas imbalance would typically be general and not address the specificities covered by a GBA. This is because the JOA would predate the GBA – at the time of concluding the JOA there would be limited information on the field. The parties would usually be required to enter into a GBA at a later stage of

¹¹ AIPN Model Gas Balancing Agreement 2014, Article 5-8.

¹² AAPL Model Gas Balancing Agreement 1992, Section 2.

¹³ This would be contained in the relevant section on balancing in kind. An example is the AIPN Model GBA 2014, Article 8.2 (Alternative 2).

operations, which could be after a development plan has been approved.¹⁴ The reason for this is that, at this stage, the parties are fairly certain of gas production and are more informed to agree on the rules relating to gas balancing.

The AIPN Guidance Notes on the Model GBA indicate that it is intended to serve a three-fold purpose.¹⁵ The first is to balance the rights of the parties to lift their share of gas during any nomination period. The second is to balance the rights of parties to lift their share of the total production of gas throughout the course of extraction. The first two functions are linked and are most relevant to the discussion. These two functions are achieved through gas balancing, where a party who has lifted less than its share of gas is able to recover the deficit volumes during any nomination period and, in so doing, be able to receive its ownership share from the total gas produced throughout the course of extraction. The third function of the GBA is to require the operation to be such as to maximise the value of the hydrocarbon produced.¹⁶ This would be achieved where the parties produce more gas when the market price is higher, and reduce production when the price is lower. However, since parties to the GBA would be marketing gas independently of each other, one or more parties may be content with the market price and will not wish for production to be lowered, whilst other parties may favour a decline in the production rate. Parties to the

¹⁴ An example of this is contained in the AIPN Model JOA 2014, Article 9.3A (Alternative 1) — ‘The Parties recognize that, in the event of individual disposition of Natural Gas, imbalances may arise with the result being that a Party will temporarily have disposed of more than its Participating Interest share of production of Natural Gas. Accordingly, if Natural Gas is to be produced from an Exploitation Area, the Parties shall, in good faith and *no later than the date on which the Development Plan for a Natural Gas project is approved by the Operating Committee, negotiate and conclude the terms of a balancing agreement* to cover the disposition of Natural Gas produced under the Contract, regardless of whether all of the Parties have entered into a sales arrangement or sales contract for their respective Entitlement of Natural Gas’. (emphasis added).

¹⁵ AIPN Guidance notes on the Model GBA 2014, (Scope 2.1A) page 10.

¹⁶ *ibid.*

GBA must make clear the weight to be assigned to this function, as well as the rights and obligations of each party.

7.4. Rights and Obligations under the GBA

Each party to the GBA has a right to take delivery of gas according to its participating interest. Normally, any party seeking to exercise such right will be required to give a nomination of desired volumes of gas to the Operator.¹⁷ Where a party fails to take all of its share of gas produced, at any particular time, the GBA would give other parties the right to lift gas beyond their share at the relevant time. As an example, the AIPN Model GBA 2014 provides that:

If a Party takes less than its Lifting Entitlement Quantity of Gas Production during a Nomination Period, unless that Party is already an Overlifted Party or unless the other Parties similarly and proportionately take less than their Lifting Entitlement Quantity during the same Nomination Period,¹⁸... Each remaining Party shall have the right, but not the obligation, to take for its own account, in addition to its Lifting Entitlement Quantity of Gas Production, all or a portion of the Natural Gas attributable to the Underlifted Party in accordance with the provisions of this Gas Balancing Agreement.¹⁹

Where such a right is exercised, it creates a gas imbalance. The party who takes less than its share is commonly referred to as the ‘underproducer’,²⁰ whilst the party who lifts above its share is the ‘overproducer’.²¹ The terms ‘under/over lifter’ are also

¹⁷ AIPN Model GBA 2014, Article 5.2- Nominations of nominated quantities.

¹⁸ Article 2.1.D

¹⁹ Article 2.1.D.2. A similar provision is contained in the older AAPL Model GBA 1992, Section 3.3.

²⁰ ‘Underproduced Party’ shall mean any Party having taken a lesser quantity of Gas from the Balancing Area than the Percentage Interest of such Party in the cumulative quantity of all Gas produced from the Balancing Area’—AAPL Model GBA (Form 610-E) 1992, section 1.14.

²¹ ‘Overproduced Party’ shall mean any Party having taken a greater quantity of Gas from the Balancing Area than the Percentage interest of such Party in the cumulative quantity of all Gas produced from the Balancing Area’—AAPL Model GBA (Form 610-E) 1992, section 1.09. See also Wade A Hoefling, ‘Gas Balancing Problems in a Deregulated Market: Changes and Possible Solutions under Oklahoma Law’ (1989) 25 (1) Tulsa Law Review Journal 63, 63.

used.²² There are two main reasons for imbalance: one is pipeline related and the other is party related. The discussion in this chapter will focus on the latter. With the former, the imbalance occurs through no fault or intervention of the under-producer, rather, the reason for the imbalance can be directly attributed to the pipeline. This could be where the connecting pipeline fails to take gas from a particular field. This could be due to a number of reasons. One of these is where there is a change in the sales and supply agreement,²³ and another is where the pipeline is experiencing difficulty. In relation to the party motivated cause of imbalance, this describes a situation where a party nominates and lifts less than its share, due to storage or marketing difficulties. This could be advantageous to another joint operating party who is able to lift and market the surplus volumes of gas at a competitive price.²⁴

Yet, where any party takes more than its share of gas, there is the risk that the party who takes less will suffer a loss. This could be the loss of the deficit volumes of gas, or the loss of the initial financial value of the gas if the gas is restored at a later stage when the price is lower. Also, the overproducer is faced with the risk that the underproducer may seek a different form of balancing than it is willing to give. Alternatively, even if the parties are able to agree on the form of balancing, the underproducer may seek a higher price than the overproducer is willing to pay. There is also the risk that the underproducer may seek to adjust the imbalance during a peak season, thereby maximising profits. Consequently, the terms of gas balancing are highly significant.

²² Peter Roberts, *Joint Operating Agreements: A Practical Guide* (2nd edn, Globe Law and Business 2012) 125; AIPN Model GBA 2014, Definitions.

²³ See *Transcontinental Gas Pipeline Corp. v State Oil & Gas Board* (1986) 474 U.S. 409.

²⁴ Maine Stephan Goodfellow and George F Goolsby, 'Gas balancing agreement' in Geoffrey Picton-Tuberville (ed), *Oil and Gas: A Practical Handbook* (Globe Law and Business 2009) 206.

The volume of hydrocarbons overproduced is a debt which the overproducers owe to the underproducer. Depending on whether a Model GBA is used or the parties draft their preferred GBA, the balancing provisions would indicate the form of balancing and the time limit (if any) during which the overproducers are to ‘repay’ the underproducing party. This repayment can be made by balancing through production or cash balancing. The former is known as balancing in kind. Both forms of balancing are not without challenges, particularly in relation to achieving an equitable result. For example, where balancing is in kind, depending on the period when the imbalance is remedied, there is the risk that there will be insufficient reserves for the underproducer to make up its production share.

In relation to cash balancing, the main issues that arise relate to the formula for calculating the amount payable to the underproducing party.²⁵ Some of the common forms of calculating the settlement price include: the amount received by the overproducing party for the imbalance volumes sold; the current market value of gas; and, the price at which the overproducing party last sold its gas production.²⁶ All of these forms of cash balancing may lead to conflict, especially where it requires the overproducing party to reveal confidential information about its marketing activities. There is also the possibility that the underproducer may seek to take advantage of the overproducing party’s marketing expertise where that party is able to secure a higher sale price than the underproducer would have, if it marketed its gas itself.

In a context where balancing in kind is used, the underproducing party receives its volumes of underproduction as ‘make-up’ gas. The AAPL Model GBA makes

²⁵ Maine Stephan Goodfellow and George F Goolsby, ‘Gas balancing agreement’ in Geoffrey Picton-Tuberville (ed), *Oil and Gas: A Practical Handbook* (Globe Law and Business 2009) 211-212.

²⁶ *ibid.*

provision for both forms of balancing.²⁷ The more recent international Model GBA by the AIPN does not make explicit reference to balancing in kind, but it does include a provision for make-up gas.²⁸

7.5. Balancing Expectations: To balance in cash or in kind?

Overall, regardless of the form of balancing, the GBA gives parties an expectation of how a gas imbalance will be addressed. In the absence of a GBA, parties will be left to debate and dispute balancing through a combination of contractual (eg, the doctrine of unjust enrichment) or possibly tort law.²⁹ It is argued that this approach would be contentious and likely unsuccessful for the underproducing party. The default position in the absence of a GBA would be for balancing in kind and not through cash balancing. This is because the imbalance was created through production and not cash. Also, cash balancing gives rise to complications on the price to be paid to the underproducer, as well as other tax implications for the overproducer. Moreover, the overproducer may be hesitant to show its accounting records due to confidentiality. Furthermore, most courts would likely be motivated by the fact that the parties are experienced commercial parties who have had the benefit of expert legal advice, thus

²⁷ AAPL Model GBA 1992, Section 4 - Balancing in kind. Section 5 - Cash balancing.

²⁸ AIPN Model GBA 2014, Article 6.3 - Make-up gas: 'An Underlifted Party shall be entitled in each Nomination Period after the Nomination Period in which such the Underlifted Quantity occurred to lift and take, in addition to its Participating Interest share of Natural Gas, a quantity of Natural Gas ("Make-Up Gas") in order to eliminate its Underlifted Quantity'. In relation to cash balancing, the AIPN Model GBA 2014, Article 8.1 - Voluntary Cash Balancing, provides that: 'An Overlifted Party may agree with one or more Underlifted Parties to balance all or a portion of their Overlifted Quantities and Underlifted Quantities for one or both Seasons through a cash payment or other form of compensation. The Parties shall notify Operator of the arrangement, and Operator shall adjust the Gas Balancing Accounts of each cash balancing Party to reflect the Parties' arrangement'.

²⁹ Maine Stephan Goodfellow and George F Goolsby, 'Gas balancing agreement' in Geoffrey Picton-Tuberville (ed), *Oil and Gas: A Practical Handbook* (Globe Law and Business 2009) 213.

they ought to have included cash balancing if this was what was required.³⁰ In particular, English courts have leaned towards a strict approach when interpreting commercial contracts.³¹ Nonetheless, in the unlikely event that a court takes a more lenient approach in favour of the underproducer, this will be of no benefit where the reservoir is depleted.

7.6. Challenges to the effectiveness of the gas balancing agreement: Forfeiture and the rule against penalties

So far, one can say that the GBA is fit for purpose because it fulfils the function for which it was set out. It envisages situations whereby a party is unable to lift its total share of gas, and makes provision for other parties to lift such volumes so as to enable the reservoir to produce at full capacity instead of operating as a storage facility for the underproducing party.³² In a sense, the GBA facilitates gas imbalance within contractually recognised limits. It also specifies the process and remedy for restoring the imbalance.

Nevertheless, the ability of the GBA to fulfil its purpose does not necessarily mean that it is an effective form of risk mitigation. Rather, its effectiveness is largely dependent on it being legally enforceable. Three main issues are considered in this section. The first is: where a GBA leads to the irrecoverable loss of gas volumes, will the underproducer suffer a forfeiture if the agreement is upheld? The second asks whether if so, the underproducer is entitled to relief from forfeiture. The third is,

³⁰ A USA example of this strict approach was seen in *Chevron USA, Inc v Belco Petrol. Corp* 755 F.2d 1151 (5th Cir. 1985).

³¹ See *Union Eagle Ltd v Golden Achievement Ltd*. [1997] AC 514; *Total Gas Marketing Ltd v Arco British Ltd & Ors* [1998] UKHL 22, 2 Lloyd's Rep. 209.

³² Peter Roberts, *Joint Operating Agreements: A Practical Guide* (2nd edn, Globe Law and Business 2012) 124.

whether the underproducer can successfully claim that the provision is an unenforceable penalty.

7.6.1. Is the loss of gas volumes a forfeiture?

This section examines some of the challenges to the GBA and how these impact upon its effectiveness. A party will be owed volumes of make-up gas where it lifts lower than its contractual quantities. Although the GBA will indicate whether the underproducer is to be repaid in cash or kind, a provision of the GBA could prevent the underproducer from recovering volumes of gas owed after a specified period. For example, the AIPN Model GBA 2014, Article 8.2 contains three alternatives for the recovery of underproduction. Alternative 1 allows for cash balancing where volumes of gas remain unbalanced:

Each Underlifted Party who has an Underlifted Quantity for a Season that has remained unbalanced for [____] consecutive Contract Years may require the Operator to cause the Overlifting Parties to pay cash for such Underlifted Quantity using the price for that Season as calculated under Article 8.5.³³

Alternative 3 preserves the right to recover make-up gas even after the specified time period has lapsed. It provides:

Each Underlifted Party who has an Underlifted Quantity for a Season that has remained unbalanced for [____] consecutive Contract Years will retain the right to Make-Up Gas for such Underlifted Quantity in accordance with this Gas Balancing Agreement.³⁴

³³ AIPN Model GBA 2014, Article 8.2 (Alternative 1).

³⁴ AIPN Model GBA 2014, Article 8.2 (Alternative 3).

Where either of these alternatives is adopted the potential challenge as to forfeiture is averted.³⁵

Alternative 2 is more contentious since it leads to the loss of gas volumes. It provides that:

An Underlifted Party who has an Underlifted Quantity for a Season that has remained unbalanced for [_____] consecutive Contract Years will lose the right to claim Make-Up Gas for such Underlifted Quantity, and the Underlifted Party will have no further claims against the other Parties for such Underlifted Quantity.³⁶

The implications of this option are discussed below under ‘loss of gas volumes following expiration of time limit’.

There is another scenario which could raise a challenge as to forfeiture where the GBA only provides for balancing in kind and the reservoir becomes depleted before the underproducer is able to recover its make-up gas. This is also discussed below.

Where the GBA prescribes a time limit where the underproducing party is to recover make-up gas, or where the gas field/block reaches depletion before recovery, this may lead to a claim by the underproducing party that there has been a forfeiture. Chapter 6, section 6.2.2 discussed forfeiture and elucidated four key features of a forfeiture provision. The discussion that follows seeks to ascertain whether a provision of the GBA leading to the loss of gas volumes may be properly classified as a forfeiture clause. This is because the loss of gas volumes is not necessarily an

³⁵ However, with alternative 1 there is the risk that a party may deliberately fail to recover make-up gas so as to take advantage of a better cash-balance. Also, with alternative 3, the overproducing parties have no certainty as to when the underproducer will seek to claim its underproduction. These uncertainties may dissuade parties from adopting these options.

³⁶ According to the guidance notes on the AIPN Model GBA 2014 (page 26), this option is common in countries of Anglo-Saxon legal tradition.

indication that there has been a forfeiture. The first key feature of a forfeiture is that the provision is triggered in response to a breach of contract.

i. The requirement for a breach of contract

a. Loss of gas volumes following expiration of time limit

In evaluating whether the failure of a party to lift its underproduced volumes of gas within the time specified qualifies as a breach of contract, it must first be determined whether such requirement is a primary or secondary obligation. This thesis considers two opposing arguments. On the one hand, there is the view that the provision concerning the offtake of under-production is a contractual right ascribed to the underproducing party, whilst the overproducing party/parties have a contractual duty to allow the underproducing party to make-up its undertake. The inclusion of a time limit does not impose a contractual duty on the underproducing party, but rather its purpose is to specify the period during which the right to make-up gas is effective. Thus, the right to make-up gas is subject to a contractual limitation – the time period specified in the contract. In this case, the failure to lift within the allocated period is not a breach of contract but rather a loss of the right to recovery. Therefore, the overproducing parties could argue that the failure of a party to exercise a contractual right cannot be a breach of contract and, as such, there is no forfeiture.³⁷

On the other hand, it may be argued that the requirement to lift make-up gas within a specified period qualifies as a contractual obligation, although this would depend on the terms of the GBA. As the party seeking to prove that there has been a forfeiture, the underproducing party could argue that the inclusion of a time limit

³⁷ If this position is accepted, the underproducing party could consider arguing that the time limit is an unfair term.

imposes upon it a contractual duty to lift make-up gas within the specified period. Where there is no duty there can be no breach, but because there is a duty, the failure to comply puts the underproducing party in breach of contract. An argument in favour of this view is that the language of many JOAs³⁸ indicates that each party has the right and obligation to lift its share of hydrocarbons produced. This right and obligation could also extend to make-up gas. An example of this is the AIPN Model GBA 2014, Exhibit G which opens up with a statement that, 'Each Party has the right and obligation to own, take in kind, and separately dispose of its Entitlement under the Agreement...'. The entitlement of a party extends to all its share of production; this includes the volumes lifted and subject to be lifted as make-up gas. Therefore, the underproducing party has a right and obligation to lift its entitlement of gas which includes make-up gas. Failure to do so would be a breach of contract.

Although the thesis favours the latter view, the determination of whether there has been a breach or not is a matter of interpretation based on the language of the particular GBA. If the GBA refers only to a right to take gas, then there is no obligation to lift, in which case there is no breach of contract. Where it refers to a right and obligation to lift, there can be a breach of contract. In the absence of a breach of contract, the provision does not come within forfeiture. However, where there is an obligation to lift make-up gas, it is argued that the failure to abide by the time limit is a breach of contract, and the first and most definitive feature of a forfeiture is present. Such a provision may be framed along the following lines:

³⁸ Examples include - AAPL Model JOA 810 section 15.1; AMPLA Model JOA section 4.3; OGUK Model JOA s18 (b); AIPN Model JOA 2012, Article 9.1.

Where a gas imbalance is restored in-kind, an underproducing party has the right and obligation to lift its volumes of make-up gas within two years from the date the imbalance was created.

b. Loss of gas volumes due to well depletion

The loss of gas volumes due to well depletion can arise in different ways. The underproducing party may have had the opportunity to recover its under-production at an earlier stage but refused to do so. Alternatively, despite best efforts to gauge the life span of the well, it becomes depleted prematurely before the underproducing party is able to recover all of its under-lift. Either way, the result is the same – the underproducing party is unable to recover owed gas volumes. On the face of it, the loss is simply attributed to depletion; it is not flowing from a breach of contractual obligation. There is little or nothing the underproducing party can do where the GBA provides only for balancing in kind. A U.S. case example of this, albeit old, is *Chevron USA, Inc v Belco Petrol. Corp.*³⁹ (hereafter *Chevron*). The GBA provided that:

To allow the recovery of gas in storage and to balance the gas account of the parties in accordance with their respective interests, ... a party with gas in storage shall be entitled to take or deliver to a purchaser its current share of the gas produced ... plus up to 25% of the other party's share of gas production ... until such time as that quantity of gas in storage shall be reduced to zero.

Chevron underproduced but the field depleted before it could commence recovery. The GBA only provided for balancing in kind, but since this was no longer possible,

³⁹ 755 F.2d 1151 (5th Cir. 1985).

Chevron sought balancing in cash.⁴⁰ However, it is central to note that the loss of gas volumes was not due to a breach of contract. Chevron had simply lost the opportunity to recover owed volumes of gas.

Although it could be argued that the depletion of the well resulted in a ‘forfeiture’ of gas volumes, yet the court did not consider relief against forfeiture. Generally, where a party suffers a forfeiture due to its failure to act within a specified period, the form of relief granted would be an extension of time.⁴¹ However, where the well had become depleted, such relief would serve no purpose. This could explain why relief was not considered.

Having determined that the loss of gas volumes due to well depletion is not triggered by a breach of contract, there is no forfeiture. Therefore, the assessment of the other key features of forfeiture will only be in relation to the loss of gas volumes following the expiration of time.

ii. *The defaulting party suffers an irrecoverable loss*

The second key feature of forfeiture is that the defaulting party suffers the loss of property, interest, money etc. There can be no forfeiture without a loss. In regard to property ‘forfeiture’ is a loss of the right to possess.⁴² This is not a temporary loss by

⁴⁰ It is surprising that in drafting the GBA, Chevron as an experienced commercial party did not make provision for cash balancing. Chevron’s negotiator testified that ‘[h]e thought a cash balancing clause was unnecessary because the field was thought to contain large gas reserves’. *Chevron USA, Inc v Belco Petrol. Corp* 755 F.2d 1151 (5th Cir. 1985). The District Court approved balancing in cash by implying equitable principles of unjust enrichment to the contract. However, the Appeals Court (United States Court of Appeals, Fifth Circuit) reversed this decision, reasoning that there was no room to apply equitable principles to permit cash balancing because the GBA specified an exclusive mode of balancing in kind. It was also relevant that the GBA had been negotiated by experienced parties. In relation to the decision of the Appeals Court not to imply cash balancing in favour of Chevron, it is considered that an English Court would likely take the same course since it is usual for courts to interpret commercial contracts strictly, and not allow equity to intrude in commercial bargains.

⁴¹ *BICC Plc v Burndy Corp* [1985] Ch 232.

⁴² *Re Sumner's Settled Estates* [1911] 1 Ch 315 [319] (Eve J).

which the defaulting party retains the right to recover or retake the forfeited interest; rather, it must be an irrecoverable loss. Although the loss is suffered by the breaching party, it is the innocent party who retains or retakes the object of the forfeiture. A case example is *B.I.C.C v Burndy Corp*,⁴³ (hereafter *Burndy*) where there was an agreement over patent rights between the claimant and defendant. There was a transfer provision which provided that upon default the breaching party would assign its rights in the patents to the innocent party. The effect of this was that the breaching party would lose rights in the patents. Similarly, the effect of the retransfer provision in *Jobson v Johnson*⁴⁴ was that upon default the buyer would lose proprietary rights in the shares.

In the context of a GBA where there is an obligation on the underproducer to lift its underproduction within a time limitation, the underproducing party would be in default where it fails to lift within the time specified. The effect of such provision is that the defaulting party will suffer the irrecoverable loss of gas volumes unclaimed within the specified period. Therefore, the second key feature is satisfied.

iii. *Direct benefit to the innocent party or a third party appointed by the innocent party*

Following the defaulting party's loss, another key feature of a forfeiture is that it is the innocent party or a third party appointed by the innocent party who directly benefits from the defaulting party's loss. Where the beneficiary of the loss is a third party, the clause may provide that the breaching party will lose something, such as part of the

⁴³ [1985] Ch 232.

⁴⁴ [1989] 1 WLR 1026.

price, but the innocent party will not retain it and must give it to a third party, such as a charity. The question addressed here is whether this feature is present in a GBA leading to forfeiture.

For example, in *Makdessi*, the effect of the forfeiture clause was that the seller who had breached its restrictive covenants/non-compete clause could no longer receive the value of the goodwill of the business as part of the sale price. Although the FC was interpreted as a primary obligation which amounted to ‘...a reshaping of the parties’ primary obligation’,⁴⁵ such reshaping was as a result of the breach of the restrictive covenant. The reduction in the sale price meant that the seller suffered a loss and the buyer acquired a direct benefit by paying a lower price than previously agreed. Similarly, in a GBA, it is the defaulting underproducing party who suffers the loss of gas volumes, whilst the overproducing party benefits from such loss since it is no longer required to repay the overproduced volumes of gas. In this way, the result of forfeiture may be likened to a tennis match. The failure of one party to ‘serve properly’ directly results in the other player acquiring a benefit (score).⁴⁶ It is submitted that this third key feature of a forfeiture is present in a GBA where the overproducing parties benefits from the loss of the underproducing party.

⁴⁵ *Cavendish Square Holdings BV v Talal El Makdessi* [2015] UKSC 67, [2015] 3 WLR 1373 (SC) [183] (Lord Mance SCJ). Lord Neuberger and Lord Sumption SCJJ, with whom Lord Carnwath SCJ agreed, also interpreted the forfeiture provision as primary obligation - see para 83.

⁴⁶ Tolulope Taiwo, ‘Forfeiture in joint operating contracts subject to English law’, Unpublished LLM dissertation, University of Birmingham 2014, 1,13.

iv. The provision is a security to compel performance or it gives a right to abstain from future performance

In determining whether the last key feature of a forfeiture is satisfied, the impugned provision of the GBA must either compel performance of a specified contractual obligation, and where the obligation is not performed, it gives the innocent party the right to abstain from performance of a specified future obligation. That is, the non-performance of the defaulting party, gives the innocent party the right to also withhold a specified obligation to the defaulting party.

The provision can be used as a sword against the defaulting party to compel performance, or where performance does not occur, it can be used as a shield by the innocent party to refuse to perform a future obligation. This was the position in *Makdessi* in respect of clause 5.6 where the buyer argued that the seller had lost the right to recover the agreed sale price which included the value of the goodwill of the business, after the seller breached the non-compete clause in the contract. In this case, all four key features of a forfeiture were present – there was a breach of contract, an irrecoverable loss suffered by the defaulting party which resulted in a direct benefit to the innocent party, leading this party to abstain from future performance (full payment of sale price).

In the case of a GBA provision leading to the loss of gas volumes, where the underproducing party does not take its volumes of make-up gas within the required period, the overproducing party no longer has to make available volumes of make-up gas to the underproducing party (thereby withholding future performance). Therefore, the fourth and last key feature of a forfeiture is also present.

A conclusion on the key features of a forfeiture as they relate to the GBA.

The loss of gas volumes following well depletion is no longer considered under forfeiture because there is no breach of contract. However, in relation to the loss of gas volumes following the expiration of time, it is submitted that all four features of forfeiture are present, albeit the fate of the first feature (breach of contract) depends on whether there is an obligation to lift make-up gas. The other features are: loss to the defaulting party; direct benefit to the innocent party or a third party appointed by it; and the provision is a security to compel performance or, where performance does not occur, to give the innocent party a right to abstain from future performance. This brings such loss within the forfeiture 'rule'. In a bid to avoid the forfeiture provision, the underproducing party can seek relief from forfeiture. The underproducing party can also challenge the provision under the penalty rule – this will be examined after discussing relief from forfeiture.

7.6.2. Are the conditions for relief from forfeiture satisfied?

The courts have a limited jurisdiction to grant equitable relief from forfeiture in certain situations.⁴⁷ The specific circumstances⁴⁸ to which relief may apply have been discussed in the previous chapter. In a GBA, the question is whether the court ought to grant equitable relief to allow the underproducing party to recover its make-up gas after the time period for recovery has lapsed.

⁴⁷ Hugh G Beale (ed) *Chitty on Contracts: Volume I General Principles* (32nd edn, Sweet & Maxwell 2015) 1694-1700; Edwin Peel, *Treitel on The Law of Contract* (14th edn, Sweet & Maxwell/Thomson Reuters 2015) 1000-1003.

⁴⁸ Lord Wilberforce in *Shiloh Spinners v Harding* [1973] AC 691, [722D-723F] listed some of these circumstances.

In *Makdessi*, the UKSC cited with approval⁴⁹ the approach taken by the Court of Appeal in *Burndy*.⁵⁰ This approach was, first to consider whether the clause was an unenforceable penalty. Where it was not, the court moved on to determine whether it could grant equitable relief, looking at the position of the parties at the time of the breach and after the breach. However, the UKSC did not discuss the circumstances in which relief may be granted or the relevant conditions. This is because relief from forfeiture was not sought in either *Makdessi* or *ParkingEye*.⁵¹ Yet, the court did cite cases such as *Shiloh Spinners*⁵² and *Burndy*,⁵³ where equitable relief was discussed.

In *Shiloh Spinners*,⁵⁴ it was held that the court has discretion to grant relief, ‘...where the primary object of the bargain is to secure a stated result which can effectively be attained when the matter comes before the court, and where the forfeiture provision is added by way of security for the production of that result’.⁵⁵ Consequently, in a GBA, the inclusion of the time-based limitation which results in a forfeiture is not to secure the payment of money, but the primary purpose is to secure a result, which is the lifting of make-up gas within a stipulated duration.⁵⁶ In terms of whether the forfeiture provision is added as security to secure the result, this depends

⁴⁹ *Cavendish Square Holdings BV v Talal El Makdessi* [2015] UKSC 67, [2015] 3 WLR 1373 (SC) [161], [227] and [294].

⁵⁰ [1985] Ch 232.

⁵¹ *Cavendish Square Holdings BV v Talal El Makdessi* [2015] UKSC 67, [2015] 3 WLR 1373 (SC) [18].

⁵² [1973] AC 691.

⁵³ [1985] Ch 232, 246-247 and 252 (Dillon LJ). This case was cited by the UKSC in *Makdessi* (at para 17) whilst referring to circumstances in which equitable relief might be granted.

⁵⁴ *Shiloh Spinners v Harding* [1973] AC 691, 723.

⁵⁵ *ibid* at p723. This was cited in *Makdessi v Cavendish Square Holdings BV* [2015] UKSC 67, [2015] 3 WLR 1373 (SC) [10].

⁵⁶ Thus, it could be argued that the aim of the provision is to encourage performance, rather than seek a remedy for a breach.

on whether the requirement to lift make-up gas is an obligation and not just a right. If it is, then it could be argued that the forfeiture provision is added to ensure that result, although it is debatable whether the forfeiture is a security to achieve the result. It is submitted that the forfeiture is added as a means of achieving certainty of lifting make-up gas, and where there is no lifting, certainty that the imbalance will be cancelled.

The preceding chapter's discussion of *Burndy*⁵⁷ and *Scandinavian Trading Tanker co. AB. v Flota Petrolera Ecuatoriana*⁵⁸ indicated that relief from forfeiture is only available in respect of rights in an agreement which are proprietary or possessory.⁵⁹

Accordingly, one of the requirements of relief is that, the rights in question are proprietary or possessory. In chapter 6 section 6.3.3, it was submitted that rights existing in oil and gas JV agreements could be possessory or proprietary in nature. The GBA discussed so far would pertain to rights under a JV, such that relief against forfeiture is in principle available, particularly where the underlying licence or contract confers proprietary rights and these rights extend to the JV. Therefore, it is submitted that an English court would have jurisdiction to grant relief from forfeiture in a GBA.

⁵⁷ [1985] Ch 232.

⁵⁸ [1983] 2 AC 694, [1983] 3 WLR 203 (HL). This case was discussed in chapter 6, section 6.3.3.

⁵⁹ Both cases were cited with approval in *Makdessi*, where it was also added that, '[w]here a proprietary interest or a "proprietary or possessory right" is granted or transferred subject to revocation or determination on breach, ... relief from forfeiture may be granted'. *Cavendish Square Holdings BV v Talal El Makdessi* [2015] UKSC 67, [2015] 3 WLR 1373 (SC) [17] (Lord Neuberger and Lord Sumption SCJJ) (with whom Lord Carnwath SCJ agreed). In deciding whether clause 5.1 (the withholding clause) was a penalty, it was held that '[i]f this constitutes a forfeiture, it would appear that, at least on the current state of the authorities, there would be no jurisdiction to relieve against it, because a contractual right to be paid money is not a proprietary or possessory interest in property'. (para 69).

The form of relief granted by the court could be to grant a time extension to the underproducer to recover its make-up gas or it could be to scale back the extent of the forfeiture.⁶⁰ The scaling back approach was applied in *Jobson v Johnson*⁶¹ although this was criticised by the UKSC in *Makdessi*.⁶² It is recommended that an extension of time would be more appropriate in the context of the GBA (time-based forfeiture) because the extent of the forfeiture is not excessive and only pertains to the volumes of make-up gas, not to future volumes of gas.

However, English courts have tread very carefully when it comes to granting relief from forfeiture in commercial contracts where time is of the essence.⁶³ The earlier chapter argued that timeous performance is of the essence in oil and gas JOAs. Overall, if the court goes on to decide that relief would be appropriate, it would be concerned with the period from when the default occurred. Here, this is the period from when the time limit for recovery of make-up gas lapsed. In granting a time extension, the court would consider the impact on the GBA and ultimately the underlying JV. Arguably, neither of these would be severely impacted by a time extension since the issue of gas imbalance only concerns the underproducing and overproducing party/parties, not the joint venture at large. This is an argument in favour of relief. Although a grant of relief may not be detrimental to the overall

⁶⁰ *Jobson v Johnson* [1989] 1 WLR 1026.

⁶¹ [1989] 1 WLR 1026.

⁶² Three of the Lordships held that the scaling back approach in *Jobson* was unorthodox if the retransfer provision was interpreted as a forfeiture, and wrong in principle if the provision was treated as a penalty. *Cavendish Square Holdings BV v Talal El Makdessi* [2015] UKSC 67, [2015] 3 WLR 1373 (SC) [87] (Lord Neuberger and Lord Sumption SCJJ) (with whom Lord Carnwath SCJ agreed).

⁶³ An example of this caution is seen in *Union Eagle Ltd v Golden Achievement Ltd* [1997] AC 514. Here the bidder was ten minutes late in tendering the purchase price and forfeited its 10% deposit, relief was declined.

functioning of the GBA, it is possible that relief could discourage overproducing in future, thereby impacting on the smooth running of the JV.

Nonetheless, in the event that equitable relief is not granted, the underproducing party may seek to avoid the enforcement of the provision leading to forfeiture by arguing that it is an unenforceable penalty.

7.7. The question of right or obligation under the GBA

Before the discussion on penalty, this section considers whether the provision of the GBA relating to lifting gas and make-gas confers a right or imposes an obligation. This is a relevant question that affects whether the provision leading to forfeiture is interpreted as conferring either a primary or secondary obligation.

If the GBA indicates that the underproducing party has only a right to make-up gas and not an obligation, the failure to exercise the right is not the same as a failure to perform an obligation. It is more akin to a voluntary relinquishment of rights and does not come within the rule against penalties, thus the provision would be enforceable. A sample provision in line with this view is the AAPL Model GBA 1992, section 3 where the heading refers only to, '[r]ight of parties to take gas'.

Alternatively, where the GBA is silent but the operating agreement refers to the right and obligation of parties to take gas, this could also extend to make-up gas. Most Model JOAs indicate that each party has both the right and duty to lift its contractual share of gas.⁶⁴ In such scenario, and where the GBA clearly refers to the right and obligation to take gas, the provision leading to the forfeiture of make-up gas must be assessed under the *Makdessi* primary/secondary obligation divide. An example of this

⁶⁴ Examples of this include the AAPL Model JOA 810 section 15.1; AMPLA Model JOA section 4.3; OGUK Model JOA s18 (b); AIPN Model JOA 2012, Article 9.1.

is the AIPN GBA 2014, Article 2.1c- '[e]ach Party has the *right and obligation* to own, take in kind, and separately dispose of its Participating Interest share of Natural Gas delivered at the Delivery Point'.⁶⁵

7.8. The penalty rule

This section considers whether time-based forfeiture is subject to the rule against penalties. A GBA may in effect stipulate that a failure to lift gas is a breach if it is framed as an obligation to lift gas, not just a right to do so. If the failure to discharge this obligation in the time limit leads to permanent loss of the gas, the forfeiture provision could be subject to the controls of the penalty rules. The *Makdessi* test⁶⁶ will be applied to the forfeiture of gas volumes following an expiration of time.

However, before applying the two stage *Makdessi* test, the first phase is to consider the construction test which examines whether the provision is a primary or secondary obligation. This considers whether the forfeiture may be classed as a secondary obligation triggered by failure to observe a primary obligation (lifting contract quantities of gas).

i. Primary/ secondary obligation divide

This is the construction test. Where the challenged provision is a primary obligation, it is not subject to the penalty rule and is thus enforceable. However, if it is a secondary obligation, it is subject to the penalty rule.

⁶⁵ (emphasis added).

⁶⁶ *Cavendish Square Holdings BV v Talal El Makdessi* [2015] UKSC 67, [2015] 3 WLR 1373 (SC) [32]. The *Makdessi* test was laid down by Lord Neuberger and Lord Sumption SCJJ (with whom Lord Carnwath SCJ agreed).

In the context of a GBA, the primary/secondary divide only applies if the underproducing party has a contractual obligation to lift make-up gas. The primary obligation of each party is to lift its contractual share of gas produced. It is argued that the inability of a party to lift its full share of gas at any period should be interpreted as a breach of contract. However, short of the underproducing party being held in breach of contract, the contractual response in the GBA is to allow another party to lift gas beyond its contractual share,⁶⁷ subject to balancing at a later date. This might be explained in the following manner. A party who lifts 80% of its share of gas has not fulfilled its full contractual obligation and ought to be in breach of contract, unless another party steps in to lift the remaining 20%, thereby fulfilling the duty of the underproducing party in relation to the 20% underlifted. Therefore, as far as the GBA is concerned, there is no breach of contract by the underproducing party because the full extent of its obligation has been carried out (though it is the overproducing party who fulfils the full extent of the underproducing party's duty in relation to lifting gas). However, only the underproducing party can fulfil the full extent of its contractual duty in relation to lifting make-up gas.

A secondary obligation is one which is included in the contract as a remedy for a failure to fulfil a primary obligation.⁶⁸ Thus, the secondary obligation is contingent on a primary obligation.

In a GBA, where the underproducing party has a right and obligation to lift make-up gas, the primary obligation is to lift its make-up gas within a specified

⁶⁷ See the AIPN Model GBA 2014, Article 2.1.D.2. A similar provision is contained in the older AAPL Model GBA 1992, Section 3.3.

⁶⁸ Judith Aldersey-Williams and others, 'Default clauses in joint operating agreements: recent guidance from the English courts' (2016) 1 I.E.L.R 36, 39.

period. The failure to do so is a breach and triggers the forfeiture provision, which is more in the nature of a secondary obligation, since it is designed to deter the underproducing party from lifting gas after a specified period.⁶⁹ Thus, this provision engages the rule against penalties. Consequently, the two stage *Makdessi* test must then be applied; both elements of the test must be satisfied in order for the provision to be interpreted as an unenforceable penalty. The first stage of the test is to assess whether the provision serves a legitimate interest.

ii. Does the gas balancing agreement serve a legitimate interest?

The overproducing party/parties would have to demonstrate a genuine commercial basis for the inclusion of the time-based limitation on recovery of make-up gas. To proceed with the notion that this provision pertains to a secondary obligation, the primary obligation would be the duty of the underproducing party to lift its volumes of make-up gas. This asks the question, what legitimate interest do overproducing parties have in the enforcement of the primary obligation? Moreover, does this interest go beyond compensating the innocent parties, in that the provision has a commercial justification?

Where one party is unable or unwilling to take delivery of all its gas volumes, one of the functions of the GBA is to allow other willing parties to lift the excess volumes of gas, thus overproducing.⁷⁰ Depending on the frequency of production, it is imperative that all parties take delivery of their respective volumes of gas so that the

⁶⁹ In *Makdessi*, three of the seven Lordships (Lord Hodge, Lord Clarke and Lord Toulson SCJJ) concluded that the forfeiture clause was a secondary obligation, because it was designed to deter the seller from breaching the restrictive covenants. *Cavendish Square Holdings BV v Talal El Makdessi* [2015] UKSC 67, [2015] 3 WLR 1373 (SC) [280], [291] -[292].

⁷⁰ An example of this is contained in the AAPL Model GBA 1992, section 3.3.

reservoir can continue to produce to maximum efficiency.⁷¹ Where the GBA only makes provision for balancing in kind, the overproducing party remains cognisant of the fact that it has to restore the gas imbalance within the time frame indicated. In a GBA which includes a time-based limitation on recovery, the main purpose is to prevent an underproducing party from using the reservoir as a storage facility or to avoid burdening the overproducing party indefinitely. This thesis takes the view that, in the event that the underproducing party does not lift its make-up gas during this time, it is in the interest of commercial certainty that the overproducing party becomes free from the obligation to restore the imbalance. The legitimate interest for the imposition of the provision is thus, commercial certainty. During the period where there is a gas imbalance, the gas account would reflect this and remain unbalanced.⁷² Therefore, the inclusion of the time limitation on recovery of make-up gas is to allow certainty that the gas account would be balanced within a specified duration. It is argued that to allow an indefinite period of recovery of make-up gas would lead to greater uncertainty for the overproducing parties as to when the underproducer might seek to recover make-up gas. This could have implications on long term gas sales agreements. For example, a conflict of interest could occur where a seller who is also an overproducer has to supply make-up gas under a ToP contract to its buyer at the same time as the underproducer in the GBA seeks to lift its make-up gas.⁷³ The overproducer would be in a better position to fulfil its obligations to supply make-up

⁷¹ Peter Roberts, *Joint Operating Agreements: A Practical Guide* (2nd edn, Globe Law and Business 2012) 124.

⁷² The gas balancing account is defined in the AIPN Model GBA 2014 as: '[t]he account the Operator maintains for each Party under this Gas Balancing Agreement, which account includes the cumulative quantities of Natural Gas actually lifted and delivered to such Party; and any resulting Overlifted Quantity or Underlifted Quantity for each Season and cumulatively.'

⁷³ Tomás Lanardonne, ' "Cash-or-Gas": The Quest for Balancing the Imbalance' (2016) 9 *Revista Argentina de Derecho de la Energía, Hidrocarburos y Minería*, mayo-julio de 1,30.

gas under the gas sales agreement if it has certainty of the duration in which the underproducer party is entitled to make-up gas.

A possible counter-argument is that another way of guaranteeing certainty to an overproducing party where there is an indefinite period to recover make-up gas, is by requiring the underproducing party to give a reasonable period of notice before claiming its make-up gas. In this way, the overproducing party has certainty of when it has to make volumes of gas available to the underproducing party. Although this is a credible argument, it does not avoid the conflict of interest described above. Even where the overproducing party has notice of the period in which the underproducing party wishes to claim make-up gas, this does not mean that a ToP buyer cannot also require make-up gas at the same period. More importantly, an indefinite period of recovery means that the overproducing party cannot make commercial plans regarding lifting gas without considering the interest of the underproducer party in relation to make-up gas. Consequently, it is argued that, in the interests of certainty, the best approach is to apply a limited period of recovery to make-up gas.

For these reasons, it is submitted that a time-based forfeiture serves a legitimate interest. Nevertheless, in the unlikely event that the provision is found to lack a legitimate interest, the next stage is to consider whether the provision is unconscionable or exorbitant.

iii. Is the application of the gas balancing agreement unconscionable or exorbitant?

This considers whether the loss of gas volumes resulting from the failure of the underproducer to lift within the contract limitation is unconscionable or exorbitant. The analysis of unconscionability in the discussion of forfeiture provisions in the previous chapter pointed to proportionality for the interpretation of what qualifies as unconscionable or exorbitant. Therefore, when weighed against the legitimate interest that the innocent party (overproducer) is trying to protect, is the remedy of forfeiture proportionate? In answering this, one must consider whether a less restrictive alternative was available. In the context of a GBA, there are two alternatives – the first is to give the underproducing party the right to recover make-up gas over an indefinite period.⁷⁴ The problem with this is that it could create a perpetual gas imbalance and lead to uncertainty as to when recovery will be made.

The second alternative is to allow for balancing in cash where the underproducing party does not recover make-up gas in kind during the stipulated time frame.⁷⁵ However, this option comes with complexities in relation to the formula for calculating the cash payable or taxation implications on the overproducer. Furthermore, where there is an option for cash balancing, the underproducing party may intentionally decline to take make-up gas in kind, if it believes balancing in cash would be more favourable to it. An example of this could be where the overproducing party is able to secure a superior sales price for the make-up gas, than the underproducer would have secured. In such a case, cash balancing would yield

⁷⁴ An example of this is contained in the AIPN Model GBA 2014, Article 8.2, Alternative 3.

⁷⁵ *ibid*, Alternative 1.

increased revenue for the underproducing party, than balancing in kind. This would encourage opportunism.

In assessing proportionality, the time period given to the underproducing party to recover make-up gas is crucial, although it is not the only factor. The time period must be reasonable and in line with what is common in the industry. In *ParkingEye*,⁷⁶ the parking industry norm to impose charges for overstaying assisted in the defendant's argument that the fine was proportionate.⁷⁷ Thus, in the context of the GBA, if the standard time period for recovery is two years, a GBA which gives six months is arguably unreasonable unless there are special considerations in view – such as imminent well depletion. It is argued that unless the time period for recovery is unreasonably short, the forfeiture of gas volumes after the expiration of a time limit should not be deemed to be unconscionable or exorbitant because there are no less restrictive alternatives which would guarantee certainty in the manner in which gas imbalance is restored. Additionally, this remedy is not 'out of all proportion' since the underproducing party has not lost its participating interest in the joint venture; it has simply lost the make-up gas which it failed to recover during the time limit. Nevertheless, the court would also consider the volumes of gas lost. Where such volumes are significant⁷⁸ and there is a shorter period of recovery than is common in the industry, this could be considered out of all proportion and point to unconscionability. However, where such volumes are less significant and there is a

⁷⁶ *ParkingEye Limited v Beavis* [2015] UKSC 67.

⁷⁷ See Judith Aldersey-Williams and others, 'Default clauses in joint operating agreements: recent guidance from the English courts' (2016) 1 I.E.L.R 36, 48.

⁷⁸ The frequency of balancing would determine whether the volumes owed are significant or not. Where balancing is on a monthly basis, the volumes owed would not be as high as would be due where balancing is on an annual basis.

reasonable period to reclaim make-up gas, the provision would be neither unconscionable nor exorbitant.

Having examined the function of the GBA and the challenges to its effectiveness, the next section briefly evaluates whether the GBA is an effective contractual method of reducing risks and uncertainties in a JV agreement subject to a shared gas reservoir.

7.9. Can the effectiveness of the gas balancing agreement be enhanced?

The main challenge to the enforcement of the GBA is where it includes a provision on time-based forfeiture. However, this does not negate the effectiveness of the GBA since as indicated above the provision is likely to be enforceable. Nevertheless, there are methods through which the effectiveness of the GBA may be enhanced for both underproducing and overproducing parties, albeit that certain recommendations would be more beneficial to one party than the other. These are discussed below.

Combined form of balancing

Although balancing in kind is the preferred form, it must be considered that there are circumstances where it can lead to inequalities.⁷⁹ An example of this is where the volumes of gas left in the reservoir are insufficient to allow the underproducing party to recover all outstanding volumes of make-up gas, or where the reservoir becomes depleted prematurely before recovery. In the case of *Chevron*,⁸⁰ discussed earlier, it was held that the underproducing party was not entitled to balancing in cash because the GBA only made provision for balancing in kind. As a matter of contract, one can

⁷⁹ Maine Stephan Goodfellow and George F Goolsby, 'Gas balancing agreement' in Geoffrey Picton-Tuberville (ed), *Oil and Gas: A Practical Handbook* (Globe Law and Business 2009) 216.

⁸⁰ 755 F.2d 1151 (5th Cir. 1985).

see no flaw in this decision, particularly as the parties were experienced commercial parties. It is submitted that an English court would likely be motivated by the fact that the parties are experienced, such that the court will not rewrite the GBA to allow cash balancing simply because circumstances create an injustice to the underproducing party. The underproducer may seek to argue that there is a role for principles of unjust enrichment to apply, but this is unlikely to be accepted. Experienced contracting parties ought to have included cash balancing in the agreement if that was what they required. In the *Chevron* decision the Appeals Court⁸¹ reasoned that there was no room to apply equitable principles to permit cash balancing where the GBA only specified balancing in kind.⁸²

Therefore, it is recommended that the GBA combines both forms of balancing – targeted gas balancing. This would benefit both underproducing and overproducing parties, although cash balancing may benefit one party over the other, depending on the formula used. Generally, balancing in kind should be the predominant way of restoring the imbalance as it avoids conflicts relating to the price payable and taxation. Most importantly, it prevents an underproducer from deliberately nominating less gas so as to take advantage of a cash payment, either because it is in financial difficulty or simply because the overproducer can secure a higher market price. Furthermore, it is logical for the imbalance to be restored in the same way as it was created, through gas and not cash.

Nevertheless, cash balancing has its advantages, an example of which is where there has been a premature well depletion or where the underproducing party was

⁸¹ United States Court of Appeals, Fifth Circuit.

⁸² *Chevron USA, Inc v Belco Petrol. Corp* 755 F.2d 1151 (5th Cir. 1985).

unable through no fault of its own to recover all of its make-up gas in kind before well depletion. The GBA must dictate the price index through which cash balancing must be made, as well as other relevant considerations (eg, taxation) which accompany balancing in cash. The GBA must be clear as to the specific circumstances where balancing in cash is allowed, quite distinguishable from a situation where the underproducing party simply refuses to recover its make-up gas, perhaps so as to get a higher sales price. Where there is proof that the underproducing party had the opportunity to recover make-up gas but declined to, balancing in cash should not be allowed. The guidance notes to the AIPN Model GBA 2014 states that:

There is a clear intent in the agreement that balancing should be achieved through the mechanisms that are contained within this Gas Balancing Agreement. However there always remains the possibility that this cannot be achieved, in which event cash balancing is to be seen as a fall-back position and the intent is that this ought not to be attractive to the underlifter.⁸³

This thesis agrees with the AIPN quotation. In order to avoid disputes relating to cash balancing, it must be used as a last resort. Yet, the notion that cash balancing ought not to be attractive or favour the underproducer should not be taken as a presumption that it should punish the underproducer. That is, the cash balancing provision should not be structured in a way which manifestly deprives the underproducer of the value of its underlifted gas. Rather, the provision must be fair and reasonable; one of the factors to consider is the associated costs the overproducer would have incurred in selling the overlifted gas.

⁸³ Guidance Notes on Article 8- cash balancing. Page 26.

Language associated with lifting

A central method of enhancing the effectiveness of the GBA is to mitigate the risks that it may be deemed unenforceable under the penalty rule. In relation to time-based forfeiture, it was discussed that whether the underproducing party has a right or an obligation, or both, to lift its contractual share of gas is crucial to the determination of whether the GBA comes with the rule against penalties. Therefore, the language of the GBA can determine whether or not it can be successfully challenged under the penalty rule. On one hand, where there is only a right to lift and not a duty/obligation, there can be no contractual breach for a failure to exercise that right. Consequently, the GBA would not come within the rule against penalties. As such, the superior argument for the protection of the GBA against the penalty rule is for the language of the GBA to be phrased as conferring a right to make-up gas, and not an obligation/duty. It is for this reason that overproducing parties would prefer the GBA to state that underproducers have a right and not an obligation to make-up gas. The thesis recommends a stipulation along these lines:

Each party has the right and obligation to lift its share of gas produced. However, the failure of any party to lift all its share of production during any lifting period will not be considered a breach, provided another party is able to lift the volumes of underlift. An underproducing party has the right but not the obligation to lift its volumes of make-up gas within — months. Where such volumes are not lifted by the said date, the underproducing party will be taken to relinquish its rights to such volumes of make-up gas.

However, this approach should not be used to reflect lifting obligations under the JOA; if parties do not have an obligation to lift, this can lead to problems where parties refuse to lift gas because the market is unfavourable or where there are supply

difficulties. This is less often the case. It has been noted in earlier sections of this chapter that most Model JOAs refer to a right and obligation to lift gas.⁸⁴

On the other hand, if the wording indicates that the underproducing party has an obligation to lift its make-up gas, then it is possible for the provision to be examined under the penalty rule. Therefore, the forfeiture of gas volumes would come within the rule against penalties. This would be preferable to underproducing parties where the GBA only makes provision for balancing in kind. Nevertheless, the chapter has argued that a provision relating to time-based forfeiture is likely to be enforceable (to the benefit of overproducing parties), where it makes clear the legitimate interest which the overproducing parties seek to protect. Additionally, in order to ensure that the remedy of forfeiture is neither unconscionable or exorbitant, the time limit for the recovery of make-up gas must be reasonable and in line with what is standard practice in the industry.

Insolvency and the GBA

A critical issue noted by Roberts is the following: what if the overproducing party becomes insolvent?⁸⁵ The risk that a party may become insolvent is the nightmare of any joint venturer. In a GBA where the stipulated form of balancing is through cash either periodically or at well depletion, the parties must consider the implications where the overproducing party becomes insolvent prior to repaying the underproducer in cash. Two solutions are recommended. The first is for the creation of a security, with such security giving the underproducing party ‘first rights’ to recover its debt

⁸⁴ See AAPL Model JOA 810 section 15.1; AMPLA Model JOA section 4.3; OGUK Model JOA s18 (b); AIPN Model JOA 2012, Article 9.1.

⁸⁵ Peter Roberts, *Joint Operating Agreements: A Practical Guide* (2nd edn, Globe Law and Business 2012) 125.

before other creditors outside the JV to which the GBA is subject. This right of first recovery would, of course, be second to the security provided for decommissioning where there is a DSA.⁸⁶ In this sense, it is more of a ‘second right’ of first recovery.

The second solution, possibly preferred by the underproducing party, is to pay that party in kind from the remaining share of gas volumes belonging to the insolvent party. This is only viable where the reservoir is not depleted. Where cash balancing is used, periodic payment is recommended as opposed to waiting to clear the entire gas imbalance at the time of well depletion. This is because the amount would be quite high at this point and the underproducing party would be exposed to greater risks of not recovering the full cash amount of its gas imbalance where an overproducing party becomes insolvent. Periodic cash repayment does not remove the risk of insolvency but it certainly reduces the amount of money which would be owed to the underproducing party.

The application of the recommendations provided will assist in making the GBA a more effective contractual mechanism for the mitigation of uncertainties related to the lifting of gas between multiple parties involved in a long term gas agreement.

⁸⁶ This is discussed in chapter 9 of the thesis.

Conclusion

This chapter has demonstrated that the decision in *Makdessi* has an impact on GBAs containing a provision leading to the forfeiture of gas volumes. These GBAs are vulnerable to challenge by an underproducing party under the penalty rule. It has been argued that this challenge will fail where the GBA only gives the underproducing party the right (not the obligation) to lift its volumes of make-up gas within the specified time limit. Where there is no obligation to lift, there is no breach of contract. In the absence of a contractual breach, a GBA governed by English law cannot come within the net of the penalty rule.

However, it was argued that GBAs including a right and obligation of each party to lift its share of gas, which includes make-up gas, come within the penalty rule. It has been argued that the failure to lift make-up gas within the time limit constitutes a breach of contract. Although it is difficult to distinguish between a primary and secondary obligation of the GBA in relation to make-up gas, the chapter has argued that the primary obligation is the duty of the underproducing party to lift make-up gas within the time limit, and the secondary obligation is forfeiture after the time limit has lapsed. In assessing the GBA under the two stage *Makdessi* test, it was argued that the provision relating to time-based forfeiture will not be a penalty. It was submitted that the legitimate interest for the imposition of the time limit is commercial certainty. An overproducing party requires commercial certainty of the duration in which it has an obligation to have make-up gas available for the underproducing party. It was also argued that the application of the time limitation on make-up gas will not be unconscionable or exorbitant where the underproducing party has only lost volumes of make-up gas owed for a particular period, not subsequent gas

production – albeit that the volumes of gas lost would be a significant consideration. The loss of small volumes of make-up gas may be proportionate, but a larger loss may be exorbitant. The evaluation of exorbitance is essentially a fact based assessment; it may not always be possible to specify in advance what volumes of gas will be considered exorbitant. Nevertheless, a reasonable time limitation based on what is standard in the industry would assist in the argument that the forfeiture is proportionate.

Therefore, a GBA with a legitimate interest which is neither unconscionable nor exorbitant will pass the penalty test, and is enforceable.

There is very limited scope for the underproducing party to make an application for relief against forfeiture. The chapter recommended that a time extension for recovery of make-up gas would be more appropriate than a scaling back of the forfeiture as applied in *Jobson*.

Having made these arguments, the chapter provided a recommendation on how GBAs containing a provision leading to forfeiture can reduce vulnerability to the penalty rule. It was recommended that the underproducing party should be given a right to make-up gas, but not an obligation. By so doing, failure to lift make-up gas within a specified period is not a breach of contract but simply a voluntary relinquishment of rights. This would avoid the provision coming within the net of the penalty rule in contracts governed by English law.

Lastly, the chapter provided other recommendations on how to enhance the effectiveness of the GBA, in relation to using a combined form of balancing and how to mitigate insolvency.

The next chapter also considers make-up gas in its assessment of the ToP clause.

CHAPTER 8

THE TAKE OR PAY CLAUSE

Introduction

This chapter considers the relationship between an IOC seller and a buyer in a long term gas sales agreement containing a Take or Pay clause (hereafter ToP).

The ToP clause is used in long term oil agreements,¹ but it is more popular in gas agreements because gas projects are highly cash intensive. Moreover, gas is not as easily traded on the spot market.² As a result, the seller needs to secure buyers prior to production, so that it has a guarantee of realising its investments.

A ToP clause is one by which a buyer of gas agrees to pay for the minimum contractual quantities at specified times, whether it takes delivery of such quantities or not.³ The ToP frequency may be monthly, annual or as otherwise agreed by the parties. The annual contract quantity (ACQ) is the agreed quantity that the buyer may be required to take delivery of during the course of the contract year.⁴ This will

¹ It is also used in long term sales and supply agreements outside the oil and gas sector.

² Paul Griffin (ed), *Liquefied Natural Gas: The Law and Business of LNG* (2nd edn, Globe Law and Business 2012) 66; Daniel R. Rogers and David Y. Phua, 'Project Development and Finance LNG-Asia: Re-examining the Take-or-Pay Obligation in LNG Sale and Purchase Agreements' (Lexology: King and Spalding LLP, November 2015) <<http://www.lexology.com/library/detail.aspx?g=a55fc12f-9eef-4353-8d59-b9016aa3f5f3>> accessed 19 May 2017.

³ An example is contained in the AIPN Model Gas Sales Agreement 2006*

Article 1.1.1- 'Take or Pay Quantity ("TOPQ") means for each Contract Year during the Delivery Period a Quantity of Gas equal to [—] percent (—%) of the Adjusted Annual Contract Quantity for that Contract Year'.

Article 12.6- 'In each Contract Year Buyer shall be obligated to take and pay for, or to pay for it not taken, a quantity of gas at least equal to the Take-or-Pay Quantity'.

*Accessed in Ernest E Smith and others, *Materials on International Petroleum Transactions* (Rocky Mountain Mineral Law Foundation 2010) 1056.

⁴ Peter Roberts, *Petroleum Contracts: English Law and Practice* (Oxford University Press 2013) 180.

typically be flexible and subject to permitted adjustments.⁵ The adjusted annual contract quantity (AACQ) represents the final quantities which the buyer is expected to take delivery of. Where the buyer takes less than the AACQ, it is required to make a ToP payment for the quantities not taken.⁶ As an example, the contract may specify that the buyer is to purchase no less than 20,000 volumes of gas annually. The buyer is bound to pay for such volumes, even if it takes delivery of less than 20,000 in any contract year.

The buyer would seek to reclaim the gas volumes for which it has made a ToP payment. This is referred to as 'make-up gas'. It is common for ToP provisions to include a right to make-up gas, although there are circumstances in which the buyer may lose the right due to lapse of time. An example of this is where the gas sales agreement (hereafter GSA) indicates that the buyer must claim its make-up gas within a specified time.⁷ Failure to make this claim within the specified period would lead to a loss of make-up gas. In such a case, the buyer could argue that this amounts to a forfeiture and/or that it is a penalty and therefore unenforceable in a contract governed by English law.

The possibility of a buyer challenging a ToP provision as an unenforceable penalty raises concerns about the effectiveness of the provision. Although there is no lack of literature on the ToP clause, particularly in relation to forfeiture and the link to

⁵ An example of this is a force majeure event or the application of a carry forward provision (this reduces the ACQ).

⁶ Peter Roberts, *Petroleum Contracts: English Law and Practice* (Oxford University Press 2013) 181.

⁷ See for example The Association of International Petroleum Negotiators (AIPN) Model Form Gas Sales Agreement, (Approved on March 29, 2006) Art. 12.7, (make-up-gas must be taken within a specified period).

the penalty rule,⁸ much of this predates the landmark UKSC decision on penalty clauses in *Makdessi*,⁹ discussed in chapters 6 and 7 above. Following the decision, the literature fails to adequately engage with the effect of the decision on ToP clauses. In view of *Makdessi*, it is necessary to evaluate how an English court might apply the current rules on penalty and forfeiture clauses to a ToP provision. Although their Lordships did not debate the enforceability of the ToP clause, Lord Neuberger and Lord Sumption SCJJ (with whom Lord Carnwath SCJ agreed) briefly stated that ToP clauses ought not to be deemed as penal provisions.¹⁰ However, this view is by no means conclusive. This chapter examines whether a ToP provision would be enforceable under English law.

⁸ Ben Holland and Philip Spencer Ashley, ‘Enforceability of Take-or-Pay Provisions in English Law Contracts (2008) 26(4) Journal of Energy & Natural Resources Law 610-617; Allen & Overy LLP, ‘Take or pay clauses as penalties’ (2008) 23(5) Butterworths Journal of International Banking & Financial Law 260; Kate Cahill and Mal Cook, ‘High Court ruling impacts take-or-pay clauses’ (Lexology: Herbert Smith Freehills LLP 2012) <<http://www.lexology.com/library/detail.aspx?g=4b4b5af2-4514-48cb-83b6-7085aa8bde68>> accessed 11 May 2017; Efe Uzezi Azaino, ‘Natural gas contracts: Do take or pay clauses fall foul of the rule against penalties?’ (May 2012) 1,16 <https://www.w.w.a.c.a.d.e.m.i.a.e.d.u./10666060/Natural_Gas_Contracts_Do_Take_Or_Pay_Clauses_Fall_Foul_of_The_Rule_Against_Penalties> accessed 17 March 2017; Ben Holland and Philip Spencer Ashley, ‘Enforceability of Take-or-Pay Provisions in English Law Contracts – Revisited’ (2013) 31(2) Journal of Energy & Natural Resources Law 205-218; Danielle Lodge, ‘“Take or pay” clause unenforceable as a penalty?’ (2013) 19(3) Computer and Telecommunications Law Review 97-98; <<http://www.20essexst.com/sites/default/files/u58/Nov2015Penalties-HBV.pdf>> accessed 09 March 2017; Nour A Terki, ‘Penalty clauses and “take or pay” clauses in international long-term contracts’ (2014) 2 International Business Law Journal 109-130; Michael A Polkinghorne, ‘Take-or-pay Conditions in Gas Supply Agreements’ (2014) 12(4) Oil, Gas & Energy Law Intelligence (OGEL) 1, 1-2 <www.ogel.org.uk> 12 October 2018; Cook H.B., ‘“Take or pay” clauses and the law of penalties: Cavendish Square Holding BV v Talal El Makdessi ParkingEye Limited v Beavis [2015] UKSC 67’ (20 Essex Street, Bulletin 2015); Nicholaos D. Moussas, ‘Take-or-pay clauses in the natural gas sales contracts and potential claims against buyers’ (Moussa & Partners, 22 April 2016) <<http://www.moussaspartners.gr/take-or-pay-clauses-in-gas-supply-agreements/>> accessed 18 May 2017; Rajdeep Chowdhury, ‘Enforceability of Take-or-Pay Provision in Offtake Agreements Post Cavendish’ (2017) 15(4) Oil and gas Energy Law 1-20 <www.ogel.org.uk> accessed 27 July 2018.

⁹ *Cavendish Square Holdings BV v Talal El Makdessi* [2015] UKSC 67, [2015] 3 WLR 1373 (SC).

¹⁰ Their Lordships took the view that, the potential assimilation of contractual provisions such as the ToP into clauses imposing penal remedies for breach of contract would ‘...represent the expansion of the courts’ supervisory jurisdiction into a new territory of uncertain boundaries, which has hitherto been treated as wholly governed by mutual agreement’. *Cavendish Square Holdings BV v Talal El Makdessi* [2015] UKSC 67, [2015] 3 WLR 1373 (SC) [42].

Another aspect of the ToP clause which has received little or no consideration is the obligation of the seller to supply make-up gas to the buyer. The obligation to supply make-up gas is typically one of reasonable endeavours. Yet its meaning remains unclear, particularly in relation to the actions required of the seller in discharging this duty. This chapter examines the reasonable endeavours obligation, looking at some of the actions a seller might take to discharge the duty and the impact on the buyer's challenge that the ToP provision is a penalty. It argues that where the obligation of reasonable endeavours has been discharged by the seller, the buyer's challenge would be weakened.

The discussion in this chapter is in three parts. The first part considers the nature of the ToP clause, the penalty problem and the likelihood of enforcement. The second part examines the reasonable endeavours obligation of the seller to deliver make-up gas. The third part focuses on the overall effectiveness of the ToP provision, looking at how it could be made a more effective contractual method of mitigating financial risks in a long term GSA.

8.1. The nature of the Take or Pay clause

As described above, the ToP clause in GSAs is a contractual mechanism used to regulate the volumes of gas a buyer is committed to pay for during the applicable contract period. This commitment to pay applies irrespective of whether the buyer has taken delivery of all the agreed volumes of gas during the relevant contract period. At first glance, the ToP mechanism appears to be an unfavourable arrangement for the buyer since its obligation to pay remains, irrespective of whether it has taken delivery. However, the ToP clause serves a commercial purpose, both for the seller and buyer.

8.2. The commercial purpose of the Take or Pay clause

The exploration and exploitation of gas requires substantial investment from gas companies. For each of these companies, the end goal is always to recoup the investment with a significant profit. Many of these companies would often seek external project financing for large scale operations which are highly cash intensive. Project financiers of energy projects would be more willing to give their financial support where the IOC can show that it will have access to a long term steady revenue stream, thereby being able to meet its repayment obligations.¹¹ Even in the absence of external project finance, it is advantageous for an IOC to limit financial risk by ensuring it has a steady and stable flow of income. To secure this in a GSA, the IOC would require a buyer who can commit to purchasing minimum quantities of gas every month, quarter or year.

An IOC can dispose of its gas production through two forms of long term gas sales agreements.¹² The first is the supply contract, where the seller has an obligation to deliver specified volumes of gas to the buyer over an agreed contract period.¹³ The

¹¹ Henning Matthiesen, 'To What Extent do Take-or-Pay Contracts facilitate the Development of Infant Gas Markets and What Challenges do they pose at a Time of Liberalisation?' (2003) 1(4) *Oil, Gas & Energy Law Intelligence (OGEL)* 1, 3-4 <www.ogel.org.uk> accessed 22 February 2017; Colin Lockhart, 'Upstream Oil & Gas Marketing Agreements: Trade Practices Issues' (2004) 23(2) *Journal of Energy & Natural Resources Law* 185, 193; Daniel O'Neil, 'Gas sale and purchase agreements' in Picton-Tuberville G (ed), *Oil and Gas: A Practical Handbook* (Globe Law and Business 2009) 138.

¹² Daniel O'Neil, 'Gas sale and purchase agreements' in Picton-Tuberville G (ed), *Oil and Gas: A Practical Handbook* (Globe Law and Business 2009) 147; Ernest E Smith and others, *Materials on International Petroleum Transactions* (Rocky Mountain Mineral Law Foundation 2010) 1052; Michael Polkinghorne, 'The Paris energy series No. 7: Take-or-pay conditions in gas supply agreements' (Lexology: White & Case, 12 April 2013) <<https://www.lexology.com/library/detail.aspx?g=d681302d-37ce-4848-9cd4-f117932487f6>> accessed 19 June 2019; Daniel R. Rogers and David Y. Phua, 'Project Development and Finance LNG- Asia: Re-examining the Take-or-Pay Obligation in LNG Sale and Purchase Agreements' (Lexology: King and Spalding LLP, November 2015) <<http://www.lexology.com/library/detail.aspx?g=a55fc12f-9eef-4353-8d59-b9016aa3f5f3>> accessed 19 May 2017; <<http://www.gasstrategies.com/industry-glossary#S>> accessed 10 September 2019.

¹³ <<https://www.gasstrategies.com/industry-glossary#S>> accessed 10 September 2019.

second is the depletion contract.¹⁴ Here, the volumes of gas sold/delivered to the buyer depend on the performance of the reservoir.¹⁵ The seller is under no obligation to deliver agreed volumes of gas. However, the buyer commits to purchase gas from a particular reservoir, field or well until it is no longer economical for the seller to continue production.¹⁶ These two forms of gas supply agreements often include a ToP element. Polkinghorne¹⁷ comments that: '[t]he take-or-pay percentage in gas supply agreements is in our experience generally set at between 75% and 95% of the contract'.¹⁸

The aim of a ToP clause is to mitigate the financial risks in a long term GSA. This risk is twofold. Firstly, there is the risk that because there is no readily available market for gas, the IOC may have difficulty marketing its production. This will limit its ability to recoup its investment. Secondly, even where there is a buyer available, unless the buyer can commit in advance to paying for minimum quantities of gas, the

¹⁴ Daniel O'Neil, 'Gas sale and purchase agreements' in Picton-Tuberville G (ed), *Oil and Gas: A Practical Handbook* (Globe Law and Business 2009) 147; Ernest E Smith and others, *Materials on International Petroleum Transactions* (Rocky Mountain Mineral Law Foundation 2010) 1052; Michael Polkinghorne, 'The Paris energy series No. 7: Take-or-pay conditions in gas supply agreements' (Lexology: White & Case, 12 April 2013) <<https://www.lexology.com/library/detail.aspx?g=d681302d-37ce-4848-9cd4-f117932487f6>> accessed 19 June 2019; Daniel R. Rogers and David Y. Phua, 'Project Development and Finance LNG- Asia: Re-examining the Take-or-Pay Obligation in LNG Sale and Purchase Agreements' (Lexology: King and Spalding LLP, November 2015) <<http://www.lexology.com/library/detail.aspx?g=a55fc12f-9eef-4353-8d59-b9016aa3f5f3>> accessed 19 May 2017; <<http://www.gasstrategies.com/industry-glossary#S>> accessed 19 June 2019..

¹⁵ *ibid.*

¹⁶ Ernest E Smith and others, *Materials on International Petroleum Transactions* (Rocky Mountain Mineral Law Foundation 2010) 1052; Michael Polkinghorne, 'The Paris energy series No. 7: Take-or-pay conditions in gas supply agreements' (Lexology: White & Case, 12 April 2013) <<https://www.lexology.com/library/detail.aspx?g=d681302d-37ce-4848-9cd4-f117932487f6>> accessed 19 June 2019; <<http://www.gasstrategies.com/industry-glossary#S>> accessed 10 September 2019.

¹⁷ Michael Polkinghorne is a partner at White & Case, based in Paris. He specialises in oil and gas matters, and advises on both international arbitration and transactional issues in the sector. <<https://www.whitecase.com/people/michael-polkinghorne>> accessed 19 June 2019.

¹⁸ Michael Polkinghorne, 'The Paris energy series No. 7: Take-or-pay conditions in gas supply agreements' (Lexology: White & Case, 12 April 2013) <<https://www.lexology.com/library/detail.aspx?g=d681302d-37ce-4848-9cd4-f117932487f6>> accessed 19 June 2019. See also Daniel O'Neil, 'Gas sale and purchase agreements' in Picton-Tuberville G (ed), *Oil and Gas: A Practical Handbook* (Globe Law and Business 2009) 147.

seller is faced with the risk of satisfying any long term repayment obligations in the absence of a steady income.¹⁹

From the buyer's perspective, the ToP clause allows it to effectively manage the volumes of gas delivered, especially during periods when it faces storage, marketing or other operational difficulties. Also, there is the added benefit that the buyer has a steady source of supply. This could be a blessing or a curse, depending on the market price. Where the existing market price is lower than the ToP price, the buyer is unable to take advantage of this. It may seek to renegotiate the price with the seller, but there is no certainty of success. In a bid to escape the ToP contract the buyer may argue that the ToP clause is an unenforceable penalty. The prospect of a buyer raising such a challenge or in defence to the seller's claim has given rise to numerous discussions on the ToP clause.²⁰ The general thrust of the discussion is that depending on how the

¹⁹ Although the IOC might be able to meet such obligations through other avenues, such as income from other fields or investments, this could become a strain on resources in the long run.

²⁰ Ben Holland and Philip Spencer Ashley, 'Enforceability of Take-or-Pay Provisions in English Law Contracts (2008) 26(4) *Journal of Energy & Natural Resources Law* 610-617; Allen & Overy LLP, 'Take or pay clauses as penalties' (2008) 23(5) *Butterworths Journal of International Banking & Financial Law* 260; Kate Cahill and Mal Cook, 'High Court ruling impacts take-or-pay clauses' (Lexology: Herbert Smith Freehills LLP 2012) <<http://www.lexology.com/library/detail.aspx?g=4b4b5af2-4514-48cb-83b6-7085aa8bde68>> accessed 11 May 2017; Efe Uzezi Azaino, 'Natural gas contracts: Do take or pay clauses fall foul of the rule against penalties?' (May 2012) 1,16<https://www.w.a.c.a.d.e.m.i.a.e.d.u./10666060/Natural_Gas_Contracts_Do_Take_Or_Pay_Clauses_Fall_Foul_of_The_Rule_Against_Penalties> accessed 17 March 2017; Ben Holland and Philip Spencer Ashley, 'Enforceability of Take-or-Pay Provisions in English Law Contracts – Revisited' (2013) 31(2) *Journal of Energy & Natural Resources Law* 205-218; Danielle Lodge, '“Take or pay” clause unenforceable as a penalty?' (2013) 19(3) *Computer and Telecommunications Law Review* 97-98; <<http://www.20essexst.com/sites/default/files/u58/Nov2015Penalties-HBV.pdf>> accessed 09 March 2017; Nour A Terki, 'Penalty clauses and "take or pay" clauses in international long-term contracts' (2014) 2 *International Business Law Journal* 109-130; Michael A Polkinghorne, 'Take-or-pay Conditions in Gas Supply Agreements' (2014) 12 (4) *Oil, Gas & Energy Law Intelligence (OGEL)* 1, 1-2 <www.ogel.org.uk> 12 October 2018; Cook H.B, '“Take or pay” clauses and the law of penalties: Cavendish Square Holding BV v Talal El Makdessi ParkingEye Limited v Beavis [2015] UKSC 67' (20 Essex Street, *Bulletin* 2015); Nicholaos D. Moussas, 'Take-or-pay clauses in the natural gas sales contracts and potential claims against buyers' (Moussa & Partners, 22 April 2016) <<http://www.moussaspartners.gr/take-or-pay-clauses-in-gas-supply-agreements/>> accessed 18 May 2017; Ben Holland, 'Enforceability of take-or-pay provisions in English law contracts – resolved' (2016) 34(4) *Journal of Energy & Natural Resources Law* 443-453; Masayu Lynn Masagoes, 'Take or pay: a different perspective? Ensuring TOP clauses always come out on top in Australia' (2017) 10(4) *Journal of World Energy Law and Business* 348–357.

ToP clause is framed, the buyer may be able to challenge the provision as an unenforceable penalty.

8.3. Challenges to the effectiveness of the Take or Pay clause: The Penalty Problem

The buyer's challenge that the ToP clause is an unenforceable penalty may arise where it suffers the loss of significant volumes of make-up gas. Also, where a seller brings a claim for a ToP payment, the buyer could raise the defence that the clause is an unenforceable penalty. When faced with the question of whether the provision is a penalty, an English court must first of all determine whether it is a primary or secondary obligation. Where it is a primary obligation, the provision will escape further scrutiny under the penalty rule, and it is an enforceable obligation. However, if it is interpreted as a secondary obligation, it comes within the penalty net and the two stage *Makdessi* test will be applied.

8.3.1. Is the Take or Pay clause within the penalty rule?

Prior to *Makdessi*, an English court had examined the position of the ToP clause in two cases. These are *M & J Polymers Ltd v Imerys Minerals Limited*²¹ (hereafter *M & J Polymers*) and *E-Nik Limited v Department for Communities and Local Government*,²² (hereafter *E-Nik*).

The two decisions of the High Court in *M & J Polymers* and *E-Nik* sparked much discussion on whether the ToP clause comes within the penalty rule and

²¹ [2008] EWHC 344 (Comm).

²² [2012] EWHC 3027(Comm).

whether it is an enforceable obligation.²³ In both cases the court did not find that the ToP provisions in view were penalties, though it held that in principle a ToP clause might qualify as a penalty.²⁴ It is argued that the phrase ‘in principle’ was likely added because prior to both cases, there was no authority indicating that a ToP payment can engage the penalty rule – the judge decided the point de novo.²⁵ Also, a ToP payment gives rise to a claim in debt such that it is ordinarily outside the sphere of the penalty rule. Therefore, it could not be stated authoritatively or categorically that the provision engages the penalty rule. *M & J Polymers* concerned a contract for the sale of chemicals, subject to a ToP provision, the contents of which are below.

Article 5: Stock Level and minimum purchase

5.3. During the term of this Agreement the Buyer will order the following minimum quantities of Products:

5.5 Take or pay: the Buyers collectively will pay for the minimum quantities of Products as indicated in this Article at 5.3 of Jaypol 1183, Jaypol BTC2 and Jaypol 1160 even if they together have not ordered the indicated quantities during the relevant monthly period.

Following a disagreement, the buyer terminated the contract. The seller brought an action in debt to recover the ToP payment for the quantities which the buyer had not taken during the relevant period.²⁶ In its defence, the buyer argued that the ToP clause was an unenforceable penalty. The case of *E-Nik* concerned a similar claim. There

²³ Ben Holland and others (n20).

²⁴ *M & J Polymers Ltd v Imerys Minerals Limited (M & J Polymers)* [2008] EWHC 344 (Comm) [44]; *E-Nik Limited v Department for Communities and Local Government (E-Nik)* [2012] EWHC 3027(Comm) [25]. The consideration of the ToP provisions under the penalty rule was seen as an attempt to redefine the law relating to ToP provisions.

²⁵ *M & J Polymers Ltd v Imerys Minerals Limited (M & J Polymers)* [2008] EWHC 344 (Comm) [40].

²⁶ *ibid.*

was a clause relating to a minimum order of service provision.²⁷ The local government failed to order the minimum order of 500 days of service, and the claimant brought an action to claim the balance of the 500 days which it held was a debt.²⁸

In both cases, the same High Court judge (Burton J) found for the claimants who pursued the ToP payment as a debt, and not damages for breach of contract. *M & J Polymers* is the most comprehensive of the two cases, yet the penalty issue was discussed in a mere eight paragraphs.²⁹ In his rationale, the judge expressed that the distinction between claims in debt and the law of penalty was too simplistic.³⁰ The judge referred to *White & Carter (Councils) Ltd v McGregor*³¹ and its citation in Chitty on Contracts where it was held that, ‘The law on penalties ... is not relevant where the claimant claims an agreed sum (a debt) which is due from the defendant in return for the claimant’s performance of his obligations’.³² Burton J opined that this

²⁷ ‘2. AUTHORITY’S OBLIGATIONS

2.1 The Authority hereby undertakes to purchase minimum of 500 days of Consultancy from the Supplier per year based on project requirement, additional days will be required once the purchased days have been exhausted.

2.2 The Authority shall issue an Assignment Note to requisition Services from the Supplier.

2.3 The Authority shall pay the Supplier fees at the rate of not less than £850 per day but subject to mutually agreed assignment notes for each change request. This rate may be revised upward at the time of issue of an Assignment Note to reflect the complexity of the Services requisitioned or the level of skill required for the provision of the Services.

2.4 Payment of the fees shall be made within 30 days of the date of a valid invoice from the Supplier.’

²⁸ *E-Nik Limited v Department for Communities and Local Government* [2012] EWHC 3027(Comm) [5], [20-23].

²⁹ *M & J Polymers Ltd v Imerys Minerals Limited (M & J Polymers)* [2008] EWHC 344 (Comm) [39-48]. In *E-Nik*, there was no analysis of the penalty question per se. The entire reasoning on this issue is contained in three paragraphs, which concluded that the clauses ‘...were commercially justifiable, did not amount to oppression, were negotiated and freely entered into between parties of comparable bargaining power and did not amount to a provision *in terrorem*.’ *E-Nik Limited v Department for Communities and Local Government* [2012] EWHC 3027(Comm) [24-26].

³⁰ *M & J Polymers Ltd v Imerys Minerals Limited (M & J Polymers)* [2008] EWHC 344 (Comm) [41] (i).

³¹ [1962] AC 413.

³² Hugh Beale, *Chitty on Contracts Volume I: General Principles* (32nd edn, Sweet & Maxwell 2015) para 26-118.

was too simplistic since there are instances where a provision can be held to be a penalty, though expressed as a claim in debt.³³ An example of which is a minimum payment clause in a hire purchase agreement.³⁴ It appeared that the central argument of the judge was that, just because a provision confers a claim in debt for non-payment or non-performance does not mean that the penalty rule cannot apply.

In addition, Burton J cited *Export Credits Guarantee Dept v Universal Oil Products Co*³⁵ (hereafter *ECGD*), where all the Lordships agreed with Lord Roskill that a clause is not a penalty if it provides for payment of money upon a specified event other than a breach of contract.³⁶ However, Burton J noted that there was a central difference between the clause in *ECGD* and that in *M & J Polymers*, reflecting that there was no other way in which the obligation to make a payment under Article 5.5 (the ToP provision in *M & J Polymers*) could arise, other than where the buyer breached its obligation to order certain quantities under Article 5.3.³⁷ Furthermore, Burton J indicated that:

There may be an option for a claimant to pursue its claim either for damages for breach of Article 5.3 or for the price in respect of Article 5.5, but on the face of it the “*specified event*” in Article 5.5 is the same event as amounts to a breach of duty under Article 5.3.³⁸

³³ *M & J Polymers Ltd v Imerys Minerals Limited (M & J Polymers)* [2008] EWHC 344 (Comm) [41] (i).

³⁴ *ibid.*

³⁵ [1983] 1 WLR 399.

³⁶ *M & J Polymers Ltd v Imerys Minerals Limited (M & J Polymers)* [2008] EWHC 344 (Comm) [41].

³⁷ *ibid* para 41 (ii) - ‘I do not see how a payment obligation can arise under Article 5.5 in a case other than where there has been a breach of the obligation to order under Clause 5.3. If the goods are in fact ordered, then they will be delivered, and the price will be due quite irrespective of Article 5.3 or 5.5’.

³⁸ *M & J Polymers Ltd v Imerys Minerals Limited (M & J Polymers)* [2008] EWHC 344 (Comm) [41] (iii).

Consequently, the Judge was satisfied that as a matter of principle, the rule against penalties may apply to a ToP clause.³⁹ This decision and that in *E-Nik* has faced criticism by those who struggle with the consideration of a debt under the penalty rule.⁴⁰ Some writers suggested that the ToP clause in both cases was interpreted as a ‘Take and Pay’ clause, for which the failure to take would be a breach of contract. Nevertheless, the court did not make this argument; it decided both provisions as ToP and not ‘Take and Pay’.⁴¹ Another argument is that the failure of the buyer to order the minimum quantities was also interpreted as a breach of contract, thereby allowing the ToP payment to be considered in principle under the rule against penalties. However, this would be inaccurate. The essence of the ToP provision is to give the buyer a choice to take or to pay, hence the decision to pay rather than take should not be a breach of contract, provided the buyer does actually pay.

Nevertheless, the decision by Burton J’s to consider whether a ToP provision may qualify under the penalty rule must be remembered as simply a consideration ‘in principle’, with both clauses deemed to be enforceable. Furthermore, the impact of the two decisions on ToP clauses is limited when viewed that both were decided at the High Court and by the same judge.

More recently, the decisions in both *M & J Polymers* and *E-Nik* have become of limited importance, in the light of the UKSC decision in *Makdessi*. Although the case did not concern a ToP clause, the guidelines provided are to be applied where a clause is challenged under the rule against penalties.

³⁹ *ibid* para 44.

⁴⁰ See Ben Holland and Philip Spencer Ashley, ‘Enforceability of Take-or-Pay Provisions in English Law Contracts – Revisited’ (2013) 31(2) *Journal of Energy & Natural Resources Law* 205, 211-212. This journal criticises the approach taken in both *M & J Polymers* and *E-Nik*.

⁴¹ *ibid*.

Depending on the manner in which the ToP provision is framed, it is possible for it to come within the penalty rule. An example of this is where the provision indicates that the buyer must take a certain volume of gas during the contract period, with the failure to take those volumes triggering a ToP payment in favour of the seller. In such a case, the ToP payment could appear to be a penalty for the failure to take gas, rather than a method through which the buyer fulfils its contractual obligation. The framing of the ToP provision is central to weakening the buyer's challenge that the provision is an unenforceable penalty. (This argument would also be weakened where the agreement includes make-up gas.) Nonetheless, even where the ToP provision is framed in a way which allows the buyer to fulfil its obligation either by taking or paying, it would be imprudent to conclude that such a provision will not come within the penalty rule, and that it will be enforceable. This is because every provision is subject to interpretation. Therefore, in examining a ToP provision under *Makdessi*, the starting point is to assess whether the provision imposes a primary or secondary obligation.

i. Is a Take or Pay clause imposing a primary or secondary obligation?

In a ToP clause, the obligation of the seller is to make available to the buyer the minimum volumes of gas under the contract, and the buyer's obligation is either to take and pay for the minimum quantities, or to simply pay and not take.⁴² What then is the ToP payment? It may be argued that it is a primary obligation since taking gas is

⁴² Ben Holland and Philip Spencer Ashley, 'Enforceability of Take-or-Pay Provisions in English Law Contracts (2008) 26(4) Journal of Energy & Natural Resources Law 610, 614; Ben Holland, 'Enforceability of take-or-pay provisions in English law contracts – resolved' (2016) 34(4) Journal of Energy & Natural Resources Law 443, 445-446.

an option not an obligation. This argument is supported by the opinion of three of the Lordships in *Makdessi*:

...[I]f the contract does not impose (expressly or impliedly) an obligation to perform the act, but simply provides that, if one party does not perform, he will pay the other party a specified sum, the obligation to pay the specified sum is a conditional primary obligation and cannot be a penalty.⁴³

This opinion, which fits in with the writer's analysis, indicates that a ToP payment should not be interpreted as a secondary obligation. However, it must be noted that this is merely an opinion; it is not authority on the ToP clause.

It may also be argued that if a secondary obligation is generally a remedy for the failure to perform a primary obligation, then the ToP payment cannot be a secondary obligation because it is not a remedy, but a form in which the buyer fulfils its primary obligation. By making the minimum volumes of gas available, the seller would have discharged its primary obligation to the buyer. In return, the buyer can take delivery and pay the agreed price, or it can decline delivery and make a ToP payment. Either of these methods would mean that the buyer has fulfilled its primary obligation. The decision of the buyer to decline a delivery gives the seller a claim in debt to recover the ToP payment. The inclusion of a right to make-up gas would strengthen the argument that the ToP payment is a payment in debt since the buyer would later take delivery of the volumes of gas for which it has made payment. Yet, even where there is no make-up right, unless the ToP payment is payable upon a breach of contract, it is difficult to interpret such payment as a payment in damages. On this basis, it is

⁴³ *Cavendish Square Holdings BV v Talal El Makdessi* [2015] UKSC 67, [2015] 3 WLR 1373 (SC) [14] (Lord Neuberger and Lord Sumption SCJJ) (with whom Lord Carnwath SCJ agreed).

submitted that most ToP provisions would likely be interpreted as a primary obligation, thus avoiding the penalty rule.

However, one must consider an alternative position since precise terms may differ and what is interpreted as a primary obligation in one scenario may be a secondary obligation if it has slightly different wording. An example could be where the clause indicates that the failure to take contractual quantities of gas will give the seller a claim for the payment of a stipulated amount from the buyer. It may be argued that the ToP payment is the seller's remedy for the buyer's failure to order the minimum quantities. This argument would be more convincing where the ToP clause is framed in a way which obliges the buyer to take gas, as well as where the ToP price is different to the sale price for the gas the buyer took delivery of. Furthermore, although most ToP provisions would include make-up gas, there is no guarantee that the buyer would receive it. The obligation of the seller to deliver make-up gas is one of reasonable endeavours, not a strict duty. Therefore, the seller may be unable to deliver make-up gas, and the buyer would have suffered a loss. As such, the ToP payment cannot always be regarded as a payment for gas which the buyer will later receive. (The discussion on reasonable endeavours is in section 8.5 below).

It is not inconceivable that an English court may take the view that a ToP provision in question is a payment in damages for a breach of contract, and it is a secondary obligation. Where this is the case, the *Makdessi* test will be applied. The two parts of the test are: one, whether the provision serves a legitimate interest; two, whether its application is not unconscionable or exorbitant.

ii. Does a Take or Pay clause serve a legitimate interest?

If the ToP provision is held to be a secondary obligation, the seller in a GSA must demonstrate that there is a legitimate interest (genuine commercial basis) for the inclusion of the provision. The commercial basis for the ToP clause is to guarantee the seller a steady revenue stream to cover financing and operating costs. In the absence of a ToP clause, the seller may find itself struggling to meet its repayment obligations under any project financing, as well as generally struggle to realise its investments. Therefore, the inclusion of the ToP clause serves a genuine commercial purpose. For this reason, it is submitted that the ToP provision serves a legitimate interest.

Where a ToP provision is interpreted as a secondary obligation, but one which serves a legitimate interest, it would have passed the first limb of the two stage test. The next stage is to consider whether it also imposes an obligation which is unconscionable or exorbitant when viewed against the legitimate interest.

iii. Circumstances where a Take or Pay clause may be unconscionable or exorbitant

A provision which is unconscionable or exorbitant can be described as one which goes beyond what is necessary in the pursuit of a certain objective. This objective could be to secure payment or performance of an obligation. In which case, an exorbitant clause is one which is out of all proportion to the interest sought to be protected. The assessment of unconscionability or exorbitance lies in the specificities of the provision. For instance, where the ToP provision does not include a right to make-up gas, this could point to unconscionability, since the seller may be able to

market the undelivered volumes of gas to another buyer. Effectively, the seller would be paid twice.

Nevertheless, the seller may be unable to market undelivered volumes of gas, since gas (unlike oil) is not easily sold on the spot market.⁴⁴ Also, the seller may find itself in a difficult situation where the buyer waits till the cargo (if LNG) turns up before declining delivery.⁴⁵ Unless the seller has adequate storage facilities, it could find itself left with significant volumes of gas for which it has no storage. It would have to secure storage elsewhere and this may be at a premium price because of the lack of notice. Therefore, the fact that a seller receives payment for volumes of gas not taken by the buyer is not necessarily an indication that the provision is unconscionable. Upon paying transportation, storage and other associated costs of the rejected cargo, the seller may actually spend more money than it is due to receive as a ToP payment.

Having said this, the inclusion of a right to make-up gas does reduce the likelihood that the ToP provision could be deemed unconscionable or exorbitant. This is because the ToP payment would be deemed to be payment for a future delivery of gas. Therefore, the seller must demonstrate that it has discharged its obligation of reasonable endeavours to deliver make-up gas.

⁴⁴ Paul Griffin (ed), *Liquefied Natural Gas: The Law and Business of LNG* (2nd edn, Globe Law and Business 2012) 66; Daniel R. Rogers and David Y. Phua, 'Project Development and Finance LNG-Asia: Re-examining the Take-or-Pay Obligation in LNG Sale and Purchase Agreements' (Lexology: King and Spalding LLP, November 2015) <<http://www.lexology.com/library/detail.aspx?g=a55fc12f-9eef-4353-8d59-b9016aa3f5f3>> accessed 19 May 2017.

⁴⁵ Daniel R. Rogers and David Y. Phua, 'Project Development and Finance LNG-Asia: Re-examining the Take-or-Pay Obligation in LNG Sale and Purchase Agreements' (Lexology: King and Spalding LLP, November 2015) <<http://www.lexology.com/library/detail.aspx?g=a55fc12f-9eef-4353-8d59-b9016aa3f5f3>> accessed 19 May 2017.

Additionally, where there is a time limit on the recovery of make-up gas, this should be in line with standard industry practice. For example, a time limit of two months would deviate from industry practice and unless there are exigent circumstances, such a provision may be deemed disproportionate to the legitimate interest sought to be protected.

Overall, the determination of whether the provision is unconscionable or not will rest on several factors, such as the presence or absence of a make-up right, time limit for recovery and industry practice. It is submitted that based on the nature and operation of the ToP clause in long term GSA, it is unlikely that it will be found to lack a legitimate interest as well as be unconscionable. Therefore, the conclusion is that the ToP clause has a strong likelihood of being enforceable.

In further analysing the effectiveness of a ToP clause, a relevant question that arises is whether it is the most appropriate method of mitigating financial risks in long term gas sales agreements.

8.4. Can Take or Pay clauses effectively mitigate financial risks in long term gas sales agreements?

This section evaluates how the type of ToP clause has a direct impact on its effectiveness in mitigating financial risks.

The focus of the discussion on ToP clauses is on those with annual/contract year frequency, as this is the most common position. Rogers and White comment thus: '[m]ost commonly, take-or-pay obligations are determined on an annual or contract

year basis...'.⁴⁶ As earlier discussed, the ToP clause allows the seller to regulate the minimum quantities which the buyer must purchase during the contract period. This guarantees the seller a steady and stable stream of income through which it can meet its repayment obligations under the project financing, thereby mitigating financial risks. The buyer in return is assured of a stable source of supply. Overall, the ToP clause creates some stability in long term GSAs.

Nevertheless, despite the intentions of the ToP provision, the seller's guarantee of a steady stream of income is not without complications. The obligation of the buyer under a true ToP clause (where the effect of the provision is consistent with its title) is either to take gas or to pay for it – there is no imperative to take delivery but there is an obligation to pay for the minimum quantities. Theoretically, a buyer subject to an annual ToP contract can elect to take delivery only a few times in the year or to even decline delivery throughout the contract year.⁴⁷ This is of course less likely to occur, but the possibility still exists. Such a buyer is not in breach of contract for any missed delivery so far as it meets its obligation to pay the annual ToP invoice when due. The consequence of this is that the seller will not receive a regular income under the contract until the end of the year when the ToP amount becomes payable. In this scenario, the ToP is arguably not fit for purpose because it does not guarantee the seller a steady income. Furthermore, where the ToP payment is payable annually, the seller is exposed to the financial risk that the buyer may become insolvent before

⁴⁶ Daniel R Rogers and Merrick J White, 'Key considerations in energy take-or-pay contracts' (Lexology: King and Spalding LLP, April 2013) <<http://www.lexology.com/library/detail.aspx?g=abec95b0-aec8-4c88-8bcb-f3e8a0ef451f>> accessed 19 May 2017.

⁴⁷ Daniel R. Rogers and David Y. Phua, 'Project Development and Finance LNG - Asia: Re-examining the Take-or-Pay Obligation in LNG Sale and Purchase Agreements' (Lexology: King and Spalding LLP, November 2015) <<http://www.lexology.com/library/detail.aspx?g=a55fc12f-9eef-4353-8d59-b9016aa3f5f3>> accessed 19 May 2017.

paying the ToP amount. Thus, rather than mitigating the financial risk in a long term agreement by providing the seller a secure revenue stream, the ToP clause may itself be a source of risk. This risk could be avoided by changing the ToP commitment to a quarterly, monthly or even daily frequency so that the ToP payment is made more regularly, guaranteeing the seller a steady income.⁴⁸ The annual ToP frequency appears more common though because it offers more flexibility to the buyer.⁴⁹

Another issue with the ToP clause is that it may lead to financial loss for the seller where the buyer rejects delivery at the point when the cargo⁵⁰ arrives. A party still has to bear transportation costs and often this would be the seller. No ToP payment is due where the buyer goes on take the minimum adjusted contractual quantities before the end of the contract year. Yet, where the contract contains a right to make-up gas, the seller has to arrange transportation again as well as bear the associated costs of delivering make-up gas.⁵¹ Further, the seller may find itself in a difficult position where the buyer does not take delivery of the first cargo and it has no alternative marketing or adequate storage facilities.

In view of these challenges, Rogers and Phua argue that the cargo-by-cargo alternative may be more beneficial than the ToP clause in LNG sales and purchase

⁴⁸ Peter Roberts, *Petroleum Contracts: English Law and Practice* (Oxford University Press 2013) 180.

⁴⁹ Daniel R Rogers and Merrick J White, 'Key considerations in energy take-or-pay contracts' (Lexology: King and Spalding LLP, April 2013) <<http://www.lexology.com/library/detail.aspx?g=abec95b0-aec8-4c88-8bcb-f3e8a0ef451f>> accessed 19 May 2017; Daniel R. Rogers and David Y. Phua, 'Project Development and Finance LNG - Asia: Re-examining the Take-or-Pay Obligation in LNG Sale and Purchase Agreements' (Lexology: King and Spalding LLP, November 2015) <<http://www.lexology.com/library/detail.aspx?g=a55fc12f-9eef-4353-8d59-b9016aa3f5f3>> accessed 19 May 2017.

⁵⁰ Unlike with natural gas transported through pipelines, cargos are used in the transporting of liquified natural gas.

⁵¹ Daniel R. Rogers and David Y. Phua, 'Project Development and Finance LNG - Asia: Re-examining the Take-or-Pay Obligation in LNG Sale and Purchase Agreements' (Lexology: King and Spalding LLP, November 2015) <<http://www.lexology.com/library/detail.aspx?g=a55fc12f-9eef-4353-8d59-b9016aa3f5f3>> accessed 19 May 2017;.

agreement.⁵² In this case, the buyer's obligation is satisfied on a cargo-by-cargo basis, not at the end of the contract year. Where the buyer does not take delivery of a cargo, the seller has the right to sell the goods to another person, but is bound to pay the buyer the net income from the sale minus costs incurred.⁵³ The buyer is then obliged to pay the seller the agreed contract price for the cargo. Here, there is no annual invoice issued to the buyer, rather each loss is compensable from the time the loss arises. The benefits of this are apparent – the payment for each cargo is due more immediately so the risk of insolvency is mitigated and the seller has a steady stream of income. More importantly, the cargo-by-cargo alternative avoids the penalty problem.

However, despite the advantages of the cargo-by-cargo alternative, it is not ideal in long term agreements. Its structure is more suited to short term sales agreement since it operates on the basis of immediate availability, without any future commitment. Additionally, there is little or no precedent for its use.⁵⁴ Consequently, despite the shortcomings of a ToP clause, it is a more appropriate contractual method in long term GSAs. The scenario described above, where the buyer does not take delivery of gas throughout the year, is a worst case scenario, one which reflects the weaknesses of the ToP clause. Yet, these weaknesses can be mitigated. For example, a buyer who persistently declines delivery of gas may be required to put up security to meet its annual contractual quantities, or the contract period may be reduced to every six months instead of annually. Furthermore, the persistent refusal to take delivery

⁵² *ibid.*

⁵³ *ibid.*

⁵⁴ *ibid.*

may point to bigger problems faced by the buyer which will affect the long term GSA. Therefore, there may be more benefit for both the seller and buyer to discuss the price in the ToP clause and the annual ToP quantities. Given the volatility in market price in the oil and gas industry, it is argued that both a price review clause and a renegotiation clause would be useful in long term GSAs.

Overall, the ToP clause is able to mitigate the financial risks in a long term GSA, although there are methods through which its effectiveness might be enhanced. These will be discussed in the concluding section.

8.5. Reasonable Endeavours: The seller's obligation to supply make-up gas

The discussion on the ToP clause now turns to consider the reasonable endeavours obligation of the seller to deliver make-up gas. This is a topic very rarely discussed but one which is highly relevant since the buyer could argue that the loss of make-up gas renders the ToP provision an unenforceable penalty. It has often been argued that the ToP payment is not a damages provision (secondary obligation) because the buyer is simply paying for gas which it will later take delivery of.⁵⁵ Thus, where the seller is unable to deliver make-up gas, it is imperative that it proves that it has discharged its reasonable endeavours obligation, thereby weakening the buyer's argument as to the

⁵⁵ Ben Holland and Philip Spencer Ashley, 'Enforceability of Take-or-Pay Provisions in English Law Contracts (2008) 26 (4) Journal of Energy & Natural Resources Law 610, 616; Kate Cahill and Mal Cook, 'High Court ruling impacts take-or-pay clauses' (Lexology: Herbert Smith Freehills LLP 2012) <<http://www.lexology.com/library/detail.aspx?g=4b4b5af2-4514-48cb-83b6-7085aa8bde68>> accessed 11 May 2017; Efe Uzezi Azaino, 'Natural gas contracts: Do take or pay clauses fall foul of the rule against penalties?' (May 2012) 1, 16 <https://www.academia.edu/10666060/Natural_Gas_Contracts_Do_Take_Or_Pay_Clauses_Fall_Foul_of_The_Rule_Against_Penalties> accessed 17 March 2017; Ben Holland and Philip Spencer Ashley, 'Enforceability of Take-or-Pay Provisions in English Law Contracts – Revisited' (2013) 31(2) Journal of Energy & Natural Resources Law 205-218; Nour A Terki, 'Penalty clauses and "take or pay" clauses in international long-term contracts' (2014) 2 International Business Law Journal 109-130; Michael A Polkinghorne, 'Take-or-pay Conditions in Gas Supply Agreements' (2014) 12(4) Oil, Gas & Energy Law Intelligence (OGEL) 1, 1-2 <www.ogel.org.uk> 12 October 2018; Ben Holland, 'Enforceability of take-or-pay provisions in English law contracts – resolved' (2016) 34 (4) Journal of Energy & Natural Resources Law 443-453; Masayu Lynn Masagoes, 'Take or pay: a different perspective? Ensuring TOP clauses always come out on top in Australia' (2017) 10 (4) Journal of World Energy Law and Business 348-357.

ToP provision being an unenforceable penalty. The legal question for discussion is this, what competing interests is the seller required to consider in discharging its reasonable endeavours obligation? This section seeks to make a valuable contribution by illustrating some efforts which the seller may be expected to make in discharging its reasonable endeavours obligation, as well as the seller's commercial interests.

The seller has a strict duty to deliver the volumes of gas nominated by the ToP buyer in each contract period. Where the seller is unable to meet its delivery obligation, unless the failure is due to an occurrence excused in the GSA (such as force majeure), the seller would be financially liable to the buyer.⁵⁶ The sales agreement would indicate the measure of damages payable to the buyer. Therefore, the commercial rationale is that it is not prudent for the seller to take on another strict duty in relation to the delivery of make-up gas. It is for this reason that the obligation to deliver make-up gas in sales contracts is typically one of reasonable endeavours.⁵⁷

8.5.1. The reasonable endeavours obligation: Lessons from the past

In evaluating the competing interests a ToP seller is required to consider in discharging its reasonable endeavours obligation, this section examines the position in the caselaw.

The discussion begins with an examination of relevant caselaw on 'reasonable and all reasonable endeavours' obligation.⁵⁸ It then considers the application in the ToP context, assessing the duty of the seller to use reasonable endeavours to deliver

⁵⁶ Daniel O'Neil, 'Gas sale and purchase agreements' in Picton-Tuberville G (ed), *Oil and Gas: A Practical Handbook* (Globe Law and Business 2009) 141, 151.

⁵⁷ More generally, one might say that the obligation is framed in terms of 'reasonable endeavours' because these stipulations about what is required are difficult to make in advance.

⁵⁸ '(It is common ground that "all reasonable endeavours" means the same as "best endeavours.")' *Jet2.com Limited v Blackpool Airport Limited* [2011] EWHC 1529 [36].

make-up gas to the buyer. The main question asked here is this: what are the commercial interests of the seller and what steps must it take in discharging its reasonable endeavours obligation?

A reasonable endeavours obligation is an undertaking by a contracting party to use reasonable efforts to bring about an event or to perform an action.⁵⁹ It is not a commitment to ensure absolute performance of the desired result. The duty is on the party with the obligation to show that it has used reasonable endeavours.⁶⁰

In proving that the actions taken have discharged the obligation of reasonable endeavours, one might question whether the seller is required to act against its own business interests. What is 'reasonable' will be dependent on the facts of each case. In *Brauer v James Clark*⁶¹ the seller in a free on board contract was required to use its reasonable endeavours to obtain an export licence which would allow it to import the goods from Brazil. However, the conditions of the licence meant that the seller would have to pay a higher price for the goods, thus making the contract unprofitable. The seller declined to obtain the licence on these grounds. The Court of Appeal held that the seller had not discharged its reasonable endeavours obligations. This was because the seller had accepted a fixed sale price and thus the burden for any increase in prices was on it and not the buyer. The increased price could not be described as a supervening event outside the contemplation of the contracting parties.

⁵⁹ Edwin Peel, *Treitel on the Law of Contract* (14th edn, Sweet & Maxwell/Thomson Reuters 2015) 2-104 -107.

⁶⁰ *Yewbelle Limited v London Green Developments Limited* [2007] EWCA Civ 475 [104].

⁶¹ [1952] 2 All ER 497.

A later case, *Yewbelle Limited v London Green Developments Limited*⁶² (hereafter *Yewbelle*) concerned the sale of land. Under clause 25.2,⁶³ the seller was required to use ‘all reasonable endeavours’ to obtain planning permission by entering an agreement with the local authority under the Town and Country Planning Act 1990 s.106. It was held by the first instance judge that, in discharging the ‘all reasonable endeavours obligation’, the seller was not required to sacrifice its commercial interests although it must pursue efforts until all reasonable endeavours have been exhausted.⁶⁴ This had not been demonstrated by the seller. Although the Court of Appeal reversed the decision,⁶⁵ Lloyd LJ (with whom Waller LJ agreed) did however approve of how the judge interpreted the reasonable endeavours obligation.⁶⁶ In a Singapore case, *KS Energy Services Ltd v BR Energy (M) Sdn Bhd*,⁶⁷ the Appeal Court also held that a party need not always sacrifice its financial interests in fulfilling its obligations.

The interpretation of an all reasonable endeavours obligations was again raised before an English court in 2011. *Jet2.com Limited v Blackpool Airport Limited*⁶⁸

⁶² [2007] EWCA Civ 475.

⁶³ ‘The Seller will use all reasonable endeavours by completion to obtain the completed S.106 Agreement and the Buyer will not be bound to complete until the S.106 Agreement has been obtained by the Seller subject to the Buyer hereby indemnifying the Seller against all obligations contained in the S.106 Agreement and the buyer paying the legal costs of the London Borough of Merton in connection therewith’.

⁶⁴ [2007] EWCA Civ 475 [29]; [2006] EWHC 3166 (Ch) [122], [123].

⁶⁵ The reason for this was because of the point concerning the third party land- [111] (Lloyd LJ), with whom Waller LJ agreed [124]. (The proposed development encroached on land belonging to a third party and gave rise to other issues.) *Yewbelle Limited v London Green Developments Limited* [2007] EWCA Civ 475.

⁶⁶ [2007] EWCA Civ 475 [29], [33], [124].

⁶⁷ (2014) SGCA 16.

⁶⁸ [2011] EWHC 1529. The decision was upheld by the Court of Appeal in 2012- *Jet2.com Limited v Blackpool Airport Limited v Jet2.com Limited* [2012] EWCA Civ 417.

(hereafter *Jet2*) concerned a long term agreement for the claimant to operate from the defendant's airport. The agreement stated amongst other things that the airport would '...use all reasonable endeavours to provide a cost base that will facilitate Jet2.com's low cost pricing'.⁶⁹ During a financial crisis, the airport refused to honour the claimant's flights which had previously operated outside normal hours, arguing that it was not required to sacrifice its own commercial interest. However, the High Court held that this was a breach of contract⁷⁰ because the interpretation of the agreement meant that the airport chose to bear the risk of providing a cost base to facilitate Jet2's low cost pricing. Also, the parties could not have intended that the airport would be free to simply '...pick and choose what to do in the light of what suits it or Balfour Beatty⁷¹ financially'.⁷² Thus, at the time of contracting, it was not contemplated that the airport could withdraw the extra hours service. The decision was upheld by the Court of Appeal.⁷³ One might argue that this conflicts with *Yewbelle* because by continuing to operate the extra hours service, the airport was running at a loss and was thus sacrificing its commercial interests. Yet, this was the effect of the contract and there is no rule in English law that allows escape from a contract when it becomes a bad deal. Also, this case must be distinguished from *Yewbelle* because there was a third party issue involved. Furthermore, in *Yewbelle*, the party with the obligation did not commit to bear such risk as in *Jet2* (the facilitation of low cost pricing).

⁶⁹ *Jet2.com Limited v Blackpool Airport Limited v Jet2.com Limited* [2011] EWHC 1529 [9].

⁷⁰ *ibid* para 80.

⁷¹ 95% percent of the shares in Blackpool Airport's holding company were acquired by a subsidiary of Balfour Beatty Plc.

⁷² *ibid* para 47.

⁷³ *Jet2.com Limited v Blackpool Airport Limited v Jet2.com Limited* [2012] EWCA Civ 417.

An Australian case more within the context of GSAs is *Electricity Generation Corporation* (trading as Verve Energy) *v Woodside Energy Ltd.*⁷⁴ This was a long term GSA where the sellers had to make available a maximum daily quantity of gas. The sellers also had an obligation to use reasonable endeavours to make available a Supplemental Maximum Daily Quantity (SMDQ) of gas at an agreed fixed price. According to clause 3.3, the sellers could take into account ‘...all relevant commercial, economic and operational matters...’⁷⁵ when considering whether to supply the SMDQ. During the contract, the other main supplier of gas in Western Australia suffered an explosion and this led to an increased demand for gas. The seller (Woodside) informed the buyer (Verve) that it could no longer supply the SMDQ under the GSA. Nonetheless, it could supply an equivalent quantity of gas under a short term sale agreement at the prevailing market price which was higher than under the long term GSA. The buyer protested and without prejudice to its rights under clause 3.3 (SMDQ) entered into the short term agreement. It later brought an action that the sellers had breached its reasonable endeavours obligation, seeking to recover the additional price paid under the short term agreement.

At first instance, the court held that there had been no breach of the contract. The Court of Appeal unanimously reversed this decision holding that the sellers had breached their reasonable endeavours obligation because they were able (in terms of having the capacity) to supply gas under the SMDQ. However, the majority of the

⁷⁴ (2014) HCA 7.

⁷⁵ Clause 3.3- Supplemental Maximum Daily Quantity:

- (a) ‘If in accordance with Clause 9 (‘Nominations’) the Buyer’s nomination for a Day exceeds the MDQ, the Sellers *must use reasonable endeavours* to make available for delivery up to an additional 30TJ/Day of Gas in excess of MDQ (‘Supplemental Maximum Daily Quantity’ or ‘SMDQ’).
- (b)) In determining whether they are able to supply SMDQ on a Day, the Sellers may take into account all relevant commercial, economic and operational matters ...’

High Court of Australia disagreed with the Appeal Court, holding that when viewed in the context that the sellers were to take into account all relevant commercial, economic and operational matters,⁷⁶ they were not able to supply gas under the SMDQ. It would thus appear that the issue about sacrificing commercial self-interest turns on the interpretation of the contract. The dissenting judge (Justice Gageler) argued that, the sellers' construction in relation to the considerations which they were to take into account, '...renders the obligation to use reasonable endeavours... elusive, if not illusory...'.⁷⁷ This argument has merit. In a sense, the purpose of the reasonable endeavours obligation is to confer on the buyers the possibility of purchasing additional quantities of gas. Yet, the application of clause 3.3 meant that reasonableness could not be subject to an objective standard, rather the sellers could create that standard according to what they judged as relevant commercial, economic and operational matters.

Nevertheless, the view of the majority is more convincing, particularly because the reasonable endeavours obligation concerned a supplemental quantity of gas, not the maximum daily quantity. There would be a stronger argument that the reasonable endeavours obligation ought to be viewed very strictly in favour of the buyer where it pertained to the daily quantity of gas. However, the interpretation of clause 3.3 was that it gave the seller some respite such that it was not compelled to supply the SMDQ under an arrangement unfavourable to its commercial interest.

How do the rules found in the authorities discussed above apply in the context of GSAs subject to a ToP provision?

⁷⁶ *ibid.*

⁷⁷ *Electricity Generation Corporation (trading as Verve Energy) v Woodside Energy Ltd* (2014) HCA 7 [60].

8.5.2. Reasonable steps expected of the Take or Pay seller

A point emerging from the authorities is that the specific actions of the party with the reasonable endeavours obligation are central in determining whether the duty has been discharged or not. Consequently, it is not a question of whether the party has acted, but rather how it is acted. This is a decision dependent on the facts of each case and the precise terms of the clause.

In a GBA, in the absence of technical or operational difficulties, the seller would in principle have the capacity to deliver make-up gas. Therefore, some of the reasonable steps expected of the seller are that, where the buyer nominates certain quantities as make-up gas, the seller is to make provision for such quantities by including this in its own nominations to the Operator under the JV. However, the seller's capacity to lift all of its contractual share of gas during any period would be affected by its own obligations under the JV and/or the GBA. For instance, an underproducing party may nominate more than its contractual share of gas in order to recover make-up gas.⁷⁸ Furthermore, the underproducer could also request temporary rebalancing, the effect of which is to reduce the amount of gas an overproducer can lift. This is contained in the AIPN Model GBA 2014, Article 6.5A:

An Underlifted Party having an Underlifted Quantity in a Season shall be entitled to have the Operator temporarily have additional Make-Up Gas made available to such Underlifted Party from the Natural Gas that would otherwise have been lifted and taken by the Overlifted Parties in such Season.

⁷⁸ As an example is the AIPN Model GBA 2014, Article 6.3: 'An Underlifted Party shall be entitled in each Nomination Period after the Nomination Period in which such the Underlifted Quantity occurred to lift and take, in addition to its Participating Interest share of Natural Gas, a quantity of Natural Gas ("Make-Up Gas") in order to eliminate its Underlifted Quantity.'

In such a scenario, the overproducing parties would have to make additional make-up gas available to the underproduced party. Where the ToP seller is one of these overproduced parties, the volumes of gas available to it would be reduced. In this case, its capacity to deliver make-up gas to the ToP buyer would be affected. Nonetheless, the seller must demonstrate that there were no other reasonable steps it could have taken where its allocation of gas was reduced. An example of a reasonable step would be for the seller to seek to increase its nominations where another party reduces its nominations. Although the GBA is a contractual agreement, it also has a relational angle, such that parties can agree to assist each other out by loaning volumes of gas. A reasonable step would be for the seller to seek to loan volumes of gas from other joint venturers. Where this is unsuccessful, the seller would at least be able to show that it took reasonable steps.

Furthermore, where the seller has the duty to arrange transportation for the volumes of make-up gas, part of its efforts would be to arrange transportation within a reasonable period. In the event that the transportation arrangement fails due to difficulties experienced by the third party (eg, shipper), the seller must demonstrate that it took steps to arrange alternative transportation.

A recurring theme in the cases discussed is the commercial interest of the seller, particularly in relation to it not sacrificing such interests. The question considered in the following section is: what commercial interests can a seller consider in contemplating how to fulfil its reasonable endeavours obligation?

8.5.3. *The commercial interests of the Take or Pay seller*

It has been accepted in *Yewbelle* and *Jet2* that the party with the reasonable endeavours obligation need not sacrifice its commercial interests. In the context of a GSA containing a ToP provision, what are the commercial interests of the seller? It is submitted that there are two main interests. The first is the market price of gas. This becomes relevant where the ToP price is lower or higher than the prevailing market price at the time the seller is required to make reasonable endeavours to deliver make-up gas. The provisions relating to make-up gas may indicate that make-up gas is not to be affected by the market price – in which case, make-up gas comes at no additional cost. Alternatively, it may provide that the buyer is to receive a refund where the price paid is higher than the market price at the time of delivery. In such a case, it is argued that the buyer ought also to bear the risk where the ToP price paid is lower than the market price. Here, the buyer should be required to match the price. Similarly, where the price is fixed such that it is the seller who receives the benefit where the price paid is higher than the market price, then it ought also to bear the risk and burden where the price paid is lower than market price. This approach is consistent with the earlier discussed case of *Brauer v James Clark*⁷⁹ where it was held that by accepting a fixed price the seller had assumed the risk of increased prices.

Therefore, as indicated in the decision of the HCA in *Electricity Generation Corporation (trading as Verve Energy) v Woodside Energy Ltd*,⁸⁰ the ability of the seller to deliver supplementary gas was not based on physical capacity or ability, but rather on its ability when weighed against relevant commercial, economic and

⁷⁹ [1952] 2 All ER 497.

⁸⁰ (2014) HCA 7.

operational matters. These considerations had been expressly included in the contract. Although this decision is only of persuasive authority, it is argued that, in the ToP context, it is not enough that the seller has the physical capacity to supply make-up gas; the determination of capacity should be holistic, considering the commercial interests of the seller. This of course depends on the terms of the clause.

The second commercial interest of the seller is its obligation to make make-up gas available for the underproducer under the GBA. There will be a conflict of interest between leaving make-up gas as an overproducer and also supplying make-up gas to the ToP buyer. Where there is no time limit during which the underproducer can lift make-up gas, it could potentially seek to reclaim make-up gas anytime. This could be the same period where the overproducer also has to supply make-up gas to its buyer. Consequently, the overproducing seller would be in a difficult situation. Depending on its other supply agreements and the volumes of gas available for it to lift, it may have to go as far as choosing which agreement to breach, the GBA or the GSA.⁸¹ To reduce this conflict, Smith suggests that when drafting a sales agreement, the right of the buyer to make-up gas should be made subordinate to the right of an underproducing party in the GBA.⁸² The buyer would not be eager to agree to such a clause in the sales agreement and unless the seller has the stronger bargaining power, the buyer may not consent. Of course, the chances that the buyer and underproducer

⁸¹ Ernest E. Smith, 'Gas Marketing By Co-Owners: Disproportionate Sales, Gas Imbalances and Lessors' Claims to Royalty' (1987) 39 *Baylor Law Review* 365, 397-398.

⁸² V. Smith, W. Byrd and T. Fusselman, 'Module on Oil and Gas Contracts: Model Gas Balancing Agreement' (1987) Texas Law School, Spring Semester. [Partly accessed in Ernest E. Smith, 'Gas Marketing By Co-Owners: Disproportionate Sales, Gas Imbalances and Lessors' Claims to Royalty' (1987) 39 *Baylor Law Review* 365, 398.]

under the GBA would be seeking make-up gas at the same time are relatively slim, yet the possibility exists.

Overall, the determination of whether a seller has fulfilled its reasonable endeavours obligation will be dependent on the facts and the precise terms of the clause. Nonetheless, as far as possible, the reasonable endeavours obligation should be qualified; an example of this is to indicate what efforts would be expected of the seller. Also, in relation to the assumption of risks, the agreement should be clear on which party bears the risk of a price increase or decrease. In the event that the GSA indicates that the right of the buyer to make-up gas is subordinate to the right of an underproducing party in the GBA,⁸³ it is the buyer who bears the risk that the seller may be unable to deliver make-up gas. Where the reasonable endeavours is framed as clearly as possible, this will set both the buyer and seller's expectations, thereby reducing the chances of disappointment, especially on the part of the buyer. More importantly, clear expectations are likely to weaken a buyer's challenge as to the ToP being an unenforceable penalty.

⁸³ V. Smith, W. Byrd and T. Fusselman, 'Module on Oil and Gas Contracts: Model Gas Balancing Agreement' (1987) Texas Law School, Spring Semester. [Partly accessed in Ernest E. Smith, 'Gas Marketing By Co-Owners: Disproportionate Sales, Gas Imbalances and Lessors' Claims to Royalty' (1987) 39 Baylor Law Review 365, 398.]

Conclusion

The construction part of the *Makdessi* test (primary/secondary obligation divide) leaves room for buyers to challenge a ToP clause as an unenforceable penalty. It is this part of the test that makes ToP provisions vulnerable to challenge. Where the ToP provision is framed in a way that renders the failure of the buyer to take delivery a breach of contract, with the ToP payment being a damages provision, the provision could be interpreted as a secondary obligation. The uncertainties that accompany the primary/secondary obligation divide have been discussed in several chapters of the thesis. The challenges with the divide were also expressed by Lord Denning who commented that making the distinction between whether a provision is a primary or secondary obligation is ‘...fit only for the rarefied atmosphere of the House of Lords. Not at all for the chambers of the practitioner...’.⁸⁴ The difficulty in making this distinction is seen in *Makdessi*, where only 4 out of the 7 Lordships held that the forfeiture provision was a primary obligation. Although this chapter has argued that ToP provisions are likely to be interpreted as a primary obligation, this decision rests on how the provision is framed. As such, the recommendation is that drafters of ToP provisions must frame them in such a manner that they will be clear primary obligations, thereby escaping the net of the penalty rule.

The chapter has also argued that if a ToP provision is interpreted as a secondary obligation, the seller will pass the first part of the *Makdessi* test. There is a legitimate interest for the imposition of the ToP clause – it ensures the seller has a steady source of income, thereby being able to fulfil its repayment obligations, as well as to recover

⁸⁴ *George Mitchell (Chesterhall) Ltd v Finney Lock Seeds Ltd* [1983] QB 284 [301A] (Lord Denning MR).

its investments. In relation to the second part of the *Makdessi* test, the writer took the view that a finding of unconscionability/exorbitance would depend on two main factors. Firstly, where the agreement allows for make-up gas this would operate against a finding of unconscionability. Secondly, where the time limit on the recovery of make-up gas is in line with standard industry practice, this would also indicate that the provision is not unconscionable.

Nevertheless, even if a ToP provision is a secondary obligation, it has been argued that it serves a legitimate interest which is neither unconscionable nor exorbitant (depending on the two points raised above). Thus, it is anticipated that ToP provisions will pass the penalty test and be enforceable.

The latter part of the chapter focused on the seller's obligation of reasonable endeavours to supply make-up gas. It has been recommended that, as far as possible, the parties should make clear in writing what is expected of the seller in discharging this obligation. Although the parties will not be able to speculate on every eventuality which may affect the seller in discharging its duty, they should endeavour to state what is contemplated by the reasonable endeavours obligation. It was also argued that the sales agreement should be clear on the assumption of risks where the market price is lower or higher than the ToP price. Although one party will still suffer a loss where the market price fluctuates, there will be less scope for a dispute to arise since the contract is clear on the assumption of risk.

More generally, it has been argued that despite the increased chances that a ToP provision drafted in accordance with the suggestions above is likely to be enforceable, there is the slim possibility that it may not guarantee the seller a steady income where the buyer does not take regular delivery of gas and, in breach of contract, fails to pay.

As such, a seller who cannot afford the slim risk that it may not receive a regular income should consider whether its interests may be best served through a Take and Pay clause. Although a cargo-by-cargo alternative for LNG would guarantee the seller a secure source of income, it is more suited to short term contracts. The ToP clause is likely to remain the dominant method used to dispose of gas production in long term gas agreements.⁸⁵

Finally, the ability of a seller to market its production and ensure a steady flow of income will be central to meeting its own financial obligations under long term gas agreements. This could include putting up security for the decommissioning of infrastructure at the end of field life. DSAs are discussed in the next chapter.

⁸⁵ Paul Griffin (ed), *Liquefied Natural Gas: The Law and Business of LNG* (2nd edn, Globe Law and Business 2012) 53.

CHAPTER 9

DECOMMISSIONING SECURITY AGREEMENTS

Introduction

The decommissioning security agreement (hereafter DSA) is a contractual method used to mitigate the financial risks of decommissioning where there is more than one licensee to the LOTOGA. This chapter examines the practical effectiveness of the DSA; the main contractual clause used to mitigate financial risks at the final phase (decommissioning, hereafter DCG) in the lifecycle of a LOTOGA.¹

This chapter examines how joint venturers make financial provision for the costs of DCG through the DSA and the implications where the estimated costs of DCG in the DSA exceed the actual costs. The consequences of the shortfall and the allocation of the financial liability has been a topic rarely discussed in the literature relating to DCG in JVs. This is in contrast to the plethora of literature dedicated to financial default in JVs. This is an unsatisfactory position in light of the serious financial liability that can accompany an underestimation of DCG costs and the implications for joint venturers, both old and new. The discussion provides recommendations on how IOCs can mitigate this.

The chapter begins with a brief introduction to DCG, after which it will discuss the liability of licensees (typically IOCs²) to the state. Following this, the DSA will be

¹ The rest of the clauses in the thesis have focused on other stages of a LOTOGA (post field maturity), therefore to allow the thesis's examination of contractual methods of risk mitigation to be comprehensive, it is essential to include a discussion of the DSA which targets the risk of default in relation to DCG obligations.

² Although a NOC could also be party to the licence.

assessed, looking at its purpose, the risks it mitigates and the challenges to its effectiveness. Thereafter, the chapter will explore possible ways through which the effectiveness of the DSA may be enhanced.

9.1. A brief introduction to decommissioning

The final stage of oil and gas operations is DCG,³ where the infrastructure used during operations is totally taken down where possible, or is part dismantled/modified, in accordance with the DCG standards prescribed in the legislation of the state.⁴ The objective of DCG is to make safe oil and gas installations and to restore the site to its original condition as far as is physically possible.⁵ DCG is the politically acceptable title for ‘abandonment’.⁶

DCG is a long arduous journey which requires significant planning over a considerable period before the cessation of production.⁷ An Operator cannot predict the exact schedule of DCG, rather the DCG programme remains subject to changes through the course of time. For instance, technical advancement may enhance the life of the field thereby postponing DCG, or an economic downturn may mean that DCG

³ ‘Decommissioning means all work required for the abandonment of Joint Property in accordance with good oil field practice and applicable legal obligations, including, where required, plugging of wells, abandonment, disposal, demolition, removal and/or cleanup of facilities, and any necessary site remediation and restoration’. AIPN Model JOA 2012, Definitions.

⁴ Flávia Kaczelnik Altit and Mark Osa Igiehon, ‘Decommissioning of upstream oil and gas facilities’ in Geoffrey Picton-Tuberville (ed), *Oil and Gas: A Practical Handbook* (Globe Law and Business 2009) 257-258.

⁵ Michael Davar and Ben Holland, ‘Decommissioning disputes’ in Marc Hammerson and Nicholas Antonas (eds), *Oil and Gas Decommissioning: Law, Policy and Comparative Practice* (2nd edn, Globe Law and Business 2016) 177.

⁶ Abandonment connotes a dereliction of duty whilst the former implies a sense of legal liability on the parties concerned. Marc Hammerson, *Upstream Oil and Gas: Cases, Materials and Commentary* (Globe Law and Business 2011) 439.

⁷ Oil & Gas UK, ‘Oil & Gas UK Decommissioning Insight Report 2016’ 1, 10 <<http://oilandgasuk.co.uk/wp-content/uploads/2016/11/Decommissioning-Insight-2016-Oil-Gas-UK.pdf>> accessed 20 April 2017

infrastructure is cheaper, making it prudent for smaller operators to accelerate DCG. Oil & Gas UK's decommissioning insight for 2016 indicated that a low price environment might lead to an acceleration of DCG – citing that in 2015 (when prices were at a staggering low⁸) a total of 72 projects accelerated the date for cessation of production (hereafter CoP).⁹

The financial costs of DCG are colossal. Decomworld¹⁰ forecasts that it could cost as high as £70 billion to decommission all the UK's offshore oil and gas fields.¹¹ Also, the 2018 Oil & Gas UK Decommissioning Insights Report predicts that, 'The UK is expected to spend £15.3 billion on decommissioning over the next decade'.¹² It would be politically unacceptable for such liability to fall on taxpayers, save in relation to tax relief.¹³ Therefore, states would seek to put tight measures in place to ensure that liability for DCG always remains with the licensees (IOCs). In turn, IOCs

⁸ Larry Elliott, 'Oil price falls to 11-year low with global glut expected to deepen in 2016' (The Guardian, 21 December 2015) <<https://www.theguardian.com/business/2015/dec/21/brent-crude-oil-price-11-year-low>> accessed 25 April 2017; BP, 'Oil prices: 2015 in review' <<http://www.bp.com/en/global/corporate/energy-economics/statistical-review-of-world-energy/oil/oil-prices.html>> accessed 25 April 2017; EIA, 'Crude oil prices started 2015 relatively low, ended the year lower' (EIA, 06 January 2016) <<https://www.eia.gov/todayinenergy/detail.php?id=24432>> accessed 25 April 2017; Matthew West, 'Just how low can oil prices go and who is hardest hit?' (BBC News, 18 January 2016) <<http://www.bbc.co.uk/news/business-35245133>> accessed 25 April 2017.

⁹ Oil & Gas UK, 'Oil & Gas UK Decommissioning Insight Report 2016' 1, 6 <<http://oilandgasuk.co.uk/wp-content/uploads/2016/11/Decommissioning-Insight-2016-Oil-Gas-UK.pdf>> accessed 20 April 2017.

¹⁰ 'DecomWorld is the offshore oil and gas industry's leading provider of decommissioning insight.' <<http://analysis.decomworld.com>> accessed 26 August 2018.

¹¹ DecomWorld, 'Intelligence brief: UK decom spend to be higher than previously thought; Several North Sea contracts awarded' (2016) <<http://analysis.decomworld.com/regulation-and-policy/intelligence-brief-uk-decom-spend-be-higher-previously-thought-several-north>> accessed 22 March 2017. The forecast for DCG expenditure in the UK Continental Shelf between 2016 to 2025 is £17.6 billion. Oil & Gas UK, 'Oil & Gas UK Decommissioning Insight Report 2016' 1, 47 <<http://oilandgasuk.co.uk/wp-content/uploads/2016/11/Decommissioning-Insight-2016-Oil-Gas-UK.pdf>> accessed 20 April 2017.

¹² Oil & Gas UK, 'Oil & Gas UK Decommissioning Insight Report 2018' 1, 6 <<https://oilandgasuk.co.uk/wp-content/uploads/2019/03/OGUK-Decommissioning-Insight-Report-2018.pdf>> accessed 11 September 2019.

¹³ Nicholas Ross-McCall, 'Decommissioning and the joint operating agreement' in Marc Hammerson and Nicholas Antonas (eds), *Oil and Gas Decommissioning: Law, Policy and Comparative Practice* (2nd edn, Globe Law and Business 2016) 79. DCG tax relief is discussed later at section 9.6.

would aim to reduce the risks of DCG, particularly in relation to the financial liability of each joint venturer.

9.2. Financial risk associated with decommissioning

Commercially, DCG costs are like any other costs in the JOA, such that each party is typically liable according to its participating interest.¹⁴ In the UK, DCG liability is joint and several.¹⁵ Any member of the JOA issued with a section 29 Notice under Part IV of the Petroleum Act 1998 to prepare a DCG programme could potentially be liable for the entire costs of DCG. Although the section 29 Notice may be served to a wide range of persons,¹⁶ it would typically be issued to the Operator of the installation

¹⁴ As an example, The AIPN Model JOA 2012, Exhibit E Decommissioning Procedures: Section 4.1 on Trust Fund Cash Calls provides that, ‘...each Party will be required to pay Cash Calls for the creation of a trust fund for Decommissioning (“Decommissioning Trust Fund”). Unless unanimously approved otherwise, *each Party shall bear the Decommissioning Costs proportionally to its respective Participating Interest*’. (emphasis added).

¹⁵ The concept of joint and several liability is made clear in UK DCG guidance notes. See Department of Energy and Climate Change (DECC)*, ‘Guidance Notes: Decommissioning of Offshore Oil and Gas Installations and Pipelines under the Petroleum Act 1998’ (March 2011) 1, 117 <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/69754/Guidance_Notes_v6_07.01.2013.pdf>; Judith Aldersey-Williams, ‘Decommissioning security’ in Marc Hammerson and Nicholas Antonas (ed), *Oil and Gas Decommissioning: Law, Policy and Comparative Practice* (2nd edn, Globe Law and Business 2016) 88.

*The DECC was replaced by the Department of Business Energy and Industrial Strategy (BEIS) in July 2016.

¹⁶ Section 30 of Part IV of the UK Petroleum Act 1998 gives the Secretary of State power to issue the section 29 notice to a wide net of persons. The section 29 notice may be served to a number of people listed under section 30 (1) of the UK Petroleum Act 1998 as-

‘(a)the person having the management of the installation or of its main structure;
(b)a person to whom subsection (5) applies in relation to the installation [subsection (5) refers to a person who has the right to exploit or explore mineral resources in any area];
(c)a person outside paragraphs (a) and (b) who is a party to a joint operating agreement or similar agreement relating to rights by virtue of which a person is within paragraph (b);
(d)a person outside paragraphs (a) to (c) who owns any interest in the installation otherwise than as security for a loan;
(e)a company which is outside paragraphs (a) to (d) but is associated with a company within any of those paragraphs’. <<http://www.legislation.gov.uk/ukpga/1998/17/part/IV>> accessed 10 July 2017.

and parties having a beneficial interest (financial or otherwise) in the installation or pipeline.¹⁷ These parties would include licensees and parties to the JOA.

Parties to the JOA would seek to avoid excessive financial liability through two means. The first is to provide in the JV agreement that DCG costs will be paid according to individual participating interest. This approach is consistent with the commercial arrangement under the JV where cash calls are paid based on individual participating interest. The second method used to avoid any party being liable for all the costs of DCG is to require each party to provide security in advance which should cover the party's share of the projected costs of DCG.¹⁸ The objective of these two methods is to ensure that whenever the section 29 Notice is served on one or more parties to the JV, there are sufficient funds available to cover DCG costs. In the absence of this, any party to the JV would be exposed to serious financial risk.

There are two financial risks associated with DCG. The first is that any party to the JV may run into financial difficulty, thereby being unable to meet its DCG obligations. The DSA deals with this risk. The second is the risk that the projected costs of DCG are insufficient. Although the DSA does not deal with this directly, the

¹⁷ The Department of Energy and Climate Change (DECC) Guidance Notes on Decommissioning Offshore Oil and Gas Installation and Pipelines under the Petroleum Act 1998, version 6 (March 2011) 1, 15 at para 3.23, indicate that beneficial interest means an interest arising from the exploration or exploitation of mineral resources or from recovery of gas from the field for which the installation was either built or maintained. An example of a beneficial interest is a production bonus, this would be received by licensees and joint venturers. <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/69754/Guidance_Notes_v6_07.01.2013.pdf> accessed 08 November 2017. Judith Aldersey-Williams, 'Decommissioning security' in Marc Hammerson and Nicholas Antonas (ed), *Oil and Gas Decommissioning: Law, Policy and Comparative Practice* (2nd edn, Globe Law and Business 2016) 88.

¹⁸ AIPN Model JOA 2012, Exhibit E Decommissioning Procedures: Section 5.1 contains an alternative for a party to provide security instead of paying funds into the DCG trust fund. Conversely, Holland notes that 'The share of decommissioning costs will usually, but not always, correspond with a participant's participating interests under the JOA.' Ben Holland, 'Decommissioning in the United Kingdom Continental Shelf: Decommissioning Security Disputes' (2016) 28 Denning Law Journal (Special Issue) 19.

writer seeks to provide recommendations on how IOCs can mitigate this risk in the DSA.

9.3. The challenge of providing double security

Prior to estimating the costs of DCG, joint venturers first have to deal with the risk of default through the provision of security. The provision of security would be mandatory in the JV agreement if the licence with the host state mandates it. If not, the parties may make it compulsory or optional.

Generally, each joint venturer would be required to provide satisfactory DCG security to other joint venturers. This is the standard security all joint venturers must provide. Where a joint venturer seeks to make a sale of any of its interest in the JV, it would typically require security from the buyer so as to protect itself in the event that it receives a section 29 Notice to prepare a DCG programme. This is the first security required of the buyer. The buyer would also need to provide security to the remaining joint venturers (this is the second security) – hence the terminology of ‘double security’ in the case of the buyer.¹⁹ (Arguably, the two securities each secure a different event, in that sense it is not ‘double’.) Furthermore, the buyer may have to give security a third time should the state (DECC²⁰ in particular) also request security.²¹ This would depend on its financial standing and credit worthiness.

¹⁹ *ibid.*

²⁰ Department of Energy and Climate Change.

²¹ Judith Aldersey-Williams, ‘Decommissioning security’ (Presentation) AIPN Europe-Africa Regional Chapter Meeting (09 May 2007) 1-44 accessed in <<https://www.ogel.org/article.asp?key=2623>> 24 June 2019; Department of Energy and Climate Change, ‘Guidance Notes: Decommissioning of Offshore Oil and Gas Installations and Pipelines under the Petroleum Act 1998’ (March 2011) 1, 117-118; <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/69754/Guidance_Notes_v6_07.01.2013.pdf> accessed 20 March 2017; Ashurst LLP, ‘Oil and gas decommissioning: present problems, future solutions’ (25 July 2011) <<http://www.internationalawoffice.com/Newsletters/Energy-Natural-Resources/United-Kingdom/Ashurst-LLP/Oil-and-gas-decommissioning-present-problems-future-solutions>> accessed 21 April 2017.

To a large extent, the United Kingdom Continental Shelf (hereafter UKCS) is a mature basin, with a number of fields approaching their end of life.²² Towards this end of life, major oil and gas companies with rights to a licence or JV would seek to divest their interest. This presents a unique opportunity for smaller oil and gas companies to acquire such rights and seek measures to extend the life of the field, generating some level of profit whilst keeping operating costs down. The requirement for multiple security creates a hostile environment for smaller companies often with limited resources.²³ Where smaller companies are unable to buy in at a later stage, the possibility of maximising economic recovery (MER) of the field is reduced. MER is part of the aims of the newly formed Oil & Gas Authority and the UKCS Maximising Economic Recovery Strategy.²⁴ The conception of the DSA in the UKCS was primarily as a response to the concern of double security.²⁵ Rather than the buyer being faced with the concern of providing double security, the DSA can ensure that there is only a single stream of security. When a licensee sells its interest, its contribution to the DSA stops and the buyer continues with the contributions. In this

²² Oil & Gas UK, 'Oil & Gas UK Decommissioning Insight Report 2016' 1, 7 <<http://oilandgasuk.co.uk/wp-content/uploads/2016/11/Decommissioning-Insight-2016-Oil-Gas-UK.pdf>> accessed 20 April 2017; Dr Carole Nakhle, 'Assessing the future of North Sea oil and gas' (21 April 2016) <<https://www.crystoneenergy.com/assessing-future-north-sea-oil-gas/>> accessed 24 June 2019; Department for Business, Energy & Industrial Strategy, 'Strengthening the UK's Offshore Oil and Gas Decommissioning Industry - Call for Evidence' (March 2019) 1, 3 <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/785544/strengthening-uk-offshore-oil-gas-decommissioning-industry-cfe.pdf> accessed 24 June 2019.

²³ Ben Holland, 'Decommissioning in the United Kingdom Continental Shelf: Decommissioning Security Disputes' (2016) 28 Denning Law Journal (Special Issue) 19, 23.

²⁴ Oil & Gas Authority UK, 'Economic Strategy' (2016) <<https://www.ogauthority.co.uk/news-publications/publications/2016/exploration-strategy/>> accessed 19 May 2017; Ben Holland, 'Decommissioning in the United Kingdom Continental Shelf: Decommissioning Security Disputes' (2016) 28 Denning Law Journal (Special Issue) 19, 24.

²⁵ Ashurst LLP, 'Oil and gas decommissioning: present problems, future solutions' (25 July 2011) <<http://www.internationallawoffice.com/Newsletters/Energy-Natural-Resources/United-Kingdom/Ashurst-LLP/Oil-and-gas-decommissioning-present-problems-future-solutions>> accessed 21 April 2017; Judith Aldersey-Williams, 'Decommissioning security' in Marc Hammerson and Nicholas Antonas (eds), *Oil and Gas Decommissioning: Law, Policy and Comparative Practice* (2nd edn, Globe Law and Business 2016) 90, 93.

way, there is no gap in the provision of security following a sale or transfer of interest. It also creates a uniform basis for IOCs when dealing with the provision of security. The DSA is good for the industry because it encourages oil and gas acquisitions by smaller entrants, and creates a unified approach to DCG security.

9.4. The decommissioning security agreement

9.4.1. Purpose of security

In the UK, a DSA can be between joint venturers,²⁶ a seller and a buyer,²⁷ or a buyer and the DECC.²⁸ The DSA between joint venturers is commonly referred to as field DSAs and is the focus of the discussion. The standard position under the DSA is that each joint venturer must put up security against its share of the estimated future costs of DCG. The DSA would provide for an independent person to act as a security trustee, holding security on trust until the time when DCG costs are to be expended.²⁹

It has been indicated that, '[t]he over riding aim of a DSA is to ensure that guaranteed funds (which may include future revenues in appropriate cases) will be available to cover the decommissioning costs at all times'.³⁰ One of the factors which may affect the funds available for DCG is financial default by a licensee. Default can

²⁶ Judith Aldersey-Williams, 'Decommissioning security' in Marc Hammerson and Nicholas Antonas (eds), *Oil and Gas Decommissioning: Law, Policy and Comparative Practice* (2nd edn, Globe Law and Business 2016) 91.

²⁷ This is referred to as a sale and purchase DSA. The seller may be a licensee under the LOTOGA, and/or, a joint venturer.

²⁸ DECC DSAs. This is in the occasion that the DECC has requested security from a buyer/purchaser, due to concerns that this party may have difficulty financing DCG.

²⁹ See for example the AIPN Model JOA 2012, Exhibit E on Decommissioning Procedures Section 4.4 - Trustee.

³⁰ Department of Energy and Climate Change, 'Guidance Notes: Decommissioning of Offshore Oil and Gas Installations and Pipelines under the Petroleum Act 1998' (March 2011) 1, 115 <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/69754/Guidance_Notes_v6_07.01.2013.pdf> accessed 20 March 2017; Scott C Styles, 'Joint Operating Agreements' in Greg Gordon and others (eds), *Oil and Gas Law: Current Practice and Emerging Trends* (2nd edn, Dundee University Press 2011) 407.

occur prior to or upon the insolvency of such party. The provision of security seeks to ensure that prior to actual DCG, each licensee has contributed security to cover its share of the estimated costs of DCG. Therefore, even if a party becomes insolvent at any time before DCG, the remaining parties can draw on its security towards the costs of DCG. The DSA protects the security of an insolvent party in a trust until the time to expend DCG costs – such funds would not be available to general creditors of the insolvent party.³¹

9.4.2. Parties to the decommissioning security agreement

The DSA would include three class of participants (as shown in the diagram below).³²

First-tier participants are made up of current licensees or joint venturers where there is a JV in place. Second-tier participants are parties who have sold their oil and gas

³¹ This protection was included in Section 38A of the Petroleum Act 1998, as amended by the Energy Act 2008. <<https://www.publications.parliament.uk/pa/ld200708/ldbills/086/08086.61-67.html>> accessed 16 March 2017. A recent oil and gas insolvency (2016) involved Iona Energy, one of the JOPs in the UK Huntington field (North Sea). One of the Joint Administrators (Chad Griffin) cited the current oil price environment as a significant challenge leading to insolvency. Although the Huntington Field began oil production in 2013 there is no indication whether there was a DSA in place prior to this insolvency. However, in the event that there was one, Iona's contribution to the DSA would have been protected from its general creditors. Offshore Energy Today, 'First Oil Flows from Huntington Field (UK)' (14 April 2013) <<http://www.offshoreenergytoday.com/first-oil-flows-from-huntington-field/>> accessed 11 November 2017; Offshore Energy Today, 'Iona Energy goes into administration' (07 January 2016) <<http://www.offshoreenergytoday.com/iona-energy-goes-into-administration/>> accessed 11 November 2017.

³² Marc Hammerson, *Upstream Oil and Gas: Cases, Materials and Commentary* (Globe Law and Business 2011) 469.

interests.³³ Such parties may still be subject to a section 29 Notice.³⁴ This party may be a former section 29 holder if the notice was withdrawn after the sale of its interest, although the notice can be re-issued under section 34.³⁵ The role of such party is to ‘police’ the DSA and check that first-tier participants keep up with their financial contributions.³⁶ This is the case where there is only one remaining first tier participant who has 100% participating interest.³⁷ The second-tier participant to ‘police’ the DSA will typically be the last licensee to sell its participating interest to the remaining licensee.³⁸ Third tier participants are not direct parties to the agreement but may be given rights under Contracts (Rights of Third Parties) Act 1999 to enforce security, in the event that they ever have to carry out DCG (if caught under section 34).³⁹ An example is a parent company to any of the licensees, be it a present or former

³³ Oil and Gas UK Model DSA September 2013, paras 3.3 and 3.4; Judith Aldersey-Williams, ‘Decommissioning security’ in Marc Hammerson and Nicholas Antonas (eds), *Oil and Gas Decommissioning: Law, Policy and Comparative Practice* (2nd edn, Globe Law and Business 2016) 93.

³⁴ The Section 29 Notice may be served to a number of people listed under section 30 (1) of the UK Petroleum Act 1998 as-

‘(a)the person having the management of the installation or of its main structure;
(b)a person to whom subsection (5) applies in relation to the installation [subsection (5) refers to a person who has the right to exploit or explore mineral resources in any area];
(c)a person outside paragraphs (a) and (b) who is a party to a joint operating agreement or similar agreement relating to rights by virtue of which a person is within paragraph (b);
(d)a person outside paragraphs (a) to (c) who owns any interest in the installation otherwise than as security for a loan;
(e)a company which is outside paragraphs (a) to (d) but is associated with a company within any of those paragraphs’. <<http://www.legislation.gov.uk/ukpga/1998/17/part/IV>> accessed 10 July 2017.

³⁵ Section 34 of the Petroleum Act 1998 - revision of programme.

³⁶ Department of Energy and Climate Change (DECC), ‘Guidance Notes: Decommissioning of Offshore Oil and Gas Installations and Pipelines under the Petroleum Act 1998’ (March 2011) 1, 117 <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/69754/Guidance_Notes_v6_07.01.2013.pdf> accessed 20 March 2017.

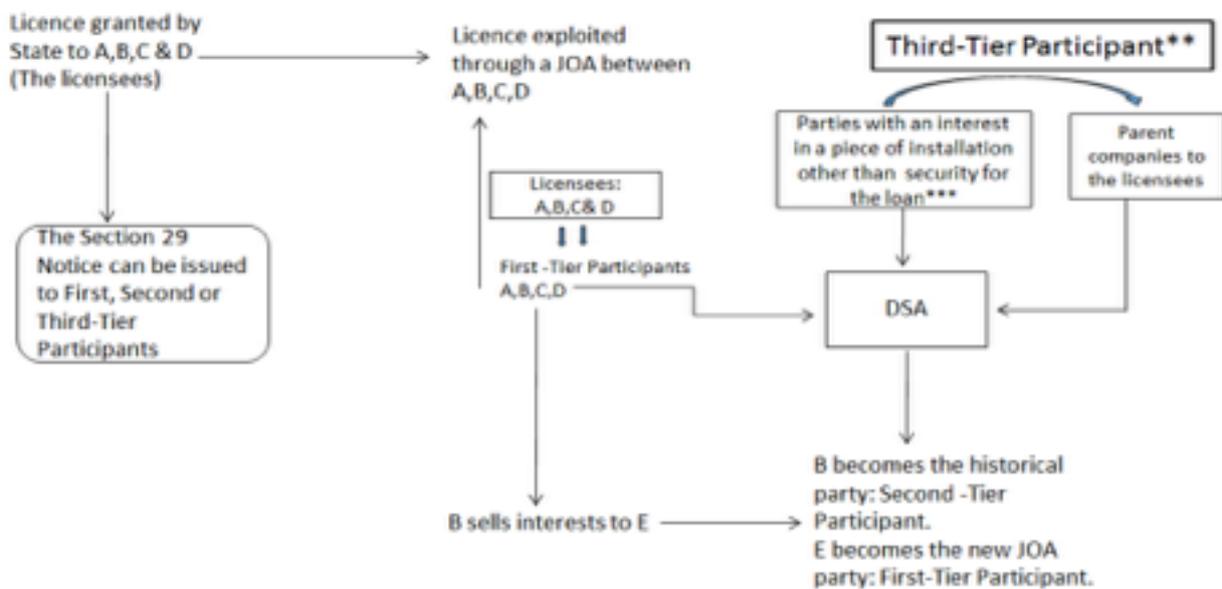
³⁷ *ibid.*

³⁸ *ibid.*

³⁹ Oil and Gas UK Model DSA September 2013, paras 14.2; Squires Patton Boggs, ‘Decommissioning in the United Kingdom Continental Shelf: Decommissioning Security Disputes’ <<http://www.squirepattonboggs.com/~media/files/insights/publications/2016/01/decommissioning-in-the-united-kingdom-continental-shelf/22069--oil-and-gas-decommissioning-alert.pdf>> accessed 09 March 2017.

licensee.⁴⁰ Finally, in the UK, the Secretary of State for Energy and Climate Change may also be a party to the DSA if there is concern that those liable for DCG will be unable to discharge their DCG obligations, as well as to prevent amendments to the DSA without its approval.⁴¹

UK DSA: PARTICIPANTS



* The section 29 notice may be served to a number of people listed under section 30 (1) of the UK Petroleum Act 1998. This includes existing licensees, historical licensees, managers of the installation, parties

⁴⁰ Parent and sister companies of a present licenses may be issued with a section 29 notice under section 30 (1)(e) and 30(2)(b) UK Petroleum Act 1998. More so, under section 30 (1)(e), s30(2)(c) and s34, parent companies of a former licensee may also be issued with a section 29 notice.

⁴¹ Department of Energy and Climate Change (DECC), 'Guidance Notes: Decommissioning of Offshore Oil and Gas Installations and Pipelines under the Petroleum Act 1998' (March 2011) 1, 117 <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/69754/Guidance_Notes_v6_07.01.2013.pdf> accessed 20 March 2017; Peter Roberts, *Joint Operating Agreements: A Practical Guide* (2nd edn, Globe Law and Business 2012) 183. The DECC is responsible for ensuring compliance with the Petroleum Act 1998.

receiving a beneficial interest from the exploration and exploitation of hydrocarbons at the installation and parent companies.

** Some of the other parties who would be under the class of third-tier participants to the DSA are managers of the installation or its main structure.⁴² According to the DECC Guidance Notes, this refers to the Operator of the licence and not to day to day contractors managing the installation.⁴³

*** Those falling into the category of ‘a party with an interest in a piece of installation other than as security for a loan’⁴⁴ are platform owners.⁴⁵

9.4.3. Forms of security

The UK guidance notes on DCG indicates the acceptable security where the DECC is party to a DSA. This includes: ‘...cash, irrevocable standby Letters of Credit (LoCs) issued by a Prime Bank, or on demand (performance) bonds from Prime Banks or issued by an Insurer regulated under the Financial Services and Markets Act

⁴² Section 30 (1) (a) of the UK Petroleum Act 1998.

⁴³ Department of Energy and Climate Change, ‘Guidance Notes: Decommissioning of Offshore Oil and Gas Installations and Pipelines under the Petroleum Act 1998’ (March 2011) 1, 12 <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/69754/Guidance_Notes_v6_07.01.2013.pdf> accessed 13 July 2017. The position may be different for tieback installations.

⁴⁴ Section 30 (1) (d) of the UK Petroleum Act 1998.

⁴⁵ An example of a platform owner would be the owner of a floating production storage and offloading (FPSO) system or the owner of a drilling rig used for production purposes - such a party would have no beneficial interest in the oil/gas field. ‘FPSOs are commonly deployed for offshore production in locations that have little infrastructure. They serve as gathering, processing and storage facilities for fluids produced from subsea wells.’ Michael Davar and Ben Holland, ‘Decommissioning disputes’ in Marc Hammerson and Nicholas Antonas (eds), *Oil and Gas Decommissioning: Law, Policy and Comparative Practice* (2nd edn, Globe Law and Business 2016) 182; Schlumberger, ‘Oilfield Glossary’ <<http://www.glossary.oilfield.slb.com/Terms/f/fpsso.aspx>> accessed 16 August 2017.

2000...'.⁴⁶ All of these forms of security seek to provide maximum guarantee that there will be funds available to cover the costs of DCG. Arguably, the use of cash as a form of security is least beneficial to the industry because it ties up cash for a long period of time. Such cash would be more valuable if invested into the economy. It would also yield profits for IOCs. Where the DECC is not a party to the DSA, the same forms of security are used, as well as parent company guarantees.⁴⁷ The latter is an unacceptable form of security in a DSA where the Secretary of State is a party.⁴⁸ This is because of the risks that a parent company may face financial difficulty or become insolvent. However, it is interesting to note that in Norway, where the Ministry of Petroleum and Energy (MPE) asks a licensee to provide security in relation to its DCG obligations, the MPE would generally request a parent company guarantee.⁴⁹ Nevertheless, it must be noted that in Norway, DSAs are typically

⁴⁶ Department of Energy and Climate Change, 'Guidance Notes: Decommissioning of Offshore Oil and Gas Installations and Pipelines under the Petroleum Act 1998' (March 2011) 1, 117 <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/69754/Guidance_Notes_v6_07.01.2013.pdf> accessed 13 July 2017.

⁴⁷ Oil & Gas United Kingdom Model Decommissioning Security Agreement 2015, Clause 7 - 7.1.4; Ashurst LLP, 'Oil and gas decommissioning: present problems, future solutions' (25 July 2011) <<http://www.internationallawoffice.com/Newsletters/Energy-Natural-Resources/United-Kingdom/Ashurst-LLP/Oil-and-gas-decommissioning-present-problems-future-solutions>> accessed 21 April 2017.

⁴⁸ Department of Energy and Climate Change, 'Guidance Notes: Decommissioning of Offshore Oil and Gas Installations and Pipelines under the Petroleum Act 1998' (March 2011) 1, 119 <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/69754/Guidance_Notes_v6_07.01.2013.pdf> accessed 13 July 2017; Judith Aldersey-Williams, 'Decommissioning security' in Marc Hammerson (ed), *Oil and Gas Decommissioning: Law, Policy and Comparative Practice* (Globe Law and Business 2013) 76.

⁴⁹ The MPE has this power according to Section 10-7 of the Petroleum Activities Act 1996, No 72. 'The authority pursuant to section 10-7 is quite wide with regard to timing and the nature of the security that can be required. However, in practice the Ministry of Petroleum and Energy requires licensees to post an unlimited parent company guarantee for the benefit of the Norwegian State to secure all obligations in relation to the petroleum activities.' Bahr, 'Oil and Gas in Norway : An Introduction' (February 2018) 1, 5 <<https://bahr.no/wp-content/uploads/2018/04/Oil-and-gas-in-Norway-introduction-2018.pdf>> accessed 24 June 2019. See also Simonsen Vogt Wiig Advokatfirma, 'Parent company guarantee requirement for future decommissioning cost in corporate transfers on NCS' (International Law Office, 18 December 2017) <<https://www.internationallawoffice.com/Newsletters/Energy-Natural-Resources/Norway/Simonsen-Vogt-Wiig-Advokatfirma/Parent-company-guarantee-requirement-for-future-decommissioning-cost-in-corporate-transfers-on-NCS>> accessed 24 June 2019.

entered into by assignor and assignee.⁵⁰ In mitigating the risks of insolvency, the credit rating of the parent company would be considered. For example, in the Norwegian model DSA, agreement B provides that, ‘[i]f the parent company has a lower credit rating when the sales agreement is carried out, or if the credit rating falls below the limit at a later point in time, the buyer must procure a Letter of Credit.’⁵¹

Also, in Denmark, pursuant to Section 32 of the Model Licence, licensees must provide security for petroleum obligations. Security is in the form of parent company guarantees.⁵²

9.4.4. Time for giving security

There will be a trigger date to signal when parties must begin to contribute security for DCG.⁵³ The UK Model DSA defines the trigger date as ‘...the date on which the Net Value is equal to [X%] of the Net Cost’.⁵⁴ In the Norwegian Model DSA which is

⁵⁰ Erlend B Bakken, Merete Kristensen and Karl Erik Navestad note that there have been no cases of default by licensees at the DCG stage in the Norwegian Continental Shelf. Erlend B Bakken, Merete Kristensen and Karl Erik Navestad, ‘Norway’ in Marc Hammerson and Nicholas Antonas (eds), *Oil and Gas Decommissioning: Law, Policy and Comparative Practice* (2nd edn, Globe Law and Business 2016) 411.

⁵¹ Norwegian Oil and Gas Association, ‘Norwegian Oil and Gas Recommended Guidelines for Decommissioning Security Agreement for Removal obligations- Use of Model Clauses’ (No 128) (23 August 2010) 1, 22 <<https://www.norskoljeoggass.no/Global/Retningslinjer/Juridisk/128%20-%20Recommended%20guidelines%20for%20decommissioning%20security%20agreement%20for%20removal%20obligations%20-%20use%20of%20model%20clauses.pdf>> accessed 13 July 2017.

⁵² ‘If the licensee is a branch or a subsidiary of another company, the model licence requires a parent company guarantee to provide security of necessary financial resources. The terms and conditions of the parent company guarantee are set out by the DEA and the guarantee is usually provided by the ultimate parent company. The guarantee is unlimited, irrevocable and without any time limit but does impose a monetary limit.’ Per Hemmer and others, ‘Oil Regulation- Denmark’ (Getting The Deal Through, June 2019) Question and answer 24 <<https://gettingthedealthrough.com/area/24/jurisdiction/52/oil-regulation-2018-denmark/>> accessed 24 June 2019.

⁵³ Peter Roberts and Nicholas Ross-McCall, ‘Decommissioning and the joint operating agreement’ in Marc Hammerson (ed), *Oil and Gas Decommissioning: Law, Policy and Comparative Practice* (Globe Law and Business 2013) 68.

⁵⁴ Oil & Gas United Kingdom Model Decommissioning Security Agreement 2015, Definitions. Clause 6.1 provides the formula for how a Licensee’s share of DCG costs is to be calculated.

based on the UK Model DSA,⁵⁵ the trigger date is calculated as, '[t]he first date when D, calculated in accordance with the following formula; is equal to or larger than zero.'⁵⁶

Despite the differences in the way both formulas are structured, the essence is that the trigger date is reached at a time where the net value of reserves is equal to, or lower than, the estimated remaining net costs, which include DCG costs. The formula for DCG costs is generally subject to an additional risk factor (typically 120-150%).⁵⁷ The inclusion of a risk factor is an attempt to mitigate the uncertainties common to DCG, such as fluctuations in oil prices. The Net Value⁵⁸ of the field is linked to the price of oil or gas; as such the trigger date will be affected by the market price. A long

⁵⁵ Norwegian Oil and Gas Association, 'Norwegian Oil and Gas Recommended Guidelines for Decommissioning Security Agreement for Removal obligations- Use of Model Clauses' (No 128) (23 August 2010) 1, 21 <<https://www.norskoljeoggass.no/Global/Retningslinjer/Juridisk/128%20-%20Recommended%20guidelines%20for%20decommissioning%20security%20agreement%20for%20removal%20obligations%20-%20use%20of%20model%20clauses.pdf>> accessed 13 July 2017. The UK Model DSA is commonly used as a field DSA. However, it is also often adapted for sale and purchase DSAs. For more on this, see Judith Aldersey-Williams, 'Decommissioning security' in Marc Hammerson and Nicholas Antonas (eds), *Oil and Gas Decommissioning: Law, Policy and Comparative Practice* (2nd edn, Globe Law and Business 2016) 93.

⁵⁶ Norwegian Oil and Gas Association, 'Norwegian Oil and Gas Recommended Guidelines for Decommissioning Security Agreement for Removal obligations- Use of Model Clauses' (No 128) (23 August 2010) 1, 41 - Appendix 2 of DSA Model Clause, Agreement B Section 4.4. <<https://www.norskoljeoggass.no/Global/Retningslinjer/Juridisk/128%20-%20Recommended%20guidelines%20for%20decommissioning%20security%20agreement%20for%20removal%20obligations%20-%20use%20of%20model%20clauses.pdf>> accessed 13 July 2017. In another example, the AIPN Model JOA 2012, Exhibit E on Decommissioning Procedures calculates the trigger date as, '[b]eing the first Day of the Calendar Month after the Calendar Month in which the Net Value is less than ___% of the Decommissioning Cost, discounted at the Discount Rate.' AIPN Model JOA 2012, Exhibit E on Decommissioning Procedures -Section 4.2.

⁵⁷ Ashurst LLP, 'Oil and gas decommissioning: present problems, future solutions' (25 July 2011) <<http://www.internationallawoffice.com/Newsletters/Energy-Natural-Resources/United-Kingdom/Ashurst-LLP/Oil-and-gas-decommissioning-present-problems-future-solutions>> accessed 21 April 2017; Ben Holland, 'Decommissioning disputes' in Marc Hammerson (ed), *Oil and Gas Decommissioning: Law, Policy and Comparative Practice* (Globe Law and Business 2013) 195.

⁵⁸ In the AIPN Model JOA 2012, Exhibit E on Decommissioning Procedures- (Definitions), Net value is defined as, 'Operator's bona fide estimate of the aggregate of: the sales value of the quantity of Hydrocarbons forecast to be produced and delivered using:
(Alternative #1)- the production forecast contained in the Development Plan
Multiplied by
(Alternative #1) the weighted average sales price for sales of each type of produced Hydrocarbon from the Contract Area during the preceding Calendar Year'.
Also, 'Discount Rate means interest at ___ percent (___%) per annum'.

period of low oil prices would mean that the net value of the field would be reduced and thus the trigger date could be earlier than anticipated.

Additionally, where there is a significant and prolonged decrease in price it may no longer be economically viable to continue production. The joint venturers must reach an agreement as to whether to continue production or to cease production prematurely. The latter is not a decision to be taken lightly since the participants have a commercial interest in recouping their investment. Yet, where the costs of continuing operations far outweigh profits, with no imminent signs that oil prices will recover, smaller companies may consider early CoP. This has implications on the DSA because the existing security may not suffice to cover the costs of DCG.

9.5. Challenges to the effectiveness of the decommissioning security agreement

The DSA is fit for purpose because it deals with some of the financial risks of DCG. Chief of these is the risk that a JV party may default on its financial obligations for DCG. Also, in relation to the uncertainty that double security may be required from a buyer, the DSA mitigates this issue by ensuring a single stream of security.

Nevertheless, although the intention of the DSA in reducing financial risks is to ensure that there are sufficient funds to cover the costs of DCG, what it is able to do is to cover the estimated costs of DCG. Where there is no shortfall between estimated costs and actual costs, there is no problem and the DSA would have successfully mitigated the financial risks of DCG. However, where the actual costs of DCG exceed projections, the effectiveness of the DSA is reduced. Consequently, the effectiveness

of the DSA as a contractual method of dealing with the financial risks of DCG must also be assessed.

The challenges facing the other selected clauses discussed in this thesis pertain to legal and functional effectiveness. In contrast, the DSA faces a more practical challenge in relation to financial risk, where the funds available under the DSA are insufficient to cover the actual costs of DCG. Some of the issues which affect the projection of costs are oil prices, premature CoP and the formula for calculating security.

9.5.1. Projected costs of decommissioning insufficient: The gap between estimate and reality

The discussion in this section assesses some of the factors which can lead to a disparity between the estimated costs in the DSA and the actual costs of DCG, thereby resulting in underestimation.

Some of the factors which can affect DCG projections are legal, technological or economic changes. An example of the latter is the price of oil. DCG projections are calculated using the net present value of the field, which is affected by the price of oil. Thus, when prices plummet, this affects the net present value and any previous DCG costs estimates. Also, the projected cost of DCG would be linked to the disposal method. A particular disposal method may be viable as at the time of projection, yet depending on the time frame from estimation to actual DCG, that specific option may no longer be economically or even politically viable.⁵⁹ Where this is the case, a

⁵⁹ An example of this is the Brent Spa. Shell had to abandon the initial DCG programme for the Brent Spa, in favour of a more expensive programme, due to severe public and political opposition.

different disposal method could be more appropriate but at a much higher cost. This is but one of the uncertainties of DCG costs estimation.

In projecting DCG costs, the Operator will prepare a DCG plan and then estimate the costs of carrying out the plan. Following this, the Operator has an obligation to update the plan and adjust the cost estimate accordingly. As far as is possible, the Operator would seek to provide an accurate estimation of costs, but there is no guarantee that this will match up with the actual costs of DCG. The standard DSA provides first for agreement between all parties on the costs estimate. Where the parties cannot agree, the agreement will typically provide for expert determination as to the correct estimate of the costs of DCG.⁶⁰ Irrespective of whether the estimate is agreed by the parties or determined by an expert, each party will be required to provide security based on its share of that estimate.

Using a Norwegian example, where a party is using a LoC to provide security under the DSA, the amount due is calculated according to the following formula –

⁶⁰ Norwegian Oil and Gas Association, 'Norwegian Oil and Gas Recommended Guidelines for Decommissioning Security Agreement for Removal obligations- Use of Model Clauses' (No 128) (23 August 2010) 1, 21- Appendix 2 of DSA Model Clause, Agreement B Section 4.11 (Expert Referral). <<https://www.norskoljeoggass.no/Global/Retningslinjer/Juridisk/128%20-%20Recommended%20guidelines%20for%20decommissioning%20security%20agreement%20for%20removal%20obligations%20-%20use%20of%20model%20clauses.pdf>> accessed 13 July 2017; Judith Aldersey-Williams, 'Decommissioning security' in Marc Hammerson and Nicholas Antonas (eds), *Oil and Gas Decommissioning: Law, Policy and Comparative Practice* (2nd edn, Globe Law and Business 2016) 91. Other interested parties in the estimation of costs are, the Department for Business Energy and Industrial Strategy (BEIS) and the Oil and Gas Authority (OGA). BEIS has a significant database of decommissioning costs against which to compare cost estimates.

According to DECC Guidance, even in the absence of a dispute between the parties, an independent audit of the cost estimation of the operator must be carried out at least every three years- with a DECC approved expert verifying the audit. Department of Energy and Climate Change, 'Guidance Notes: Decommissioning of Offshore Oil and Gas Installations and Pipelines under the Petroleum Act 1998' (March 2011) 1, 120 at para 19 <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/69754/Guidance_Notes_v6_07.01.2013.pdf> accessed 09 November 2017.

$A = X \times Y \{x [1-t]\}$.⁶¹ The key for this is: X- Anticipated DCG costs; Y- 1.5; {t}- prior to the Trigger Date: total of current corporate tax rate plus current special tax rate in Norway (or After the trigger Date: 0). However, if no trigger date is used in the calculation, the LoC will be the post tax DCG cost.⁶² The LoC will have a term of 364 days; with the value annually increased or decreased in accordance with the revised estimate of DCG costs.⁶³ In this case, the absence of a trigger date will have a crucial effect on the calculation of security. This example also reflects the importance of regularly revisions and updates to the DCG cost estimate. The LoC cannot be static, it must move with the times and changes which affect the DCG cost estimate.

More generally, the costs of DCG will be estimated using the net present cost (NPC) and net present value of the field (NPV).⁶⁴ The NPC is the estimated cost of performing all DCG activities, multiplied by a risk factor; the NPV represents the value of the expected production along with other receipts from the field and the security already provided.⁶⁵ Where the NPC exceeds the NPV, the difference is the

⁶¹ Norwegian Oil and Gas Association, 'Norwegian Oil and Gas Recommended Guidelines for Decommissioning Security Agreement for Removal obligations- Use of Model Clauses' (No 128) (23 August 2010) 1, 41- Appendix 2 of DSA Model Clause, Agreement B Section 4.3 <<https://www.norskoljeoggass.no/Global/Retningslinjer/Juridisk/128%20-%20Recommended%20guidelines%20for%20decommissioning%20security%20agreement%20for%20removal%20obligations%20-%20use%20of%20model%20clauses.pdf>> accessed 13 July 2017. 41.

⁶² *ibid.*

⁶³ *ibid* 42. Section 4.5 and 4.6.

⁶⁴ Michael Davar and Ben Holland, 'Decommissioning disputes' in Marc Hammerson and Nicholas Antonas (eds), *Oil and Gas Decommissioning: Law, Policy and Comparative Practice* (Globe Law and Business 2016) 198.

⁶⁵ *ibid* 198, 201; Ben Holland, 'Decommissioning in the United Kingdom Continental Shelf: Decommissioning Security Disputes' (2016) 28 Denning Law Journal (Special Issue) 19, 26; Ben Holland and Michael Davar, 'Decommissioning in the United Kingdom Continental Shelf: Net Costs and Net Value Disputes' (Squires Patton Boggs, June 2016) <http://www.squirepattonboggs.com/~/_/media/files/insights/publications/2016/06/decommissioning-in-the-united-kingdom-continental-shelf-net-costs-and-net-value-disputes/23529holland-and-davar-insightarticle.pdf> accessed 16 August 2017.

amount payable as security for the year.⁶⁶ In a hypothetical example, field Athena has a NPC of £60 million, a NPV of £30 million and £22 million in existing security. Using a risk factor of 150%, the security for the year will be £38 million – with each party providing its share according to its participating interest. [(NPC- 60 x 150% risk factor = 90) - (NPV- 30 + 22=52) =£38 million.] Given the implications of these calculations, it is imperative that realistic figures are used for NPV and NPC.

It has been noted that many industry participants consider that, '[a]s a result of prior beneficial market conditions, ...optimistic assumptions as to future "net value" have historically been made'.⁶⁷ The higher the net value calculation, the lower the amount of security to be put up. However, the tide may quickly turn and oil prices plummet, lowering the net value of the field. The implications of this are not so severe where the Operator adjusts the net value calculations in the subsequent year. The difficulty that arises is where net value calculations have persistently been too generous, combined with premature CoP. The result of this is that the security in the DSA could potentially be insufficient to cover the actual costs of DCG. Although exaggerated net value calculations are noted as an historical position,⁶⁸ new-entrant oil and gas operators must avoid falling into this trap.

At the time of actual DCG, the costs will be expended by the Operator and levied to each party under the JOA according to individual participating interest. If a party wishes to challenge such costs it must go through the agreed process under the JOA. In the event that any party does not pay its share of costs, the Operator will have

⁶⁶ Ben Holland, 'Decommissioning in the United Kingdom Continental Shelf: Decommissioning Security Disputes' (2016) 28 Denning Law Journal (Special Issue) 19, 26.

⁶⁷ *ibid.*

⁶⁸ *ibid.*

recourse to that participant's security under the DSA. Where a party becomes insolvent prior to DCG, the security posted would be triggered and held on trust, protected from other creditors.⁶⁹ Such security would be held as the insolvent's party share of DCG costs, subject to a reduction for that party's share of any remaining hydrocarbons and the operating costs of recovering those reserves, according to the formula agreed in the DSA.⁷⁰

Nevertheless, despite the best efforts of the Operator to estimate the actual costs of DCG, there remains the risk that the security posted may be insufficient. There is a paucity of caselaw on issues of underestimation. Where all parties remain solvent, the likelihood of dispute is low as they would simply cover the additional costs according to their participating interests. Nevertheless, two case examples of underestimation are considered. The first example where there were insufficient funds for DCG is the Maureen Field/Facilities⁷¹ in the North Sea which ceased production in 1999.⁷² The projected costs of DCG were £150 million⁷³ but the actual costs were slightly over

⁶⁹ This protection was included in Section 38A of the Petroleum Act 1998, as amended by the Energy Act 2008. <<https://www.publications.parliament.uk/pa/ld200708/ldbills/086/08086.61-67.html>> accessed 16 March 2017. For a discussion, see Squires Patton Boggs, 'Decommissioning in the United Kingdom Continental Shelf: Decommissioning Security Disputes' <<http://www.squirespattonboggs.com/~media/files/insights/publications/2016/01/decommissioning-in-the-united-kingdom-continental-shelf/22069--oil-and-gas-decommissioning-alert.pdf>> accessed 09 March 2017.

⁷⁰ Department of Energy and Climate Change, 'Guidance Notes: Decommissioning of Offshore Oil and Gas Installations and Pipelines under the Petroleum Act 1998' (March 2011) 1, 117 <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/69754/Guidance_Notes_v6_07.01.2013.pdf> accessed 20 March 2017.

⁷¹ The Maureen field was discovered in 1973 Block 16/29a of the United Kingdom Continental Shelf, about 260 km northeast of Aberdeen. The much smaller Moira field was later discovered in 1988, approximately 10km from the Maureen field- developed as a one-well satellite field. Both fields are referred to as the Maureen facilities and were decommissioned together. Department of Energy and Climate Change 'Maureen Decommissioning Programme' (Issue 7, September 2001) 1, 3 <<https://itportal.decc.gov.uk/upstream/decommissioning/programmes/maureen/Sect02.pdf>> accessed 02 May 2017.

⁷² Department of Energy and Climate Change 'Maureen Decommissioning Programme' (Issue 7, September 2001) 1, 3 <<https://itportal.decc.gov.uk/upstream/decommissioning/programmes/maureen/Sect02.pdf>> accessed 02 May 2017.

⁷³ *ibid* 14.

£200 million.⁷⁴ Due to the scarcity of financial information on the field, the writer was unable to determine the reason for the increase, but notes that there was no premature CoP.⁷⁵ Nevertheless, what is clear is that the cash shortfall could have created a significant financial burden. Fortunately, the joint venturers were in a position to pay the actual costs of DCG in full, likely through each party bearing a percentage of the additional costs according to its participating interest. This is the standard process of allocating costs under the JOA. The risk of default in this case would have been worse if one or more parties were insolvent or in financial difficulty, thereby being unable to make further cash contributions.

The second example of underestimation is the North West Hutton Field. Here, the actual costs of DCG was £246 million, a total of £86 million more than the estimated cost of £160 million.⁷⁶ This was due to a number of delays linked to difficulties encountered with the soil type around the field.⁷⁷ As with the Hutton field,

⁷⁴ For a reference to actual decommissioning and disposal costs of the Maureen, see P Broughton, R.L, Davies and M Green, 'Maritime Engineering- Discussion: Deconstruction of the Maureen platform and loading column' (2005) 158(2) Institution of Civil Engineers (proceedings) 85-88 <<http://www.icevirtuallibrary.com/doi/pdf/10.1680/maen.2005.158.2.85>> accessed 02 May 2017 [The paper is a transcription of the discussion which followed the authors' presentation of their paper at an ICE Ordinary Meeting on 16 June 2004]; Rust Resources, 'Case Studies: Maureen Decommissioning' (2016) <<http://www.rustresources.com/case-studies.html>> accessed 03 May 2017. See also University of Aberdeen: Archives and Manuscripts- Special Collections MS 3769/1/155- 'Lives in the Oil Industry' Oral History Archive & associated records: Interview with Geoffrey Moulton Tilling (1944-), chemical engineer (2002-2003) <[http://calms.abdn.ac.uk/Dserve/dserve.exe?dsqIni=dserve.ini&dsqApp=Archive&dsqDb=Catalog&dsqCmd=show.tcl&dsqSearch=\(RefNo==%27MS%203769%2F1%2F155%27\)](http://calms.abdn.ac.uk/Dserve/dserve.exe?dsqIni=dserve.ini&dsqApp=Archive&dsqDb=Catalog&dsqCmd=show.tcl&dsqSearch=(RefNo==%27MS%203769%2F1%2F155%27))> accessed 03 May 2017.

⁷⁵ Production forecasts in the early 1990s had indicated that the economic life of the Maureen facilities would end by the late 1990s. Department of Energy and Climate Change, 'Maureen Decommissioning Programme' (Issue 7, September 2001) 1, 6 <<https://itportal.decc.gov.uk/upstream/decommissioning/programmes/maureen/Sect02.pdf>> accessed 02 May 2017.

⁷⁶ Jee for BP, 'North West Hutton Decommissioning Programme Close-out Report' (2014) 1, 27 <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/371545/NWH_Decommissioning_Programme_Close_Out.pdf> accessed 12 July 2017; Michael Davar M and Gideon Shirazi, 'Decommissioning in the UK continental shelf: a litigator's perspective' (2015) 5 International Energy Law Review 192, 194.

⁷⁷ Jee for BP, 'North West Hutton Decommissioning Programme Close-out Report' (2014) 1, 27 <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/371545/NWH_Decommissioning_Programme_Close_Out.pdf> accessed 12 July 2017

it has been noted that in most of the early cases of DCG in the northern area of the North Sea, the cost estimates were far too low. However, there were no known disputes about payment of the actual costs.

More recently, the UK Oil and Gas Authority (OGA) 2017 Report provides a starting point cost estimate of £59.7 billion to decommission all the offshore oil and gas infrastructure in the UK Continental Shelf (UKCS).⁷⁸ The report sets a target for the industry to reduce through improved knowledge and methods the probabilistic⁷⁹ cost estimate by at least 35% – from 59.7 billion to 38.805 billion.⁸⁰ The objective behind this is, ‘...to save industry and the tax payer money and achieve safe decommissioning for £39 billion or less’.⁸¹ However, this comes with its own challenges. One of these is that Operators seeking to avoid scrutiny from the OGA who will monitor industry’s performance towards the target may feel compelled to underestimate the expected costs of DCG. Thus, the gap between estimation and reality could become wider, leading to a deficit at the time of actual DCG. Although estimated costs from 2018 onwards are lower, at £58 billion,⁸² it has been argued that

⁷⁸ Oil and Gas Authority, ‘UK Decommissioning: Cost Estimate Report 2017’ (June 2017) 1, 3 <<https://www.ogauthority.co.uk/media/3815/ukcs-decommissioning-cost-report-2.pdf>> accessed 12 July 2017.

⁷⁹ ‘*The estimate has been prepared probabilistically*, with an accompanying deterministic assurance estimate, using cost information sourced directly from operators from the 2016 UKCS Stewardship Survey’. Oil and Gas Authority, ‘UK Decommissioning: Cost Estimate Report 2017’ (June 2017) 1, 7 <<https://www.ogauthority.co.uk/media/3815/ukcs-decommissioning-cost-report-2.pdf>> accessed 12 July 2017. (emphasis added).

⁸⁰ *ibid.*

⁸¹ (Gunther Newcombe- OGA Operations Director) Oil & Gas Authority, ‘OGA provides new estimates on the cost of UK oil and gas decommissioning’ (29 June 2017) <<https://www.ogauthority.co.uk/news-publications/news/2017/oga-provides-new-estimates-on-the-cost-of-uk-oil-and-gas-decommissioning/>> accessed 12 July 2017.

⁸² ‘The 7% underlying reduction on a like-for-like basis is primarily driven by rapidly improving planning and execution practices...’. Oil and Gas Authority, ‘UKCS Decommissioning: 2018 Cost Estimate Report’ (June 2018) 1, 3, 5 <<https://www.ogauthority.co.uk/media/4925/decommissioning-cost-report-2018.pdf>> accessed 12 July 2018.

the general lack of experience (albeit slowly improving) with DCG on the UKCS means that any estimate is attended by considerable uncertainty.⁸³

Furthermore, the UK's impending exit from the European Union is likely to have an adverse impact on DCG costs, in terms of DCG equipment or services sourced from the EU. This is particularly the case where freedom of people, goods, services and capital no longer apply post-Brexit.⁸⁴

In the earlier discussion on underestimation in the Maureen Field, it was stated that the participants in the Maureen Field were able to pay the increased costs of DCG (approximately £50m). Fortunate as this was, one must consider the alternative where one or more parties are unable to cover their share of the increased costs of DCG. There are three scenarios in view. First, prior to actual DCG, the Operator adjusts the cost estimates and each party is required to put up more security yearly. (The yearly estimate will adjust the figures so that any impact of oil prices on the NPV will be properly adjusted. Although this reduces the risk of underestimation, it does not eliminate it.) Secondly, due to depressed oil prices the majority of parties agree to a premature CoP, thereby requiring each party to increase its security ahead of actual DCG. Thirdly, at the time of actual DCG, the costs estimates are insufficient because the formula for calculating security was too low.

⁸³ John Paterson, 'Decommissioning Offshore Installations: International, Regional and Domestic Legal Regimes in the Light of Emergent Commercial, Political, Environmental and Fiscal Concerns' (2015) *AMPLA Yearbook* 344, 358. The OGA also notes the lack of industry experience with DCG. See Oil and Gas Authority, 'UKCS Decommissioning: 2018 Cost Estimate Report' (June 2018) 1, 26 <<https://www.ogauthority.co.uk/media/4925/decommissioning-cost-report-2018.pdf>> accessed 12 July 2018.

⁸⁴ Centre on Constitutional Change, 'The Implications of Brexit for the Movement of Goods' <<https://www.centreonconstitutionalchange.ac.uk/publications/reports-briefings/implications-brexit-movement-goods>> accessed 25 January 2019; Tom Batchelor and Ben Chapman, 'Customs union: What is it, what would leaving it mean and what post-Brexit alternatives are there?' (*Independent*, 28 September 2018) <<https://www.independent.co.uk/news/uk/politics/customs-union-what-is-eu-brexit-single-market-alternatives-labour-corbyn-speech-a8557046.html>> accessed 25 January 2019.

In all of these scenarios, a party unable to meet its increased financial obligation or to put up adequate security would be in default, leading the Operator to resort to the usual remedies under the JV, such as the forfeiture of the participating interest. Yet, in this scenario, forfeiture is not an adequate remedy because the field will no longer be producing and there would be little or no value in the interest. Indeed the defaulting party would welcome forfeiture at this stage because its participating interest in the agreement has become a liability rather than a benefit. Therefore, there is the risk that the remaining parties who are solvent would be faced with the additional financial liability of making up the shortfall.

The writer's proposed solution is discussed in section 9.7, after the discussion on decommissioning relief deeds.

9.6. Decommissioning relief deeds

It was earlier indicated that the government will seek to ensure that liability for DCG remains with the licensees, to avoid bearing the costs of DCG through the tax payer. Yet the government is not immune from DCG expenses. It is not uncommon, in countries with mature oil and gas fields, for the government to give a tax relief for DCG expenditure. In the UK for example, the decommissioning relief deed (hereafter DRD) was introduced in October 2013. The DRD is a contract between the UK government and oil and gas companies operating in the UK and the UKCS in relation to tax relief.⁸⁵ Under the UK tax relief regime, a licensee can claim a certain amount

⁸⁵ HM Treasury, 'Decommissioning Relief Deeds: Claim Statement' (2016) <<https://www.gov.uk/government/publications/decommissioning-relief-deeds-claim-statement>> accessed 05 May 2017; Judith Aldersey-Williams, 'Decommissioning security' in Marc Hammerson and Nicholas Antonas (eds), *Oil and Gas Decommissioning: Law, Policy and Comparative Practice* (2nd edn, Globe Law and Business 2016) 96.

in tax deduction for the associated costs of DCG.⁸⁶ The effect of the DRD is to guarantee to individual companies that, if the law changes after 2013 resulting in a company receiving a lower amount of tax relief, the government (HM Treasury) will pay the difference to the company.⁸⁷

The DRD provides that, in such circumstances as are specified in the agreement, if the amount of tax relief in respect of any decommissioning expenditure incurred by the qualifying company is less than an amount determined in accordance with the agreement (the reference amount), the difference is payable to the company.⁸⁸

The DRD is beneficial to IOCs because it provides certainty and stability to oil and gas companies in relation to the tax relief they will receive when DCG assets.⁸⁹ Further, the DRD allows security to be provided on a post-tax basis and not on a higher pre-tax basis.⁹⁰ The practical effect of this is that a post tax calculation frees up capital for investment since less security is tied down in the DSA. According to Tholen, in 2015 the Treasury estimated that ‘...almost £3.5 billion that would have been locked away as security for decommissioning costs has been freed up for

⁸⁶ In the UK, it is estimated that the Treasury is liable for around 50-75% of the costs of DCG, through tax relief. Callum Falconer and Chris Wicks, ‘Decommissioning and the offshore oil and gas life cycle’ in Marc Hammerson and Nicholas Antonas (eds), *Oil and Gas Decommissioning: Law, Policy and Comparative Practice* (2nd edn, Globe Law and Business 2016) 16.

⁸⁷ Edward Milliner and William Watson, ‘Decommissioning Relief Deeds’ (Slaughter and May: Briefing Notes, September 2013) <<https://www.slaughterandmay.com/media/2003911/decommissioning-relief-deeds.pdf>> accessed 19 July 2017. This will be applied to a hypothetical scenario. Under the Finance Act 2013, company A would have received £500,000 (the reference amount) as tax relief, but a subsequent change in law results in an amount of £420,000 in 2025 when DCG takes place. Company A is entitled to claim the difference of £80,000 from the government.

⁸⁸ HM Treasury, ‘Decommissioning Relief Deeds: Claim Statement’ (2016) <<https://www.gov.uk/government/publications/decommissioning-relief-deeds-claim-statement>> accessed 05 May 2017.

⁸⁹ *ibid.* On a different note, recall that chapter 4 on the stabilisation clause indicated that the UK does not give stabilisation guarantees. Yet, the DRD has some semblance to the stabilisation clause because by committing not to amend the amount of tax relief under the agreement, the DRD is in effect a stabilisation guarantee in respect of tax relief for DCG costs.

⁹⁰ Ben Holland, ‘Decommissioning in the United Kingdom Continental Shelf: Decommissioning Security Disputes’ (2016) 28 *Denning Law Journal* (Special Issue) 19, 27.

possible investment in further production...'.⁹¹ This is good for investment in the UKCS. It is also good news for first-tier participants to the DSA (current licensees) because less security is required under a post-tax calculation. However, this is not without challenges. The previous position (pre-tax) meant that more security was provided, thereby reducing the risk of underestimation. The current position (post-tax) means that a lower rate of security is provided. Consequently, it is possible that the post-tax calculation leads to a scenario where the funds available in the DSA are not sufficient to cover the actual costs of DCG. This is not to suggest that the DRD will always lead to underestimation, rather that, it increases the likelihood that there may be a gap between the estimated costs and actual costs of DCG. The only way to mitigate this is for parties to use an increased risk factor in the calculation of security. However, parties may be hesitant to agree to this.

To the best of the writer's knowledge, there are no other countries using a DRD; therefore, there is no way to compare how the problem may be addressed in other jurisdictions.

Despite the challenges to the DSA, it remains an effective means of mitigating the financial risks of DCG. This is because it reduces the risk that there may be no security to cover the estimated costs of DCG. It also protects the security contributed from other creditors in the event of insolvency. The DSA is not a liability because current and historical licensees are able to reduce their exposure to financial risk by being party to the DSA. However, there are methods through which the effectiveness of the DSA could be enhanced. These are explored below.

⁹¹ (Mike Tholen- Oil & Gas UK's Economics Director) Oil and Gas UK, 'Oil & Gas UK Welcomes Evidence of Effectiveness of Decommissioning Relief Deeds' (21 July 2015) <<http://oilandgasuk.co.uk/oil-gas-uk-welcomes-evidence-of-effectiveness-of-decommissioning-relief-deeds/>> accessed 19 July 2017.

9.7. How can the effectiveness of the decommissioning security agreement be enhanced?

This section makes a number of recommendations on how IOCs can enhance the effectiveness of the DSA, thereby limiting the financial risks which participants are exposed to.

Sliding scale security

The UK Industry Model DSA 2015 includes an option for the parties to adopt a stepped factor in relation to the risk factor.⁹² The percentage of the stepped factor is reduced as DCG becomes more imminent and cost issues are better understood by the Operator.⁹³ The thesis' recommendation of 'sliding scale' security expands upon this option.

Having determined that the effectiveness of the DSA is dependent on accurate costs estimation, it is vital that participants to a DSA seek to mitigate challenges which may affect the projection of costs. A significant factor which affects DCG estimate is the price of oil. Operators can adjust future projections for net cost in line with the current price of oil. Indeed, it is better that any future projections as to the value of the remaining hydrocarbons in the reserves are based on an expectation that oil prices will be low. This will increase the amount of security provided and limit the risks that the security in the DSA may not cover the actual costs of DCG. Clearly, first-tier participants will not welcome the idea of paying higher security at a period

⁹² See Clause 6.

⁹³ Judith Aldersey-Williams, 'Decommissioning security' in Marc Hammerson and Nicholas Antonas (ed), *Oil and Gas Decommissioning: Law, Policy and Comparative Practice* (2nd edn, Globe Law and Business 2016) 94.

where oil prices are low. Therefore, it would be more efficient to project higher values of security during the first ten years of production when the field is generating a steady and attractive income. In subsequent years, if the price of oil decreases, the amount of security required may be reduced by an agreed %. The security contribution is thus on a sliding scale as higher security is required in the early years of production, with reduced security towards the end of production. The benefit of this is that there is a reduced risk of underestimation since higher security is made at the beginning of production. Also, it reduces the impact of any insolvency which may occur during the later phase of production, since each participant would have already made significant contributions.

This writer accepts that a high rate of security will dissuade smaller companies due to limited resources. However, major IOCs tend to sell their interest to smaller IOCs when the profitability of the field is reduced, during the later stage in the production phase. Therefore, such smaller companies need not be deterred since the formula used to calculate security would result in a lower amount of security during the later phase of field life. Also, although a higher rate of security will tie up funds which could be used for investment, it is argued that this is small price to pay to guarantee that there will be enough funds to cover the costs of DCG. More so, the higher rate will be adjusted over time as the sliding scale formula will lead to a lower rate of calculation later. At this point, more funds would be released which could be used for investment. The pursuit of investment should not be at the sacrifice of the financial security of the DSA.

Sliding scale arrangements are not new to the oil and gas industry. Where royalty is payable to the state, it is not uncommon to use a sliding scale rate. This

calculates the amount of royalty payable by the IOC according to the volume of oil or gas extracted from the contract area.⁹⁴ This is in contrast to fixed royalty rates. Sliding scale rates are more flexible and may be used to incentivise increased or decreased production. For example, the state may impose a higher rate of royalty where the IOC reaches a specified high level of production within a specified time frame. The IOCs may consider that it is worth paying increased royalties where the market price of oil is high. Also, in a PSC where the state and IOCs share production as profit oil, a sliding scale rate can be used to allocate the percentage of profit oil. Where production increases, the state will receive an increased percentage of profit oil.⁹⁵ Thus, given the use of sliding scale arrangements in other areas of oil and gas, the concept should be easily transferrable to the area of DCG security.

Security projections: Approvals by Second-Tier Participants

Under the UK Petroleum Act 1998, a section 29 Notice to prepare a DCG programme can be issued to a wide range of participants, including historical licensees. Therefore, historical licensees (second-tier participants) have an interest in ensuring that current licensees (first-tier participants) are making sufficient contributions into the DSA to cover the costs of DCG. The UK Model DSA 2013 includes an optional provision dealing with the rights of second-tier participants, either to approve or merely comment on the DSA.⁹⁶ However, the inadequacy of security presents a real financial liability to both participants; therefore it is not enough that second-tier participants

⁹⁴ Ernest E Smith and others, *Materials on International Petroleum Transactions* (Rocky Mountain Mineral Law Foundation 2010) 451.

⁹⁵ An example of this is contained in the Model Bangladesh Production Sharing Contract 2012- Table 14.6, page 37 (Profit Oil).

⁹⁶ Oil & Gas United Kingdom Model Decommissioning Security Agreement 2013, Appendix 5, paragraphs 7.10 and 7.11.

remain satisfied with mere commenting on security proposals, a higher degree of participation in the DSA is required. Second-tier participants have a direct interest in policing the DSA. Therefore, it is argued that they should seek to negotiate for the inclusion of an appropriate provision in the DSA which gives second-tier participants the right to approve the Operator's proposals on security. This could be in the form of giving second-tier participants a veto. The provision would allow second-tier participants to provide evidence (eg, related to oil price, choice of DCG programme) which may indicate that security contributions by first-tier participants ought to be higher, so as to avoid subsequent underestimation. Where there is a dispute as to the evidence presented, the dispute should be referred to arbitration or an independent expert.

Use of forfeiture provisions to deal with default pre decommissioning

The provisions of the relevant JV in relation to default have direct implications on the DSA. The use of the FC to deal with default in the JOA has beneficial effects on the DSA. Default in JOAs and some of the contractual methods for its mitigation, most especially forfeiture, were discussed in chapter 6. The inadequacies of alternatives to forfeiture were also there discussed. Where the default provision contained in the JOA does not provide a permanent remedy, the consequences of keeping a financially unstable party in the JOA will be felt in the DCG phase. In the event of default prior to the DCG stage, the use of the FC offers a final solution – the removal of the financially unstable party from the JV. For the purposes of the DSA, the party or parties acquiring the forfeited interest will acquire the chance to make increased profits, as well as additional liability which includes security for the DSA. In contrast,

where there is a withering option – a less restrictive variant of the forfeiture provision – the breaching party will only forfeit a fraction of its interest according to the amount owed.⁹⁷ This may simply be delaying the inevitable if the defaulting party is in real financial problems. Furthermore, this party may become unable to keep up with its obligations to provide DCG security or it could become insolvent later on. Although the FC is not without challenges, to better protect the DSA, it is recommended that forfeiture provisions, in particular the targeted FCs recommended (rather than other default remedies) should be used to mitigate the risks of default.

Collaboration with the industry

Lastly, collaboration with relevant stakeholders such as Oil and Gas UK, as well as with other Operators in the North Sea is essential. This collaboration is key to knowledge sharing which will reduce unnecessary costs.⁹⁸ As far as possible, Operators must avoid economic waste when expending actual DCG costs. Although no two fields are exactly the same, Operators of fields with similar time frames for cessation of production can procure DCG equipment and supplies together, which can save costs. Small measures such as this will reduce overspending and keep Operators close to the limit of security available in the DSA.

⁹⁷ Peter Roberts, *Joint Operating Agreements: A Practical Guide* (3rd ed, Globe Business Publishing 2015) 232-236.

⁹⁸ Decom North Sea, 'Decom News' (February 2016, Issue 23) 1, 5 <http://decomnorthsea.com/uploads/pdfs/newsletters/decom_feb16_spreads.pdf> accessed 05 May 2017.

Conclusion

The DSA is an essential contractual method of reducing financial risk at the DCG stage in a long term oil and gas joint venture. Nevertheless, the discussion has shown that underestimation remains a real risk for joint venturers party to a DSA. The consequence of this is that parties to the DSA would be faced with additional financial liability. This chapter has argued that the use of sliding scale security will reduce the risk of underestimation since higher contributions are made during the early years of production. In addition, this option ensures that even if a party were to become insolvent later on towards the time of DCG, it would have already made significant contributions towards the cost of DCG. This reduces the financial impact of an insolvency on the solvent parties.

It was also recommended that the DSA include a provision which allows second-tier participants to veto security proposals by the Operator. Such form of 'policing' would also reduce the risk of underestimation since the Operator would be aware that the proposal would be subject to significant scrutiny.

Additionally, although the forfeiture provision has its challenges, it has been argued that the JOA deal with default through forfeiture as it removes any financially unstable party from the JV. This reduces the risk of default prior to and at the DCG phase.

The DSA can be likened to a harvest; participants reap what they sow. To be sure of a good harvest, participants must sow enough during the years of 'plenty' to avoid getting caught out in fallow times. Admittedly, paying higher rates of security during the later stages of development and during early production comes at a price (increased costs), yet the benefits of this decision will be felt when the actual costs of

DCG are expended. Parties who are in the process of negotiating DSAs must be brutal in arriving at the agreed formula for security – higher rates of security are in the best interest of all parties if they wish to avoid incurring additional liability.

The next and last chapter contains recommendations and conclusions on the thesis.

CHAPTER 10

RECOMMENDATIONS AND CONCLUSIONS

This thesis has endeavoured to examine the effectiveness of contractual clauses used to reduce risks and uncertainties in LOTOGAs. It focused on the legal and functional effectiveness of the six selected clauses. The discussion on each of the selected clauses provided recommendations on how the clause could be made a more effective method of risk mitigation. This final chapter draws the recommendations together.

In the analysis of the preventative and protectionist views of the SC, the conclusion is that the SC should realistically be viewed as serving a protectionist role, which is to ensure that the IOC is duly compensated if the state affects the terms of the LOTOGA. The current practical limitations of the SC were identified and it was recommended that a 'SC damages provision' be used as an effective way of enhancing the value of the SC. A SC damages provision recognises and respects state sovereignty, but seeks to protect and compensate the IOC from the state's exercise of its sovereignty. Nevertheless, it must be stressed that a damages provision may face challenge as an unenforceable penalty. To mitigate this, it is recommended that IOCs frame the provision as an option, rather than a response to a breach of contract. That is, the decision of the state to act contrary to the SC is not a breach, but rather the exercise of an option for which a specified amount is payable to the IOC.

It was noted that the Australian position on the penalty rule stands in stark contrast to the English position, chiefly because it can apply to a provision that is not enlivened by a contractual breach. This thesis argues that the English position is preferable for IOCs as it provides another level of protection for IOCs seeking to

enforce a SC damages provision, FC, GBA or ToP clause. More importantly, the Australian position is in great danger of opening the floodgate of litigation/arbitration in relation to penalty clauses. Notwithstanding, one must not ignore the reality that numerous oil and gas joint venture agreements will be governed by Australian law, and therefore provisions capable of engaging the penalty rule must be revised and protected to ensure they pass the penalty test. In a contract governed by Australian law, the recommendation for IOCs is to concentrate on demonstrating the legitimate interest served by the provision, and that the provision is neither unconscionable nor exorbitant.

In the analysis of the revised penalty test as laid down in *Makdessi*, the discussion in chapters 6, 7 and 8 led to the conclusion that there remains a considerable degree of uncertainty in distinguishing between primary and secondary obligations in many commercial contracts. Although IOCs may seek to disguise a concerned provision as a primary obligation, it has been contended that this will not always be successful, particularly in relation to the FC. This thesis has argued that the superior strategy to protect the operation of the FC is for IOCs to focus on making sure it passes the *Makdessi* test for secondary obligations. Nevertheless, despite the uncertainty presented by the primary/secondary divide in the revised penalty test, there have been no pressing recommendations to amend the test. In expressing its final view on the penalty rule, the Scottish Commission held that the rule should not be abolished, and that legislative reform would not be recommended prior to seeing

how the law develops post *Makdessi* and *ParkingEye*.¹ In this writer's view, the conflicting decisions in *Gray*² and *Purves*³ highlight the uncertainty that can be expected in future decisions on the penalty rule.

The discussion also considered relief from forfeiture. The conclusion on this is that although an English court is unlikely to follow the approach in *Jobson*⁴ which 'scaled down the forfeiture', since this amounts to rewriting the provision, the innocent parties may avoid a claim for relief against forfeiture by using targeted forfeiture provisions which apply to different stages of the oil and gas operations. The effect of targeted forfeiture provisions is to demonstrate that the forfeiture reflects a fair commercial result and that the provision is neither unconscionable nor exorbitant. To illustrate the working of such FCs, sample clauses have been suggested in this thesis.⁵

Another issue considered in this thesis is the possible impact of systems of governance on the selected clauses used to mitigate risks in LOTOGAs involving a state party. In the different systems of governance considered, the conclusion on the RC is that it serves as an effective method of mitigating political risks, as well as a

¹ It gave three primary reasons for its decision. Firstly, the evidence thus far did not indicate that the decision from both cases was creating major difficulties in legal practice. Secondly, the reformulation of the penalty test is still capable of being used to strike down clauses which are excessively penal in their effects. Thirdly, in its view, the Supreme Court has pointed the law in the right general direction (in line with the position largely in the rest of Europe), while leaving it open for further refinement in the future. Scottish Law Commission, *Report on Review of Contract Law: Formation, Interpretation, Remedies for Breach, and Penalty Clauses* (Scot Law Com No 252, 2018) 1, 190-195 <https://www.scotlawcom.gov.uk/files/1115/2222/5222/Report_on_Review_of_Contract_Law_-_Formation_Interpretation_Remedies_for_Breach_and_Penalty_Clauses_Report_No_252.pdf> accessed 17 June 2018.

² *Gray v Others v Braid Group Holdings Limited* [2016] CSIH 68, 2016 SLT 1003.

³ *Richards and Purves v IP Solutions Group Ltd* [2016] EWHC 1835 (QB). Also known as *Richards Anor v IP Solutions Group Ltd* [2016] EWHC 1835 (QB).

⁴ *Jobson v Johnson* [1989] 1 WLR 1026. The Court of Appeal scaled down the forfeiture. This decision has received mixed judicial treatment.

⁵ See Chapter 6, section 6.4.

broad range of changes which affect the LOTOGA. It was also recommended that IOCs include an express obligation to negotiate in good faith in the RC. A sample clause was provided.⁶ Despite concerns that a RC can reduce the stability of the LOTOGA, it was argued that the RC can actually be beneficial in the pursuit of stability. The thesis advanced five arguments why IOCs should include the RC as an essential contractual method of risk mitigation in LOTOGAs.

Chapter 7's discussion of the GBA argued that a provision leading to the loss of gas volumes can only engage the penalty rule where the underproducing party commits a breach by not taking its make-up gas. Where the GBA specifies that the underproducing party has the right but not the obligation to lift its volumes of make-up gas within the specified time limit, the failure to exercise that right does not constitute a breach. Consequently, the provision cannot engage the penalty rule. The language in most JOAs indicates that each party has both a right and an obligation to lift its share of gas produced. To avoid the penalty net, it was recommended that the GBA indicate that the obligation to lift gas does not apply to make-up gas, and that an underproducing party has the right and not the obligation to lift make-up gas. The thesis has suggested a sample clause to this effect.⁷ It must be stressed that IOCs with GBAs of this nature must ensure that there is a legitimate interest for the imposition of the time-based forfeiture of gas, also that it is neither unconscionable nor exorbitant. This thesis has argued that the innocent parties' legitimate interest is commercial certainty. The evaluation of exorbitance/unconscionability is essentially a fact based assessment. The volumes of make-up gas would be a consideration.

⁶ For the convenience, the sample clauses proposed by this thesis will be set out below.

⁷ *ibid.*

Additionally, a time limitation which is consistent with industry standards would aid in the defence that the provision is proportionate to the legitimate interest protected.

Similarly, the analysis of the ToP clause in chapter 8 concluded that although the re-evaluation of the penalty rule under *Makdessi* makes the ToP clause vulnerable, the provision is likely to be enforceable. The language of a ToP clause is central to whether it can engage the penalty rule or not. It was submitted that although ToP provisions are likely to be interpreted as a primary obligation, the decision rests on how the provision is framed. Furthermore, the ability of the seller to discharge its reasonable endeavours obligation to supply make-up gas will weaken the buyer's argument as to the ToP provision being an unenforceable penalty. Although the seller is not required to sacrifice its commercial interests, this thesis indicated some of the efforts the seller should make in discharging its obligation of reasonable endeavours. The position taken is that the reasonable endeavours obligation of the seller to supply make-up gas must be framed as clearly as possible, with the use of examples (where possible). The effect of this is to avoid disputes resulting from the buyer's disappointment, it also weakens a challenge by the buyer as to the ToP provision being an unenforceable penalty.

Chapter 9's assessment of the DSA found that although the purpose of a DSA is to ensure that the required funds are available to cover DCG costs, there could be situations in which the actual costs of DCG exceed the estimated costs in the DSA. It was argued that this could be linked to early CoP, market price volatility, or where the formula for calculating DCG security was based on an exaggerated net value. Nevertheless, it was concluded that the DSA is fit for purpose because it deals with

some of the financial risks of DCG – the risks of default, insolvency and early CoP indicate that it is far better to have a DSA than not to have one at all.

However, the DSA cannot guarantee that there will be enough funds to cover the actual costs of DCG. It can only guarantee that parties provide security towards their share of estimated DCG costs. In a sense, the effectiveness of the DSA is tied to the accuracy of the formula for calculating DCG costs. Where DCG estimations are made closer to the time of actual DCG, the risk of underestimation is reduced.

It is recommended that parties to the DSA limit their financial risk through the use of sliding scale security. Another recommendation is that second-tier participants should be given the right to present evidence on the calculation of security, rather than mere commenting. This could include a veto on the Operator's security proposals. Furthermore, given the impact of financial default by any party on the JV, this writer argued for the use of forfeiture provisions to deal with default prior to DCG. The removal of a financially unstable party from the JV reduces the financial risk remaining joint venturers are exposed to.

Finally, much as contractual risk mitigation features heavily on the agenda of the IOC, IOCs should consider that a LOTOGA with a host state is intended to be mutually beneficial. Where the terms of the agreement ensure such mutual benefit, many host states would be hesitant to resort to unilateral change of contract, nationalisation or expropriation, in a bid to secure greater benefits for the state. In situations where the state considers that the IOC is 'making a killing', it is more likely to use its sovereign position to affect the LOTOGA, so as to generate more revenue. Also, IOCs must consider that despite best efforts to mitigate risks through contractual methods, it is not always possible to mitigate every risk or uncertainty

through contract. Therefore, it is crucial that IOCs understand the importance of pursuing a positive relationship with any contractual party, be it state, other IOCs or buyers. In circumstances where the LOTOGA is affected by events not mitigated through contract, IOCs should rely on the goodwill of the other contractual party in order to make relevant changes – such changes may prove difficult where relationships are broken down between the parties. Therefore, much as contractual risk mitigation through the selected clauses is crucial, this should not do away with party relationship. An agenda for future research is to explore the relational side of LOTOGAs. It would be interesting to see the extent to which IOCs regard the pursuit of positive party relationships as a form of risk mitigation.

In summary, this thesis has advanced a number of arguments and offered various suggestions including sample contractual provisions to enhance some of the clauses studied. For the convenience, the sample clauses proposed by this thesis are set out below, in the order in which they are considered in the thesis.

1. *SC damages provision:*

The state commits itself to ensure stable investment conditions for the IOC. Where legal, political or economic conditions compel the state to alter or affect the economic equilibrium of the LOTOGA through legislative, regulatory or other measures, the state reserves the right to effect such changes. Pursuant to this, the IOC is to receive full financial compensation for the economic detriment of the change to the investment conditions on the LOTOGA and consequently the IOC. This compensation is payable no later than 120 days from the first date the economic equilibrium of the LOTOGA was altered or affected by state action.

2. *A good faith obligation in a RC:*

Where the renegotiation clause is triggered, the contracting parties agree to renegotiate in good faith, with the primary purpose of arriving at a renegotiated agreement which maintains the economic equilibrium of this

Agreement. Actions indicative of good faith include, but not limited to, full engagement in renegotiations, evidence-based consideration of how the trigger event has affected the economic equilibrium of the LOTOGA, the use of experienced and well-advised negotiators, timely consideration of relevant factors, clear evidence of reasonable compromise on the issue or issues renegotiated e.t.c. Where renegotiations are unsuccessful, the party resisting a renegotiated agreement must provide an impact assessment which proves that it has reasonably considered the legitimate interests of the other party seeking renegotiation, and that acquiescence to the form of renegotiation sought would amount to a disproportionate sacrifice of its own commercial interests.

3. *Provision avoiding double jeopardy after the application of a FC:*

Following the application of the forfeiture provision, the innocent parties agree not to pursue any claim against the breaching party for damages at common law. The defaulting party must however satisfy its obligations in relation to decommissioning.

4. *Forfeiture clause for the exploration phase in a joint venture:*

Where a financial default remains uncured at the last day of the grace period, the defaulting party will forfeit its participating interest in the JOA.

Following such forfeiture at the exploration phase prior to a commercial discovery, an innocent party or parties is to acquire the forfeited interest freely according to its respective participating interest in the joint venture.

5. *Forfeiture clause for the appraisal phase in a joint venture:*

In the interests of a fair commercial result, it is agreed that the defaulting party will receive ——% of its total cash-call contributions in cash within six months from the date of the commercial discovery. The remaining —— % deduction from the total cash-call invested is accepted by all parties to be a concession for the additional risks borne by the innocent parties.

6. *Forfeiture clause for the development phase in a joint venture:*

Where a financial default remains uncured at the last day of the grace period, the defaulting party will forfeit 30% of its participating interest in the JOA. The innocent parties who acquire the forfeited interest must pay the defaulting party a total of 14.5% of its total cash-call contributions (at the date of forfeiture) in a once and final cash payment within six months of forfeiture, or in kind at the date of first production. This amount is

payable in accordance with the participating interest acquired by each innocent party. (The failure of the innocent parties to comply accordingly will lead to the defaulting party reacquiring an additional 5% of its interest.)

The non-payment of the remaining 15.5% of the defaulting party's cash contributions is accepted by all parties to be a concession for the additional risks borne by the innocent parties.

7. Forfeiture clause for the production phase in a joint venture:

Where a financial default remains uncured at the last day of the grace period, the defaulting party will forfeit 40% of its participating interest in the JOA.

The innocent parties who acquire the defaulting party's interest must pay the defaulting party 23% of its total cash contributions in a once and final cash payment within six months of forfeiture, or in kind within three months of forfeiture. (The failure of the innocent parties to comply accordingly will lead to the defaulting party reacquiring an additional 6% of its interest.)

The non-payment of the remaining 17% of the defaulting party's cash contributions is accepted by all parties to be a concession for the additional risks borne by the innocent parties.

8. Forfeiture clause for the development phase in a joint venture:

Where default occurs towards the end of the life of the reservoir and the defaulting party fails to cure its default by the last day of the grace period, it shall be deemed to have withdrawn from the agreement, subject to its remaining liabilities under the agreement. The Operator shall lift such party's allocation of hydrocarbons if the field is still producing (albeit nearly depleted) and shall sell this at arm's length. After such sale and upon a deduction of associated costs including the amount in default, the Operator shall credit any excess monies towards the defaulting party's decommissioning liabilities.

9. Provision relating to make-up gas in a GBA:

Each party has the right and obligation to lift its share of gas produced. However, the failure of any party to lift all its share of production during any lifting period will not be considered a breach, provided another party is able to lift the volumes of underlift. An underproducing party has the right but not the obligation to lift its volumes of make-up gas within — months. Where such volumes are not lifted by the said date, the underproducing party will be taken to relinquish its rights to such volumes of make-up gas.

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