The Rationale and Instrumentalities for Stability in Long-term State Contracts

The Context for Petroleum Contracts

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I. INTRODUCTION

Risk and uncertainty are basic features of long-term State contracts. The viability of long-term contracts depends upon effective and efficient distribution of risk and reward between the parties and adjustment to future pressures for change. Long-term State contracts, including petroleum agreements, involve complex legal and economic issues and important policy considerations, which suggests that they should not be viewed as isolated and discrete commercial transactions but that their performance depends upon the sustained relationship between host State and company.

Stability in the contractual relationship becomes particularly relevant to the petroleum contract for the two basic propositions associated with it: that it is essentially a long-term contract; and that it falls into the category of State contracts. The fact that these are of long duration means that changes of circumstances may eventually materialize and may frustrate the objectives of the parties. Therefore, a stable contractual relationship is conditioned by the contract’s capacity for survival in the face of changes of circumstances and by the accommodation of changing expectations in the framework of contract and the adjustment of contractual rights and duties in a changed context. On the other hand, the legal characterization of a petroleum contract as a form of State contract always raises the issue of the prerogatives of States, which presupposes that public interest in one degree or another is always involved and posits the context of broad social, economic, and political conditions under which the contract is entered into and is performed.¹

The importance of stability in petroleum contracts can hardly be over-emphasized. The perception of instability in the legal and regulatory regime that governs the contract plays a significant role in the investment decisions of petroleum companies. At one end of the spectrum, investors assess the stability of the negotiated contract by

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reference to the host countries' political and judicial institutions, laws and policies and their attitudes towards foreign investment, which in turn help them to determine the profitability of the project. At the other end of the spectrum, a commitment to the stability of the legal and regulatory scheme which ensures that the foreign investor will receive consistent legal treatment in the future can increase the ability of States to attract investment in the natural resources sector. It is axiomatic that perceptions of instability in the overall investment climate of a country can increase bargaining costs, delay the exploration envisaged in the project and induce the invocation of harsh terms and conditions in petroleum contracts, which can act as a deterrent factor in attracting foreign investment.

The main objective of this article is to examine the notion of stability in petroleum contracts in the light of the present context of contract negotiation and contract drafting and to identify underlying sources of contract instability. It also provides guidelines about the factors shaping the notion of stability and sheds light on instrumentalities to ensure stability in petroleum contracts. Finally, it briefly discusses the nature and kinds of stability guarantees that are offered to the international petroleum companies against political and regulatory risks.

II. THE NOTION OF STABILITY IN MODERN PETROLEUM CONTRACTS

In the context of long-term investment contracts, the notion of stability generally refers to the preservation of the underlying expectations of the parties created out of the contract. It denotes a maintenance of the internal balances and financial assumptions behind the contractual undertaking of the parties. Any definition of stability in long-term State contracts should take into account the temporal and economic dimensions. Stability has a temporal dimension to the extent that it requires the continuity of the contractual relationship towards its successful completion and the achievement of desired objectives as contemplated by the parties. The economic dimension, which is also regarded as the most important indicator of a stable contract order, implies maintaining the contractual equilibrium perceived by the parties throughout the duration of the contract. In this regard, contractual equilibrium denotes maintaining stability for the fulfilment of the legitimate expectations of the parties over the life of the project arising out of such a contractual relationship. The notion of "legitimate expectation" covers not only the profitability of the project for the company but also takes into account the economic and social objectives that a State desires to pursue through such contracts.

However, a balanced notion of stability does not seek the continuity of a contractual relationship at the expense of its dynamism, but necessarily it recognizes the evolution of the relationship and changes of circumstances which may be inevitable in one form or another in long-term contracts. This assertion is equally true for petroleum contracts and can be testified to by the design of contracts and contract negotiations that