5.8 Investment Guarantees: Stabilization

A challenge to the design of any optimal legal and fiscal regime for oil, gas or mining is created by the combination of unknowns at the time the contract is signed and the volatility of markets for these resources once extracted. ‘Changed circumstances’ is a familiar doctrine in international law (*rebus sic stantibus*) but it acquires greater than usual force in the EI sector when prices may rise or fall with precipitous speed, magnitude and duration, with disruptive consequences for all parties. Governments have the legal capacity to introduce new laws or revise the terms of existing contracts in response to these and other changed circumstances. Their sovereign power to do so is not in question. Once an investor has taken the initial risk and proved that a commercial deposit exists, the allocation of risks in the original bargain shifts from the capital-hungry state to the investor. The resulting ‘political risk’ of unilateral alteration of acquired rights has encouraged the industry practice of using *stabilization* instruments such as clauses in contracts with host governments or separate stability agreements.

Stabilization instruments take many forms but the very idea is often criticized because it appears to invite states receiving investment to fetter key sovereign rights. In the text of the Model Mine Development Agreement (MMDA), Section 13.2 on tax stabilization cautions: “Stabilization Clauses are very controversial, even within the MMDA Working Group. Neither this generic clause nor the example clauses provided reflect the opinions of the Working Group.”[1] Their target is not to stabilize markets but to limit the consequences of a *political* response to market changes (such as a very large rise in prices) or legislative actions due to other circumstances (such as a realignment of domestic politics affecting foreign investment). The principal beneficiary of stabilization is the foreign investor but the state too can benefit by acquiring a competitive advantage over a neighbour by including such an incentive in a bid to attract capital from investors that typically will have a number of options in their portfolios.

Form of stabilization. The majority of stabilization instruments take a contractual form. The practice of including clauses in mining and hydrocarbons agreements with host states is widespread but not universal. It is an option for the host state to take a policy decision on. The four main kinds of stabilization clause are

---

[1] MMDA, 13.2: Tax Stabilization Clause at p.89.

described in Box 5.11[2]. It is important to note that hybrids are common and that more than one form of stabilization clause may exist in a single contract, representing a kind of 'belt-and-braces' approach on the part of the investor. In practice, the names of particular types of clause may well vary from one actual contract to another, underlining that any classification is for guidance purposes only. However, the essential idea is the same: the parties to the agreement seek to provide contractual assurance that the investment terms at its core will remain the same over the life of the agreement.

Carve-outs It is common for a state to insist upon a narrowing of the scope of a stabilization clause, so that for example, matters of health, safety and environmental protection are sometimes expressly excluded from its scope.

Stability Agreements. Some countries offer distinct stability agreements. Chile, for example, enters into such agreements for mining investments made under a concession. Taxes specified in the agreement, applicable to the investment, as well as customs and foreign exchange provisions for the payment of costs and the repatriation of profits and capital, are 'frozen' for terms of up to 20 years. The agency is the Foreign Investment Committee. Ghana is another example. Under its Minerals and Mining Act 2006, section 48, a stability agreement may be granted for the mining lease holder's interest. This has a term of 15 years and protects the holder of a lease from being adversely affected by future changes in laws that result in heavier financial burdens being imposed on the leaseholder. It has to be ratified by the Parliament. If a development agreement is entered into, under Section 49 of the same Act, it may contain stability terms. This kind of agreement is also subject to ratification by Parliament. In the hydrocarbons sector, both Timor-Leste and Nigeria have provided dedicated instruments for stabilization prior to investments being made, mostly in the natural gas sector. Some Latin American countries have provided for stabilization agreements that cover various kinds of forward investment and not only mining, oil and gas investments.

Asymmetry A dimension of these clauses which governments may want to consider carefully before agreeing to them is their occasional asymmetry. As Drs Sunley and Daniel have stated:

> "[t]he fiscal stability clauses in many mining and petroleum agreements are asymmetric: protecting the contractor from adverse changes to the fiscal terms but passing on benefits of reductions in tax rates or other changes beneficial to the contractor…"

[2] The following is drawn from P Cameron (2010), International Energy Investment Law: the Pursuit of Stability, Oxford University Press, Oxford.

Box 5.11: The Four Main Forms of Stabilization Clause

Freezing In its strictest form a freezing clause prohibits the host state from changing its laws and handcuffs the state so that it cannot exercise its sovereign rights to change its law with respect to the particular contract containing the stabilization clause. It may also ‘incorporate’ the country’s laws in their entirety at the time the contract was signed into the particular contract creating a special governing law.

> **Example:** “The Government hereby undertakes and affirms that at no time shall the rights (and the full and peaceful enjoyment thereof) granted by it under Article [X] (Income Taxation), Article [X] (Royalty), and Article [X] (Other Payments to the Government) of this Agreement be derogated from or otherwise prejudiced by any Law or the action or inaction of the Government, or any official thereof, or any other Person whose actions or inactions are subject to the control of the Government. To the extent there is inconsistency between the [Tax Law] as defined in Article [X] (Taxation), the Agreement shall govern” (MMDA, 13.2).

Intangibility This attempts to freeze the contract rather than the law. It prohibits unilateral changes to the investment agreement and requires the consent of both parties before any changes may be made.

> **Example:** “The government will not without the agreement of the contractor exercise its legislative authority to amend or modify the provisions of this Agreement and will not take or permit any of its political subdivisions, agencies and instrumentalities to take any administrative or other action to prevent or hinder the Contractor from enjoying the rights accorded to it hereunder” (Model PSC, Mozambique (2001), Art 30.7(d) and (e).

Rebalancing These clauses require a renegotiation of contract terms in the event of specified circumstances occurring. If the host state adopts a measure subsequent to the conclusion of the contract (a triggering event) that is likely to have damaging consequences to the economic benefits of the original bargain for one or both of the parties, a re-balancing has to take place. Petroleum contracts differ in their treatment of how that balancing will be effected. These clauses do not seek to prevent a change in the law or contract by the host state; rather, they seek to address the economic impact of such a change in the original bargain and establish a framework for its preservation.

Example:

"(a) In the event of changes in any Law, the provisions of which are more favorable to the Company, then such provisions shall apply to the Company if Company so requests.

(b) In the event there occurs any change in the legislation of the Government or local legislation (including provisions relating to imposts, duties, fees, charges, penalties, and tax related legislation) after the date of this Agreement, and if in the Company's sole and good faith opinion such change would have the effect of divesting, decreasing, or in any way limiting any rights or benefits accruing to the Company under this Agreement or under current legislation, then the Parties shall, in good faith, negotiate to modify this Agreement so as to restore the Company's economic rights and benefits to a level equivalent to what they would have been if such change had not occurred" (MMDA, 13.2).

Allocation of Burden The burden arising from a change in laws applicable to the contract is shifted by means of this clause from the investor to the state company. No balancing is implied and no amendment of the contract is required. It is the national company that is required to take remedial action under the contract, such as paying an additional tax or royalty.

Example: "The GOVERNMENT shall indemnify each CONTRACTOR entity upon demand against any liability to pay any taxes, duties, levies, charges, impositions or withholdings assessed or imposed upon such entity which relate to any of the exemptions granted by the GOVERNMENT under this Article 31.1"(Model PSC, Kurdistan (2007) (see Cameron 2010 at p.80).

For Drs Sunley and Daniel such asymmetry is a 'one way bet' that offers both protection and benefits to the investor. They provide an illustration of how this stability would operate by reference to the Kurdistan Model Contract of 2007 (check date). In addition to a right to negotiate an offsetting change if a package of government initiated changes leaves the investor in an adverse economic position, this "would allow the contractor to request the benefit of any future changes. In effect the contractor could cherry pick a balanced tax reform package combining, say, lower tax rates with less favourable capital recovery rules".[3] In other words, this kind of fiscal stability clause can provide both a positive and a negative form of protection with respect to future state actions, with the positive element working to

[3] P. Daniel and E. Sunley (2010), 'Contractual Assurances of Fiscal Stability', in The Taxation of Petroleum and Minerals: Principles, Problems and Practice (edited by P Daniel, M Keen and C McPherson), Routledge, Oxford, pp. 422-423.

ensure that any available benefits occurring after the original agreement is signed are brought into that contract to benefit the investor. It contrasts with the kind of fiscal stability offered by Timor-Leste in its tax stability agreement which, they note, is an example of a 'two way bet': it "fixes tax parameters in both directions – the contractor does not benefit from tax reductions".[4]

[4] Ibid., pp. 417-18.