

**NEGOTIATION OF TRANSIT PIPELINE AGREEMENTS:
BARGAINING IN THE SHADOW OF STABILITY PROVISIONS**

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Dedicated to

My wife Gulsah Ayse and my son Ahmet Faruk

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LIST OF ABBREVIATIONS

AIOC	Azerbaijan International Operating Company
BIL	Botas International Limited
BTC	Baku-Tbilisi-Ceyhan Pipeline
BYIL	British Yearbook of International Law
CEPMLP	Centre for Energy, Petroleum and Mineral Law and Policy
CERD	Charter of Economic Rights and Duties
CIS	Commonwealth of Independent States
CPC	Caspian Pipeline Consortium Pipeline
CUP	Cambridge University Press
EC	European Communities
ECS	Energy Charter Secretariat
ECT	Energy Charter Treaty
EMP	Energy Materials and Products
ETF	Energy Transport Facilities
FET	Fair and Equitable Treatment
FSR	Former Soviet Republics
FSU	Former Soviet Union
GATT	General Agreement on Tariffs and Trade
HGA	Host Government Agreement
HUP	Harvard University Press
IBA	International Bar Association
ICC	International Chamber of Commerce
ICJ	International Court of Justice
ICLQ	International and Comparative Law Quarterly

ICSID	International Centre for Settlement of Investment Disputes
IELTR	International Energy Law and Taxation Review
IGA	Intergovernmental Agreement
ILM	International Legal Materials
ILR	International Law Reports
IMF	International Monetary Fund
IOC	International Oil Companies
IPC	Iraq Petroleum Company
JENRL	Journal of Energy and Natural Resources Law
JIA	Journal of International Arbitration
JVA	Joint Venture Agreement
JWELB	Journal of World Energy Law and Business
JWIT	Journal of World Investment and Trade
LNG	Liquefied Natural Gas
LSA	Legal Stabilization Agreement
MTA	Million Tonnes Annually
MTPA	Mandatory Third Party Access
NREP	Northern Route Export Pipeline
OIES	Oxford Institute of Energy Studies
OUP	Oxford University Press
OPEC	Organization of the Petroleum Exporting Countries
PSA	Production Sharing Agreement
PSONR	Permanent Sovereignty over Natural Resources
REIO	Regional Economic Integration Organization
SCC	Stockholm Chamber of Commerce

SCGP	South Caspian Gas Pipeline
SPSE	South European Pipeline
TAL	Trans Alpine Pipeline
TAPLINE	The Trans Arabian Petroleum Pipeline
TPA	Third Party Access
UN	United Nations
UNCITRAL	United Nations Commission on International Trade Law
UNIDROIT	International Institute for the Unification of Private Law
WREP	Western Route Export Pipeline
WTO	World Trade Organization

DECLARATION

By the Candidate:

I, Huseyin Akif Karaca do hereby declare that I am the author of this thesis; that unless otherwise stated, all references cited have been consulted by me; that the work of which the thesis is a record has been done by me and that it has not been previously accepted for a higher degree.

Signed

Huseyin Akif Karaca

By the Supervisors:

It is hereby declared that the work presented in this thesis is the work of the candidate Huseyin Akif Karaca, and that in carrying out this work, the conditions of the relevant Ordinance and regulations have been fulfilled.

Signed

Dr. Abba Kolo

Dr. Sergei Vinogradov

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ABSTRACT

The significance of transit pipelines has increased, in particular since the start of the exploration of oil and gas resources in land-locked regions such as the Caspian. The legal arrangements for transit pipelines are long-term in nature and are susceptible to unilateral changes and consequent disputes. Therefore, there is a need to stabilize the terms of these agreements. However, at the same time these agreements operate in a particular economic and geopolitical environment.

The main questions are (1) “To what extent can transit disputes be managed through the use of stability provisions as bargaining factors?” (2) “What are the determinative factors during the negotiation and renegotiation of transit pipeline agreements in the Caspian Region?” and (3) “How have stability provisions functioned in negotiated settlements of transit disputes?” This research seeks to answer these questions by taking into account the above considerations.

Transit pipelines have more often than not experienced disputes relating to the transit terms included in transit pipeline agreements. Many a times, such disputes are resolved through renegotiation by the contracting and participating parties instead of through court litigation or arbitration. Therefore, this research focuses on the concession process during the negotiation and renegotiation of transit pipeline agreements. The thesis asserts that the renegotiation of transit pipeline agreements and the concession process occur in the shadow of the law as well as the economic and geopolitical environment. In particular, they occur in the shadow of the stability provisions that are contained in the transit pipeline agreements. This research defines stability as being maintenance of

the economic equilibrium of the contract. Therefore, both stabilization and renegotiation clauses are stability provisions in the context of the thesis.

Determining the bargaining factors that are effective in the concession process is essential to answer the research questions listed above. This research uses the alternating offers model of bargaining theory as an analytical framework to answer the research questions. According to the alternating offers model, there are four factors that affect the concession process. These are discount rates, risk aversion and the outside options and inside options of the parties. These four factors have been reclassified under economic, geopolitical and legal factors in the context of transit pipelines. The legal factors are stability provisions in transit pipeline agreements and the treaty provisions that provide stability to these agreements.

In order to evaluate the value of stability provisions as bargaining factors during renegotiations, an analysis of their legal effect is required. This research adopts the methodology of doctrinal analysis of stability provisions in addition to the analysis of economic and geopolitical factors that constitute bargaining factors during renegotiations. The viability of stability provisions has been tested through assessing how they would have been used as bargaining factors in negotiated settlements in their economic and geopolitical contractual environment.

Five pipelines have been selected as case studies. These pipelines mainly originate in the Caspian Region and are directed towards Western states. This research tests the viability of stability provisions in the agreements governing these pipelines, taking into

consideration the economic and geopolitical contractual environment of each pipeline in the context of the analytical framework of the thesis.

The research has found that legal factors, stability provisions (inside options), can be effective when the parties' economic and geopolitical factors (discount rates and risk aversion) are equal and there is no preferable alternative pipeline (outside option) in the event of the renegotiation of the transit pipeline agreement. When there is a fundamental change in the economic and geopolitical contractual environment, stabilization clauses are not effective in resisting renegotiation demands by the parties and the subsequent changes in transit pipeline agreements. Therefore, flexibility should be provided through inclusion of adaptation clauses for financial terms while stabilizing the general legislative framework.

CHAPTER 1. INTRODUCTION: HISTORY, CERTAIN DEFINITIONS AND THE CONTEXT OF THE THESIS

1.1 Historical Context of Transportation via Pipelines

A transit pipeline according to its traditional definition is a pipeline that crosses at least two borders, in other words, one sovereign territory –the transit state- before it reaches its destination country or the highseas.¹ However, according to the definition of transit under the Energy Charter Treaty (ECT), not only pipelines that originate in a state and are destined for the port facilities of the transit state, or for a third state after passing through the transit state, but also pipelines that originate in a contracting state and are destined for the same state after passing through a contracting transit state are accepted as transit pipelines.² It should be noted that there is a difference between transit pipeline and cross-border pipeline. A transit pipeline crosses at least two borders. However, a cross-border pipeline crosses just one border. It originates in a state and ends in neighbouring destination state.

If oil and gas resources can be described as the lifeblood of the world economy, pipelines can be described as the blood vessels. Because of the ever-increasing demand of industrialized countries for oil and gas and the remoteness of traditional resource countries to consumer states, the transportation of oil and gas and the transit via third countries has arisen as an essential part of the energy security of these consumer states.

The history of the transportation of oil via pipelines is as old as the first oil discoveries in

¹ P Stevens, “Transit Troubles: Pipelines as a Source of Conflict” (2009) Chatham House Report

² ECT Article 7.10.a-i,ii. In order to apply transit provisions of ECT its adequate the transit state and either the state of origin or the state of destination should be contracting party. www.encharter.org last accessed 5 September 2012

the USA and not surprisingly John D. Rockefeller built his vast fortune through the control of transportation and refining complexes. Although the first long-distance pipeline was constructed in the USA, it was not a transit pipeline. The centre of gravity of oil moved to Middle East after Second World War following the exploration and production of vast resources in Iran, Iraq and Saudi Arabia in the first half of the 20th century. This situation resulted in the development of transit pipelines that traversed transit states, some of which were just moving towards statehood.³

The second fact that contributed to the movement of the centre of gravity to the eastern hemisphere of the world is the exploration of huge oil and natural gas reserves in the Former Soviet Union (FSU) in the second half of the 20th century. This fact has resulted in the construction of trunk oil and natural gas pipelines which originate mainly in Russia and are destined for Europe or the Caspian countries.⁴ There is a web of numerous oil and gas pipelines that are in operation and a limited number of pipelines that are at the project phase, as can be seen in the maps at the end of this chapter. However, this thesis focuses on the pipelines that originate in the Caspian countries (e.g. Russia, Azerbaijan, Kazakhstan, Turkmenistan) or Middle East countries (e.g. Iraq) and are destined for Western –traditional consumer- countries.⁵

The Kirkuk-Tripoli Pipeline was the first transit oil pipeline in the world. It was constructed in 1943 to transport the oil that was produced in Kirkuk, a city in northern

³ D Yergin, *The Prize: The Epic Quest for Oil, Money and Power* (Free Publishers 2008) 373 et seq

⁴ S Vinogradov, *Cross-border Oil and Gas Pipelines: International Legal and Regulatory Regimes* (CEPMLP 2001)

⁵ The reasons for the selection of these pipelines are availability of their legal arrangements and geopolitical particularities of that specific region.

Iraq, by the Iraq Petroleum Company (IPC). It was destined for the Syrian port Banias and the port of Tripoli in Lebanon. It traversed the transit countries of Syria and Lebanon. The Trans Arabian Petroleum Pipeline (TAPLINE) was constructed and financed by Aramco partners. It started to operate in 1950 to transport Saudi oil through the transit countries of Jordan, Syria and Lebanon. Tapline was the first pipeline that was financed by private companies. However, due to the reasons explained in the second section of this chapter, these two pipelines were closed in 1982 and 1975 respectively.⁶ The Kirkuk-Ceyhan pipeline was constructed by Iraq as an alternative to the Kirkuk-Tripoli pipeline. It started to operate in 1977 to transport oil via the transit country Turkey to the Mediterranean port of Ceyhan. Although it had experienced long closures as a result of transit disputes between Iraq and Turkey and United Nations (UN) sanctions against Iraq after the first Gulf War, it started to operate without restrictions in 2010.⁷

The depletion of oil and gas resources in traditional resource regions, the aim of consumer states to diversify their resource countries, the transportation routes and the development of new oil and gas resources in newly independent and land-locked states of the Caspian Region have increased the significance of pipeline transportation. It has resulted in the development of two major and two minor oil transit pipeline projects and one gas transit pipeline project in the Caspian.⁸

⁶ P Stevens, "A History of Transit Pipelines in the Middle East: Lessons for the Future", in *Boundaries and Energy: Problems and Prospects*, (G.H. Blake et al ed, Kluwer 1998) 221-225

⁷ www.botas.gov.tr last accessed 5 September 2012

⁸ P Stevens, *Cross-border Oil and Gas Pipelines: Problems and Prospects* (ESMAP 2003)

The two major transit pipelines are the Caspian Pipeline Consortium (CPC) oil pipeline, which was constructed to transport Kazakh and Russian oil via Russia to the Russian Black Sea port, Novorossiysk⁹ and the Baku-Tbilisi-Ceyhan (BTC) oil pipeline, which was constructed to transport Azeri oil via Georgia and Turkey to the Turkish Mediterranean port, Ceyhan. The two minor pipelines, the early oil pipelines, are the Western Route Export Pipeline (WREP), which was constructed to transport Azeri oil via the transit country of Georgia to the Black Sea port, Supsa and the Northern Route Export Pipeline (NREP), which was constructed to transport Azeri oil via the transit country of Russia to the Black Sea port of Novorossiysk. The gas transit pipeline project is the South Caucasus Gas Pipeline (SCGP), which was constructed to transport Azeri gas via the transit country of Georgia to Turkey. All of these pipelines are examples of integrated pipeline projects and were constructed by consortiums mainly dominated by private international petroleum companies and operated by them.¹⁰

1.2 The Transit State: The Weakest Part of the Chain and Transit Disputes

A pipeline is part of a longer chain, whether it is a cross-border or a transit pipeline. It is the mid-stream part of the chain that links the up-stream (production) and the down-stream (consumption) parts of the oil or gas operation. An interruption at the mid-stream part naturally influences both the up-stream and down-stream parts of the operation. Reliable transit contributes to the security of supply of consumer countries. Moreover, it provides market access for producers and income from transit fees and/or tariffs for transit countries. However, transit encounters risks and disputes that can be caused by

⁹ For the history of and information about CPC pipeline see www.cpc.ru last accessed 5 September 2012

¹⁰ For the histories of and information about BTC pipeline, WREP, NREP and SCGP see www.caspiandevlopmentandexport.com last accessed 5 September 2012

technical problems, contractual disputes mainly based on commercial conflicts and political risk including regulatory intervention.¹¹

The main source of disputes with regard to transit pipelines is the interruption of flow by transit states. These transit disputes are often based on the transit state's demand to renegotiate transit fees.¹² In the context of this thesis, a transit dispute means any kind of dispute on transit terms arising out of the agreements between the transit state and the pipeline company in the case of integrated pipeline projects, and the disputes between transit state and the producer state or between their state companies in the case of national pipeline projects.

The Kirkuk-Tripoli pipeline (1943-1982) experienced several transit interruptions and demands from transit states to renegotiate transit fees. In some cases, conflicts arose over the price of the oil that was taken by transit states from the pipeline. In particular, after a regime change in Syria in 1967, Syria triggered renegotiations over transit terms and the price of the oil taken by Syria. As a consequence of several transit interruptions and following renegotiations over transit terms, the pipeline closed in 1982. In the TAPLINE case, in addition to the transit disputes between Aramco and the transit states (Jordan, Syria and Lebanon) the fall in tanker rates played an important role in the closure of the TAPLINE in 1975 as well. The alternative routes that were developed by Iraq have experienced similar disputes. The Kirkuk-Ceyhan pipeline started to operate in 1977.

¹¹ Energy Charter Secretariat, "Energy Transit-The Multilateral Challenge" (ECS 1998) 14-15

¹² Stevens, *supra* note 1 8-9

However, this pipeline has experienced similar interruptions caused by renegotiation demands by the transit country, Turkey, over transit terms as well.¹³

The situation is similar for the pipelines started in Russia and traversed Former Soviet Republics (FSRs). Between just 1 January 1992 and 31 December 1994, 27 gas transit events were recorded; 10 of these related to negotiations or renegotiations of transit agreements, 6 were related to threats to supply, 3 were related to irregularities in supplies and 8 were related to actual cuts or reductions in supply.¹⁴ Similar to the January 2006 crisis, the January 2009 gas crisis between Russia and Ukraine found its basis in the disagreement between the parties on gas volumes, gas prices and transit tariffs.¹⁵

All the above-mentioned pipelines are examples of the connected national lines model. However, this situation raises an important question that should be answered; that is, whether these disputes were caused by the specific nature and characteristics of this model and the inadequacy of its legal arrangements or by the fact that the integrated pipeline projects are too new and their abilities to provide an uninterrupted flow of oil and gas have not been tested. The answer to this question was provided by the arbitration case at the International Chamber of Commerce (ICC) and the renegotiated solution between the operator of Turkish part of the BTC pipeline, Botas International Limited (BIL, state-owned company) and the BTC Pipeline Company (owner of the pipeline). The claims of BIL arose out of the non-adjustable nature of operating fees that are paid to

¹³ For a detailed discussion about Kirkuk-Tripoli pipeline and Tapline see Stevens, *supra* note 6 221-225

¹⁴ Energy Charter Secretariat, *supra* note 11 14

¹⁵ S Pirani, J Stern and K Yafimava, "The Russo-Ukrainian Gas Dispute of January 2009: a comprehensive assessment" (2009) OIES Report 43-44

BIL by the BTC Pipeline Company and the demands of BIL with regard to a throughput guarantee and the price of pumping fuel. However, this dispute was settled through renegotiation between BIL and the BTC Pipeline Company in October 2011.¹⁶ The CPC pipeline's capacity expansion dispute was resolved by the interested parties through long renegotiations in 2009 as well.¹⁷ The details of these disputes and their settlements are analysed in Chapter VI, which deals with the case studies in this thesis.

Transit disputes might arise from regulatory interference by a transit state through an attempt to change the agreed fiscal regime under an agreement that disrupts the original economic equilibrium of the project. Another dispute scenario might arise from regulatory interference by a transit state in an integrated gas pipeline project when an off-taker transit state deregulates its gas market and new players enter the market. Under this possible scenario, change in the market structure as a result of change in regulation might have effects on the performance of take or pay obligations of the former gas monopoly in that transit country. The inadequacy of the former gas monopoly would inevitably affect capacity arrangements under the gas transportation contract. A conflict might arise between the pipeline company and the transit state because of the change in the economic equilibrium of the project resulting from the deregulation of the market.¹⁸

¹⁶¹⁶ <http://ekonomi.haberturk.com/makro-ekonomi/haber/683648-100-milyon-dolari-kurtardik> ; <http://haber.gazetevatan.com/btcde-zarar-ettiren-anlasma-degistirildi/407765/2/Haber> last accessed 5 September 2012

¹⁷ www.cpc.ru last accessed 5 September 2012

¹⁸ This possible dispute scenario is inspired from the conflict between British Gas and North Sea gas producers after the deregulation of British gas market. For this conflict see A Kolo and T Walde, "Renegotiation and Contract Adaptation in International Investment Projects: Applicable Legal Principles and Industry Practices" (2000) 1 Journal of World Investment 5, 26-27

The economic and political interests of the parties are merged together in transit pipeline projects. Whoever controls the flow of oil and gas can demand the higher profit from them. Therefore, a transit pipeline is a geostrategic asset as well as an economic asset. These geostrategic and economic interests of the parties are reflected on either in the treaty or in the contract that regulates transit terms between them and which binds the parties. However, the extent and the conditions of the state's obligation to perform the terms of these agreements constitutes one of the underlying themes of this thesis as well. These agreements that regulate transit either in the integrated model or the national lines model are signed after long negotiations. They reflect the bargaining power of the parties at the time of the negotiations. However, the long lifetime of pipeline projects and their agreements make them vulnerable to change in the bargaining powers of the parties.

The producer country and/or company and the consumer country and/or company are the real beneficiaries of a pipeline project as, respectively, they sell hydrocarbons and have their demand supplied. However, the transit country does not have an economic interest apart from getting the transit fee unless it is an off-taker. This is one of the facts that make the transit state the weakest part of the whole chain and a chain is only as strong as its weakest link.

Transit disputes have been attributed to two facts. The first is the obsolescing bargain effect in the operation stage of the pipeline. The bargaining power shifts from the project company to the transit state after the pipeline is constructed and starts to operate. Due to the fixed route and immobility of pipelines, the hostage effect is stronger than other

investments.¹⁹ The second fact is the cycles in the oil and gas industry. When oil and gas prices are at low levels, host states grant considerable incentives to investors. The contracts that are concluded during the low phase always reflect the low bargaining power of the host state. However, when the prices reach to high levels, the bargaining power of the host state increases. This rise in bargaining power results in the host state's demands for renegotiation of the contract terms.²⁰

As a consequence of the fact that there is little specific national legislation and regulation dealing with transit, in particular in developing countries, the terms of commercial contracts and treaties have governed existing transit arrangements.²¹ Moreover, the international legal framework dealing with transit, in particular the transit provisions of the ECT are inadequate. They should be supplemented by well-drafted contracts in order to be effective.²² Due to the inadequacy of the international legal framework and national regulations in developing countries, quick resolutions to transit disputes and/or effective dispute avoidance mechanisms in contracts are required to manage transit disputes.

The agreements related to the recent integrated pipelines (e.g. BTC, SCGP, CPC and West African Gas Pipeline (WAGP)) have adopted complex, new and different approaches in terms of the stability of the contract to maintain economic equilibrium of the contract. This new form of stabilization clause, the economic equilibrium clause, aims to restore the original economic equilibrium of the contract in case of a change in the

¹⁹ Stevens, *supra* note 8 46

²⁰ T Walde, "Renegotiating Acquired Rights in the Oil and Gas Industries: Industry and Political Cycles Rule of Law" (2008) 1 JWELB 55, 71-72

²¹ Energy Charter Secretariat, *supra* note 11 25

²² Vinogradov, *supra* note 4 47

original economic equilibrium of the contract as a result of a state act. However, a one-sided approach to the stability, focusing only on stabilization clauses, will not achieve the intended aim, the stability of the contract.

Therefore, this thesis will analyse the role and viability of the economic equilibrium clause in managing transit disputes in comparison with the renegotiation clauses that aim to maintain economic equilibrium of the contract in case of a change in the surrounding contractual environment. These clauses are analysed in the context of the bargaining relationship between the pipeline investors and transit states during the negotiation and renegotiation of the legal arrangements, with a special focus on the effects of these clauses on the bargaining power of the parties. However, before that, it is necessary to state the contractual structure of transit pipeline arrangements and specific legal issues that are dealt with in these legal arrangements, which qualify these agreements as transit contracts. These specific legal issues that qualify the contract as transit contract are transit fees and tariffs, taxation, and capacity and access rights. First reason to define these concepts is that they are recurring concepts throughout the thesis. Second reason is that different people might understand them in different manner.

1.3 Transit Pipeline Agreements and Their Particular Aspects

1.3.1 Contractual Structure of Transit Pipeline Arrangements

Transit pipelines traverse territories of at least the producer and the transit country. Therefore, national laws of these individual states and contractual arrangements deal with regulation of transit. Although national laws play an important role in the relevant part of

the pipeline, the domestic legal framework is normally supplemented and/or varied by treaties and investment and/or commercial agreements.²³

A multi-tiered contractual legal framework is required with respect to any cross-border and transit pipeline project, which should address the following contractual relationships. In the integrated pipeline model, the first contractual relationship is between participating countries in the form of a treaty -an intergovernmental agreement (IGA). The second contractual relationship is between the transit state and pipeline consortium (investors) in the form of an investment agreement with the host states -host government agreement (HGA). This second contractual relationship regulates the transit terms in detail. However, in the national lines model, these legal arrangements can be intergovernmental and between the national companies of the producer and the transit country. The third contractual relationship is between the shippers of the commodity and the pipeline company in the form of a transportation contract.²⁴

The structure of contractual arrangements varies according to the model of transit pipeline projects. There are two models of transit pipelines, which are the international -integrated- pipeline model and the national pipeline model. The transit pipelines of the national pipeline model are constructed and operated by the national pipeline companies of the participating states. They are owned and operated under each jurisdiction by these

²³ M Dulaney and R Merrick, “Legal Issues in Cross-border Oil and Gas Pipelines” (2005) 23 JENRL 247 249

²⁴ G Picton-Turbervill, “Financing and Structuring of Cross-border Pipelines” Paper Presented at the Conference of the IBA Section on Energy and Natural Resources Law (2-4 April 2000) 5 in Vinogradov, *supra* note 4 21

national pipeline companies. Their operation is subject to the laws of each jurisdiction in their respective areas. The contractual structure of these pipelines consists of the IGAs and agreements between the state companies.²⁵

The transit pipelines that were constructed and have operated according to the national lines model are the Kirkuk-Ceyhan oil transit pipeline and Russia-Ukraine gas transit pipeline. The legal framework of the Kirkuk-Ceyhan Pipeline consists of the IGA that regulates transit between the governments of the producer country, Iraq, and the transit country, Turkey.²⁶ The legal framework of the Russia-Ukraine gas transit pipeline consists of the long-term transit and supply contracts between the national companies of each state as well as the IGA.²⁷

Integrated-model transit pipelines are constructed and operated by international oil and gas companies. Their capacity is dedicated to the same companies that produce oil or gas in the up-stream side of the project. They adopt integrated legal arrangements that constitute the legal regime of the pipeline operation in all of the participating states. These legal arrangements consist of the IGA between participating states and the HGAs between each host state and the investor. These IGA and HGAs regulate the transit terms and, together with transportation agreements that are entered into by the pipeline company and the shipper of the commodity, they constitute the legal framework of pipeline operation.²⁸

²⁵ Vinogradov, supra note 4

²⁶ Renewed Intergovernmental Agreement of 2010 www.tbmm.gov.tr last accessed 9 September 2012

²⁷ Pirani et al, supra note 15

²⁸ Vinogradov, supra note 4.

Examples of the international –integrated- pipeline model are the BTC oil transit pipeline, the SCGP (gas transit pipeline) and the CPC oil transit pipeline. The legal framework of the BTC consists of the IGA between the producer country, Azerbaijan, and the transit countries, Georgia and Turkey, in addition to the HGAs between each host state and the BTC Pipeline Company.²⁹ The legal framework of the SCGP is identical to the legal framework of the BTC pipeline. It consists of the IGAs between Azerbaijan and Georgia and between Azerbaijan and Turkey, and the HGAs between the SCGP Pipeline Company and the producer country, Azerbaijan, and the transit country Georgia.³⁰ In contrast, the legal framework of the CPC pipeline consists of a joint-venture agreement (JVA) between the participating states (Kazakhstan and Russia) and the pipeline investors.³¹

1.3.2 Taxation

The method of taxation is one of the fundamental issues for the viability of any transit pipeline project. Providing clarity and transparency is essential in the design of clauses that deal with taxation issues in pipeline agreements. Taxes can be levied in the form of an income tax that is imposed on the tariff earnings of the pipeline company. They might be in the form of a transit fee or other service related taxes that are imposed on transportation services. Moreover, they might be in the form of land taxes that are imposed on the right of way and on other access rights to land by pipeline owners. If the transit state has a high percentage of equity participation in the pipeline, it may provide

²⁹ For these agreements see, www.caspiandevlopmentandexport.com last accessed 5 September 2012

³⁰ *ibid*

³¹ www.cpc.ru last accessed 5 September 2012

exemptions from some of the taxes mentioned above.³² Providing harmonization with regard to taxation of the pipeline in different countries is an essential matter with regard to the commercial viability of the project.³³

Coherent and harmonic tax treatment is one of the advantages of the international pipeline model. Under this model, transit terms, including the tax structure, are regulated in HGAs that are negotiated between each host country and the pipeline company or in the project agreement that is negotiated between all of the host countries and pipeline owners. In addition to the harmonization of the taxation in different countries, tax incentives, which are provided by host states to pipeline investors for the assumed risks in developing countries, are essential for the commercial viability of transit pipeline projects.

In the BTC pipeline project, a broad exemption regime is granted to pipeline investors by the host states. The BTC Pipeline Company and their affiliates, which were incorporated outside the territory of Turkey and have no activity other than activities related to the pipeline operation, as well as the shippers, are not subjected to any taxes and tax-filing obligations. Any provision of the agreement relating to taxes will prevail over Turkish taxation laws. Double tax treaties shall have effect with respect to tax benefits.³⁴

³² Dulaney and Merrick, *supra* note 23

³³ M A Osman Khairuddin, "An Asean Perspective of Transboundary Oil and Gas Transportation System: Legal and Commercial Considerations" Paper presented at the Conference of the IBA Section on Energy and Natural Resources Law (2-6 April 2000)

³⁴ BTC HGA Turkey, Article 9.1.i-ii-iii

The HGA states that the BTC Pipeline Company shall be subject to Turkish corporation tax law as amended by the HGA. Corporation tax consists of base corporation tax and corporation tax surtax. Base corporation tax liability is equal to taxable income multiplied by the corporation tax rate in the Turkish Tax Code on 1 January 1999, which was %30.³⁵ Corporation tax surtax is equal to the excess of total corporation tax liability over base corporation tax liability. Total corporation tax liability is equal to the corporation tax amount per barrel of petroleum that is transported at the point of terminus by the company. If the base corporation tax liability is in excess of total corporation tax liability, it should be reduced to total corporation tax liability, which is determined in the HGA.³⁶ The corporation tax amount is determined as \$0.20 per barrel for the first 5 years, \$0.20 per barrel between the 6th and 16th years; for the remaining 24 years the amount is \$0.37 per barrel.³⁷ The corporation tax amount is the transit fee that is paid to the government. The BTC Pipeline Company is exempted from VAT on all goods, works, services and technology supplied by them in connection with pipeline activities.³⁸

An identical taxation system applies to the Georgian part of the BTC project. The only difference is that the tax is called profit tax instead of corporation tax. There is a profit tax amount while determining total profit tax liability. The amount of profit tax is made equal to the transit fee for Georgia. It is equal to \$0.12 per barrel for the first 5 years; between the 6th and 16th years it is \$0.14, between the 17th and 25th years it is \$0.17,

³⁵ *ibid*, Article 9.2.i

³⁶ *ibid*, Article 9.2.ii-iii

³⁷ *ibid*, Appendix 1 Corporation Tax Amount Definition

³⁸ *ibid*, Article 9.8

between the 26th and 30th years it is \$0.20, between the 31th and 35th years it is \$0.225, and between the 35th and 40th years it is equal to \$0.25.³⁹

In the CPC oil transit pipeline, the CPC-R company, which is responsible for the operation of the Russian part of the pipeline, and the CPC-K company, which is responsible for the operation in the Kazakhstan part, are exempted from VAT with regard to the transfer of pipeline assets from the former company, CPC-Bermuda, to themselves.⁴⁰ Shareholders and affiliate shippers are exempted from transit fee, in the terms of the agreement, “pipeline transportation fee”, which means any tax, charge, fee with respect to pipeline transportation, including VAT that might be imposed by federal, regional or local government authorities. Shareholders and affiliates are exempted from any port fee or tax in Russia and Kazakhstan.⁴¹ Import and export taxes are reduced to the minimum amount for such taxes.⁴² Pipeline transportation services are exempted from VAT in Russia and Kazakhstan through regarding the service as transportation of goods outside the Commonwealth of Independent States (CIS) area.⁴³ Double taxation treaties shall be in effect.⁴⁴ The main tax that is imposed on CPC-R, CPC-K, shareholders and affiliated shippers is the profit tax. The base rate for the profit tax is 35% in Russia and 30% in Kazakhstan.⁴⁵

³⁹ BTC Georgia HGA, Article 8 and Appendix 1 Profit Tax Amount Definition www.caspiandevlopmentandexport.com last accessed 5 September 2012

⁴⁰ CPC Restructuring and Shareholders Agreement, Article 7.4.6-7 Barrows Collection Russia and NIS Section, Supplement 45

⁴¹ *ibid*, Article 7.4.8-9

⁴² *ibid*, Article 7.4.12

⁴³ *ibid*, Article 7.4.19

⁴⁴ *ibid*, Article 7.5.2

⁴⁵ *ibid* Article 7.5.1 and Schedule 2

1.3.3 Transit Tariffs and Fees

1.3.3.1 Conceptual Clarification

Although they are sometimes confused in the literature and treated as being the same, “transit fee” and “tariff” are different concepts. The tariff is the price paid to the owner of the pipeline by the shipper of the commodity as a user charge. A transit fee is negotiated compensation or tax paid to the transit country by the pipeline consortium or producer for the right of way.⁴⁶ Another argument about the nature of a transit fee, in particular from the point of view of economists, is that it is rent rather than compensation or tax.⁴⁷ Although a transit fee can be classified as “rent” in the terminology of the economist’s discipline, in legal terms it is more akin to a tax. In the BTC Turkey HGA, the transit fee is paid to the government by the consortium as corporation tax. In the BTC Georgia HGA, it is paid to the government as profit tax.⁴⁸

A transit tariff, which is paid to the pipeline company by the shippers as the price for the transportation service, covers the costs of investment, financing, operation and maintenance in addition to an element of profit for the operator. These costs may include such items as local taxes levied on commercial entities, mainly under the national pipeline model. On the other hand, a transit fee (government charge) is a tax levied by a transit country essentially as a fee for the right of way through that country’s territory and for services rendered by the country, such as security of the pipeline. It is not related to

⁴⁶ Vinogradov, supra note 4 24

⁴⁷ Stevens, supra note 8; E Omonbude, *Cross-border Oil and Gas Pipelines and the Role of the Transit Country: An Analysis of the Consequences of Shift in Bargaining Power of the Parties to the Pipeline Agreement*, Unpublished PhD Thesis (CEPMLP 2007)

⁴⁸ R A Muratoglu, “Trilateral Agreements: Baku-Tbilisi-Ceyhan Case Study”, Natural Gas Transit and Storage in Southeast Europe Conference (2002); BTC HGA Appendix 1 Corporation Tax Amount Definition; BTC Georgia HGA Appendix 1 Profit Tax Amount Definition

the cost of transport itself. The fundamental difference between a tariff and a transit fee is that a tariff is charged based on real costs while a transit fee is a tax, the size of which is based on political judgments and negotiations. However, in a number of important cases in the ECT area in which pipeline tariffs were originally set by intergovernmental negotiations, it is not always clear whether or not tariffs and transit fees are bundled together.⁴⁹ When the transit country owns the transit pipeline, the transit fee is supposed to be included in the tariff. The services included in the transit tariff vary. This often complicates comparisons between different countries. Another complicating factor is that the transit of gas is often paid in kind. The cost of transit is determined according to the value of gas in these cases.⁵⁰

1.3.3.2 Imposition Method of Transit Tariffs

Transit tariffs and conditions are either the result of commercial negotiations or regulatory authorities determine them. If an alternative transit route exists, the maximum price that will be paid is the opportunity cost, which is the cost of arranging transit through the alternative route. If there is not an alternative route, the maximum price for transit is the price that makes the commodity sale agreement unprofitable for the seller. These price levels could be considered as ceilings for transit tariffs. The floor for the negotiations of the transit tariffs would be the real cost of transit. The opportunity cost concept and the cost of service concept are the two main factors while determining transit tariffs. Under the first, transit tariffs reflect what the market can bear. Under the second,

⁴⁹ J Bielecki and G Gonul, *Gas Transit Tariffs in Selected Energy Charter Treaty Countries* (ECS 2006) 23

⁵⁰ *ibid*

transit tariffs reflect the cost of transit. Market-based transit tariffs may be negotiated within these two ranges.⁵¹

If access tariffs are not cost-reflective, a vertically integrated company might acquire significant advantage over its non-vertically integrated rivals through cross-subsidization between its different business divisions. The Draft Transit Protocol of the ECT sets out criteria for the determination of tariffs. Transit tariffs should not be affected by market distortions. They should not be subjected to the abuse of natural monopoly. They should be cost-based. They should be calculated by taking investment and operational costs and a reasonable rate of return into consideration.⁵²

The main method of tariff setting in the ECT Contract Parties is the cost-based method. Under this method, tariffs are calculated according to the costs incurred by the pipeline company in transporting gas. These costs include costs derived from the fixed investment in pipeline networks, including financing and some level of commercial profit, as well as operational costs inclusive of the gas for compression.⁵³ However, the procedure for tariff setting depends crucially on whether a country has set up a regulatory agency for the gas sector or whether control has been undertaken by some direct government authority. Regulatory agencies exist in most of the ECT Contract Parties in the EU area, even though some are at relatively early stages of development and may have a limited degree of independence. On the other hand, in some important gas transit countries, the transit of gas is governed by intergovernmental agreements that largely bypass national

⁵¹ ECS, *supra* note 11 24-25.

⁵² Draft Transit Protocol Article 10 www.encharter.org last accessed 5 September 2012

⁵³ Bielecki and Gonul, *supra* note 49 24

regulatory agencies. Examples of the latter situation are the transit tariffs for Russian gas through Ukraine and Belarus.⁵⁴

The methodology for setting transport and transit tariffs comprises two stages. The first stage is the calculation of the total allowable cost in order to determine the revenue requirement. The second stage is the allocation of these costs to individual shippers.⁵⁵

The first phase of tariff setting covers all the costs, which are fixed and operational costs, in addition to an element of profit, which is calculated as an allowed rate of return on the asset value of the operation. The cost of amortizing the pipes is represented by a depreciation charge on the capital asset. New investment is normally added to the asset base at its full cost and offers no methodological problems.⁵⁶ Fixed costs consist of the costs incurred during the construction of the pipeline. The operating costs are mainly related to payments for power supply and fuel for operation.⁵⁷ Moreover, there can be other determining factors in tariff setting. A reduction in capacity utilization might result

⁵⁴ *ibid*

⁵⁵ Energy Charter Secretariat, *supra* note 49 24

⁵⁶ A number of alternative methods exist for setting the asset base:

- the actual real investment cost in the case of a new facility operated separately from any other system,
- the book value of the system as it appears in the accounts of the company,
- the replacement value of the system,
- the replacement value depreciated for a notional period,
- the value placed on the pipeline when privatized or sold. Calculation of the allowed return on capital (often called the weighted average cost of capital or WACC) varies slightly under different methodologies, but essentially involves setting a debt/equity ratio for the TSO, setting a cost of debt finance, estimating a normal equity return, adjusting this by a factor for the risk category of the enterprise and finally putting together a weighted average of these two rates of return, *ibid* 25

⁵⁷ *ibid*

in an increase in tariffs. The pipeline diameter also makes a significant impact on the value of a unit delivery cost. The bigger the pipeline, the lower the transit tariffs.⁵⁸

There are four types of tariff methods for allocating the overall costs to the shippers. These are the postal, distance-based, point-to-point and entry-exit methods. There are also various hybrid forms of these four types: for instance, zonal schemes that are broadly distance-based or entry-exit tariffs with postal charges inside the zone. However, in tariff setting for transit pipelines, distance-based and entry-exit methods are applied.⁵⁹

Distance-based tariffs: These are most useful for systems in which gas moves in one direction for long distances, with rather few intermediate take-off points. Under distance-based tariffs, a shipper is required to pay a charge based on the distance between designated entry and exit points. They are usually expressed on a booked capacity basis in dimensions of \$/m³/h/100km/year. In a number of Western European pipelines, the charge varies in relation to the diameter of the pipes used. This capacity charge would have to be paid regardless of utilization. The only element reflecting utilization would be the cost of fuel gas, which would often be supplied in kind. The specific transportation costs would then depend on the utilization factor. In Europe, distance-based tariffs have been used by a number of important systems although recently they have often been supplemented by entry-exit tariffs for domestic transmission in some EU member states. Outside the EU, distance-based tariffs are the norm although they are usually presented in

⁵⁸ M Kanai and G Gonul, *From Wellhead to Market: Oil Pipeline Tariffs and Tariff Methodologies in Selected Energy Charter Member Countries* (ECS 2007) 35-36

⁵⁹ Bielecki and Gonul, *supra* note 49 31

the form of a commodity charge rather than a capacity charge in view of the high utilization factor for transit volumes.⁶⁰

Entry-exit tariff system: A separate tariff is determined for each entry and exit point. This can be seen as a specific form of point-to-point system, since a full point-to-point matrix can be constructed by adding two charges together. Under this system, capacity booking can be done separately for each entry and exit point. The split of entry and exit booking makes it difficult for the system operator to know whether entry capacity can be booked due to the fact that it depends ultimately on the total balance between entry and exit capacity booked. Transit tariff determination is mostly based on distance-based tariffs. The entry-exit tariff methodology is used by Germany and Slovakia.⁶¹

Gas Transit Pipelines: Gas transit pipelines are considered as natural monopolies. In EU countries, the main transmission system operator (TSO) conducts gas transit. In these countries, with the exemption of Germany and Slovakia, transit tariffs are determined by commercial negotiations between the shippers of gas and the pipeline company. This is in contrast to domestic tariffs, which are regulated. In Germany and Slovakia, transit tariffs are regulated and allocated according to the entry-exit methodology, as for domestic tariffs. In Austria (one line), in Belgium and in Germany (some TSOs such as Wingas) distance-based capacity tariffs are used to determine transit tariffs. In the UK

⁶⁰ ibid 32

⁶¹ ibid 33

(Interconnector Pipeline), Poland and Bulgaria, distance-based commodity tariffs are used.⁶²

In FSRs, there is no specific national regulation for gas transit and transit tariffs. Therefore, tariffs are determined in inter-company and inter-governmental negotiations. Gas transit companies are mostly state owned in FSRs. Negotiations on gas transit terms are influenced by high-level political considerations. In Ukraine and Belarus, distance-based commodity tariffs are used for the transit of Russian gas to Europe. Transit terms for Russian gas through Ukraine to Europe were determined in a 2009 transit contract for 10 years. However, the transit tariffs are determined in annual intergovernmental contracts.⁶³

Oil Transit Pipelines: In Western Europe, oil pipelines are not regarded as natural monopolies due to the existence of other means of transport that provide competition, such as sea and road transport. The issues of access to oil pipelines and tariff setting are subjected to the general competition rules of the EU and national laws. Crude oil transit in Western Europe is rare. The only oil transit pipelines are the Trans Alpine Pipeline (TAL), the South European Pipeline (SPSE) and the offshore Norpipe from Ekofisk to Teesside. The entire capacity of the TAL and the SPSE pipelines is dedicated to the exclusive use of shareholders who are also owners of oil refineries that are supplied by these pipelines. Norpipe belongs to oil producers in the Ekofisk area. In all of these pipelines, tariffs are based on the sharing of costs actually incurred by the pipeline joint

⁶² *ibid* 46 et seq

⁶³ *ibid* 58

venture.⁶⁴ In contrast to the situation in Western Europe and the US, oil pipelines in the FSRs are considered as natural monopolies. Transit tariffs and other rules are determined in agreements that are negotiated at inter-governmental or inter-company level.⁶⁵

The CPC oil transit pipeline and the BTC oil transit pipeline were constructed to transport oil from the upstream producer companies that own the pipeline. The capacity of these pipelines is dedicated to oil producers who have ownership interests in the pipeline. Transit tariffs for the CPC pipeline were raised to \$38 in September 2007.⁶⁶ In the BTC oil transit pipeline, a number of figures have been quoted ranging from \$2.58 to \$3.30 per barrel as transit tariffs. BP has confirmed that it lies within this range.⁶⁷

1.3.4 Capacity and Access Rights

1.3.4.1 Concept

Although the production and supply parts of the chain are not regarded as natural monopolies, pipelines, in particular gas pipelines, are considered as natural monopolies. The natural monopoly concept applies to an activity that cannot be conducted in a competitive context by any commercially viable means. A company provided with incentives in the public interest normally conducts it. In addition to the natural monopoly character of transport, which is caused by economies of scale due to the cost factor, gas transportation is considered as an integrated part of gas sale activities and the gas industry is structured as vertically integrated companies. This vertically integrated structure of the

⁶⁴ Kanai and Gonul, supra note 58 32-34

⁶⁵ ibid 48

⁶⁶ www.cpc.ru last accessed 5 September 2012

⁶⁷ Kanai and Gonul, supra note 58 57-60

gas industry contributes to the monopolization of gas sales market as well.⁶⁸ It is difficult to create a competitive market without providing third- party access rights due to the natural monopoly character of transport.

Third-party access entitles the competitors of the pipeline owner either to use unused capacity in the pipeline or to use the pipeline through sharing existing capacity by payment of a reasonable tariff. There are two types of access regimes: negotiated and regulated access. In negotiated access, the parties themselves set the fundamental access terms and conditions. In regulated access, a third-party authority sets the terms and conditions.⁶⁹ This thesis focuses on transit pipelines in the Caspian Region. Therefore, the access regime to these pipelines is stated in the following section.

1.3.4.2 Access to Transit Pipelines in the Caspian Region

In the case of transit pipelines that are constructed and operated according to the international (integrated) pipeline model, such as the CPC and the BTC oil transit pipelines, pipeline capacity is dedicated to owners of the pipeline proportional to their equity interests according to the agreements that govern their operation. If the owners do not use the capacity rights, these capacity rights might be sold to third parties.

The CPC oil pipeline Restructuring and Shareholders Agreement stated that “(e)ach shareholder shall have a preferential right to capacity for its equity production... Capacity that is not nominated for use by a shareholder for its equity production in any month shall

⁶⁸ K B Moen, “Gas Directive and Third Party Transport Rights: What pipeline volumes are available?” (2003) 21 JENRL 49, 50

⁶⁹ A R Borner, “Negotiated Third Party Access in Germany: Electricity and Gas” (2002) 20 JENRL 27, 28

be deemed to be excess capacity. Excess capacity shall be reallocated in accordance with the following procedure.”⁷⁰ According to the procedures that are set out in the agreement, excess capacity should be offered first to the other shareholders who are equity producers proportional to their equity interest. If other shareholders do not use this excess capacity, it can be offered to third-party shippers.⁷¹ If available capacity exists, the access regime to this capacity will be negotiated access.

However, in the case of the Nabucco Gas Transit Pipeline project, which is an example of the international pipeline model as well, 50% of the capacity of the pipeline is open to third-party access (TPA) on a negotiated basis. The Nabucco project agreement states that

“(f)ifty percent (50%) of the maximum available total technical annual transportation capacity in the Nabucco project, but not more than 15 billion cubic meters per year in the event of a final expansion of capacity to 31 billion cubic meters per year, shall initially be offered to, and if accepted, reserved by the shareholders, or their affiliates or transferees provided that the remaining capacity will be offered in a transparent, objective and non discriminatory procedure for shipper access.”⁷²

In the case of transit pipelines that are constructed according to the national pipeline model, these pipelines are subject to the jurisdiction of each state it traverses in addition to the intergovernmental agreements and/or the agreements between state companies. Therefore, access to these transit pipelines is determined according to their agreements and the regulations of each jurisdiction.

⁷⁰ CPC Agreement Article 8.2.1 and 8.2.3

⁷¹ *ibid.*

⁷² The Nabucco Project IGA, Article 3(3) This agreement is in the file of the author.

1.3.4.3 Take or Pay, Ship or Pay Clauses and Capacity Rights

Under take or pay clauses, gas buyers agree to take delivery of not less than a minimum quantity over a specific period (usually one year). If they do not, they are required to pay for the shortfall from the agreed minimum irrespective of whether the gas is actually taken or not.⁷³ These clauses reduce the risk for producers and facilitate their ability to finance the infrastructure of their projects by assuring a regular cash-flow over a period of many years. Therefore, the justification behind take or pay clauses is financing the project and ensuring security of supply through long-term contracts.⁷⁴

In this way, the buyer bears the market risk while the gas producer takes the production and delivery risk. It guarantees the volume of gas that should be supplied. An adequate pricing mechanism, in terms of price escalators (indices to crude oil and gas) and a price adjustment clause that can be applied over a time period of every three months to every year and a price review clause that can be applied every three or five years, is required to manage price and market risk.⁷⁵ Through the inclusion of take or pay clauses in the contract, the seller overcomes the risk of non-payment if the buyer does not want to take the gas that is delivered by the seller. There is not alternative gas market. Transportation of gas is only available through pipelines or through Liquefied Natural Gas (LNG)

⁷³ H Davey, "Take or Pay and Send or Pay: A Legal Review and Long Term Prognosis" (1997) 11 OGLTR; M Broothwood, "The EU Gas Directive and Take or Pay Contracts" (1998) OGLTR

⁷⁴ G J Pegg and M R Waller, "Take or Pay Provisions in Natural Gas Contracts. The US Experience as a Comparator to the UK Gas Industry's Problems" (1996) 14 JENRL 456, 457

⁷⁵ Broothwood, *supra* note 73

shipping. Therefore, take or pay clauses provide stability for the contractual and commercial relationship between the gas seller and the gas buyer.⁷⁶

Ship or pay clauses are part of transportation contracts. However, ship or pay clauses are complementary to take or pay clauses. Therefore, the main aim of the buyer is reserving transportation capacity to ensure transit through the pipeline. According to ship or pay clauses, part of the pipeline capacity is reserved for the shipper and the shipper promises to transport a certain volume of the gas reserved through the pipeline. The principal feature of such clauses is the obligation of the gas buyer to pay for the capacity or the volume contracted even if that capacity is not used or the volume is not transported.⁷⁷

Ship or pay clauses underpins the tariff payments of the shipper to the pipeline operator. They provide a minimum level of income to the pipeline company and ensure the pipeline company can recoup investment and get some profit.⁷⁸

1.4 Stability: Maintaining the Economic Equilibrium of the Contract

Any kind of contract or treaty establishes equilibrium between the parties, which has been reached after long negotiations or, in other words, bargaining. The equilibrium of the contract is based on the reciprocal rights and responsibilities of the parties. One of the

⁷⁶ P Roberts, *Gas Sales and Gas Transportation Agreements: Principles and Practice* (2nd ed, Sweet&Maxwell 2008) 153 et seq

⁷⁷ Davey, supra note 73 419

⁷⁸ Robert, supra note 76 227 et seq

recent transit pipeline agreements defines the concept of economic equilibrium in the following words.

“...(t)he 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.”⁷⁹

According to bargaining theory, a bargaining situation is described as being one where the parties have a common interest to co-operate, but have conflicting interests over how to co-operate. According to Rubinstein’s “alternating offers model” of bargaining theory, the bargaining power of the parties and the bargaining outcome will depend on issues such as their discount rates, risk aversion, outside options and inside options.⁸⁰ The discount rates of the parties describe how much the actors value present gains when compared to future gains. The risk aversion of the parties means the conducts of the parties when no agreement is reached. The availability of outside options means possible alternative partners, projects or other means outside the negotiation being conducted between the parties. The availability of inside options means the ability to acquire benefit from the circumstances in which bargaining occurs and continues.⁸¹ However, an important question arises at this point: is it possible to preserve the outcome of the negotiations, the equilibrium established in the contract, throughout the life of the project when the longevity of investment contracts is considered?

⁷⁹ BTC Turkey HGA, Appendix 1, Certain definitions. www.caspiandevlopmentandexport.com last accessed 5 September 2012

⁸⁰ A Muthoo, *Bargaining Theory with Applications* (CUP 1999) 1-5

⁸¹ *ibid.*; J A Gould, M S Winters, “An Obsolescing Bargain in Chad: Explaining Shifts in Leverage between the Government and the World Bank” Paper presented to the Annual Meeting of International Studies Association (March 2, 2007) 15

The obsolescing bargain concept was coined by Vernon in order to explain the multinational company-host state relationship. According to this concept, when an investment starts to produce profit, investors are increasingly committed to the project by the sinking of commitments. On the other hand, the host state raises demands for a higher share during the operation phase of the project.⁸² Obsolescing bargain theory explains the relation between the host state and a multinational company through assessment of their goals, resources and of the constraints on each of them. The goals of the host country and company are assumed to be in conflict. The outcome will depend on the valuation of the relative resources of each party by the other party and the relative constraints on each party.⁸³

The alternating offers model explains how, and on which bases, the parties can reach an agreement. The obsolescing bargain concept explains the motives behind the acts of a host state, one of which is a renegotiation demand. However, the obsolescing bargain concept leaves blank the legal aspect and confronts us with the inevitable question: should the state bend to the rule of the law without any exception or can it change the rules of the game when it feels more powerful? Moreover, from a legal perspective it also reminds us of an important and inherent conflict in contract law, between the principles of sanctity of contracts and the flexibility of contracts.

⁸² R Vernon, *Sovereignty at Bay: The Multinational Spread of US Enterprises* (Longman 1971) 52

⁸³ L Eden, S Lenway and D A Schuler, "From the Obsolescing Bargain to the Political Bargaining Model", Paper Presented at the workshop International Business & Government Relations in the 21st Century, Thunderbird, Phoenix, A&M University Bush School Working Paper 403 (January 5 2004) 10

According to the sanctity of contract theory, a contract is an expression of the parties' free will and it should be honoured. The individual must bear the risk of his free will. The terms of the contract must be implemented no matter how onerous or burdensome their performance might be. Although it is a general principle of law and accepted by all modern legal systems with variations, it is not an absolute principle. If the underlying circumstances of the contract changes fundamentally as a result of unforeseen changes in circumstances and performance of the contract becomes onerous to one party, renegotiation or contract adaptation may happen, based on the principle of flexibility of contracts.⁸⁴

The pursuit of stability in investment contracts has mostly moved away from traditional freezing clauses to economic equilibrium clauses. However, these latter clauses are in some cases coupled with traditional freezing clauses. Economic equilibrium clauses have been set out in petroleum investment contracts for more than a decade. They provide that when the original economic equilibrium established in the contract is disrupted as a result of a change in the law of the host state or any other kind of state interference, it should be restored by way of a stipulated formula that exists in the clause, or by way of renegotiation, or by automatic amendment of the contract. In the absence of restoration, compensation should be paid to the investor.⁸⁵ Economic equilibrium clauses are more flexible devices of stability when compared with traditional freezing clauses. They attempt to provide a compromise between the conflicting rights of the state's legislative freedom and the legitimate expectations of private parties about the maintenance of the

⁸⁴ Kolo and Walde, *supra* note 18 6 et seq

⁸⁵ P Bernardini, "Stabilization and Adaptation in Oil and Gas Investments" (2008) 1 JWELB 98, 102

economic equilibrium of the contract. They do not exclude the possibility of new regulation that negatively influences the equilibrium of the contract, but they intend to remedy the negative impact of such regulation on the contract.⁸⁶

However, one important distinction and clarification should be made at this point relating to effect of the economic equilibrium clause. All the examples of economic equilibrium clauses that have been studied by the author of this thesis can be activated after the economic equilibrium of the contract is disrupted as a result of a change in the law or any other kind of state interference. However, economic equilibrium clauses remain silent about the changes in the economic equilibrium of the contract that occur as a result of changes in the economic environment of the contract, such as price changes.

The pursuit of stability that is merely based on the analysis of stabilization clauses might not achieve its intended aim. In order to maintain the economic equilibrium of the contract, not only the clauses that aim to protect the equilibrium from the negative effects of state acts but also the clauses that aim to maintain the equilibrium in case of a change in the underlying economic circumstances of the contract should be analysed.

The latter types of clause are clauses that require renegotiation in case of the occurrence of the triggering event that is defined in the contract. These kinds of clauses might be classified according to the extent of contract change that might be caused by them in the following types. Adaptation clauses aim to renegotiate certain provisions of the

⁸⁶ A Faruque, *Stability in Petroleum Contracts: Rhetoric and Reality* Unpublished PhD Thesis (CEPMLP 2007) 119-120

agreement according to a formula that is adopted in the original contract. Renegotiation clauses require the renegotiation of a broader part of the agreement. Hardship clauses require renegotiation after the occurrence of an unforeseen event that fundamentally changes the economic equilibrium of the contract. Force majeure clauses might require renegotiation after the occurrence of an unforeseen event that is outside the economic environment of the contract, such as natural disasters.⁸⁷

All of these types of economic equilibrium clauses and renegotiation clauses aim to maintain the economic equilibrium of the contract. The former addresses the changes in the legal environment of the contract while the latter addresses the changes in the economic environment of the contract. Therefore, in the context of this thesis, both of them are regarded as stability provisions.

1.5 Research Questions

This thesis shall analyse the bargaining factors that influence the parties' bargaining power and the outcome in the context of negotiations and renegotiations of transit pipeline agreements. It examines how the change in bargaining power of the transit state in the operation stage of the transit pipelines could be managed by contractual clauses that aim to maintain the economic equilibrium of these transit pipeline agreements.

This thesis will analyse the viability of stabilization clauses, in particular, economic equilibrium clauses and renegotiation clauses, to manage disputes between the transit state and the investor from the angle of their effects on the parties' bargaining power. In

⁸⁷ N Horn, *Adaptation and Renegotiation of Contracts in International Trade and Finance* (Kluwer 1985)

order to achieve these aims, the following pipelines and their agreements are selected as case studies: the CPC oil transit pipeline, the BTC oil transit pipeline, the SCGP, the Kirkuk-Ceyhan (Iraq-Turkey) oil transit pipeline and the Russia-Ukraine gas transit pipeline. The agreements governing these pipelines and the bargaining factors that are effective in the negotiation and renegotiation of these agreements, in particular relevant clauses in them that aim to maintain stability of the contract, will be analysed in comparison with each other.

This research will endeavour to answer the main research question of:

- To what extent can transit disputes be managed through the use of stability provisions as bargaining factors?

Two subsidiary research questions are asked to answer the main research question:

- What are the determinative factors during the negotiation and renegotiation of transit pipeline agreements in the Caspian Region?
- How have stability provisions functioned in negotiated settlements of transit disputes?

1.6 Aims and Significance of the Research

Studies relating to legal aspects of transit pipelines have mainly focused on the international legal framework of pipelines, such as GATT or the ECT transit provisions and the viability of these provisions in terms of transit disputes.⁸⁸ However, it is correctly

⁸⁸ S Vinogradov, *Cross-Border Oil and Gas Pipelines: International Legal and Regulatory Regimes* (CEPMLP 2001); M Roggenkamp, "Transit of Networkbound Energy: the European Experience" in *Energy Law in Europe: National, EU and International Regulation*, (M Roggenkamp et al ed, 2nd. ed, OUP 2007); C Bamberger, T Walde; "The Energy Charter Treaty", in *Energy Law in Europe: National, EU*

asserted in these studies that the international legal framework, on its own, is not adequate to provide the security of supply via pipelines. Although the instruments of international law provide a benchmark for pipelines, they should be supplemented by well-drafted contracts.

In a recent PhD thesis, characterization and taxation of cross-border pipelines was analysed from the angle of the OECD Model Tax Convention. The author argued that cross-border pipelines should be characterized as permanent establishments, since transportation is a core activity of oil and gas exploration. Therefore, they can be taxed not only where the pipeline company is registered but also in countries where the pipeline traverses.⁸⁹ In another recent PhD thesis, which looks from the angle of regime theory, creation of an autonomous and regulatory international organization with enforcement mechanisms, international pipeline agency, was proposed to govern cross-border pipelines.⁹⁰

There are studies relating to the economics of transit pipelines. They seek solutions to the obsolescing bargain effect and transit interruptions from the economic and political perspective.⁹¹ As possible solutions, making the transit country an off-taker, creating alternative transit routes, developing a mutual dependency framework between

and International Regulation, (M. Roggenkamp et al ed, 2nd. ed, OUP 2007); R Liesen, "Transit under the 1994 Energy Charter Treaty", (1999) 56 JENRL

⁸⁹ K Olsen, *Characterization and Taxation of Cross-border Pipelines* (IBFD 2012)

⁹⁰ C I A, Siddiky, *Cross-Border Pipeline Arrangement: What would a Single Regulatory Framework Look Like?* (Kluwer 2011)

⁹¹ P Stevens, *Cross-Border Oil and Gas Pipelines: Problems and Prospects* (ESMAP 2003); E Omonbude, *Cross-border Oil and Gas Pipelines and the Role of the Transit Country: An Analysis of the Consequences of Shifts in Bargaining Power of the Parties* Unpublished PhD Thesis (CEPMLP 2007); P Stevens, *Transit Troubles: Pipelines as a Source of Conflict* (Chatham House Report 2009)

producers, transit country and consumers, and introducing progressive transit terms were discussed in these studies. It was argued in these studies that the state can easily break the rules of the contract or “rip up” the contract because it can simply do so as a sovereign power. However, the role of the law is not just to prevent illegal acts, more than that, its role is to provide sufficient remedies for these acts.

There is some scope for an approach to transit pipeline projects and their agreements from the perspective of stability and, in particular, the roles of stability provisions that aim to maintain the economic equilibrium of the contract in transit pipeline agreements, in the literature.⁹² However, they are not specific to transit disputes and not comprehensive. There is a gap in the current literature relating to the viability of the clauses that aim to maintain the economic equilibrium of the contract, in particular of economic equilibrium clauses in investment agreements. Most importantly, their usage in transit pipeline agreements and their viability coping with transit disputes have not been studied. Economic equilibrium clauses have been used in recent integrated transit pipeline agreements, such as those relating to the BTC, SCGP, CPC and WAGP. An in-depth analysis of their usefulness in minimizing transit disputes and their effectiveness in coping with shifts in the parties’ bargaining power and changes in value of the throughput in the operation stage of the pipeline is warranted.

⁹² P Cameron, *Stabilisation in Investment Contracts and Change of Rules in Host Countries: Tools for Oil and Gas Investors* (AIPN Report 2006); 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 OGEL; L Cotula, “Reconciling Regulatory Stability and Evolution of Environmental Standards in Investment Contracts: Towards a Rethink of Stabilization Clauses” (2008) 1 JWELB

The case studies in this thesis are selected from the Caspian Region, where the geopolitics of the region has had an effect on the negotiation of their agreements and on the operation of them. Geopolitical interests of the host states and also the home states of the companies has played a very important role in the negotiation process of the pipelines from determining the route of the pipeline to the drafting process of the agreements, in particular in the case of the BTC oil transit pipeline. In that case, the geopolitical interests of the transit states even overshadowed their commercial interests. As a consequence they needed to grant extraordinary incentives to make the pipeline route commercially viable for oil companies.⁹³ The priority of geopolitics over the economics of the pipeline is confirmed in an article that was written by one of the negotiators of the BTC pipeline agreements on the Turkish side.⁹⁴ This thesis will focus on what kind of interaction has happened between the agreements' clauses and geopolitical interests of the parties in transit pipeline projects as well. How have the geopolitical interests of the host states and the investors' home states affected their behaviour during both the negotiation process and the operation stage of these pipelines?

1.7 Methodology

The methodology of this thesis depends on both doctrinal research and on comparative analysis of the case studies that is based on the transit disputes, which have been experienced during the operation of the pipelines that are subject of the case studies. This thesis aims to answer the main research question of to what extent transit disputes can be

⁹³ Z Baran, "The Baku-Tbilisi-Ceyhan Pipeline: Implications for Turkey", in *The Baku-Tbilisi-Ceyhan Pipeline: Oil Window to the West* (S.F. Starr and S.E. Cornell ed, Central Asia and Caucasus Institute-Silk Road Studies Programme 2005) 107

⁹⁴ S Cal, "Baku-Tiflis-Ceyhan Boru Hattı Projesi Kapsamındaki Anlaşmaların Hukuki Yönden Değerlendirilmesi" (2006) AUSBD

managed through the use of stability provisions as bargaining factors, as well as related subsidiary research questions through the adoption of the methodology that is defined in this section.

Doctrinal research and comparative analysis of the case studies are based on both primary resources, such as available pipeline agreements and arbitral awards, and on secondary resources, such as scholarly writings of academics. This thesis approaches transit disputes in the context of a bargaining relationship. The clauses that aim to maintain economic equilibrium of the contracts are regarded as dispute management tools as well as bargaining factors that affect the bargaining power of the parties and the outcome of negotiations. Therefore doctrinal research is based on:

- Analysis of bargaining theory to determine bargaining factors and the outcome in negotiations and renegotiations of transit pipeline agreements
- Analysis of stability provisions (economic equilibrium clauses and renegotiation clauses) and the stability provided by treaty to contracts in the context of transit pipeline agreements

In the case study chapter, the author aims to test the viability of stability provisions in the settlement of transit disputes under each case study, through assessing how they would have been used as bargaining factors in renegotiated settlements in their economic and geopolitical contractual environment. Moreover, interviews are conducted for the BTC pipeline case regarding the transit dispute experienced between the parties.

1.8 Structure of the Thesis

This thesis is divided into seven chapters. Chapter 2 constitutes the analytical framework of the thesis. It analyses bargaining theory in order to define the bargaining factors that are effective in the determination of the bargaining powers of the parties during the negotiation of transit pipeline agreements and their operation stage. It examines the role of contract clauses as bargaining factors. It deals with the role of economic, geopolitical and mainly legal factors from the perspective of obsolescing bargain concept and, in particular, of alternating offers model of bargaining theory. It should be noted that the literature review is conducted throughout the thesis instead of in a particular chapter.

Chapter 3 identifies and analyses the international legal regime applicable to transit pipelines in the context of the ECT. Moreover, the stability provided by the treaty provisions of the fair and equitable treatment standard and the umbrella clause for transit contracts is the subject of this chapter.

Chapter 4 addresses the stabilization clauses. It analyses the theoretical background of traditional freezing clauses and modern economic equilibrium clauses. It addresses the validity and efficiency of stabilization clauses under the applicable law of the contract. It deals with the contractual equilibrium concept and the scope of the economic equilibrium clause and its functional value. Moreover, it identifies the differences between the kinds of economic equilibrium clauses. The legal effect of both freezing and economic equilibrium clauses are analysed in this chapter to assess their value as bargaining factors.

Chapter 5 analyses the applicable law on contract change that determine the rights of parties to request renegotiation in the absence of a renegotiation clause. Moreover, it analyses the clauses that require renegotiation of the contract from the angle of the extent of contract change they might cause. The procedural aspects of renegotiation, such as the triggering events, the role of the arbitrator to adapt the contract and the extent of contract change are subjects of this chapter.

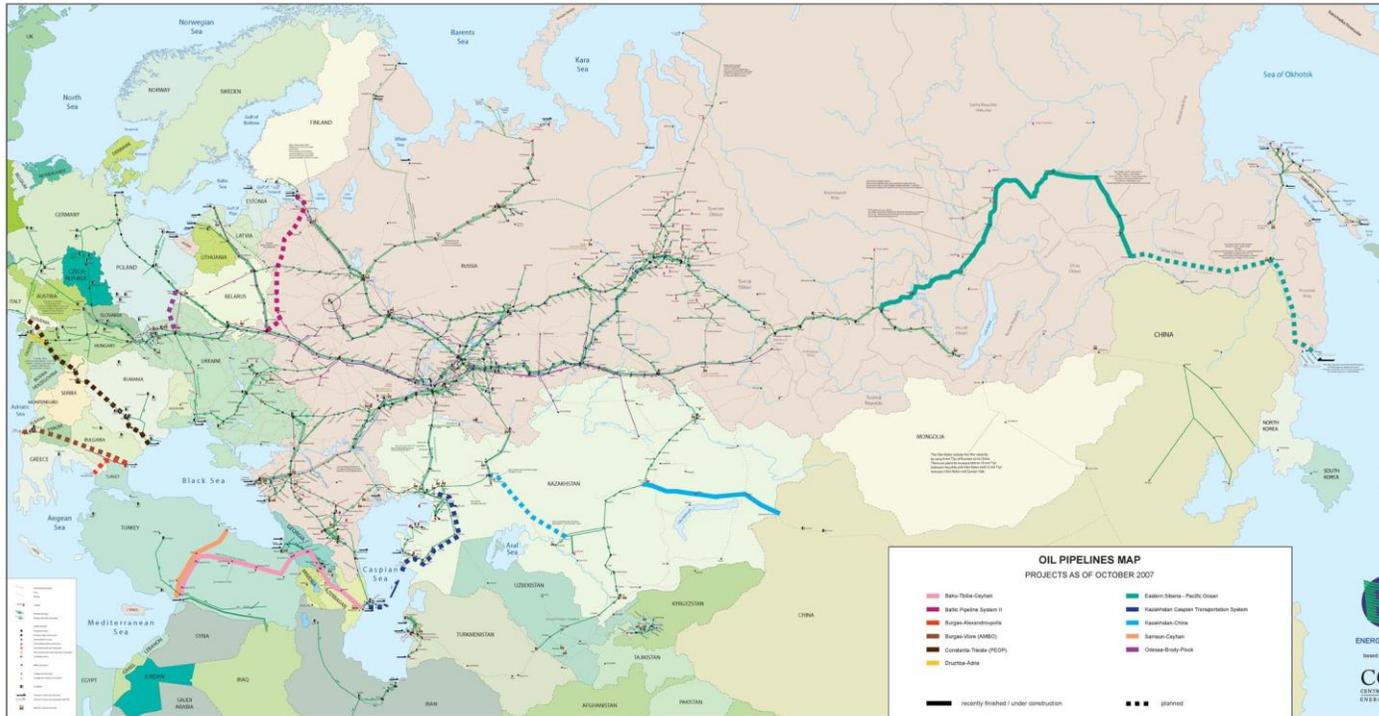
Chapter 6 addresses the settlement method of transit disputes that have been experienced by transit pipeline projects in selected case studies. It analyses the viability of the clauses that aim to maintain economic equilibrium of these contracts in their economic and geopolitical contractual environment from the perspective of how they would have been used as bargaining factors during the operation of these pipelines.

Chapter 7 is the conclusion chapter of the thesis. It summarizes the findings of the thesis in addition to giving recommendations to future negotiators of transit pipeline agreements.

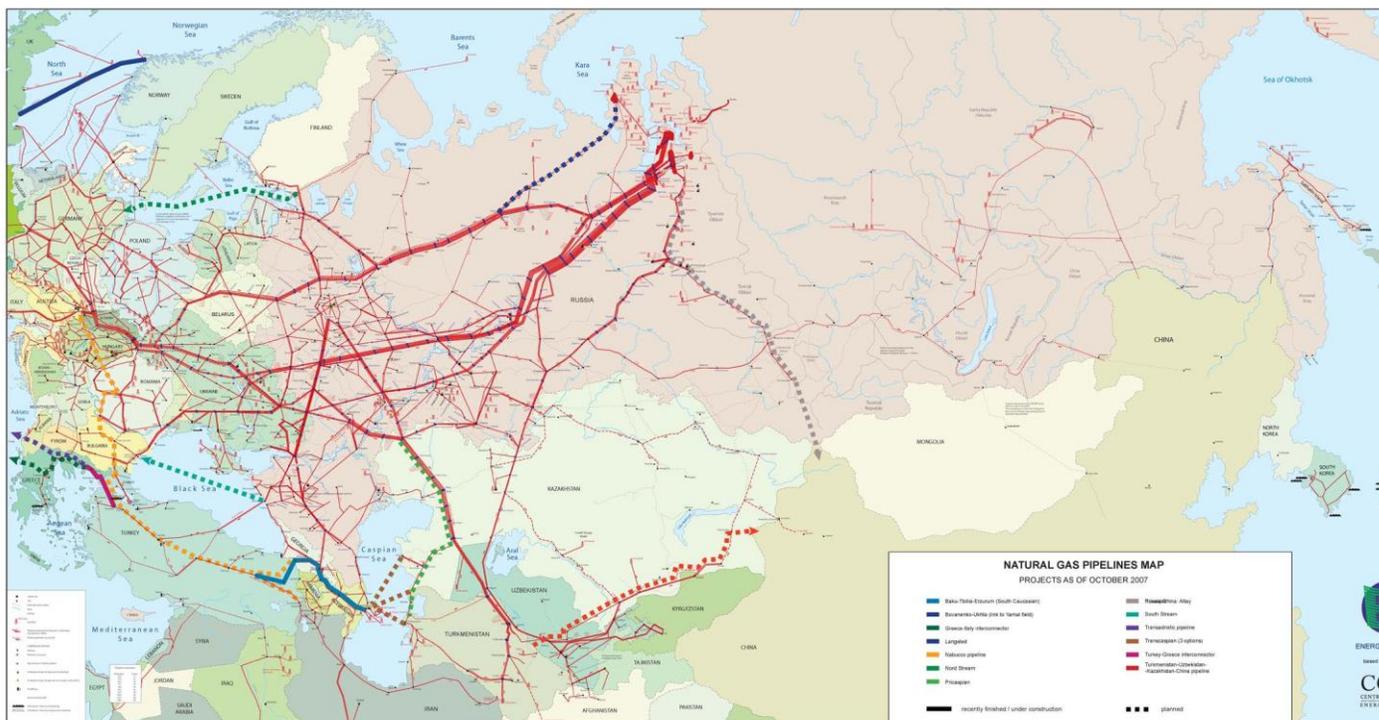
Maps:

Oil Pipelines, as of October 2007⁹⁵:

⁹⁵ <http://www.encharter.org/index.php?id=36>



Natural Gas Pipelines, as of October 2007⁹⁶:



⁹⁶ ibid

CHAPTER 2. NEGOTIATION FACTORS IN THE OPERATION STAGE OF TRANSIT PIPELINE AGREEMENTS

2.1 Introduction

In the first chapter, the historical context of transportation via pipelines and certain definitions relating to transit disputes and transit pipeline agreements, the reasons for these disputes, and access to pipelines were explained. Moreover, the role of contractual clauses that aim to maintain the economic equilibrium of the contract, in the case of both stabilization and renegotiation clauses, was explained briefly. The research questions, the justification for and the methodology of the thesis, as well as the structure of the thesis, were also the subject of the previous chapter. This thesis approaches the negotiation of transit pipeline agreements from the perspective of bargaining theory. The clauses that aim to maintain the economic equilibrium of the contract are analysed as bargaining factors. This chapter constitutes the analytical framework of the thesis. It analyses the economic, geopolitical and, in particular, legal bargaining factors in the operation stage of transit pipeline agreements from the angle of alternating offers model of bargaining theory

2.2 Bargaining: Theory, Factors and Outcome

2.2.1 Milestones in Bargaining Theory

Bargaining is defined as a situation in which two individuals have the opportunity to collaborate for mutual benefit in more than one way.¹ Another definition of a bargaining situation is one in which the parties have a common interest to co-operate but have conflicting interests over how to cooperate. The parties can mutually benefit from

¹ J Nash, "The Bargaining Problem" (1950) 18 *Econometrica* 155, 155

reaching agreement from a set of possible outcomes but have conflicting interests over the set of outcomes.² A bargaining situation has three main problems, which are: the outcome of the negotiation, the concession process and the role of the negotiators in influencing the bargaining outcome.³ This thesis focuses on the concession process: the role of the bargaining factors in determining the behaviours of the negotiators and the bargaining outcome in the context of transit pipelines.

The bargaining problem was first dealt with by Edgeworth in the 1880s. However, the bargaining equilibrium was accepted as indeterminate by Edgeworth and subsequent authoritative economists until the beginning of the 1930s. Two attempts were made at around this time to determine the bargaining equilibrium by Hicks and Zeuthen. According to Hicks' theory, the bargaining equilibrium is determined by the intersection between the expectation of the extreme rates of the bargainers and the length of strike, the time element, in a wage negotiation. However, Hicks' theory is all about the limits of the contract zone and does not explain anything about what happens between these limits, in other words, about the bargaining process.⁴ Zeuthen was the first economist who studied the factors that determine the bargainers' conduct. According to the Zeuthen, the bargainers' conduct and the outcome are determined by their valuation of advantages and disadvantages. The advantage is to get a more favourable price. The disadvantage is the possibility of a conflict. The decisive factor is not the magnitude of advantages and disadvantages but the bargainers' estimation of their possibility. The expectation of the

² A Muthoo, *Bargaining Theory with Applications* (CUP 1999) 1-2

³ J Cross, *The Economics of Bargaining* (Basic Books 1969)

⁴ J Pen, "A General Theory of Bargaining" (1952) 42 *The American Economic Review* 24, 24-25

risk of a conflict is the central factor.⁵ However, the bargaining problem was not presented as a model until the path-breaking 1950 and 1953 articles of John Nash.

2.2.1.1 Nash's Game Theory

Nash based his theory on the assumptions that the players in a bargaining situation are highly rational. Therefore, each can accurately compare his desires for various things. They are equal in bargaining skills and each of them has full knowledge of the preferences of the other.⁶ The theory is based on the utility functions of each party's anticipations. However, one anticipation is especially important in a bargaining situation -the anticipation of non-cooperation between the parties. In two-party games, if the utility function of one pay-off (a) is higher than utility function of another pay-off for both of the players then the solution will be the pay-off whose utility function is bigger -that is (a).⁷

Nash added the threat concept to game theory in his 1953 article. He argued that a common device in negotiation is threat. According to the threat concept, the solution of the game not only gives what should be the utility of the situation to each player, but also tells the players what threats they should use in negotiating. Player A threatens player B that if B does not act in conformity with A's demands, then A will follow a certain policy. For the success of the threat, it is essential that A be compelled to carry out his

⁵ *ibid*, 33-34

⁶ Nash, *supra* note 1 155

⁷ *ibid*, 157-159

threat if B does not comply. The negotiation model is based on three assumptions and four stages.⁸

Although Nash's theory was path-breaking in the history of bargaining theory, it focused heavily on the bargaining outcome and the role and tactics of the negotiators in influencing the outcome, the threat concept. However, this thesis focuses on the bargaining process and the factors determining the bargaining outcome.

2.2.1.2 Rubinstein's Alternating Offers Model

The last milestone in the theory of bargaining is Rubinstein's "alternating offers model".⁹ Rubinstein's contribution to bargaining theory is that he moved the bargaining model from Nash's cooperative game theory to the non-cooperative game theory. Moreover, the alternating offers model directly deals with bargaining factors that determine the outcome of the negotiation. The alternating offers model is based on the bargaining situation in

⁸ J Nash, "Two Person Cooperative Games" (1953) 21 *Econometrica* 128, 130-131

The first assumption is that each player is fully informed on the structure of the game and on the utility function of the other party; of course he also knows his own utility function. The second assumption is that the players are intelligent, rational individuals. The third assumption is that a common device in negotiation is threat. The threat concept is that the solution of the game not only gives what should be the utility of the situation to each player, but also tells the players what threats they should use in negotiating. Player A threatens player B that if B does not act in compliance with A's demands, then A will follow a certain policy. For the success of the threat it is essential that A be compelled to carry out his threat if B does not comply. The fourth assumption is that there is an adequate mechanism for forcing the players to stick to their threats and demands once made; and one to enforce the bargain once agreed. Thus a sort of umpire is needed who will enforce contracts or commitments. It is also assumed that the players have no prior commitments that might affect the game. In stage one, each player chooses a strategy that he will be forced to use if the players cannot come to an agreement: that is, if their demands are incompatible. This strategy is that players threaten. In stage two the players inform each other of their threats. In stage three, the players act independently and without communication. In this stage, each player decides on his demands. A player will not cooperate unless the mode of cooperation has utility to him. In stage four, the pay-offs are determined. If the demands can be simultaneously satisfied, then each player gets what he demanded. Otherwise, the threats must be executed. The effect of the choice of threats on this game is to determine the pay-offs if the players do not cooperate.

⁹ A Rubinstein, "Perfect Equilibrium in a Bargaining Model" (1982) 50 *Econometrica* 97, 97 et seq

which two players have to reach an agreement on the partition of a pie. A perfect equilibrium is defined as where not only the strategies that are chosen at the start of the game determine the equilibrium but also one where the strategies planned after all turns (in every subgame) determine the equilibrium. Each party has to make a proposal in each turn. After one of the parties has made his offer, the other should accept or reject it and continue to bargain through making his offer. According to Rubinstein, if continuing to bargain does not have any cost to any of the bargainers, bargaining will continue without an end. However, the most important cost is time in any bargaining situation. The bargaining outcome and the pay-offs will be determined according to the ratio between their discount rates: the time factor. The more patient party will take more from the pie. If their discount rates are equal, they will divide the pie evenly.

After the alternating offers model, bargaining theory has been based on this model and other scholars have added various bargaining factors in addition to Rubinstein's 'discount rates'. All of these developments were compiled by Muthoo in his book "Bargaining Theory with Applications". I will use the terminology of Muthoo on bargaining factors to analyse the negotiation process for transit pipeline agreements. These bargaining factors are:

- discount rates of the parties
- risk aversion of the parties
- outside options of the parties
- inside options of the parties

These factors were analysed, in the context of transit pipelines, in the thesis of Omonbude as well.¹⁰ However, in addition to these factors, he analysed as “bargaining principles” three more concepts. These concepts are a common interest to trade, information asymmetry and commitment tactics. It was accepted by Omonbude that a common interest to trade is a bargaining prerequisite more than a bargaining factor. Moreover, commitment tactics are part of the acts of negotiators that influences the bargaining rather than a bargaining factor. Information asymmetry is not a vital bargaining factor, in the context of negotiations of transit pipeline agreements, provided that the host state or the pipeline company is not a new entrant to the market. Moreover, Omonbude analysed these principles entirely from the angle of economics. However, this thesis aims to analyse the value of contractual stability provisions as bargaining factors in the context of the economic and geopolitical contractual environment in particular. The next section of this chapter analyses in detail the above-mentioned four bargaining factors and their roles in determining the outcome of the negotiations of pipeline agreements.

2.2.2 Bargaining Factors and Bargaining Outcome: Reaching a Deal

2.2.2.1 Discount Rates

In a bargaining situation, each party would like to reach an agreement. However, each party would like to reach an agreement in the interests of himself. Therefore, either the parties will reach an agreement after some costly delay or they will fail to reach an agreement. Bargaining is a time-consuming process in which the players make offers and counter-offers to each other. If neither party incurs any cost during the bargaining

¹⁰ E Omonbude, *Cross-border Oil and Gas Pipelines and the Role of the Transit Country: An Analysis of the Consequences of Shift in Bargaining Power of the Parties to the Pipeline Agreement* Unpublished PhD Thesis (CEPMLP 2007)

process, then each player may continuously demand that agreement should be made on terms that he wants. However, in most bargaining processes there is a bargaining cost for both of the parties. A basic source of the cost that is incurred by a player comes from the fact that bargaining is time-consuming and time is valuable. Therefore, the discount rates of the parties, which represent their valuation of time is one of the bargaining factors that determine the bargaining power of the parties and the bargaining outcome. The discount rates of the parties means how much the actors value present gains when compared to future gains in a time-consuming offer-counteroffer bargaining process. The more patient party will take more of the surplus from the pie. The parties will reach to an immediate agreement only if time is valuable to at least one of the two players.¹¹

In terms of transit pipeline negotiations, the transit state would be more patient than the pipeline company. In international –integrated- pipeline projects, the owners of the pipeline company are the owners of the company that produces the upstream resources. Therefore, they would be impatient to reach the market through the construction of the pipeline to realize the profit. Moreover, in an open-access pipeline system, the pipeline operator would have obligations under existing transport contracts. Therefore, it is submitted that the transit country has more bargaining power at the operation stage due to the impatience of the pipeline company to reach the market.

2.2.2.2 Risk Aversion

Another source of the cost in a bargaining situation is that each negotiation has an exogenous risk of breakdown. The bargainers' attitude to the risk of breakdown will

¹¹ Muthoo, *supra* note 2 41 et seq; Rubinstein, *supra* note 9

determine their bargaining power and the pay-off they would get from the negotiations. The risk aversion of a party means the conduct of that party in the case of there being no agreement. The more risk-averse party will be more akin to minimize the risk of breakdown. Therefore, his concession rate is higher than the less risk-averse party. Consequently, the less risk-averse party has more bargaining power by exploiting the more risk-averse party's eagerness to trade.¹²

The risk aversion of a transit state is determined by the following factors: its dependence on transit revenues, the significance given to the transit state's relation with the participating countries in the pipeline chain, its cost contribution to the project,¹³ the significance given to foreign investment, and the transit state's relations with investors' home governments and international institutions. The effects of these economic and mostly geopolitical factors can be seen in the negotiation processes for the BTC oil transit pipeline, the SCGP and the CPC oil transit pipeline, which are analyzed in the chapter that deals with case studies.

2.2.2.3 Outside Options

In many bargaining situations, the parties may have access to possible outside options. They can have the possibility of being a party to an alternative bargaining process. The availability of outside options means possible third-party allies, alternative partners, alternative projects or other means outside of the negotiations being conducted between the parties. An attractive outside option increases the bargaining power of the party.

¹² Muthoo, *supra* note 2 73 et seq

¹³ Omonbude, *supra* note 10 64

However, the effect of this bargaining factor is dependent on two prerequisites. First, there should be no risk of breakdown. Secondly, parties' discount rates should be equal: in other words, they should value time equally.¹⁴ The availability of outside options affects the outcome when an alternative exists that influences the size of the stake (the significance of negotiation) for each party. The best available alternative in the case of a disagreement has an important effect on the significance of the negotiations to each party in the context of overall host state-investor relations.¹⁵

In the negotiation process for transit pipeline agreements, an alternative investor consortium can be an outside option for the transit country. Although having no pipeline running through the transit country was also indicated as an outside option for the transit country,¹⁶ this argument is questionable, since how can a transit country reject the producer country's freedom of transit? On the other hand, an alternative pipeline route can be an outside option for the pipeline company, which increases its bargaining power.

2.2.2.4 Inside Options

The availability of inside options means the ability to get benefits from the circumstances in which bargaining occurs and continues. If a party's inside option is more attractive than the other party's, that party has more bargaining power unless one of the parties has

¹⁴ Muthoo, *supra* note 2 99 et seq

¹⁵ L Eden, S Lenway and DA Schuler, 'From the Obsolescing Bargain to the Political Bargaining Model' in *International Business and Government Relations in the 21st Century* (R. Grosse ed, CUP 2005) 253 et seq

¹⁶ Omonbude, *supra* note 10 68

an attractive outside option. However, the effect of this bargaining factor is dependent on both parties not having an attractive outside option.¹⁷

In the context of the negotiation of transit pipeline agreements, the inside options of the parties are the rights, incentives and responsibilities of the parties that were agreed and set out in the agreement. For instance, particularly in the operation stage of the pipeline, the determination system of tariffs and/or transit fees and the off-take volumes or the clauses that aim to maintain the economic equilibrium of the contract, such as the economic equilibrium and/or renegotiation clauses and the applicable law clause, can be inside options for one of the parties. According to their provisions, they might increase the bargaining power of one of the parties.

2.2.3 Reclassification of Bargaining Factors Based on Their Scope in the Context of Transit Pipeline Agreements

The facts that are classified under the four bargaining factors, of discount rates, risk aversion, outside options and inside options that were analyzed above can be classified under three main groups, in the context of transit pipeline projects, as well. These are economic factors, geopolitical factors and legal factors.

The economic factors are the impatience of the pipeline company to reach the market and to gain profits, which is classified under discount rates. The significance given to foreign investment by the transit country, the significance given to existing and possible future investments in the transit country by the pipeline company and transit fees that are

¹⁷ Muthoo, supra note 2 137 et seq

classified under risk aversion are economic factors as well. The availability of an alternative route for pipeline investors and the availability of alternative investors for the transit state are economic factors that are classified under outside options.

The negotiation of transit pipeline agreements has been influenced by geopolitical factors in addition to the economic factors. The geopolitical factors that have an influence on the negotiation of transit pipeline agreements are the significance given to the relationship between the participating countries in the pipeline chain or to the relationship between the transit country and the home governments of pipeline investors and international institutions such as the World Bank and the International Monetary Fund (IMF). Energy security concerns and the aim of transit state to control energy routes are geopolitical factors as well. These factors determine the risk aversion of the parties.

The legal factors constitute the main part of this thesis. They are the clauses that aim to maintain the economic equilibrium of the contract either in the form of an economic equilibrium clause or a renegotiation clause. The legal factors also include applicable law clause that determines whether a party is entitled to contract change in the absence of a renegotiation clause, and the stability provided by investment treaties to transit contracts under the fair and equitable treatment standard and the umbrella clause.

The economic, geopolitical and legal factors mentioned above and their effects during the negotiation and renegotiation of pipeline agreements are analyzed in detail in section 2.4 of this chapter, Transit Pipeline: A Multidimensional Project. However, before that, one

more theory should be analyzed in order to achieve the aim of this chapter. This theory is the “obsolescing bargain” and constitutes the subject of the next section of this chapter.

2.3 Shift of the Deal Pursuant to the Obsolescing Bargain Model

2.3.1 Obsolescing Bargain Concept

The obsolescing bargain concept was coined by Vernon in 1971 in order to explain the multinational company-host state relationship. According to this concept, when an investment starts to produce profit, investors are increasingly committed to the project by the sinking of commitments. On the other hand, the host states raises demands for higher share.¹⁸ The obsolescing bargain model envisages that bargaining power in large private infrastructure projects shifts during the operation stage of the investment. The host state needs private investors and offers attractive incentives, concessions, at the pre-investment stage. Once the investment becomes operational, the investor requires a long amortization period to get the expected return while the host state has already got what it wants. Therefore the original bargain has become obsolete.¹⁹

The bargaining outcome is the result of the relative bargaining powers of the parties. The relative bargaining power favours the foreign investor at first due to its mobility, which enables it to extract raw materials in any country other than the host state. New technology and the management skills of the investor also contribute to the investors’ bargaining power. At this stage, the host country offers great incentives. However, once the investment is made, the initial bargaining power obsolesces over time. The host

¹⁸ R Vernon, *Sovereignty at Bay: The Multinational Spread of US Enterprises* (Longman 1971) 52

¹⁹ E J Woodhosue, “Obsolescing Bargain Redux? Foreign Investment in the Electric Power Sector in Developing Countries” (2006) 7 *New York University Journal of International Law and Politics* 121, 127

country's perception of the cost-benefit ratio offered by the company decreases, particularly when the investment is more profitable than first envisaged. The transfer of technology and the emergence of local competitors influence the host country's perception as well. If the host country's cost-benefit ratio obsolesces, the host country will demand more commitments from the investor. This demand results in the obsolescence of the original bargain.²⁰

The obsolescing bargain concept is not only based upon the parties' internal factors, such as their respective resources and goals, but also on the external dimensions that influence it. These dimensions are the availability of alternative countries, the influence of the pressure groups and political opposition, and probable government change on the host state side. On the other hand, possible competitors for the investor, the investor's ability to invest in another country and its relations with customers and suppliers have an effect on the bargaining power of the investor. Change in these dimensions results in change in the bargaining power of the parties and the obsolescence of the bargain.²¹

The goals and priorities of the host state may change when new political forces come into power or political leaders and voters change their views towards economic development. This situation was experienced in Canada when the country applied its National Energy Program in the 1980s.²² Increased pressure on the host government from domestic sources, such as business communities and opposition politicians, and the immobility of

²⁰ Eden et al, supra note 15 253 et seq

²¹ R Grosse, "The Bargaining View of Government Business Relations" in *International Business and Government Relations in the 21st Century* (R. Grosse ed, CUP 2005) 276 et seq.

²² B Jenkins, "Reexamining the Obsolescing Bargain: A Study of Canada's National Energy Program", (1986) 40 *International Organization* 140, 141

the foreign company after the investment is sunk creates a situation where the attractive agreement first agreed will become obsolete. Obsolescence might take the form of renegotiated contracts, higher taxes, expropriation of assets or seizure of the income stream of the firm as well as creeping expropriation through regulation.²³

Although the obsolescing bargain concept is an old concept that was first used in the 1970s, it is still relevant in explaining host state-investor relations. The nationalizations that took place either by direct expropriation or creeping expropriation through regulatory changes, in the first decade of the millennium in Latin America, Eastern Europe and FSRs, and in particular in Russia, have confirmed the statements of Vernon set out in “In the Hurricane’s Eye” in 1998. Vernon argued that the liberal treatment that investors received from host states, which started in the late 1970s and which improved after the Washington Consensus and vast privatizations of the 1990s, would face at least a slowdown. The positive climate in which investors operate would change in the following decade.²⁴

Venezuela increased the share of state oil company Petroleos de Venezuela to a stockholding majority by renegotiation of concessions and joint venture contracts with foreign investors in 2005 and 2006. Argentina increased taxes on oil exports from 20% to 25-45% in 2005. Bolivia nationalized its natural gas sector step by step through

²³ E J Malesky, “Re-thinking the Obsolescing Bargain: Do Foreign Investors Really Surrender their Influence over Economic Reform in Transition States?” Paper prepared for the presentation at Annual Conference of International Studies Association, San Diego (March 24 2005) 5

²⁴ R Vernon, *In the Hurricane’s Eye: The Troubled Prospects of Multinational Enterprises* (HUP 1998)

regulatory changes.²⁵ Although oil production was privatized in the Yeltsin era, pipelines and natural gas remained in state control in Russia. The Russian government increased its shares in Gazprom from 39% to 50% in 2005. Expropriations occurred in the oil sector (e.g. Yukos case).²⁶ The state ownership in Russia's equity market capitalization rose from 20% in 2003 to 35% in 2007. The increase in state ownership is particularly evident in the oil sector. State controlled companies produced 16% of the oil in the country in 2003. The share of these companies rose to the level of 40% in 2007. This occurred due to direct or indirect expropriations, which could be seen in the YUKOS or TNC cases.²⁷ The last and notorious example of an obsolescing bargain is Argentine's nationalization of YPF, its national oil and gas company, which was sold to the REPSOL, a Spanish Company, in 1999 for 15 billion dollars.²⁸

In a study, the author examined the subject matter of the International Centre for Settlement of Investment Disputes (ICSID) disputes and the conduct of a particular country, Jamaica, with regard to multinational investors over the last three decades. It was argued that obsolescing bargain is still the reality of host state-investor relations and the main cause of the disputes between them. However, the manner of the obsolescence has changed from the host states' attitude to get ownership of the investment project to

²⁵ K Kalotay, "Multinational at Bay? Why the Liberalization of Host Countries towards Foreign Investor is still Alive", (2007) 2 The Geneva Post Quarterly 2, 22-25

Through its Hydrocarbon Law, Bolivia increased production taxes from 18% to 50% and required foreign investors to sign new contracts which stipulate the sole ownership of production, transport, refining, stocking and distribution, commercialization and industrialization of oil and gas in the country by the state owned company. Government decrees fix the share of private companies within the production to 18% compared to 82% during the time of privatization

²⁶ *ibid*, 27

²⁷ W Thompson, "Back to the Future? Thoughts on the Political Economy of Expanding State Ownership in Russia" The Russia Papers, CERJ (2008)

²⁸ <http://www.guardian.co.uk/commentisfree/2012/apr/22/will-hutton-argentina-oil-grab-justified?cat=commentisfree&type=article> last accessed 5 September 2012

unilateral state act that results in changes in the contractual fiscal regime (e.g. taxes, tariffs) of the investment.²⁹

2.3.2 Obsolescing Bargain and Transit Pipelines

The obsolescing bargain effect is the phenomenon behind transit disputes. Much of the problems relating to transit pipelines can be attributed to the obsolescing bargain effect. Transit pipelines are more prone to obsolescing bargain compared to other investments. There are two reasons behind this situation. The first is the bygone rule: transit pipelines are large-scale investments. They require huge fixed upfront investment, while their operating costs are very low. Therefore, the pipeline continues to operate if the parties can get some profit in addition to the operating costs. The second factor that makes transit pipelines more prone to obsolescing bargain is that the routes of the transit pipelines are fixed. After the pipeline is constructed it is not possible to remove it from the host state. Therefore, the hostage effect is stronger compared to other investments. These two factors lead to a strong temptation for governments to take advantage of the obsolescing bargain in transit pipeline projects.³⁰

These views relating to the obsolescing bargain effect on transit pipelines are confirmed by the experience of investments that are mobile and have a lower up-front cost, such as investments in the manufacturing sector. These are less prone to the obsolescing bargain

²⁹ A G Wint, "Has the Obsolescing Bargain obsolesced? Negotiating with Foreign Investors" in *International Business and Government Relations in the 21st Century* (R. Grosse ed, CUP 2005) at 317 et seq

³⁰ P Stevens, *Cross-border Oil and Gas Pipelines: Problems and Prospects* (ESMAP 2003) 16

effect.³¹ However, in transit pipeline projects, relative bargaining power changes during the operation stage. Therefore, the parties may not want to honour agreed conditions in the contract. This can encourage the opportunistic behavior of a transit country and lead to the obsolescing bargain effect. As a result of this inflexibility and the hostage effect, the agreements that govern construction and operation of a pipeline should be sustainable over the life of the pipeline. This can be achieved by addressing the possibility of changing circumstances in the contract.³²

It could be argued that the significance of oil and gas resources for the world economy and the security of supply concerns of the international community contribute to the obsolescing bargain situation for transit pipelines. Transit states can abuse the dependence of business communities and the world economy on oil and gas resources, and the concerns of the international community regarding security of supply, by changing transit terms. Therefore, transit pipeline agreements in which the rules of the game are set out should be carefully negotiated and drafted, addressing changes in the regulatory environment and the changes in the underlying economic conditions of the contract.

2.3.3 Cycles in the Oil and Gas Industry and Their Effects on Transit Pipelines: A Contributing Factor to Obsolescence

Although it is a different concept from the obsolescing bargain, industry cycles influence investment contracts in the same way. When oil and gas prices are low, considerable

³¹ S Kobrin, "Testing the Bargaining Hypothesis in the Manufacturing Sector in Developing Countries", (1987) 41 International Organization

³² Stevens, *supra* note 30 17

promotions and concessions are granted to the investors by the host states in this low phase of the cycle. This is more evident in states whose economy is dependent on oil and gas revenues. However, substantial price rises during the operation stage of the investment will lead to renegotiation demands by the host country.³³

Although industry cycles cause similar results when compared to the obsolescing bargain, these concepts are different from each other. The reason behind the industry cycles is a change in the price of the commodity, which is caused by market conditions, an external function to the host state-investor relationship. However, the reasons behind the obsolescing bargain are caused by changes in the functions of the host state or the investor company.

The renegotiation demands might be more severe where the original contract did not provide for a balanced internal adaptation system that provides a politically acceptable outcome for the host state. In some cases, an internal adaptation system in the contract that responds to changes in profitability and rent may not be able to completely accommodate host state revision demands if the original contract's structure reflects the unequal bargaining powers at the time of negotiation. Moreover, contracts that are concluded with inexperienced governments may come under pressure, in particular if the

³³ P Cameron, *Stabilization in Investment Contracts and Change of Rules in Host Countries: Tools for Oil and Gas Investors* (AIPN 2006) 20 et seq; P Stevens, "Cycles and the International Oil Industry: Where are we today?" World Petroleum Council: Official Publication (2010)

steep rise in oil prices during the high phase of the cycle has not led to a corresponding increase in government income.³⁴

In transit pipelines, when a significant change occurs in the oil or gas price the role of the pipeline in the value chain will alter. This change might encourage an attempt by the transit country to gain a greater share of the rent.³⁵ Therefore, transit terms agreed according to the price of the throughput will be out of line with the reasonable expectations of the host state if the price moves significantly. This will lead to renegotiation demands by the transit country to demand better terms if the price has increased.³⁶

In transit pipeline projects, linking transit fees to the price of the commodity might encounter criticism. The transit country provides the right of way and security for the pipeline while the pipeline company provides transport services to the shipper (upstream producer). Arguably, the transit country has no interest in the commodity price. However, it is submitted that, the transit fee should be linked to at least some objective criteria, such as the inflation index, to manage changes in bargaining power during the operation stage. On the other hand, the tariff is the price paid to the pipeline company for transportation of commodity by the shipper. Moreover, national lines model pipelines are owned and operated by transit states. The tariffs might include the transit fees in these cases. Therefore, these tariffs should be linked to the price of the commodity.

³⁴ T Walde, "Renegotiating Acquired Rights in the Oil Industries: Industry and Political Cycles Rule of Law" (2008) 1 JWELB 55, 56

³⁵ Stevens, *supra* note 30 17

³⁶ P Stevens, "Transit Troubles: Pipeline as a Source of Conflict" Chatham House Report (2009) 28

2.3.4 Is Obsolescence Inevitable or Preventable? Economic, Geopolitical and Legal Constraints

Obsolescing bargain theory explains the relation between the host state and a multinational company as a function of both parties' goals, resources and of the constraints on each of them. The goals of the host country and company are assumed to be in conflict. The outcome favours the party with the stronger resources, higher issue salience, weaker constraints and greater coercive power.³⁷

According to the obsolescing bargain theory, both of the parties possess assets or resources that are valuable to the other party. The value of each party's resources are determined not by its owner but by the other party's desire for those resources. The other party's valuation depends on its need for that resource and on the available alternatives in other words, on the outside options. The resources of the multinational company are its firm specific assets, which are difficult to imitate, such as know-how, brand names and commercial secrets. On the other hand, the resources of the host state are the size of its market and its country-specific advantages, which can be classified as economic, cultural, political and legal advantages. However, it is correctly argued that the resource concept of the obsolescing bargain theory should be updated. The host state's real advantage is its location, which is derived from a geographical situation that has no substitute and cannot be imitated (e.g. a central location for efficient logistics).³⁸

The economic and political constraints affect the exercise of the parties' bargaining power. The political constraints on the host state can be an unstable government. The

³⁷ Eden et al, supra note 15 253 et seq

³⁸ ibid 262

actions of the host state might be restricted by international agreements. The economic constraints on the host state might be balance of payment difficulties. The constraints on the multinational company can be political, such as previous commitments to the host or home country and legal restrictions on its activities, and they can also be economic, such as restrictions imposed by its parent firm.³⁹

In spite of the predictions of the obsolescing bargain theory, foreign investors without specific resources, such as special technologies, access to markets or regular inputs of capital, are not completely hostage to the host governments. Host states should have concerns about how their actions might be viewed by lenders and other investors. When their need on loans for their development projects and their eagerness to attract foreign direct investment are considered, obsolescence might reduce future investments. The outcome of the obsolescence should be regarded by the outside world as fair. Moreover, foreign investors sometimes request their home governments to intervene on their behalf. For instance, the US could invoke the Hickenlooper Amendment to cut off aid to a country taking US property, or the Gonzalez Amendment to instruct its directors in multilateral finance organizations to vote against loans to an offending country or to discharge the host country from a generalized system of preferences.⁴⁰

The above mentioned possibilities became a reality after US investors had experienced difficulties in Indonesia. US government officials and politicians (e.g. Secretary of State, Secretary of Treasury, Secretary of Commerce, senators, ambassadors) intervened in

³⁹ *ibid* 265

⁴⁰ L T Wells, R Ahmed, *Making Foreign Investment Safe: Property Rights and National Sovereignty*, (OUP 2007) 71-72.

favour of the US investors in the processes of both negotiation and renegotiation of the agreements and in the enforcement of the arbitral awards that relate to power projects that had been conducted by US investors in Indonesia.⁴¹

The effect of home government support was seen in Canada's treatment of US investors when Canada tried to apply its National Energy Program as analyzed above. Canada tried to nationalize the shares of foreign oil companies, which resulted in 50% Canadian ownership. Moreover, it changed tax rates and required companies to use Canadian goods in their investments. Canada's investment agency (FIRA) slowed down the entrance procedure for new investors. These acts by Canada received diplomatic attacks from the Reagan administration. The acts of FIRA and the requirement to use domestic goods was challenged at the World Trade Organization (WTO) under the rules of General Agreement on Tariffs and Trade (GATT). The US won a condemnation of Canada. The Canadian government changed its policies after this condemnation and adopted a flexible attitude while applying its program.⁴²

A very important constraint that was not predicted by obsolescing bargain theory is the role of international institutions, such as the WTO, and multilateral treaties, such as GATT, negotiated between governments at these institutions. Another constraint that was not predicted by obsolescing bargain theory is regulatory convergence, which is created by bilateral investment treaties and the multilateral ones such as North American Free

⁴¹ See *ibid*

⁴² Jenkins, *supra* note 22 153 et seq

Trade Agreement (NAFTA) and the ECT.⁴³ These international organizations play an important role in developing legal principles. The Energy Charter Model Agreements on Cross-border Pipelines and the AIPN Host-government Agreement Handbook can be given as examples.

The ICSID plays a very important role. Investors can directly file arbitration cases against states at ICSID through using their rights that arise out of investment contracts or BITs. The first case was filed after the obsolescing bargain term was coined. The number of cases in front of the ICSID remained small until the 1980s but there are more than a hundred cases still pending at the ICSID now.⁴⁴

The risks of arbitration, such as losing face in the international community, business community and the high compensation amounts awarded by arbitrators, also constitute important constraints on host states. The contracting practice has been enhanced as well. The specific investment contracts, and the clauses drafted in these contracts, such as traditional stabilization (freezing) clauses and economic equilibrium clauses, the applicable law clause and the effect of the applicable law on contract change, can be important constraints when the state wants to change the legal regime of the contract.⁴⁵ On the other hand, the clauses that require renegotiation in order to maintain the economic equilibrium of the contract in the case of an unforeseen event might provide stability to the contractual relationship.

⁴³ Eden et al, supra note 15 266

⁴⁴ <http://icsid.worldbank.org/ICSID/FrontServlet?requestType=GenCaseDtIsRH&actionVal=ListPending>
last accessed 5 September 2012

⁴⁵ P Cameron, *International Energy Investment Law: The Pursuit of Stability*, (OUP 2010)

2.4 Transit Pipeline: A Multidimensional Project

Transit pipelines are not only economic projects. They also have geopolitical influences, mostly at the regional but sometimes at the global level. Transit pipelines require a complex matrix of legal arrangements between participating governments and between each host state and the pipeline company as well. These economic and geopolitical dimensions of the pipelines and the design of their legal arrangements constitute bargaining factors that affect the bargaining power of the parties and the bargaining outcome both in the pre-investment and post-investment (operation) phases of these projects. Although economic and geopolitical factors are more effective in the pre-investment phase negotiations than legal factors, they both affect the parties' bargaining power. The effects of these bargaining factors are analyzed in detail in this section.

2.4.1 Economic Factors

2.4.1.1 Transit Fees and Tariffs

The tariff is the price paid to operator of the pipeline by the shipper of the commodity in order to transport oil or gas. The transit fee is a tax paid to the transit country by the pipeline company for the right of way and security of the pipeline.⁴⁶ The practice of transit pipeline agreements confirms this conceptualization as can be seen in the HGAs between Turkey and the BTC Pipeline Company and between Georgia and the BTC Pipeline Company. The transit fee is determined as corporation tax and profit tax, respectively in these agreements.⁴⁷ However, the nature of transit fee is dealt with in

⁴⁶ S Vinogradov, *Cross-Border Oil and Gas Pipelines: International Legal and Regulatory Regimes*, (CEPMLP 2001) 24 For a detailed analysis of transit fees and tariffs see Chapter 1 17-24

⁴⁷ HGA Turkey and HGA Georgia, www.caspiandevlopmentandexport.com last accessed 5 September 2012

Chapter 1 of this thesis in detail and in this section, I analyze the significance of the transit fee and the tariff as crucial economic factors in transit pipelines.

A transit fee can be paid to the transit country in cash or in kind when the transit country is an off-taker. However, the role of the transit fee as an economic factor depends on its size relative to the total economy of the transit country. For instance, in the case of the BTC pipeline, Turkey gets an annual transit fee of \$250-300 million. However, this can be regarded as very low for a country that has a GDP of \$770 billion. Therefore, this fact decreases the risk aversion of the transit country. Therefore, the transit country may easily raise a transit dispute. On the other hand, the transit fee paid to Georgia in the case of the BTC pipeline constitutes 2% of its GDP. In the case of the SCGP, the off-take volume that Georgia gets as a transit fee constitutes 80% of natural gas consumption of its capital city. Georgia is in a very risk-averse position. The possibility of Georgia raising a transit dispute is lower than that of Turkey when its economic dependence on these pipelines is considered.⁴⁸

Tariffs are the main earning of a pipeline company from its operation. If a transit dispute occurs, the pipeline company might not provide the transportation service due to the possibility of an interruption. Therefore, it will not get the tariffs from the shipper of the commodity. This situation would raise disputes between the pipeline company and

⁴⁸Z Baran, "The Baku-Tbilisi-Ceyhan Pipeline: Implications for Turkey", in *The Baku-Tbilisi-Ceyhan Pipeline: Oil Window to the West* (S F Starr, S E Cornell ed, Central Asia and Caucasus Institute-Silk Road Studies Program 2005); V Papava, "The Baku-Tbilisi-Ceyhan Pipeline: Implications for Georgia", in *The Baku-Tbilisi-Ceyhan Pipeline: Oil Window to the West* (S F Starr, S E Cornell ed, Central Asia and Caucasus Institute-Silk Road Studies Program 2005)

shippers under transportation contracts and the pipeline company would be liable for compensation. Therefore, it increases the risk aversion of the pipeline company.

2.4.1.2 Realizing Profit through Reaching Markets

A transit pipeline is part of a bigger chain. It constitutes the midstream part of the oil or gas project. Upstream producers use transit pipeline to reach the downstream (consumer) side of the project. In integrated pipeline projects that are developed by international oil companies (e.g. the BTC, SCGP and CPC pipelines), the pipeline is linked to the upstream of the oil or gas project not only in physical terms but also in economic terms. The upstream producer is also the owner of the pipeline. Therefore, these pipelines are classified as dedicated pipelines. However, independent from the pipeline model, any transit interruption in the midstream part of the project might affect the upstream part of the project. Therefore, the oil and gas producer incurs important costs should there be a transit interruption by the transit country. This vulnerability of producers and pipeline owners increase the bargaining power of the transit country at the operation stage. It may create a temptation for the transit country to interrupt the flow of energy or to raise a transit dispute on contractual terms.

2.4.1.3 Approach of Transit Country to Foreign Investment

Pipeline investments are large-scale projects that cost billions of dollars to construct. They constitute an important source of foreign direct investment in a host state. However, the approach of the transit country to foreign investment is one of the main determinative factors that affect the bargaining relationship between the pipeline company and the

transit state. For instance, Turkey's economy has become part of the global economy and attracting foreign investment has been a major tool in its economic development program since 2000. This affected its transit country behavior with regard to the BTC pipeline, which started to operate in 2006, and the Kirkuk-Ceyhan pipeline, which restarted operating without restriction in 2010. After the change in Turkey's attitude to foreign investment, the flow of oil was not interrupted by transit country, as was usually the case in the 1970s and 1980s.⁴⁹

Another example of the relationship between the transit state's attitude to foreign investment and transit disputes can be seen in the operation of the IPC's Kirkuk-Tripoli pipeline. Syria has been governed under a socialist economic program and has not regarded foreign investment as part of its economic development. Therefore, it had triggered renegotiations of transit fees and interrupted the flow of oil many times before the pipeline was closed in 1982.⁵⁰

2.4.1.4 Approach of Pipeline Company to Existing and Future Investments in Transit Country

Integrated pipeline projects are constructed and operated by international oil companies. These companies may have investments in the petroleum industry of that transit country, other than the transportation part, which might be in production, refining and distribution sectors of the industry. Moreover, companies may have future plans to invest in the transit country.

⁴⁹ Stevens, *supra* note 30 24

⁵⁰ P Stevens, "A History of Transit Pipelines in the Middle East: Lessons for the Future", in *Boundaries and Energy: Problems and Prospects*, (G.H. Blake et al Kluwer 1998)

Disputes that result in arbitration between foreign investors and host states might cause the breakdown of the investment relationship between that investor and the host state in most cases. In a study that analysed the power plant project disputes in Indonesia, it is argued that the power plant operators that have other investments in Indonesia tend to resolve the conflicts through renegotiation and not through arbitration. This tendency of foreign investors increases their risk aversion. It can be used as a bargaining factor by the transit country.⁵¹

2.4.1.5 Equity Participation of Transit Country in Pipeline Project

Equity participation of a transit country in a pipeline project may reduce the possibility of transit disputes between the transit country and the pipeline company due to the sharing of the costs and the fact that transit country benefits from the profits of the project. Equity participation might increase the risk aversion of the transit state and might reduce its bargaining power.

It is submitted that, in order to be effective, the equity participation of the transit state should be at adequate levels. For instance, the 2% equity participation of the transit states Benin and Togo in the WAGP or the 5.60% equity participation of Turkey in the BTC pipeline might not be adequate to prevent the risk of a transit dispute.⁵² On the other hand, the 31% equity participation of Russia in the CPC pipeline might be adequate to

⁵¹ See Wells and Ahmed, *supra* note 40

⁵² WAGP Website www.wagpco.com; BTC Pipeline Website www.caspiandevlopmentandexport.com last accessed 5 September 2012

prevent Russia from intervening in the pipeline operation due to the fact that it gets an important amount of tariff from the pipeline operation.⁵³

2.4.2 Geopolitical Factors

2.4.2.1 Energy Security Concerns and the Emergence of the Caspian Region

Energy security is defined as the accessibility of sufficient energy resources at reasonable prices for the foreseeable future without risk of serious major disruption of service to a nation or most of its citizens and businesses.⁵⁴ The main pillars of energy security are the control of resource regions, control of prices through providing the stability of producing countries, easing tensions in the resource regions and control of transport routes.⁵⁵

Adequacy of energy supply at reasonable prices constitutes the core of the energy security concept. However, the security of two sources of energy, oil and gas, should be distinguished from each other. In contrast to oil, natural gas is relatively difficult to store and transport. Moreover, oil has a worldwide market, while the gas market is regional. Oil can be transported through pipelines and tankers. However, LNG transportation is very costly. It is not cost-effective under 3000 miles. This makes pipelines the dominant way of transporting natural gas. Furthermore, fixing an oil pipeline in the case of disruption is relatively easy when compared to a gas pipeline. Every pump of the gas pipeline is required to be controlled before the start of the operation. This makes gas

⁵³ CPC Pipeline Website www.cpc.ru last accessed 5 September 2012

⁵⁴ B Barton, C Redgwell, A Ronne and D N Zillman, *Energy Security: Managing Risk in a Dynamic Legal and Regulatory Environment* (OUP 2004) 5

⁵⁵ G Joffe, "The Geopolitics of Energy Security", EUISS Annual Conference on Effective Multilateralism: Engaging with the New Global Players" Paris (22-23 November 2007)

pipelines more prone to interruption.⁵⁶ Therefore, uninterrupted transportation of gas is both more important and more difficult to achieve than oil.

The dependence on energy of not only the world economy and business communities but also the average person in modern life makes the uninterrupted flow of energy resources one of the main pillars of energy security. The effects of this dependence were observed during the Russia-Ukraine gas crises of 2006 and 2009.⁵⁷ The energy security concerns of the consumer countries, their business communities and their citizens provide important bargaining leverage to the transit country and increase its bargaining power.

After the collapse of the Soviet Union, the Caspian Region emerged as an important security and strategic area with an apparent potential to provide additional energy for the world economy.⁵⁸ Resources in the Caspian Region attracted consumer countries and international oil companies in order to diversify supply and transport routes and to decrease dependency on oil supplied by the members of the Organization of the Petroleum Exporting Countries (OPEC), in particular by Middle East countries.⁵⁹ Western companies' involvement was welcomed by Caspian countries, in contrast to the Russian involvement in the upstream part of the projects, for both commercial and political reasons. Pipeline routes were developed by these countries according to these

⁵⁶ S Haghghi, *Energy Security: The External Legal Relations of the European Union with Major Oil and Gas Supplying Countries*, (Hart 2007) 13

⁵⁷ See A Kovacevic, "The Impact of the Russia-Ukraine Gas Crisis on South Eastern Europe" (OIES 2009)

⁵⁸ A Ehteshami, "Geopolitics of Hydrocarbons in Central and Western Asia" in *The Caspian: Politics, Energy and Security*, (Shirin Akiner ed, RoutledgeCurzon 2004) 63

⁵⁹ R Ahrend and W Tompson, "Caspian Oil in a Global Context", 24 *Transition Studies Review* (2007)

considerations, such as strengthening their independence through by-passing Russia and being part of the market economy.⁶⁰

The region has witnessed two main oil and gas discoveries and development of these projects after the collapse of the Soviet Union. The first of these projects is the Tengiz oil field project, which was developed by Chevron, and the Kachaganak gas field project in Kazakhstan. The second of these projects is the Azeri-Chirag-Guneshli oil field project and the Shah Deniz gas field project, which were developed by the Azerbaijan International Operating Company (AIOC). However, these upstream projects raised the question of pipeline transportation due to the land-locked nature of the Caspian countries. Three options were considered for transportation of oil and gas resources in the region. These were the northern route through Russia, the southern route through Iran and the western route through Turkey.⁶¹

The determination of pipeline routes in the Caspian was a highly political issue due to the fact that it was seen by both regional and, moreover, global powers as being part of energy security. In this context, pipelines were regarded as geostrategic assets more than commercial ones.⁶² In the end, in addition to the early oil pipelines (WREP, NREP), two main pipeline routes and four pipelines were developed according to the US east-west energy corridor policy. The CPC oil pipeline and the Karachaganak gas pipeline traverse

⁶⁰ O Marashian, "Pipeline Routes and Pipeline Politics: The Geopolitics of Oil and Gas Exports from the Caspian Basin", in *The Geopolitics of Oil, Gas and Ecology in the Caucasus and Caspian Basin*, Conference Report, Berkeley Programme in Soviet and Post-Soviet Studies (May 1998)

⁶¹ J Roberts, "Pipeline Politics", in *The Caspian: Politics, Energy and Security* (Shirin Akiner ed, RoutledgeCurzon 2004) 77 et seq

⁶² Marashian, supra note 60

the transit country, Russia. The BTC oil pipeline and the SCGP traverse the transit countries of Georgia and Turkey. The east-west energy corridor policy is based on the following principles. First, to prevent Russia remaining the dominant country in energy transport routes. Secondly, in accordance with the ILSA act and the US policy, to prevent Iran becoming an energy transport route and increasing its influence in the Region. Thirdly, to support independence of newly independent South Caucasian states through decreasing their dependence on Russia by developing alternative routes. Pipelines were considered as tools for attaching the region to the western alliance. In order to realize the US east-west energy corridor policy in the Caspian, Turkey became the main pillar of this policy.⁶³

2.4.2.2 Control of Energy Routes: Pipelines as a Geostrategic Asset for the Transit State

Control over pipeline routes is a very significant geopolitical issue. Whoever controls the pipeline route can control the flow of energy and/or share the profit.⁶⁴ Control of pipeline routes is considered as a determining factor in the political and economic future of participating countries and of the region that the pipeline traverses as a whole. States that are traversed by a pipeline obtain influence and control over the oil flow in addition to the heavy capital inflow in terms of investment and transit fees.⁶⁵

⁶³ Ehteshami, *supra* note 58 69

⁶⁴ Vinogradov, *supra* note 46 11

⁶⁵ E Karagiannis, "Iran as a Transportation Corridor for Azerbaijan's Oil to the International Market", (2001) 7 IELTR, 148, 148.; C. Miles, "Caspian Pipeline Debate Continues: Why not Iran?", (1999) 53 Journal of International Affairs 325, 325; Marashian, *supra* note 56 34

The political tensions that arise due to pipeline competition can best be exemplified in the Caspian region. Competition for pipeline projects and their routes has even reached the point where there is rivalry between US-backed Turkey and Russia in the region.⁶⁶ It was argued in an article published in the Russian newspaper *Izvestiya* that “(t)he victor in the struggle will receive not only billions of dollars annually in the form of transit fees. The real gain will be control over the pipelines, which will be the most important factor of geopolitical influence in the Transcaucasus and in Central Asia in the next century.”⁶⁷

This rivalry resulted in a compromise of two pipelines, one passing through Russia and one through Turkey. The CPC pipeline originates in Kazakhstan and traverses Russia as a transit state. The BTC pipeline originates in Azerbaijan and traverses Georgia and Turkey as transit states. Although this latter route was regarded commercially unviable by oil companies, the US east-west energy corridor policy and Turkey’s ambition to become an energy corridor shaped the pipeline route. The international oil companies’ concerns were managed through providing more incentives and low transit fees.⁶⁸

The importance of being an energy corridor can be seen in Turkey’s official energy strategy document. Half of the document consists of Turkey’s role as an energy corridor in existing pipelines and future projects. Turkey is geographically close to 70% of the world’s proven oil and natural gas resources, which are situated in the Middle East and

⁶⁶ Vinogradov, *supra* note 46 16

⁶⁷ Quoted in C Miles, *supra* note 65 332

⁶⁸ T Adams, “Caspian Energy Development”, in *The Caspian: Politics, Energy and Security* (Shirin Akiner ed, RoutledgeCurzon 2004) 92; Baran, *supra* note 48

the Caspian. It is a natural bridge between the Asian and European continents.⁶⁹ Pipelines are regarded by Turkey as tools of control over hydrocarbons originating in the Caucasus and for gaining influence in Caucasus countries in order to improve its geopolitical clout.⁷⁰ However, the political temptation of the country to become an energy corridor and its non-economic approach to the issue might provide important leverage to pipeline companies, which increases their bargaining power.

The risks of determining the pipeline route according to political considerations and non-commercial approaches and of negotiating the agreements under high political pressure were raised by commentators particularly with regard to the BTC pipeline.⁷¹ These concerns of the commentators have become a reality, since a dispute arose between BIL (Turkish state-owned company), operator of the BTC pipeline in Turkey, and the BTC Pipeline Company in 2009.⁷²

2.4.2.3 Availability of Alternative Pipelines

A preferable outside option, an alternative to the existing negotiation, is a factor that increases the bargaining power of the party that has the outside option. This statement is absolutely relevant to transit pipelines and their routes. If a pipeline company has an

⁶⁹ Turkey's Energy Strategy, 2009, [http://www.mfa.gov.tr/data/DISPOLITIKA/EnerjiPolitikasi/Turkey's%20Energy%20Strategy%20\(Ocak%202009\).pdf](http://www.mfa.gov.tr/data/DISPOLITIKA/EnerjiPolitikasi/Turkey's%20Energy%20Strategy%20(Ocak%202009).pdf) last accessed 5 September 2012

⁷⁰ Marashian, supra note 60 38

⁷¹ D Yergin, *The Prize: The Epic Quest for Oil, Money and Power* (Free Publishers 2008) 764; see also Stevens supra note 32 45

⁷² <http://www.hurriyetdailynews.com/n.php?n=caspian-oil-to-mediterranean-at-risk-of-operational-dispute-2011-04-11> last accessed 5 September 2012

alternative route for constructing the pipeline, its bargaining power is enhanced by this alternative.

When Syria triggered renegotiations and interrupted the flow of oil in order to increase transit fees it had received from the IPC pipeline, which originates in Iraq, Iraq searched for alternative routes to transport its oil resources. One of these alternatives is the Kirkuk-Ceyhan pipeline that traverses the transit country of Turkey. The IPC pipeline and Kirkuk-Ceyhan pipeline operated at the same time between 1977 and 1982. However, when the IPC pipeline was closed in 1982, the Turkish route remained the sole route for transporting Kirkuk oil. Turkey triggered renegotiations over transit fees as soon as the IPC line was closed.⁷³

Although their capacities were not sufficient to transport the amount of oil that is produced, the availability of early oil pipelines (WREP, NREP) was used as a bargaining factor by AIOC members when the BTC pipeline route was negotiated with Turkey. AIOC members argued that they could enlarge the capacity of the WREP and NREP to transport Azerbaijani oil.⁷⁴ Moreover, the availability of the shortest route through Iran was used as a bargaining factor against Turkey during the negotiation of the BTC pipeline route and its legal arrangements.⁷⁵ These commercially more viable alternative routes increased the bargaining power of the pipeline company. Therefore, Turkey

⁷³ Stevens, *supra* note 50

⁷⁴ Miles, *supra* note 65 336

⁷⁵ Karagiannis, *supra* note 65 148.; Miles, *supra* note 65 341-342

granted significant incentives to pipeline consortium in terms of transit fees and tax exemptions.⁷⁶

The recent Nord Stream and South Stream pipeline projects and the Southern Corridor pipeline project (Trans Anatolian Pipeline, TANAP) aim to by-pass Ukraine and other FSRs as transit countries following the transit disputes, which have become common between Russia and FSRs, in particular between Russia and Ukraine. After these pipelines start to operate, the availability of these alternative pipeline routes might decrease the bargaining power of the FSR transit countries, with regard to the existing pipelines, when transit terms are negotiated.

2.4.2.4 Relationship between Transit State and Participating Countries

Transit pipelines create rent as part of an integrated project between the participating countries. Moreover, the transit country enables oil producers and producer countries to realize profit in exchange for transit fees and geopolitical clout. This interdependency framework increases their risk aversion and decreases the risk of breakdown.

The historical relations as well as the ethnic and linguistic similarities between Turkey and the Turkic state, Azerbaijan, is one of the factors that make the Turkey the transit country for transporting Azerbaijani oil.⁷⁷ Turkey used its historical ties with Azerbaijan and neighbourhood ties with Georgia to facilitate the BTC project.⁷⁸

⁷⁶ Baran, *supra* note 48 107; Marashian, *supra* note 60 38

⁷⁷ Roberts, *supra* note 61 81

⁷⁸ R Morningstar, "The Baku-Tbilisi-Ceyhan Pipeline: A Retrospective and a Look at the Future", Central Asia-Caucasus Institute, <http://www.cacianalyst.org/?q=node/4113> last accessed 5 September 2012

The influence of Russia on FSRs and Kazakhstan's membership of the Commonwealth of Independent States (CIS) increased the level of cooperation between Russia and Kazakhstan and facilitated the development of the CPC oil pipeline. The coherent relationship between transit state and participating states might increase the risk aversion of the parties and decrease the risk of breakdown in a pipeline chain.

The recent developments in Caucasus and Caspian geopolitics, particularly changes in the relationship between Turkey and Russia in recent years, might change future pipeline politics and the routes that are determined according to them. The relationship between Turkey and Russia reached the point of a "strategic alliance" in the words of the prime ministers of the two countries, Erdogan and Putin, respectively.⁷⁹ Moreover, Turkey and Russia signed protocols on the construction of a parallel line to the Blue Stream gas pipeline, which transports Russian gas to Turkey via the Black Sea. Turkey gave its consent to construction of the part of the South Stream project that traverses part of Turkey's continental zone in the Black Sea. Furthermore, an agreement relating to construction and operation of a nuclear power plant by Russia in Turkey was signed.⁸⁰

2.4.2.5 Relationship between Transit State, Home Governments of Investors and International Institutions

The support by home governments of investors constitutes an important bargaining leverage when investors negotiate with host states. Home governments of investors not only intervene after a dispute has arisen through diplomatic protection but they also

⁷⁹http://www.rferl.org/content/Moscow_Visit_By_Turkish_PM_Underscores_New_Strategic_Alliance/1927504.html last accessed 5 September 2012

⁸⁰ See <http://news.bbc.co.uk/1/hi/8186946.stm> last accessed 5 September 2012

intervene to facilitate the negotiations between host state and foreign investor. The effect of home government support as a constraint on change in the bargaining power of the host state was highlighted above regarding power plant disputes between Indonesia and US investors. The US government support changed the attitude of Canada while conducting its National Energy Programme, as explained above.

Home government support could be seen in the negotiation of the BTC pipeline. The US actively participated during the negotiation of BTC pipeline route. Negotiations on the route of the pipeline and on its legal arrangements took place under a great deal of pressure from the US. The route of the pipeline was shaped according to the US east-west energy corridor policy.⁸¹ The US, a strategic ally of Turkey through NATO, applied pressure on consortium members to accept the BTC route. It applied pressure on Turkey to convince it to make concessions in order to make the route commercially viable for oil companies. Moreover, it provided technical and legal support to Turkey in order to realize the project. US Eximbank also provided a \$250 million loan to finance the BTC pipeline.⁸² The volatile situation of the Turkish economy at the time of the negotiation of the pipeline arrangements and its dependence on IMF loans at that time influenced the negotiations and the terms of the agreement.

US aid to Georgia and the Georgia's security dependence on the US, in opposition to Russia, might decrease Georgia's bargaining power. The political weight of the project

⁸¹ S E Cornell, M. Tsetereli and V. Socor, "Geostrategic Implications of the Baku-Tbilisi-Ceyhan" in *The Baku-Tbilisi-Ceyhan Pipeline: Oil Window to the West* (S F Starr, S E Cornell ed, Central Asia and Caucasus Institute-Silk Road Studies Program) 31

⁸² *ibid*

might make the pipeline vulnerable to changes in political relationships. Moreover, geopolitical changes and a decrease in transit countries' dependence on hegemonic powers might increase their bargaining power.

2.4.3 Legal Factors

2.4.3.1 The Relationship between Bargaining and the Law

The applicable legal regime, either in the form of legal rules and principles or in the form of a contract, provides a framework within which bargaining might take place. The existing methods of dispute settlement that are alternative to negotiation, such as litigation by courts or resolution of the dispute through arbitration, influence the bargaining in the sense that if the parties were to submit the dispute to court or arbitrators they need to consider what the probable outcome under the applicable legal rules would be.⁸³

As a result of the influence of alternative options on the bargaining power of the parties and the bargaining outcome, if any of the parties has a better outside option, that party will end the negotiations and choose that outside option. Therefore, the outcome of the negotiation should be perceived by both parties as being better than submitting the dispute to litigation or arbitration provided that the consequences of the latter can be known and evaluated.

⁸³ R H Mnookin, L Kornhauser, "Bargaining in the Shadow of the Law: The Case of Divorce", (1979) 88 The Yale Law Journal 950, 968

The degree of uncertainty if the parties submit the dispute to litigation or arbitration in case of a failure to reach an agreement at the bargaining table has effect on the negotiations. This depends on to what extent the legal rules and/or contract is clear cut and how much discretion is provided to the judge or arbitrator. Another legal factor that has an effect on the parties' risk aversion is transaction costs and the efficiency cost caused by the time factor if they submit the dispute to a court or arbitration. The amount of fees paid to the court or arbitrators and the lawyers in a litigation or arbitration and the time it might take to resolve the dispute might be determining factors.⁸⁴

It was argued that the parties have a deliberate tendency to draft contracts with inartful language and not to deal with all of the contingencies that can occur in the future. This rational choice increases the uncertainty and cost of litigation and enables parties to reach a solution regarding a future conflict or contingency, when it occurs, without going to court or arbitration. Hill asserted that, "(t)he uncertainty and costs of litigation serve as a bond the parties give against precipitous recourse to litigation, aligning the parties' incentives to resolve any disputes without formal resort to the court system."⁸⁵ Confirming this argument, Friedman and Wicklegren argued that settlement by litigation or arbitration, "...can reduce the accuracy of legal outcomes. Under a range of parameters where chilling is a concern, this effect can be sufficient to outweigh the social benefits of reduced legal costs."⁸⁶ The less risk-averse party, which has a tendency to submit the

⁸⁴ *ibid*, 969-971

⁸⁵ C A Hill, "Bargaining in the Shadow of the Lawsuit" (2009) 34 *Del. Journal of Corp. L.* 191, 208.

⁸⁶ E Friedman and A.L. Wickelgren, "Chilling, Settlement and the Accuracy of the Legal Process" (2010) 26 *The Journal of Law, Economics, & Organization* 144, 154

dispute to litigation or arbitration due to its strong position under the contract or which has a tendency to bear the transaction costs, might have more bargaining power.

There is not too much of a role for the law to play during the negotiation of an investment contract before it becomes effective. At this stage, lawyers look at applicable rules such as the tax laws, foreign investment law and competition law. They intend to sign a contract, which will protect them during the operation stage of the investment. However, when the contract becomes effective and bargaining power shifts to the government, renegotiation takes place in most cases. The law has a greater role in bargaining at this stage: bargaining will take place in the shadow of the law and its 'harrasment' factor. Walde argued that "(w)hile the government will negotiate in the shadow of threatened, or hinted legislation, the investor will use the protective devices implanted into the contract."⁸⁷

These implanted protective devices can be invoking the arbitration clause and activating the harrasment power of the investor through the loss of face of the host state. It can be a clause that stabilises the legal environment of the investment, or that chooses a legal regime other than the laws of the host state as the governing law of the contract.⁸⁸ Moreover, some of the provisions of investment treaties, such as an umbrella clause or the fair and equitable treatment standard, enable the investors to raise a claim under the relevant treaty's dispute settlement forum in the case of a breach of the investment contract.

⁸⁷ T Walde, "Negotiating Transnational Investment: Lawyers in the Shadow" (1991) Inaugural Lecture University of Dundee 1 13

⁸⁸ *ibid*

From a global governance perspective relating to bargaining in the shadow of the law, it was argued that “transnational litigation is the foundation of a form of global governance, whereby judges make decisions that not only directly affect the parties to particular disputes, but also indirectly regulate the behavior of actors who engage in activity in the transnational shadow of the law.”⁸⁹ In an article that analyzed in a comparative way the decisions of the European Court of Justice and informal settlements through negotiations from the bargaining perspective, it was argued that instead of a hierarchical or hybrid relationship between formal decisions and informal decisions through negotiations “...a mutually transformative relationship between the two processes, that brings together the best features from each process in a symbiotic interaction, must be desirable.”⁹⁰ Furthermore, “(t)he shadow of the law, which presumably constrains negotiating parties, is instead cast by them. In other words, in litigation, judges may be following the patterns they see in informal settlements, rather than the other way around.”⁹¹

The bargaining can occur in the shadow of soft law instruments as well. Guzman and Meyer define soft law as “...non-binding instruments, though it includes in the definition statements about legal rules that go beyond explicit agreements among states. Soft law ...

⁸⁹ C A Whytock “Litigation, Arbitration and the Transnational Shadow of the Law” (2007-2008) 18 *Duke J. Comp. & Int'l L.* 449, 452

⁹⁰ T Hervey, “Adjudicating in the Shadow of the Informal Settlement: The Court of Justice of the European Union, New Governance and Social Welfare” (2010) 63 *Current Legal Problems* 92, 152

⁹¹ H S Erlanger, E Chambliss and MS Melli, ‘Participation and Flexibility in Informal Processes: Cautions from the Divorce Context’ (1987) 21 *Law and Society Review* 585, 599-600 cited in *ibid* at 107

refers broadly to quasi-legal rules that are not legally binding on states.”⁹² Therefore, although the decisions of tribunals such as the International Court of Justice (ICJ) are not binding other than on the states that are parties of the disputes, they constrain other states as soft law instruments. The effect of these soft law instruments is analyzed in detail in the relevant sections of Chapter 4 and Chapter 5.

While explaining the bargaining theory and bargaining factors, inside options are defined as the ability of a party benefitting from the existing circumstances. The party that has better inside options has more bargaining power. This thesis particularly focuses on the contractual stability provisions and the stability provided by treaty provisions to contracts. These instruments constitute a legal regime that creates existing circumstances in which the parties act and bargaining in other words, renegotiation occurs. These protective devices implanted into the contract, and the provisions of investment treaties, such as the fair and equitable treatment standard and umbrella clauses that reinforce the parties’ contractual commitments, might play the role of inside options at the bargaining table.

2.4.3.2 The Energy Charter Treaty Framework and the Stability Provided by Treaty Provisions to Contracts

2.4.3.2.1 The Energy Charter Treaty Transit Provisions

Bargaining takes place in the shadow of the treaty framework as well. The ECT is the only multilateral treaty that regulates significant aspects of transit, in particular freedom

⁹² A T Guzman, T . Meyer, “International Common Law: The Soft Law of International Tribunals” 9 Chi. J. Int'l L. (2008-2009) 515, 518.

of transit, access to transit, the non interruption obligation and a dispute settlement mechanism in the form of hybrid conciliation mechanism in its Article 7.

The ECT Article 7(1) sets out the principle of freedom of transit. It provides that “...contracting states shall take all necessary measures to facilitate transit consistent with the principle of freedom of transit.” Moreover, the conditions of transit are based on the principle of non-discrimination, requiring no distinction with regard to the origin, destination or ownership of the Energy Materials and Products (EMPs).⁹³ Furthermore, Article 7(3) provides the national treatment standard. Contract Parties are obligated to treat EMPs in transit no less favourably than energy destined for the transit state or originating in that transit state unless an existing international agreement provides otherwise.⁹⁴

The ECT does not obligate the parties to provide mandatory third-party access. However, it provides that “...when the transit of EMPs cannot be achieved on commercial terms the Contracting Party shall not place obstacles for the establishment of new capacity, except as may be provided otherwise in applicable legislation.”⁹⁵ The applicable legislation includes exemptions for environmental protection, land use, safety or technical standards.⁹⁶ Furthermore, a Contracting Party shall not be obligated to permit the construction or modification of energy transit facilities (ETFs) or permit new or additional transit through ETFs, provided it demonstrates to the concerned Contract

⁹³ ECT, Article 7(1)

⁹⁴ *ibid*, Article 7(3)

⁹⁵ *ibid*, Article 7(4)

⁹⁶ *ibid*, Understanding 8

Parties that this would endanger the security or efficiency of its energy systems, including the security of supply.⁹⁷

Article 7 of the ECT further obligates the parties not to interrupt the transit of EMPs. In the case of a dispute over any matter arising from that transit, the transit state or any entity subject to its jurisdiction shall not interrupt or reduce the existing flow of energy resources prior to the conclusion of the dispute resolution procedures set out in paragraph 7 (the conciliation mechanism). The only exemptions to this rule are that where the right to interrupt or reduce is provided for in a contract or other agreement governing such transit or is permitted according to the decision of the conciliator.⁹⁸

Article 7(7) provides an innovative dispute settlement procedure “in the event of a dispute arising out of that transit” in the form of a hybrid conciliation procedure, though it can only be applied after the exhaustion of all relevant contractual or other dispute resolution remedies previously agreed between the Contract Parties or between their entities.⁹⁹ According to the conciliation mechanism, the Contract Parties are under the obligation to observe any interim decision on tariffs, terms and conditions for 12 months following the conciliator’s decision.¹⁰⁰ ECT Article 27, the inter-state arbitration mechanism, constitutes an alternative to the hybrid conciliation mechanism. ECT Article 7 transit provisions are analyzed in detail in the relevant section of Chapter 3 of this thesis.

⁹⁷ *ibid*, Article 7(5)

⁹⁸ *ibid*, Article 7(6)

⁹⁹ *ibid*, Article 7(6-7)

¹⁰⁰ *ibid*

2.4.3.2.2 Stability Provided by the ECT to Transit Contracts

The applicability of Article 26, (investor-state) arbitration mechanism, to transit disputes remains unclear. The reason for this ambiguity is that ECT Article 26 deals with disputes that concern the alleged breach of Part III (investment promotion and protection) provisions of the ECT by a Contracting Party. However, Article 7 transit provisions are situated in Part II (commerce) of the ECT.

On the other hand, the definition of “investment” under ECT Article 1(6)-f¹⁰¹ includes “...any right conferred by law or contract or by virtue of any licenses and permits granted pursuant to law to undertake any economic activity in the energy sector.” Land transport, transmission and distribution are the examples of economic activity in the energy sector given under the definition of investment.¹⁰² When the investment definition is interpreted together with the ECT Article 10(1), umbrella clause, which states that “each contracting party shall observe any obligations it has entered into with an investor or an investment of an investor of any other contracting party”, certain transit related disputes on rights conferred by law, contract or license to undertake transport activities in a contracting state can be referred to arbitration under Article 26’s investor-state arbitration mechanism. If the subject of the transit dispute is not clearly granted as a legal or

¹⁰¹ **Investment** is defined by ECT Article 1(6) in the following terms: “investment means every kind of asset, owned or controlled directly or indirectly by an investor and includes: (f): any right conferred by law or contract or by virtue of any licences and permits granted pursuant to law to undertake any Economic Activity in the Energy Sector.

¹⁰² “**Economic Activity in the Energy Sector**” is defined by ECT Article 1(5) in the following terms: “an economic activity concerning the exploration, extraction, refining, production, storage, land transport, transmission, distribution, trade, marketing, or sale of Energy Materials and Products except those included in Annex NI, or concerning the distribution of heat to multiple premises.”

contractual right, these kinds of disputes can only be arbitrated under Article 27 by the home government of the investor.

The ECT Fair and Equitable Treatment (FET) standard states that

“(e)ach contracting party shall, in accordance with the provisions of this Treaty, encourage and create stable, equitable, favourable and transparent conditions for investors of other contracting parties to make investment in its area. Such conditions shall include a commitment to accord at all times to investments of investors of other contracting parties’ fair and equitable treatment.”¹⁰³

Therefore, the conditions of transit in the investment agreements for transit pipelines under the international –integrated- pipeline model, which constitutes investment according to the definition of investment under the ECT, can be subjected to ECT Article 26 investor-state arbitration mechanism. The stability provided by the ECT to transit contracts through both the umbrella clause and FET standard are analyzed in detail in the relevant section of Chapter 3 of this thesis.

2.4.3.3 Contractual Leverage: The Role of Contract Clauses

2.4.3.3.1 Applicable Law Clause

Negotiations do not end with the signing of the investment contract. They actually start at this point: in one way or the other, the contract will be renegotiated between the parties. However, the investment contract provides a point of referral if unpredictable problems arise. Parties may deviate from the agreement. However, always there is a risk and cost factor arising from this contract breach when it is enforced in litigation or arbitration. The contract will remain with the parties as a sword of Damocles.¹⁰⁴

¹⁰³ ECT, Article 10(1)

¹⁰⁴ Walde, supra note 87 22

When there is a shift in the bargaining power of the parties or a fundamental change in the economic circumstances underlying the contract, a renegotiation demand is raised mostly by the state party. At this stage, the focus should be returned to whether there is a clause in the contract that enables parties to change the contract in the form of renegotiation or whether there is a clause in the contract, such as a stabilization clause, that prohibits any kind of change in the contract. In the absence of such clauses, the parties' right to ask for renegotiation and the extent of contract change will be determined by the applicable law of the contract.¹⁰⁵

The traditional approach to applicable law in investment contracts was stated in Serbian Loan's case. The tribunal decided that "(a)ny contract which is not a contract between States in their capacity as subjects of international law is based on the municipal law of some country."¹⁰⁶ This municipal law is generally that of the state with whom the contract is made and in where it is performed according to the "closest connection" criterion of conflict of laws discipline if there is no choice of the parties. On the other hand, the parties to the investment contract can make a choice and determine the applicable law of the contract based on freedom of contract and the party autonomy principles of contract law.¹⁰⁷

¹⁰⁵ W Peter, *Arbitration and Renegotiation of International Investment Agreements*, (2nd ed, Kluwer 1996) 201-203; A Kolo, T Walde, "Renegotiation and Contract Adaptation in International Investment Projects: Applicable Legal Principles and Industry Practices", (2000) 1 *Journal of World Investment* 5, 32 et seq

¹⁰⁶ Serbian Loan's Case 1929 P.C.I.J. (ser. A) No 20 (July 12)

¹⁰⁷ J Fawcett and J M Carruthers, *Cheshire, North & Fawcett Private International Law* (14th ed, OUP 2008) 665 et seq

The range of applicable law in investment contracts changes from a mere reference to the municipal law to an exclusive choice of the rules of international law depending on parties' bargaining power and skills. Between these two points, general principles of law, industry usage and commercial practices, rules of natural justice or of equity are chosen. A combination of national law and international rules might be chosen as a compromise for the applicable law.¹⁰⁸ The choice of law clause usually aims to prevent the application of the domestic law of the host state and seeks to subject the investment contract to some external standards such as "general principles of law" or "standards that prevail within the industry" that are interpreted by some commentators as "nebulous external standards."¹⁰⁹

The reason for this tendency is that many foreign investors are either uncertain of the law of the host-state or have concerns about a possible change in host-state law or about possible alteration or cancellation of the contract by some kind of sovereign act. Therefore, they seek to "delocalize" the investment contract through choosing general principles of law or public international law as the governing law of the investment contract. Hence, the contract is internationalized in such a way.¹¹⁰

A review of case law demonstrates the tendency in investment arbitration to delocalize the investment contracts. In early Middle East arbitral awards, the arbitrators argued that

¹⁰⁸ R Dolzer and C Schreuer, *Principles of International Investment Law* (OUP 2008) 74

¹⁰⁹ M Sornarajah, *The International Law on Foreign Investment* (2nd ed CUP 2004) 406

¹¹⁰ R B Lillich, "The Law Governing Disputes under Economic Development Agreements: Reexamining the Concept of Internationalization", in *International Arbitration in the 21st Century: Towards Judicialization and Uniformity?*, Twelfth Sokol Colloquium, (R B Lillich, C N Brower ed, Transnational Publishers 1994) 63-64

the principle is to apply the law of the host state, however, the law of these states do not have any principles that can be applied to oil contracts. Instead, the arbitrators applied either what is equitable or the general principles of law. The tribunal of the Aramco arbitration, after recognising the relevance of Saudi Arabian law, stated that “...it is necessary to resort to the general principles of law and to apply them in order to interpret, and even to supplement, the respective rights and obligations of the parties.”¹¹¹ The sole arbitrator in the Sapphire Arbitration held that the obligation of parties is “to carry out the provisions of the contract in accordance with the principles of good faith and good will and to respect the spirit of the agreement.”¹¹² Moreover, according to the arbitrator, the provision for arbitration is not compatible with the strict application of the municipal law of a particular country. Therefore, based upon these reasons, the general principles of law was applied to dispute.¹¹³

The internationalization of contract with its fundamental elements and theoretical justification was set out in the Texaco award.¹¹⁴ Internationalization of contract is assisted by the concept of economic development agreements.¹¹⁵ The theory of internationalization is based on three pillars, which are the choice of law clause, the

¹¹¹ Saudi Arabia v. Arabian American Oil Company (Aramco), 27 ILR 1963 117 and 168

¹¹² Sapphire International Petroleum Ltd v. National Iranian Oil Company, 35 ILR 1967 136-140

¹¹³ *ibid*, 173

¹¹⁴ Texaco Overseas Petroleum Company v. The Government of the Libyan Arab Republic, 53 ILR 1979 14-19

¹¹⁵ It is argued in the Texaco award that the subject matter of **economic development agreement** contributes to development of the country and realizing economic and social progress. The extensive responsibilities taken in the long duration of these agreements requires close cooperation between the parties and the general interest on one side and the profitability of investment on the other side should be balanced by the contractual nature of the legal relation. The private party should be supplied with a certain stability and this stability justified by the considerable investments made in the host country. The investor must be protected by stabilization clauses accommodated in the contract against legislative uncertainties such as the modification of the municipal law of the host country or an abrogation or recession of the contract through government measures.

stabilization clause and the arbitration clause. The choice of law clause enables the parties to choose the governing law of their contracts. The stabilization clause aims to freeze the law of the host state and/or investment contract at the time of entry. The insertion of the stabilization clause is intended to remove the agreement from the internal law and provides for its submission to *sui generis* rules or to a proper international law system. Accommodation of the stabilization clause indicates the need for external supervision, since the host state can not decide whether or not it interfered with the contract that had been insulated by the stabilization clause. Accommodation of the arbitration clause is another indicator of the internationalization of the investment contract. Reference to international arbitration situates the investment contract within a specific legal order -the international law of contracts.¹¹⁶

The tribunal in the *Revere Copper v. OPIC* award made reference to the arguments developed in the *Texaco* award. The theory of internationalization of contracts reached its heyday in this award. Although the agreement did not have a choice of law clause or stabilization clause, only through making reference to the economic development agreement concept and its characteristics, the tribunal decided that this was sufficient to internationalize the contract. The tribunal reached the conclusion that it was not only the domestic law of Jamaica but also the applicable principles of international law that were the applicable law.¹¹⁷

¹¹⁶ *ibid*

¹¹⁷ *Revere Copper and Brass Incorporated v. Overseas Private Investment Corporation (OPIC)*, 17 ILM 1978 1333 et seq

The theory of internationalization received criticisms particularly from positivist international lawyers. Sornarajah argued that there is no body of international law on state contracts. The general principles of law as part of international law is considered as a weak source. These principles are extracted based on some subjective and selective methodologies to build a system of investment protection. The sanctity of contract enshrined in the phrase *pacta sunt servanda* is not reflected in an absolute manner in any major legal system. There are exceptions to the sanctity of contract principle in all main legal systems.¹¹⁸ Internationalization of the contract based on the economic development agreement concept is regarded as without merit. It was argued that this idea is against the notion of equality of states due to the fact that the same kind of agreements entered into between foreign investors and developed countries is not subjected to international law.¹¹⁹

The Aminoil concession contained all the clauses, which are necessary for internationalization of contract. However, the justification of internationalization theory was not used by the arbitral tribunal. The tribunal stated that the law of Kuwait applies to many matters in the case. However, according to the arbitral tribunal, public international law is part of the highly evolved Kuwaiti law and the general principles of law are part of public international law. Therefore, this part of law specifically applies to the Aminoil concession.¹²⁰ A similar approach was adopted by the tribunal in the SPP award. The agreement between SPP and Egypt contained an arbitration clause. However, there was

¹¹⁸ Sornarajah, *supra* note 109 421; see also J Cartwright, *Unequal Bargaining: A Study of Vitiating Factors in the Formation of Contracts* (OUP 1991)

¹¹⁹ Sornarajah, *supra* note 109 420

¹²⁰ *The Government of the State of Kuwait v. American Independent Oil Company (Aminoil)*, 21 ILM 1982 976 et seq

no choice of law clause or stabilization clause. The tribunal decided that the governing law of the agreement is Egypt law. However, Egyptian law includes general principles of law and reference to Egyptian law includes such principles of international law as part of the applicable law.¹²¹

It can be observed from these arbitral awards that, after the Aminoil award, the justification that was used by internationalization theory was not applied. However, all of the tribunals applied general principles of law in one way or another and reached the same conclusion. The various approaches to determining the rules that govern the contract change under different laws lead to the general principles of law. If municipal law applies, contractual change is determined by the general principles of law as specifically codified in that particular legal system. On the other hand, if the parties choose international law as the applicable law of the contract, or the contract is internationalized based on the above considerations, international law includes general principles of law as one of its sources.¹²²

Although *pacta sunt servanda* (sanctity of contract principle) is part of the legal order of all common and civil law countries as a general principle of law, it is not absolute and has some limitations in all these legal systems. The approach of fundamental municipal laws to contract change is briefly demonstrated below through the indication of the exceptions to the sanctity of contract principle under these legal systems.

¹²¹ Southern Pacific Properties (Middle East) Ltd v. Arab Republic of Egypt, 22 ILM 1983 752 et seq

¹²² Peter, supra note 105 183

Under English common law, the sanctity of contract principle is restricted by the doctrine of frustration. According to this doctrine, legal or physical impossibility of performance and frustration of the implied purpose of the contract due to unforeseen events result in the termination of the contract. There is no way of adaptation under English law. Under US law, the sanctity of contract principle is restricted by commercial impracticability based on a supervening event. In order to implement impracticability, the non-occurrence of this event should be the basic assumption on which the contract was made. As a result of impracticability, the performance of the party is discharged.¹²³

Under French law, French administrative law developed two doctrines: “fait du prince” and “imprevision” with regard to the contract change. According to the “fait du prince” doctrine, in matters of overriding public interest, administrative contracts cannot restrict the freedom of action of public authorities. However, full compensation should be paid to a private contractor. According to the “imprevision” theory, when the economic equilibrium of the contract is seriously affected by an unforeseen change of circumstances, the doctrine of imprevision applies and the contract is adapted. Under German Law, the exceptions to the sanctity of contract principle are based on the objective impossibility of performance in a no-fault situation. Moreover, when there is a deficiency and collapse of the basis of the transaction, the doctrine of *Geschäftsgrundlage*¹²⁴ applies to the contract and the contract is adapted.¹²⁵

¹²³ *ibid*,185-188

¹²⁴ The doctrine of “*Geschäftsgrundlage*” is qualified by German case law as “the common representation of both contracting parties at the time of signing of the contract, or the representations of one party which have been perceived and implicitly accepted by the other party, with regard to the existence or future occurrence of circumstances upon which the intention for contracting of both parties is based” 74 BGHZ, 373 quoted in *ibid*, 191

¹²⁵ *ibid*, 189-192

The approaches of fundamental municipal laws to contract change demonstrates that although exceptions to the sanctity of contract principle are very narrowly defined, there is the possibility of contract change under these municipal systems and under general principles of law, such as *rebus sic stantibus* (fundamental change in circumstances). Therefore, design of the contract clauses regarding contract change is very important. This thesis focuses in particular on the effect of contractual clauses that aim to maintain the economic equilibrium of the contract on the parties bargaining power during the operation stage of projects. These clauses can be grouped under two categories. The first category consists of stabilization clauses: traditional freezing and economic equilibrium clauses. These type of clauses aim to address the change in the legislative framework of the contract. The second category consists of clauses that require renegotiation in the case of a change in the underlying economic circumstances of the contract. These latter clauses might take the form of renegotiation, adaptation and hardship clauses according to the extent of change that is caused by them. The following sub-sections of this chapter briefly address stabilization and renegotiation clauses that aim to maintain the economic equilibrium of the contract and provide stability in the contractual relationship from the angle of their effect on the bargaining power of the parties.

2.4.3.3.2 Stabilization Clauses: In Particular, Economic Equilibrium Clauses

Stabilization clauses “...intended to immunize the foreign investment contract from a range of matters, such as taxation, environmental controls and other regulations as well as to prevent the destruction of the contract itself before the contract expires.”¹²⁶ Economic equilibrium clauses are developed in search of contract stability. They can be invoked in

¹²⁶ Sornarajah, *supra* note 109 407

the case of a disruption in the economic equilibrium of the contract as a result of an act of state that occurs through the use of legislative, executive or judicial bodies. There are different types of economic equilibrium clauses. They differ according to the method of restoration when the economic equilibrium of the contract is disrupted.¹²⁷

The first method is by way of amendment of the contract through a stipulated formula (e.g. readjustment of split of petroleum profit or a corresponding factor in production share percentage).¹²⁸ The second method is through automatic amendment of the contract without providing a stipulated formula or without requiring agreement of the parties. The third method is through negotiation by the parties if the equilibrium of the contract is disrupted as a result of a state act.¹²⁹ In some cases, mixed methods can be found, such as first requiring the automatic amendment of the contract and, in the absence of this, government indemnification.¹³⁰

¹²⁷ F Alexander, “Comment on Articles on Stabilization by Pierro Bernardini, Lorenzo Cotula and AFM Maniruzzaman”, (2009) 2 JWELB 243, 243 et seq; AFM Maniruzzaman, “The Pursuit of Stability in International Energy Investment Contracts: A Critical Appraisal of Emerging Trends” (2008) 1 JWELB 121, 127-131.

¹²⁷ Maniruzzaman, supra note 127 126.

¹²⁸ An example of **stipulated economic equilibrium clause**: “In case of modifications to the tax regime, including the creation of new taxes, or the labor participation, or its interpretation, that have consequences on the economics of this Contract, *a corresponding factor will be included in the production share percentages to absorb the increase or decrease in the tax burden or in the labor participation of the previously indicated contractor*. This correction factor will be calculated between the Parties and approved by the Ministry of Energy and Mines” Art. 11.7 of Ecuador Model Production Sharing Contract of October 2002 for the Exploration of Hydrocarbons and the Exploration of Crude Oil, Barrows

¹²⁹ An example of **negotiated economic equilibrium clause**: “at the request of the Company, the States (represented by the Relevant Ministers) *shall meet with the Company and endeavour in good faith to negotiate a solution which restores the Company and/or the Shareholders to the same or an economically equivalent position it was or they were in prior to such change*, and the State or States in respect of which the Regime Failure has occurred shall use its or their best endeavors to procure that the solution is implemented; Art. 36.2-a of West African Gas Pipeline International Project Agreement

¹³⁰ An example of **hybrid type of economic equilibrium clause**: “the state authorities shall take all actions available to them to restore the economic equilibrium established under the project agreements if and to the extent that economic equilibrium is disrupted or negatively affected as a result of any change in Turkish

It was stated above that the obsolescing bargain effect, the change in the bargaining power of the parties during the operation stage of the pipeline in favour of the host state, and the change in the economic conditions as a result of the industry cycles effect are realities of the investment relationship between the parties in the case of transit pipelines. The demand for more favourable terms and for contract change occurs after the shift in bargaining power and a change in economic conditions. The role of the economic equilibrium clause as a constraint on change in the bargaining power is briefly discussed below in this section. However, it is thoroughly analyzed in Chapter 4 of the thesis.

Economic equilibrium clauses would appear designed to constrain to a great extent the demands of the state party relating to contract changes that occur as a result of a change in bargaining power. It is elaborated above that the contracting party acts under the shadow of possible enforcement of the contract. There is not any available arbitral award with regard to enforcement of economic equilibrium clauses. However, under the literal interpretation of economic equilibrium clauses, the state party can exercise its sovereign power to make legislative change, provided that if this change makes a negative effect on the economic balance of the original deal, the equilibrium should be restored. The original economic equilibrium can be restored by direct compensation of the investor by the host state or by way of a stipulated formula that was accommodated in the contract, or by way of agreement between the parties in the case of negotiated and non-specified types of economic equilibrium clauses. However, some questions still remain such as

law...the foregoing obligation to take all actions to restore the economic equilibrium shall include the obligation to take all appropriate measures to resolve promptly by whatever means may be necessary, including by way of exemption, legislation, decree and/or other authoritative acts, any conflict or anomaly between any Project Agreement and such Turkish Law” Art. 7.2-x of the BTC oil pipeline Turkey HGA

what happens if the parties cannot agree on adaptation of the contract in the case of negotiated and non-specified types and whether the arbitral tribunal can amend the contract with a mere referral to arbitration or not. These questions are dealt with in Chapter 5 of the thesis, where the role of arbitrator in contract adaptation is analyzed.

Maniruzzaman argued that the reason for the increasing tendency of foreign investors, in particular international oil companies (IOC), to favour economic equilibrium clauses lies in the fact that if state interference occurs that adversely affects the contract, the available remedies could be more favorable than under traditional freezing clauses. The breach of a freezing clause may result in only lump-sum damages that could be far below what the IOC would consider acceptable. However, some types of economic equilibrium clauses include the provision for “government pays” or “government indemnifies” in the case even of a simple state act that affects the equilibrium of the contract. Therefore, they are designed to keep whole the investor on an on-going basis in the case of any state interference.¹³¹ Moreover, when it is considered that the host state can unilaterally revise the contractual relationship any time in the future, based on its sovereign power, traditional freezing clauses are much less effective than economic equilibrium clauses that focus on the possible specific performance as a result of the unilateral change.¹³²

Another flexibility provided by economic equilibrium clauses when compared with freezing clauses is that the breach of a freezing clause by the host state may lead to the investor’s pursuit of remedial action through international arbitration. This may in turn

¹³¹ Maniruzzaman, *supra* note 127 126

¹³² Cameron, *supra* note 33 52

lead to full breakdown of the contract. However, the breach of an economic equilibrium clause may lead to renegotiation or, in absence of this, compensation by the host state. Arbitration might play a role, in particular when the contract entitles arbitrators to revise the contractual terms if negotiations fail. Nevertheless, in this case the contractual relationship may continue.¹³³

Moreover, another function of economic equilibrium clauses is that they undermine the proposition that the simple regulation under the state's police power cannot amount to indirect expropriation; therefore, it is not compensable. The existence of an economic equilibrium clause in the contract can make such action compensable and provide the missing link for invoking fair and equitable treatment under treaty arbitration. Furthermore, an express stabilization clause can make the violations of specific commitments in relation to the investment contract tantamount to the violation of the umbrella clause. Therefore, the presence of a stabilization clause appears to trigger the activation of the umbrella clause.¹³⁴ Thus, if international law is not chosen as the applicable law, the existence of a stabilization clause may provide for the application of BIT, that is, application of international law to the dispute. It might fundamentally increase the prospects for enforcement of the contract and the award of damages in the event of a dispute.¹³⁵

¹³³ L Cotula, "Reconciling Regulatory Stability and Evolution of Environmental Standards in Investment Contracts: Towards a Rethink of Stabilisation Clauses", (2008) 1 JWELB 158, 161

¹³⁴ Maniruzzaman, *supra* note 127 146, 155

¹³⁵ Cameron, *supra* note 33 99

2.4.3.3 Renegotiation Clauses, In Particular, Adaptation Clauses

Long-term contracts, in particular transit pipeline agreements, are negotiated and entered into by the parties in a certain economic and geopolitical environment. They are performed in that contractual environment as well. Therefore, when there is a change in the underlying geopolitical and economic conditions, renegotiation might happen to accommodate these changes. The existence of a stabilization clause might not prevent the parties from renegotiating the contract. This assertion was confirmed by the negotiated settlement of the disputes and following adaptation of the contracts in the operation of the CPC and BTC transit oil pipelines that are analyzed in detail in the case studies chapter. Stevens argued that the best practices in transit pipeline projects that operate with minimum disputes and without interruption are the ones whose agreements include adaptation clauses to address change in the economic conditions -e.g. oil or gas price increases.¹³⁶ Moreover, industry cycles and the resulting renegotiation demands are realities of the petroleum industry. Therefore, there is a need to proceduralize these renegotiations through the design of an adaptation clause in the contract in order to accommodate change in the underlying economic conditions of the contract.

The clauses that obligate the parties to renegotiate might take the form of adaptation clauses, renegotiation clauses, hardship clauses and, in some cases, *force majeure* clauses, according to the extent of contract change they might cause. Adaptation clauses aim to address changes in the economic conditions, e.g. price changes, through providing a specific formula in the original contract. They result in the adaptation of a very specific

¹³⁶ Stevens, *supra* note 30

part of the contract in the event of a change in the economic conditions.¹³⁷ Renegotiation clauses obligate the parties to renegotiate the contract on the occurrence of a triggering event that is provided in the clause. The adaptation that follows is not conducted based on a certain formula. It requires the cooperation of the parties to adapt the contract in order to address changes in the underlying conditions of the contract.¹³⁸ Hardship clauses obligate the parties to renegotiate and adapt the contract when there is a fundamental change in the economic conditions of the contract that increases the cost of performance by at least 50%.¹³⁹ *Force majeure* clauses aim to address the results of external factors, such as natural disasters, war and strikes, on the contract. They might require renegotiation when the suspension of performance continues longer than expected.¹⁴⁰ These clauses are analyzed in detail in Chapter 5 of the thesis.

The procedural aspects of renegotiation are common to all these clauses that require renegotiation. These aspects are: the triggering events, the duty of the parties to negotiate in good faith, the role of the arbitrators in the adaptation of the contract if the parties cannot agree on adaptation, and the extent of contract change.¹⁴¹ If a clause exists in a contract that requires renegotiation, there is a certain duty of the parties to renegotiate.

However, this duty to renegotiate does not involve a duty to agree on the changes. The

¹³⁷ N Horn, "Standard Clauses on Contract Adaptation in International Commerce", in *Adaptation and Renegotiation of Contracts in International Trade and Finance* (N Horn ed, Kluwer 1985)

¹³⁸ N Horn, "The Concepts of Adaptation and Renegotiation in the Law of Trans-national Commercial Contracts" *Adaptation and Renegotiation of Contracts in International Trade and Finance* (N. Horn, ed, Kluwer 1985)

¹³⁹ K H Bockstiegel, "Hardship, Force Majeure and Special Risk Clauses in International Contracts" in *Adaptation and Renegotiation of Contracts in International Trade and Finance* (N. Horn, ed Kluwer 1985)

¹⁴⁰ *Ibid.*

¹⁴¹ K P Berger, "Renegotiation and Adaptation of International Investment Contracts: The Role of Contract Drafters and Arbitrators" (2003) 36 *Vanderbilt Journal of Transnational Law* 1347

parties should conduct renegotiations in good faith and with an aim to agree. However, they are not under an obligation to agree. The power of the arbitrators in contract adaptation is based on the language of the clause. If there is a provision in the contract that authorize the arbitrators to adapt the contract, the tribunal can adapt the contract. However, the authorization by the contract is not adequate of itself. The procedural law of arbitration, *lex arbitri*, should grant this authority to arbitrators as well. The extent of contract change depends on the language of the contract. The contract might include objective criteria, such as maintaining the equilibrium of the contract, or subjective criteria, such as fairness or equity, in order to determine the extent of the contract change.¹⁴² The procedural aspects of renegotiation are analyzed in detail in Chapter 5 of the thesis.

2.5 Conclusion

To sum up, when there is significant change in bargaining power, existing contractual rights are exposed to pressure through enforced renegotiation, change in regulation, creeping expropriation or direct expropriation. Although applicable law clauses and stabilization clauses, either in the form of freezing or economic equilibrium clauses, cannot completely resist the dynamics of the obsolescence demands, they set out the rules of the game. The proper design of these clauses might enhance the investor's bargaining power during the operation stage of projects. It might even convince the host state to resolve the dispute without resorting to arbitration.¹⁴³

¹⁴² *ibid*

¹⁴³ Cameron, *supra* note 32 100.

Under the possible remedies explained above, applicable law clauses and economic equilibrium clauses in transit pipeline agreements might slow down the exploitation of dramatically increased bargaining power. These clauses might provide bargaining leverage for investors against the factors that build leverage for the host state under possible enforcement of them by arbitral tribunals.¹⁴⁴

However, the significant influence of geopolitics and change in the economic circumstances underlying the agreement should be taken into consideration when dealing with transit pipeline agreements. The geopolitical and economic factors are classified under discount rates, risk aversion and outside options of the parties. However, the legal factors, (e.g. contractual clauses) are classified under inside options of the parties, which are defined as the ability of the parties to benefit from existing circumstances.

According to bargaining theory, inside options can only play a role if the discount rates and risk aversion of the parties are equal and there is not any outside option. Therefore, if there is an overriding geopolitical interest or a fundamental change in the underlying economic conditions of the contract, the stabilization clauses and other provisions that provide stability might not be effective. Therefore, the design of an adaptation clause in order to address the changes in the underlying economic conditions of the contract, e.g. substantial price increases, might be useful in minimizing the use of unconstrained bargaining power and the risk of disputes.

¹⁴⁴ Walde, *supra* note 24 84-86

CHAPTER 3. INTERNATIONAL TREATY FRAMEWORK OF TRANSIT PIPELINES AND THE STABILITY PROVIDED BY TREATY: THE ENERGY CHARTER TREATY EXAMPLE

3.1 Introduction

This thesis approaches to the negotiation of transit pipeline agreements from the angle of bargaining theory. In last chapter, bargaining theory, in particular alternating offers model, obsolescing bargain concept and economic, geopolitical and legal factors that function as bargaining factors during the negotiation and renegotiation of transit pipeline agreements were analysed.

The legal factors were grouped under the ECT framework and contractual clauses. In order to evaluate the significance of legal factors during the renegotiations, an assessment of their legal effect is required. This chapter analyses the international treaty framework of transit pipelines. In this context, it addresses the ECT transit provisions, the Draft Transit Protocol's (hereafter called the Protocol) provisions and the obstacles for ratification of the Protocol. The enforcement mechanisms of the ECT, in particular Article 7 conciliation mechanism and arbitrability of transit disputes under Article 26, investor-state arbitration, are subjects of this chapter. This chapter addresses the umbrella clause and the fair and equitable treatment (FET) standard of the ECT, in the context of stability provided by them to transit pipeline agreements.

3.2 Regulation of Transit under the Energy Charter Treaty

3.2.1 Background to the Treaty, Context and the Concept of Transit

The ECT is the first multilateral treaty dealing with a specific economic sector. It was developed on the basis of bilateral investment treaty practice and the European Energy Charter declaration. The ECT aimed to establish and improve the legal framework for energy co-operation between European countries and the FSRs.¹ It was intended to develop economy and the infrastructure in energy-rich countries of FSRs, by providing the international legal foundation for a market-economy, while offering investment and energy security for Europe, in particular for gas flow in the east-west direction.²

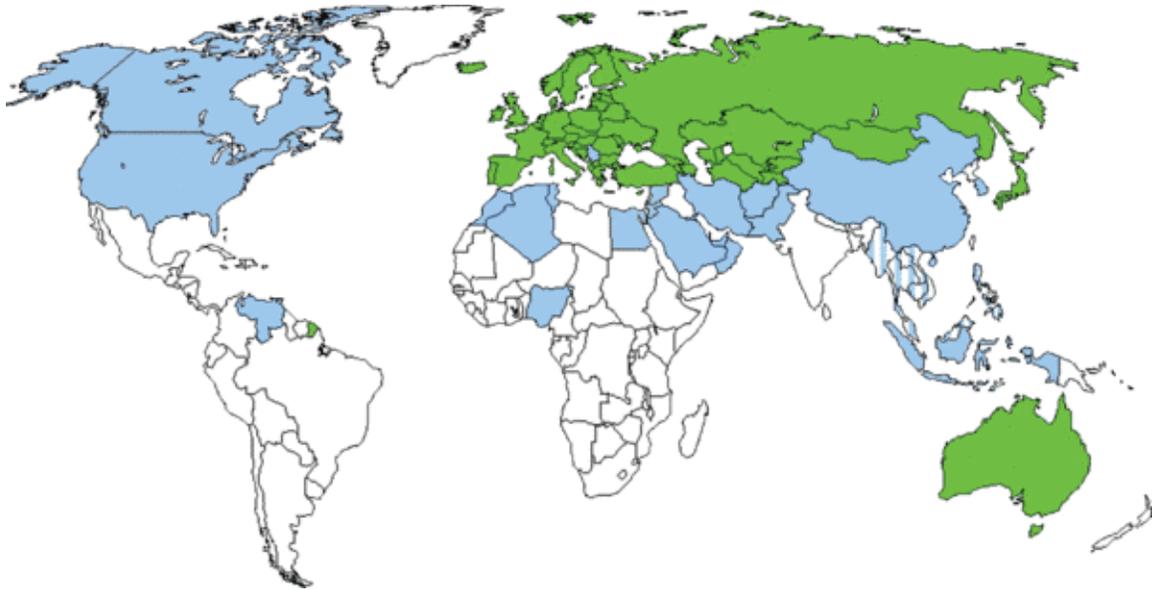
The ECT was signed by approximately 50 states, mainly European states and newly independent FSRs, on 17 December 1994. It entered into force after ratification by 30 states in April 1998. The number of signatory states has now reached 52; these are marked in green on the map below. However, the signatories Australia, Belarus, Norway, Iceland and Russia have not yet ratified the Treaty. Furthermore, on 20 August 2009 Russia informed the Energy Charter Secretariat (ECS) that it did not intend to ratify the ECT and the Protocol on Energy Efficiency and Related Environmental Aspects (PEEREA). This notification resulted in Russia's termination of its provisional

¹ The Energy Charter Secretariat, "The Energy Charter Treaty and Related Documents" (ECS 1997) 11; The Energy Charter Secretariat, "The Energy Charter Treaty: A Reader's Guide" (ECS 2002) 7-8.

² P D Cameron, *International Energy Investment Law: The Pursuit of Stability* (OUP 2010) 152-153; M D Slater, "The Energy Charter Treaty: A Brief Introduction to its Scope and Initial Arbitral Awards" in *Alternative Dispute Resolution in the Energy Sector* (Association for International Arbitration ed, Maklu 2009) 16; T Walde (ed.), *The Energy Charter Treaty: An East-West Gateway for Investment and Trade* (Kluwer 1996)

application of the ECT and the PEEREA as of 20 November 2009 under Article 45(3)-a of the ECT.³

Source: www.encharter.org



Although the ECT covers a broad range of energy sector-specific subjects, its fundamental provisions are on investment protection, trade and the transit of energy resources (limited to hydrocarbons and electricity) through member states.⁴ It is the only multilateral treaty that aims to provide a general legal framework for a secure and uninterrupted transport of EMPs.⁵ When the significance of transit to the effective operation of energy trade is considered, the ECT provides a level playing field in the Euro-Asian market for energy trade,⁶

³ <http://www.encharter.org/index.php?id=61>

⁴ C Bamberger and T Walde, “The Energy Charter Treaty” in *Energy Law in Europe: National, EU and International Regulation* (M. Roggenkamp et al ed, 2nd edn, OUP 2007) 149; Cameron, *supra* note 2 154

⁵ S Vinogradov, *Cross-Border Oil and Gas Pipelines: International Legal and Regulatory Regimes* (CEPMLP 2001) 38

⁶ Cameron, *supra* note 2 158

Reliable transit secures supply to consumer countries, provides market access to producers and provides income (transit fees and/or tariffs) for transit countries. However, risks at each of these stages, including technical problems, commercial disputes, contractual breakdowns and political risks, threaten to interrupt flow.⁷ Moreover, political instability in transit states endangers energy investments and security of supply. Energy projects in transition and developing countries involve high political risk. The absence of a reliable legal framework is a contributing factor to instability. The transit provisions of the ECT aim to decrease the transportation risks caused by political and commercial disputes between the participating states.⁸

The ECT regulates transit under Article 7. Article 7 includes provisions for three main parts of the transit. These are access to transit, conditions of transit and non-interference of transit. It contains so-called soft-law provisions of cooperation between contracting states relating to the development, operation and modernization of transit facilities, to the mitigation of the effects of interruptions and to the facilitation of interconnectivity as well. Furthermore, it provides a unique dispute settlement mechanism: a hybrid conciliation procedure.

The innovative aspect of the ECT's transit definition⁹ is its scope of application. The transit provisions can be applied provided that the transit state and either the state of

⁷ Energy Charter Secretariat, "Energy Transit-The Multilateral Challenge" (ECS 1998) 14-15

⁸ R Liesen, "Transit under the 1994 Energy Charter Treaty" (1999) 17 JENRL 56, 57

⁹ ECT Article 7(10) defines transit in the following terms: "the carriage through the Area of a Contracting Party, or to or from port facilities in its Area for loading or unloading, of Energy Materials and Products originating in the Area of another state and destined for the Area of a third state, so long as either the other state or the third state is a Contracting Party" or "the carriage through the Area of Contracting Party of

origin or the state of destination of the energy material is party to the ECT. Moreover, according to the second part of the definition, if the EMP originates in a contracting state and returns to that same contracting state after traversing a contracting transit state, the ECT applies. The significance of this definition is that transit in its traditional definition requires at least three states. However, under this definition there are only two states.¹⁰ The principal exceptions are those existing in the area of the FSRs: a pipeline originates in and returns to Russia after traversing Ukraine and another originates in and returns to Ukraine after traversing Moldova.¹¹

3.2.2 Access to Transit and Conditions Thereof

The transit provisions of the ECT require that parties shall take necessary measures to facilitate the transit of EMPs consistent with the principle of freedom of transit.¹² Article 7(1) provides that “contracting states shall take all necessary measures to facilitate transit consistent with the principle of freedom of transit.” Although the ECT broadly establishes the principle of freedom of transit,¹³ such language puts less emphasis on freedom of transit and more on the principle of state sovereignty when compared to an analogous provision in GATT Article 5, “there shall be freedom of transit”. It is not clear what is covered by “measures to facilitate” as well.¹⁴

Energy Materials and Products originating in the Area of another Contracting Party and destined for the Area of that other Contracting Party. “

¹⁰ ECT, Article 7(10).

¹¹ K Yafimava, *The Transit Dimension of EU Energy Security: Russian Gas Transit Across Ukraine, Belarus and Moldova* (OUP 2011) 20

¹² *ibid*, Article 7(1)

¹³ G Coop, “The Energy Charter Treaty: More than a MIT”, in *Investment Arbitration and the Energy Charter Treaty* (C. Ribeiro ed, Juris Net LLC 2006) 10

¹⁴ M Roggenkamp, “Transit of Network-bound Energy: The European Experience”, in *Energy Law in Europe: National, EU and International Regulation* (M Roggenkamp et al ed, 2nd ed, OUP 2007)

The ECT transit provisions set out that when the transit of EMPs cannot be achieved on commercial terms, the Contracting Party shall not place obstacles for the establishment of new capacity, except as may be provided otherwise in applicable legislation.¹⁵ The applicable legislation includes exceptions for environmental protection, land use, safety or technical standards.¹⁶ Furthermore, a Contracting Party shall not be obligated to permit the construction or modification of energy transit facilities (ETFs) or permit new or additional transit through ETFs provided that it demonstrates to the concerned Contract Parties that this would endanger the security or efficiency of its energy systems, including the security of supply.¹⁷ The generality and vagueness of this provision offers an opportunity to certain countries reluctant to allow the construction of new or additional capacity in transit facilities to delay or obstruct transit applications.¹⁸ When combined with the exceptions mentioned above, the ECT appears to favour state sovereignty at the expense of transit.

The ECT distinguishes between the two types of issues that can arise under access to transit: use of existing pipelines, where the interests of international trade play a predominant role, and establishing new capacity (new or additional transit), including interconnectivity that requires the explicit consent of the transit state in accordance with the principle of state sovereignty.¹⁹ However, the ECT does not, unlike some national and trans-national legislations (e.g. the EU Gas Directive), obligate any Contracting Party to

¹⁵ ECT, Article 7(4)

¹⁶ *ibid*, Understanding 8

¹⁷ *ibid*, Article 7(5)

¹⁸ Vinogradov, *supra* note 5 42

¹⁹ Vinogradov, *supra* note 5 41-42

introduce mandatory third-party access (MTPA).²⁰ It is hereby submitted that the equivocal requirement of Article 7 “to facilitate transit”, the broad exceptions in paragraph 4 and 5 for state sovereignty and the absence of MTPA establishes a transit regime that creates insecurity rather than security of transit.

The conditions of transit are based on the principle of non-discrimination, requiring no distinction with regard to the origin, destination or ownership of EMPs. ECT Article 7 introduces an obligation not to impose any unreasonable delays, restrictions or charges on the basis of origin, destination country or ownership of the commodity.²¹ However, the efficient implementation of this non-discrimination provision requires considerable transparency and international coordination mechanisms, which do not exist in transit oil and gas contracts and under the ECT regime.

Article 7(3) provides for a national treatment standard. Contract Parties are obligated to treat EMPs in transit no less favourably than energy destined for or originating from that transit state unless an existing international agreement provides otherwise.²² There have been concerns, in particular about Russia, regarding the national treatment obligation, since it can be interpreted as merely requiring that transit tariffs should be equal to export, import and domestic tariffs.²³

²⁰ ECT, Understanding 1.b.i.

²¹ *ibid*, Article 7(1)

²² *ibid*, Article 7(3)

²³ A Konoplyanik, “Gas Transit in Euroasia: Transit Issues between Russia and the European Union and the Role of the Energy Charter” (2009) 27 JENRL 445, 475

3.2.3 Non-Interference Obligation

In the case of a dispute over any matter arising from transit, the transit state or any entity subject to its jurisdiction shall not interrupt or reduce the existing flow of energy resources prior to the conclusion of the dispute resolution procedures set out in paragraph 7 (the conciliation mechanism). The only exceptions to this rule are where the right to interrupt or reduce is provided for in a contract or other agreement governing such transit or is permitted according to the decision of the conciliator.²⁴

The non-interference obligation under paragraph 6 and hybrid conciliation mechanism under paragraph 7, discussed next, are regarded as the ECT transit provisions most likely to force action.²⁵ The non-interference obligation weakens the ability of the transit state to use its most powerful economic weapon: cutting of the flow of energy flowing through its territory.²⁶

3.2.4 Dispute Settlement Mechanism: Binding Conciliation

Article 7(7) provides an innovative dispute settlement procedure “in the event of a dispute arising out of that transit” in the form of a hybrid conciliation mechanism. However, conciliation mechanism can only be applied after the exhaustion of all relevant contractual or other dispute resolution remedies previously agreed between the Contract Parties or between their entities.²⁷

²⁴ ECT, Article 7(6)

²⁵ Bamberger and Walde, *supra* note 4

²⁶ Vinogradov, *supra* note 5 43

²⁷ ECT, Article 7(6-7)

According to the hybrid conciliation procedure, a Contracting Party to a dispute may refer it to Secretary General of the Energy Charter. Within 30 days of the referral to the Secretary General, in consultation with the parties to the dispute and other concerned parties, the Secretary General will appoint a conciliator. In the event that the conciliator cannot bring the parties to agree upon a resolution or upon a procedure to achieve such resolution within 90 days, he shall recommend a resolution or a procedure to achieve such resolution and shall decide the interim tariffs and other terms to be observed for transit until the dispute is resolved, or for 12 months, whichever is earlier. The Contract Parties are under obligation to observe any interim decision on tariffs, terms and conditions for 12 months following the conciliator's decision.²⁸

Once initiated the ECT transit dispute settlement procedure could prevent a transit country from interrupting transit in order to enforce its claim in a dispute for up to 16 months so that the conciliation for which the ECT provides can proceed.²⁹ However, no party has yet utilized the conciliation procedure; this is perhaps explained by the risk of losing control over the dispute, since if agreement is not reached within 3 months of the referral, the conciliator decides on binding interim terms.³⁰

The hybrid nature of this dispute settlement mechanism is questionable. If the conciliator cannot secure the agreement of the parties, he acts as an adjudicator and determines the terms of settlement. However, the success of conciliation is partly based on the candour and cooperation of the parties and the information flow between them and the conciliator.

²⁸ *ibid*

²⁹ Energy Charter Secretariat, *supra* note 7 17

³⁰ Cameron, *supra* note 2 162

Moreover, a party may not act candidly and the chance for such a resolution may, therefore, be reduced if information volunteered during conciliation could be used against that party during the subsequent interim decision phase.³¹

The ECT requires a party to exhaust “contractual or other dispute settlement mechanisms” that are agreed by parties before commencing the conciliation process.³²

This exhaustion requirement may make the conciliation mechanism of Article 7 illusory in practice. Nearly all of the transit and/or transport contracts include arbitration or other dispute settlement mechanisms.³³ The obligation to exhaust contractual remedies is a major limitation on the application of the conciliation mechanism. This obligation might be time-consuming or the dispute might be settled through contractual mechanisms without the need for the conciliation mechanism.³⁴ For instance, Russia submitted its 2009 gas supply and transit dispute with Ukraine to arbitration by the Stockholm Chamber of Commerce (SCC) based on the arbitration clause of their 2002 transit and supply agreement. The 2009 transit contract between Russia and Ukraine includes an arbitration clause in its Article 12(2) as well.³⁵ Furthermore, when the binding nature of arbitration awards is considered, it is

³¹ B Clark, “Transit and the Energy Charter Treaty: Rhetoric and Reality” (1998) Web Journal of Current Legal Issues <http://webjcli.ncl.ac.uk/1998/issue5/clark5.html>

³² ECT, Article 7(7)

³³ See Baku-Tbilisi-Ceyhan Oil Pipeline HGA Turkey, Art. 18; South Caucasus Gas Pipeline HGA Georgia Art 17 www.caspiandevlopmentandexport.com last accessed 6 September 2012; Caspian Pipeline Consortium Reconstruction and Shareholders Agreement, Art. 11(8) Barrows Collection Russia and NIS Section, Supplement 45

³⁴ P Cameron, “The Energy Charter Treaty and East-West Transit”, in *Energy Dispute Resolution: Investment Protection, Transit and the Energy Charter Treaty* (G. Coop ed, Juris Publishing 2011) 306

³⁵ See A Marhold, “The Russia-Ukrainian Gas Disputes, the Energy Charter Treaty and the Kremlin Proposal-Is There a Light at the End of the Gas Pipe?” (3 OGEL 2011) 36-37

questionable whether a dissatisfied party can apply for the conciliation procedure of paragraph 7.

The relationship between the dispute settlement mechanisms of Article 7 and Article 27 is not very clear. The Article 7 conciliation procedure provides an alternative to the Article 27 inter-state arbitration mechanism.³⁶ If the conciliation procedure is unsuccessful, the dispute can be referred to arbitration under Article 27.³⁷ However, the opposite cannot be argued given the binding nature of arbitration awards.³⁸ Moreover, only the home government of the investor can pursue the dispute under these articles. An investor has no right to pursue its dispute either through conciliation under Article 7 or inter-state arbitration under Article 27.³⁹

The Article 7 conciliation mechanism applies only to disputes arising out of existing transit, as described in Article 7(6). The issues set out in other paragraphs of Article 7, such as if a transit state refuses to grant new transit rights, stipulates unacceptable conditions for transit or places obstacles to the establishment of new capacity, remain outside the conciliation procedure. As such, if a Contracting Party refuses to grant transit rights, sets unreasonable conditions or rejects the establishment of new capacity, the aggrieved state must pursue its remedies under Article 27 inter-state arbitration. However, the applicability of Article 26 investor-state arbitration mechanism to these

³⁶ T Walde, *Investment Arbitration under the Energy Charter Treaty: From Dispute Settlement to Treaty Implementation* (CEPMLP 1996) 21

³⁷ ECT, Article 27

³⁸ ECT, Article 27(3)-h

³⁹ P Andrews-Speed and T Walde, "Will the Energy Charter Treaty Help International Energy Investors?" (1996) 5 *Transnational Corporations* 31, 50

kinds of disputes, and thus the investors' dispute resolution remedy, remains unclear. This issue is dealt below in the relevant section.

3.3 Draft Transit Protocol of the Energy Charter

3.3.1 Background and Context

The Energy Charter transit group prepared the Protocol. Transit group started its work after the foreign ministers of the countries around the Caspian Region had highlighted the need for a suitable environment for international oil and gas pipeline investments that addresses the political considerations of states in addition to the technical, financial, commercial and legal issues at a meeting in March 1998. The parties at the G8 Meeting in April 1998 declared that the ECT could provide a framework for creating such conditions.⁴⁰

The Protocol was developed to augment the transit provisions of the ECT. It regulated noteworthy areas, such as negotiated third-party access to available capacity, transit tariffs and dispute settlement under Article 27 (inter-state arbitration) of the ECT, which the ECT failed to treat in detail or completely ignored. The Protocol stated that “nothing in the Protocol shall derogate from the provisions of the Treaty. The provisions of the Protocol shall complement, supplement, extend or amplify the Treaty provisions.”⁴¹ However, the Protocol negotiations between parties other than Russia and the European Communities (EC) ended in December 2003. The negotiations between Russia and the EC were suspended in 2006 as well due to the disagreement on three matters that remain

⁴⁰ Draft Transit Protocol, Background www.encharter.org last accessed 6 September 2012

⁴¹ *ibid*, Article 3

obstacles to the Protocol's ratification. These three obstacles are the right of first refusal clause in relation to access, the regional economic integration area clause and the use of auctions as a congestion management mechanism while determining transit tariffs.⁴²

3.3.2 Obstacles to Ratification

3.3.2.1 Access Regulations and Right of First Refusal

The Protocol would create an obligation to ensure that an owner and operator of pipeline under the jurisdiction of one Contracting Party negotiates in good faith with another Contracting Party or entity of a Contracting Party to provide access to available transit capacity.⁴³ The negotiations should be transparent, have a commercial basis and be non-discriminatory as to the origin, destination or ownership of throughput.⁴⁴ If access to available capacity were refused, the owner and/or operator of the pipeline would provide a duly substantiated explanation.⁴⁵ There is no obligation for a transit country or an entity⁴⁶ under its jurisdiction to provide MTPA.

⁴² Coop, supra note 13 12-13

⁴³ **"Available Capacity"** means the total physical operating capacity of the Energy Transport Facilities, less the physical operating capacity:

(a) necessary for the fulfillment of obligations by the owner or operator of the Energy Transport Facilities under any valid and legally binding agreements relating to the transportation of Energy Materials and Products;

(b) necessary for the fulfillment of any other binding obligations pursuant to laws and regulations to the extent those laws and regulations are intended to ensure the supply of Energy Materials and Products within the territory of a Contracting Party;

(c) regarding hydrocarbons, necessary to account for the reasonable requirements, including forecasted requirements, for the transportation of Energy Materials and Products which are owned by the owners or operators of the Energy Transport Facilities or their Affiliates¹; and

(d) necessary for the efficient operation of the Energy Transport Facilities, including any operating margin necessary to ensure the security and reliability of the system. Draft Transit Protocol Article 1(2)

⁴⁴ Draft Transit Protocol Article 8(1).

⁴⁵ Ibid, Article 8(2)

⁴⁶ **"Entity"** means:

(a) with respect to a Contracting Party:

(i) a natural person having the citizenship or nationality of or who is permanently residing in that Contracting Party in accordance with its applicable law;

The right of first refusal means that if the terms of the transit agreement⁴⁷ and the supply contract do not match, owners and/or operators of pipelines under the jurisdiction of a transit state should consider the renewal of such transit agreements in competitive conditions. The existing user shall be treated neither better nor worse than potential users, with the exception that an existing user shall be given the first opportunity to accept the conditions offered for that available capacity.⁴⁸ The significance of the contractual mismatch and right of first refusal clause is that if the seller can not secure the transport of gas to the buyer, the seller will be faced with liability under the relevant gas sales agreement.⁴⁹

The complaint of the EC against the right of first refusal clause is based on the established competition rules of the EC. Although the right of first refusal might bring better security for the supplier within the terms of the supply contract, from the angle of EU countries, the market-economy principles suggest that competition will better guarantee energy security in the long term.⁵⁰ On the other hand, Russia and its gas company, Gazprom, have concerns that the non-discriminatory treatment principle might result in third-party access for Central Asian producers to its pipeline system, which

(ii) a company or other organization organized in accordance with the law applicable in that Contracting Party.

(b) with respect to a "third state", a natural person, company or other organization which fulfils, mutatis mutandis, the conditions specified in subparagraph (a) for a Contracting Party. Draft Transit Protocol Article 1(3)

⁴⁷ **"Transit Agreement"** means any agreement relating to Transit and which is entered into between:

(a) a Contracting Party and an Entity of another Contracting Party; or

(b) an Entity of a Contracting Party and an Entity of another Contracting Party, Ibid., Article 1(5)

⁴⁸ Ibid, Article 8(4).

⁴⁹ P Roberts, *Gas Sales and Gas Transportation Agreements: Principles and Practice* (2nd edn, Sweet&Maxwell 2008) 201

⁵⁰ S Haghghi, *Energy Security: The External Legal Relations of the European Union with Major Oil and Gas Supplying Countries* (Hart Publishing 2007) 329

would result in Russia's losing control of the energy flow.⁵¹ Access for land-locked Central Asian states to its pipeline system would make Russia a transit country for Central Asian gas, for which Russia currently acts as a buyer and resells to customers at higher prices. Russia would create its own competitors that would lessen the monopolistic power of Gazprom through providing its transport infrastructure to Central Asian producers.⁵²

3.3.2.2 Imposition of Transit Tariffs

The Protocol sets out rules and criteria for the imposition of transit tariffs. Transit tariffs should be objective, reasonable, transparent and non-discriminatory. They should not be affected by market distortions. They should not be subjected to the abuse of natural monopoly. They should be calculated by taking into consideration investment and operational costs and a reasonable rate of return. They may be determined by appropriate means, including regulation, commercial negotiations and congestion management mechanisms. The congestion management mechanisms imply the use of auctions to access available capacity.⁵³

Russia objects to auctions due to the potential for unpredictably high tariffs, which might result in extremely high consumer prices or in unreasonable financial losses to shippers who pay tariffs. However, EU countries argue that such a mechanism increases

⁵¹ A Belyi, "A Russian Perspective on the Energy Charter Treaty" Real Instituto Elcano (2009) 4 http://www.realinstitutoelcano.org/wps/wcm/connect/e6e3e5004f018b7db7c6f73170baead1/ARI98-2009_Belyi_Russian_Perspective_Energy_Charter_Treaty.pdf?MOD=AJPERES&CACHEID=e6e3e5004f018b7db7c6f73170baead1 last accessed 6 September 2012

⁵² D Marcinkeviciute, "Energy Charter Treaty Transit Protocol: European Gas Market Liberalization and its Effect on the European-Russian Gas Trade" 5 Texas Journal of Oil, Gas and Energy Law (2009) 110, 123

⁵³ Draft Transit Protocol, Article 10

competition.⁵⁴ The EC and Russia assert that auctions will not be reflective of the cost and they can be used only on a temporary basis. Excess revenue will be used to increase capacity.⁵⁵ In order to prevent an incentive to perpetuate congestion, revenues collected beyond cost recovery should be used to relieve congestion or to reduce tariffs.⁵⁶

3.3.2.3 Regional Economic Integration Organisation Clause

The last problematic issue between Russia and the EU is the regional economic integration organisation (REIO) clause. According to the Protocol, when the area of a Contracting Party that is a member of the REIO is referred to, it should be considered as referring to the whole area of the REIO.⁵⁷ Therefore, the REIO should be considered as a whole when transit occurs. The REIO is under the obligation to ensure that its provisions treat energy that originated in other Contracting Party and which is in free circulation in its area, no less favourably than energy that originated in one of its member states. The rules of an REIO should provide an overall standard at least equivalent to those of the Protocol.⁵⁸

The EC is the only recognized REIO under the ECT. This means that after energy enters in the area of EC, instead of the Protocol, EC law will apply in cases whenever the EMPs are destined for an EC member state or cross the borders of any EC member state. The Protocol can only be applied when the energy originates outside the EU and is destined for a third state such as Switzerland or Turkey. This is particularly important, since after

⁵⁴ Haghghi, *supra* note 50 334

⁵⁵ Coop, *supra* note 13 13

⁵⁶ Konoplyanik, *supra* note 23 477

⁵⁷ Draft Transit Protocol, Article 20(1).

⁵⁸ *ibid*, Article 20(2)

EU enlargement, the delivery point for Russian gas remained inside the EU. Therefore, according to the gas sale and transportation contracts, Russia objects to being subject to a regulatory regime that has been created without its participation.⁵⁹ In the context of an REIO clause, the EU exempts itself from applying the ECT and the Protocol provisions. Russia has concerns about this, since it must comply with a regime, the creation of which it has not been involved in.⁶⁰

3.3.3 Compliance with Transit and Swap Agreements and Dispute Settlement under ECT Article 27 (inter-state arbitration)

Contract Parties are under obligation to observe all obligations resulting from transit agreements they have entered into with entities of other Contract Parties. They shall ensure that their domestic law provides effective and non-discriminatory means for the assertion of claims and the enforcement of rights arising out of transit agreements.⁶¹ This provision is the restatement of the sanctity of contracts principle in the Protocol. It constitutes one of the most important provisions of the Protocol if an enforcement mechanism were to be created under it.

The Protocol sets out rules for international energy swaps as well.⁶² Contract Parties are under obligation not to place obstacles to the conclusion or execution of energy swap

⁵⁹ T I Shtilkind, “Energy Charter Treaty: A Critical Russian Perspective”, (1 OGEL 2005) quoted in Haghghi, supra note 47 333

⁶⁰ Belyi, supra note 51 4

⁶¹ Draft Transit Protocol, Article 5

⁶² “**International Energy Swap Agreement**” means any agreement relating to the exchange of a quantity of energy in the territory of one Contracting Party for an equivalent quantity of the same type in the territory of another Contracting Party and which is entered into between:

(a) a Contracting Party and an Entity of another Contracting Party; or
(b) an Entity of a Contracting Party and an Entity of another Contracting Party, ibid Article 17(1)

agreements. They should observe the agreements they have entered into. They should not interfere with or take energy that is exchanged. Moreover, they are under obligation to prohibit interference with or unauthorized taking of energy materials by entities under their jurisdiction.⁶³ The economic rationale behind energy swaps are: creating win-win situations through transporting energy without using the transport facilities of a transit country and exploiting the price differentials of the parties to the swap agreements for the mutual benefit of the parties.⁶⁴

The Protocol restated the non-interference obligation of a Contracting Party. A Contracting Party is under obligation not to interfere with or take from the energy in flow. It should prohibit and address unauthorized taking by an entity under its jurisdiction unless interference with or the taking of energy is particularly provided for in the specific transit contract.⁶⁵

The Protocol provides a dispute settlement mechanism regarding application or interpretation of the Protocol under ECT Article 27, inter-state arbitration. If a dispute cannot be settled through diplomatic channels between the Contract Parties, any of them may submit the dispute to an ad hoc arbitral tribunal in accordance with the procedures of Article 27, paragraph 3 of the ECT.⁶⁶

⁶³ *ibid*, Article 17(2-5)

⁶⁴ K P Waern, "Transit Provisions of the Energy Charter Treaty and the Energy Charter Protocol on Transit" (2002) 20 JENRL 172, 184 et seq

⁶⁵ Draft Transit Protocol, Article 6

⁶⁶ *ibid*, Article 21

Although contracting parties are under obligation to observe transit and swap agreements that they have entered into with entities of other contracting parties, there is no enforcement mechanism in existence under the Protocol. There is only an obligation of the transit state to provide effective means within its domestic legal system for the assertion of claims and enforcement of rights with regard to transit agreements. The only dispute settlement procedure under the Protocol is Article 27 (inter-state arbitration) of the ECT. Under the existing provisions of the Protocol, private parties to transit agreements can only subject disputes to bodies created under specific transit agreement. The Protocol should provide the parties with the right to enforce transit agreements under Article 26 (investor-state arbitration) of the ECT through drafting supplementary provisions. However, Article 26 can only be applied if the dispute arising out of a transit agreement constitutes an investment dispute according to the definition of investment under the ECT.

3.4 Viability of the Transit Provisions of the ECT and the Draft Transit Protocol

3.4.1 Inefficiency of Dispute Settlement and Enforcement Mechanisms

The viability of the ECT transit provisions and its dispute settlement mechanism were seriously questioned after the transit disputes between Russia and FSRs, notably after the 2006 and 2009 gas supply and transit crises between Russia and Ukraine. Although Ukraine ratified the ECT and provisional application was available at that time for Russia, the parties preferred to resolve the dispute through bilateral and high-level political negotiations.⁶⁷

⁶⁷ S Pirani, J Stern and K Yafimava, "The Russo-Ukrainian Gas Dispute of January 2009: A Comprehensive Assessment" (OIES 2009) 49-53

In addition to the internal deficiency of the ECT that was analysed above, the unwillingness of the parties to use the conciliation mechanism provided by ECT Article 7 clouded its practical application. Such reluctance was attributed to the different approaches to dispute resolution that exist in Europe and the FSRs. It was argued that Russia and Ukraine are not part of the international market economy and are less willing than their European counterparts to accept third-party dispute settlement mechanisms on an institutionalised international basis. They instead prefer to resolve disputes through methods based on power politics.⁶⁸

Russia and its state controlled company, Gazprom, regard the dispute settlement procedure of ECT Article 7 as giving the conciliator too much power, as the conciliator can decide on tariffs and supply terms for up to 12 months.⁶⁹ The transfer of sovereign control to a conciliator might be an abdication too far for the governments of Russia and Ukraine, considering the strategic and economic significance of gas supply and transit for these countries.⁷⁰

3.4.2 Russia's Draft Convention on International Energy Security and the Energy Charter Conference's Road Map for Modernizing the Energy Charter Process

One of the most significant developments after the 2009 gas crisis was Russia's unveiling of its "Conceptual Approach to the New Legal Framework for Energy Cooperation" later in that year to replace or amend the ECT. It included the much-debated statement of

⁶⁸ For a detailed analysis of "realpolitik" and "institutionalist" theories and their effects on dispute settlement see A V Belyi, U G Klaus, "Russia's Gas Exports and Transit Dispute Resolution under the ECT: Missed Opportunities for Gazprom or False Hopes in Europe?" (2007) 25 JENRL 205, 205 et seq

⁶⁹ Belyi, supra note 51 4

⁷⁰ Cameron, supra note 34 307

principles on sovereignty over natural resources, non-discriminatory access to markets, transparency, access to technology and information exchange. Russia supported extending the scope of the ECT framework both to include nuclear energy and to include additional countries.⁷¹ One of the outstanding issues in the proposal is the establishment of a system of international commissions to resolve emergencies connected with transit.⁷² If this proposal were incorporated into the ECT, it would provide the quick dispute resolution mechanism that is needed for the resolution of transit disputes. Most recently, in November 2010, Russia presented a “Draft Convention on Ensuring International Energy Security”⁷³ (hereafter called the Draft Convention) to the Energy Charter, which is a translation of the ideas contained in the “Conceptual Approach to the New Legal Framework for Energy Cooperation” into legal terms.

The Draft Convention Article 5 deals with transit. It states the obligation of states to ensure unimpeded transit (freedom of transit) on the basis of non-discrimination.⁷⁴ It subjects the creation of new capacity to the limitations of applicable legislation in the transit state, as long as these are consistent with freedom of transit. It does not obligate the transit state to permit construction of new transit capacity and access to existing capacities if the state can demonstrate that this will undermine the reliability and efficiency of its energy systems.⁷⁵ It obligates the transit state not to interrupt or reduce energy flows unless this is particularly provided for in the transit agreement.⁷⁶

⁷¹ Belyi, supra note 51 5

⁷² Konoplyanik, supra note 23 484

⁷³ Draft Convention on Ensuring International Energy Security, The text is available at <http://ua-energy.org/upload/files/Convention-eng11.pdf> last accessed 6 September 2012

⁷⁴ *ibid*, Article V(1)

⁷⁵ *ibid*, Article V(2)

⁷⁶ *ibid*, Article V(3)

According to the Draft Convention, the transit definition and transit provisions shall apply to the REIO and each of its member states individually.⁷⁷ This provision reflects one of Russia's objections to the ECT and the Protocol's REIO provisions. The Draft Convention addresses Russia's concerns over contractual mismatch between the terms of transport and supply contracts as well. It provides that energy diversification policies should be adopted with no detriment to existing contracts.⁷⁸ The transit provisions of the Draft Convention shall not apply in short-supply situations arising from outside the control of that state.⁷⁹ The Draft Convention proposes the establishment of bilateral or multilateral mechanisms in the case of emergency situations. The mechanisms might provide monitoring and consultation services with the participation of interested parties, independent observers and experts from international energy organizations.⁸⁰

There is no special provision in the Draft Convention for the settlement of transit disputes. However, it provides settlement through ad hoc arbitration for disputes related to the interpretation and application of the Draft Convention if the parties cannot reach a settlement through negotiations within six months. The arbitral tribunal shall determine its procedure to apply to the dispute.⁸¹

The Draft Convention proposes nothing new in addition to the transit provisions of the ECT and the Protocol except for providing provisions on Russia's objections to the ECT and the Protocol, such as the application of transit provisions to an REIO and member

⁷⁷ *ibid*, Article V(4)

⁷⁸ *ibid*, Article II(2)e

⁷⁹ *ibid*, Article VII(2)

⁸⁰ *ibid*, Article II(11)

⁸¹ *ibid*, Article X(1)

states individually and giving priority to existing users for access to capacity. In the words of the Secretary General of the Energy Charter, “(t)he proposals are consistent with the fact that the Member States of the Energy Charter have agreed to recognize the changes which have come about in the energy sector.”⁸² The Energy Charter Conference adopted a Road Map for Modernization of the Energy Charter Process in November 2010. Member States agreed that the Energy Charter is the appropriate tool for making progress on this issue.⁸³

In the Road Map, the Energy Charter Conference targeted the expansion and consolidation of the ECT’s geographical scope. This would be the key option for modernization if key players (e.g. Russia, Norway) could be convinced to sign or ratify the ECT.⁸⁴ The Road Map aims to achieve expeditious conclusion of the negotiations on the Transit Protocol. Moreover, it aims to establish mechanisms for the resolution of the transit disputes in the event of emergency and secure established flows of energy. In order to reach these objectives, the Road Map proposes strengthening the implementation of the ECT provisions during emergency situations on the basis of enhanced inter-state arbitration (Article 27 (2-3)). It states that member states can subscribe to additional binding rules, e.g. in the form of a Protocol, which would obligate them to support an accelerated process of fast-track state to state arbitration, or commit themselves to accelerated procedures by means of a Conference Declaration. The Road Map states that

⁸² A Mernier, “Understanding the role of the Energy Charter in 2011: Protecting Investment, Securing Transit, and Providing International Arbitration” 2011 European Gas Conference, Vienna (27 January 2011) 4

⁸³ *ibid.*

⁸⁴ Road Map for Modernization of the Energy Charter Process, http://www.encharter.org/fileadmin/user_upload/document/Road_Map_ENG.pdf last accessed 6 September 2012

an analysis of the substantive ECT provisions that can be subjected to arbitration is required.⁸⁵

Although the Energy Charter adopted “Rules Concerning the Conduct of Conciliation of Transit Disputes” to provide an efficient conciliation mechanism, the Energy Charter Conference further proposed in the Road Map to clarify the application of the conciliation procedure. The Road Map stated that “(a)n assessment of the status quo is necessary, including all Conference decisions, conclusions of the Conference Chairman or provisions of the draft Transit Protocol relating to ECT Article 7(7) and clarifying the relationship to arbitration under Article 27 ECT.”⁸⁶ The unclear situation of the relationship between ECT Article 7(7) conciliation mechanism and the Article 27 interstate arbitration mechanism has already been analyzed above.

The Draft Convention proposed by Russia does not propose an innovative solution to the criticized ineffectiveness of the ECT transit provisions. The Draft Convention’s principles differ substantially (e.g. REIO provisions) from the ECT and the Protocol. It might not, therefore, convince the EU.⁸⁷ It seems that the ECT will remain as the only multilateral framework for international energy governance to provide international energy security.⁸⁸ However, the proposals that are stated in the Draft Convention should be taken into account for modernization of the ECT. The transit provisions of the ECT

⁸⁵ *ibid*, 3

⁸⁶ *ibid*, 5

⁸⁷ A Belyi, S Nappert and V Pogoretsky, “Modernising the Energy Charter Process? The Energy Charter Conference Road Map and the Russian Draft Convention on Energy Security” (2011) 29 JENRL 383, 398

⁸⁸ K W Grewlich, “International Regulatory Governance of the Caspian Pipeline Policy Game” 29 JENRL (2011) 115

and the Protocol will remain largely inefficient without the participation of Russia. Cameron argued that The Energy Charter Conference review process should aim to balance the interests of not only producer and consumer states but also the interests of the transit states in order to ensure that they reap the benefits of their location. The review should be dedicated to specific problems rather than wide-ranging issues.⁸⁹

It is unclear whether Russia's Draft Convention and/or the Road Map of the Energy Charter Conference can create a multilateral framework acceptable to both Europe and Russia. It is a difficult task to agree on modernization of the ECT or to reach an acceptable framework for both sides considering that, after more than a decade, the parties have still not been able to agree on the provisions of the Protocol. However, without participation of Russia, the key energy player in Eurasia, the ECT transit provisions will remain mostly inefficient.

3.4.3 Arbitrability of Transit Disputes under Article 26 Investor-State Arbitration Mechanism

The transit provisions of ECT Article 7 and its conciliation procedure have not accomplished their intended aim either due to the inadequacy of the provisions or due to the unwillingness of the parties to refer the disputes to the conciliation mechanism. However, one question remains to be answered relating to the possible protection that can be provided by the ECT framework to transit pipelines: to what extent can the ECT investment provisions and the ECT Article 26 (investor-state) arbitration mechanism be

⁸⁹ Cameron, *supra* note 34 313

available for transit disputes, in particular for disputes arising out of transit and/or transport contracts?

The answer to this question is particularly important, since the Protocol negotiations were initiated after the call by the foreign ministers of the countries around Caspian for a suitable framework for international oil and gas pipeline investments. Although the Protocol regulates important issues, e.g. access to available capacity on negotiated basis, methods of imposition of transit tariffs, obligation to observe transit contracts, it does not provide an enforcement and/or dispute resolution mechanism other than the ECT Article 27 inter-state arbitration. However, the Caspian Region has witnessed the development of transit pipeline projects by private investors. These pipelines are the CPC oil transit pipeline, the BTC oil transit pipeline, the SCGP (gas transit pipeline), and the Baku-Supsa (WREP) and Baku-Novorossiysk (NREP) oil transit pipelines. These pipelines traverse Contract Parties to the ECT. Their legal arrangements are based on the investment contracts, which include transit terms as well. The availability of the ECT Article 26 investor-state arbitration to investors of these pipelines is not clear.

The reason for this ambiguity is that ECT Article 26 deals with disputes that concern the alleged breach of Part III (investment promotion and protection) provisions of the ECT by a Contracting Party; however, Article 7 transit provisions are found in Part II (commerce) of the ECT. The definition of “investment” under the ECT Article 1(6)-f⁹⁰

⁹⁰ **Investment** is defined by ECT Article 1(6) in the following terms: “investment means every kind of asset, owned or controlled directly or indirectly by an investor and includes: (f): any right conferred by law or contract or by virtue of any licences and permits granted pursuant to law to undertake any Economic Activity in the Energy Sector.”

includes “...any right conferred by law or contract or by virtue of any licences and permits granted pursuant to law to undertake any economic activity in the energy sector.” Land transport, transmission and distribution are the examples of economic activity in the energy sector given under the definition of investment.⁹¹ When the investment definition is interpreted together with the ECT Article 10(1) umbrella clause, which states that “each contracting party shall observe any obligations it has entered into with an investor or an investment of an investor of any other contracting party”, certain transit-related disputes on rights conferred by law, contract, license to undertake transport activities in a contracting state can be referred to arbitration under the Article 26 investor-state arbitration mechanism.

This view is supported by the argument that disputes arising out of the provisions of Article 7, which relate to the construction of new or additional transit facilities and establishment of new capacity can be arbitrated under Article 26 in addition to Article 27.⁹² However, these disputes can only be arbitrated under Article 26 if the investor is entitled to these rights under an investment contract. On the other hand, if the subject of the transit dispute is not clearly granted as a legal or contractual right, these kinds of disputes can only be arbitrated under Article 27 by the home government of the investor. The next section of the chapter examines the availability of investment protection to pipeline investors and of stability to transit contracts, by means of invoking umbrella

⁹¹ “**Economic Activity in the Energy Sector**” is defined by ECT Article 1(5) in the following terms: “an economic activity concerning the exploration, extraction, refining, production, storage, land transport, transmission, distribution, trade, marketing, or sale of Energy Materials and Products except those included in Annex NI, or concerning the distribution of heat to multiple premises.”

⁹² Roggenkamp, *supra* note 14

clause and fair and equitable treatment standard of the ECT and by enforcement of them under the Article 26 investor-state arbitration.

3.5 Stability Provided by the ECT Investment Provisions to Transit Contracts

3.5.1 Umbrella Clause

3.5.1.1 Background, Scope and Function

The origins of the umbrella clause are in the settlement proceedings between the Anglo Iranian Oil Company and the government of Iran in the 1950s and on the basis of the advice given by the Lauterpacht. The intention was to provide parallel protection in such a way that a breach of “the consortium agreement” should be treated as a breach of the Treaty. It included a provision through which the Iranian government guaranteed on behalf of itself and the National Iranian Oil Company to fulfil the terms of the contract. A group of oil companies that planned to develop a trunk pipeline from Iraq through Syria and Turkey was also given advice by Lauterpacht in 1956-57 to secure the transit contracts between oil companies and transit states with an umbrella treaty that would include all participating states and oil companies. Therefore, a breach of transit contracts between investors and transit states would become a breach of treaty. However, this trunk pipeline was never constructed.⁹³

The 1959 Abs-Shawcross Draft Convention on Investments Abroad and the 1967 OECD Draft Convention on the Protection of Foreign Property include umbrella clauses. The first BIT, the 1959 Treaty between Germany and Pakistan on Promotion and Protection

⁹³ A C Sinclair, “The Origins of the Umbrella Clause in the International Law of Investment Protection” (2004) 20 *Arbitration International* 411, 411 et seq

of Investments, includes an umbrella clause as well.⁹⁴ The ECT was negotiated on the basis of the practice of BITs. It includes an umbrella clause in the last sentence of Article 10(1), and states “(e)ach Contracting Party shall observe any obligations it has entered into with an investor or an investment of an investor of any other Contracting Party.”

An umbrella clause in an investment treaty guarantees the performance of the obligations undertaken by the host-state in a contract with the investor. However, “the most contentious issue in relation to clauses of this kind is whether, and under what circumstances, they place investment agreements...under the treaty’s protection.”⁹⁵ The main source of uncertainty with regard to these circumstances is whether the umbrella clause changes the character of the obligation and a contract claim becomes a breach of treaty under international law or remains a breach of contract under its applicable law.⁹⁶ The second cause of uncertainty is whether a breach by a sovereign act, e.g. regulatory action, is required to invoke the umbrella clause or whether a simple commercial breach is adequate.⁹⁷

⁹⁴ The Abs-Shawcross Draft Convention includes an umbrella clause of “Each Party shall at all times ensure the observance of any undertakings which it may have given in relation to investments made by nationals of any other Party.” The OECD Draft also includes similar umbrella clause “Each Party shall at all times ensure the observance of undertakings given by it in relation to the property of nationals of any other Party.” The umbrella clause of Germany-Pakistan BIT is as “Either Party shall observe any other obligation it may have entered into with regard to investments by nationals or companies of the other Party.” quoted in Sinclair, 421, 427, and 433

⁹⁵ R Dolzer and C Schreuer, *Principles of International Investment Law* (OUP 2008) 153

⁹⁶ Cameron, *supra* note 2 172

⁹⁷ T Walde, “Energy Charter Treaty-based Investment Arbitration: Controversial Issues” (2004) 5 JWIT 373

The conventional interpretation of the umbrella clause has adopted an internationalist approach. A BIT that includes an umbrella clause protects the investor against a simple breach of contract. It elevates the breach from the contract's governing law to international law under treaty. F. A. Mann argued that the umbrella clause protects the investor even against a mere breach of a contract:

“(t)his is a provision of particular importance in that it protects the investor against any interference with his contractual rights, whether it results from a mere breach of contract or a legislative or administrative act, and independently of the question whether or not such interference amounts to expropriation. The variation of the terms of a contract or licence by legislative measures, the termination of the contract or the failure to perform any of its terms, for instance, by non-payment, the dissolution of the local company with which the investor may have contracted and the transfer of its assets (with or without the liabilities)-these and similar acts the treaties render wrongful.”⁹⁸

Dolzer and Stevens supported these views in a leading book on BITs. They argued that

“(t)hese provisions seek to ensure that each Party to the treaty will respect specific undertakings towards nationals of the other Party. The provision is of particular importance because it protects the investor's contractual rights against any interference which might be caused by either a simple breach of contract or by administrative or legislative acts, and because it is not entirely clear under general international law whether such measures constitute breaches of an international obligation.”⁹⁹

Under the conventional view, any breach of a contract becomes a breach of a treaty through invoking the umbrella clause. Therefore, the dispute settlement clause of the investment treaty becomes applicable to claims arising out of the breach of the contract.¹⁰⁰

⁹⁸ F A Mann, “British Treaties for the Promotion and Protection of Investments” (1981) 52 BYIL 241, 246

⁹⁹ R Dolzer and M Stevens, *Bilateral Investment Treaties* (Kluwer 1995) 81-82

¹⁰⁰ C Schreuer, “Travelling the BIT Route: Of Waiting Periods, Umbrella Clauses and Forks in the Road” (2004) 5 *The Journal of World Investment & Trade* 231, 251

3.5.1.2 Arbitral Jurisprudence on the Umbrella Clause

Although most of the investment treaties include umbrella clauses, the *SGS v. Pakistan* and the following contradictory *SGS v. Philippines* awards are the first awards that directly interpreted the umbrella clause. The tribunal in the *SGS v. Pakistan* case asserted that the umbrella clause of the BIT “while consisting in its entirety of only one sentence, appears susceptible of almost indefinite expansion... Article 11 does not purport to state that breaches of contract alleged by an investor in relation to a contract it has concluded with a State... are automatically ‘elevated’ to the level of breaches of international law.”¹⁰¹ In the view of the tribunal, clear and convincing evidence is required to elevate the contract claims to claims under BIT, which demonstrates that “...such was indeed the shared intent of the contracting parties to the Swiss-Pakistan Investment Protection Treaty in incorporating Article 11 in the BIT.”¹⁰²

The tribunal rejected to give effect to the umbrella clause based on the arguments that¹⁰³ first, it would lead to the so-called flood effect: in the terms of the tribunal “...any alleged violation of those contracts and other instruments would be treated as a breach of the BIT.” Secondly, it would deprive the effects of substantial treaty provisions. According to the tribunal, if a simple breach of contract is treated as a breach of a treaty resulting in the international responsibility of the state, there is no need to demonstrate substantive treaty standards are violated. Thirdly, the forum selection clause of the contract would not bind the investor while it is binding for the host state. Fourthly, the

¹⁰¹ *SGS Societe Generale de Surveillance v. Islamic Republic of Pakistan*, Decision on Jurisdiction 42 ILM 2003 1290 para 166

¹⁰² *ibid*, para 167

¹⁰³ *ibid*, para 168

umbrella clause is situated at the end of the Treaty instead of with other substantive treaty standards. This prevents a far-reaching interpretation and application of the clause. The tribunal restricted the scope of the umbrella clause to where the investor is prevented from prosecuting its claims before an international arbitration tribunal that was agreed in a contract or where state does not participate in the proceedings. These actions should amount to “denial of justice” as well.¹⁰⁴

The *SGS v. Pakistan* award has been widely criticized by commentators. It was argued that in the absence of filtering tools, the tribunal gave zero effect to the umbrella clause because of its fear of the flood effect.¹⁰⁵ The flood effect will not happen, since only the disputes that relate to an investment under the BIT can be sued under the umbrella clause.¹⁰⁶

The tribunal in the following contradictory *SGS v. Philippines* award criticized the *SGS v. Pakistan* award. The tribunal stated that the tribunal of *SGS v. Pakistan* failed to give the umbrella clause a clear meaning and the reasons of the tribunal were unconvincing.¹⁰⁷

The tribunal of *SGS v. Philippines* asserted that the umbrella clause

“...makes it a breach of the BIT for the host State to fail to observe binding commitments, including contractual commitments, which it has assumed with regard to specific investments. But it does not convert the issue of the extent or content of such obligations into an issue of international law. That issue (in the present case, the issue of

¹⁰⁴ *ibid*, para 172

¹⁰⁵ T Walde, “Contract Claims under the Energy Charter Treaty’s Umbrella Clause: Original Intentions versus Emerging Jurisprudence”, in *supra* note *Investment Arbitration and the Energy Charter Treaty* (C Ribeiro ed, JurisNet LLC 2006) 219- 220.

¹⁰⁶ S A Alexandrov, “Breaches of Contract and Breaches of Treaty: The Jurisdiction of Treaty-based Arbitration Tribunals to Decide Breach of Contract Claims in *SGS v Pakistan* and *SGS v Philippines*” (2004) 5 *JWIT* 555, 564 et seq; Schreuer, *supra* note 87 253

¹⁰⁷ *SGS Societe Generale de Surveillance v Republic of the Philippines*, Decision on Jurisdiction, 29 January 2004, 8 *ICSID Reports*, 2005, at 518 et seq., par 125

how much is payable for services provided under the CISS Agreement) is still governed by the investment agreement.”¹⁰⁸

The tribunal in the *Noble Ventures v. Romania* case, after making reference to Article 31 and 32 of the Vienna Convention, the principles of effectiveness and object and purpose of the treaty,¹⁰⁹ held the view that the wording of the umbrella clause in the case

“...which speaks of ‘any obligation (a party) may have entered into with regard to investments’: it is difficult not to regard this as a clear reference to investment contracts.... An interpretation to the contrary would deprive the investor of any internationally secured legal remedy in respect of investment contracts that it has entered into with the host State. While it is not the purpose of investment treaties per se to remedy such problems, a clause that is readily capable of being interpreted in this way and which would otherwise be deprived of practical applicability is naturally to be understood as protecting investors also with regard to contracts with the host State generally in so far as the contract was entered into with regard to an investment...in including Art. II(2)(c) in the BIT, the Parties had as their aim to equate contractual obligations governed by municipal law to international treaty obligations as established in the BIT...the Tribunal therefore considers the Claimant’s claims of breach of contract on the basis that any such breach constitutes a breach of the BIT.”¹¹⁰

The tribunal of *El Paso Energy v. Argentina* made a distinction between the state as a merchant and the state as a sovereign. The tribunal held the view that “...it is necessary to distinguish the state as a merchant from the state as a sovereign.”¹¹¹ An umbrella clause “...will not extend the treaty protection to breaches of an ordinary commercial contract entered into by a State or State-owned entity, but will cover additional

¹⁰⁸ *ibid*, para 129

¹⁰⁹ *Noble Ventures Inc. v Romania*, Award, ICSID Case No ARB/01/11, 12 October 2005, para 50-51. <http://italaw.com/documents/Noble.pdf> last accessed 6 September 2012; The tribunal in the *Eureka BV v. Republic of Poland* case held a similar line. It concluded that, any breach of contract is protected by umbrella clause. It based its’ decision on the interpretation criteria of ordinary meaning, purpose of the treaty and principle of effectiveness. See, *Eureka BV v Republic of Poland*, Partial Award, 19 August 2005, 12 ICSID Reports 335 et seq, para 246-248

¹¹⁰ *ibid*, para 51-52 and 61-62

¹¹¹ *El Paso Energy International Company v The Argentine Republic*, Decision on Jurisdiction, ICSID Case No ARB/03/15, 27 April 2006, para 79. <http://italaw.com/documents/el Paso-jurisdiction27april2006.pdf> last accessed 6 September 2012

investment protections such as stabilization clauses contractually agreed by the state as a sovereign.”¹¹² The tribunal asserted that the broad interpretation of umbrella clauses would transform all the commitments of the state with respect to investment to treaty claims. This would destroy the distinction between national and international legal orders.¹¹³ The award of the tribunal reduces the application of the umbrella clause and makes it ineffective. It restricts the application of the clause to the existence of a stabilization clause that does not exist in many of the investment contracts. It is highly questionable whether an investor with an investment contract that has a stabilization clause needs to invoke an umbrella clause. The umbrella clause stabilizes the legal framework of the investment *ex post*. However, it does not exclude the regulation based on police power of the host state in public purpose and on contingencies such as change in circumstances, *force majeure*, hardship and imprevision.¹¹⁴

The tribunal in the CMS v. Argentine case asserted that pure contractual claims could not benefit from treaty protection. Protection is available when government or public agencies seriously interfere with the rights of the investor. Furthermore, after making reference to stabilization clauses that obligate the state party not to freeze the tariff regime and not to change the rules governing the licence without the consent of the licensee, the tribunal concluded that the umbrella clause was breached by the host state.¹¹⁵ However, the CMS v. Argentine award, particularly the part of it relating to the

¹¹² *ibid*, par 81

¹¹³ *ibid*, par 81-82

¹¹⁴ S W Schill, “Enabling Private Ordering: Function, Scope and Effect of Umbrella Clauses in International Investment Treaties” (2009) 18 Minnesota Journal of International Law 1, 76-81

¹¹⁵ CMS Gas Transmission Company v. The Argentine Republic, Award, 12 May 2005, 44 ILM, 2005 1205 et seq para 299 and 303

umbrella clause, was annulled by an ad hoc arbitration tribunal due to lack of reasoning. The annulment tribunal found the interpretation of the first tribunal too broad and asserted that “(t)he effect of the umbrella clause is not to transform the obligation which is relied on into something else; the content of the obligation is unaffected, as is its proper law. If this is so, it would appear that the parties to the obligation (i.e., the persons bound by it and entitled to rely on it) are likewise not changed by reason of the umbrella clause.”¹¹⁶ The CMS v. Argentine annulment tribunal held a similar view to the tribunal of SGS v. Philippines tribunal, which was that the claims relating to breach of a contract should be adjudicated under the applicable law and the dispute settlement clause of the licence.

The tribunal in the Plama v. Bulgaria case interpreted the umbrella clause of the ECT in such a way that the wording of the umbrella clause is wide enough that refers to all obligations either contractual or statutory. However, after making reference to the CMS v. Argentine annulment decision’s assertion that only consensual obligations that are entered into should be protected under the umbrella clause, the tribunal concluded that whether the broad or narrow interpretation is adopted the umbrella clause covers the contractual obligations.¹¹⁷

¹¹⁶ CMS Gas Transmission Company v. The Argentine Republic, Annulment Decision, ICSID Case No ARB/01/8, 25 September 2007, para 95. http://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=showDoc&docId=DC687_En&caseId=C4 last accessed 6 September 2012

¹¹⁷ Plama Consortium Limited v. Republic of Bulgaria, Award, 27 August 2008, http://www.encharter.org/fileadmin/user_upload/document/Plama_Bulgaria_Award.pdf last accessed 6 September 2012

3.5.1.3 Clarifying the Criteria for Application of the Umbrella Clause

Crawford has identified four schools of thoughts with regard to interpretation of umbrella clause:¹¹⁸ The first school of thought adopts a restrictive interpretation. According to this school, umbrella clauses can be activated only where there is a shared intent by the parties to the treaty that any breach of contract is a breach of the BIT (e.g. *SGS v. Pakistan*, *Joy Mining v. Egypt*). The second school adopts a sovereignty-based approach. Umbrella clauses can be activated when the host state breaches the contract through the exercise of sovereign power (e.g. *CMS v. Argentine*, *Pan American Energy v. Argentine*, *El Paso Energy v. Argentine*). The third school adopts an internationalist approach. According to this school, umbrella clause directly transforms contractual claims into treaty claims and subjects the claims to treaty rules. (e.g. *Fedax v. Venezuela*, *Eureko v. Poland*, *Noble Ventures v. Romania*). The last school of thought, which is supported by Crawford and called the integrationist approach, adopts the view that an umbrella clause can be activated and may form the basis for a substantive treaty claim. However, it does not convert a contractual claim into a treaty claim. The umbrella clause does not change the governing law of the contract.

Crawford criticized the first three schools on the basis that the restrictive school deprives the umbrella clause of any content. The restrictive view is a reaction against the internationalist view that sees umbrella clauses as elevators of contract claims to treaty claims. He criticized the views of the sovereignty-based school, which distinguishes between commercial acts of a state and governmental acts of a state, using the argument

¹¹⁸ J Crawford, "Treaty and Contract in Investment Arbitration" The 22nd Freshfields Lecture on International Arbitration London (29 November 2007) 18

that there is no textual warrant and determinative test. Therefore, this could result in arbitrary decisions.¹¹⁹ Crawford argued that

“...under the integrationist view as applied to standard umbrella clauses the claims are still contractual and they are still governed by their own applicable law. The distinction between treaty and contract is maintained. The purpose of the umbrella clause is to allow enforcement without internationalization and without transforming the character and content of the underlying obligation.”¹²⁰

The integrationist view’s interpretation might result in ineffectiveness of the umbrella clause. The *SGS v. Philippines* tribunal adopted the integrationist view.¹²¹ It decided that although the umbrella clause could be activated under the treaty, the contractual claim should still be adjudicated by the tribunal established according to the dispute settlement clause of the contract and according to the applicable law of the contract. However, restricting the application of the umbrella clause as an enforcement mechanism of the award of the arbitral tribunal established under contract is highly questionable.

On the other hand, scholars adopting the internationalist view asserted that the canons set out in Article 31 of the Vienna Convention can not be ignored and references to conventional terminological distinctions (the sovereignty based approach) or to a specific national law (the integrationist approach) does not change that method of interpretation.¹²² Dolzer and Schreuer argued that,

“(i)f the parties choose to extend the scope of the agreement beyond the confines of the classical understanding of an ‘investment treaty’ and also cover, to some extent, operations previously deemed ‘commercial’, or ‘contractual’ in nature, the conventional terminology cannot stand in the way of the parties’ intentions. For this reason, any attempt to define the scope of the umbrella clause by reference to abstract concepts such

¹¹⁹ *ibid*, at 19

¹²⁰ *ibid*, at 20

¹²¹ *SGS v Philippines*, *supra* note 107 para 125 et seq

¹²² Dolzer and Schreuer, *supra* note 95 161

as sovereign acts, commercial acts, or contrats administratifs will carry no methodological power of persuasion when it comes to interpret and apply the clause.”¹²³

Schill argued that umbrella clauses provide protection for investors against any kind of breach by the state relating to the investment independent of the nature of the obligation, arising either out of the contract or a unilateral state act, such as licence or regulation, and independent of the nature, either sovereign or commercial nature, of the breach.¹²⁴ Moreover, the fair and equitable treatment standard and indirect expropriation require a sovereign act of the state and provide protection for contracts, provided that a sovereignty based breach occurs and that commercial breach of the agreement remains outside the protection of the treaty. Therefore, the umbrella clause is created to fill this gap. It provides protection and enforcement for investment related contract breaches, without taking into consideration whether the act of the state is of a sovereign or commercial nature.¹²⁵ This raises the question of why this distinction (sovereign versus commercial) is accepted as a qualifying test in order to invoke substantive treaty standards, such as the fair and equitable treatment standard and protection against direct or indirect expropriation, and not applied to same nature of (substantive) treaty standard of the umbrella clause.

The scholars who adopted the sovereignty-based approach, such as Walde, argued that most investment contracts are not between an investor and the central authorities of the state but rather are with sub-national authorities, independent licensing and regulatory bodies, or state-owned or controlled enterprises. Therefore, the rules and indicators that

¹²³ *ibid*

¹²⁴ Schill, *supra* note 114 6

¹²⁵ *ibid* 35

are used to attribute the conduct of such entities to the state are analogous to the indicators that distinguish commercial acts from governmental acts.¹²⁶

In addition to the structural test of whether the entity is owned or controlled by the state, a functional test is required to determine whether the contracting entity fulfills a public service and/or governmental function or it acts as a normal commercial entity at arm's length from governmental intervention. The indicators that have been described by investment tribunals to attribute the act of the entity to the state and make the act sovereignty based have been classified under five criteria:¹²⁷

First, the entity should pursue a public service function within the particular contract (e.g. *Maffezini I and II*, *Salini v. Morocco*, *Nykomb*, *SGS v. Pakistan*, *Metalclad v. Mexico*). Secondly, the highly regulated nature of the industry and the preparation method used for the contract is an indicator of a governmental act (e.g. procurement for public transportation in *Salini v. Morocco*, electricity purchase by a state-owned electricity monopoly in *Nykomb v. Latvia*, *Himpurna v. Indonesia*). Thirdly, if the content of the contract is not freely negotiated but rather mandated (e.g. Latvian state energy monopoly's mandatory purchase obligation at a prescribed tariff from co-generators in *Nykomb v. Latvia*), this is an indicator of a governmental act. Fourthly, the involvement of senior government officials in the preparation, performance and dynamics of the investment contract dispute (e.g. *Nykomb v. Latvia*, *Petrobrat v. Kyrgyzstan*) and heavy politicization implies a governmental nature. Fifthly, if the undertakings in the public

¹²⁶ Walde, *supra* note 105 229

¹²⁷ *ibid*, 231-232

utility concession, particularly at privatization contracts, targets sensitive and strategic governmental actions (e.g. the freezing of tariffs in *CMS v. Argentine*), this is an indicator of a governmental act.

According to the Walde, the requirements that qualify an act of the state as being commercial are the following.¹²⁸ First, the state-owned enterprise should operate at arm's length from government with minimal governmental and political influence. The state should exercise its right only as a shareholder with a primarily normal commercial ownership perspective. Secondly, the state-owned entity should operate in a fully competitive market where transactions and disputes are governed by market rules and the government has minimal influence. Thirdly, a particular transaction leading to a dispute should not indicate that the government has intervened or abused its dual role as a contracting party and a regulator. The criterion that should be applied is: do normal businesses of that type typically have such disputes or is it the involvement of the government that explains the dynamics of the dispute?

3.5.1.4 Implications of the Umbrella Clause of the ECT on Transit Pipeline Agreements and on Transit Disputes

The umbrella clause of the ECT¹²⁹ is broad enough to cover obligations of the host state independent of the nature of the obligation, either contract based or the rights granted under law or other unilateral state acts such as licences to undertake energy sector specific economic activity. Its wording of “shall observe any obligations” and the

¹²⁸ *ibid*, 233

¹²⁹ ECT Article 10(1) states that “Each Contracting Party shall observe any obligations it has entered into with an investor or an investment of an investor of any other Contracting Party.”

definition of investment under the ECT, which includes “...claims to performance pursuant to contract having an economic value and associated with an investment”¹³⁰ and “any right conferred by law or contract or by virtue of any licences and permits granted pursuant to law to undertake any economic activity in the energy sector”¹³¹ puts both contractual and unilateral obligations under the scope of the umbrella clause of the ECT.

The legal nature of the licence and whether the licences are included in the scope of umbrella clause depends on how these licences are classified under the specific jurisdiction and on the specific language of the umbrella clause in the relevant treaty. A broad “shall observe any obligation it has entered into” definition in an umbrella clause is not restricted to contractual rights. It includes non-contractual obligations in licences or acts within the scope of the umbrella clause. Host countries might limit this broad application by incorporating in the umbrella clause the requirements such as “be in writing and made with respect to specific investment”, or limiting it to only contractual obligations, or determining the venue for dispute settlement as being the one in contract.¹³² The tribunal in the *Eureko v. Poland* case expressed the view that

“(t)he plain meaning –the ordinary meaning- of a provision that a state ‘shall observe any obligations it may have entered into’ with regard to certain foreign investments is not obscure. The phrase ‘shall observe’ is imperative and categorical. ‘Any’ obligations is capacious; it means not only obligations of a certain type, but ‘any’ –that is to say, ‘all’ obligations entered into with regard to investments of investors of the other Contracting Party.”¹³³

¹³⁰ *ibid*, Article 1(6)c

¹³¹ *ibid*,

¹³² J W Salacuse, *The Law of Investment Treaties* (OUP 2010) 278-279

¹³³ *Eureko BV v Republic of Poland* (Partial Award) 19 August 2005, para 246

<http://italaw.com/documents/Eureko-PartialAwardandDissentingOpinion.pdf> last accessed 6 September 2012

It is clear that if the umbrella clause, such as the one in ECT Article 10, does not limit the obligations to be observed to contractual ones, the scope of the umbrella clause includes both contractual and unilateral obligations such as the obligations that are contained in licences and acts.

The licence contains elements of both consensus, particularly with regard to the financial terms, and regulation, in the form of imposition by the states of obligations to protect public interest through proper exploration or operation of petroleum activities.¹³⁴ The central matter in determining the legal nature of the licence is that how the relevant state balances its commitments to the licensee and its general regulatory powers. Another determinative criterion is whether the relevant licence norm is part of negotiation element of the licence arrangements or whether it is the part of regulatory element. How far the relevant norm will be modified depends on the status of the norm.¹³⁵

In the UK, although the content of the licence is determined by clauses that are specified by regulation, the licence is regarded as contract in form between the relevant minister and the licence holder. The legal nature of the rights of the investor in the licence is regarded as contractual in Canada and the US as well. However, in Australia and Germany, the licence is regarded as administrative in nature. The rules of contract law cannot be used to interpret, or to fill gaps in, the licences in these latter jurisdictions.¹³⁶ In

¹³⁴ T Daintith, "Petroleum Licences: A Comparative Introduction" in *The Legal Character of Petroleum Licences: A Comparative Study*, (T Daintith ed, CEPMLP and IBA Energy and Natural Resources Committee 1982) 12

¹³⁵ *ibid* 25-26

¹³⁶ T Daintith, "State-Company Relations in Offshore Oil Exploitation: Regulatory and Contractual Analyses" in *Regulating Energy and Natural Resources* (B. Barton et al ed, OUP 2006) 276-268

the UK, changes regarding to the content of future licences have no effect on existing licences unless the consent of the licence holder is obtained. This is in contrast to the US and Canada where a licence is classified as a contract, as in the UK.¹³⁷ However, even in the US, the Supreme Court decided that the lease obtained by Mobil Oil incorporated the relevant provisions of the regulations and that the refusal of the state authority to decide on a drilling application was contrary to those provisions of the licence. The act of the state was a repudiatory breach of the lease, entitling the leaseholder to cash-bid monies, in spite of the fact that the refusal was mandated by later legislation.¹³⁸

The legal arrangements of transit pipeline projects that have been developed in the Caspian Region were based on the intergovernmental agreements between participating states and investment agreements between pipeline investors and the transit states. The transit terms, such as transit fees and/or tariffs, capacity and access rights, were determined in these investment contracts.¹³⁹ Therefore, it is submitted that the umbrella clause of the ECT provides protection against breach of these transit terms found in investment contracts, provided that the act of the state is sovereignty-based (governmental in nature). The parties to these investment agreements are either the government itself or state-owned oil and gas companies. Government officials took part in the negotiation, performance and dynamics of the disputes. Therefore, these transit contracts might be qualified as governmental in nature under the clarified criterion mentioned above.

¹³⁷ *ibid* 277-278

¹³⁸ *Mobil Oil Exploration and Production Southeast Inc. v United States* 530 US 604; 120 SCt 2423; 147 Led 2d 528, 2000, cited in *ibid* 281

¹³⁹ *Baku-Tbilisi-Ceyhan HGA Turkey*, Article II.4; *South Caspian Gas Pipeline HGA Georgia* Article 18; *Caspian Pipeline Consortium Oil Pipeline Recontstruction and Shareholders Agreement* Article 5, 8, 11.

Thus, the umbrella clause of the ECT provides protection for, and enforcement of, these transit terms included under relevant investment contracts. It makes the breach of these transit contract provisions a breach of the umbrella clause of the ECT, provided that the transit state acts in its sovereign capacity. The same argument is relevant for the licences that entitle the investors in the pipeline construction and operation, since the language of the ECT umbrella clause includes the licence as a source of obligation in its scope. Even if the scope of the umbrella clause was limited to the contractual obligations, the obligations of the state under the licence might be protected by that specific umbrella clause due to the classification of licence as contractual under the specific jurisdiction.

The most important implication of the ECT umbrella clause is that through providing enforcement of the transit terms and rights included in investment contracts and licences, which already constitute investment according to the definition of investment in the ECT, it provides Article 26 investor-state arbitration for disputes on the above mentioned transit terms included in these transit pipeline investment contracts.

3.5.2 Fair and Equitable Treatment Standard

3.5.2.1 Concept, Scope and Function

The FET standard is the prominent standard on which investor claims and arbitral decisions have been based on in investment treaty arbitration in the last decade.¹⁴⁰

Although the FET standard is included in most of the investment treaties and is invoked frequently by foreign investors in arbitration cases, its conceptual interpretation and

¹⁴⁰ Dolzer and Schreuer, *supra* note 95 119

normative content is far from clear.¹⁴¹ The scope of the FET standard is controversial. The debate is on whether the protection provided by the FET standard is equal to the minimum standard under customary international law or whether it is an autonomous standard. The debate has particularly become apparent after the interpretation of the NAFTA FET clause (Article 1105.1) by the NAFTA Free Trade Commission (The Commission). The Commission stated that “(t)he concepts ‘fair and equitable treatment’ and ‘full protection and security’ do not require treatment in addition to or beyond that which is required by the customary international law minimum standard of treatment of aliens.”¹⁴²

The ECT includes the FET standard in its particular investment treatment provision of Article 10(1). However, without such limitation as included in the NAFTA, the FET standard of the ECT stipulates that

“(e)ach contracting party shall, in accordance with the provisions of this Treaty, encourage and create stable, equitable, favourable and transparent conditions for investors of other contracting parties to make investment in its area. Such conditions shall include a commitment to accord at all times to investments of investors of other contracting parties’ fair and equitable treatment.”

The independent stipulation of this standard in BITs is regarded as evidence of an autonomous standard. Dolzer and Stevens argued that “...the fact that parties to BITs have considered it necessary to stipulate this standard as an express obligation rather than relied on a reference to international law and thereby invoked a relatively vague concept

¹⁴¹ S W Schill, “Fair and Equitable Treatment under Investment Treaties as an Embodiment of the Rule of Law” IILJ Working Papers 2006/6 in Global Administrative Law Series Institute of International Law and Justice (2006) www.iilj.org last accessed 6 September 2012

¹⁴² NAFTA FTC Note of Interpretation, 31 July 2001 http://www.international.gc.ca/trade-agreements-accords-commerciaux/disp-diff/nafta_commission.aspx?lang=en last accessed 6 September 2012

such as the minimum standard, is probably evidence of a self-contained standard.”¹⁴³

Moreover, in his article on British treaties, Mann argued that

“(t)he terms fair and equitable treatment envisage conduct which goes far beyond the minimum standard and afford protection to a greater extent and according to a much more objective standard than any previously employed form of words. A tribunal would not be concerned with a minimum, maximum or average standard. It will have to decide whether in all the circumstances the conduct in issue is fair and equitable or unfair and inequitable. No standard defined by other words is likely to be material. The terms are to be understood and applied independently and autonomously.”¹⁴⁴

On the other hand, Mayeda argued that the FET standard should be interpreted in line with the minimum standard. The FET standard should be interpreted in the light of the drafting history of the standard and through referencing the FET clause in the OECD Draft Convention on Foreign Investment, which states that “(t)he standard required conforms in effect to the ‘minimum standard’ which forms part of international law...”¹⁴⁵

The second reference point is NAFTA cases, which stated that the FET standard should be equal to the minimum standard.¹⁴⁶ Moreover, it was argued that broadening the scope of the FET standard from that of the minimum standard to a plain meaning interpretation and setting down principles under the FET standard, such as legitimate expectations of the parties and predictable and stable business environment, might result in idiosyncratic interpretation by arbitrators based on their interpretation of fairness.¹⁴⁷ Furthermore, this line of interpretation might prevent states from exercising their regulatory and legislative capacity and undermine the development objective of states through solely focusing on

¹⁴³ Dolzer and Stevens, *supra* note 99 60

¹⁴⁴ Mann, *supra* note 98 244

¹⁴⁵ G Mayeda, “Playing Fair: The Meaning of Fair and Equitable Treatment in Bilateral Investment Treaties” (2007) 41 *Journal of World Trade* 273, 280-284

¹⁴⁶ *ibid*

¹⁴⁷ J R Picherack, “The Expanding Scope of Fair and Equitable Treatment Standard: Have Recent Tribunals Gone Too Far?” (2008) 9 *JWIT* 255, 255 et seq

specific interests of the investor.¹⁴⁸ Sornarajah argued that the reiteration of expansive standards by Canada and the US “...as the principal backers of both the international minimum standard and the fair and equitable standard in treaty practice will deprive the latter standard of any content, if it indeed did have any.”¹⁴⁹

Three main types of FET standard can be identified in treaty practice. Each of these types should be interpreted based on its own particular form of words, according to the Article 31 of the Vienna Convention. Under the first type of FET standard, it is stated that “(e)ach Contracting State shall in its territory in any case accord investments by investors of the other Contracting State fair and equitable treatment...”¹⁵⁰ In this type of clauses, there is no reference to international law. Therefore, customary international law’s minimum standard is not invoked and the FET standard is interpreted autonomously.¹⁵¹ The second type states that “(e)ach Party shall at all times accord to covered investments fair and equitable treatment... and shall in no case accord treatment less favourable than that required by international law.”¹⁵² This type sets the minimum standard as the floor. The FET standard cannot be interpreted as being lower than the protection required by the minimum standard.¹⁵³ The third type is adopted by the NAFTA and US model treaty of 2004. NAFTA Article 1105 (Minimum Standard of Treatment) states that “(e)ach Party shall accord to investments of investors of another Party treatment in accordance with international law, including fair and equitable treatment...” The US 2004 model

¹⁴⁸ *ibid*

¹⁴⁹ M Sornarajah, *The International Law on Foreign Investment* (2nd ed, CUP 2004) 339

¹⁵⁰ German Model BIT 2005, Article 2(2); UK Model BIT 2005 also adopts same approach: “Investments of nationals or companies of each Contracting Party shall at all times be accorded fair and equitable treatment...” Article 2(2).

¹⁵¹ Dolzer and Stevens, *supra* note 99 60

¹⁵² US Model BIT 1994, Article 2(3)a

¹⁵³ T J Westcott, “Recent Practice on Fair and Equitable Treatment” (2007) 7 JWIT 409, 427

treaty adopts an identical approach in its Article 5, paragraph 1. Moreover, it sets out in paragraph 2 that the FET standard “...does not require treatment in addition to or beyond that which is required by that (customary international law minimum standard) and does not create additional substantive rights.”¹⁵⁴ It is clear that the NAFTA and US model treaty of 2004 sets the customary international law minimum standard as the ceiling.

The authority of the NAFTA and the following of US and Canada BIT practice are of limited relevance for the interpretation of other treaties. NAFTA clause is titled as “minimum standard of treatment” and is worded as the FET that is included in international law. Moreover, there is the binding interpretation of the Commission.

The tribunals applying treaties that do not align the FET to customary international law interpreted the FET autonomously on the basis of the respective wording of the treaties.¹⁵⁵ However, theoretical discussions in scholarly writings about the FET standard seem more apparent than real. The tribunals interpreting the FET standard have tackled with this debate either by adopting the view that the FET standard is set out in approximately all investment treaties, therefore, become part of customary international law or that customary international law is an evolutionary concept and has developed to include the FET standard. This interpretation of the tribunals has equated the FET standard and the minimum standard.¹⁵⁶

¹⁵⁴ US Model BIT 2004, Article 5(1-2)

¹⁵⁵ Dolzer and Schreuer, *supra* note 95 126 and footnote 36

¹⁵⁶ See Pope & Talbot, UNCITRAL, Award in Respect of Damages of May 31, 2002, par. 58 et seq.; *Mondev International Ltd. v. The United States of America*, ICSID Case No. ARB(AF)/99/2, Award of Oct. 11, 2002, par. 125; *ADF Group Inc. v. United States*, ICSID Case No. ARB(AF)/00/1, Final Award of

3.5.2.2 The Content of the FET Standard in the Light of Arbitral Jurisprudence and Doctrine

Instead of giving a specific definition to the FET standard, arbitral tribunals have adopted a plain-meaning approach. They determined some sub-principles and applied them to the facts on a case-by-case basis.¹⁵⁷ The Tecmed v. Mexico tribunal defined the scope of the FET in detail through indicating the underlying principles of the standard. The tribunal stated that

“(t)he Arbitral Tribunal considers that this provision of the Agreement, in light of the good faith principle established by international law, requires the Contracting Parties to provide to international investments treatment that does not affect the basic expectations that were taken into account by the foreign investor to make the investment. The foreign investor expects the host State to act in a consistent manner, free from ambiguity and totally transparently in its relations with the foreign investor, so that it may know beforehand any and all rules and regulations that will govern its investments, as well as the goals of the relevant policies and administrative practices or directives, to be able to plan its investment and comply with such regulations. Any and all State actions conforming to such criteria should relate not only to the guidelines, directives or requirements issued, or the resolutions approved there under, but also to the goals underlying such regulations. The foreign investor also expects the host state to act consistently, i.e. without arbitrarily revoking any preexisting decisions or permits issued by the State that were relied upon by the investor to assume its commitments as well as to plan and launch its commercial and business activities...”¹⁵⁸

The tribunal in the Saluka v. Czech Republic case held a relatively narrow interpretation and adopted a balanced approach between the right of the state to regulate in the public interest and the principles underlying the FET standard. Although the tribunal stated that the legitimate expectations principle is the dominant principle in the FET standard, it

Jan. 9, 2003, par. 179; Occidental v Ecuador, par 189-190; CMS v Argentina 282-284), quoted in Schill supra note 123 3

¹⁵⁷ S L Escarsena, “The Elements of Fair and Equitable Treatment in International Investment Law” Leuven Center of Global Governance Studies Policy Brief No 14 (2010) 4

¹⁵⁸ Tecnicas Medioambientales Tecmed S. A. v. The United Mexican States, Award, 29 May 2003, 43 ILM, 2004 133 et seq para 154

required a manifest violation for breach of the FET standard and set the threshold high¹⁵⁹.

The tribunal stated that

“(t)he Czech Republic, without undermining its legitimate right to take measures for the protection of the public interest, has therefore assumed an obligation to treat a foreign investor’s investment in a way that does not frustrate the investor’s underlying legitimate and reasonable expectations. A foreign investor whose interests are protected under the Treaty is entitled to expect that the Czech Republic will not act in a way that is manifestly inconsistent, non-transparent, unreasonable (i.e. unrelated to some rational policy), or discriminatory (i.e. based on unjustifiable distinctions). In applying this standard, the Tribunal will have due regard to all relevant circumstances.”¹⁶⁰

It can be observed from the arbitral awards that the underlying principles to meet the legitimate expectations of the investor are: to act in a transparent and consistent manner, to provide a stable and predictable business environment, not to act in an arbitrary or discriminatory manner, to provide procedural and judicial propriety (due process, due diligence and not to deny justice) and to act in a reasonable and proportional manner.

Schill argued that to clarify the content of the standard, it should be understood as embodiment of the rule of law. The sub-principles underlying the FET standard are functional equals of the principles underlying the rule of law concept under domestic legal systems.¹⁶¹ A methodical approach of comparative analysis of main liberal domestic systems’ rule of law understanding and comparative analysis of rule of law understanding of international courts, such as European Court of Human Rights and the World Trade Organization Appellate Body, of investment tribunals would provide the definition of the FET standard. The FET standard as an embodiment of the rule of law

¹⁵⁹ Saluka Investments BV v Czech Republic, Partial Award, 17 March 2006, para 302 et seq <http://www.pca-cpa.org/upload/files/SAL-CZ%20Partial%20Award%20170306.pdf> last accessed 6 September 2012

¹⁶⁰ *ibid*, para 309

¹⁶¹ Schill, *supra* note 141 36-37

can be set out objectively and the purpose of the treaties and the standard can have a clear normative content.¹⁶²

Legitimate expectations are based on the legal framework of the investment. This legal framework consists of any undertaking given explicitly or implicitly by the host state that is contained in legislation, decrees and contracts.¹⁶³ While assessing whether or not the legitimate expectations of the investor have been breached, it is necessary to make a distinction between the situation where the state has encouraged particular investor confidence in the stability of certain regulations and where the investor has relied on the general legal framework. In the first case, the breach of the FET standard can be genuinely invoked and applied. It was argued that

“(n)ot only are expectations in this context directly attributable to a host state, but moreover did the host state know about the specific weight the foreign investor placed on the regulatory infrastructure in making its investment decision. Yet, absent specific contractual commitments for instance, legitimate expectations will not operate so as to absolutely deny any changes in the regulatory framework. Based on the principle of proportionality, in particular emergency situations may justify even severe interferences.”¹⁶⁴

On the other hand, in the second case, legitimate expectations can barely be applied. It can be applied where legislation is enacted with retroactive effect. Apart from this situation, it is hard to imagine that the legislation violates the FET standard unless it constitutes an indirect expropriation.¹⁶⁵ The legitimate expectations principle does not freeze the legal framework of the host state in favour of the investor. A reasonable and

¹⁶² *ibid* 31-32

¹⁶³ Dolzer and Schreuer, *supra* note 95 134

¹⁶⁴ Schill, *supra* note 141 28

¹⁶⁵ *ibid*

proportional change in the legal framework should be part of the investor's expectation.¹⁶⁶

3.5.2.3 Observance of Contractual Obligations under the FET Standard and Implications of the ECT FET Standard for Transit Pipeline Agreements

To what extent and under what circumstances the failure of the host state to observe contractual obligation can constitute a breach of the FET standard under an investment treaty has been subject to decisions of arbitral tribunals. The tribunal in the *Mondev v. US* case, although not directly dealing with the issue in its decision, stated that “(i)ndeed a governmental prerogative to violate investment contracts would appear to be inconsistent with the principles embodied in Article 1105 and with contemporary standards of national and international law concerning governmental liability for contractual performance.”¹⁶⁷

The tribunal in the *SGS v. Philippines* case, in its decision on jurisdiction, expressed the view that

“...an unjustified refusal to pay sums admittedly payable under an award or a contract at least raises arguable issues under Article IV (FET)... In the circumstances the Tribunal reaches the same conclusion on Article IV as it does on Article X(2) (umbrella clause)... there being an unresolved dispute as to the amount payable, for the Tribunal to decide on the claim in isolation from a decision by the chosen forum under the CISS Agreement is inappropriate and premature.”¹⁶⁸

¹⁶⁶ Escarsena, supra note 157 7

¹⁶⁷ *Mondev International Ltd v USA*, Award, 11 October 2002, 42 ILM 2003 85 et seq para 134

¹⁶⁸ *SGS v Philippines*, supra note 107 para 162

On the other hand, the tribunal in the Waste Management v. Mexico case held the restrictive view. It did not find that the partial non-payment of a concession contract amounts to a breach of the FET standard. The tribunal stated that

“(i)n the Tribunal’s view the evidence before it does not support the conclusion that the City acted in a wholly arbitrary way or in a way that was grossly unfair. It performed part of its contractual obligations, but it was in a situation of genuine difficulty, for the reasons explained above. It sought alternative solutions to the problems both parties faced, without finding them. The most important default was its failure to pay... even the persistent non-payment of debts by a municipality is not to be equated with a violation of Article 1105, provided that it does not amount to an outright and unjustified repudiation of the transaction and provided that some remedy is open to the creditor to address the problem.¹⁶⁹”

The tribunal set the threshold high, through requiring that the act of non-payment under contract should be grossly unfair and wholly arbitrary in order to breach the FET standard. However, this was a NAFTA tribunal and protection provided under the FET standard of NAFTA is limited to the minimum standard of customary international law.

The tribunal in the Impreglio v. Pakistan case, in its decision on jurisdiction, concluded that the threshold for a breach of the contract in order to constitute a breach of treaty is a high one: such an activity would have to be one that was beyond of an ordinary contracting party (*puissance publique*).¹⁷⁰ The tribunal in the RFCC v. Morocco case held a similar view. The tribunal asserted that only measures taken by the state that were taken in its sovereign capacity could breach the FET standard. A breach of contractual

¹⁶⁹ Waste Management Inc v United Mexican States, Final Award, 30 April 2004, 43 ILM 2004 967 et seq para 115

¹⁷⁰ Impreglio S.p.A v Islamic Republic of Pakistan, Decision on Jurisdiction, 22 April 2005, 12 ICSID Reports 245 et seq para 266-267

undertaking that could also be committed by an ordinary contract partner could not be a breach of the FET standard.¹⁷¹

The tribunal in the *Petrobart v. Kyrgyzstan* case interpreted the FET standard of the ECT. A claim to the performance of rights under a gas sale contract between the investor company and the state-owned company was accepted as an investment by the tribunal. The tribunal held the view that the acts taken by the state during the restructuring of the state company and the non-payment of the debts by the state company was a breach of the FET standard. The tribunal asserted that

“(t)he Arbitral Tribunal does not doubt that there may have been good reasons for restructuring the system for supply of oil and gas in the Kyrgyz Republic. The Arbitral Tribunal considers, however, that as a Contracting Party to the Treaty the Republic was under an obligation to carry out this reorganization in a way which showed due respect for investors such as Petrobart. A central element in the restructuring was that assets were transferred from KGM to Kyrgyzgaz. Other assets were leased to Munai, and although this was not a transfer of ownership, the leased assets apparently became unavailable to KGM’s creditors. Moreover, although Kyrgyzgaz and Munai benefited from the assets, they did not take over those of KGM’s debts, which had originated prior to 1 October 1998. Consequently, while KGM lost its assets, it remained responsible for its debts. The transfer of assets, but not of debts, from KGM to other companies must be assumed to have been disadvantageous to KGM’s creditors, including Petrobart.”¹⁷²

The intervention by the vice-president of the Kyrgyz government in the judicial proceedings, through asking the chairman of the court that had already granted a judgment to Petrobart requiring payment of debts by the state owned company, KGM, for a deferral of the enforcement, was regarded as contrary to the standard. The tribunal stated that “... such Government intervention in judicial proceedings is not in conformity

¹⁷¹ Consortium RFCC v Kingdom of Morocco, Award, 22 December 2003, 20 ICSID Review-FILJ 2005 391 para 33-34, quoted in Dolzer and Schreuer, *supra* note 93 141

¹⁷² *Petrobart Limited v. Krygyz Republic*, Arbitral Award rendered on 29 March 2005, Arbitration Institute of Stockholm Chamber of Commerce
http://www.encharter.org/fileadmin/user_upload/document/Petrobart.pdf last accessed 6 September 2012

with the rule of law in a democratic society and that it shows a lack of respect for Petrobart's rights as an investor having an investment under the Treaty."¹⁷³ The tribunal concluded that Article 10(1) of the Treaty in its entirety intended to ensure fair and equitable treatment. The Kyrgyz Republic breached the FET standard of the ECT by transferring assets of the KGM to Kryrgyzgas and Munai without transferring the debts of the company, by the non-payment of the debts under the gas sale contract and by the governmental intervention in the judicial proceedings.¹⁷⁴

The rights of investors arising from licences come under the protection of the ECT FET standard. The rights under licences constitute investment under the ECT. In the *CME v. Czech Republic* case, the Czech Media Council changed its previous position on the legal situation of the licence holder. The local partner of the investor terminated the contract on which the investment depended. The tribunal decided "...the Media Council breached its obligation of fair and equitable treatment by evisceration of the arrangements in reliance upon which the foreign investor was induced to invest."¹⁷⁵ The tribunal decided that the Media Council intentionally undermined CME's investments because it had both the power and obligation under Czech law to remedy the partner's unlawful actions in severing the investment agreement with CME.¹⁷⁶ In the *Tecmed v. Mexico* case, the government replaced an unlimited licence with a licence of limited duration for the operation of a landfill. The tribunal decided that "the foreign investor also expect the host state to act consistently, i.e. without arbitrarily revoking any preexisting decisions or

¹⁷³ *ibid*, 75

¹⁷⁴ *ibid*, 76

¹⁷⁵ *CME Czech Republic B.V. v. The Czech Republic (Partial Award)*, 13 September 2001 para 611 <http://italaw.com/documents/CME-2001PartialAward.pdf> last accessed 6 September 2012

¹⁷⁶ *ibid*.

permits issued by the State that were relied upon by the investor to assume its commitments as well as to plan and launch its commercial and business activities.”¹⁷⁷ The tribunal further asserted that Mexico’s act frustrated the investor’s legitimate expectations that the investor depended on when it made the investment.¹⁷⁸

The breach of a contract or a licence can only constitute a breach of the FET standard if it is breached by a governmental act of the state. The state entity or government is the party to a transit contract. Moreover, the participation and the intervention of high-level governmental officials and politicians in the preparation, performance and the dynamics of the transit contract can create an environment under which the breaches of these contracts can be qualified as governmental acts and can constitute the breach of a treaty standard -that of the FET standard- similar to the situation regarding the umbrella clause analyzed above. Therefore, the breach of transit terms agreed under pipeline investment agreements or licences that entitle the investor to operate a pipeline would constitute a breach of the FET standard of the ECT if the act of a state were governmental in nature.

3.6 Conclusion

In conclusion, although the ECT transit provisions set out in Article 7 established the fundamental rules for the general international legal framework relating to energy transit, they do not provide an efficient enforcement mechanism for the obligations of the parties under Article 7 and the transit contracts. Therefore, well-drafted transit and/or

¹⁷⁷ Tecmed v United Mexican States, *supra* note 158 para 154

¹⁷⁸ *ibid*, para 172

transportation contracts are essential either in the form of an IGA, HGA or inter-company agreement.

The Protocol includes innovative provisions on imposition methods for tariffs, negotiated third-party access and compliance with transit and swap agreements. However, it only provides inter-state arbitration under Article 27 of the ECT for the enforcement of the obligations set out in it. Therefore, under ECT Article 7 and the Protocol the investor could not arbitrate disputes arising out of transit contracts between a contracting state and an entity of another contracting state.

Nevertheless, it is submitted that the interpretation of the umbrella clause of the ECT, together with the definition of investment under the Treaty, enables the parties to arbitrate disputes arising out of transit terms set out under recent pipeline investment agreements under Article 26, the investor-state arbitration mechanism. Moreover, the FET standard of the ECT can be invoked for the enforcement of contractual claims arising out of transit agreements that are in the form of investment agreements, provided that the breach is governmental in nature.

CHAPTER 4. STABILIZATION CLAUSES: FROM TRADITIONAL FREEZING CLAUSES TO MODERN ECONOMIC EQUILIBRIUM CLAUSES

4.1 Introduction

Cameron argued that disputes between host states and foreign investors are usually settled through renegotiations that are conducted in the shadow of the terms of the investment contract. Although investors do file cases at arbitration institutions, an arbitrated outcome is an exception rather than the norm. Parties to investment contracts use the rules of international investment law and the contractual clauses, in particular the stabilization clause, as leverage in order to improve their bargaining position during renegotiations.¹

The role of law, in particular contract clauses, in the negotiation context was analysed in Chapter II of the thesis, which constitutes the analytical framework of the thesis. The international treaty framework of transit pipelines and the stability provided by treaty to contracts in the context of the ECT is the subject of Chapter III of the thesis.

Renegotiations take place in the shadow of the law and the terms of the contract. However, in order to assess to what extent these clauses affect the bargaining power of the parties and the bargaining outcome, the content and the legal effect of these clauses should be known beforehand. This chapter analyses the legal effect of stabilization clauses, both the traditional freezing clauses and the modern economic equilibrium clauses, in order to assess their legal value at the negotiation table.

¹ P Cameron, *International Energy Investment Law: The Pursuit of Stability* (OUP 2010) 423-425

4.2 Theoretical Context

4.2.1 Sanctity of Contract Principle

A stabilization clause finds its theoretical roots in the contract law principle of sanctity of contract. There have been two approaches with regard to this principle. The classical nineteenth century post-industrialization contract theory proposes a discrete understanding of the sanctity of contract principle. The parties as equal, free and rational actors create the contract based on their free will. The parties should foresee all future risks when they sign the contract, even in cases where the contract term reaches 40-60 years. The parties should determine the *lex contractus* with all its features when they sign the contract, without it being subject to any change in the future. Contract interpretation is isolated from prior negotiations and later developments in the contractual context. The contract should be interpreted within its own limits.²

This discrete understanding of the sanctity of contract principle considers the contract as an expression of the parties' free will in the context of party autonomy. The courts should respect and not interfere with the contract, which is an exercise of the parties' freedom and autonomy. Their duty is just to uphold the contract that is agreed upon by the parties. The individual is regarded as the best judge of his interests. Therefore, he should blame himself for a bad deal. The contract should be implemented no matter how onerous or burdensome it is to one of the parties.³

² N Nassar, *Sanctity of Contracts Revisited: A Study in the Theory and Practice of Long-term International Commercial Transactions* (M. Nijhoff 1995) 12 et seq

³ A Kolo and T Walde, "Renegotiation and Contract Adaptation in International Investment Projects: Applicable Legal Principles and Industry Practices" (2000) 1 JWIT 5, 7-8

The sanctity of contract principle was at its strongest and understood in an absolute manner in the nineteenth century. Sir George Jessel M. R. asserted in 1875 that “...if there is one thing more than another which public policy requires, it is that men of full age and competent understanding shall have the utmost liberty in contracting, and that their contracts, when entered into freely and voluntarily, shall be held sacred and shall be enforced by Courts of Justice.”⁴ The only exceptions to this absolute sanctity of contract interpretation are cases of fraud, misrepresentation and mistake, which aim to assure moral standards required by fair dealing. Change of circumstances only plays a role if it frustrates the contract.⁵

In contrast, the modern approach to the sanctity of contract principle interprets the contract in the context of an ongoing relationship. The contractual context evolves during the contractual relationship. The contract should be interpreted through taking into consideration the prior negotiations and the conduct of the parties during the term of the contract. According to the modern theory, all of the terms of the contract may not have been determined when concluding the contract in a discrete manner due to the contingencies caused by the long-term nature of the contract. There should, therefore, be mechanisms to provide flexibility, through accommodating the future contingencies that are caused by changes in the contractual environment. The modern theory best accommodates the needs of long-term contracts through providing flexibility mechanisms instead of absolute sanctity in order to maintain the contractual equilibrium.⁶

⁴ *Printing & Numerical Registering Co. v. Sampson* (1875) L.R. 19 Eq. 462, at p. 465, quoted in J. Beatson, *Anson's Contract Law* (28th ed, OUP 2002) 17

⁵ *ibid* 7-8

⁶ Nassar, *supra* note 2 35 et seq

On the matter of contract change in investment contracts, Delaume argued that

“(e)xtreme views, based on the principle *pacta sunt servanda* would uphold in all circumstances the sanctity of contract, or at the other end of the spectrum, the unfettered right of a sovereign state to interfere with contracts involving foreign partners. Neither view corresponds to the realities of this world. Dogmatic assertion of unrestrained sovereign prerogatives would appear not only unrealistic, but might have counter-productive effects. It might simply but effectively deter foreign investors from making an investment or it might prompt investors to inflate the cost of the investment by making it self-liquidating in a very short period of time. Similarly, investors cannot reasonably expect that, in a world in rapid evolution, there may not be circumstances which might justify a reasonable adjustment of a long-term relationship.”⁷

4.2.2 Stabilization Clause as a Tool for Political Risk Management

In addition to the commercial risks that are naturally assumed by the investors, the long-term nature of the foreign investment contracts, particularly in the natural resources industry, makes them prone to political risks. These may occur in the form of the unilateral intervention of the host state through its legislative, administrative or judicial powers. The political risk is addressed during the initial negotiations between the investor and the host state. The tools that aim to manage this risk are found in the investment contract, which creates a project-specific legal regime for the investment.⁸ A change in the fiscal regime of the agreed-upon contract or restrictions on repatriation of foreign exchange earnings by regulatory change that might adversely affect the remuneration received are types of political risks encountered by investors.⁹ The unilateral change of the *lex contractus* and the contractual content without the consent of the investor might even constitute abuse of the state authority. Therefore, investors should be protected

⁷ G. Delaume, *Law and Practice of Transnational Contracts* (Oceana 1988) 44-45

⁸ R Dolzer and C Schreuer, *Principles of International Investment Law* (OUP 2008) 3-4; Nassar, *supra* note 2 122

⁹ T Walde and G Ndi, “Stabilizing International Investment Commitments: International Law Versus Contract Interpretation” (1996) 31 *Texas International Law Journal* 215, 232-234

against the arbitrary exercise of state authority when it is used without the existence of valid policy reason.¹⁰

A stabilization clause finds its basis on the concerns of investors that the host state can change its law against the interests of an investor with the effect of changing original economic balance of the investment that was agreed upon. The content of the governing law may change to an extent that disrupts the economics of the contractual relationship significantly. Therefore, the law should be stabilized.¹¹ Even in cases where the applicable law of the contract is strict on contract change, it was argued that, "...in the absence of an appropriate device in the contract "stabilizing" its economy in point of time, a stipulation of applicable law can never be a perfect technique of conflict avoidance..."¹²

A stabilization clause is an attempt to redress the imbalance between the contracting parties, which is caused by the ability of the state to unilaterally change the contract through its sovereign powers.¹³ It provides a legal guarantee against the change in state policy. It guarantees the persistence of political and economic security conditions.¹⁴

A stabilization clause is one of the contractual risk management tools that are adopted by the investors. Other contractual risk management tools are the choice of law clauses and

¹⁰ Nassar, *supra* note 2 118

¹¹ Delaume, *supra* note 7 43-44

¹² *ibid*, 32

¹³ *ibid*, 134

¹⁴ T Hansen, "The Legal Effect Given Stabilization Clauses in Economic Development Agreements" (1988) 28 *Virginia Journal of International Law* 1015

arbitration clauses. In the context of contractual risk management, a choice of law clause intends to remove the contract from the sphere of the municipal law of the host state, while a choice of forum clause subjects a possible dispute to an objective forum.¹⁵ There are other methods of political risk management, which include spreading the risk through creating joint-ventures, sharing the risk with other corporations, investment insurance at national or multilateral level (e.g. MIGA) and defence against risk through economic, financial and political persuasion.¹⁶

4.3 Traditional Stabilization –Freezing- Clauses

4.3.1 Concept, Scope and Types

A stabilization clause is a special variant of the choice of law clause, which is designed to deal with the risks of the time element.¹⁷ Under a stabilization clause, a state party undertakes not to change the terms of the agreement, or to terminate it through legislative or administrative measures, without the consent of the investor.¹⁸

Although the language of the clause changes from contract to contract, traditional stabilization clauses can be classified under two main categories. The first stabilization technique freezes the law of the host state at a certain time. That is, the time when the contract is signed. It incorporates the law at a certain time into the contract through a regulatory chill. This technique is called “stabilization clause *stricto sensu*”. Another variant of this technique, which is not as strong as the first one, excludes only the changes

¹⁵ Walde and Ndi, *supra* note 9 236-237

¹⁶ *ibid*, 233

¹⁷ Dolzer and Schreuer, *supra* note 8 75

¹⁸ N Blackaby and C Partasides, *Redfern and Hunter on International Arbitration* (5th edn, OUP 2009) 202; I Brownlie, *Principles of Public International Law* (7th edn, OUP 2008) 550

in law that modify the contractual rights of the parties and which are inconsistent or contrary to the contract terms.¹⁹ The second technique requires that any modification of the contract should not be made without the consent of the other party. This technique is called the “intangibility clause”. This type of clause freezes the contract rather than the law. Most of the time, these two types are combined together in an investment contract.²⁰

An example of the freezing type of stabilization clause is found in clause 16 of the oil concession between Texaco and Libya in the following terms: “(t)he concession shall throughout the period of its validity be construed in accordance with the Petroleum Law and Regulations in force on the date of execution of this agreement.”²¹ The same clause includes an intangibility clause in the following terms: “(t)he contractual rights expressly created by this concession shall not be altered except by mutual consent of the parties.”²² The difference between the first and second category of stabilization clauses is that the former protects the investor against legislative risks, including modification or termination of the agreement by legislative act. In contrast, the latter aims to protect the investor against the exercise of public authority through administrative acts of the state that aim to amend the contract.²³

Stabilization of the contractual content with regard to its scope can be partial and aimed only at fiscal stabilization, which includes tax incentives, export-import duties and an

¹⁹ E Paasivirta, “Internationalization and Stabilization of Contracts Versus State Sovereignty” (1989) 60 BYIL 315, 323

²⁰ Nassar, *supra* note 2 126-127; Delaume, *supra* note 7 45

²¹ *Texaco Overseas Petroleum Company v. The Government of the Libyan Arab Republic*, 17 ILM 1978 4

²² *ibid*

²³ A Faruque, “Validity and Efficacy of Stabilization Clauses” (2006) 23 JIA 317, 319-320; AFM Maniruzzaman, “Some Reflections on Stabilization Techniques in International Petroleum, Gas and Mineral Agreements” (2005) 4 IELTR 96, 97

exchange regime that is closely linked to capital and profit remuneration. The second method is isolating all parts of the contract from any future changes.²⁴

Another stabilization technique is enactment of the contract as law through parliamentary approval. Maniruzzaman argued that this gives supremacy to the contract over current or subsequent legislation as *lex specialis*. It will then be difficult to interfere with the contract, since this would require various formalities.²⁵ This act elevates the contract to a higher level in the national legal system, since it can only be changed by legislation. Therefore, change of the contract requires a higher level of authority than ordinary executive authority.²⁶ Although parliamentary approval grants investment contracts superiority over current and subsequent legislation as *lex specialis*, a parliament can abolish a law that it has enacted. However, parliamentary approval provides a further guarantee to the investor, since it increases the legitimate expectations of the investor.²⁷

4.3.2 Arbitral Jurisprudence

In the post-colonial period of the 1970s, the petroleum industry experienced nationalizations of investments by host countries in the context of the doctrine of permanent sovereignty over natural resources. The legal effect of stabilization clauses in the event of nationalization was one of the main issues that were discussed in the arbitration awards that dealt with these nationalizations. The last decade has witnessed

²⁴ P Cameron, "Stabilization in Investment Contracts and Changes of Rules in Host Countries: Tools for Oil & Gas Investors" (2006) AIPN Report 28

²⁵ AFM Maniruzzaman, "The Pursuit of Stability in International Energy Investment Contracts: A Critical Appraisal of the Emerging Trends" (2008) 1 JWELB 121, 122-123

²⁶ A Faruque, "The Rationale and Instrumentalities for Stability in Long-term State Contracts: The Context for Petroleum Contracts" (2006) 7 JWIT 85, 107

²⁷ Cameron, *supra* note 1 63

the re-emergence of arbitral jurisprudence on stabilization clauses. However, these recent awards (e.g. *Duke v. Peru*) deal with the effect of stabilization clause on regulatory change. The next section analyses the interpretation of stabilization clauses by arbitral tribunals in both early and recent cases.

4.3.2.1 Texaco v. Libya Award

Libya nationalized its oil industry in the 1970s, based on political judgments against policies of Western powers, after a revolution that had occurred in the country. Three of the oil concessions that were granted to the oil companies, BP, Texaco and Liamco, were the subject of arbitration cases.²⁸ These concessions included stabilization clauses. Out of these three arbitration cases, the sole arbitrator in the BP award did not directly discuss the effect of the stabilization clause. However, in Texaco and Liamco awards the effect of stabilization clauses were discussed widely.

The concession between Texaco and Libya contained a stabilization clause in its Article 16.²⁹ The sole arbitrator regarded the inclusion of the stabilization clause in the concession to be one of the pillars of the internationalization of the contract. The arbitrator stated “(h)ence, the insertion, as in the present case, of so-called stabilization

²⁸ R B Mehren and P N Kourides, “International Arbitrations between States and Foreign Private Parties: The Libyan Nationalization Cases” (1981) 75 *American Journal of International Law* 476, 483 et seq

²⁹ Article 16 states that “The government of Libya will take all steps necessary to ensure that the company enjoys all the rights conferred by this concession. The contractual rights expressly created by this concession shall not be altered except by mutual consent of the parties.” In 1961 by a Royal Decree another paragraph was added to this clause: “This concession shall throughout the period of its validity be construed in accordance with the Petroleum Law and the Regulations in force on the date of execution of the agreement of amendment by which this paragraph (2) was incorporated into the concession agreement. Any amendment to or repeal of such Regulations shall not affect the contractual rights of the Company without its consent.” *Texaco v. Libya*, supra note 21 4

clauses: these clauses tend to remove all or part of the agreement from the internal law and to provide for its correlative submission to sui generis rules as stated in the Aramco award, or to a system which is properly an international law system.”³⁰ The arbitrator asserted that the internationalization of the contract, through the inclusion of the stabilization clause and an applicable law clause that subjects the contract to the international law or general principles of law, puts the concessions in the scope of the international legal order, similar to treaties.³¹

According to the arbitrator, a stabilization clause is not a tool that impairs the sovereignty of the state. It is a manifestation of that same sovereignty. The arbitrator asked the following: “...does the act of sovereignty which constitutes the nationalization authorize a State to disregard its international commitments assumed by it within the framework of its sovereignty?”³² The arbitrator held the following views on the lawfulness of the nationalization: “...it is clear from an international point of view that it is not possible to criticize a nationalization measure, ... or any measure affecting aliens in respect of whom the State concerned has made no particular commitment to guarantee and maintain their position.”³³ However, the situation was regarded as being completely different when the concession was internationalized either through stabilizing the law at a given date or subjecting the contract to international law in order to guarantee a certain legal and economic status.³⁴

³⁰ *ibid*, 17

³¹ *ibid*, 23

³² *ibid*, 22

³³ *ibid*

³⁴ *ibid*

The arbitrator interpreted the effect of the stabilization clause on the nationalization measure in the following terms.

“The Deeds of Concession entered into by the parties do not include any provision by which the Libyan Government limited its recourse to nationalization. However, Clause 16 of the Deeds of Concession contains a stabilization clause with respect to the rights of the concession holder. As consideration for the economic risks to which the foreign contracting parties were subjected, the Libyan State granted them a concession of a minimum duration of 50 years and, more specifically, containing a non-aggravation clause.”³⁵

The arbitrator argued that the host state could exercise its sovereignty and nationalize the assets of the investors if it had not given special commitments. However, the stabilization clause in the contract made “...such acts invalid as far as contracting parties are concerned... Any changes, which may result from the adoption of new laws and regulations, must to affect the contracting parties, be agreed to by them.”³⁶ The arbitrator concluded that, considering the existence of the stabilization clause and the internationalized nature of the contract, the nationalization of Texaco’s assets was unlawful. The restitution of the legal status is the normal remedy for non-performance of contractual obligations.³⁷

4.3.2.2 Liamco v. Libya Award

The interpretation of the stabilization clause in the Liamco v. Libya award is not in line with the interpretation of it in the Texaco award, even though they include the same stabilization clause. Although the arbitrator gave effect to the stabilization clause, he did

³⁵ *ibid*, 24

³⁶ *ibid*

³⁷ *ibid*, 36

not regard the inclusion of the clause in the concession to be a factor that made the nationalization unlawful. The arbitrator argued that

“(t)he above clause comes under what has been termed ‘stabilization’ and ‘intangibility’ clauses, which have been considered as legally binding under international law...However, clause 16 is not only justified by the said Libyan Petroleum legislation, but also by the general principle of sanctity of contracts recognized also in municipal and international law... It is likewise consistent with the principle of non-retroactivity of laws, which denies retrospective effect to a new legislation and asserts the respect of vested rights (droits acquis) acquired under a previous legislation.”³⁸

The arbitrator regarded the stabilization clause as binding under both the national law and the principles of international law. However, he did not regard it as making nationalization unlawful. The arbitrator, through making reference to the valid grounds for termination that were to be found in the agreement, argued that

“... Liamco’s concession agreements are binding, and cannot validly be terminated except on the following grounds: ... (b)- mutual consent of the contracting parties, in compliance with the said principle of sanctity of contracts and particularly with the explicit term of clause 16 of the agreements; ... (d)-non-discriminatory nationalization coupled with the required compensation.”³⁹

The arbitrator regarded a lawful nationalization of the contractual rights that had been agreed upon by the parties in the contract as a valid termination ground. Moreover, he did not interpret the scope of the stabilization clause broadly and did not regard that it prohibited the nationalization.

The arbitrator decided, regarding the compensation of the nationalized assets of Liamco, that “...there is no doubt that Liamco is entitled to *damnum emergens*, which represent the value of the nationalized physical plant and equipment that Liamco owns and has the right to recover at the termination of the concession under clause 26 of the concession

³⁸ Libyan American Oil Company (Liamco) v. The Government of the Libyan Arab Republic, 20 ILM 1981 31

³⁹ *ibid*, 62

agreements.”⁴⁰ The compensation decided by the arbitrator did not include the lost profits. The arbitrator asserted that to determine the amount of compensation

“...recourse should be made to general principles of law as may have been applied by international tribunals, and in particular the principle of equity. Whereas taking this principle into consideration, the arbitral tribunal has reached the conclusion that it is just and reasonable to adopt the formula of ‘equitable compensation’ as a measure for the assessment of damages in the present dispute, with the classical formula of ‘prior, adequate and effective compensation’ remaining as a maximum and a practical guide for such assessment.”⁴¹

4.3.2.3 Agip v. Congo Award

Another important arbitration award on the effect of stabilization clauses in the event of nationalization is the Agip v. Congo award. The investment agreement between the parties included a stabilization clause in its Article 11.⁴² The arbitral tribunal asserted that the state exercises sovereign powers from the moment that consent is freely given in concluding an international agreement with a private individual.⁴³

The tribunal interpreted the effect of a stabilization clause on a nationalization decree in the following terms. “The unilaterally-decided dissolution which took place under Order no. 6/75 represented a repudiation of these stability clauses, whose applicability results not from the automatic play of the sovereignty of the contracting state but from the common will of the parties expressed at the level of the international juridical order.”⁴⁴

The tribunal argued that “(i)t is sufficient to focus the examination of the compatibility of

⁴⁰ *ibid*, 86

⁴¹ *ibid*

⁴² Agip S.p.A v. People’s Republic of Congo, 21 ILM 1982 727, Article 11 states that “adopt appropriate measures to prevent the application to the Company of future amendments to company law affecting the structure and composition of company bodies.” The government further agreed under Article 4 of the agreement that, the company should retain the status of a limited liability company under private law despite the government participation.

⁴³ *ibid*, 735

⁴⁴ *ibid*

the nationalization with international law to the stabilization clauses... The reference to international law is enough to demonstrate the irregular nature, under this law, of the act of nationalization which occurred in this case.”⁴⁵

The tribunal decided that the amount of loss suffered (*damnum emergens*) and the lost profits (*lucrum cessans*) should be paid to the investor as compensation. The tribunal argued that

“(t)he tribunal considers that the present case involves not just an act of nationalization but also a series of repudiations by the Government of its contractual undertakings, distinct from the nationalization and already referred to by the Tribunal. It therefore considers that AGIP is justified in its request for damages... As regards compensation for material losses, according to the basic rule of Article 1149 of the French Civil Code both the loss suffered (*damnum emergens*) and the loss of profits (*lucrum cessans*) must be taken into account.”⁴⁶

4.3.2.4 Kuwait v. Aminoil Award

The concession between the Aminoil and Kuwait included stabilization clauses in its Article 1 and in Article 17.⁴⁷ The tribunal argued that although a straightforward and direct reading of stabilization clauses can lead to the conclusion that they prohibit any nationalization, this was not the interpretation adopted by the tribunal, since the

⁴⁵ *ibid*, 736

⁴⁶ *ibid*, 737

⁴⁷ **The Government of the State of Kuwait v. The American Independent Oil Company (Aminoil)**, 21 ILM 1982 1028; According to Article 1, “The period of this Agreement shall be sixty (60) years from the date of signature.” Article 17 states that, “The Shaikh shall not by general or special legislation or by administrative measures or by any other act whatever annul this Agreement except as provided in Article 11. No alteration shall be made in the terms of this Agreement by either the Shaikh or the Company except in the event of the Shaikh and the Company jointly agreeing that it is desirable in the interest of both parties to make certain alterations, deletions or additions to this agreement.” Article 7(g) of the 1961 Supplemental Agreement substituted the Article 11 of the 1948 Concession. It included another stabilization clause that states, “(B) Save as aforesaid this Agreement shall not be terminated before the expiration of the period specified in Article 1 thereof except by surrender as provided in Article 12 or if the Company shall be in default under the arbitration provisions of Article 18.”

prohibition of the nationalization should be for a limited period and be expressly provided for, in the clause, by the parties.⁴⁸ The tribunal interpreted the legal effect of the stabilization clause as not prohibiting nationalization unless it included a confiscatory character. The tribunal stated that “...what the Parties had in mind in drafting the stabilization clauses in 1948 and 1961, was anything which, by reason of its confiscatory character, might cause serious financial prejudice to the interests of the Company.”⁴⁹

The Aminoil award is the first award that took into consideration the evolving nature of the contractual context during the term of the contract. The tribunal argued that

“...respect for the equilibrium of reciprocal undertakings is a fundamental principle of the law of contracts. But in the present case it has to be realized that the main difficulties that arise are not about respect for the financial equation that reflects the contractual equilibrium, but about the method of applying Article 9, -that is to say not over respect for the original equilibrium, but over the search for a new, equitable equilibrium.”⁵⁰

Although the tribunal gave full effect to the principle of *pacta sunt servanda*, it argued that the contract had undergone several changes during its term, including the changes with regard to levies paid to the government, the role of government in the ownership and management structure of the company. The evolutionary character of contract was partly caused by the existence of a renegotiation clause,⁵¹ in the form of most favoured nation

⁴⁸ *ibid*, 1020-1023

⁴⁹ *ibid*, 1022

⁵⁰ *ibid*

⁵¹ Article 9 of the 1961 Supplemental Agreement includes a renegotiation clause in the following words. “If, as a result of changes in the terms of concessions now in existence or as a result of the terms of concessions granted hereafter, 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, including the conditions in which operations are carried out, and taking into account all payments made, any alterations in the terms of the agreements between the Ruler and the Company would be equitable to the parties.”

clause, and tacit acceptances of the company.⁵² Therefore, the contract had changed its character. It had become one of the contracts under which the government enjoyed special advantages, even though it respected the contractual equilibrium.⁵³

The tribunal further argued that "...the stabilization clauses, as being no longer possessed of their former absolute character...the take-over of Aminoil's enterprise was not, in 1977, inconsistent with the contracts of concession, provided always that the nationalization did not possess any confiscatory character."⁵⁴ Therefore, the tribunal decided that the nationalization was lawful.⁵⁵ The tribunal determined the amount of compensation based on the "appropriate compensation" criterion. The compensation that should be paid to investor was "the reasonably appraised value of what constituted the object of the takeover."⁵⁶ The compensation further included some measure of lost profits based on the loss of legitimate expectations of the investor.⁵⁷

In his dissenting opinion, Sir Gerald Fitzmaurice disagreed with the tribunal on the interpretation of the stabilization clauses. The arbitrator argued that "...these clauses are not really concerned with confiscation at all, in the direct sense. What they are concerned with is any measure terminating the Concession before its time."⁵⁸ According to the arbitrator, nationalization was unlawful, since a stabilization clause existed in the contract. The arbitrator asserted that "...although the nationalization of Aminoil's

⁵² P Y Tschanz, "The Contributions of the Aminoil Award to Law of State Contracts" (1984) 18 *International Lawyer* 245, 277

⁵³ *Kuwait v. Aminoil*, 1023-1024

⁵⁴ *ibid*

⁵⁵ *ibid*

⁵⁶ *ibid*, 1042

⁵⁷ *ibid*, 1039

⁵⁸ *ibid*, 1051

undertaking may otherwise have been perfectly lawful, considered simply in its aspect of being an act of the state, it was nevertheless irreconcilable with the stabilization clauses of a Concession that was still in force at the moment of the take-over.”⁵⁹

4.3.2.5 Duke v. Peru Award

The Duke v. Peru Award was the first award that directly dealt with the legal effect of stabilization clauses following the awards in the nationalization cases. The subject matter of this award is not nationalization. It dealt with the effect of a stabilization clause on regulatory change -the change in the tax regime.

Duke Energy acquired DEI Egenor in 1999 through its subsidiaries. DEI Egenor was an electricity company that had been owned before the acquisition by Dominion Energy. It entered into a Legal Stabilization Agreement (LSA) with Peru for 10 years in 1996. It merged with another company, Power North, which had been owned by Dominion Energy as well, in order to increase book values to the level of market value without paying tax. The subsidiaries of Duke Energy, DEI Peru and DEI Bermuda, signed two new LSAs in 2001 with Peru. Peru’s tax authorities started a tax audit for DEI Egenor after a change in government in 2000. However, the tax authorities changed their attitude to the interpretation of Merger Revaluation Law, which had been formerly interpreted as providing tax benefits to the companies.⁶⁰

⁵⁹ *ibid*, 1053

⁶⁰ Duke Energy Peru Investments No 1 Limited v. Republic of Peru, ICSID Case No ARB/03/28, Award, 18 August 2008, para 14 et seq. http://italaw.com/documents/DukeEnergyPeruAward_000.pdf last accessed 6 September 2012

The stabilization guarantees were to be found in Clause 3 (freezing) and Clause 5 (intangibility) of the DEI Bermuda LSA. Moreover, stabilization guarantees were stipulated in Article 10 of the Foreign Investment Law and Article 23 (close to the balancing type) of the Investment Regulation.⁶¹ An LSA is a stability guarantee in a specific agreement dedicated to this aim that reinforces the rights and protections that are guaranteed under the country's general investment regime at the time the contract is signed.⁶²

The subject matter of the dispute was related to the scope and effect of the stabilization clause: that is, whether the stabilization clause prevents changes in the interpretation of the laws by the authorities in addition to changes in tax regulation. The change in interpretation related to the interpretation of the Merger Revaluation Law (MRL). It was

⁶¹ *ibid*, para 186-190 Clause 3 states that "...the state guarantees legal stability for Duke Energy International, according to the following terms: 1. Stability of the tax regime with respect to the Income Tax, as stipulated in subsection a of Article 10 of Legislative Decree No. 622, in effect at the time this Agreement was executed..."

Clause 5 further provides that "This Legal Stability Agreement shall have an effective term of ten (10) years as from the date of its execution. As a consequence, it may not be amended unilaterally by any of the parties during this period, even in the event that Peruvian law is amended, or if the amendments are more beneficial or detrimental to any of the parties than those set forth in this Agreement."

Article 10(a) of the Foreign Investment Law which stipulates the tax stabilization that is referred to in Clause 3 of the LSA provides that "By virtue of the guaranteed stability of the tax regime, the foreign investor shall not be subject to a rate higher than the one established in the appropriate agreement for the purposes of the income tax payable by the company receiving the investment, and the tax assessing the profits attributed thereto and/or the dividends distributed in favor thereof; therefore, if the income tax payable by the company is increased, the rate applied to the foreign investor shall be reduced by the required amount so that the company's profits freely available thereto are at least equal to the guaranteed profits."

Article 23 of the Investment Regulation further states regarding the tax stabilization guaranteed under the LSA that "The stability of the tax regime implies the following: a) For investors: It guaranties [*sic*] that while the stability agreement is in force, the income tax which results in a greater tax burden than the one effective as from the date of execution of the agreement will not be imposed on the amounts they are entitled to, in such a manner that they will be entitled to receive effectively such amounts in the same proportion for the following concepts: a.1. The dividends agreed upon in their favor; a.2. The profits they are entitled to; a.3. The profits available thereto; or a. 4. The remittance of sums pertaining thereto for any of the concepts regulated in the various items of this section."

⁶² Cameron, *supra* note 1 247

first interpreted as meaning that revaluation did not require tax increase. However, subsequently, in 2000 it was interpreted as meaning that revaluation did require a tax increase.⁶³

On the matter of whether the stabilization guarantees include the changes in the interpretation of the regulation, in addition to the changes in the regulation itself, the tribunal held the view that

“...if at the time when the guarantee was granted, the application of the existing rules resulted in a consistent interpretation, such interpretation must be deemed to be incorporated into the guaranteed stability. In a broad sense, stability is the standard by which the legal order prevailing on the date on which the guarantee is granted is perpetuated, including the consistent and stable interpretation in force at the time the LSA is concluded.”⁶⁴

The tribunal interpreted the scope of the stabilization guarantee in the following terms.

“...tax stabilization guarantees that: (a) laws or regulations that form part of the tax regime at the time the LSA is executed will not be amended or modified to the detriment of the investor, (b) a stable interpretation or application that is in place at the time the LSA is executed will not be changed to the detriment of the investor, and (c) even in the absence of (a) and (b), stabilized laws will not be interpreted or applied in a patently unreasonable or arbitrary manner.”⁶⁵

The tribunal held the view that not only the change in the regulation but also the change in the interpretation of the Merger Revaluation Law constituted a breach of tax stabilization guarantees.⁶⁶ The tribunal concluded that Duke Energy should be paid compensation in the amount of eighteen million dollars, which was equal to the loss suffered due to the change in interpretation.⁶⁷

⁶³ Duke v. Peru, supra note 60 para 196-200

⁶⁴ ibid, para 219

⁶⁵ ibid, para 227

⁶⁶ ibid, para 366

⁶⁷ ibid, para 488

4.3.2.6 Paushok v. Mongolia, Parkerings v. Lithuania and Methanex v. US Awards

The tribunal in the Paushok v. Mongolia case dealt with the effect of a tax stabilization clause on a change in tax regulation. Although there was no stabilization clause in the contract between the parties, the tribunal stated that

“...investors cannot legitimately expect that the taxation environment which they face at the time of their first investment will not be substantially altered with the passage of time and the evolution of events. The proper way for an investor to protect itself in such circumstances is to ensure that it will benefit from a stability agreement covering taxation and other matters; absent such an agreement, the investor will face the much more difficult task of demonstrating that a breach of particular provision of a BIT has occurred. This, Claimants have not succeeded in doing.”⁶⁸

The tribunal in the Parkerings v. Lithuania case dealt with the effect of a stabilization clause on legislative changes. The tribunal held the view that

“(i)t 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 stabilization clause or otherwise, there is nothing objectionable about the amendment brought to the regulatory framework existing at the time an investor made its investment. As a matter of fact, any businessman or investor knows that laws will evolve over time. What is prohibited however is for a State to act unfairly, unreasonably or inequitably in the exercise of its legislative power.”⁶⁹

The tribunal in the Methanex v. USA case implicitly indicated that regulation in the existence of a stabilization clause requires compensation. The tribunal stated that

“(a)s a matter of general international law, a non-discriminatory regulation for a public purpose, which is enacted in accordance with due process and, which affects, inter alios, a foreign investor or investment is not deemed expropriatory and compensable unless specific commitments had been given by the regulating government to the then putative

⁶⁸ Sergei Paushok et al v. The Government of Mongolia, Uncitral Award on Jurisdiction and Liability, 28 April 2011, para 370 <http://italaw.com/documents/PaushokAward.pdf> last accessed 6 September 2012

⁶⁹ Parkerings-Compagniet AS v. Republic of Lithuania, ICSID Case No ARB/05/8, Award, 11 September 2007, para 332 <http://italaw.com/documents/Pakerings.pdf> last accessed 6 September 2012

foreign investor contemplating investment that the government would refrain from such regulation.”⁷⁰

The decisions of the tribunals in these cases demonstrate that even the legitimate expectations principle of the FET standard does not guarantee full legal stability. Therefore, a foreign investor would gain significant benefit if the investment contract included a specific stabilization clause or the parties entered into an LSA. Stabilization clauses have great practical importance for investors. There is a consensus in arbitral jurisprudence on the effect of stabilization clauses on regulatory change and change in interpretation of regulations. These acts of state authorities are breaches of stabilization clauses. The investor should be compensated for the loss it has suffered.

4.3.2.7 CMS v. Argentine Award

The licence between the Argentine and the TGN in which the CMS was a shareholder contained stabilization clauses in clause 9(8) and clause 18(2).⁷¹ The tribunal argued that the stabilization clauses provided under the licence could be invoked under the treaty by the simultaneous operation of the licence and the treaty.⁷² The tribunal considered the change in the currency of the tariffs from dollar to peso and the fixing of the rate of 1

⁷⁰ Methanex Corporation v. United States of America, Final Award, Part IV, Chapter D, para 7 <http://www.state.gov/documents/organization/51052.pdf> 6 September 2012

⁷¹ CMS Gas Transmission Company v The Argentine Republic, ICSID Case No ARB/01/8, Award, 12 May 2005, para 145-146

http://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=showDoc&docId=DC504_En&caseId=C4 last accessed 6 September 2012; It is provided by clause 9.8 that “...the tariff structure would not be frozen or subject to further regulation or price control, and that in the event that a price control mechanism compelled the licensee to adjust to a lower level of tariff ‘...the Licensee shall be entitled to an equivalent amount in compensation to be paid by the Grantor.’⁷¹”

Furthermore, Clause 18.2 provided that, “the basic rules governing the licence would not be amended totally or partially, without the written consent of the licensee.”

⁷² *ibid*, para 151

dollar to 1 peso, as elimination of the stabilization clauses.⁷³ The tribunal held the view that the stabilization clauses had significant effects when the protection under the umbrella clause of the treaty was extended to them.⁷⁴ According to the tribunal, the respondent had not observed its legal and contractual obligations. Therefore, the respondent had breached the umbrella clause of the treaty.⁷⁵ The tribunal gave effect to the stabilization clauses under the treaty regime through invoking the umbrella clause of the treaty.

The part of the award relating to the breach of the umbrella clause was annulled by the CMS v. Argentine annulment committee on the basis that the tribunal had not stated adequate reasons.⁷⁶ The annulment committee argued that the umbrella clause covers only consensual and specific obligations. It particularly covers the obligations undertaken towards the relevant parties under contracts. Therefore, it could not be invoked by CMS, which was not party to the licence. The annulment committee asserted that the tribunal had not stated the reasons why it had reached the decision that CMS could enforce the obligations towards TGN that had been entered into by Argentine, but not those towards CMS.⁷⁷

⁷³ *ibid*, para 162

⁷⁴ *ibid*, para 302

⁷⁵ *ibid*, para 303

⁷⁶ CMS Gas Transmission Company v. The Argentine Republic, ICSID Case No ARB/01/8, Annulment Decision, 25 September 2007, para 96-97 http://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=showDoc&docId=DC687_En&caseId=C4 last accessed 6 September 2012

⁷⁷ *ibid*, para 96

4.3.3 The Legal Effect of Stabilization Clauses

4.3.3.1 The Effect of Arbitral Awards

Arbitral jurisprudence demonstrates that the inclusion of the stabilization clauses in the investment contract is not contrary to the sovereignty of the state. Instead of impairing the sovereignty of the state, the stabilization clause is a manifestation of the same sovereignty. However, it should be mentioned that, although the acts of state that breach stabilization clauses result from the sovereignty of states, they require payment of compensation to foreign investors.

There is no consensus in arbitral jurisprudence on the effect of the stabilization clauses in the event of nationalization. According to the tribunals in the Texaco and Agip cases, nationalization is unlawful if the contract includes a stabilization clause. The tribunal in the Texaco case decided on restitution of the legal status as a legal remedy. The tribunal in the Agip case decided on compensation that included lost profits in addition to the loss suffered, since nationalization measures are breaches of contractual undertakings as well.

On the other hand, the tribunals in the Liamco and Aminoil cases argued that the existence of a stabilization clause does not make nationalization unlawful. Nationalization is not unlawful, provided that it is for public purpose, not discriminatory and that compensation is paid to the investor. These tribunals argued that contractual undertakings could be nationalized based upon the above conditions of lawful nationalization. The tribunal decided to grant the value of the assets that had been nationalized as compensation in Liamco arbitration. In Aminoil arbitration, in addition to

the loss suffered, damages included some measure of lost profits due to loss of legitimate expectations.

The recent cases that dealt with the effect of stabilization clauses on regulatory changes or the change in the interpretation of the regulations regarded these changes as breaches of the stabilization clause. The tribunal in the *Duke v. Peru* case based its decision on the LSA and on the stability provisions in investment regulations that specify the stabilization guarantees in the LSA. The investment regulations in Peru stated that the changes that resulted in the increase of the “tax burden” were contrary to stabilization guarantees that were to be found in the agreements. It is hereby submitted that this approach is close to that of the economic equilibrium clauses, since the increase in the tax burden results in a change in the economic equilibrium of the contract and requires payment of compensation to restore the contractual balance.

In the *Duke v. Peru* case, the host state did not challenge the validity of the stabilization clause based on the principle of sovereignty. This attitude is contrary to the cases of 1970s. Another significant aspect of the case is that the tribunal interpreted the stabilization clause’s scope as including the change in the interpretation of the laws in addition to the changes in the laws. This is reasonable, since changes in interpretation of tax laws can have significant effects on investors.

The significance of arbitral awards is that although they are binding only on the parties to the disputes, they affect the awards of later arbitral tribunals, since they constitute soft

law, or even international common law in the terms of Guzman and Meyer. They correctly argued that

“(i)ndeed, it is as soft law that the decisions of international tribunals have their broadest effect; the decisions of international tribunals at most bind the parties to the dispute before the tribunal on the facts of the case, but their non-binding interpretation of hard legal obligations affects the legal expectations of all states subject to the underlying obligation. The fact that this is so allows particularly committed states to bind relatively less-committed states through the creation of an international tribunal. The grant of jurisdiction is, in effect, delegation to the international tribunal to create an international common law. Thus, while states can escape the monitoring function of an international tribunal by refusing to consent to its jurisdiction, they cannot escape the soft legal expectations created by the tribunal's jurisprudence. In this way, states are able to partially surmount the difficulties created by the traditional requirement of state consent. International tribunals create an international common law that can evolve without the need for the consent of all affected states, thus creating potential welfare gains, if sometimes at the expense of the principle of sovereignty.”⁷⁸

When it is considered that the awards of the tribunals constitute soft law or even international common law, negotiation of investment agreements, in particular transit pipeline agreements, are conducted also in the light of these arbitral awards.

4.3.3.2 The Doctrinal Views

The views in arbitral jurisprudence, which argued that nationalization in the existence of a stabilization clause is internationally unlawful, have received criticism. Paasivirta argued that investment contracts are not treaties. They are contracts between states and private parties. Moreover, there is no rule of customary international law that makes the existence of a stabilization clause as a criterion for the assessment of the legality of the unilateral termination of the contract. A stabilization clause increases the amount of compensation that needs to be paid to an investor. The inclusion of a stabilization clause in a contract increases the legitimate expectations of the foreign investor. If there is a contractual breach, there is, therefore, then a duty on the state to pay a higher level of

⁷⁸ A T Guzman and T L Meyer, “International Common Law: The Soft Law of International Tribunals” (2008-2009) 9 Chi. J. Int'l L 515, 535.

compensation.⁷⁹ Maniruzzaman argued that “in the case of a going concern, i.e. a business enterprise with demonstrable future earning power...It is possible that the significance of stabilization clauses can be fully reflected in the award of lost profits.”⁸⁰ The payment of compensation is at a higher level including the lost profits in the case of a breach of stabilization clause, depending upon the circumstances in a case.⁸¹

This approach does not regard the contract breaches to be internationally unlawful. This interpretation is in line with the principles of state responsibility, whilst giving effect to contractual practice. A stabilization clause cannot abrogate a state’s right to nationalize. A contractual undertaking cannot prevail over a general norm of international law.⁸² The views that assert stabilization clause does not invalidate nationalization but makes it unlawful⁸³ is questionable, since contractual breach is not a prerequisite of unlawful nationalization. The stabilization clause does not make the expropriation unlawful. What is unlawful is the lack of payment of compensation. However, the act of the state constitutes a breach of the contract. The stabilization clause in the contract increases the legitimate expectations of the host state. Therefore, a higher level of compensation should be paid to the foreign investor.⁸⁴

A stabilization clause cannot prevent the regulation by the host state in the public interest.

However, a change in regulation that adversely affects the investor is a breach of the

⁷⁹ Paasivirta, *supra* note 19 327-331

⁸⁰ AFM Maniruzzaman, “Damages for Breach of Stabilisation Clauses in International Investment Law: Where Do We Stand Today?” (2007) IELTR 246, 248

⁸¹ *ibid*, 250

⁸² Faruque, *supra* note 23 325-326

⁸³ R D Bishop, “International Arbitration of Petroleum Disputes: The Development of a Lex Petrolea” (1997) CEPMLP Discussion Paper No 12 24-25

⁸⁴ Cameron, *supra* note 1 121-122

stabilization clause. Therefore, it entitles the investor to a higher rate of compensation.⁸⁵ The effect of the stabilization clause is that it reduces the threshold for the unlawfulness of the breach. Moreover, it increases the amount of the compensation due to the breach of the agreement. The compensation can reach the level of including lost profits.⁸⁶

4.3.3.3 The Effect of Applicable Law

State responsibility in the event of nationalization with the existence of stabilization clauses completely depends on the applicable law of the contract. If the contract is internationalized, through choosing international law or the general principles of law as the applicable law, the obligations in the contract and the character of the contract are internationalized. Therefore, according to the principle of *pacta sunt servanda*, the state bears state responsibility in the event of breach of stabilization clauses under the contract.⁸⁷

On the other hand, if the national law is chosen as the applicable law of the contract, the breach does not bear the responsibility of state under international law and the breach does not constitute an internationally unlawful act, as long as it does not constitute confiscation, is non discriminatory and is for public purpose.⁸⁸ This view is based on the view that the contract is not removed from the municipal law of the host state. Therefore, the stabilization clause cannot prevent a state from exercising its sovereign power to

⁸⁵ M Erkan, *International Energy Investment Law* (Kluwer 2010) 130; Maniruzzaman, *supra* note 23 126

⁸⁶ Walde and Ndi, *supra* note 9 243-247

⁸⁷ F V Garcia-Amador, "State Responsibility in case of Stabilization Clauses" (1993) 2 *Journal of Transnational Law and Policy* 23, 33-34; M T B Coale, "Stabilization Clauses in International Petroleum Transactions" (2001-2002) 30 *Denver Journal of International Law and Policy* 217, 224; ; Walde and Ndi, *supra* note 19 241-243

⁸⁸ Garcia-Amador, *supra* note 87 24-25

affect acquired rights.⁸⁹ If the national law is the applicable law of the contract, cancellation of the contract or abrogation of the stabilization clause through enactment of law is regarded as a prerogative implicit in the sovereignty of a state and cannot be prevented. Therefore, the investor might not succeed in claiming damages if the national law is chosen as the applicable law.⁹⁰

A stabilization clause should not be in conflict with the constitution of the host state. There should not be any provision in the constitution that prevents the host state from granting a stabilization clause.⁹¹ If such a provision exists, even the application of international law cannot validate the stabilization clause. The clause cannot then have any legal effect. Moreover, if the contract is negotiated with an entity that does not have the authority to enter into such a contract, the contract is *ultra vires*. Therefore, stabilization clause again has no legal effect.⁹²

The view adopted by the author of this thesis is that the mere existence of a stabilization clause in the contract does not make nationalization unlawful under international law, since the existence of stabilization clause and a contractual breach are not criteria for the assessment of the lawfulness of the nationalization. However, the inclusion of a stabilization clause in the contract increases the legitimate expectations of the foreign investor. Therefore, it raises the level of compensation to a higher level.

⁸⁹ *ibid*, 48-49

⁹⁰ F Alexander, "Comment on Articles by Piero Bernardini, Lorenzo Cotula and AFM Maniruzzaman" (2009) 2 JWELB 243, 247; Maniruzzaman, *supra* note 25 138; Coale, *supra* note 87 23-24

⁹¹ Cameron, *supra* note 24 13

⁹² Walde and Ndi, *supra* note 12 239; Maniruzzaman, *supra* note 25 138; Erkan, *supra* note 85 110-111

Regulatory changes or a change in the interpretation of the regulations are breaches of the stabilization clause. Therefore, these breaches require compensation under the contract. The compensation should be equal to the amount of the economic burden of the legislative change in order to restore the economic balance of the contract, which was originally created based on the rights and the obligations of the parties when it was signed.

4.4 Economic Equilibrium Clause: A New Hybrid Tool for an Old Purpose

4.4.1 The Reasons behind the Evolution from Freezing to Economic Equilibrium Clauses: The Negotiation Context

The search for stability in contractual practice has evolved from traditional stabilization clauses to economic equilibrium clauses. However, in many contracts they are combined. An empirical study indicates that 12 contracts out of 76, from various countries, include traditional freezing clauses.⁹³ This evolution reflects the orientation of the case law relating to the legal effect of stabilization clauses in the nationalization cases of the 1970s. The main function of the stabilization clause in these cases was that, although it could not prevent regulatory change that was the legal basis of the nationalization, it increased the level of compensation. Dissatisfaction with the results of these classical awards was a major factor in the creation of the new forms of stabilization clause, since traditional stabilization clauses could not realize their aim of preventing unilateral state

⁹³ A Shemberg, “Stabilization Clauses and Human Rights”, OECD Global Forum on International Investment (27-28 March 2008) 19

actions. Moreover, only lump sum damages were awarded, in these cases, which was less than the expectations of the investors.⁹⁴

Most importantly, the kinds of political risk encountered by the investor have changed. Direct expropriation does not constitute the main threat nowadays. The real and most commonly faced political risk is regulation, which can even reach the level of creeping expropriation or coercive renegotiation.⁹⁵ An economic equilibrium clause does not aim to prevent a host state from enacting legislation. However, it aims to deal with the economic imbalance caused by this legislation through adjustment of the contract or payment of compensation.⁹⁶ Economic equilibrium clauses, through focusing on the results of unilateral state action, recognize the ability of the state to enact law in its sovereign capacity .

Another contributing factor to this evolution is that, for a long time, investment contracts have been negotiated mostly with state enterprises instead of governments. Therefore, economic equilibrium clauses in these contracts aim to allocate the financial effect of regulatory change to the enterprise rather than aim to prevent this change, since the enterprise cannot guarantee on behalf of the state not to change the regulations. Economic equilibrium clauses have the nature of commercial contracting practice, in particular with regard to the remedy in the event of breach of contractual undertakings.⁹⁷ The state enterprise will provide an adjustment to address the adverse effect of new regulations on

⁹⁴ Cameron, *supra* note 1 141

⁹⁵ *ibid* 142

⁹⁶ L Cotula, "Pushing the Boundaries vs. Striking a Balance: The Scope and Interpretation of Stabilization Clauses in Light of the *Duke v Peru Award*" (2010) 11 *JWIT* 27, 28-29; Maniruzzaman, *supra* note 25 126

⁹⁷ Walde and Ndi, *supra* note 9 218-219

the economic equilibrium of the contract through reimbursing tax increases out of its profit petroleum share or royalty, or by direct payment of compensation from general revenues.⁹⁸

4.4.2 Concept, Types and Scope

4.4.2.1 The Meaning of Economic Equilibrium

The economic equilibrium of a contract represents the value of the contract on the execution date and constitutes a balance that is based on the rights and obligations of the each party. The Aminoil tribunal stated that the concept of economic equilibrium consists of economic calculations, the weighing up of rights and obligations and of the chances and risks that are involved in long-term contracts.⁹⁹ One of the recent transit pipeline investment contracts includes a definition of the economic equilibrium concept in the following words.

“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.”¹⁰⁰

Equilibrium can be understood, first, as an equitable relation between the contributions of both sides. A substantial rise in the petroleum profit should result in a determination of equitable sharing between the parties or a procedure might be determined at the time of concluding the contract to accommodate the effects of price increases. Secondly, equilibrium can be understood as simple maintenance of the original deal. Any

⁹⁸ Cameron, *supra* note 1 416

⁹⁹ Kuwait v. Aminoil, *supra* note 47 1034

¹⁰⁰ BTC Turkey HGA, Appendix 1, Certain definitions www.caspiandevolepmentandexport.com last accessed 6 September 2012

subsequent government action will constitute disruption of the equilibrium and require restoration of the original equilibrium under this understanding.¹⁰¹

The understanding adopted by economic equilibrium clauses is the second one. It can be invoked only as a result of a unilateral state act. Therefore, it acts as a stabilization clause. On the other hand, the first understanding is adopted by renegotiation clauses, which can be invoked in the event of a fundamental change in the underlying economic circumstances of the contract.

Some arbitral tribunals have argued that the concept of contractual equilibrium should be interpreted by not only taking into consideration the original equilibrium agreed upon at the time of concluding the contract, but also taking into consideration the evolution of the contractual relationship, the conduct of the parties and subsequent changes during the term of the contract.¹⁰²

4.4.2.2 Types of Economic Equilibrium Clauses According to the Method of Restoration in the Light of Contractual Practice

4.4.2.2.1 Specified Economic Equilibrium Clause

A specified economic equilibrium clause requires amendment of the contract in the event that the stabilized elements are revised as a result of unilateral state action. It aims to restore the equilibrium through inclusion of a specified method in the clause (e.g.

¹⁰¹ T Walde, “Renegotiating Acquired Rights in the Oil and Gas Industries: Industry and Political Cycles Meet the Rule of Law” (2008) 1 JWELB 55, 79-80

¹⁰² Mobil Oil Iran Inc. v. Islamic Republic of Iran, 16 Iran-US Claims Tribunal Report 1987 54; Kuwait v. Aminoil, supra note 47 1034

readjustment of the profit petroleum split in the PSA).¹⁰³ The Ecuadorian Model PSA includes a specified economic equilibrium clause in the following terms.

“In case of modifications to the tax regime, including the creation of new taxes, or the labor participation, or its interpretation, that have consequences on the economics of this Contract, a corresponding factor will be included in the production share percentages to absorb the increase or decrease in the tax burden or in the labor participation of the previously indicated contractor. This correction factor will be calculated between the Parties and approved by the Ministry of Energy and Mines.”¹⁰⁴

The ECT Model HGA for cross-border pipelines includes a specified type of economic equilibrium clause that requires a tax decrease in the event that the economic equilibrium is disrupted by a unilateral state action:

“(t)he Host Government shall take all actions available to it to restore the Economic Equilibrium established under this Agreement and any other Project Agreements if and to the extent the Economic Equilibrium is disrupted or negatively affected, directly or indirectly, as a result of any change (whether the change is specific to the Project or of general application) in [insert name of the State] law ... At the option of [individual] project investors, economic equilibrium shall be achieved by a reduction in the amounts of tax otherwise payable under Article 26.9 hereof.”¹⁰⁵

4.4.2.2.2 Non-specified Economic Equilibrium Clause

A non-specified economic equilibrium clause requires automatic amendment of the contract without providing any specific method in the contract and without requiring the negotiation of the parties. It aims to restore the economic equilibrium through an automatic amendment when the state party unilaterally interferes with the stabilized contract.¹⁰⁶ A non-specified economic equilibrium clause requires that the contract

¹⁰³ Maniruzzaman, supra note 23 127; Alexander, supra note 87 244

¹⁰⁴ Ecuador Model Production Sharing Contract of October 2002 for the Exploration of Hydrocarbons and the Exploration of Crude Oil, Barrows, Article 11(7).

¹⁰⁵ The ECT Model Agreement for Cross-border Pipelines, Article 37 option 2 www.encharter.org last accessed 6 September 2012

¹⁰⁶ Maniruzzaman, supra note 25 127; Alexander, supra note 90 244

should be amended automatically by the parties to restore the equilibrium: the parties will be required to engage in a process similar to renegotiation even when this is not explicitly expressed in the clause.¹⁰⁷

An Azeri production sharing agreement (PSA) includes a non-specified economic equilibrium clause in the following terms.

“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, then SOCAR shall indemnify the Contractor (and its assignees) for any disbenefit, deterioration in economic circumstances, loss or damages that ensue therefrom...”¹⁰⁸

4.4.2.2.3 Negotiated Economic Equilibrium Clause

A negotiated economic equilibrium clause requires the parties to meet and negotiate in order to reach the terms on which the contract should be amended to restore economic equilibrium when the stabilized regime is revised by the host state through a unilateral act.¹⁰⁹ The CPC oil pipeline agreement includes the following negotiated economic equilibrium clause.

“Each of Russia and Kazakhstan agrees that, in the event of a change in tax, currency conversion rights, or other legislation or executive act at the federal, regional or local level within its territory resulting in a material detriment to the economics of the CPC project, its Shareholders, lenders, or contractors, each of Russia and Kazakhstan, as the

¹⁰⁷ Cameron, supra note 1 83

¹⁰⁸ 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 Co of Azerbaijan and Kura Valley Development Co Ltd and Socar Oil Affiliate (Azerbaijan), Barrows (art 24.2) cited in Maniruzzaman, supra note 25 128

¹⁰⁹ *ibid*; Alexander, supra note 90 244

case may be, in its capacity as a government, will discuss measures and take all possible steps within the limits of its authority under applicable law to restore the previous economic situation with respect to the CPC Project.”¹¹⁰

The WAGP International Project Agreement includes a negotiated economic equilibrium clause in the following terms.

“At the request of the Company, the States (represented by the Relevant Ministers) shall meet with the Company and endeavour in good faith to negotiate a solution which restores the Company and/or the Shareholders to the same or an economically equivalent position it was or they were in prior to such change, and the State or States in respect of which the Regime Failure has occurred shall use its or their best endeavors to procure that the solution is implemented.”¹¹¹

4.4.2.2.4 Hybrid Economic Equilibrium Clause

Hybrid clauses share characteristics of both freezing and economic equilibrium clauses. In the event that the economic equilibrium of the contract is adversely affected by unilateral state action, instead of amendment of the contract, hybrid clauses explicitly state exemption from the new law as one of the ways of restoring the economic equilibrium. Otherwise, the state should pay compensation to the investor.¹¹²

The BTC oil transit pipeline HGA includes a hybrid type of economic equilibrium clause:

“...the state authorities shall take all actions available to them to restore the economic equilibrium established under the project agreements if and to the extent that economic equilibrium is disrupted or negatively affected as a result of any change in Turkish law...the foregoing obligation to take all actions to restore the economic equilibrium shall include the obligation to take all appropriate measures to resolve promptly by whatever means may be necessary, including by way of exemption, legislation, decree and/or other

¹¹⁰ CPC Restructuring and Shareholders Agreement, Article 7.4.3. Barrows Collection Russia and NIS Section, Supplement 45

¹¹¹ Article 36.2-a of WAGP International Project Agreement <http://www.wagpco.com/images/stories/docs/reports/IPA-English.pdf> last accessed 17 November 2012

¹¹² Shemberg, supra note 93 6-7

authoritative acts, any conflict or anomaly between any Project Agreement and such Turkish Law.”¹¹³

The BTC HGA requires payment of compensation in the event of the host state does not restore the economic equilibrium. The HGA states that “...the Government shall provide monetary compensation as provided in this Article 10 for any Loss or Damage which is caused by or arises from:.. iii. any failure by the State Authorities, whether as a result of action or inaction, to maintain Economic Equilibrium as provided in Section 7.2(xi)”¹¹⁴

4.4.3 The Legal Effect of Economic Equilibrium Clauses

The main aim of an economic equilibrium clause is not to address direct expropriation. Other forms of stabilization clauses might be designated to address this issue. The main aim of an economic equilibrium clause is to cope with unilateral legislation and regulatory actions that might even lead to the level of creeping expropriation.¹¹⁵ States can take necessary regulatory measures that are not arbitrary or discriminatory. This is a principle of international law. However, the real issue is the result of these measures in terms of damages and possible performance by the parties. An economic equilibrium clause, by requiring amendment of the contract, exemption, and/or payment of compensation, addresses the results of specific unilateral state action.¹¹⁶ In the cases of specified types, if the parties could not achieve the specific performance required by the contract, “the tribunal may award damages to such an extent that would place the

¹¹³ Article 7.2-xi of BTC Turkey HGA

¹¹⁴ Article 10.1-iii of BTC Turkey HGA

¹¹⁵ Cameron, *supra* note 24 38

¹¹⁶ *ibid*, 49

aggrieved party in the position that it would have been in had the obligations under the stipulated economic balancing provision been performed.”¹¹⁷

The trigger for restoring economic balance of the contract is determined in precise terms in the BTC HGA as “any change in law”, while in the CPC agreement the trigger is a change in law that results in a material detriment to the economics of the CPC project. Some agreements include material change or material adverse effect as the threshold for a triggering event. Such concepts are very rarely defined in contracts. Therefore, they are prone to conflicting interpretations in different contexts. In order not to provide escape clauses or leverage for the parties to renegotiate the contracts, these triggering events should be clearly defined in the contract.¹¹⁸ Although the triggering events and negotiation procedure should be clearly defined for the success of renegotiation, in practice, triggering events might not be foreseen by the parties during the conclusion of the contract due to the contingencies caused by the long-term nature of the contract.¹¹⁹

A negotiated economic equilibrium clause simply obligates the parties to demonstrate their best efforts and to negotiate in good faith to reach an agreement. However, it does not obligate the parties to reach an agreement. If the parties negotiate in good faith but cannot agree on the amendment, this does not mean that they bear any liability. A negotiated economic equilibrium clause can be defined as agreement to agree clauses.¹²⁰

¹¹⁷ Maniruzzaman, *supra* note 80 250

¹¹⁸ Maniruzzaman, *supra* note 25 129

¹¹⁹ K P Berger, “Renegotiation and Adaptation of International Investment Contracts: The Role of Contract Drafters and Arbitrators” (2003) 36 *Vanderbilt Journal of Transnational Law* 1347, 1362

¹²⁰ J W Salacuse, “Renegotiating International Business Transactions: The Continuing Struggle of Life Against Form” (2001) 35 *International Lawyer* 1507, 1517; P Bernardini, “Stabilization and Adaptation in Oil and Gas Investments” (2008) 1 *JWELB* 98, 105; Berger, *supra* note 119 1367.

Moreover, the duty to negotiate in good faith can only be assumed if the applicable law entitles the party with this right.¹²¹ Only if a party acts in bad faith can the renegotiation clause be breached, thus entitling the other party to damages. Examples of bad faith are delaying the renegotiations unjustifiably, intentionally obstructing the renegotiation or objecting to the proposals based on reasons other than business judgment.¹²²

There are inherent uncertainties in the case of an open-ended negotiated economic equilibrium clause. These include whether the definition of triggering events and the legal consequence of failure to agree on amendment are determined in the clause, or whether the tribunal is authorized to adapt the contract in the event of failure of the parties to agree.¹²³ Therefore, for the success of the amendment process, the triggering events, the negotiation process and the solution in the event of a failure of the parties to agree on the amendment should be clearly determined.¹²⁴ The procedural aspects of negotiation, the content of the duty to negotiate, the role of the arbitrator in the event of the failure of the parties to agree and the extent of contract change are analyzed in detail in next chapter of the thesis, which explicitly deals with renegotiation of long-term contracts.

An open-ended approach, such as a non-specified or a negotiated economic equilibrium clause, might not be an efficient risk-management strategy. The obligation to negotiate should be supplemented by further details with regard to the procedure and penalties for

¹²¹ Berger, *supra* note 119 1357

¹²² *ibid*, 1369

¹²³ *ibid*1361

¹²⁴ Bernardini, *supra* note 120 103; Erkan, *supra* note 85 220

non-compliance in order to be efficient. The compensation for loss or damage and recourse to arbitration in the event of disagreement should be provided for in the clause.¹²⁵ A stipulated type of an economic equilibrium clause that states the method of restoration coupled with recourse to arbitration would be more efficient.¹²⁶

Economic equilibrium clauses require the amendment of the contract to restore the economic equilibrium in the event of a unilateral state act or exemption from that act. Some of the economic equilibrium clauses require payment of compensation in cases where no amendment or exemption is made. In the BTC HGA, the economic equilibrium clause requires prompt, adequate and effective compensation for the loss or damage incurred by the investors in the event of any failure of the state authorities to restore economic equilibrium. Irrespective of whether the state act constitutes expropriation or even creeping expropriation, the BTC HGA requires the state party to pay compensation in the event that any act by the state destroys the economic equilibrium.¹²⁷ Maniruzzaman argued that this approach goes beyond the traditional “no expropriation no compensation” criterion of international law. This approach to pay compensation for expected profits is closer to contract law more than it is to international takings jurisprudence. The state can only exercise regulatory power, if it pays compensation to remedy the adverse effect of that regulation on the foreign investor.¹²⁸

¹²⁵ Cameron, *supra* note 1 102

¹²⁶ Cameron, *supra* note 24 99

¹²⁷ Article 10.1.iii of BTC Turkey HGA

¹²⁸ Maniruzzaman, *supra* note 25 136

Economic equilibrium clauses set the threshold for payment of compensation at a lower level when compared to the threshold of general international law, in particular to that of the regulatory taking doctrine.¹²⁹ Economic equilibrium clauses represent a shift from the substantial deprivation of property rights standard under the regulatory takings doctrine to the impact on the economic equilibrium of the project. Even the material detriment standard that is included in some of the clauses represents a significantly lower threshold than the substantial deprivation standard.¹³⁰ The investor would not be entitled to damages in the absence of a stabilization clause in the event of regulatory change that does not amount to the level of creeping expropriation. In cases of direct expropriation, the stabilization clause increases the amount of compensation due to the fact that it increases the legitimate expectations of the foreign investor.¹³¹

An economic equilibrium clause might provide flexibility. The breach of a freezing clause might result in arbitration. However, the breach of the economic equilibrium clause results in renegotiation to restore the equilibrium or in payment of compensation. Arbitrators may play a role, in particular in revising the agreement, if the negotiations between the parties fail to restore the equilibrium. The chance of continuing the contractual relationship is higher in the case of economic equilibrium clauses.¹³² On the other hand, this view disregards the fact that not all of the economic equilibrium clauses provide for payment of compensation when the parties do not amend the contract. There

¹²⁹ L Cotula “Reconciling Regulatory Stability and Evolution of Environmental Standards in Investment Contract” 2008 1 JWELB 158, 166

¹³⁰ *ibid*, 167

¹³¹ Alexander, *supra* note 90 254

¹³² Cotula, *supra* note 129 162

is no rule of compensation in the absence of amendment.¹³³ Moreover, there is no guarantee of avoiding arbitration and no guarantee of agreement by the parties to the amendment of the contract, particularly in the cases of non-specified and negotiated economic balancing clauses. The state might not implement even the specified economic balancing when it abrogates the clause by way of the enactment of law to that effect. Therefore, arbitrators might have a role to play in cases of economic balancing provisions.¹³⁴

If the economic equilibrium clause includes some kind of indemnification provision in addition to the amendment of the contract in the clause, the economic equilibrium can be restored either by readjustment of the contract or indemnification of the affected party.¹³⁵ In cases where the financial burden of the investor is increased as a result of subsequent unilateral acts by the host state, compensation can be paid to the investor either through an offset of the value of the unilateral act against payments due by the investor to the state party or through a direct payment by the state company to the investor.¹³⁶

In international investment pipeline projects, if the host state interferes with the operation of the pipeline by obstructing the pipeline company from transporting the throughput, the company can seek damages for its loss under the economic equilibrium clause of the investment contract.¹³⁷ The equilibrium might be restored in this case either by amendment of the contract (e.g. a decrease in the state's transit fee) or by payment of

¹³³ Alexander, *supra* note 90 251

¹³⁴ *ibid*, 252

¹³⁵ AFM Maniruzzaman, "International Energy Contracts and Cross-Border Pipeline Projects: Stabilization, Renegotiation and Economic Balancing in Changed Circumstances-Some Recent Trends" (2006) 4 OJEL 1, 5

¹³⁶ Walde and Ndi, *supra* note 9 263

¹³⁷ Cameron, *supra* note 1 99

direct compensation to the pipeline company if the contract states this remedy, such as in the case of the HGA of the BTC pipeline. The amount of compensation should be equal to the company's loss in terms of the tariffs that would have been paid to the company if the interference had not occurred. Moreover, the responsibilities of the pipeline company under the transportation contract to the shippers in the event of an interruption should be taken into account when the amount of compensation is calculated.

4.5 Environmental and Human Rights Exemptions

The increasing awareness by governments, the public and NGOs of environmental standards and human rights has attracted attention to the effect of investments on the environmental and human rights in recent decades. In order to comply with their international obligations under relevant treaties, governments have enacted new environmental regulations. New regulations relating to environmental and human rights standards constitute a significant part of the regulatory risk.

Environmental concerns were used to start renegotiations in both the Sakhalin II and Imperial Energy projects in Russia and in the Kashagan dispute in Kazakhstan. The real aim was to increase state participation to a controlling level in the former cases while in the latter case the aim was just to increase the rate of state participation. These aims were achieved through purchases at reduced levels rather than at the real market prices.¹³⁸

There are concerns based on the notion that investment protection guarantees, in particular stabilization clauses, are inconsistent with environmental and human rights

¹³⁸ Cameron, *supra* note 1 338-342

development. The reason for these concerns is that stabilization clauses either make the investor immune from complying with new regulations relating to environmental and human rights protection or require the host state to pay compensation to the investor for compliance with these regulations. These guarantees prevent host states from implementing their international treaty obligations relating to environmental and human rights standards.¹³⁹

A stabilization clause that freezes the general legislative framework covers environmental regulation unless it excludes them from its scope. The state is under obligation either to pay compensation or to exempt the investor from new regulations.¹⁴⁰ Investors can rightly assume that a freezing clause protects them from complying with new environmental and human rights regulations.¹⁴¹ Therefore, stabilization clauses infringe the power of the host state to regulate for the progressive realization of environmental rights. Therefore, governments are not able to respond to new environmental threats. If the host state does not act in such a way, it will be required to pay compensation to the investor.¹⁴²

¹³⁹ Shemberg, *supra* note 93 10-11

¹⁴⁰ G Verhoosel, "Foreign Direct Investment and Legal Constraints on Domestic Environmental Policies: Striking a Reasonable Balance between Stability and Change" (1998) 29 *Law and Policy in International Business* 451

¹⁴¹ Shemberg, *supra* note 93 35

¹⁴² T E Lawson Remer, "A Role for the IFC in Integrating Environmental and Human Rights Standards into Core Project Covenants: Case Study of the Baku-Tbilisi-Ceyhan Oil Pipeline Project" New York University School of Law Global Working Paper (01/05/2005) 25-26; N Hildyard, G Muttitt, "Turbo-Charging Investor Sovereignty: Investment Agreements and Corporate Colonialism" (2006) 47 <http://www.thecornerhouse.org.uk/resource/turbo-charging-investor-sovereignty> last accessed 6 September 2012

On the other hand, it is argued that a contractual obligation cannot prevent a state from complying with its international obligations under relevant treaties regarding environmental protection. Host states can adopt legislative measures with this aim. Therefore, stabilization clauses cannot prevent a state from protecting the environment through new environmental regulation that is in the public interest.¹⁴³ Compliance with international law exemption limits the scope of stabilization clauses, even though it is not explicitly provided for in the contract. However, in order to provide clarity, compliance with international law exemption, and its scope and conditions, should be included explicitly in the contract.¹⁴⁴

The effect of stabilization clauses on new regulations relating to environmental rights strictly depends on the content of the stabilization clause. Some of these clauses exclude environmental regulatory changes from their scope. The other method is to refer to international environmental standards or petroleum industry practices in relevant provisions of the contract. Therefore, the evolution of these standards will not constitute a breach of a stabilization clause unless the state enacts an environmental law that has a higher standard than international environmental standards.¹⁴⁵ Referring to the international standards, which are included in codes of industry organizations or international conventions, requires the injection of changes in these standards into the contract.¹⁴⁶

¹⁴³ A Faruque, *Stability in Petroleum Contracts: Rhetoric and Reality* Unpublished PhD Thesis (CEPMLP 2006) 227

¹⁴⁴ L Cotula, "Regulatory Takings, Stabilization Clauses and Sustainable Development", OECD Global Forum on International Investment (27-28 March 2008) 15

¹⁴⁵ Alexander, *supra* note 90 249; Shemberg, *supra* note 93 39

¹⁴⁶ Cameron, *supra* note 24 83

Some of the contracts in the petroleum industry adopt this method. The Kashagan PSA between the foreign investors and Kazakh government and the Mozambique model PSA explicitly excludes non-discriminatory environmental regulation from the scope of the stabilization clause, provided that environmental standards created by new regulations are consistent with international environmental standards.¹⁴⁷ However, in an empirical study on stabilization clauses, it was reported that only two contracts from non-OECD countries exclude new environmental and human rights obligations from the scope of the stabilization clause. On the other hand, the contracts from the OECD countries only prohibit discriminatory regulation. They exclude environmental regulation from the scope of stabilization clauses.¹⁴⁸

Another method used in the industry is an undertaking document relating to environmental and human rights that is provided by the investor. In the BTC pipeline HGAs, the stabilization clause includes environmental regulation in its scope. However, after intense pressure from non-governmental organizations the pipeline company revealed a document relating to environmental and human rights obligations.¹⁴⁹ In this document, the investor withdrew its right to invoke the stabilization clause in the case of new environmental regulation. However, the legal value of this undertaking is questionable, since it is a unilateral commitment of the investor rather than a mutually agreed amendment to the contract.¹⁵⁰

¹⁴⁷ Cotula, *supra* note 144 15

¹⁴⁸ Shemberg, *supra* note 93 31

¹⁴⁹ Lawson-Remer, *supra* note 142 13-14

¹⁵⁰ *ibid*, 24; Cotula, *supra* note 144 15

4.6 Conclusion

It is a settled issue of international investment law that stabilization clauses are an expression of the sovereignty of the state rather than being in conflict with sovereignty. However, they cannot prevent unilateral acts by the state that are a result of the exercise of that same sovereignty. The legal effect of stabilization clauses is that they address the economic results of unilateral state acts through providing compensation to the investor. They reduce the threshold for compensation when compared with the legitimate expectations principle of the FET standard or the substantial deprivation criterion of the regulatory takings doctrine. They increase the level of compensation, since inclusion of such clauses in the contract increases the legitimate expectations of the investor.

The inability of traditional freezing clauses to prevent unilateral state action resulted in an evolution to economic equilibrium clauses, which aims to address the economic imbalance caused by the specific unilateral state action. In most cases, these clauses require amendment of the contract to restore the original economic equilibrium. In order to achieve their intended aim, these clauses should provide sufficient detail on triggering events and the amendment procedure. Moreover, in the event of disagreement by the parties, the arbitrators should be authorized in the contract with the power to amend the contract, and/or compensation should be paid to investor to remedy the adverse effects of the unilateral state act.

The evolving environmental standards, and the obligation of states to comply with international law relating to these standards, constitute a challenge to contract stability. A

moderate approach is to refer to the international environmental standards in specific codes. This can ensure both compliance with evolving international standards and a flexible approach to stability in this specific area.

Although they cannot prevent unilateral state action, through addressing the economic results of that specific action, stabilization clauses in both traditional freezing and economic equilibrium forms might significantly increase the bargaining power of the investor at the negotiation table under the risk of possible enforcement of these clauses by arbitral tribunals.

CHAPTER 5. THE QUEST FOR STABILITY FROM THE OTHER END: APPLICABLE LAW ON CONTRACT CHANGE AND CONTRACTUAL FORMS OF RENEGOTIATION

5.1 Introduction

The sanctity of contract principle is a tenet of contract law. This principle is reinforced by the stabilization clauses that are the subject of the previous chapter. However, the sanctity of contract principle is balanced and limited by the principle of change in circumstances that is equally a principle of contract law. Therefore, a complete understanding of long-term contracts, including the contracts of transit pipeline projects, can only be acquired through assessment of both of these principles.

Given the nature of long-term contracts and the inevitable contingencies that might be encountered by the parties during their term, renegotiation can be regarded as a reality of these types of contracts. This chapter addresses the reasons behind the occurrence of renegotiation. It is certain that, if the contract includes a renegotiation clause, the parties are under an obligation to renegotiate the contract according to the party autonomy principle. However, in cases where the contract does not include a renegotiation clause, the party that requested renegotiation should refer to the applicable law of the contract. Therefore, the approaches of different types of legal systems that are potentially applicable to contract change are dealt with in this chapter. The extent of contract change under different types of clauses that require renegotiation and the procedural aspects of renegotiation (e.g. triggering events, the duty to renegotiate in good faith and the role of the arbitrator in the event of a failure by the parties to agree on the amendment) are all subjects of this chapter.

It should be noted that even in situations where the contract does not include a renegotiation clause, renegotiation might take place. However, given that renegotiation is the alternative to the resolution of the dispute by a court or an arbitral tribunal, renegotiation takes place under the shadow of the applicable law of the contract. According to the best available alternative rule, one of the parties might not accept a renegotiated solution if that party can acquire better a resolution through a court or arbitration. Therefore, an assessment of the legal provisions that would constitute bargaining factors during the renegotiation is essential for the parties to measure their bargaining power and to anticipate the result of renegotiation. In order to assess their role during renegotiation, this chapter deals with analyses of the applicable law on contract change, the clauses that require renegotiation, and the procedural aspects of renegotiation, including the power of an arbitrator to adapt the contract.

5.2 Causes of Renegotiation

5.2.1 Long-Term Nature of Contract: Incompleteness and Contingency

Transit pipeline agreements, either intergovernmental or between the state companies of governments, or in the form of host government agreements (HGA) between the transit state and the investor, in addition to the underlying agreements of oil or gas sale and transportation, are all long-term agreements reaching terms of 40 years in some cases. They possess all the problems of the time element that is inherent in long-term agreements. Planning for the future is essential in long-term contracts in order to deal with the effects of the time element. However, it is near to impossible to plan every aspect of the relationship at the time of the contract is concluded. Therefore, there should be adequate tools to accommodate contingencies and provide flexibility.

Flexibility does not necessarily present uncertainty. In many cases, as in price adjustment clauses in gas sale contracts or progressive transit fees and tariffs in transit and transportation contracts, flexibility can promote specificity and certainty, which help to create a sustainable relationship.¹

The complex nature of long-term commercial transactions prevents an all-encompassing contract, in which the terms are fixed at the time of contracting.² There might be many considerations, which depend on the occurrence of future contingencies. The parties might be unable to make a final decision due to a lack of information regarding certain parts of their relationship or the contractual context might develop over the course of time. For instance, the geology of the area might be different from what was expected or more than the anticipated amount of condensate gas might be found during petroleum exploration. Therefore, regulating the relationship in the contract in an all-encompassing style might be neither possible nor practical.³

The time-consuming nature of the negotiation of long-term contracts raises the problem of transaction-costs, which is one of the reasons for incomplete contracts. It might be too costly to sustain negotiations in order to predict and address all future contingencies. Therefore, the contract might have gaps that should be filled later either by the parties to the contract or by a third party.⁴

¹ See the case studies in P Stevens, *Cross-border Oil and Gas Pipelines: Problems and Prospects* (ESMAP 2003)

² N Horn, "The Concepts of Adaptation and Renegotiation in the Law of Trans-national Commercial Contracts" in *Adaptation and Renegotiation of Contracts in International Trade and Finance* (N. Horn ed, Kluwer 1985) 4

³ N Nassar, *Sanctity of Contracts Revisited: A Study in the Theory and Practice of Long-Term International Commercial Transactions* (M. Nijhoff 1995) 170-171

⁴ A Kolo and T Walde, "Renegotiation and Contract Adaptation in International Investment Projects: Applicable Legal Principles and Industry Practices" (2000) 1 *JWI* 5, 21

5.2.2 Change in Economic Circumstances and the Particular Case of Windfall Profits

The parties to long-term contracts have mostly experienced the contingency of a change in the underlying economic circumstances of the contract. An investment is made based on the assumptions of the investor on the geology of the area, the payments to the state in the form of taxes, royalties, levies, fees and the cost of complying with environmental standards. These are assessed by the investor against the estimated output from the investment, which is based on the price of the commodity over the lifetime of the project. However, the price of the commodity might change to the extent that it creates windfall profits for the investor and makes the original agreement onerous for the host state. The result of this situation is the “industry-cycle effect”, which has been experienced in the form of demands for renegotiation of financial aspects of the contracts by the state party when there is a steep rise in the price of the commodity. Moreover, when the industry-cycle effect is coupled with the increase in the bargaining power of the host state (obsolescing bargain), the risk of renegotiation is more severe.⁵

Windfall profits are particularly important for the petroleum industry, since an excessive profit is gained by one party without harm being done to the other party. However, this situation does not possess the requirements of the hardship concept, which is dealt with in detail below, under which renegotiation might occur to adapt the contract due to a fundamental change of economic circumstances. Therefore, if there is no provision in the contract that allocates the risk to one of the parties, the

⁵ T Walde, “Renegotiating Acquired Rights in the Oil and Gas Industries: Industry and Political Cycles Meet the Rule of Law” (2008) 1 JWELB 55; P Stevens, “National Oil Companies and International Oil Companies in the Middle East: Under the Shadow of Government and Resource Nationalism Cycle” (2008) 1 JWELB 5; Kolo and Walde, *supra* note 4 22

parties can draft a renegotiation clause in a clear way that covers events that create windfall profits for one of the parties. A contractual relationship that creates unexpected profits for one party, while the other has no possibility of benefitting from this situation can hardly survive. In the case of windfall profits, renegotiation can occur even in the absence of a hardship or a broader renegotiation clause.⁶ In cases where the contract does not include an escalation or similar clause to address windfall profits, or even when these clauses become unoperative and inefficient because of a fundamental change of circumstances, renegotiations might occur.⁷

The contract's financial system can be adapted through a progressive method that aims to get a resource rent tax from the investor when the investor's profit reaches a specific level. The percentage of the tax might be increased to an amount that is higher than the one that is applied under normal terms.⁸ However, when the contract includes a clause such as an economic equilibrium clause that stabilizes the contract and can be invoked when the financial burden of the investor is increased, the host state cannot adopt measures that aim to reap a share of the profit in the event of windfall profits. Moreover, if these measures reach a level that is tantamount to expropriation, the host state will have to pay high levels of compensation.⁹

Changes in the fiscal system of long-term petroleum projects due to windfall profits acquired by the investor have not only occurred in developing countries. They have

⁶ N Horn, "Standard Clauses on Contract Adaptation in International Commerce" in *Adaptation and Renegotiation of Contracts in International Trade and Finance* (N. Horn ed, Kluwer 1985) 136

⁷ M Erkan, *International Energy Investment Law: Stability Through Contractual Clauses* (Kluwer 2010) 170

⁸ See, R Garnaut and A C Ross, "Uncertainty, Risk Aversion and the Taxing of Natural Resource Projects" (1974) 85 *The Economic Journal* 272, 272 et seq

⁹ See T Walde and A Kolo, "Renegotiating Previous Governments Privatisation Deals: The 1997 UK Windfall Tax on Utilities and International Law" (1998-1999) 19 *Northwestern Journal of International Law* 405

been experienced in North Sea projects as well. The UK and Norway increased the level of taxes to get their share of investor's windfall profits in 1975 and, more recently, in 2006.¹⁰ In these countries, the legal framework of investment, either created by contract or licence, does not include any stabilization clause. However, even in projects in which the contracts included a stabilization clause, renegotiation has occurred when there were steep rises in the price of the commodity (e.g. Ghana-Valco renegotiation, Chilean copper renegotiation, Papua New Guinea copper renegotiation).¹¹

In a study that conducted case studies, based on the lessons of these cases, the author asserted that "...terms of agreements become progressively more out of date as economic conditions change, and multinational investors can no longer expect to freeze the conditions at one point in time by iron-clad contract terms."¹² It is justifiably argued that

"(c)hanges are intrinsic to the passage of time. A contractual relationship extending over a prolonged period of time is not expected to operate under the same conditions as those existing at the beginning of the relationship... It is true that one can calculate potential risks, but there is no guarantee that they will materialize in the same manner as envisaged."¹³

In the first decade of this century, petroleum contracts, in particular the fiscal regime of these contracts, have been renegotiated or changed unilaterally worldwide. The changes in the fiscal regime of contracts has not only occurred in developing

¹⁰ See S K B Asante, "Stability of Contractual Relations in the Trans-national Investment Process" (1979) 28 ICLQ 401, 413; R Young and R Devine, "Managing Government Renegotiation Risk in International Energy Projects" (2009) 7 International Energy Law Review 256

¹¹ For details of renegotiation cases see, W Peter, *Arbitration and Renegotiation of International Investment Agreements*, (2nd ed, Kluwer 1995); G A E Sackey, "Renegotiation of the Ghana-Valco Agreement: The Sanctity of Contract Doctrine v. Economic and Political Reality" (1989) 17 Journal of International Business Law 514; J G Laylin, "Renegotiation of Investment Contracts: with an Idea Suggested by Experience" (1970-1971) 8 Houston Law Review 479

¹² W A Stoeber, *Renegotiations in International Business Transactions* (Lexington Books, 1981) 315

¹³ Nassar, *supra* note 3 29

countries (e.g. Algeria, Argentine, Bolivia, Venezuela, Ecuador, India, Papua New Guinea, Nigeria, Kazakhstan, Vietnam, Russia and China), but also in developed countries (e.g. Canada, United Kingdom, the continental United States and Alaska).¹⁴ The practice of renegotiation in the petroleum industry conforms to the reality quoted above that change is intrinsic to the passage of time.

A change in market conditions can be caused by the economic policy of the state as well. The deregulation of the gas market in the US in the 1980s, and in the UK in the 1990s, created a market that is more competitive. As a result of this competition, the price of gas decreased dramatically. This situation made the take or pay clauses in long-term gas sale contracts onerous for buyers. Renegotiations resulted in a decrease in the take or pay levels and/or the amount of the gas that had been determined in the original contracts. However, these results were gained through the payment of high compensation to the sellers (250 million pounds in the case of the BP-North Sea gas seller's case).¹⁵

5.2.3 Government as a Party to the Contract: The Effect of Geopolitics, Change in Politics and Perceived Imbalance of the Contract

The special cases of the renegotiations that occurred during the decolonisation period in the 1960s and 1970s are a closed chapter of history. They can hardly provide lessons for future renegotiations.¹⁶ The renegotiations in the post-decolonisation era have mostly been caused by changes in market conditions or by changes in policy

¹⁴ For details see P Cameron, *International Energy Investment Law: The Pursuit of Stability* (OUP, 2010) 10-11

¹⁵ Kolo and Walde, *supra* note 4 23-26

¹⁶ N Horn, "Changes in Circumstances and the Revision of Contracts in Some European Laws and in International Law" in *Adaptation and Renegotiation of Contracts in International Trade and Finance* (N Horn ed, Kluwer 1985) 29

considerations by the host state that have been made in order to achieve certain economic and political aims as an exercise of its statehood (e.g. to increase state ownership in the investment project or to adopt a socialist or less liberal economic policy)¹⁷, or by the obsolescing bargain effect that is inherent in investment projects.¹⁸

In some cases, a change of government to one that upholds a policy more ideologically committed to the ownership of resources or to the control of the strategic sectors of the economy has resulted in partial or full ownership of an investment, particularly in natural resources investment projects.¹⁹ The examples of these kinds of renegotiations can be found not only in the renegotiations of the 1970s but also in the renegotiations of the last decade initiated by pro-socialist governments in Latin America, particularly in Venezuela. Moreover, renegotiations have occurred in Russia, which aimed to regain the ownership of petroleum companies, particularly full ownership of the pipeline network.²⁰

The government as a contract party brings its particularities to the negotiation table and to the contractual relationship. In contrast to private companies, which act only with the aim of profit, governments or state companies have to consider the interests of their citizens. They have to act in the public interest.²¹ Transit pipeline agreements, as already indicated above, are concluded either between governments or state companies of governments, or between the government/the state company and investors. Moreover, geopolitics has significant effects on the route of transit pipelines, the negotiation of the contracts and the operation stage of transit pipelines.

¹⁷ Stoeber, *supra* note 12 309

¹⁸ For the detailed discussion of the concept of obsolescing bargain see Chapter 2 53 *et seq*

¹⁹ Asante, *supra* note 10 413

²⁰ Young and Devine, *supra* note 10

²¹ M Sornarajah, "Supremacy of the Renegotiation Clause in International Contracts" (1988) 5 JIA 97

There are factors that have to be considered during all these stages, which were analysed in detail in Chapter 2 of this thesis. These factors are the global political and business communities' energy security concerns, control of the pipeline routes, the relationships, in particular alliances, between not only the resource country and transit states but also between the host states and the home states of the investors, the equity participation of the transit state in the project, and the interests of the investors in other projects in a specific host state other than the transit pipeline project. All these factors influence the risk aversion of both host states and investors. Therefore, they have significant effects on the behaviour of the investors and the state parties.²²

5.3 Renegotiation without a Clause

5.3.1 The Role of Applicable Law

The proper law of contract determines under which conditions and to what extent a party is entitled to contract change. It also determines the legal consequences of a rejection by a party of a request for a renegotiation or, if the renegotiation is unsuccessful, the consequences of this failure.²³ In cases where the contract does not include a renegotiation clause, the parties are faced with the phenomenon of “bargaining in the shadow of law”. Kröll argued that

“(t)he contractual provisions and the applicable law have a considerable bearing on the renegotiations: they occur in the shadow of law. The respective bargaining positions and the result of the negotiations is influenced by the alternatives existing to negotiated solutions. These alternatives, however, are determined to a large extent by the underlying investment contracts and the applicable law.”²⁴

²² For a detailed discussion of the effects of economic and geopolitical factors on negotiation and renegotiation see Chapter 2 65 et seq

²³ Peter, supra note 11 130

²⁴ S Kröll, “The Renegotiation and Adaptation of Investment Contracts” in *Arbitrating Foreign Investment Disputes: Procedural and Substantive Legal Aspects* (N Horn and S Kröll ed, Kluwer 2004) 436

The search for law applicable to contract change under different laws potentially applicable to state contracts²⁵ leads to the general principles of law either as a source of international law²⁶, when the parties choose these principles as the applicable law of the contract, or as a supplementary source of international law when the applicable domestic law of contract is inadequate.²⁷

These general principles of law are the rules accepted in the domestic laws of all main legal systems in particular, the private laws of these legal systems.²⁸ The sanctity of contract principle is common to all the main legal systems. However, at the same time, all legal systems include rules that release a party from the performance of its obligations in other words, rules that permit contract change, though to varying degrees.²⁹

Exceptions to the sanctity of contract principle, which release a party from the performance of its obligations and/or entitle that party to adapt the contract under the main legal systems, are dealt with below through adopting a comparative law approach. The rules of treaty law, customary and soft international law, which deal with contract change that is possibly applicable to transit pipeline agreements are addressed after the analysis of comparative law.

²⁵ For a detailed analysis of applicable law to state contracts and change in contracts see Chapter 2 88 et seq

²⁶ Article 38 of the statute of the ICJ states that “The Court, whose function is to decide in accordance with international law such disputes as are submitted to it, shall apply:

- (a) international conventions, whether general or particular, establishing rules expressly recognized by the contesting States;
- (b) international custom, as evidence of a general practice accepted as law;
- (c) the general principles of law recognized by civilized nations

subject to the provisions of Article 59, judicial decisions and the teachings of the most highly qualified publicists of the various nations, as subsidiary means for the determination of rules of law.

²⁷ A F M Maniruzzaman, “State Contracts with Aliens: The Question of Unilateral Change by the State in Contemporary International Law” (1992) 9 JIA 141, 147; Peter, supra note 11 183

²⁸ I Brownlie, *Principles of Public International Law* (7th edn, OUP 2008) 16; Lord McNair, “General Principles of Law Recognized by Civilized Nations” (1957) 37 BYIL 1

²⁹ Peter, supra note 11 185

5.3.1.1 Comparative Law on Contract Change

5.3.1.1.1 English Law

The frustration doctrine addresses the exceptions to the sanctity of contract principle under English law. According to the doctrine of frustration, the parties are released from the performance of their obligations when the performance becomes legally or physically impossible as a result of subsequent events or when enforcing the contract under changed circumstances would amount to enforcing a different contract from the one which the parties concluded.³⁰

Physical impossibility occurs when the person or the thing has been destroyed on which performance depends. Legal impossibility can be a war between the exporter's and importer's country. It can occur as well in cases where the government prohibits performance by an embargo throughout the term of the contract.³¹ If the government refuses to grant export or import licences, the contract is frustrated unless the party expressly obligated under the contract to obtain that licence. Otherwise, in particular, when the contract includes a provision such as "subject to licence", the party only needs to prove that due diligence was demonstrated.³²

Physical destruction was regarded as a cause of frustration in the Taylor v. Caldwell case. In this case, the hall that was rented for musical performance was destroyed by fire without the fault of either party a couple of days before the first concert. The tenant claimed damages for the expected profit of the performance. However, the court rejected the claim and stated that "(t)he principle seems to us to be that, in

³⁰ Maniruzzaman, supra note 27 148

³¹ C. Murray et al, *Schmitthoff's Export Trade: The Law and Practice of International Trade* (11th edn, Sweet and Maxwell 2009) 120-123

³² *ibid* 127-130

contracts in which the performance depends on the continued existence of a given person or thing, a condition is implied that the impossibility of performance arising from the perishing of the person or thing shall excuse the performance.”³³

Frustration of the purpose of the original contract occurs when an unforeseen event that results in a situation where “...the foundation of the contract has gone and the contract, if kept alive, would amount to a new and different contract from that originally concluded by the parties.”³⁴ However, a careful approach should be adopted. In the Suez Canal cases, closure of the canal was not considered as a frustrating event, since the performance was still possible through the Cape of Good Hope, which was in the court’s view practical and reasonable.³⁵ Frustration of purpose was addressed in the Davis Contractors Ltd v. Fareham U.D.C. case in the following words.

“Frustration occurs when the law recognizes that without default of either party a contractual obligation has become incapable of being performed because the circumstances in which the performance is called for would render it a thing radically different from that which was undertaken by the contract. Non-foedera veni. It was not this that I promised to do.”³⁶

It has already been stated above that frustration might occur when there is physical impossibility (e.g. destruction of the subject) or legal impossibility (e.g. expropriation).³⁷ The frustrating events must occur without the fault of either party.

³³ Taylor v. Caldwell (1863), 3 B & S 826 839, Quoted in *ibid*

³⁴ *ibid* 125

³⁵ Tsakiroglou v. Noble Thörl GmbH (1962) AC 93

³⁶ Davis contractors Ltd. v Fareham U.D.C. (1956) A.C. 696 729

³⁷ A H Puelinckx, “Frustration, Hardship, Force Majeure, Imprevision, Wegfall der Geshäftsgrundlage, Unmoghlichkete, Changed Circumstances” (1986) 3 JIA 47, 49

Moreover, mere hardship is not sufficient under English law to discharge or even partially discharge performance.³⁸

The effect of frustration is termination of the contract. Judges cannot amend the contract or adjust it to new circumstances. Frustration terminates the contract and the defendant will be excused from payment.³⁹ It was held in one case that “(w)hen frustration occurs, it does not merely provide one party with a defence in an action brought by the other. It kills the contract itself and discharges both parties automatically.”⁴⁰

The sanctity of contract principle is very strictly applied under English law. The experience of the take or pay cases after the deregulation of the UK gas market demonstrated that if the gas sale contract became onerous and unprofitable to a party as a result of a change in market conditions, the party could not escape from complying with the terms of the original agreement and the courts did not want to interfere with the contract to adapt it to the changed circumstances.⁴¹ These cases demonstrate that relief from contract performance is limited to very strict terms of frustration.

Under English law, a government cannot be prevented contractually from performing its essential functions through a public law contract. It was stated in *Amphitrite v. The*

³⁸ Nassar, *supra* note 3 196

³⁹ Puelinckx, *supra* note 37 51

⁴⁰ *Joseph Constantine Steamship Line Ltd v Imperial Smelting Corporation Ltd* (1942) AC 154 163

⁴¹ H Davey, “Take or Pay and Send or Pay: A Legal Review and Long Term Prognosis” (1997) 11 OGLTR 419; P Hodges, “Take or Pay and Send or Pay-A Perspective on Recent Litigation” (1997) 12 OGLTR 469; M Saunders, “Take or Pay: Total Gas Marketing Limited v. Arco British Limited” (1998) 13 OGLTR 355

King case that “(i)t is not competent for the government to fetter its future executive action, which must necessarily be determined by the needs of the community when the question arises. It cannot by contract hamper its freedom of action in matters which concern the welfare of the State.”⁴² No government department can contractually constrain parliament to enact legislation that amends concession contracts. However, a government department can agree by contract to compensate the other party for amendment of the contract through a parliamentary act or lawful exercise of executive power.⁴³

The applicable law of transit pipeline agreements is English law in most cases (e.g. the BTC oil transit pipeline, the SCGP and the CPC oil transit pipeline). Therefore, these contracts might be frustrated temporarily if the transit is interrupted as a result of a terrorist attack on the pipeline without the fault of either party, or when an embargo is applied by either the resource state or transit state on the other party.

5.3.1.1.2 US Law

Under US law, exceptions to the sanctity of contract principle are addressed under the doctrine of commercial impracticability. Commercial impracticability is regulated under section 2-615 of the Uniform Commercial Code (UCC) and in section 261 of the Second Restatement of Contracts (1979). Section 2-165 of the UCC states the following.

“Excuse by Failure of Presupposed Conditions

Except so far as seller may have assumed a greater obligation and the subject of the preceding section on substituted performance: (a) Delay in delivery or non-delivery in whole or in part by a seller who complies with paragraph (b) and (c) is not a breach of his duty under a contract for sale if performance as agreed has been made

⁴² *Amphitrite v. The King* (1921) LR KB 500

⁴³ Maniruzzaman, *supra* note 27 149-151

impracticable by the occurrence of a contingency the non-occurrence of which was a basic assumption on which the contract was made or by compliance in good faith with any applicable foreign or domestic governmental regulation or order whether or not it later proves to be invalid”

The Second Restatement of Contracts in its section 261 states that

“(w)here, after a contract is made, a party’s performance is made impracticable without his fault by the occurrence of an event the non-occurrence of which was a basic assumption on which the contract was made, his duty to render that performance is discharged unless the language or the circumstances indicate the contrary.”

The requirements for an event in order to make a performance impracticable are that its non-occurrence should be a basic assumption, as an implied term of the contract, and that the event should occur without the fault of the party that invokes the contractual impracticability.

While the English common law doctrine of frustration refers to both literal impossibility and frustration of purpose, the American terminology (impracticability) refers to only the frustration of purpose.⁴⁴ Although adaptation of the contract is not possible under the doctrine of frustration, there is an evolution of adaptation of contract under the doctrine of impracticability.⁴⁵

Although the same rules apply to government contracts under US law, the government can override its contractual obligations in the exercise of police power, provided that the act is reasonable and not arbitrary. The legitimate exercise of police power does not require the payment of compensation. However, when the interference reaches the level of taking, compensation has to be awarded. The level of compensation does not include anticipated profits.⁴⁶ Changes in government contracts have occurred under the “changes clause” in construction contracts or under statutory

⁴⁴ *ibid* 149

⁴⁵ Peter, *supra* note 11 188

⁴⁶ Maniruzzaman, *supra* note 27 151

acts such as the “Renegotiation Act” of 1951. This act provided for the recapture of excessive profits made under defence contracts, similar to the case of windfall profits in petroleum contracts. “Renegotiation boards” conducted renegotiations under the renegotiation clauses that were inserted into contracts.⁴⁷

5.3.1.1.3 French Law

Under French private law, the sanctity of contract principle is absolute. According to Article 1134 of French Civil Code, “(a)greements legally made take the place of law for those who make them. They may be revoked only by mutual consent or for causes, which the law authorizes. They must be executed in good faith.” This strict obligation of performance is limited only by events that would constitute *force majeure*. According to Article 1147 of the French Civil Code, a debtor can only be held responsible when he is negligent, or at fault for non-performance. Article 1148 of the French Civil Code states the doctrine of force majeure in the following terms: “no damages arise when as a result of an act of God or of a fortuitous event, the debtor was prevented from giving or doing that for which he had obligated himself, or did what was forbidden to him.”

Unless there is a specific clause in the contract, French law permits relief from contractual obligations only in cases of *force majeure* events. The performance should be made impossible by the occurrence of an unforeseen event that was unavoidable and which occurred without the fault of either party. Economic hardship is not adequate for relief from performance.⁴⁸

⁴⁷ Peter, supra note 11 188-189

⁴⁸ Nassar, supra note 3 197

However, under the French doctrine of administrative contracts, the Conseil d'Etat has developed certain principles. The government can modify the terms of a contract due to the changing needs of the public service or because of a supervening event under the doctrines of "fait du prince" and "imprevision" respectively.

Doctrine of "fait du prince": Under this doctrine, a government body directly interferes with the contract in matters of overriding public interest either in the form of modification or termination. Full compensation, including anticipated profits, should be paid. However, in the case of indirect interference with contractual rights through legislative or executive action, compensation is only paid when the economic equilibrium is seriously affected.⁴⁹

Doctrine of "imprevision": This doctrine was developed by the Conseil d'Etat in the famous *Gaz de Bordeaux* case, in which, as a result of supervening events (an abnormal increase in prices after the First World War), the equilibrium of the energy supply contract was completely destroyed. The basis of the imprevision is the need for continuity of public service. Under this doctrine, when the economic equilibrium of the contract is seriously affected as a result of unforeseen events that are beyond the reasonably envisaged risk taken by the party, the administrative contract can be adjusted. The contract can be terminated only if the equilibrium is destroyed to the extent that performance of the contract is irremediable.⁵⁰

Imprevision theory is particularly important for contracts in international business where the applicable law is French law. Moreover, "...the concept has inspired

⁴⁹ Maniruzzaman, *supra* note 27 153; Peter, *supra* note 11 189-190

⁵⁰ Maniruzzaman, *supra* note 27 154

corresponding provisions in the civil codes of many Arab countries, such as Egypt, Algeria, Iraq, the UAE and Sudan.”⁵¹, who are important players in the oil industry. The private party is entitled to compensation for its actual loss but not for anticipated profits, since full compensation is due when the authority is responsible for the occurrences (*fait du prince*) and compensation is limited to actual losses when the causes are external (*imprevision*).⁵²

5.3.1.1.4 German Law

German law release a party from performance in the event of objective impossibility of performance without the fault of either party due to an event beyond that party’s control according to Article 275 of the German Civil Code.⁵³ Another situation that releases a party from performance is when the performance cannot be expected from a party for a major reason and the doctrine of “*Wegfall der Geschäftsgrundlage*” (collapse or deficiency of the foundation of the contract) applies.⁵⁴ The German Civil Code does not directly regulate the fundamental change in circumstances rule. However, “the Code sanctions the principle of good faith as the basis of contract law (Article 157, 242, 315 BGB) and this principle has been invoked by the courts when deciding on cases involving problems of *force majeure* and hardship.”⁵⁵

The collapse of the foundation of the contract doctrine finds its basis in Article 242 of the German Civil Code, which states “the debtor is obligated to render performance as

⁵¹ Horn, *supra* note 16 18

⁵² Peter, *supra* note 11 190

⁵³ Article 275 of German Civil Code states that “Impossibility for which one is not responsible (1) The debtor is relieved from his obligation to perform if the performance becomes impossible because of a circumstance, for which he is not responsible, occurring after the creation of the obligation. (2) The inability of the debtor to perform after the creation of the obligation is equivalent to subsequent impossibility of performance.”

⁵⁴ Peter, *supra* note 11 191

⁵⁵ Horn, *supra* note 16 19

required by good faith, taking account of common usage.” The doctrine is defined under German case law in the following terms: “the common representation of both contracting parties at the time of signing of the contract, or the representations of one party which have been perceived and implicitly accepted by the other party, with regard to the existence or future occurrence of circumstances upon which the intention for contracting of both parties is based.”⁵⁶ According to the collapse of the foundation doctrine, “an uncontrollable change in the circumstances surrounding the contract that leads to a fundamental disequilibrium in the contract and puts an undue burden on the party who had not anticipated and accepted that risk in the contract, justifies an adaptation or termination of that contract.”⁵⁷

This doctrine is based on the idea that the parties’ fundamental aim of contracting cannot be achieved without the existence of a certain environment (e.g. prevailing social and economic order). When this “implied condition” is destroyed by a supervening event, the foundation of the contract is collapsed.⁵⁸ However, the collapse of the foundation is not adequate in itself. The change of circumstance should happen without the fault of either party.⁵⁹ The decisive issue in determining when the performance cannot be expected is the equivalence between the obligations of the parties. However, if one of the parties assumes the risk under the contract or the event is foreseen by the parties under the contract, it cannot be adapted to changed circumstances.⁶⁰ The effect of the application of this doctrine is that the contract is

⁵⁶ 74 BGHZ 37 373

⁵⁷ Horn, *supra* note 16 19

⁵⁸ Puelinckx, *supra* note 37 60

⁵⁹ Maniruzzaman, *supra* note 27 155

⁶⁰ Peter, *supra* note 11 192

either adapted to the change of circumstances or it is terminated when the performance cannot reasonably be expected from the parties.⁶¹

5.3.1.1.5 Conclusion

Exceptions to the sanctity of contract principle are addressed by the frustration doctrine under English law, the impracticability doctrine under US law, the “imprevision” and “fait du prince” doctrines under French law, and the collapse of the foundation of the contract doctrine under German law.

According to the frustration doctrine, the parties are released from performance if an unforeseen event that occurs without the fault of either party results in a physical or legal impossibility of performance. Secondly, enforcing the contract under changed circumstances would amount to enforcing a different contract. The foundation of the contract has gone and frustration of the purpose of the contract occurs.

Physical impossibility occurs when the person or thing the performance depends on is destroyed. Legal impossibility occurs when there is a rule that bans the performance. Frustration of the purpose occurs when the demand of performance under new circumstances would change the performance completely to a different one from the performance originally undertaken by the party. The frustrating event discharges the performance. The contract is terminated. Judges cannot adapt the contract in the event of frustration. However, under the frustration doctrine, mere hardship is not sufficient to discharge performance.

⁶¹ Maniruzzaman, *supra* note 27 155

Under the impracticability doctrine, an unforeseen event that occurs without the fault of either party, non-occurrence of which is a basic assumption of the contract, should render the performance of one of the parties impracticable. While the doctrine of frustration refers to both physical and legal impossibility of performance and frustration of the purpose of the contract, the doctrine of impracticability refers only to the frustration of the purpose of the contract. The result of the impracticability is discharge of the performance.

Under French private law, the sanctity of contract principle is absolute with the exception of force majeure events. Only force majeure events which were not contemplated by the parties and occurred without the fault of either party and that render the performance impossible result in termination of the contract.

Under the administrative contracts doctrine of French law, the parties can be released from performance under the “fait du prince” and “imprevision” doctrines. According to the “fait du prince” doctrine, a government organ can interfere with the contract and can either modify or terminate it due to the changing needs of public service in matters of overriding public interest. Full compensation should be paid to the contractor. Under the “imprevision” doctrine, when the equilibrium of the contract is destroyed as a result of an unforeseen event, the contract is adapted to the new circumstances in order to continue the public service. Compensation is limited to the actual loss.

Under German law, a party is released from performance when the performance of the contract become impossible as a result of an unforeseen event that occurs without the

fault of, and out of the control of, that party. This is close to the *force majeure* doctrine of French law. The other doctrine that releases a party from performance is the collapse of the foundation of the contract doctrine. According to this doctrine, if an unforeseen event occurs without the fault of a party and causes a fundamental change in the circumstances, which results in a fundamental disequilibrium between the performances of the parties, this event destroys the foundation of the contract. The result is adaptation of the contract to the new circumstances.

The conditions for the events that release a party from performance are common to all legal systems although the results of these events vary from one legal system to another. Under all of the doctrines, the event should be unforeseen, unavoidable and occur without the fault of the party that invokes the doctrine. Under the common law doctrines of frustration and impracticability, the result of the occurrence of these events is termination of the contract. Under the *force majeure* doctrine of French private law, the result of the occurrence of the event is termination of the contract. Only in cases where the performance is temporarily impossible can the contract be adapted to new circumstances. However, under the administrative contracts doctrine of the French legal system, the contract can be adapted to new circumstances according to the “fait du prince” and the “imprevision” doctrines. Under the collapse of the foundation of the contract doctrine of German law, the contract is adapted to new circumstances.

Imprevision and the collapse of the foundation doctrines are invoked as a result of an event that results in a hardship situation. However, hardship is not sufficient to invoke the common law doctrines of frustration and impracticability. Compared with civil

law doctrines, common law doctrines set a higher threshold to exempt parties from performance. However, neither of these doctrines are mandatory rules of these legal systems. Therefore, they can be contractually set aside through the drafting of hardship, adaptation and renegotiation clauses that can be invoked when the triggering event occurs.

5.3.1.2 The Law of Treaties and Contract Change

Although the Vienna Convention on the Law of Treaties is applied to treaties between states, through analogy it can be used to derive principles that might be applied to contracts between host states and investors. It can be applied when international law is chosen as the applicable law as well. Moreover, it can be applied to intergovernmental agreements relating to transit pipelines (e.g. the Kirkuk-Ceyhan (Iraq-Turkey) crude oil transit pipeline or the Russia-Ukraine-EU gas transit pipeline, as well as the BTC oil transit pipeline IGA).

Article 26 of the Vienna Convention on the Law of Treaties formulates the *pacta sunt servanda* principle in the following words. “Every treaty in force is binding upon the parties to it and must be performed by them in good faith.” However, Article 61 (supervening impossibility of performance) and Article 62 (fundamental change of circumstances –*rebus sic stantibus*-) principles balance and limit Article 26 (*pacta sunt servanda*) principle.

According to Article 61 (supervening impossibility of performance) of the Convention:

“1. A party may invoke the impossibility of performing a treaty as a ground for terminating or withdrawing from it if the impossibility results from the permanent

disappearance or destruction of an object indispensable for the execution of the treaty. If the impossibility is temporary, it may be invoked only as a ground for suspending the operation of the treaty.

2. Impossibility of performance may not be invoked by a party as a ground for terminating, withdrawing from or suspending the operation of a treaty if the impossibility is the result of a breach by that party either of an obligation under the treaty or of any other international obligation owed to any other party to the treaty.”

The conditions for invoking Article 61 are that performance should become impossible as a result of a supervening event that resulted in the permanent destruction of the object, which was indispensable for the execution of the treaty. The event should not result from any fault or breach of treaty obligations by the invoking party.

According to Article 62 (fundamental change of circumstances) of the Convention:

“1. A fundamental change of circumstances which has occurred with regard to those existing at the time of the conclusion of a treaty, and which was not foreseen by the parties, may not be invoked as a ground for terminating or withdrawing from the treaty unless:

- (a) The existence of those circumstances constituted an essential basis of the consent of the parties to be bound by the treaty; and
- (b) The effect of the change is radically to transform the extent of obligations still to be performed under the treaty.”

2. A fundamental change of circumstances may not be invoked as a ground for terminating or withdrawing from a treaty:

- (a) If the treaty establishes a boundary; or
- (b) If the fundamental change is the result of a breach by the party invoking it either of an obligation under the treaty or of any other international obligation owed to any other party to the treaty.”

The *rebus sic stantibus* principle is very strictly formulated in the Convention. First, the party should not have foreseen the change. Secondly, the change should destroy the basis of the consent of the parties and it should radically transform the agreement to the extent that it would be a different one from the one originally agreed upon. Thirdly, the change of circumstances should not occur as a result of the fault of the invoking party or the breach of an obligation by that party under treaty or international law. Although the principle has never been applied in court practice, it

is a relevant principle of treaty law and constitutes an exception to the *pacta sunt servanda* principle.

The Article 62 (fundamental change of circumstances) principle is nearly identical to the “frustration of purpose”, “impracticability” and “collapse of the foundation” doctrines of comparative law. All of these doctrines release the party from performance or enable the parties to adapt the contract when an implied term in the contract is breached by a supervening event. Horn argued that under the *rebus sic stantibus* (fundamental change of circumstances) principle

“...performance was still possible but a fundamental change in the circumstances surrounding the contract had rendered performance much more burdensome so that continued contractual liability appeared as an unfair hardship for the assert that the contract contained an implied term (clausula) that certain important circumstances must remain unchanged (sic stantes).”⁶²

The International Court of Justice (ICJ) in the Fisheries Jurisdiction Case stated the relevance and significance of the principle. The tribunal asserted that

“(i)nternational law admits that a fundamental change in the circumstances which determined the parties to accept a treaty, if it has resulted in a radical transformation of the obligations imposed by it, may under certain conditions, afford the party affected a ground for invoking the termination or suspension of the treaty. This principle and the conditions and exceptions to which it is subject, have been embodied in Article 62 of the Vienna Convention on the Law of Treaties.”⁶³

The ICJ interpreted the *rebus sic stantibus* principle restrictively. In the Gabcikovo-Nagymaros case, Hungary claimed that a change of circumstances (e.g. the collapse of socialism and the independence of Slovakia, the development of new international environmental rules and the diminishing economic value of the project) constituted grounds for withdrawal from the treaty. However, the tribunal stated that it did not

⁶² Horn, *supra* note 16 17

⁶³ Fisheries Jurisdiction Case (Federal Republic of Germany v. Iceland) (1973) ICJ Reports 19 para 36.

“consider that new developments in the state of environmental knowledge and environmental law can be said to have been completely unforeseen...The changed circumstances advanced by Hungary are, in the Court’s view, not of such a nature, either individually or collectively, that their effect would radically transform the extent of the obligations still to be performed in order to accomplish the project. A fundamental change of circumstances would have been unforeseen; the existence of circumstance at the time of the Treaty’s conclusion must have constituted an essential basis of the consent of the parties to be bound by the Treaty.”⁶⁴

The principles of the Vienna Convention can be applied to intergovernmental agreements of transit pipelines. However, given the restrictive interpretation of these principles by the courts in cases where these principles have been invoked, there is little chance of applying these principles in practice.

5.3.1.3 Customary International Law and Soft Law

A rule should have two elements in order to be part of customary international law. These elements are “general state practice” and “*opinio juris et necessitatis*”. The state practice should be general. However, a universal practice is not required. The practice of all the states that are specifically affected by the rule in question is adequate. In order to establish “*opinio juris et necessitatis*” the general practice should be accepted as law. It should be recognized by states as obligatory. The practice should be consistent with prevailing international law.⁶⁵ In North Sea Continental Shelf cases, the ICJ stated that

“...an indispensable requirement would be that within the period in question, short though it might be, State practice, including that of States whose interests are specially affected, should have been both extensive and virtually uniform in the sense of the provision invoked; -and should moreover have occurred in such a way as to show a general recognition that a rule of law or legal obligation is involved.”⁶⁶

⁶⁴ Gabčíkovo-Nagymaros Project Case (Hungary v. Slovakia) 37 ILM 1998 162 para 104

⁶⁵ Brownlie, *supra* note 28 7-9

⁶⁶ North Sea Continental Shelf Cases (Federal Republic of Germany v. The Netherlands) (1969) ICJ Reports 43

The required conditions for creating a rule of customary international law were also further clarified by the ICJ in the case of *Nicaragua v. United States*.⁶⁷

The United Nations (UN) General Assembly Resolution 1803 of 1962 on permanent sovereignty over natural resources (PSONR), Resolution 3171 of 1973 on PSONR and Resolution 3281 of the 1974 Charter of Economic Rights and Duties (CERD) all dealt with, to a certain extent, the law that can be applied to investment, in particular petroleum contracts. In order to clarify whether these resolutions reflect the state of customary international law in this field, it should be analyzed whether these resolutions possess the two requirements of “general state practice” and “*opinio juris necessitatis*”.

Resolution 1803 on PSONR is accepted as part of customary international law because of its universal recognition by the states of all representative groups.⁶⁸ However, the situation is different for Resolution 3171 on PSONR and Resolution 3281 of the CERD, since they were accepted mainly by developing countries while being opposed by developed countries. Therefore, they cannot provide the requirement of general state practice. However, they constitute part of soft law, though not part of customary international law “... since the lack of support of one major political and economic group, the industrialized countries, demonstrates the

⁶⁷ The ICJ stated that “In considering the instances of the conduct above described, the Court has to emphasize that, as was observed in the *North Sea Continental Shelf* cases, for a new customary rule to be formed, not only must the acts concerned “amount to a settled practice”, but they must be accompanied by the *opinio juris sive necessitatis*. Either the States taking such action or other States in position to react to it, must have behaved so that their conduct is “evidence of a belief that this practice is rendered obligatory by the existence of a rule of law requiring it. The need for such a belief, i.e. the existence of a subjective element, is implicit in the very notion of the *opinio juris sive necessitatis*.” See, *Nicaragua v. United States Case (Merits)* (1986) ICJ Reports 108-109 para 207.

⁶⁸ See *Texaco Overseas Petroleum Company v. The Government of Libyan Arab Republic*, 17 ILM 1978

absence of general consensus necessary to transform these instruments into binding international law.”⁶⁹

The UN General Assembly Resolutions mentioned above mostly address the problem of expropriation. They have nevertheless included some provisions that are relevant to the matter of contract change. UN Resolution 1803 on PSONR, which is part of customary international law and binding, states that “(f)oreign investment agreements freely entered into by, or between, sovereign States shall be observed in good faith.”⁷⁰ A right to renegotiation might be established through Article 2 of CERDS that states “(e)very State has and shall freely exercise full permanent sovereignty, including possession, use and disposal, over all its wealth, natural resources and economic activities.”⁷¹ The approach of developing countries can be interpreted as sovereignty permits the restructuring of contracts.

The conditions that are required to make a UN resolution a rule of customary international law are also required to make decisions or declarations of international organizations, such as OPEC and OECD, a rule of customary international law. Although they include renegotiation clauses or recommendations for renegotiation, OPEC Resolution XVI of “Declaratory Statement of Petroleum Policy in Member States”⁷², the OECD Guidelines for Multinational Enterprises and the UN Draft Code

⁶⁹ Peter, *supra* note 11 180

⁷⁰ General Assembly Resolution of 1962 on Permanent Sovereignty over Natural Resources in I Brownlie (ed.), *Basic Documents in International Law* (OUP 5th ed., 2002) 176

⁷¹ Article 2 of the CERD, in *ibid* 183

⁷² The OPEC Declaration stated that “(n)otwithstanding any guarantee of fiscal stability that may have been granted to the operator, the operator shall not have the right to obtain excessively high earnings after taxes. The financial provisions of contracts which actually result in such excessively high earnings shall be open to renegotiation.” 7 ILM1968 1183

of Conduct on Transnational Corporations⁷³ do not have the requirement of general state practice and *opinio juris*. Therefore, they cannot be regarded as part of customary international law.⁷⁴ However, they at least demonstrate the views of developing countries or petroleum exporting countries on contract change.

5.3.2 The Reality in Practice: Forced Renegotiations and the Need to Legalize Renegotiation

The driving forces of renegotiation in practice are economic and political conditions rather than legal provisions. When there is a fundamental change in the economic circumstances underlying the contract or when there is a fundamental shift in the policy considerations of the host state, renegotiation might take place not only in the absence of a renegotiation clause but also when there are no legal grounds for renegotiation under the applicable law of the contract.⁷⁵

The long-term nature of transit pipeline agreements includes in itself potential conflicts due to the contingencies and changing circumstances caused by the time element. However, even in the event of forced renegotiations, the legal provisions situated in the contract and applicable law might strengthen the investors' bargaining power during the renegotiations, even though the bargaining power of the host state is

⁷³ The Draft Code stated that, "(a) Contracts and agreements between Governments and transnational corporations should be negotiated and implemented in good faith. In such contracts or agreements, especially long-term ones, review or renegotiation clauses should normally be included. (b) In the absence of such clauses and where there has been a fundamental change of circumstances on which the contract or agreement was based, transnational corporations acting in good faith, should cooperate with Governments for the review or renegotiation of such contract or agreement Draft Code of Conduct on Trans-national Corporations, <http://www.unctad.org/sections/dite/ia/docs/Compendium//en/13%20volume%201.pdf> last accessed 8 September 2012

⁷⁴ Peter, *supra* note 11 177

⁷⁵ *ibid*, 225

increased due to the hostage status of the investment. Bargaining –negotiations- always take place in the shadow of law.⁷⁶

The long-term nature of investment contracts makes them unsuitable for the strict application of the rigid rules of domestic laws on contract change. These rules deal with transactions that are mostly over the counter, short-term and between parties that have roughly equal bargaining power. The static model is more suitable for short-term transactions. It is not appropriate for long-term transactions given their dynamic nature. Therefore, contracts should reflect the dynamic nature of long-term investments through including a clause that enables parties to accommodate changes in economic circumstances and maintain the economic equilibrium of the contract.⁷⁷ Moreover, insisting on a strict interpretation of the sanctity of contract principle is contradictory to the realities of the drafting process and the special features of investment contracts. Unlike commercial contracts, in investment contracts one of the parties is a state or a state entity and does more than merely act in a profit oriented manner. It has to take into account the public interest, which cannot be neglected.⁷⁸

Asante argued that

“(m)ost juristic writing in this area has suffered from excesses of formalism and has failed to address itself to the crucial issues of a practical and functional character which beset the economic and legal relations between host governments and transnational corporations. A basic flaw in the approach of many jurists derives from the valiant attempt to analyze the intricate problems posed by the transnational contract, a highly complex phenomenon, by reference to some tidy and simplistic doctrine of international law or municipal law, which has little or no relevance to such a transaction.”⁷⁹

⁷⁶ *ibid*, 203

⁷⁷ Puelinckx, *supra* note 37 53; Sornarajah, *supra* note 21 100-102

⁷⁸ Kröll, *supra* note 24 466

⁷⁹ Asante, *supra* note 10 407

The sanctity of contract principle is constantly challenged by the realities of economic conditions. Despite the very restrictive doctrines (e.g. frustration, impracticability, imprevision, or collapse of the foundation of the contract) under applicable laws, an appeal to changed circumstances that does not fit into the above doctrines can be a starting point for a contract renegotiation provided that the economic and political structure of the investment environment and bargaining power of the party support the renegotiation.⁸⁰

At least in legal terms, without a provision in the contract for that purpose, a contract cannot be adapted to new circumstances, or terminated based on the argument that the contract has lost its economic equilibrium.⁸¹ Given the inherent contingencies of long-term contracts, a certain degree of flexibility is a second imperative for the required contractual stability that parties should seek during the contracting. These imperatives of stability and flexibility can be balanced through including a clause that enables parties to renegotiate key elements of an investment agreement upon the occurrence of certain events.⁸²

Berger argued that “(t)oday, one can observe a trend to move away from a contractual model which is static and complete at the time of conclusion and thus unalterable and towards a contractual understanding which is dynamic and therefore unavoidably accepts interference by the parties or by third parties that they have authorized.”⁸³

Moreover, in an empirical work conducted as part of a recent study, it was reported

⁸⁰ Sackey, *supra* note 11 517

⁸¹ Puelinckx, *supra* note 37 53

⁸² J W Salacuse, “Renegotiating International Project Agreements” (2000-2001) 24 *Fordham International Law Journal* 1319, 1327

⁸³ K P Berger, “Renegotiation and Adaptation of International Investment Contracts: The Role of Contract Drafters and Arbitrators” (2003) 36 *Vanderbilt Journal of Transnational Law* 1347, 1377

that the 70% of industry players commented that renegotiation should happen when circumstances change substantially.⁸⁴ However, while 74% of the respondents argued that renegotiation is useful as a means of protecting a petroleum contract from unilateral state action, 56% of the respondents agreed on the effectiveness of renegotiation clauses in contract practice.⁸⁵

Given the realities of the process and the lifetime of transit pipeline projects, it is in the interest of the parties to design a renegotiation or adaptation clause that legalizes and proceduralizes the renegotiation through setting clearly determined triggering events, the extent of contract change and the consequences of failed renegotiations. In the next section, the contractual clauses that require renegotiation are classified and analyzed according to the extent of contract change. The procedural aspects of renegotiation are addressed in the last section of this chapter, since they are common to all types of clauses that require renegotiation.

5.4 Contractual Forms of Renegotiation

5.4.1 Adaptation Clauses

Adaptation clauses are designed either for filling the gaps in or adjusting the specific terms or provisions of a contract. They relate to events that have been anticipated by the parties but whose details are unknown or uncertain at the time of concluding the contract. Therefore, these clauses are intended either to specify the details of filling the gaps or to modify the contract slightly.⁸⁶ An adaptation clause allows contract changes through adopting an automatic formula or a predetermined pattern in the

⁸⁴ Erkan, *supra* note 7 169

⁸⁵ *ibid* 183-184

⁸⁶ Horn, *supra* note 6 122

clause.⁸⁷ By means of a stipulated formula, such clauses provide for automatic adjustment of the financial or fiscal aspects of the agreement to new situations.⁸⁸ The particular feature of adaptation clauses is that the “...contract contains a clear directive on how the rights and obligations of each party change under certain conditions.”⁸⁹ However, they do not require any substantial departure from the original contract.⁹⁰

Adaptation clauses might be used to specify the payment obligations under investment contracts. They link the payment of a price or royalty to an index or a formula to reflect a change in circumstances.⁹¹ Adaptation clauses aim to provide flexibility without the inherent risks of renegotiation. However, renegotiation might take place in order to apply the adaptation formula to the unanticipated events or when the index becomes inappropriate or disappears.⁹² These clauses are best suited to the intervention of a third party, since they include a precise formula and the change does not amount to rewriting the agreement.

Adaptation clauses qualify as examples of built-in flexibility. They can be found in construction contracts (e.g. the quantity of work might not be feasible in advance and it might be adapted according to FIDIC rules) or in loan agreements (e.g. the interest rates adjusted annually according to the London inter bank offered rate –LIBOR).⁹³ Adaptation might take place through invoking price review clauses that require the

⁸⁷ W Peter, “Arbitration and Renegotiation Clauses” (1986) 3 JIA 29, 29

⁸⁸ Asante, supra note 10 417

⁸⁹ M Bartels, *Contractual Adaptation and Conflict Resolution* (Kluwer 1985) 27

⁹⁰ Peter, supra note 11 232-233

⁹¹ Kröll, supra note 24 438

⁹² Salacuse, supra note 82 1332

⁹³ For details see Horn supra note 6 112-119

adaptation of prices and conditions of payment according to some objective standard (e.g. a cost index for a certain commodity).⁹⁴

Further examples of adaptation clauses can be found in long-term gas sales contracts (the price of gas is determined according to the formula adopted in the contract), or indexation clauses in upstream and midstream petroleum contracts such as transit pipeline agreements. According to these clauses, royalties, taxes or transit fees are indexed to the price of the commodity or to some objective standard such as the consumer price index or inflation rate of a certain country. Examples of these latter clauses can be found in Iraq-Turkey (Kirkuk-Ceyhan) crude oil transit pipeline, in which the transit fee charged by Turkey is indexed to the US consumer price index.⁹⁵ In the CPC oil transit pipeline agreement, transit tariffs are linked to the US consumer price index.⁹⁶ In the South Caucasus Gas Pipeline contract, the transit fee charged by Georgia was determined as being 5% of the amount of gas that is transported.⁹⁷

These kinds of linkage or index clauses are regarded as being examples of flexibility that provide for the smooth operation of a transit pipeline without experiencing problems.⁹⁸ On the other hand, transit pipeline agreements that adopted fixed transit fees, such as the BTC oil transit pipeline, have been the subject of disputes. However, this particular dispute was resolved through renegotiation and the renegotiated

⁹⁴ K H Bockstiegel, "Hardship, Force Majeure and Special Risk Clauses in International Contracts" in *Adaptation and Renegotiation of Contracts in International Trade and Finance* (N. Horn ed, Kluwer 1985) 163

⁹⁵ 2010 Intergovernmental Renewal Agreement Article 4.2 www.tbmm.gov.tr last accessed 6 September 2012

⁹⁶ CPC Restructuring and Shareholders Agreement Article 8 Barrows Collection Russia and NIS Section, Supplement 45

⁹⁷ Stevens supra note 1

⁹⁸ *ibid*

contract includes an adaptation clause for operating fees as analyzed in detail in the following chapter.

A hardship clause might exist alongside the adaptation clause. It can be invoked when the adaptation formula becomes meaningless. The adaptation formula can then be renegotiated. These kinds of renegotiations were experienced in the EDF-Shell case, in which the adaptation clause for the gas price obsolesced after the 1973 petroleum crisis, and in Nippon-steel case, where the adaptation clause for the price became meaningless under new economic circumstances.⁹⁹

5.4.2 Renegotiation Clauses

Renegotiation clauses provide that, on the occurrence of specific events, the parties should renegotiate either certain parts of an agreement or the whole agreement to address the effects of a change in circumstances. Under these clauses, renegotiation is regarded as a legitimate activity while the parties are bound by the agreement.¹⁰⁰

Renegotiation clauses require efforts by both parties to adjust the contract to changing circumstances through a material change of its terms. Although the required process – renegotiation- is identical to where there be an adaptation clause, it departs substantially from the latter case in terms of the extent of contract change. It requires a material change of the contract through the setting aside of important clauses of the original contract. Moreover, a renegotiation clause is more focused on the procedure

⁹⁹ For details of these cases see M R Firouzmand, “Changed Circumstances and Immutability of Contracts: A Comparative Analysis of Force Majeure and Related Doctrines” (2007) 8 Business Law International 161; Kröll, supra note 24 438

¹⁰⁰ Salacuse, supra note 82 1321

than on the result. It requires cooperation of the parties to adjust the contract to the new circumstances, not the reaching of new terms through a precise formula.¹⁰¹

Renegotiation clauses are distinguished from adaptation clauses by the fact that contract adaptation is not conducted automatically but as a result of agreement between the parties.¹⁰² Moreover, such clauses can be applied to any part of a contract. Only the parties themselves can limit their scope. This is in contrast to the inherent limitation that exists in adaptation clauses.¹⁰³ However, in any case, they should provide the criteria to which the parties should refer when reviewing their contract. The aim and extent of contract change should be stated through objective standards, such as maintaining or restoring the economic equilibrium, or through subjective standards, such as fairness or equity.¹⁰⁴

These clauses relate to future contingencies, which might bring about a fundamental change in the foundations of the contract.¹⁰⁵ They provide the parties with the opportunity to meet and agree on the new conditions in order to restore the contractual equilibrium when the predetermined triggering events occur.¹⁰⁶ The parties decrease the risk of dispute and unilateral termination of the contract through envisaging the manner in which their contract will evolve in the future.¹⁰⁷

¹⁰¹ Horn, *supra* note 2 9

¹⁰² Kröll, *supra* note 24 439

¹⁰³ L Russi, "Chronicles of a Failure: From a Renegotiation Clause to Arbitration of Trans-national Contracts" (2008-2009) 24 Connecticut Journal of International Law 77, 80

¹⁰⁴ *ibid* 84

¹⁰⁵ Horn, *supra* note 6 122

¹⁰⁶ Sornarajah, *supra* note 21 108

¹⁰⁷ Z A Qurashi, "Renegotiation of Petroleum Agreements" (2005) 22 JIA 261, 261

The necessary flexibility in long-term contracts can be provided not only through a classic renegotiation clause but also through creation of a joint venture where the decisions are taken at the board or shareholders meetings.¹⁰⁸ The legal arrangement for the CPC oil transit pipeline is in the form of joint-venture agreement. Under this agreement, any decision relating to the operation of the pipeline and to change in the provisions of the agreement should be taken by a vote of all of the parties.¹⁰⁹ Although the requirement of a vote by all the parties might seem rigid, it might force the parties to agree to new offers: a party might subject his acceptance of an offer of the other party to the acceptance of his offer by that party. The operation of this pipeline is analysed in Chapter 6, which deals with case studies. A review clause is contained in the WAGP International Project Agreement. The review clause states that “(t)he Parties shall meet at least every 5 years following the execution of this Agreement to review the implementation of this Agreement and to consider whether any amendments to the Agreement should be made.”¹¹⁰

5.4.3 Hardship Clauses

A fundamental change of circumstances can result in situations where the performance of the contract becomes either impossible or more burdensome for one of the parties. While the impossibility of performance is addressed by a *force majeure* clause, a hardship situation that renders the performance more burdensome, although still possible, is addressed by a hardship clause.¹¹¹ A hardship clause deals with situations where an unforeseen event that is out of the control of either party

¹⁰⁸ Horn, supra note 6 at 117

¹⁰⁹ CPC Restructuring and Shareholder Agreement, supra note 96 Article 8.1.4

¹¹⁰ WAGP International Project Agreement Article 53.1 www.wagp.com last accessed 6 September 2012

¹¹¹ Horn, supra note 16 16; Horn, supra note 6 131

fundamentally destroys the contractual equilibrium to an extent that exceeds the limits of sacrifice and an excessive economic burden is put on a party.¹¹²

A fundamental change in economic circumstances might occur in such a way that either the cost of the performance by one party increases substantially or the value of the performance received by a party diminishes substantially.¹¹³ This can be defined as covering cases where “at the time of concluding the contract, both parties proceeded on the basis of an equal distribution of profits, but subsequent developments meant greater benefits for one side.”¹¹⁴

The essential requirements for an event to constitute hardship are “first they must have arisen beyond the control of either party; self-induced hardship is irrelevant. Secondly, they must be of fundamental character. Thirdly, they must be entirely unanticipated and unforeseeable. These criteria make it clear that the hardship concept is very similar, if not identical, to that of frustration.”¹¹⁵ However, the parties can circumvent the strict rules of frustration through the design of a hardship clause.¹¹⁶ Hardship clauses are special type of renegotiation clauses. Although the events that trigger renegotiation clauses cannot be limited to hardship situations, beyond the above-mentioned restrictive standards, hardship clauses possess all the features of renegotiation clauses with regard to procedure and sanctions.¹¹⁷

¹¹² Bockstiegel, *supra* note 94 159; Qurashi, *supra* note 107 281

¹¹³ Definition of Hardship, *Unidroit Principles on International Commercial Contracts* 34 ILM 1995

¹¹⁴ Bartels, *supra* note 89 56

¹¹⁵ C M Schmitthoff, “Hardship and Intervener Clauses” (1980) *Journal of Business Law* 85

¹¹⁶ Sornarajah, *supra* note 21 109

¹¹⁷ Peter, *supra* note 87 34

Although the prevailing contractual practice reflects that a fundamental change in the equilibrium of the contract which results in a substantial imbalance between performances is required for an event to constitute hardship (e.g. the performance is only possible at a multiple of the anticipated cost and with the possible ruin of one of the parties), the parties can draft clauses that include less dramatic situations. The events that constitute hardship depend on the wording of the clause;¹¹⁸ otherwise, the events that render performance onerous but not excessively burdensome for a party cannot create a hardship situation, since courts cannot interfere just because bad bargains that were made by the parties.¹¹⁹ Beneath the level of excessively burdensome performance, parties can only overcome the sanctity of contract principle through drafting a renegotiation clause to address unfavourable commercial changes.¹²⁰

The particular case of windfall profits does not constitute hardship, since no harm is done to the other party. Envy cannot create hardship. On the other hand, a contractual relationship that creates exorbitant and unexpected profits for one party while the other has no way of benefitting from this situation can hardly survive. In the case of windfall profits, renegotiation can occur even in the absence of a relevant clause.¹²¹ A transit pipeline is part of an economic chain that includes upstream, midstream (transit) and downstream projects. Therefore, if transit fees are linked to a certain percentage of the commodity or to the price of the commodity, the chance of an uninterrupted transit without disputes might increase.

¹¹⁸ Horn, *supra* note 6 132-136

¹¹⁹ Qurashi, *supra* note 107 284

¹²⁰ Berger, *supra* note 83 1354-1355

¹²¹ Horn, *supra* note 6 136

In addition to a list of events that constitute hardship, a general definition of hardship might be essential for guidance in a hardship clause.¹²² The result of a hardship event is the adaptation of the contract to new circumstances. If the parties cannot agree on contract adaptation, the court or arbitrator can adapt the contract, provided that the applicable law and the wording of the clause permit it.¹²³ It is essential in a hardship clause to state the threshold for activating the clause and how the parties should readjust the contractual terms when the economic balance is destroyed.¹²⁴ The International Institute for the Unification of Private Law (UNIDROIT) Principles of International Commercial Contracts (ICC) define hardship and its effects.¹²⁵

The commentary on the UNIDROIT Principles of ICC states that a fundamental alteration of equilibrium occurs where the contract can be performed only at a cost that amounts to 50% or more of the costs or there is a 50% decrease in the value of the original performance.¹²⁶ However, contrary to practice in long-term commercial

¹²² *ibid* 133

¹²³ Peter, *supra* note 11 237

¹²⁴ Puelinckx, *supra* note 37 53-54

¹²⁵ UNIDROIT Principles of International Commercial Contracts, *supra* note 113 1067

Article 6.2.2 - Definition of Hardship

There is hardship where the occurrence of events fundamentally alters the equilibrium of the contract either because the cost of a party's performance has increased or because the value of the performance a party receives has diminished, and

(a) the events occur or become known to the disadvantaged party after the conclusion of the contract;

(b) the events could not reasonably have been taken into account by the disadvantaged party at the time of the conclusion of the contract;

(c) the events are beyond the control of the disadvantaged party; and

(d) the risk of the events was not assumed by the disadvantaged party.

Article 6.2.3 - Effects of Hardship

(1) In case of hardship the disadvantaged party is entitled to request renegotiations. The request shall be made without undue delay and shall indicate the grounds on which it is based.

(2) The request for renegotiation does not in itself entitle the disadvantaged party to withhold performance.

(3) Upon failure to reach agreement within a reasonable time either party may resort to the court.

(4) If the court finds hardship it may, if reasonable,

(a) terminate the contract at a date and on terms to be fixed; or

(b) adapt the contract with a view to restoring its equilibrium

¹²⁶ *ibid*

contracts, petroleum industry contracts do not usually include hardship clauses. This is due to the fact that, first, *force majeure* clauses are sometimes drafted broadly to include hardship situations. Secondly, the clauses in the contract that adopt a flexible fiscal system in order to address windfall profits eliminate the need for hardship clauses. Thirdly, the imprecise nature of triggering event in hardship clauses can provide some discretion for the host state.¹²⁷

5.4.4 Force Majeure Clauses

Force majeure clauses address future events that are beyond the control of the parties. They should be unavoidable and unforeseen at the time of contracting and render the performance of the contract either temporarily or permanently impossible.¹²⁸ The conditions for an event to constitute *force majeure* (unforeseeable, unavoidable, external nature and impossibility of performance) might have different meanings under different applicable national laws. Therefore, the definition of these conditions should be provided in the clause for clarity.¹²⁹

Force majeure events are caused by “acts of God” or by other external events that result in impossibility of performance rather than by events that are economic in character and change the contractual balance.¹³⁰ A typical *force majeure* clause consists of two parts. The first part includes the various types of events that constitute *force majeure*. The second part is a general clause that operates as a safety net to include the events that are not listed such as “any other contingency whatsoever

¹²⁷ A Faruqie, *Stability in Petroleum Contracts: Rhetoric and Reality* Unpublished PhD Thesis (CEPMLP 2006) 152

¹²⁸ Bockstiegel, *supra* note 94 159-160; Peter, *supra* note 11 235

¹²⁹ M R Firouzmand, “Force Majeure Clause in Long-Term Petroleum Contracts” (2006) 24 JENRL 423, 426

¹³⁰ Qurashi, *supra* note 107 284

beyond the control of either party.”¹³¹ *Force majeure* clauses usually contain a list of events that constitute force majeure. The list of *force majeure* events might be either explanatory or exclusionary in character (e.g. excluding one of the conditions for *force majeure*, such as unforeseeability). For instance, although it is at least theoretically foreseeable in Bangladesh, flood can be made a *force majeure* event.¹³² It was argued that the *force majeure* clause should be interpreted through focussing on whether the parties contemplated the event and made it part of a risk distribution among them rather than focussing on the foreseeability of the event.¹³³ Although *force majeure* clauses are inspired by the common law concept of frustration and the French concept of *force majeure*, the parties might widen the narrow scope of these concepts.¹³⁴

The result of the occurrence of a *force majeure* event is either termination of the contract (permanent impossibility) or suspension of the performance (temporary impossibility). However, termination of the contract is a remedy of a last resort. Therefore, when the effect of the event is temporary, an adaptation is required for the survival of the contract. No party can claim damage for such termination.¹³⁵

The main aim of a *force majeure* clause is exempting the affected party from performance of the contract and relieving that party from contractual liability. The clause might obligate the parties to renegotiate to continue the contractual relationship, particularly in cases where the suspension continued for longer than expected. The parties can either adapt the affected parts of the contract or adapt the

¹³¹ Murray, supra note 31 135

¹³² Firouzmand, supra note 129 428

¹³³ Horn, supra note 6 134

¹³⁴ Sornarajah, supra note 21 109

¹³⁵ ibid 137

contract completely. Renegotiation is expressly provided for by the *force majeure* clause of a Vietnam PSA, which states that “if the cause of the force majeure is not removed within twelve months, the Parties shall enter into negotiations in good faith to discuss the continuance of this Contract.”¹³⁶ Given the complexity of the contract and financial burdens already incurred by the parties, an investment contract is ill suited for termination and should be renegotiated if the performance is possible after removal of the *force majeure* effect.¹³⁷

The CPC oil transit pipeline agreement includes a clause named “contingencies” that covers both *force majeure* and hardship situations.¹³⁸ According to this clause, an event should not have to be unforeseen to constitute either *force majeure* or hardship (contingency). Therefore, it excludes the condition of unforeseeability. Moreover, the events that constitute *force majeure* are listed in the clause. These events are: the classic force majeure events (e.g. war, civil disturbance, natural disasters (fire, flood, earthquake), labour strike and acts of God), as well as the failure of governments to grant right of way for the pipeline route and to grant the necessary licences. The result of the occurrence of a *force majeure* is suspension of performance for a determined time. If the force majeure continues after this time, the contract will be terminated.

The contingency clause includes events that result in severe economic disruption of the project (e.g. a major long-term decrease in crude prices), which would normally qualify as a hardship situation. However, the contract requires, first, suspension of

¹³⁶ Quoted in Firouzmand, supra note 129 436

¹³⁷ Berger, supra note 83 1352

¹³⁸ CPC Restructuring and Shareholders Agreement supra note 96 Article 11.12

performance and, secondly, the termination of the contract if the situation continues for longer than 24 months, which is the normal remedy for *force majeure* situations. Therefore, the clause qualifies as a hybrid clause that includes elements of both *force majeure* and hardship.

5.5 The Procedural Aspects of Renegotiation

In all types of contractual forms of renegotiation, the parties should pay particular attention to the following matters and clearly define them while drafting a clause that requires renegotiation. These are: the events that trigger renegotiation, the content of the contractual obligations, the consequences of the non-fulfillment of the contractual obligations in the event of a failure of the parties to agree on contract change, whether the contract and/or applicable law provide the basis for arbitrators to adapt the contract and the extent of contract change.¹³⁹ This section addresses all of these procedural aspects of renegotiation that are common to all types of clauses that require renegotiation.

5.5.1 Triggering Events

Triggering events are specific events that are stated in the clause and on whose occurrence in the future the affected party is entitled to invoke the renegotiation clause and make a request for renegotiation to the other party. For a renegotiation clause to be efficient, triggering events and the criteria that have to be met for an event to trigger renegotiation should be defined clearly.¹⁴⁰ However, envisaging all of the possible triggering events that might occur in the future is not an easy task. The

¹³⁹ P Bernardini, “Stabilization and Adaptation in Oil and Gas Investments” (2008) 1 JWELB 98, 103; J Y Gotanda, “Renegotiation and Adaptation Clauses in Investment Contracts: Revisited” (2003) 36 Vanderbilt Journal of Transnational Law 1461, 1473; Berger, *supra* note 83 at 1361.

¹⁴⁰ Qurashi, *supra* note 107 288-290

parties might not foresee these events during the conclusion of the contract due to the contingencies caused by the long-term nature of the contract. Therefore, the renegotiation clause might take the form of a general review clause. Nevertheless, according to the type of contract, the parties might define certain triggering events such as a change in the price of certain raw materials (adaptation clause), or a fundamental change in the economic equilibrium of the contract as a result of an economic event (hardship clause) or a change in law that results in a change in the economic equilibrium of the contract (negotiated type of economic equilibrium clause) or specific risks that are likely to occur in the future (renegotiation clause).¹⁴¹

If the clause does not state triggering events clearly, it may result in a vague renegotiation clause that might not obligate a party to renegotiate due to the unclear triggering events. An example of this type of renegotiation clause can be found in the OK Tedi Papua New Guinea Concession Agreement in the following terms: “(t)he 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.”¹⁴²

While the triggering events are well defined in adaptation clauses (e.g. a change in the price of a commodity), in renegotiation clauses the triggering events are usually not as clearly defined as in adaptation clauses. They generally refer to a certain time when the review of the existing contract is required or to a particular change in circumstances, such as the Aminoil clause that defines a change in other contracts in a particular region as a triggering event. In various types of hardship clauses, the triggering event is a fundamental change in the economic equilibrium of the contract.

¹⁴¹ Berger, *supra* note 83 1362

¹⁴² OK Tedi PNG Concession Agreement, quoted in Nassar *supra* note 3 175

This is very broad and so the notion of hardship has no clearly defined and generally accepted meaning.¹⁴³

When a change in the economic equilibrium of the contract is defined as being a triggering event, the parties usually do not define what amounts to change in the economic equilibrium and who will determine that. The parties should not start renegotiations on flimsy grounds. Economic equilibrium should be severely distorted to initiate a renegotiation process. As already noted above, UNIDROIT principles of ICC require at least a 50% increase in the cost of performance or a similar decrease in the value of the performance as a result of an event in order to constitute a fundamental alteration of the economic balance of the contract.

If the triggering event is undefined or not defined clearly enough, such as a “profound change in circumstances existing at the time of contracting” or “when the agreement is not continuing to operate fairly to each of the parties”, these provisions are open to broad interpretation. They might result in an open-ended clause.¹⁴⁴ Therefore, “(t)o be recognized legally, a revision clause has to be precisely worded so as to impose a sufficiently clear and defined duty. Vaguely worded clauses...impose no legal obligation.”¹⁴⁵

On the other hand, if the triggering event is defined as being the passage of a certain length of time, the host country will find it hard to justify renegotiations before that time.¹⁴⁶ Defining the triggering event as being some definite time in the future, such

¹⁴³ Kröll, *supra* note 24 444-445

¹⁴⁴ Peter, *supra* note 87 32-33

¹⁴⁵ Nassar, *supra* note 3 176-177

¹⁴⁶ Bartels, *supra* note 89 66

as the time of investment recovery, makes renegotiation certain and inevitable. These kinds of clauses differ from the hardship clauses that require a fundamental change in the economic equilibrium of the contract, the occurrence of which is a more remote possibility than the lapse of a certain length of time or of investment recovery.

What will happen if the triggering event is under the control of the state party? For instance, can a state company claim for *force majeure* and can it be released from performance due to the acts of a public authority? The principle of separation between the state and the state enterprise is respected unless there is adequate evidence demonstrating that the company is not independent of the government, or the contract expressly contemplates that government action and states that the state enterprise is responsible for certain acts of the state.¹⁴⁷ However, it was asserted that

“...even when the contract was not made with the state directly, but instead with a government corporation, as is common in natural resources exploration. These corporations are denied reliance on the contractual force majeure clause because, in a fashion similar to piercing the corporate veil, they are regarded as an integral component of the state, which is responsible for the change of conditions in the host country.”¹⁴⁸

5.5.2 The Duty to Negotiate in Good Faith

On the occurrence of a triggering event, the party affected by that event is entitled to request renegotiation, while the other party is under an obligation to renegotiate in good faith.¹⁴⁹ Good faith is a general and abstract concept that is not easy to define. At a higher level of abstraction it might be understood as a moral principle that reflects good senses such as honesty, fairness, equity, reasonableness and fair dealing.¹⁵⁰ “It

¹⁴⁷ Qurashi, supra note 107 283, Bockstiegel, supra note 94 46

¹⁴⁸ Berger, supra note 83 1352

¹⁴⁹ Peter, supra note 87 37-38; Qurashi, supra note 107 291; Nassar, supra note 3 177

¹⁵⁰ L C Arenas and A F M Maniruzzaman, “Cooperation as a Philosophical Foundation of Good Faith in International Business Contracting: A View through the Prism of Transnational Law” (2012) Oxford

consists of honesty in a party's contractual behaviour, or loyalty to, or collaboration with other party."¹⁵¹ Good faith is a framework for the relationship between the parties to a contract. Cooperation is the main vehicle to maintain good faith. The content of good faith is determined according to the particular context instead of depending on the abstract concept.¹⁵² Whittaker and Zimmermann argued that

“(i)t suggest a standard of honest, loyal and considerate behaviour, of acting with due regard for the interests of the other party, and it implies and comprises the protection of reasonable reliance. Thus, it is not a legal rule with specific requirements that have to be checked but may be called an open norm. Its content cannot be established in an abstract manner but takes shape only by the way in which it is applied”¹⁵³

Section 1-201 of the US UCC defines good faith as “honesty in fact and the observance of reasonable commercial standards of fair dealing.” Good faith is a general principle of law that is embodied in the main legal systems with the exemption of English law. However, it is more evident in contract law, particularly in the interpretation, performance and enforcement of contracts.¹⁵⁴

As a general principle of law, good faith is part of international law. Schreuer stated that “(g)ood faith is a broad principle that is inherent in the legal architecture of

University Comparative Law Forum 1 http://ouclf.iuscomp.org/articles/carjaval_maniruzzaman.shtml
text after note 20

¹⁵¹ S Litvinoff, “Good Faith” (1996-1997) 71 Tulane Law Review 1645 1663

¹⁵² Arenas and Maniruzzaman, supra note 150 text after note 33

¹⁵³ S Whittaker and R Zimmermann, “Good Faith in European Contract Law: Surveying the Legal Landscape” in *Good Faith in European Contract Law* (S Whittaker, R Zimmermann ed, CUP 2000) 31

¹⁵⁴ Under German Law, good faith finds its basis in Article 252 of the BGB, which states that “the debtor is bound to perform according to the requirements of good faith, ordinary usage being taken into consideration.” Article 157 of the BGB provides that “contracts shall be interpreted according to the requirements of good faith, taking into consideration of ordinary usage.”

Under French Law, Article 1134.3 of the Civil Code provides that “contracts must be contracted and performed in good faith.

Under US Law, UCC Article 1.203 provides that “every contract or duty imposes an obligation of good faith in its performance or enforcement.” Article 205 of the Restatement (Second) of Contracts provides that “every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement.”

Principles of European Contract Law Article 1.106(1) provide that “each party in exercising his rights and performing his duties ... must act in good faith.” See Whittaker and Zimmermann supra note 153; A Farnsworth, “Duties of Good Faith and Fair Dealing under the Unidroit Principles, Relevant International Conventions and National Laws” (1995) 3 Tulane Journal of International and Comparative Law 47

international law.”¹⁵⁵ It is an underlying principle in the performance and interpretation of international treaties as well.¹⁵⁶ Acting in bad faith was regarded as a breach of the minimum standard of customary international law in the Neer case.¹⁵⁷ Moreover, acting in good faith is one of the requirements of the FET standard. The tribunals in the Tecmed and the Waste management cases regarded acting in bad faith as a breach of the FET standard.¹⁵⁸

The principle of good faith is the underlying concept for the renegotiation and adaptation of the contract in the event of a hardship situation, where the equality between the performances of the parties is seriously disrupted.¹⁵⁹ These good faith obligations apply to an existing contract. In the context of negotiations, there should be a contract that obligates the parties to negotiate, such as a preliminary agreement, or a clause in the contract that obligates the parties to renegotiate.¹⁶⁰

The obligation to negotiate in good faith requires that parties should demonstrate preparedness to shift their position or compromise in order to reach agreement. The nature of the negotiation involves the making of concessions to reach agreement. The parties should demonstrate a genuine desire to reach agreement instead of adopting a

¹⁵⁵ C Schreuer, “Fair and Equitable Treatment in Arbitral Practice” (2005) 6 JWIT 357 383

¹⁵⁶ Vienna Convention on the Law of Treaties Article 26 (pacta sunt servanda) states that “Every treaty in force is binding upon the parties to it and must be performed by them in good faith.” Article 31(1) states that “A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.”

¹⁵⁷ Neer v. Mexico, Opinion, United States-Mexico General Claims Commission, 15 October 1926, 25 A.J..I.L. 1927 555 556

¹⁵⁸ Tecmed SA v. United Mexican States, Award 29 May 2003, 43 ILM 2004 133 para 153-154; Waste Management Inc. v. United Mexican States, Award, 30 April 2004, para 138

http://italaw.com/documents/laudo_ingles.pdf last visited 19 March 2013

¹⁵⁹ Horn, *supra* note 16 19

¹⁶⁰ R D Bishop, “The Duty to Negotiate in Good Faith and the Enforceability of Short Term Natural Gas Clauses in Production Sharing Agreements” (1997) CEPMLP Discussion Papers No DP 13

rigid position.¹⁶¹ The duty to negotiate in good faith requires strong efforts by the parties to strive towards agreement.¹⁶²

It is argued that the “obligation to negotiate in good faith does not mean parties have to discuss unrelated topics, but it does mean that they are not entitled to ignore the other party's interests. That would not mean that a party must abandon their own interests but simply to have regard to the aims of the contract.”¹⁶³ The content of the duty to renegotiate in good faith includes the obligations of the parties to demonstrate “...earnest efforts, flexibility (as a vital component of these clauses) and a willingness to consider the needs and interests of the other party.”¹⁶⁴ The parties should enter into serious negotiations and consider each other's positions and interests with a view to compromise.¹⁶⁵ However, this obligation to renegotiate in good faith does not obligate the parties to agree on the contract change. Therefore, failure to agree on new conditions is not a breach of the contract and the parties cannot be held responsible for a failure to agree.¹⁶⁶

With regard to good faith negotiations, UNIDROIT Principles of the ICC, in its Article 2.15, provide that

“(1) A party is free to negotiate and is not liable for failure to reach an agreement. (2) However, a party who negotiates or breaks off negotiations in *bad faith* is liable for the losses caused to the other party. (3) It is bad faith, in particular, for a party to enter

¹⁶¹ L Flynn, “What does Negotiate in Good Faith Mean for the Grantee Party in a Right to Negotiate Process?” (1999) 18 Australian Mining and Petroleum Law Journal 153 156

¹⁶² C Hutchison, “Coming in from the Shadow of the Law: The Use of Law by States to Negotiate International Environmental Disputes in Good Faith” (2005) 43 Canadian Yearbook of International Law 101 114

¹⁶³ J O'Connor, “Enforceability of Agreements to Negotiate in Good Faith” (2010) 29 University of Tasmania Law Review 179 193

¹⁶⁴ Berger, supra note 83 1364

¹⁶⁵ Nassar, supra note 3 180-181

¹⁶⁶ Bernardini, supra note 139 105; Salacuse, supra note 82 1334

into or continue negotiations intending not to reach an agreement with the other party.”¹⁶⁷

Acting in bad faith alone can breach the renegotiation clause. A court or arbitrator can hold responsible the party that breached the obligation to negotiate in good faith. It might further be ruled that damages should be paid to the other party. Examples of bad faith are delaying the renegotiations unjustifiably, intentionally obstructing the renegotiations and rejecting the proposals based on reasons other than business judgment.¹⁶⁸ Although the breach of the duty to renegotiate in good faith entitles the other party to damages, it is difficult to quantify these damages.¹⁶⁹ Therefore, it is useful for the parties to include a liquidated damages amount in the contract.¹⁷⁰

Good faith negotiations have been the subject of some arbitral awards. In the North Sea Continental Shelf Case (Germany v. Denmark), with regard to the content of good faith negotiations, the ICJ stated that

“(t)he parties are under an obligation to enter into negotiations with a view to arriving at an agreement, and not merely to go through a formal process of negotiation as a sort of prior condition for the automatic application of a certain method of delimitation in the absence of agreement: they are under an obligation so to conduct themselves that the negotiations are meaningful, which will not be the case when either of them insists upon its own position without contemplating any modification of it.”¹⁷¹

Moreover, the ICJ by referring to the Railway Traffic case between Lithuania and Poland stated that “(d)efining the content of the obligation to negotiate, the Permanent

¹⁶⁷ Unidroit Principles of International Commercial Contracts supra note 113; See A Hartkamp, “The Concept of Good Faith in the Unidroit Principles for International Commercial Contracts” (1995) 3 Tulane Journal of International and Comparative Law 65; L F G Falla, “Good Faith in Commercial Law and the Unidroit Principles of International Commercial Contracts” (2004-2005) 23 Penn St. Int'l L. Rev. 507

¹⁶⁸ Berger, supra note 83 1369

¹⁶⁹ Kröll, supra note 24 447

¹⁷⁰ Berger, supra note 83 1369

¹⁷¹ North Sea Continental Shelf (Germany v. Denmark), Judgment, I.C.J. Reports 1969 3 47

Court, in its Advisory Opinion in the case of Railway Traffic between Lithuania and Poland, said that the obligation was ‘not only to enter into negotiations but also to pursue them as far as possible with a view to concluding agreements’, even if an obligation to negotiate did not imply an obligation to reach agreement. (P.C.I.J., Series A/B, No.42, 1931, at p. 116).”¹⁷²

In the Nuclear Tests case, the ICJ held the view that “(o)ne of the basic principles governing the creation and performance of legal obligations, whatever their source, is the principle of good faith. Trust and confidence are inherent in international co-operation, in particular in an age when this co-operation in many fields is becoming increasingly essential.”¹⁷³

The Aminoil tribunal stated the content of the duty to negotiate in the following terms: “...the general principles that ought to be observed in carrying out an obligation to negotiate that is to say, good faith as properly to be understood, sustained upkeep of the negotiations over a period appropriate to the circumstances, awareness of the interests of the other party, and a preserving quest for an acceptable compromise.”¹⁷⁴

In the Wintershall v. Qatar arbitration, the government did not agree on the development of condensate gas although a clause existed that obligated the parties to renegotiate. The arbitral tribunal held the view that

“...there was not a violation by the Respondent of any duty to negotiate in good faith regarding this matter. Even accepting the view of the expert legal witness for the Claimants...that there was such a duty to negotiate in good faith, it is clear that such a

¹⁷² *ibid* 47-48

¹⁷³ Nuclear Tests (Australia v. France), Judgment of 20 December 1974, I.C.J. Reports 1974, 253-268

¹⁷⁴ The Government of Kuwait v. American Independent Oil Company (Aminoil), 21 ILM 1982 1014

duty does not include an obligation on the part of the Respondent to reach an agreement with respect to the proposals made by the claimant...the finding by the Tribunal that any proposals by the Claimants relating to the joint development of the Government area beyond the Contract Area were clearly no more than offers by the Claimants and their acceptance was not required by the duty of good faith negotiation under the EPSA.¹⁷⁵

In the context of renegotiation of transit pipeline agreements, it can be deduced from the above doctrinal analysis and the arbitral jurisprudence that, in order not to breach the obligation to renegotiate in good faith, the parties to these agreements should take into consideration the interests of the other party during renegotiations. They should honestly engage in serious and fruitful negotiations to reach agreement. They should not insist on their own position and reject proposals of the other party based on reasons other than business judgment. They should conduct and pursue renegotiation, as far as possible, with a view to arriving at an agreement. The parties should demonstrate their intention and genuine desire to reach agreement. However, the obligation to renegotiate in good faith does not obligate the parties to agree. The failure of the parties to agree does not breach the obligation to renegotiate in good faith. The parties can only be held responsible if they act in bad faith.

5.5.3 Adaptation by the Arbitrator: The Role of the Contract and the Applicable Law

The parties may refer a conflict between them on whether the triggering event has occurred or whether there has been a breach of the duty to renegotiate in good faith to arbitration. These are clearly legal disputes and are arbitrable.¹⁷⁶ In the event of a

¹⁷⁵ Ad Hoc Arbitral Tribunal: Partial Award and Final Award in the Matter of an Arbitration between Wintershall A.G., Et AL., and the Government of Qatar, 28 I.L.M. 1989 795 814-815

¹⁷⁶ Bernardini, supra note 139 105

failure of the parties to agree on contract adaptation, the main point is whether the conflict constitutes a legal dispute.¹⁷⁷

Therefore, in the event of a failure by the parties to agree on the amendment, to determine whether the arbitral tribunal has the authority to adapt the contract, the parties need first to refer back to the contract. If there is an express provision in either the adaptation clause or the arbitration clause that authorizes the arbitrators to amend the contract, the arbitrators have the power to adapt the contract in accordance with the freedom of parties and sanctity of contract principles. In the absence of an express provision that authorizes the arbitrators to amend the contract, the parties need to refer to the applicable procedural law (*lex arbitri*) and substantial law (*lex causae*).¹⁷⁸

While the procedural law determines whether the arbitrators have the power to adapt the contract, the substantive law determines whether the conditions of contract adaptation have been met.¹⁷⁹ The authorization of the arbitrators by the procedural law revolves around the discussion on whether the disagreement on adaptation of the contract constitutes a legal dispute. The ICC Rules, the United Nations Commission on International Trade Law (UNCITRAL) Rules on International Commercial Arbitration and the ICSID Convention require the existence of a legal dispute to initiate an arbitration process.¹⁸⁰ However, some arbitration acts interpret the dispute concept broadly, including the adaptation of contract as analysed below.

¹⁷⁷ Kröll, supra note 24 450

¹⁷⁸ K P Berger, "Power of Arbitrators to Fill Gaps and Revise Contracts to Make Sense" (2001) 17 *Arbitration International* 1, 7-8

¹⁷⁹ Russi, supra note 103 94

¹⁸⁰ *ibid* 104

Mere referral to arbitration in the contract does not entitle the arbitrators to amend the contract unless the arbitrators are provided with the power to act as *amiable compositeur* to amend the contract.¹⁸¹ Moreover, the applicable law should recognize the ability of the arbitral tribunal to amend the agreement.¹⁸² The parties need to refer to the *lex arbitri* even in cases where the arbitrators are authorized by the contract to adapt it. It is correctly argued that “...it is not the arbitration agreement alone, but the agreement in its combined effect with the *lex arbitri* which conveys the necessary authority to the arbitral tribunal.”¹⁸³

If the *lex arbitri* does not authorize the arbitrators to amend the contract, there is no award that is enforceable according to the New York Convention. However, few arbitration acts grant this authority to arbitrators. Among those, which do, are the 1986 Dutch Arbitration Act, which provides in section 1020(4) that “the parties may agree to submit ... to arbitration ... the filling of gaps in, or the modification of, the legal relationship between the parties.” Likewise, paragraph 1(2) of the 1999 Swedish Arbitration Act provides that “the parties may authorize the arbitrators to supplement contracts beyond the boundaries of the principles of the construction of contracts.” The UK 1996 Arbitration Act authorizes the arbitrators to amend the contract. It interprets the term of dispute as including conflicts resulting from differences of opinion.

The applicable law might tolerate a deviation of an arbitral tribunal from a strict application of the law. It might limit the judicial revision of the arbitral decision to the cases of violation of the *ordre public*. The applicable law might authorize the arbitral

¹⁸¹ Cameron, *supra* note 14 92

¹⁸² Gotanda, *supra* note 139 1472

tribunal to act as *amiable compositeure*, which delivers its decision according to the rules of fairness and equity within the limits of the *ordre public*.¹⁸⁴

In cases where the arbitration act remains silent on the matter, the parties need to refer to the power of the courts to adapt the contract. If the courts are authorized to adapt the contract by domestic procedural law, it is regarded that the arbitral tribunal is also authorized according to the synchronized competence of the arbitrators. If the domestic procedural law does not authorize the courts to adapt the contract, the parties need to refer to the substantial law of that jurisdiction, since it acts as an indicator for contract adaptation.¹⁸⁵

German law is an example of this last situation. Although the procedural law does not include a provision for contract adaptation, section 317 of the German Civil Code states that the parties may leave certain provisions to be determined by a third party. According to section 319, if the third party does not fulfill this duty or adapt the contract unjustly, the parties may refer to the court to supply the missing terms.¹⁸⁶

If neither the procedural law nor the substantive law allows contract adaptation, the arbitrator acts as a third-party intervener outside the realm of procedural law, irrespective of the fact that the parties authorized the third party. Therefore, the effects of the third-party intervener's decision can only be interpreted according to the law of obligations.¹⁸⁷ The decision of the third party intervener can only be binding if the parties decided in the contract that this should be the case. Otherwise, it has only a

¹⁸⁴ N Horn, "The Procedures of Contract Adaptation and Renegotiation" in *Adaptation and Renegotiation of Contracts in International Trade and Finance* (N. Horn ed, Kluwer 1985) 179

¹⁸⁵ Berger, supra note 178 10

¹⁸⁶ Kröll, supra note 24 453

¹⁸⁷ Berger, supra note 178 11

declaratory character that does not bind an arbitrator later. The arbitrator might take the decision into account if the applicable law does not prohibit this.¹⁸⁸ The ICC has indicated that when the adaptation of the contract is conducted according to the 1978 Rules for the Regulation of Contractual Relations, the adaptation by the third-party intervener is contractual in nature and the adapted terms should be inserted into the parties' contract. Therefore, it does not have the power of an award. The reference to this kind of third-party intervener should be accompanied by a parallel reference to arbitration.¹⁸⁹

In cases where the arbitrators are authorized by contract and the *lex arbitri*, there is a further role of substantive law (*lex causae*). It is stated that

“(i)t is the law applicable to the substance of the dispute which has to be consulted to decide on the validity of the adaptation clause and of the adaptation standards agreed upon by the parties, the canon of interpretation to be applied to such clauses and the methods of adaptation to be applied by the arbitrators if the contract does not contain specific instructions for the tribunal.”¹⁹⁰

The arbitration clause that authorizes the tribunal for the amendment of the contract should state the procedure for this amendment and the limits of the tribunal during this amendment procedure. Without sufficient parameters the tribunal may rewrite the agreement.¹⁹¹ However, the parties often include only soft criteria such as fairness, equity or maintaining the equilibrium of the contract. This is caused by the fact that

¹⁸⁸ Ottoarndt Glossner, “Third Party Intervener in Contract Adaptation, The Referee Arbitral” in *Adaptation and Renegotiation of Contracts in International Trade and Finance* (N Horn ed, Kluwer 1985) 195-196

¹⁸⁹ Bernardini, *supra* note 139 108

¹⁹⁰ Berger, *supra* note 178 11

¹⁹¹ Gotanda, *supra* note 139 1463

the circumstances of the contract adjustment process cannot be foreseen at the time of the contracting and by the requirements of flexibility.¹⁹²

Arbitral jurisprudence demonstrates that the tribunals are reluctant to amend the contract if there is no specific contractual provision that authorizes the tribunal to make the amendment. It was stated by the tribunal in the Aminoil case that “(t)here can be no doubt that, speaking generally, a tribunal cannot substitute itself for the parties in order to ... modify a contract unless that right is conferred upon it by law, or by the express consent of the Parties.”¹⁹³ The tribunal in the Himpurna case, in which there was no express authorization of the arbitrators in the contract, held that

“(i)t is not for the Arbitral Tribunal to question the motives or judgment of the Parties, but to assess their rights and obligations in light of their legally significant acts or omissions. That is all; that is enough. To go beyond this role would be to betray the legitimate expectations reflected in the Parties’ agreement to arbitrate, and indeed to impair the international usefulness of the arbitral mechanism...The arbitrators cannot usurp the role of government officials or business leaders. They have no political authority, and no right to presume to impose their personal view of what might be an appropriate negotiated solution. Whatever the purity of their intent, arbitrators who acted in such a fashion would be derelict in their duties, and would create more mischief than good. The focus of the Arbitral Tribunal’s inquiry has been to ascertain the rights and obligations of the parties to the particular contractual arrangements from which its authority is derived.”¹⁹⁴

The ICSID rules and the rules of UNCITRAL model law on International Commercial Arbitration require the existence of a legal dispute to initiate arbitration. Therefore, arbitrators acting under the ICSID Convention are not able to amend the agreement, even if they are given the power to act as *amiable compositeur*, due to the fact that

¹⁹² Berger, *supra* note 178 13

¹⁹³ Kuwait v. Aminoil, *supra* note 174 1016

¹⁹⁴ Himpurna California Energy v. Republic of Indonesia UNCITRAL Award of May 4, 1999, (2001) 25 Yearbook of Commercial Arbitration 61

mere disagreement on how to readjust the contract does not constitute a legal dispute under the ICSID Convention. It only constitutes a conflict of interest rather than a conflict of rights under article 25.1 of the ICSID Convention, in which an existence of a legal dispute is a prerequisite for arbitration. It was stated in the Report of the Executive Directors on the ICSID Convention that “(t)he expression ‘legal dispute’ has been used to make clear that while conflicts of rights are within the jurisdiction of the Centre, mere conflicts of interests are not. The dispute must concern the existence or scope of a legal right or obligation, or the nature or extent of the repatriation to be made for breach of a legal obligation.”¹⁹⁵ On the other hand, the parties can put the conflict under ICSID jurisdiction, through applying for a binding expert decision to a third-party intervener. If one of the parties were not to implement this amended agreement, then such an act would constitute a breach. Thus, an ICSID arbitrator would have jurisdiction on the matter.¹⁹⁶

The authorization of the arbitrator given by the contract and applicable law to adapt the contract in the event of a failure of the parties to agree on the amendment is an essential element that should be included in a contract that requires renegotiation. Otherwise, a renegotiation clause without the threat of arbitration can be a clause not mere than the agreement to agree. On the other hand, a contract that authorizes the arbitrators to amend the contract can be used as a bargaining factor during renegotiations. The parties might be keener to agree on the terms, given the probability of a decision on the amendment by a third party.

¹⁹⁵ Report of the Executive Directors on the Convention on the Settlement of Investment Disputes, (1965) ILM 524 para 26

¹⁹⁶ Bernardini, *supra* note 139 109-110

5.5.4 The Extent of Contract Change

The extent of the contract change is independent from triggering events. It depends on the specific wording of the relevant clause. While some clauses adopt objective standards, such as maintaining or restoring the equilibrium of the contract, others adopt subjective standards, such as fairness and equity.¹⁹⁷ The prevailing view is that the equilibrium of the contract should be maintained and that neither party should profit or suffer a loss as a result of the renegotiations. On the other hand, some hold the view that the parties or the arbitrators should not look into the original equilibrium: they should decide what is fair under the new situation. Schmitthoff stated that “(i)t is an unnecessary fetter on the renegotiation which should aim at establishing a situation fair and equitable to both parties in the new circumstances if the negotiators have to look back to the past and to adopt the old equilibrium as their guiding criterion.”¹⁹⁸ However, this second view should only be adopted if it is in conformity with the no-profit no-loss rule.¹⁹⁹ The parties should take into account the wording of the contract, the interests of the parties that are protected by the contract, the business practice of the parties during the contractual relationship and the usages and practice of that trade. However, all of these elements should be guided by the no-profit no-loss rule.²⁰⁰

The tribunal in the *Aminoil* case, on the matter of restoration of equilibrium, stated that

“(t)he original equilibrium will be modified in favor of another equilibrium deemed equally equitable...rests on the implied concept of a progressive process of justice revealing itself in the course of a sufficiently general historical evolution to be recognized for what it is by the parties. This is how they can be said to have based

¹⁹⁷ Peter, *supra* note 11 245

¹⁹⁸ Schmitthoff, *supra* note 115 87

¹⁹⁹ Horn, *supra* note 16 28

²⁰⁰ Berger, *supra* note 178 13

themselves in advance on the assumption that a division of profits equitable today will need to be modified in order still to be regarded as equitable tomorrow.”²⁰¹

An ICC tribunal, on the method of restoration, stated that

“(i)t is a rule of *lex mercatoria* that, (performance and counter-performance) remain balanced on the financial level, and that is why the price is therefore fixed as a function of the conditions existing at the moment of the conclusion of the contract and varies according to parameters mirroring the variations in value of the different elements composing the product or performance.”²⁰²

5.6 Conclusion

In this chapter, the applicable law on contract change, the contractual clauses that require renegotiation and the procedures for the renegotiation, including the role of the arbitrator to adapt the contract through authorization by contract and applicable law, were analyzed in detail. Given the probability of the occurrence of renegotiation in transit pipeline projects in which the contracts are long-term, it is hereby submitted that it is essential to legalize renegotiation through the design of a clause that clarifies the triggers for renegotiation, the exact duties of the parties during renegotiation, the aim and extent of contract change and the authorization of the arbitrators to adapt the contract. Otherwise, parties might need to refer to the applicable law on contract change, which only provides very rigid rules.

The worse scenario is the occurrence of forced renegotiations in the absence of a renegotiation clause under the threat of unilateral change. Therefore, in order not to sacrifice a party to increases in the bargaining power of the other party and to the abuse of this bargaining power in the absence of a clause that demonstrates the limits of, the method of and the procedures of renegotiation, the parties to long-term

²⁰¹ Kuwait v. Aminoil, supra note 174 1003

²⁰² I.C.C. Award no. 2291 (1975) quoted in Russi, supra note 103 88

contracts should carefully design a renegotiation clause that addresses all the above mentioned matters. The contract constitutes the law between the parties and it should be designed according to the realities of the contractual environment rather than some idealistic and questionable principles that might not work in practice, and that do not have any limitations in the event of the occurrence of a fundamental change in circumstances.

CHAPTER 6. VIABILITY OF STABILITY PROVISIONS IN THE SETTLEMENT OF TRANSIT PIPELINE DISPUTES

6.1 Introduction

The stability provided by investment treaties to transit contracts (Chapter 3), contractual forms of stabilization clauses, e.g. freezing and economic equilibrium clauses (Chapter 4), and contractual clauses that require renegotiation to maintain economic equilibrium of the contract (Chapter 5) have been the subjects of previous chapters. This chapter analyses how these legal provisions function in practice on the basis of the analytical framework of the thesis, which is the alternating offers model of bargaining theory.

Not only legal provisions are bargaining factors that influence the bargaining process and the bargaining outcome the economic and geopolitical conditions underlying the contract also have an influence.¹ Economic factors that affect the negotiation of transit pipeline agreements were defined and analyzed in Chapter 2. These factors are: transit fees and tariffs, the realization of profit through reaching markets, the approach of the transit state to foreign investment, the approach of the pipeline company (investor) to existing and future investments in the transit country, and the degree of equity participation of the transit state in pipeline project.² These factors determine the bargaining power of the parties through influencing the discount rates and risk aversion of either the transit state or the pipeline company during the operation of transit pipelines.

¹ For a detailed analysis of the Alternating Offers Model of Bargaining Theory see Chapter 2 45-51

² For a detailed analysis of the influence of economic factors on the negotiation and renegotiation of transit pipeline agreements see Chapter 2 65-70

The geopolitical factors that affect the conduct of the parties during the negotiation of transit pipeline projects and their operation stage were defined and analyzed in Chapter 2 as well. These factors are: the energy security concerns of the global business and political community, control of energy routes: the pipeline as a geo-strategic asset for the transit state, availability of alternative pipelines, the relationship between participating countries, and the relationships between the transit state, the home governments of investors and international institutions.³ These factors determine the bargaining power of the parties and the bargaining outcome, since they either constitute an outside option, e.g. alternative pipelines, or affect the risk aversion of the parties during the operation stage of transit pipelines.

On the other hand, while the parties renegotiate the agreement in a certain contractual economic and geopolitical environment, they conduct renegotiations in the shadow of the applicable law of the contract and contract provisions. Stabilization clauses aim to maintain the economic equilibrium of the contract through addressing changes in the legal regime of the contract that results from legislative, regulatory or administrative acts of the host state. Renegotiation clauses aim to maintain the economic equilibrium of the contract through renegotiation of certain parts of the agreement when the equilibrium is disturbed due to changes in the economic conditions underlying the contract. Both these type of clauses function as stability provisions since they aim to maintain the economic equilibrium of the contract.

³ For a detailed analysis of the influence of geopolitical factors on the negotiation and renegotiation of transit pipeline agreements, see Chapter 2 70-80

In order to achieve the aim of this chapter, which is analysing the selected case studies from the angle of legal, economic and geopolitical factors, five transit pipelines are selected. These originate mainly in the Caspian region and are directed towards the west. These pipelines are the BTC oil transit pipeline, the SCGP (gas transit pipeline), the CPC oil transit pipeline, Kirkuk-Ceyhan (Iraq-Turkey) oil transit pipeline and the Russia-Ukraine gas transit pipeline. The BTC pipeline and the SCGP are dealt with in the same section, since their routes and legal frameworks are nearly identical. All the other pipelines are the subject of different sections, which take into consideration the particularities of each pipeline.

The reasons behind the selection of these pipelines are the availability of the legal arrangements for these pipelines and the particular geopolitics of the region, which has influenced the considerations of the parties during the construction and operation of these pipelines. Moreover, these pipelines, except the SCGP, have experienced disputes during their operation. These disputes and their methods of settlement can be analysed in the context of their particular legal frameworks and the particular geopolitics of the region.

The disputes experienced during the operation of these pipelines have been resolved through renegotiations. The attitude of the parties during these renegotiations have not been revealed in detail. However, certain aspects of the renegotiation processes and the results of these renegotiations are publicly available. Therefore, methodologically, the legal provisions of their agreements are analysed to assess how these provisions would

have been used during renegotiations through taking into consideration the economic and geopolitical environment of the operation of each pipeline.

Map of Caspian Region Pipelines

Source: www.opednews.com



6.2 Caspian Pipeline Consortium Oil Transit Pipeline

6.2.1 Geopolitics and Economics of the Pipeline

The CPC oil transit pipeline project was first initiated by Russia, Kazakhstan and Oman in 1992. However, the state parties were unsuccessful in financing the project. Therefore,

through a “Restructuring and Shareholders Agreement”⁴, they transferred 50% of the shares to international oil companies, who would be responsible for financing the project. The current shareholder structure⁵ represents the balance established between the state parties and the international oil companies: 31% of the company is owned by Russia and 20.75% is owned by Kazakhstan. Chevron is the operator of the pipeline and is the biggest private shareholder (15%). The significant equity participation of participating states in the transit pipeline and in upstream production might reduce the risk of interruption by these states, since it is against the interests of these states. The state parties earn high incomes through transit tariffs and through the sale of oil that is produced by them in upstream and transported through the pipeline.⁶ Moreover, the state parties were tied to each other as members of the Commonwealth of Independent States (CIS). They created a custom union in July 2010.⁷ This geopolitical and economic partnership between the state parties involved in the project might facilitate the smooth operation of the pipeline.⁸

⁴ CPC Restructuring and Shareholders Agreement, Barrows Collection Russia and NIS Section, Supplement 45

⁵ **CPC Shareholders:** Russian Federation (represented by Transneft – 24% and CPC Company – 7%) – 31%; Republic of Kazakhstan (represented by KazMunaiGaz – 19% and Kazakhstan Pipeline Ventures LLC – 1.75%) – 20.75%; Chevron Caspian Pipeline Consortium Company - 15%; LUKARCO B.V. – 12.5%; Mobil Caspian Pipeline Company – 7.5%; Rosneft-Shell Caspian Ventures Limited – 7.5%; BG Overseas Holding Limited - 2%; Eni International N.A. N.V. - 2%; and Oryx Caspian Pipeline LLC – 1.75%. www.cpc.ru

⁶ For a detailed analysis of the influence of equity participation of participating states on bargaining power of the parties see Chapter 2 69-70

⁷ <http://www.nytimes.com/2010/07/06/business/global/06customs.html>
<http://www.bbc.co.uk/news/10507601> last accessed 9 September 2012

⁸ For a detailed analysis of the influence of alliances between participating states on bargaining power of the parties see Chapter 2 77-78

The CPC pipeline is a 1510 km of oil pipeline that transports the oil produced in the Tengiz field in Kazakhstan to the Russian port, Novorossiysky, on the Black Sea. The pipeline started to operate in October 2001. It was originally designed to transport 30 million tonnes annually (MTA) with the allowance for a subsequent increase to 67 MTA. It exceeded the original envisaged capacity in 2005 with a capacity of 30.5 MTA. The shareholders and the ministries of energy of the two states executed a Memorandum of Understanding in December 2008 on the principles of an expansion project. After a long-standing dispute, at a meeting in December 2009, the shareholders agreed to expand the capacity of the pipeline to 67 MTA by the end of 2014. The parties agreed on further amendments to the original CPC Restructuring and Shareholders' Agreement, including incorporation of a ship or pay obligation and changes on loan agreements. The expansion actually started in July 2011.⁹

6.2.2 Legal Arrangements and Regulation of Transit

The “Caspian Pipeline Consortium Restructuring and Shareholders' Agreement” between Russia, Kazakhstan and the investors constitutes the legal framework of the CPC project and sets out the rights and responsibilities of the parties.

6.2.2.1 Capacity Rights

The capacity of the CPC pipeline is dedicated to the shareholders. The international oil companies (IOCs) involved in the project and also Kazakhstan are the producers in the Tengiz field. They transport the oil through the CPC pipeline. Russia transports its oil

⁹ For all these information see <http://www.cpc.ru/EN/NEWS/Pages/default.aspx> last accessed 9 September 2012

produced in the Urals region through the pipeline. The CPC oil pipeline Restructuring and Shareholders' Agreement states that "(e)ach shareholder shall have a preferential right to capacity for its equity production... Capacity that is not nominated for use by a shareholder for its equity production in any month shall be deemed to be excess capacity. Excess capacity shall be reallocated in accordance with the following procedure."¹⁰ Excess capacity of a shareholder should be offered first to the other shareholders that are equity producers, in proportion to their equity interest. If the other shareholders do not use this excess capacity, it can be offered to third-party shippers.¹¹ In the event of excess capacity, the access regime to this capacity will be negotiated access. The initial capacity of the pipeline was 28 MTA with the possibility to increase this to 67 MTA, subject to the approval of the shareholders.¹²

6.2.2.2 Tax Exemptions and Tariffs

In the CPC oil pipeline, CPC-R, which is the company responsible for the operation of the Russian part of the pipeline, and CPC-K, which is responsible for the operation of the Kazakhstan part of the pipeline, are exempted from VAT in relation to the transfer of pipeline assets from the former company, CPC-Bermuda, to themselves.¹³ Shareholders and affiliate shippers are exempted from transit fees in the terms of the agreement, "pipeline transportation fee" which means any tax, charge or fee with respect to pipeline transportation, including VAT, that might be imposed by federal, regional or local

¹⁰ CPC Restructuring and Shareholders' Agreement, supra note 4 Article 8(2) 1-3

¹¹ *ibid*, Article 8(2) 3

¹² *ibid*, Article 5(5)

¹³ *ibid*, Article 7(4)6-7

government authorities. Shareholders and affiliates are also exempted from any port fee or tax in Russia and Kazakhstan.¹⁴

Import and export taxes are reduced to the minimum amounts of such taxes.¹⁵ The loans of shareholders to CPC-R are exempted from VAT.¹⁶ Pipeline transportation services are exempted from VAT in Russia and Kazakhstan through regarding the service as the transportation of goods outside the CIS area.¹⁷ Double taxation treaties shall have effect.¹⁸ The main tax that is imposed on the CPC-R, CPC-K, shareholders and the affiliated shippers is the profit tax. The base rate for the profit tax is 35% in Russia and 30% in Kazakhstan.¹⁹

Transit tariffs are inclusive of all applicable taxes and fees.²⁰ Tariffs should be market-based, including reasonable operating and capital costs, any and all base taxes regarding the operation of the CPC and a fair rate of return.²¹ Therefore, tariffs include the profit tax. The transit tariff for the CPC pipeline was determined in the 1996 CPC Shareholders' and Restructuring agreement at a level of \$25 per tonne. The tariff for Russian crude was to be 31% of the tariff for Kazakhstan crude. The shareholders were to review the tariff after they had received the final capital and construction costs of the CPC project.²²

¹⁴ *ibid*, Article 7(4)8-9

¹⁵ *ibid*, Article 7(4)12

¹⁶ *ibid* Article 7(4)17

¹⁷ *ibid*, Article 7(4)19

¹⁸ *ibid*, Article 7(5)2

¹⁹ *ibid*, Article 7(5)1 and Schedule 2

²⁰ *ibid*, Article 8(1)1

²¹ *ibid*, Article 8(1)3

²² *ibid*, Article 8(1)4

6.2.2.3 Adaptation Clause

The contract includes an adaptation clause with regard to tariffs. Tariffs were indexed to changes in the US consumer price index (CPI).²³ This inflation escalator would apply until the loans for the transferred assets were repaid or the tariff rate reached \$38. Any changes to the tariff were subjected to the unanimous agreement of the shareholders.²⁴ However, the above system has never been applied. Under the transportation level of 0.60 million barrels per day (mb/d) and 30 million tonnes per year (Mt/y) and a tariff rate of \$28.3, profitability was zero. In 2005, shareholders reached an agreement to increase tariffs by \$2.5 per tonne. The tariff was increased to \$30.83 per tonne. Moreover, in September 2007, at a shareholders meeting, the tariff was increased to \$38.²⁵

The indexation of tariffs to the US CPI might have provided the required flexibility and decreased the risk of an abuse of bargaining power. However, according to the agreement, when tariffs reached the level of \$38, this adaptation system would not be used. Therefore, it is not in use now. Moreover, the parties have to reach all decisions through a unanimous vote.²⁶ Although this requirement might seem rigid, it should increase the chance of agreement through reciprocal give and take.

6.2.2.4 Stabilization Clauses

The CPC Restructuring and Shareholders' Agreement includes stabilization clauses in the following words.

²³ *ibid*, Article 8

²⁴ *ibid*, Article 8(1)4

²⁵ <http://www.cpc.ru/EN/NEWS/Pages/default.aspx> last accessed 9 September 2012

²⁶ CPC Restructuring and Shareholders' Agreement, *supra* note 4 Article 11

“Consistent with Paragraph 6(c) of the Consortium Agreement and Paragraph 2.c of the Russian Protocol, Kazakhstan and Russia guarantee the stability of all fundamental legal and economic terms considered or relied on by the Parties in undertaking the CPC project including, but not limited to, those related to grants of rights of way, taxation (as contemplated by the provisions of this agreement), tariffs and environmental impact.”²⁷

Economic equilibrium clause states that

“(e)ach of Russia and Kazakhstan agrees that, in the event of a change in tax, currency conversion rights, or other legislation or executive act at the federal, regional or local level within its territory resulting in a material detriment to the economics of the CPC project, its shareholders, lenders, or contractors, each of Russia and Kazakhstan, as the case may be, in its capacity as a government, will discuss measures and take all possible steps within the limits of its authority under applicable law to restore the previous economic situation with respect to the CPC project.”²⁸

The language of both the traditional stabilization clause and the economic equilibrium clause is vague. The former just guarantees the stability of all legal and economic terms of the agreement. However, the content of this guarantee is not clear. The latter clause requires the restoration of the equilibrium when a change in legislation or an executive act results in material detriment to the economics of the project. When this is compared to the economic equilibrium clause of the BTC HGA, the acts of state covered by the clause in the CPC case are just limited to legislation and administrative acts, while the economic equilibrium clause in the BTC case covers the decisions of judicial bodies and changes in the interpretation of laws. Moreover, what “material detriment” means is not defined in the contract. The definition of this triggering event is very important, since the clause can only be activated when the change in the law or the administrative act resulted in material detriment to the economics of the project. When considering the provisions of this clause, they can be said to favour of the host states.

²⁷ *ibid*, Article 7(3)1

²⁸ *ibid*, Article 7(4)3

6.2.2.5 Dispute Settlement and Applicable Law Clauses

The applicable law is English law. The agreement states that “(t)his agreement shall be governed by and construed in accordance with the laws of England.”²⁹ Disputes should be settled in an amicable manner through negotiations within 30 days subject to extension by mutual consent after 10 days of the notice of a party. However, if the dispute cannot be resolved by negotiation, the parties can refer to arbitration under the arbitration rules of UNCITRAL. The seat of the arbitration is Stockholm, Sweden.³⁰

There is a restriction on the amount of damages that can be paid to the parties. Neither party can demand consequential damages or damages for lost profit or loss of opportunity with respect to the project in the event of a dispute.³¹ These provisions for calculation of damages are in favour of the host states and would increase their bargaining power in any renegotiation scenario.

6.2.2.6 Contingency Clause

The CPC pipeline contract includes a contingency clause that contains the features of both hardship and *force majeure* clauses:

“(n)o party shall be liable for any failure to perform or delay in performing any of its obligations under this agreement to the extent that such failure or delay results from a contingency. Contingency means an event or circumstance beyond the reasonable control of the party affected, whether or not foreseeable, and includes without limitation: war, civil disturbance, fire, flood, earthquake or other acts of God, any strike or other major labour difficulty, lack of necessary government action such as licenses.”³²

²⁹ *ibid*, Article 11(8)

³⁰ *ibid*, Article 11(8)2

³¹ *ibid*, Article 11(8)4

³² *ibid*, Article 11(12)1

“The producer companies may suspend the performance of their obligations under this Agreement... to the extent that a change in circumstances not due to their lack of diligence results in the frustration of the fundamental purposes of the producer companies with respect to the CPC project. Such change in circumstances shall include an extremely severe economic disruption such as major long-term decrease in crude prices or significant increase in project costs, long term closure or significant restriction of tanker passage through the Bosphorus affecting the CPC project, or long term loss of a field designated under section 8.5 as a result of a contingency, but shall exclude the unavailability of financing or any change in the cost of funds or foreign exchange rates.”³³

If the suspension of performance continues for more than 24 months, the parties can elect to terminate the agreement. This requires 65% of the votes of the producer companies if all the parties are affected. If the change in circumstances affects just one producer, a unanimous decision is required. The contingency clause is a hybrid one that possesses features of both *force majeure* and hardship clauses. The *force majeure* events of war, strike etc. and the hardship event of a fundamental change that results in severe economic disruption, such as a long-term decrease in crude prices, are listed in the clause. Moreover, the clause has an exclusionary character, since foreseeability is not a condition for the occurrence of a contingency. The result of the occurrence of a contingency is suspension of the contract. However, if the suspension continues for more than 24 months, the contract should be terminated. In any case, an adaptation of the agreement would be required if a *force majeure* or a hardship event occurred. This contingency clause would provide the required flexibility in the event of a fundamental change in economic conditions in the contractual environment.

³³ *ibid*, Article 11(12)2

6.2.3 Disputes on Capacity Expansion and Adaptation of the Agreement, and the Settlement of these Disputes

The CPC pipeline was inaugurated in 2001. However, the pipeline's designated capacity of 28 MTA was exceeded in 2004. Therefore, the CPC management raised the issue of expansion in October 2004. According to the contract governing the operation of the CPC pipeline, the shareholders should agree unanimously on the matter of expansion. However, the shareholders could not agree on the basis for proceeding with expansion. This disagreement was the start of a dispute and of long-running negotiations that continued until the end of 2009.³⁴

Although holding up capacity expansion cost the consortium \$60 million monthly and Russia's loss caused by its blocking of capacity expansion was \$173 million annually, the parties negotiated the terms of expansion for nearly five years. The attitude of Russia should not be seen only from the economic perspective. The income from tariffs was not all that Russia wanted, even though it had a 31% equity stake in the consortium. It aimed at broader control of the pipeline and control over upstream producers. Given that the CPC pipeline is the only pipeline that is not owned and operated by Transneft (Russian state pipeline monopoly), the dispute might be seen not only from the point of view of economics but also from a geopolitical angle. The resurgence of Russia in the 2000s under the Putin administration after the relatively weak position of Russia in the 1990s, when the pipeline agreement was negotiated, influenced the attitudes of Russia as well. Moreover, the expanded pipeline will not actually transport Russian oil. It will transport

³⁴ <http://www.cpc.ru/EN/NEWS/Pages/default.aspx> last accessed 9 September 2012

the oil of Kazakhstan and the IOCs that will be produced in the Tengiz field in Kazakhstan.³⁵

During the dispute, the Head of the Russian Federal Energy Agency (Rosenergo), Sergey Oganesyanyan explicitly threatened to nationalize the CPC pipeline.³⁶ On the other hand, the CPC management and Kazakhstan considered the alternative options, such as transporting between 25 MTA and 50 MTA oil through barges and tankers from Kazakhstan's Caspian port, Aktau, to Baku and then through the BTC pipeline, or transporting oil to the east through a planned pipeline to China.³⁷

Russia had raised a list of demands it wanted met before it agreed to expansion, which included a change in the tariff review mechanism so that tariffs could be increased by more than the mandated inflation index mechanism; a dismissal of the CPC claim to account for the rehabilitation of transferred assets in its balance sheet; a lowering of the interest rates for the loans provided by the operating companies to the CPC; external financing for pipeline expansion; introduction of ship or pay clauses for oil that will be transported after pipeline expansion; elimination of management secondees (representatives of shareholders) and the introduction of a board of directors.³⁸

The shareholders and ministries of energy of the two states involved executed a Memorandum of Understanding in December 2008 on the principles of an expansion

³⁵ A Dellecker, "Caspian Pipeline Consortium: Bellwether of Russia's Investment Climate" (2008) IFRI 15-16

³⁶ *ibid*, 9

³⁷ *ibid*, 14

³⁸ *ibid*

project. By this time, Russia had achieved one of its aims as the tariffs for 2008 were increased to \$38 in September 2007. The shareholders agreed to expand the capacity of the pipeline to 67 MTA, after a long-running dispute and renegotiations, at a shareholders meeting in December 2009. Moreover, the parties agreed on amendments to the shareholders' agreement, including incorporation of a ship or pay obligation for the oil that would be transported after expansion and changes on loan agreements. The expansion actually started in July 2011.³⁹

6.2.4 Assessment

The unanimous decision requirement of the joint venture agreement, the CPC Restructuring and Shareholders' Agreement, has functioned as a renegotiation clause in the operation of the CPC pipeline.⁴⁰ Russia raised its demands in exchange for its approval of the capacity expansion project. First, it gained a tariff increase from \$30 to \$38 in September 2007. Secondly, it purchased the shares held by Oman and increased the level of its shares in the CPC company to 31%. Thirdly, in the same shareholders' meeting in which the parties agreed on capacity expansion, Russia demanded the insertion of a ship or pay clause to the contract for the oil that would be transported after capacity expansion. This ship or pay clause would work as a throughput guarantee. It would guarantee a significant amount of income from tariffs for Russia.

³⁹ <http://www.cpc.ru/EN/NEWS/Pages/default.aspx> last accessed 9 September 2012

⁴⁰ See N Horn, "Standard Clauses on Contract Adaptation in International Commerce", in *Adaptation and Renegotiation of Contracts in International Trade and Finance* (N. Horn, Kluwer 1985) 117

Although the agreement includes a stabilization clause that guarantees the stability of all fundamental legal and economic rights, inclusive of tariffs, and an economic equilibrium clause under which the parties undertake to renegotiate to restore the economic equilibrium of the contract in the event of a regulatory change or administrative act, these clauses did not prevent Russia from raising its demands in shareholders' meetings based on the unanimous decision requirement. The vague and unclear language of these clauses would have contributed to the attitude of Russia and have increased its bargaining power.

The arbitration clause entitles the parties to initiate arbitration under UNCITRAL rules at SCC. Moreover, the applicable law of the contract is English law under which contract change is limited to the very strict rules of the doctrine of frustration. Although the Russian party raised the issue of nationalization and the CPC manager raised the availability of arbitration⁴¹, neither of the parties made recourse to arbitration.

The IOCs raised the availability of alternative routes, e.g. transportation by barges through the Caspian to Baku and then through the BTC pipeline. However, reference to an alternative option did not achieve its aim, since the transportation through this alternative would have been very costly compared to the CPC route.

It is arguable from Russia's point of view that the operational environment of the agreement would substantially change after the capacity expansion. It would increase the income of the IOCs through the sale and transportation of the increased amount of oil. Therefore, the agreement could not operate under the conditions of a capacity of 30 MTA

⁴¹ Dellecker, supra note 35

when the capacity increased to 67 MTA after the expansion. The increase in tariffs and inclusion of ship or pay obligations for the extra oil was the cost paid by the IOCs to get approval from Russia for the capacity expansion.

6.3 The Baku-Tbilisi-Ceyhan Oil Transit Pipeline and the South Caucasus Gas Transit Pipeline

6.3.1 Geopolitics and Economics of the Pipeline

The BTC pipeline is a 42-inch, 1,768 km (443 km in Azerbaijan, 249 km in Georgia and 1076 km in Turkey) oil transit pipeline. It transports the oil produced in the offshore Azeri-Chirag-Guneshli field in the Azeri part of the Caspian to the Mediterranean port of Ceyhan, traversing the transit countries of Georgia and Turkey. The throughput capacity of the pipeline is one million barrels daily (50 MTA). It started to operate on 28 May 2006. The pipeline is owned and operated by the BTC Pipeline Company, which comprises 11 shareholders. BP is the largest shareholder and the operator of the pipeline.⁴²

The South Caucasus Gas Pipeline (SCGP) is a 42-inch, 692 km long (443km in Azerbaijan and 250 km in Georgia) gas transit pipeline. It transports gas produced in the Shah Deniz offshore field in the Azerbaijani part of the Caspian to Turkey and traverses the transit country Georgia. The route of the SCGP is parallel to the route of the BTC

⁴² The shareholder structure of the BTC pipeline company is: BP 30.1%, AzBTC 25%, Chevron 8.9%, Statoil 8.71%, TPAO 6.53%, Eni 5%, Total 5%, Itochu 3.4%, INPEX 2.5%, ConocoPhillips 2.5%, and Amerada Hess: 2.36%. www.caspiandevlopmentandexport.com last accessed 9 September 2012

pipeline until the Georgia-Turkey border. It is linked to the Turkish gas distribution system at the Georgia-Turkey border. The South Caucasus Pipeline Company owns the SCGP. BP and Statoil are the largest shareholders in the company and the operators of the pipeline. The capacity of the pipeline will be expanded as part of the Shah Deniz field development project from the original 7 billion cubic meters (bcm) to the planned 20 bcm. After this expansion, the SCGP will be linked to new pipelines at the Georgia-Turkey border to transport gas to Turkey and European countries.⁴³

A recent development related to the transportation and transit of Azeri gas is the consortium agreement between SOCAR (the Azerbaijan state oil company) and BOTAS (the Turkish state pipeline company) following the delay in the Nabucco project, which is to construct a pipeline to transport 16 bcm of gas that will be produced in the Shah Deniz II gas field. The pipeline is called the Trans Anatolian Gas Pipeline (TANAP). The consortium agreement was signed on 26th June 2012 between the Azerbaijani and Turkish governments. According to the project, the 80% of the pipeline will belong to SOCAR and the remaining 20% will belong to BOTAS and TPAO (the Turkish state owned petroleum company). The transported volume is projected to increase to 21 bcm in the second stage and 31 bcm in the third stage. The private oil companies, BP and Statoil, are expected to become shareholders in the pipeline through purchasing relevant shares.⁴⁴

⁴³ www.caspiandevlopmentandexport.com last accessed 9 September 2012

⁴⁴ <http://www.botas.gov.tr/index.asp> ; <http://www.todayszaman.com/news-286675-trans-anatolian-gas-pipeline-deal-of-the-century--2.html>;
<http://www.bp.com/genericarticle.do?categoryId=9006615&contentId=7075555> last accessed 9 September 2012

Two days after the signing of the consortium agreement between Azerbaijan and Turkey, the Shah Deniz consortium (owner and operator of the SCGP pipeline) declared an alternative to this development, the Nabucco west project. This pipeline will traverse Turkey, Bulgaria and Romania to reach Baumgarten in Austria. In February 2012, the Shah Deniz Consortium declared the TANAP project to be the first option.⁴⁵ This development demonstrates the use of an alternative option, an alternative pipeline, as a bargaining factor by the parties during the choosing of routes and pipeline agreement negotiations.

During the construction of the BTC oil pipeline, the economics of the pipeline were overshadowed by geopolitical considerations. The priority given to geopolitical considerations over economic ones, and their influence on the negotiations, was confirmed in an article that was written by one of the negotiators of the BTC Turkey HGA.⁴⁶ The pipeline was constructed as part of the US east-west energy corridor policy. This policy aims to prevent Russia and Iran from becoming dominant transit routes and to link the South Caspian countries to the Western alliance by transporting Caspian energy resources through Georgia and Turkey.

The BTC pipeline route is longer and costlier than the possible alternatives through Iran and Russia. Therefore, transit countries, in particular Turkey, needed to grant extra incentives in terms of transit and operating fees. Turkey's energy policy to become an

⁴⁵ *ibid*

⁴⁶ S Cal, "Baku-Tiflis-Ceyhan Boru Hattı Projesi Kapsamındaki Anlaşmaların Hukuki Yönden Değerlendirilmesi" (2006) AUSB 90, 91

energy corridor for the transportation of Caspian energy resources and to control transit routes is an important factor in the political characteristics of the pipeline.⁴⁷

The World Bank, based on the argument that they could possibly cause future conflicts, subjected the extremely low transit fees to criticism. The concerns of the authorities relating to political motives being a cause of possible future conflict⁴⁸ were realised in 2009. Botas International Limited (BIL-the Turkish state company responsible for the operation of the pipeline in Turkey) filed an arbitration case at the ICC. The details of the dispute are dealt with below.

The BTC pipeline and the SCGP have been operated without an interruption of the oil and gas flow caused by acts of transit countries. The participation of the Turkey as an equity shareholder in both production and pipeline consortiums and dependence of Georgia, which is an off-taker of the gas transported by SCGP, on the gas transported, might have been influential on the attitude of the transit countries. Equity participation of transit state and being an off-taker in the transit pipeline are economic factors that influence the risk aversion and bargaining power of the parties. However, the BTC pipeline did experience closure for a few days in 2008 caused by an explosion. As a safety measure, the operating companies closed the BTC pipeline and the SCGP during the Russia-Georgia war in August 2008 as well.⁴⁹

6.3.2 Legal Arrangements and Regulation of Transit

⁴⁷ For analysis of the influence of the control of energy routes see Chapter 2 73-75

⁴⁸ P Stevens, "Transit Troubles: Pipeline as a Source of Conflict" (Chatham House Report 2009)

⁴⁹ <http://news.bbc.co.uk/1/hi/business/7556215.stm> last accessed 9 September 2012

The legal framework of the BTC pipeline consists of IGA⁵⁰ between the participating states of Azerbaijan, Georgia and Turkey and HGAs between each participating state and the BTC Pipeline Company (investor).⁵¹ The HGAs were attached to the IGA and made part of the Treaty. Thus, the obligations of host states to the BTC Pipeline Company were internationalized. Transit states might bear the responsibility for a breach of these obligations under international law.⁵²

The IGA is an agreement between governments that sets out the guarantees made by governments regarding efficient construction and operation of the pipeline. It further includes general provisions relating to security, environmental and safety measures and taxes. The HGAs are investment agreements between each host state and the pipeline company. They set out the rights and responsibilities of the parties during the construction and operation of the pipeline in each host state. The terms of all HGAs are nearly identical; therefore, the text of the Turkey HGA is considered for the analysis, except for the parts that do vary such as transit fees.

The legal framework of the SCGP is based on IGAs and HGAs. The IGAs are those between Azerbaijan and Georgia and between Azerbaijan and Turkey. The HGAs are those between the pipeline company and the individual host states, Azerbaijan and Georgia. The provisions of the HGAs of the SCGP, e.g. economic equilibrium and arbitration clauses, are nearly identical with not only each other but also with the HGAs

⁵⁰ BTC IGA www.caspiandevlopmentandexport.com last accessed 9 September 2012

⁵¹ BTC HGAs www.caspiandevlopmentandexport.com last accessed 9 September 2012

⁵² AFM Maniruzzaman, "The Pursuit of Stability in International Energy Investment Contracts: A Critical Appraisal of the Emerging Trends" (2008) 1 JWELB 121

of the BTC pipeline.⁵³ Therefore, except for provisions that do differ, such as transit fees, the Turkish HGA of the BTC pipeline only is analyzed.

6.3.2.1 Transit fees

The transit fee paid to Turkey defined as being corporation tax in the Turkish HGA. The Turkish pipeline section is operated by BIL (a state owned company). Therefore, an operating fee is paid to the BIL for the operator services it provides in addition to the payment of transit fees to Turkey. The operating fee is \$0.55 per barrel over the corporation tax amount (transit fee) for each year for the first 16 years and \$0.43 per barrel for the remaining 24 years.⁵⁴ The transit fee paid to the Turkey is \$0.20 per barrel for the first five years and \$0.20 per barrel for the 6th to 16th years. If the average daily amount of oil transported is in excess of 250.000 barrels, an amount equal to the fee corresponding to the total number of barrels transported that year divided by 1 million and further divided by number of days and multiplied by ten should be added to the transit fee for first 16 years. For the remaining 24 years the transit fee is equal to \$0.37 dollar per barrel.⁵⁵

The total corporation tax that should be paid by the BTC Pipeline Company to the transit state is made equal to the transit fee, which is defined as being the total corporation tax liability.⁵⁶ There is no tax liability of the BTC pipeline company other than the payment of transit fees.⁵⁷

⁵³ www.caspiandevlopmentandexport.com last accessed 9 September 2012

⁵⁴ BTC Turkey HGA, Article 2(4)

⁵⁵ *ibid*, Appendix 1

⁵⁶ *ibid*, Article 9(2)i-ii-iii

⁵⁷ Cal, *supra* note 46 100

The transit fee paid to Georgia is defined as being the profit tax in the Georgian HGA. The transit fee is \$.0,12 per barrel for the first five years, \$0.14 per barrel between the 6th and 16th years, \$0.17 per barrel between the 17th and 25th years, \$0.20 per barrel between the 26th and 30th years, \$0.225 per barrel between the 31st and 35th years, and \$0.25 per barrel for the remaining five years.⁵⁸ The amount of profit tax paid to Georgia is made equal to the transit fee.⁵⁹

The transit fee paid to Georgia in the case of the SCGP is 5% of the gas transported through the pipeline. The linkage of the transit fee to a certain amount of the gas, a progressive transit fee system, might provide the required flexibility for the smooth operation of the pipeline.

6.3.2.2 Stabilization Clauses

The Turkish HGA includes stabilization clauses in the form of both freezing and economic equilibrium clauses.

Classic stabilization clauses:

“Except as may be expressly provided therein, the State Authorities shall not amend, rescind, terminate, declare invalid or unenforceable, or otherwise seek to avoid or limit this Agreement, the Intergovernmental Agreement or any other Project Agreement without the prior written consent of the MEP Participants and/or any other Project Participants which are parties to such agreements;”⁶⁰

“The Parties hereby acknowledge that it is their mutual intention that no Turkish Law now or hereafter existing (including the interpretation and application procedures thereof)

⁵⁸ BTC Georgia HGA, Appendix 1

⁵⁹ *ibid*, Article 8

⁶⁰ BTC Turkey HGA Article 7(2)x

that is contrary to the terms of this Agreement or any other Project Agreement shall limit, abridge or affect adversely the rights granted to the MEP Participants or any other Project Participants in this or any other Project Agreement or otherwise amend, repeal or take precedence over the whole or any part of this or any other Project Agreement.”⁶¹

Economic equilibrium clause:

“The State Authorities shall take all actions available to them to restore the Economic Equilibrium established under the Project Agreements if and to the extent the Economic Equilibrium is disrupted or negatively affected, directly or indirectly, as a result of any change (whether the change is specific to the Project or of general application) in Turkish Law (including any Turkish Laws regarding Taxes, health, safety and the environment)... including changes resulting from:

- the amendment, repeal, withdrawal, termination or expiration of Turkish Law, the enactment, promulgation or issuance of Turkish Law,
- the interpretation or application of Turkish Law (whether by the courts, the executive or legislative authorities, or administrative or regulatory bodies),
- the decisions, policies or other similar actions of judicial bodies, tribunals and courts, the State Authorities, jurisdictional alterations, and the failure or refusal of judicial bodies, tribunals and courts, and/or the State Authorities to take action, exercise authority or enforce Turkish Law (a _Change in Law_). ...

the foregoing obligation to take all actions available to restore the Economic Equilibrium shall include the obligation to take all appropriate measures to resolve promptly by whatever means may be necessary, including by way of exemption, legislation, decree and/or other authoritative acts, any conflict or anomaly between any Project Agreement and such Turkish Law”⁶²

The stabilization clauses in the BTC Turkey HGA are all-encompassing and favour the investors. The intangibility clause prevents any change of the agreement without the prior consent of the investors. The economic equilibrium clause addresses not only changes resulting from legislative and administrative acts of the host state but also changes resulting from decisions made by judicial authorities and changes in the interpretation of laws. Moreover, there is no distinction between discriminatory or non-discriminatory laws. Any change in law that affects the economic equilibrium of the contract, even

⁶¹ *ibid*, Article 21 (2)

⁶² *ibid*, Article 7(2)xi

slightly, requires restoration of the equilibrium through exemption, legislation and decree or through the payment of compensation.⁶³

6.3.2.3 Dispute Settlement and Applicable Law

Any dispute arising under the HGA or in connection with the HGA should be settled through arbitration at the ICSID under the rules of the ICSID Convention. If a state has a reservation to the ICSID, the dispute should be resolved at the ICC under the arbitration rules of the ICC. If there is a conflict between the rules of this institution and the arbitration clause, the provisions of the clause should prevail. The seat of the arbitration is Geneva, Switzerland.⁶⁴

The applicable law of the agreement is the substantive law of England. Article 18 of the Turkish HGA states that “(t)his Article 18 shall be governed in accordance with the substantive law of England, but excluding any rules or principles of English law that would (i) prevent adjudication upon, or accord presumptive validity to, the transactions of sovereign states or (ii) require the application of the laws of any other jurisdiction to govern this Article 18.”⁶⁵

English law provides very limited grounds for contract change in the event of future contingencies under the very restrictive doctrine of frustration. Given that the agreement does not contain a renegotiation clause or even a hardship clause, the applicable law of the contract will determine whether the party that requested renegotiation is entitled to

⁶³ *ibid*, Article 10

⁶⁴ *ibid*, Article 18

⁶⁵ *ibid*, Article 18(12)

renegotiations under the specific circumstances of the renegotiation demand and whether the arbitrators have the authority to adapt the contract.⁶⁶

6.3.3 Disputes on Operating Fees, Throughput Guarantees and Adjustment of the Contract and the Settlement of these Disputes

The subject matter of the dispute and arbitration case between BIL, the state owned company that is the operator of the Turkish section of the pipeline, and the BTC Pipeline Company was concerned with the throughput guarantee and fixed operating fees. Turkey demanded adjustment of the contract by the arbitral tribunal. Moreover, parallel negotiations were conducted while the arbitration proceedings were underway.⁶⁷

There was no throughput guarantee either in the HGA or the Operating Agreement. Therefore, the agreements did not guarantee a fixed minimum level of operating fee to BIL. The pumping fuel was petroleum initially. The BTC Pipeline Company guaranteed to supply this fuel at a cost of \$18. However, BIL changed the pumping fuel to gas. Moreover, there was no adjustment mechanism for the operating fee to reflect rising operating costs in the event of an increase in the pricing of the pumping fuel.

The claims made by BIL were that the operating agreement did not comply with Article 2(4) of the HGA, which states “...the operating agreement shall contain those terms and conditions typically found in agreements for the operation of international petroleum pipelines of similar size and complexity, modified as mutually agreed to address the

⁶⁶ For a detailed analysis of English Law on contract change see Chapter 5 219-222

⁶⁷ These information depends on interviews that were made with high level officials

particular circumstances of the Project.”⁶⁸ BIL requested amendment of the agreement by the arbitrators. BIL requested that the operating fee should be re-calculated, either through payment of the operator’s actual costs and a profit element without a throughput guarantee, or through insertion of an escalator such as an inflation index, or by paying a fixed operating fee with a throughput guarantee and an escalator in the form of inflation or consumer price index.⁶⁹ Although an arbitration case at the ICC was proceeding, the parties settled the dispute through renegotiations and adaptation of the contract in October 2011.

6.3.4 Assessment

It is submitted that, given the existence of very strict stabilization clauses in the form of an intangibility clause that does not permit a change in the HGA without the consent of all of the parties and in the form of an economic equilibrium clause that requires the restoration of the economic equilibrium, or payment of compensation, if the HGA is changed even slightly by legislation, regulation, administrative act or judicial decision, or even by the interpretation of the agreement, the demands made by BIL to increase the operating fees, and to adapt the contract through insertion of an escalation clause –the adaptation clause- and through insertion of a throughput guarantee are hardly defensible, at least under the contractual clauses.

BIL claimed that the operating fees contradicted Article 2(4) of the agreement, which requires the operating agreement to be in conformity with the agreements relating to

⁶⁸ BTC Turkey HGA, Article 2(4)

⁶⁹ These information depends on interviews that were made with high level officials

pipelines of similar size and complexity. However, the economic equilibrium clause states that if the changes caused by “...the interpretation or application of Turkish Law (whether by the courts, the executive or legislative authorities, or administrative or regulatory bodies)” disturb the economic equilibrium of the contract, then the state is under obligation to restore the equilibrium, in this case according to the provisions of the clause. Therefore, this claim would hardly have been defensible under the contract even if it had been accepted. The tribunal in the *Duke v. Peru* case asserted that the interpretation of the law by the state party was under the scope of the stabilization clause, even though that clause did not clearly include the change in interpretation within its scope.⁷⁰ The parties, through accepting the terms of the operating agreement, agreed that it was in conformity with the pipeline agreements of similar size and complexity. Therefore, an interpretation, which asserts that the operating agreement is not in conformity with similar agreements, is contrary to the provisions of the economic equilibrium clause.

The adaptation of a contract by an arbitral tribunal can only be possible if the parties give that authority to the tribunal in the contract under the adaptation or arbitration clause. Moreover, the procedural law of the arbitration should authorize the tribunal to adapt the contract.⁷¹ However, these agreements include neither an adaptation clause nor a provision that authorizes the tribunal in the event of a failure of the parties on the adaptation of the contract.

⁷⁰ *Duke Energy International Peru Investments v. Republic of Peru*, ICSID Case No ARB/03/28, Award, 18 August 2008, para 14 et seq. http://italaw.com/documents/DukeEnergyPeruAward_000.pdf last accessed 9 September 2012

⁷¹ For a detailed analysis of the role of the arbitrator on contract change see Chapter 5 261-267

The applicable law in this case is English law. In the absence of an adaptation clause, the applicable law determines whether the parties are entitled to renegotiate and the conditions of renegotiation. Under English law, the change of contract is limited to the doctrine of frustration, which requires physical or legal impossibility of performance or frustration of the purpose that means radical transformation of the contract due to unforeseen events.⁷² An increase in the price of the pumping gas does not satisfy any of the requirements of frustration. An increase in the price of the gas due to the industry cycle effect is a reality of the petroleum industry; therefore, it is foreseeable. It can only entitle the party to adapt the contract through inclusion of it as a triggering event in an explicit renegotiation clause. Moreover, the state company changed the pumping fuel to gas from the oil that was guaranteed by the BTC Pipeline Company to be supplied at \$18 per barrel. As a general principle of law, no body can benefit from actions that are its own fault.

It is arguable that the significant increase in the cost of the performance of one party constitutes hardship, which fundamentally changes the economic equilibrium of a contract. The UNIDROIT principles of international commercial contracts requires a 50% increase in the cost of performance or a similar amount of decrease in the value of performance of a party to qualify hardship.⁷³ In the BTC dispute, the cost of performance by the operating company increased by more than 50% due to significant increase in oil prices that had occurred between 2001, when the agreements were signed, and 2006. However, hardship can only be invoked if the contract contains a hardship clause. Neither

⁷² For contract change under English Law and the doctrine of frustration see Chapter 5 219-222

⁷³ For the required extent of fundamental alteration of the contractual equilibrium see Chapter 5 248

the HGA nor the operating agreement contained a hardship clause. Therefore, the operating company did not have a right to demand adaptation due to a fundamental change in economic circumstances that resulted in hardship.

Despite the existence of all these provisions in the contract, the parties settled the dispute through renegotiation and adaptation of the contract in October 2011. According to the conditions of the renegotiated settlement, the BTC Pipeline Company accepted that it should pay \$100 million compensation to BIL for the losses the company suffered throughout the operation of the pipeline. Moreover, the BTC Pipeline Company accepted that it should supply pumping gas at a price of \$50, which is significantly below the market price. Furthermore, an escalation clause was inserted into the agreement for adaptation of the operating fees annually. The future costs of the refurbishment of the line are to be paid by the BTC Pipeline Company.⁷⁴

The renegotiated settlement of the BTC dispute and the results of the renegotiation confirm that renegotiation is usually invoked because of economic and political changes in the contractual environment rather than because of the legal provisions of the agreement. If these conditions change fundamentally, even a contract that includes a stabilization clause, such as the one in the BTC case, cannot survive under the new circumstances and cannot resist the change if the party that requests renegotiation has adequate economic and political bargaining power.

⁷⁴ <http://ekonomi.haberturk.com/makro-ekonomi/haber/683648-100-milyon-dolari-kurtardik> ;
<http://haber.gazetevatan.com/btcde-zarar-ettiren-anlasma-degistirildi/407765/2/Haber> last accessed 9
September 2012 ;
<http://www.eud.org.tr/TR/Genel/BelgeGoster.aspx?F6E10F8892433CFFA79D6F5E6C1B43FFE9C772194F9F9E> last accessed 9 September 2012

The BTC agreement was signed when the bargaining power of the host state, Turkey, was at a comparatively low level due to an economic crisis and the political instability experienced by the country between 1999 and 2001. However, the economic situation in Turkey and the geopolitical clout of the country at a regional and global level improved significantly during the last decade. The loan agreements with the IMF that influenced the bargaining power of the host state ceased after the recovery of the economy. The GDP of the country reached a level of \$770 billions, up from \$250 billion, and the per capita GDP rose to \$10.000 from a level of \$3000.⁷⁵ An agreement that was signed under special circumstances and was regarded as unfair from the beginning could hardly survive. Therefore, an agreement under which the state party experienced a loss instead of a profit could not survive after fundamental changes in the economic and political environment of the agreement, even though the contractual clauses such as stabilization clause and applicable law clause do not permit the contractual change.

The insertion of an escalation clause, an adaptation clause, to the contract would provide the required flexibility through linking the operating fee to some objective criterion. Instead of the fixed fees that were applied before the renegotiated settlement of the disputes, which provided a rigid contractual environment, the escalation clause would guarantee the smooth operation of the pipeline. The supply of pumping fuel at one tenth of the market price would prevent the future losses for the operating company due to a rise in fuel prices.

⁷⁵ <http://www.hazine.org.tr/tr/index.php/ekonomi/ueretim-ve-bueyueme> last accessed 9 September 2012

6.4 The Kirkuk-Ceyhan (Iraq-Turkey) Oil Transit Pipeline

6.4.1 Economics and Geopolitics of the Pipeline

The Kirkuk-Ceyhan pipeline was constructed to transport Iraqi oil produced in Kirkuk, through the transit country, Turkey, to Turkish Mediterranean port of Ceyhan. The 986 km transit pipeline was inaugurated on 25 May 1977 with a capacity of 35 MTA. The capacity of the pipeline was further expanded to 46.5 MTA in 1984 and to 70.9 MTA (1.5 million barrels daily) in 1987 through construction of a parallel line. The pipeline was closed between 1990 and 1996 due to Gulf War sanctions on Iraq. It operated between 1996 and 2010 under the UN humanitarian aid restrictions. After permission had been given by the UN, the pipeline started to operate normally again in 2010.⁷⁶

The Kirkuk-Ceyhan oil transit pipeline was constructed as an alternative route for the transit of Iraqi oil after Iraq had experienced several disputes with another transit country, Syria, in Iraq Petroleum Company (IPC) pipeline. These disputes resulted in several short and long-term closures (for three years between 1976 and 1979) due to disputes on transit fees and due to political disputes that were based on the division and struggle between the two wings of the Baath party that governed Iraq and Syria.⁷⁷ This fact demonstrates the significance of the availability of alternative options and of the relationship between the producer and transit countries in the construction and operation of transit pipelines.

The Kirkuk-Ceyhan pipeline experienced a series of disputes relating to transit fees and non-payment by the transit country for the oil that was off-taken from the pipeline

⁷⁶ See the website of BOTAS (Turkish State Pipeline Company) <http://www.botas.gov.tr/index.asp> last accessed 9 September 2012

⁷⁷ P Stevens, *Cross Border Oil and Gas Pipelines: Problems and Prospects* (ESMAP 2003) 72-74

between 1977 and 1990. These disputes are dealt with below. The operation of the pipeline has been affected by geopolitics. The political conflicts were not between the transit country (Turkey) and the producer country (Iraq) directly, but between the producer country and the international community after the invasion of Kuwait by Iraq and during the two Gulf Wars. The pipeline was mostly closed between 1990 and 2010 under UN sanctions, except for the oil that was transported for the humanitarian needs of the Iraqi people.⁷⁸

A new development with regard to the Kirkuk-Ceyhan pipeline is that, Genel Energy, a private independent company that produces two-thirds of the oil in the Kurdistan Region of Iraq, commissioned a company to construct a pipeline that will link the oil fields in the Kurdistan Region and the Kirkuk-Ceyhan pipeline.⁷⁹ This might add another geopolitical factor to the operation of this pipeline, which is the participation of an autonomous region that has been experiencing difficulties in its relations with the central government.⁸⁰

The economic factors that affect the behaviour of the transit country are the level of tariffs that have been paid to the transit country. The pipeline has experienced disputes on transit tariffs, which are dealt with below. There have been no effects related to foreign investment, since the pipeline is owned and operated by the producing and transit states under their jurisdictions. The disadvantage of the non-existence of foreign investment is that these kinds of transit pipelines might be more prone to political manoeuvring of

⁷⁸ www.botas.gov.tr last accessed 9 September 2012

⁷⁹ [www.genelenergy.com/index.php?sf=operations&k=317%20javascript:void\(0\)](http://www.genelenergy.com/index.php?sf=operations&k=317%20javascript:void(0)) last accessed 9 September 2012

⁸⁰ <http://www.reuters.com/article/2012/04/01/iraq-oil-kurdistan-idUSL6E8F100A20120401> last accessed 9 September 2012

participating states. However, if the legal arrangements for transit are given devices to cope with changing circumstances (e.g. an adaptation clause in the form of progressive tariffs) and the parties act with commercial considerations in mind, the pipeline can operate without disruption, as can be seen in the case of the Trans-Med pipeline between Algeria, Tunisia and Italy.⁸¹

6.4.2 Legal Arrangements and Regulation of Transit

The legal framework of the Kirkuk-Ceyhan oil transit pipeline is based on the 1973 Crude Oil Pipeline Agreement between the Governments of Turkey and Iraq.⁸² This agreement was amended by the 1985 Supplemental Agreement between the Governments of the two countries.⁸³ This legal framework was renewed in September 2010 through an IGA between Iraq and Turkey⁸⁴ when the terms of the earlier agreements ran out. The IGA of 2010 changed the tariffs that should be paid to the transit country and the amount of throughput guarantee. It includes an adaptation clause for tariff calculation. The dispute settlement clause was changed as well.⁸⁵

6.4.2.1 Tariffs

The tariffs that should be paid to the Turkish pipeline company (BOTAS) were determined in Article 4 of the 2010 IGA, which changed Article 3 of the 1985 Supplemental Agreement. Tariffs for the new term were determined as \$1.18 per barrel

⁸¹ Stevens, *supra* note 77 29

⁸² 1973 Crude Oil Pipeline Agreement between The Government of the Turkish Republic and The Government of the Iraqi Republic, Official Gazette 17 June 1975 Number 15268

⁸³ 1985 Supplemental Agreement to 1973 Intergovernmental Agreement, Official Gazette 5 May 1986 Number 19098

⁸⁴ Renewed Intergovernmental Agreement of 2010, www.tbmm.gov.tr last accessed 9 September 2012

⁸⁵ *ibid*

up to 22 MTA, \$1.15 up to 27 MTA, \$1.13 up to 32 MTA, \$1.09 up to 35 MTA, \$1.03 up to 45 MTA, \$0.96 up to 55 MTA, \$0.94 up to 60 MTA and \$0.90 up to 70.9 MTA.⁸⁶

6.4.2.2 Adaptation Clause

The most significant provision of the 2010 IGA is the adaptation clause regarding the calculation of tariffs. The tariffs should be adapted every five years according to the annual rate of the USA CPI.⁸⁷ The throughput guarantee was increased to the level of 22 MTA for 2010, 27 MTA for 2011, 32 MTA for 2012 and 35 MTA from 2013. Iraq is under an obligation to pay the amount of throughput guarantee irrespective of whether it transports that amount or not.⁸⁸ The inclusion of an adaptation clause with regard to tariffs might provide the required flexibility and reduce the possibility of the abuse of unconstrained bargaining power by the transit state. Moreover, the throughput guarantee would provide a certain amount of income to the transit country each year.

6.4.2.3 Dispute Settlement and Applicable Law Clauses

The parties are under obligation to settle disputes amicably through negotiation. However, if the dispute cannot be settled through negotiation within four months, the parties can submit the dispute to arbitration under the ICC rules. The seat of the arbitration is Paris and the applicable law of the arbitration is French law.⁸⁹

⁸⁶ 1985 Supplemental Agreement Article 3 set the tariffs as \$0.75 per barrel up to 35 MTA, \$0.60 up to 46.5 MTA, \$0.56 \$ up to 50 MTA, \$0.50 up to 60 MTA, \$0.43 up to 70.9 MTA. Article 7 of The 1973 Agreement set the tariff at a level of \$0.35 \$ per barrel.

⁸⁷ 2010 Renewal Agreement, Article 4(2)

⁸⁸ 1985 Supplemental Agreement Article 2 increased the throughput guarantee to the level of 35 MTA from 15 MTA, which had been the level before according to the Article 11 of 1973 Crude Oil Pipeline Agreement.

⁸⁹ 2010 Renewal Agreement, Article 10

6.4.3 Disputes on Tariffs, Non-payments by the Off-taker Transit Country and Their Settlement

The first dispute occurred in first year of the operation of the pipeline. It was closed for one month between the months of November and December 1977 due to the non-payment of the value of the oil that was off-taken by the transit country.⁹⁰ The second dispute occurred in 1981. Turkey tried to benefit from the several closures of the alternative IPC pipeline, which were caused by the political conflicts between Syria and Iraq after the start of Iraq-Iran war. Iraq announced plans to expand the capacity of transit through Turkey. Turkey tried to benefit from the closures and its monopoly status during that time. It demanded an increase in the transit tariffs to \$1.20.⁹¹ This dispute demonstrates the significance of the availability of alternative options.

The tariffs were increased to the level of \$0.75 in the Supplemental Agreement that was signed in 1985.⁹² Moreover, Turkey demanded an increase in transit fees and a lump-sum payment of \$264 million when the pipeline remained the only line for Iraqi exports permitted for humanitarian needs after the first Gulf War. The parties settled the dispute through a protocol in 1996.⁹³ The terms of the 1973 and 1985 intergovernmental agreements ceased in 2010. In September 2010, the parties signed a new agreement that adopted a progressive tariff system through linking the tariffs to the US CPI as well as a throughput guarantee. These have been analyzed above.⁹⁴

⁹⁰ Stevens, *supra* note 77 75

⁹¹ *ibid*, 74

⁹² 1985 Supplemental Agreement, Article 3

⁹³ Stevens, *supra* note 77 76

⁹⁴ 2010 Renewal Agreement, Article 4(1) and Article 3(2)

6.4.4 Assessment

Although an arbitration clause existed in both the 1973 IGA and the 1985 Supplemental Agreement, the parties resolved the disputes through renegotiations. An obvious weakness of the former arrangements for the Kirkuk-Ceyhan pipeline was the non-existence of a mechanism to deal with changing circumstances. The indexation of the tariff to the (US, German or Japanese) inflation rate was subjected to the condition that the increase in the inflation rate should be higher than 5%. Given that the realization of this probability is near to impossible in developed economies, this clause did not function. This rigidity made the operation of the pipeline prone to abuse that resulted from the change in bargaining power of the transit state as a result of the unavailability of alternative options after the closure of the IPC pipeline in 1982 and the monopoly status of the pipeline for humanitarian aids for all Iraqi oil exports after the Gulf War.

In the 2010 IGA, a progressive method was adopted. Transit tariffs were linked to the increases in the US CPI. The tariffs will be adapted every five years according to this index. Moreover, the throughput guarantee provides a significant amount of income for the transit state independent of whether the oil is actually transported or not. This progressive method of tariff calculation and throughput guarantee might minimize the risk of transit disputes, or at least abuse of unconstrained bargaining power, during the operation of the pipeline.

The experience of transit pipelines demonstrates that the good examples, which operated without interruption are those that adopt progressive tariff methods that link the tariffs to some objective criteria such as an inflation index or to a certain amount of gas

transported through the pipeline.⁹⁵ The Kirkuk-Ceyhan pipeline has never been interrupted due to a conflict between the producer and transit countries since the 2010 IGA. This fact confirms the above assertion with regard to the operation of transit pipelines.

6.5 The Russia-Ukraine Gas Transit Pipeline

6.5.1 Economics and Geopolitics of the Pipeline

The amount of gas that transits Ukraine is around 120 bcm annually. It constitutes 80% of the Russian gas exports to the EU and around 20% of total EU gas consumption. The remaining 20% of Russian gas exports to the EU passes through Belarus and Moldova.⁹⁶ The vast amount of gas that transits Ukraine and Europe's dependency on Russia for one fifth of its gas consumption are indicators of the significance of this gas transit pipeline for the economies of Russia, Ukraine and the EU countries. The dominant position of Ukraine in the transit of Russian gas to the EU raises the issue of the availability of alternative options, alternative pipeline routes, which influences the parties' bargaining power in negotiations.

The Russia-Ukraine gas transit pipeline was constructed to export Russian gas to European countries. It was part of the Soviet Union's pipeline system, which operated under an integrated model without the requirement for transit. However, after the dissolution of the Soviet Union, it became a transit pipeline. The geopolitics of the pipeline has been shaped in the context of the legacy of the Soviet Union. The pipeline

⁹⁵ See case studies in Stevens, *supra* note 77

⁹⁶ J Stern, "The Russia-Ukrainian Gas Crisis of January 2006" (OIES 2006) 2 Factual information on 2006 gas crisis mostly depends on this source.

was constructed on the assumption that the countries would remain under the same umbrella⁹⁷. However, the pipeline experienced disputes after the dissolution of the Soviet Union in the 1990s similar to those of 2006 and 2009. Each time, gas pressure to Europe dropped but the transit was not cut completely. The reasons behind these disputes were non-payment of the gas price by Ukraine, Russia's corresponding act of stopping the supply, and the lifting of gas that was destined for Europe from the pipeline by Ukraine.⁹⁸

Although the main cause of the transit disputes between Russia and Ukraine was economic and related to the price of the gas, the transit tariff rates and the non-payment of the gas price by Ukraine, politics has also been influential in Russia-Ukraine gas trade and transit.⁹⁹ The souring of relations between Russia and Ukraine after the "orange revolution", which resulted in a pro-western government in Ukraine in 2004, and changing attitudes of Ukrainian politicians relating to the structure and legal arrangements of the gas trade were influential in the gas supply and transit crises of January 2006 and 2009. Russia used the gas supply as a political weapon to influence Ukrainian politics, in particular during the January 2006 crisis. Russia exerted political and economic pressure on Ukraine to acquire better economic terms for itself and also political regime change. Ukraine used its control of the transit route in this political game.¹⁰⁰

⁹⁷ S Pirani, J Stern and K Yafimava, "The Russia-Ukrainian Gas Crisis of January 2009: A Comprehensive Assessment" (OIES 2009) 4. Factual information on 2009 gas crisis mostly depends on this source

⁹⁸ J Guillet, "Russia as a Predictable Partner: Another Reading of Russian-Ukrainian and Russian-Belarusian Energy Crisis" (2007) IFRI Report 7

⁹⁹ Stern, *supra* note 96 13

¹⁰⁰ A V Belyi and U G Klaus, "Russia's Gas Exports and Transit Dispute Resolution under the ECT: Missed Opportunities for Gazprom or False Hopes in Europe" (2007) 25 JENRL 205, 215; Stevens, *supra* note 48 9-10; Guillet, *supra* note 98 12.

6.5.2 Legal Arrangements and Regulation of Transit

A complex set of intergovernmental and commercial contracts constituted the legal basis of gas supply and transit relations between Russia and Ukraine before 2006 and 2009 crises. These agreements consisted of:¹⁰¹

- the 2000 intergovernmental agreement for transit of natural gas through Ukraine
- the 2001 intergovernmental agreement on supplemental measures to accomplish the transit of natural gas through Ukraine, which was supplemented by intergovernmental agreements every year between 2002 and 2006
- the 2002 commercial agreement between Gazprom and Naftogas on volumes and prices for supply and transfer for 2003-2013, which was supplemented by an addendum in 2004 for the years of 2005-2009
- the 4 January 2006 agreement on supply and transit for five years was signed after the 2006 crisis, which was to be supplemented annually to determine gas prices and tariffs¹⁰²
- the 19 January 2009 ten year supply and transit contract, which was signed after the 2009 gas crisis.¹⁰³

The details of these agreements with regard to tariffs and dispute settlement are analysed below, since they were either the subject or result of transit disputes between Russia and Ukraine.

¹⁰¹ Belyi and Klaus, supra note 100 213

¹⁰² Stern, supra note 99 9

¹⁰³ www.gazprom.ru last accessed 9 September 2012

6.5.3 Disputes on Tariffs, Gas Prices and on Non-payment by the Off-taker Transit Country and Their Settlement

6.5.3.1 The January 2006 Crisis

In the 2004 addendum to the 2002 Commercial Agreement, the parties agreed on a barter deal for the payment of tariffs. The amount of gas that should be supplied to Ukraine in exchange for tariffs was between 21-25 bcm annually. The notional gas price was \$50 per 1000 cubic meters and the transit tariffs was \$1.09 between 2005 and 2009. The parties decided to establish a consortium of Gazprom, Naftogas and possible European partners to operate the Ukrainian transit network.¹⁰⁴

As a result of the change of government in December 2004 (the orange revolution), Russia-Ukraine relations regarding gas supply and transit experienced dramatic developments in 2005.¹⁰⁵ Ukraine demanded European prices for tariffs in March-April 2005. This demand was enthusiastically received by Russia with the corresponding demand of European prices for the gas supplied to Ukraine. If this demand had been met by Ukraine, it would have resulted in an increase in the gas price from \$50 to \$230. There was a sharp rise in gas prices in 2005. Russia adopted a policy of increasing to European levels the gas prices that had formerly been paid by the ex Soviet countries at subsidized prices: this would mean a price 3-4 times higher than the price they had previously paid.¹⁰⁶ These facts illustrate the significance of the relationship between the supply and transit countries, even though the dispute was originally economic. Russia abandoned its

¹⁰⁴ Stern, supra note 96 2-3

¹⁰⁵ *ibid*

¹⁰⁶ *ibid*, 4-6

non-commercial policy regarding gas prices after the pro-western government had come to power in Ukraine.

The parties could not reach agreement on the terms for transit and supply contracts in December 2006. The main topic of the disputes were the increases in the price of gas and tariffs to European levels, the abolished consortium concept, the legitimacy of the intermediary company (RosUkrEnergo) that had supplied Turkmen gas to Ukraine, and the security of Russian gas in Ukrainian storage for European supply.¹⁰⁷

On 1 January 2006, Russia ceased supplies to Ukraine. As a result, Ukraine lifted the Russian gas that was destined for Europe. European countries partially lost the supply of their gas. Russia pumped additional gas on 3rd of January to compensate for Ukraine's lifting of the gas. The parties reached an agreement on 4th of January.¹⁰⁸

The significant and determining factors in the 2006 dispute were the amount and price of the gas that should be supplied to Ukraine and the transit tariff rates that were determined through annual intergovernmental agreements at the end of each year. The complicated structure of these legal arrangements was a major factor in the January 2006 gas crisis.¹⁰⁹

Although the intergovernmental agreements of 2001 Article 9, 2002 Article 10 and 2004 Article 15 provided for third-party dispute settlement and Article 12 of the 2002 commercial agreement between Gazprom and Naftogas provided for arbitration at the

¹⁰⁷ *ibid*, 6

¹⁰⁸ *ibid*, 9

¹⁰⁹ Belyi and Klaus, *supra* note 100 214

SCC, the parties preferred to resolve the January 2006 dispute through bilateral and politically influenced renegotiations.¹¹⁰

The legal centre of the January 2006 dispute was whether the 2004 addendum to the commercial contract was valid without a respective intergovernmental protocol for 2006 supplementing the 2001 intergovernmental agreement. According to the Ukrainian side, it was valid; Russia took the opposite view.¹¹¹ However, Article 2 of the 2001 intergovernmental agreement and Articles 3(2) and 8 of the 2002 commercial contract clearly stated that the amount of gas transit and the level of transit tariffs should be determined by the annual intergovernmental protocols.¹¹²

The supply and transit contracts for the next five years were signed on 4 January 2006. The tariffs were set at the level of \$1.60/mcm/100km for 2006. RUE (an intermediary company) would supply the Turkmen gas to Ukraine instead of Gazprom. The price of gas that was supplied by the intermediary company was around \$95 without the right to re-export by Ukraine during 2006. The gas supplied by Gazprom would be at European price levels. The contract determined tariffs and gas prices for 2006 only. It left it to the annual intergovernmental agreement to determine the tariffs and gas prices for the following year.¹¹³ The agreement of 2006 did not resolve the problems that were caused by the requirement for an annual intergovernmental agreement and by subsidized gas prices. These unresolved problems were the main causes of the 2009 gas crisis, which is analysed below.

¹¹⁰ *ibid*

¹¹¹ *ibid*, 220

¹¹² *ibid*, 222

¹¹³ Stern, *supra* note 96 9-10

Although on 3 January EU commissioner proposed the use of the Article 7 conciliation mechanism of the ECT, which was applicable at that time for the parties, it was not used and the parties resolved the dispute through politically influenced renegotiations.¹¹⁴ It is submitted that if the ECT mechanism had been used, the decision of the conciliator would have probably been in favour of Russia, given the absolute non-interruption obligation of the transit country, Ukraine, under ECT Article 7.

Russia's reaction to the crisis was to develop alternative options, that is pipeline routes such as Nord Stream. Russia demanded an increase to European levels in the price of the gas that was supplied to FSRs.¹¹⁵ The FSRs that shared ownership of their transit structure with Russia, such as Belarus and Armenia, were able to negotiate for the long term while the countries that did not share ownership and that adopted a pro-western political approach experienced more rapid increases in gas prices.¹¹⁶ Subsidized prices reinforced interdependency. In 2007, Belarus, Armenia and Ukraine were charged \$100, \$110 and \$130 respectively for per 1000 cubic meters of gas, in contrast to the \$235 paid on the European market. On the other hand, Georgia and Azerbaijan, which were politically part of the western system, have paid world prices since 2007.¹¹⁷

6.5.3.2 The January 2009 Crisis

Russia could not achieve a rise in the gas price for Ukraine to European levels after the 2006 dispute, even though this was decided in the January 2006 agreement. Rising gas

¹¹⁴ *ibid*, 15

¹¹⁵ *ibid*, 15-16

¹¹⁶ Pirani, Stern and Yafimava, *supra* note 97 7

¹¹⁷ S Nies, *Oil and Gas Delivery to Europe: An Overview of Existing and Planned Infrastructures* (IFRI 2008) 19

prices resulted in a huge difference between the price of gas for Ukraine and the actual market prices.¹¹⁸ The demands by Russia to increase the price of gas for FSRs to European levels resulted in a transit crisis with Belarus in 2007. The parties settled the dispute through giving 50% ownership of the Belarus transit system to Gazprom and the adoption of a three-year timetable to increase the gas price to European levels. In contrast, the tariffs and gas prices for 2007 were settled with Ukraine without a crisis.¹¹⁹ In the 2007 intergovernmental agreement between Russia and Ukraine, gas prices for 2008 increased to \$179.50 per 1000 cubic meters from \$130 (the price for 2007). The tariffs were increased slightly to \$1.70 from \$1.60 per 100 km. The RUE remained to act as the intermediary company for Turkmen gas that was re-exported by Russia to Ukraine.¹²⁰

An intergovernmental memorandum was signed in October 2008. The parties agreed to increase gas prices and tariffs to European levels gradually over three years. Gazprom would have access to Ukrainian customers. The agreement subjected the removal of RUE to the clearance of Ukraine's debts and the timely payment for future deliveries and to the access to Ukrainian customers for Gazprom. Gazprom and Naftogas signed a commercial agreement on 24 October 2008 on the Principles of Long-term Cooperation in the Gas Sector. It adopted the terms of the intergovernmental memorandum. The parties agreed that a long-term contract for the transition to market prices should be signed by 1 November. The Naftogas guaranteed the uninterrupted transit of at least 120 bcm/year. The intermediary company, RUE, was to be removed and debts due to RUE

¹¹⁸ Pirani, Stern and Yafimava, *supra* note 97 9

¹¹⁹ *ibid*, 10

¹²⁰ *ibid*, 11

would be paid to Gazprom. A two-month supply contract between Gazprom and Naftogas was to be concluded by 30 October. The January 2006 agreement would be annulled when the conditions of this commercial contract were met. The parties failed to meet the conditions of this agreement due to alleged non-payment by Ukraine.¹²¹ As a result, Russia cut the supplies to Ukraine on 1 January 2009. Russia accused Ukraine of lifting gas on 5 January. Ukraine responded that this gas was the technical gas it was entitled to because of the non-existent supply and transit contracts. The supplies to Europe were cut on 7 January. The parties resolved the dispute through signing an agreement on 19 January and the flow to Europe started on the following day.¹²²

The legal basis of the dispute was similar to the 2006 dispute. The parties disagreed on whether the 2002 commercial contract was valid without an intergovernmental agreement. According to Russia, it was valid since it expires in 2014 and Ukraine was under obligation to guarantee uninterrupted transit for at least 110 bcm. According to Ukraine, without an intergovernmental agreement on substantial provisions it was not valid and Ukraine was not entitled to accept Russian gas for transit.¹²³ Russia's loss in terms of gas supply was \$100 million daily, which amounted to more than \$2 billion over the course of the crisis. This was in addition to the possible penalties under gas supply contracts.¹²⁴

¹²¹ *ibid*, 14-15

¹²² *ibid*, 19

¹²³ *ibid*, 43

¹²⁴ Fact Sheet, Agreement Between Gazprom and Naftogas Ukrainy; Briefing Paper, Russia-Ukraine-EU Gas Cooperation, 11 November 2009 <http://www.gazpromukrainefacts.com/content/fact-sheets-ukrainian-gas-dispute> last accessed 9 September 2012

Russia raised the construction of alternative pipelines as a possible solution in the long term. The EU raised the possibility of construction of alternative supply and transit routes as well, such as the construction of a pipeline that would traverse the southern corridor through Turkey to supply gas from South Caspian countries to European countries.¹²⁵ Russia's response to the crisis was to construct the by-pass pipelines, Nord and South Stream, by 2015. The capacity of South Stream is 63 bcm and that of Nord Stream is 55 bcm. The capacity of these two pipelines is nearly equal to the 120 bcm of gas that passes through Ukraine. Russia has already constructed by-pass pipelines such as Yamal through Belarus and Poland, which has a capacity of 33 bcm, and Blue Stream, which has a capacity of 16 bcm, to Turkey through the Black Sea and without any transit country. These pipelines started to operate in 1999 and 2003, respectively.¹²⁶

The parties signed a ten-year supply and a ten-year transit contract on 19 January 2009. According to the supply contract, the price of gas for 2009 should be 80% of, and for 2010 100% of, European prices. A take or pay level of 80% of the gas amount that was sold to Ukraine was determined. There was a penalty clause for excessive lifting of the gas by Ukraine. The price can be renegotiated when the parties feel it does not reflect market conditions. The gas supply should be provided directly by Gazprom instead of intermediary company, RUE. A Gazprom subsidiary would market the 25% of the gas that it supplies to Ukraine.¹²⁷

¹²⁵ Pirani, Stern and Yafimava, *supra* note 97 57-59

¹²⁶ Nies, *supra* note 117 70-71

¹²⁷ Fact Sheet, *supra* note 124

According to the transit contract, the tariffs for 2009 remained at same rate of \$1.70. However, from 2010, the tariff would be \$2.04/mcm/100km. If the average price of gas is more than \$250, the tariffs should be increased by \$0.60. From 2011, the tariff would comprise 50% of \$2.04 plus 50% of the previous year's tariffs indexed to EU inflation rates. The volume of gas transited through Ukraine should not be less than 110 bcm annually. Both the supply and transit contracts include provision for arbitration at the SCC.¹²⁸

6.5.4 Assessment

Although the ECT conciliation mechanism was available for the parties during the 2006 and 2009 disputes, the parties did not refer the dispute to conciliation. However, if Russia had referred the dispute, a decision in its favour was probable, since there is an absolute non-interruption obligation on the transit country under the ECT Article 7 transit provisions. However, after the termination by Russia of its application of the ECT in August 2009, the conciliation mechanism would not be available for any future disputes.

The main causes of the disputes were non-payment for the gas that was off-taken by Ukraine and the disagreements on the methodology for gas price and tariff calculation. The complex nature of the legal arrangements contributed significantly to the occurrence of disputes. The parties did not remove the causes of the 2006 crisis, e.g. subsidized gas prices, the fixed tariff system, the determination of gas prices and tariffs through intergovernmental agreements and the use of an intermediary company for Turkmen gas,

¹²⁸ *ibid*

by the legal arrangements of January 2006. Therefore, the crisis repeated in 2009 with nearly identical causes.

The main weaknesses of the legal arrangements for the Russia-Ukraine gas trade and transit were their complicated structure and inflexibility with regard to tariff calculation. Tariffs were not linked to an objective criterion such as the price of the gas or a certain amount of the gas. These complicated and inflexible legal arrangements, which operated in an unstable geopolitical environment, were the main causes of the disputes.

It is submitted that the 10-year supply and transit contracts of 2009 resolved many matters that were constantly the causes and subjects of disputes between Russia and Ukraine. An adaptation clause was adopted to calculate tariffs. Tariffs were linked both to the price of gas (if in excess of \$250) and to the EU inflation rates. This progressive method of tariff calculation and the adoption of European market prices for gas minimize the risk of disputes relating to tariffs and gas prices due to the fact that best practice for transit pipelines is that which adopts flexible and market-based financial terms.¹²⁹

Although the gas price and tariffs have been determined through annual intergovernmental agreements at the end of each year since the 2009 agreement, the flow of Russian gas through Ukraine has not been interrupted since 2009. This fact demonstrates the efficiency of the inclusion of an adaptation clause for tariff calculation. Furthermore, a penalty clause was adopted in the supply contract for the illegal lift of gas by the transit country, Ukraine. This provision increases the bargaining power of Russia

¹²⁹ Stevens, *supra* note 77

as an inside option and prevents Ukraine from lifting the gas originally destined for Europe, since the penalty clause significantly increases the risk aversion of Ukraine. The intermediary company, RUE, which had been the subject of constant disputes, was also removed.

On 3 January 2009, Russia revealed that it had decided to file an arbitration case at the SCC on the basis of the breach of the 2002 transit agreement, which guarantees unimpeded transit. It was reported that RUE had also filed two arbitrations at the SCC, based on the interruption of transit and the lift of RUE's gas that was in storage by Ukraine.¹³⁰ The arbitral tribunal decided that Ukraine had expropriated the gas that belonged to the Russian companies. Ukraine was told to pay compensation for the amount of gas that it had taken.¹³¹ These arbitration cases demonstrate the viability of third-party dispute settlement clauses in commercial contracts, even though they function over the long-term.

Even since the 2009 crisis, geopolitical factors have been decisive in the regulation of gas trade and transit between Russia and Ukraine. In April 2010, the parties agreed on a 30% discount in the price of gas sold to Ukraine in exchange for the lease of the Black Sea naval base, Sevastopol, to Russia for 25 years by Ukraine¹³². This agreement again raised the matter of the influence and in fact the decisive effect of geopolitics on Russia-Ukraine gas trade and transit. These attitudes of the parties made the gas trade and transit prone to disputes that might have been initiated by the souring of political relations between the

¹³⁰ Pirani, Stern and Yafimava, *supra* note 97 32

¹³¹ <http://arbitration-blog.eu/stockholm-court-rules-against-ukraine> last accessed 9 September 2012

¹³² Nies, *supra* note 117 96

countries. It seems that the smooth operation of the Russia-Ukraine gas pipeline is dependent not only on the legal provisions of the agreements but also on the existence of a smooth political relationship between Russia and Ukraine.

6.6 Conclusion

The operation of the pipelines that are subject of the case studies demonstrates that transit disputes relating to the level of tariffs, transit fees and operating fees, and to the price of gas off-taken by the transit country have been settled through renegotiations. Adaptation of the contracts was the result of all these renegotiations.

The BTC and CPC pipeline disputes demonstrate that the existence of a stabilization clause in the form of freezing and economic equilibrium clauses and an applicable law clause, such as the English law under which contract change is very limited, could not prevent adaptation of the contract. When the economic and geopolitical contractual environment changes substantially, contract change is inevitable.

The agreements signed after the renegotiations have a common feature. This is the insertion in the contract of adaptation clauses that link the tariffs to some objective criteria such as the US consumer or producer prices index or EU inflation rates. This was what happened in the Kirkuk-Ceyhan oil transit pipeline, BTC oil transit pipeline and Russia-Ukraine gas transit pipeline. Another method, which was adopted by the 2009 Russia-Ukraine gas transit pipeline agreement, is linking the tariffs to the gas price. In the case of the SCGP, Georgia's transit fee was linked to a certain amount of gas.

The insertion of these adaptation clauses, and the smooth operation of these pipelines without interruption or any other dispute after the insertion of these clauses, confirms the assertion that good examples of transit pipelines that operate without interruption are those whose agreements accommodate clauses which provide a certain flexibility in addressing the changing economic conditions surrounding the contractual environment

CHAPTER 7. CONCLUSION

7.1 Summary of the Findings

1. A transit pipeline traverses at least a transit state and two borders before it reaches either the consumer country or the port of the transit state. Therefore, it is a multilateral project between participating states. There are two models for constructing and operating pipelines: they can either be constructed and operated by state companies in each jurisdiction or be constructed and operated vertically by foreign investors (IOCs) in each host state.

The first model is the national pipeline model, while the second is the international pipeline model. Their legal arrangements are also different. The legal arrangements for the first model consist of IGAs between participating states and commercial agreements between state companies. The legal arrangements for the second model consist of IGAs between participating states, HGAs between the pipeline company and each host state and underlying commercial contracts on supply and transportation of the commodity. Transit disputes are disputes relating to the transit rights and terms included in these agreements. These disputes can be between governments, between state companies or between the host state, state company and the pipeline company.

The transit pipelines in the Caspian Region have experienced disputes during their operation. The transit disputes that occurred under the national pipeline model resulted in the interruption of flows and were more prone to geopolitical influences. The transit disputes that occurred under the international pipeline model did not result in the interruption of flows. This is despite the fact that the reason behind these disputes was the same in both cases that is demand for the renegotiation of transit

terms. The causes lying behind these disputes are the obsolescing bargain, industry cycles and the lack of flexible contractual mechanisms to accommodate future changes in the underlying economic conditions of the contract.

In this context, stability means maintaining the economic equilibrium of the contract. Economic equilibrium clauses aim to maintain the economic equilibrium of the contract through addressing the results of a change in the law that disturbs the equilibrium of the contract. Renegotiation clauses, in particular adaptation and hardship clauses, aim to maintain economic equilibrium of the contract through addressing changes in the underlying economic conditions of the contract. Therefore, they both function as stability provisions.

Long-term contracts are obsolesced. This is a reality of the petroleum industry. This concept is more important in transit pipeline agreements due to the huge upfront investment involved and also the low operating cost and immovability of the pipeline. However, new contracts are signed after the interaction of the same bargaining factors that were decisive in the creation of the original contract.

This research adopted a methodology that consisted of both doctrinal research and case studies. Bargaining theory, in particular the alternating offers model, was analysed in order to determine the bargaining factors and the bargaining outcome in the context of transit pipeline agreements. The doctrinal research aimed to analyse the stability provisions in transit pipeline agreements. In the case studies, the viability of these stability provisions as bargaining factors in the settlement of transit disputes was addressed.

2. The analytical framework of the thesis consisted of the alternating offers model of bargaining theory. Bargaining has three main problems. These are the negotiators' tactics and their role, the concession process and the outcome. This thesis focused on the concession process. According to this model, there are four bargaining factors that determine the bargaining power of the parties in the concession process and the bargaining outcome. These factors are the discount rates of the parties, risk aversion of the parties, outside options of the parties and the inside options of the parties.

Discount rates of the parties mean their attitude towards time. These are economic factors in the context of the thesis. Risk aversion means the parties' attitude towards the risk of breakdown. In the context of the thesis, economic and geopolitical factors determine the risk aversion of the parties. Outside options mean the availability of alternatives to conducted negotiations. In the context of the thesis, this means the use of alternative pipelines. Inside options mean the ability of the parties to reap benefit from the circumstances in which bargaining occurs. In the context of the thesis, these are the legal stability provisions, contractual and treaty provisions, which provide stability to contracts through maintaining the economic equilibrium of the contracts. Bargaining theory indicates that, in a bargaining situation, inside options can be effective when the parties' discount rates and risk aversions are equal and there is no preferable alternative option.

Economic and geopolitical factors come under the discount rates, risk aversion and alternative options concepts of bargaining theory. Economic factors are tariffs and transit fees, realization of profit through reaching markets, the approach of the transit country to foreign investment, the approach of the pipeline company to existing and

future investments in the transit state, and the degree of equity participation of the transit state in the pipeline company. Geopolitical factors are the energy security concerns of the international business and political community, the control of transit routes, the relationships between the participating states in the pipeline, and the relationships between the transit state and the home governments of the investors and with international institutions. The treaty and contract stability provisions operate in a contractual environment that consists of these economic and geopolitical factors.

3. The ECT regulates the transit of energy materials in its Article 7. It states the principle of freedom of transit on a non-discriminatory basis for the Contracting Parties. It obligates the Contracting Parties to treat energy in transit and access to its transport systems according to the national treatment standard. However, establishment of new capacity is subjected to exemptions set by the legislation of the state party that is consistent with the principle of freedom of transit. A Contracting Party cannot be obligated to permit new transit through existing facilities or to construct new transit facilities if it can demonstrate that this would endanger its security, including security of supply.

The most important provisions are stated in paragraphs 6 and 7 of Article 7. There is a non-interruption obligation on the transit state in the event of a dispute over existing transit unless this right has been granted under a contract or is in accordance with the decision of a conciliator. The parties can refer their disputes over existing transit to a conciliator appointed by the Secretary General of the Energy Charter. The conciliator can decide on interim tariffs, which should be observed by the parties for 12 months or until the resolution of the dispute whichever is earlier. The parties can refer the

dispute to a conciliator after exhaustion of the dispute settlement mechanism agreed on by them in the contract. This exhaustion obligation of contractual dispute settlement mechanisms makes conciliation ineffective, since most of the transit contracts include dispute settlement clauses.

The ECT transit regulation is an exemption regime based on the sovereignty concerns of the Contracting Parties. Therefore, it might not provide secure transit. Parties concerned due either to its inefficiency or to the parties' unwillingness to refer their disputes to conciliation have never used the conciliation mechanism. Moreover, conciliation mechanism is only available for the types of disputes described in paragraph 6, which concerns the non-interruption obligation and existing transit. Disputes over the rights and obligations described in other paragraphs cannot be the subject of the conciliation mechanism.

The EU and Russia could not agree on the Draft Transit Protocol, which elaborates the transit provisions of ECT Article 7. The fundamental obstacles to ratification of the Protocol are the REIO clause, which regards the whole of the EU as a unit for transit purposes and subjects the transit to EU rules instead of the Protocol and the ECT in the EU area. The use of auctions in tariff calculations is another obstacle. Moreover, Russia terminated its provisional application of the ECT in 2009 with regard to transit provisions through informing the Energy Charter Secretariat that it did not intend to become a party to the ECT. Therefore, because of the lack of participation by Russia, the ECT transit provisions are largely ineffective.

Furthermore, Russia's Draft Convention on Energy Security and the corresponding act of the Energy Charter Conference, the Road Map of the Energy Charter, do not provide a solution to the ineffective conciliation mechanism and do not remove the obstacles to ratification of the Protocol. This is with the exception of the fast-track state-to-state arbitration mechanism proposed in the Road Map, but the details and procedures of this mechanism were not elaborated. However, there is an absolute need to provide a fast, binding and enforceable resolution mechanism. Moreover, the ECT area should be enlarged through including Norway and Russia, which are important players in energy production and supply.

The definition of investment under the ECT includes contractual rights over an economic activity in the energy sector and includes transportation in its scope. This, therefore, enables protection under the ECT investment provisions and the settlement of disputes through ECT Article 26 investor-state arbitration. However, the subject of the disputes should be transit terms (transit fees, tariffs or capacity rights) that are included in the investment contract.

The fundamental investment protection provisions are included in ECT Article 10. This includes an umbrella clause, which obligates the Contracting Parties to "...observe any obligations it has entered into with an investor or an investment of an investor." This obligation includes the transit terms stated in the transit pipeline agreements between the pipeline company and the host transit states. Another investment protection provision is the FET standard. The FET standard provides stability and obligates the parties to observe transit terms included in transit pipeline agreements. However, to benefit from protection under the umbrella clause and the

FET standard and to invoke Article 26 investor-state arbitration, the contractual breach should be sovereignty-based to put it under the protection of the Treaty.

4. Stabilization clauses, both traditional freezing and economic equilibrium clauses, are not in conflict with the sovereignty of the state. They are the expressions of that same sovereignty. They are legally valid unless the constitution of the country prohibits the inclusion of them in a state contract. A competent state authority should sign the contract for it to be legally valid.

Traditional freezing clauses cannot prevent changes in legislation or expropriation, which is their intended aim. They can only be used to remedy that state act. They cannot make an expropriation unlawful, since a contract breach is not a prerequisite of unlawful expropriation. Stabilization clauses reinforce the sanctity of contracts principle. They increase the compensation to a higher level, since inclusion of a stabilization clause in the contract increases the legitimate expectations of the foreign investor.

The experience of the petroleum industry in early arbitration cases regarding the interpretation of stabilization clauses resulted in the design of a new form of stabilization clause, the economic equilibrium clause. The second factor that contributed to this development was that investment contracts had been mostly entered into by state companies rather than the government itself. The state company party to the contract could not guarantee not to change the legislative framework of the contract. It could only guarantee to remedy, or compensate for, the results of the state act.

The award of the tribunal in the *Duke v. Peru* case interpreted the effect of a classical stabilization clause on a change in regulation and the change in interpretation of the regulation by state authorities. The award of the tribunal was in conformity with the evolution of stabilization clauses into the form of an economic equilibrium clause. There is a “tax burden” concept in stabilization provisions. The tribunal decided that the change in the interpretation of the rules by a state authority was a breach of the stabilization clause, since it increased the tax burden on the foreign investor. The tribunal decided on payment of compensation to the foreign investor, which remedied the effect of the increased tax burden. Therefore, it restored the economic equilibrium of the contract.

Economic equilibrium clauses, subject to the language of the clause, state that if a legislative, administrative or judicial state act adversely affects the economic equilibrium of the contract; the state party is under obligation to restore the economic equilibrium of the contract. The restoration of the economic equilibrium might be made through amendment of the contract according to a specified formula in the clause, a negotiated amendment that require the parties to meet and negotiate on the amendment, or an automatic amendment, without a specified formula, which requires negotiation in most cases. There are hybrid forms that require exemption from state act instead of an amendment; in the absence of such an exemption, payment of compensation is required.

In any type of economic equilibrium clause, arbitrators should be authorized by the contract to adapt the contract in the event that the parties cannot agree on the amendment. Otherwise, an open-ended clause that requires a negotiated or non-

specified amendment without authorization of arbitrators to adapt the contract might increase the bargaining power of the state party in a renegotiation. On the other hand, an economic equilibrium clause that requires amendment of the contract according to a specified formula (e.g. a decrease in tax), together with authorization of the arbitrators to adapt the contract, might increase the bargaining power of the pipeline company. Moreover, the *lex arbitri* should authorize the arbitrator to adapt the contract. Therefore, choosing a suitable applicable law or, in the absence of this, a suitable arbitration seat is essential.

The practice of transit pipeline agreements confirms the tendency to include these economic equilibrium clauses mostly together with traditional freezing clauses, of varying types. The CPC Restructuring and Shareholders' Agreement and the WAGP International Project Agreement include negotiated types of economic equilibrium clauses. The BTC HGAs include a hybrid form that requires either exemption from the state act or, if the state act disturbs the equilibrium, payment of compensation to the pipeline company. On the other hand, the ECT Model Agreement for Cross-Border Pipelines includes a specified type of economic equilibrium clause that requires a decrease in the taxes paid to the host state in the event that a state act adversely affects the economic equilibrium of the contract.

The extent of the contract amendment depends on the wording of the clause. The clause can adopt objective standards, such as restoring or maintaining the economic equilibrium. It can refer to subjective standards, such as fairness and equity. However, in either case, economic equilibrium should be understood through taking into consideration the evolving nature of the contractual relationship through time and the

changes in the underlying conditions of the contract. Moreover, neither party should experience a loss or gain as a result of the amendment.

5. The inherent contingency in long-term contracts in the form of changes in economic conditions, fundamental or steep price changes due to industry cycles, participation of a state as a contracting party and changes in geopolitics might result in renegotiation demands by the parties, in particular the state party. The parties' right to request renegotiation and adaptation of the contract will be subject to the applicable law of the contract in the absence of a clause that requires renegotiation.

The applicable law for contract change, subject to the choice of the parties and the principles of private international law, is the general principles of law. It is either chosen by the parties or applies as part of international law or as included in the national law of the host state. The sanctity of contract principle is a general principle of law and embodied in all main legal systems. However, it is limited and balanced by another general principle of law, that of fundamental change in circumstances. Therefore, a comparative law approach is required to determine the exceptions to the sanctity of contract principle in the main legal systems.

Under English Law, exceptions to the sanctity of contract principle are dealt with by the doctrine of frustration. In the event of physical or legal impossibility of performance or frustration of the purpose of the contract that means a radical change in the nature of the contract, the contract is terminated. Under US Law, the impracticability doctrine deals with exceptions to the sanctity of contract principle. The impracticability doctrine is in line with the understanding of the frustration of

purpose doctrine. The contract is terminated in the case of an unforeseen event that renders the performance impracticable.

Under French Law, exceptions to the sanctity of contract principle are dealt with by the *force majeure* concept in commercial contracts and by the *imprevision* and *fait du prince* doctrines in administrative contracts. Under the *force majeure* concept, an external unforeseen event that results in the impossibility of performance without the fault of either of the parties discharges the performance. Under the *imprevision* doctrine, if a fundamental change in economic conditions results in the complete disturbance of the economic equilibrium, the contract is adapted. Under *fait du prince* doctrine, the state party can adapt the contract in cases of overriding public interest.

Under German Law, exceptions to the sanctity of contract principle are dealt with by the doctrine of the collapse of the foundation of the contract. If the basis, the foundation of the contract, collapses as a result of a fundamental change in economic circumstances, the contract is adapted. However, neither under the doctrine of *imprevision* nor under the doctrines of collapse of the foundation or frustration is mere hardship adequate in order to bring about the adaptation or termination of the contract.

On the other hand, if the underlying economic conditions of the contract change fundamentally, e.g. there is a steep rise in a commodity price, the experience of investment contracts demonstrates that even the existence of a stabilization clause or an applicable law clause that requires the application of English law and the very strict doctrine of frustration cannot prevent the renegotiation of the contract to

accommodate the changes in economic conditions. Therefore, there is a need to include a contract clause that requires renegotiation in the event of a change in the underlying economic conditions of the contract. This attitude is in conformity with the reality of the petroleum industry.

In the context of this thesis, the clauses that require renegotiation were classified according to the extent of contract change. An adaptation clause requires change in certain provisions of the contract according to a specified formula in the contract on the occurrence of a change in key financial economic conditions (e.g. a price change). Renegotiation clauses require a more material and broad contract change without adopting a specified formula through cooperation of the parties on the occurrence of a triggering event that is defined in the contract. Hardship clauses require the adaptation of the contract in the event of a change in the underlying economic conditions as a result of an unforeseen event that results in fundamental change in the economic equilibrium of the contract. This fundamental change level is defined by the UNIDROIT Principles of ICC as a 50% increase in the cost of performance or a similar decrease in the value of the performance. *Force majeure* clauses require the termination of the contract, or temporary suspension of it, if an external event that renders the performance impossible occurs. If the impossibility is temporary and the contract is suspended, renegotiation is probable to address the changes resulting from the external event.

The procedural aspects of renegotiation, which are common to all the above-mentioned contractual forms of renegotiation, should be carefully considered for an effective renegotiation. These aspects are triggering events, the duty to negotiate in

good faith and its content, the role of arbitrators in adaptation of the contract and the extent of contract change.

Triggering events should be very clearly defined in the contract for an effective renegotiation clause, since the clause can only be invoked after the occurrence of a triggering event. Although it is not an easy task to envisage all the triggering events during contract design due to the contingency of long-term contracts, an event that is likely to happen such as a steep price rise or is certain to happen in the future such as the passage of a certain length of time or investment recovery is certain for the occurrence of the triggering event and invoking renegotiation clause. The occurrence of a triggering event, such as a fundamental change in the economic equilibrium of the contract, might be the subject of a conflict. However, the criteria provided by the UNIDROIT Principles of ICC might be used to determine whether a fundamental change in the economic equilibrium of the contract has occurred.

The duty to negotiate in good faith is subject to the existence of a renegotiation clause. In the absence of a renegotiation clause it is subject to the applicable law of the contract. If there is a renegotiation clause in the contract, the parties are under obligation to negotiate once the triggering event has occurred. However, the obligation is just to renegotiate. It does not include agreeing on the amendment. The meaning of the obligation to renegotiate is to conduct serious renegotiations in good faith with an aim to compromise. The parties are not under an obligation to agree.

The role of arbitrators in contract adaptation revolves around the existence of a legal dispute. Arguably, the conflicts about rights are clearly legal disputes, while the

conflicts about interests, such as disagreement of the parties, might not be. The disputes that result from the occurrence of a triggering event or the breach of good faith obligations are clearly legal disputes and might be referred to arbitration. However, in the event of a dispute between the parties on the adaptation of the contract and the failure of the parties to agree on contract change, the arbitrators should only be authorized to adapt the contract by the consent of the parties in the renegotiation clause or by the arbitration clause in the contract. The parties' authorization through the contract is not adequate to empower arbitrators to adapt the contract. The procedural law of arbitration (*lex arbitri*) should give this authority as well.

There is a tendency to include contractual adaptation in the scope of dispute definitions by the arbitration acts of the main arbitration seats. The English Arbitration Act and the Swedish Arbitration Act include contract adaptation under the scope of their definition of dispute. However, under ICSID arbitration there is a need for a legal dispute. Disagreement between the parties on contract adaptation is not regarded as a legal dispute by the ICSID. In order to put a dispute on contract adaptation under ICSID jurisdiction, the parties can apply to a third party intervener for a binding decision if the consent is given by them in the contract to allow adaptation by a third party. The binding decision of the third party intervener can be inserted into the contract. If one of the parties does not act in conformity with this decision, the other party can file for arbitration under ICSID rules.

The extent of the contract change as a result of the adaptation of the contract, either by the parties or by an arbitral tribunal or a third party intervener, is subject to the

wording of the renegotiation clause. The clause can include objective standards, such as maintaining or restoring the economic equilibrium of the contract, or subjective standards such as fairness and equity. The objective standards might be more effective, since determining the content of the subjective standards, fairness and equity, is not an easy task and is prone to discrete interpretation by the parties or by the arbitral tribunal or third party intervener. However, the equilibrium should be understood in an evolving manner. The evolution of the contract during the contract term and the changes in the contractual environment should be taken into account.

6. The transit disputes experienced during the operation of transit pipelines in the Caspian Region were analysed in detail in the last chapter. The transit dispute on the operating fees, pumping fuel and adjustment of the contract in the BTC pipeline case demonstrates that even the existence of very strict stabilization clauses, in both freezing and economic equilibrium form, and the applicable English Law on contract change cannot prevent the adaptation of the contract when there is a fundamental change in the economic conditions of the contract. Under the contract clauses, adaptation of the contract that is, insertion of an adaptation clause for the calculation of operating fees was not possible. However, the parties settled the dispute through the renegotiation and adaptation of the contract, since they appreciated the value of continuing the contractual relationship through removing the state company from its hardship situation rather than insisting on the strict application of contract clauses. Furthermore, they inserted an adaptation clause in the contract for the calculation of operating fees. In this case, the absence of an alternative option increased the bargaining power of the state party and allowed it to achieve its aims through renegotiation.

The dispute on capacity expansion and the negotiated settlement of this matter in the CPC pipeline case demonstrates that the unanimous decision requirement under the Restructuring and Shareholders' Agreement functioned as a renegotiation clause in the operation of this pipeline. When the capacity is expanded to 67 MTA from 30.5 MTA, the economic conditions of the contract will fundamentally change. Therefore, the state party prolonged the renegotiation on capacity expansion to obtain the tariff increases, the ship or pay guarantee for the extended capacity and the change in loan agreements. The cost of the alternative option, transportation of the oil through the Caspian Sea and then the BTC pipeline, prevented the parties from using this alternative option effectively as a bargaining factor. Therefore, they agreed to the demands of Russia in exchange for getting approval for capacity expansion.

The nationalization threat made by the Russian authorities might have influenced the investors' decision. The investors in the CPC pipeline might have considered the fact that the CPC pipeline is the only pipeline that is not completely owned by the state company in Russia and the experience of the investors in the Yukos case as well. However, the head of the CPC Pipeline Company reminded Russia of the existence of stabilization clauses and the arbitration clause. This was used as a bargaining factor by the foreign investors to constrain the bargaining power of Russia.

The operation of the Kirkuk-Ceyhan pipeline demonstrates the significance of the volatile geopolitics of the Middle East and of the availability of alternative pipelines in the operation of the pipeline. The absence of an alternative pipeline increased the bargaining power of the transit state. The fixed nature of transit tariffs before the renewal of the intergovernmental agreement in 2010 was a contributing factor to

renegotiation demands by the transit state when a change in economic and geopolitical conditions occurred. The 2010 intergovernmental agreement included an adaptation clause for tariff calculation that required the adaptation of the tariffs according to the US CPI every five years. Adoption of objective criterion for tariff calculation might have facilitated and minimized the risk of disputes during the operation of the transit pipeline. The pipeline has operated without interruption by the transit state or a conflict about transit terms since 2010.

The operation of the Russia-Ukraine gas pipeline demonstrates the significance of geopolitical effects and the use of gas flow as a political weapon, even though the subject matter of the disputes were commercial -gas price and tariffs. The adoption of European market prices for the calculation of the gas price and the inclusion of an adaptation clause that required the adaptation of the tariffs according to the gas price and the EU inflation rates might have minimized the risk of interruption and of conflicts on transit terms. The pipeline has operated without interruption since the 2009 Transit and Supply Agreements were signed. This followed some notorious disputes and interruptions that had occurred before these agreements. However, the 30% discount in the price of gas supplied to Ukraine in exchange for the lease of a Ukrainian Black Sea port to the Russian fleet demonstrates that geopolitics still has a large influence on the gas trade and transit relations between Ukraine and Russia.

The lessons that can be learned from the operation of the transit pipelines in the Caspian Region can be summed up as follows. The existence of strict stabilization clauses, the absence of a renegotiation clause and the existence of very strict applicable law, such as English law, on contract change do not prevent renegotiation

and adaptation of the contract when the economic conditions underlying the contract change fundamentally. The operation of the CPC and the BTC pipelines demonstrates that significant increase in the bargaining power of the transit states, Russia and Turkey, that has occurred in the last decade, both in economic and geopolitical terms, has facilitated the renegotiation and adaptation of the contracts. When the surrounding economic and geopolitical contractual environment changes significantly, contract change cannot be prevented.

There has been a tendency to include adaptation clauses for tariff calculation in all pipelines as a result of renegotiated settlements. The parties inserted into the BTC and the Kirkuk-Ceyhan pipeline contracts an adaptation clause that links the operating fees and the transit tariffs to the US CPI. The parties inserted adaptation clauses regarding both calculation of the gas price and the tariffs into the transit and supply contracts of the Russia-Ukraine gas pipeline. The gas price is linked to the European market prices. Transit tariffs are linked to the gas prices and the EU inflation rates.

A one-sided approach to stability through inclusion of stabilization clauses in the contracts has not achieved its intended aim. The parties inserted adaptation clauses for tariff, transit fee and operating fee calculations into the contracts, even though stabilization clauses still exist in the contracts. However, these clauses are used as bargaining factors by investors in renegotiations, as was clearly seen in the CPC case. When the state party raised the possibility of nationalization, the head of the consortium raised the existence of the stabilization and arbitration clauses.

Stabilization of the general legislative framework and adaptation of the key financial terms such as “transit fees” and “tariffs” might minimize the risk of interruptions and transit disputes in the operation of transit pipelines. Both types of action might also minimize the use of unconstrained bargaining power by the state party. They might also function as stability provisions, since both approaches aim to maintain the economic equilibrium of the contract, even though they address the results of different types of changes. Stabilization clauses address changes in legislation. Adaptation clauses address changes in economic conditions.

The operation of the pipelines confirms the theory, the alternating offers model of the bargaining theory. Legal factors (stability provisions), known as inside options in the context of the alternating offers model of bargaining theory, can only be effective when the parties’ discount rates (the time factor) and risk aversion are equal and there is no alternative option. Economic and geopolitical factors are classified under discount rates, risk aversion and outside option concepts of the alternating offers model in the context of the thesis. Therefore, stabilization clauses or a strict applicable law on contract change cannot resist demands for renegotiation if the economic and geopolitical conditions changed dramatically.

7.2 Recommendations

7.2.1 Minimizing the Effect of Geopolitics

The experience of transit pipelines demonstrates that the risk of interruption is higher in the case of the national pipeline model, under which pipelines are constructed and operated by state oil companies and their legal arrangements are between governments and between state companies. In contrast, under the international

pipeline model, pipelines are constructed and operated by IOCs and their legal arrangements consist of IGA between participating states that grants right of transit and fundamental guarantees to investors, in addition to the HGAs that state the rights and the obligations of the parties. The risk of interruption under this model is very low.

Although the transit states have requested renegotiation and adaptation under the international pipeline model, transit interruptions did not occur and the disputes were settled as the parties to the disputes regarded the situation with a commercial attitude. Therefore, future negotiators of transit pipeline projects should either adopt international pipeline model or, in the national pipeline model cases, they should act by applying commercial considerations and market-based approaches. The parties to transit pipeline agreements should not regard a pipeline as a political weapon or as a tool to acquire its political aims.

The experience of the Russia-Ukraine pipeline and the Kirkuk-Ceyhan pipeline after the agreements of 2009 and 2010, respectively, demonstrates that market-based approaches that insert adaptation clauses into agreements in terms of the calculation of the commodity price and the transit tariffs minimize the risk of interruption and the risk of transit disputes.

7.2.2 Stabilizing the Legal Regime

The general legislative framework of the investment and the fundamental provisions of the contract should be stabilized. If the legitimate expectations of the investor cannot be protected and a stable and consistent legal framework cannot be provided,

the investment will not be able to achieve its intended aim. Therefore, the fundamental rules of the game should be stated in the contract and the parties should act according to those rules throughout the term of the project operation.

An economic equilibrium clause that addresses the effects of state acts on the economic equilibrium of the contract in a specified form to amend the contract provides certainty for both of the parties. The parties should authorize arbitrators to adapt the contract in the event of the failure by themselves to agree on the amendment of the contract.

On the other hand, change is the most enduring reality of life and is intrinsic to the passage of time. A transit pipeline is fundamentally an economic project. The parties' priorities are to reach markets or to contribute to the state budget through earnings from transit tariffs. Therefore, the possibility of changes in the underlying economic conditions of the contract should be taken into account early on. They should be addressed in the contract through the adoption of adaptation and hardship clauses that accommodate changes in economic conditions such as steep price increases or fundamental changes in economic circumstances.

7.2.3 Adaptation of Financial Terms

The main reason for host states to initiate renegotiation in the petroleum industry, in particular for transit states in transit pipeline projects in the last decade, has been to get their share from windfall profits. Therefore, instead of the parties closing their eyes to this reality, this issue should be carefully addressed by adaptation clauses that

adapt key financial terms such as transit tariffs when there is a change in the economic conditions of the contract.

The methodology of this adaptation might be either to link transit tariffs to an objective index such as the US CPI, or any other inflation rate, or to link them to the price of the commodity or to a certain percentage of the commodity that is transported. The operators of oil transit pipelines have adopted the first approach particularly after the experience of transit disputes, as was the case in the 2010 Kirkuk-Ceyhan pipeline Renewal Agreement and since 2011 for the BTC pipeline. The operators of gas transit pipelines adopt the second approach. The most notorious transit pipeline, the Russia-Ukraine gas transit pipeline, linked the calculation of the tariffs to the EU inflation rates and if the price of the gas exceeds \$250, the tariff calculation is linked to the price of the gas. For the current gas price, the second method is used for this pipeline. In the case of the SCGP, the transit fee paid to Georgia is 5% of the gas that is transported by the pipeline.

7.2.4 Authorization of Arbitral Tribunal for Contract Adaptation

For either the national pipeline model or the international pipeline model the parties should authorize the arbitrators to adapt the contract in the event of their failure or disagreement on adaptation of the contract. The experience for all pipelines that were the subject of the case studies demonstrates that the absence of authorization of arbitrators by the contract makes transit pipelines prone to the use of constrained or unconstrained bargaining power by the parties. In order to minimize the use of unconstrained bargaining power in particular, by means of either renegotiation or

arbitration clauses the parties should authorize the arbitrators to adapt the contract according to the terms of the contract.

The extent of contract change is determined by the terms of the contract. In the contract, the parties can either adopt maintaining or restoring the economic equilibrium of the contract or they can adopt the concepts of fairness or equity. As already indicated above, objective standards, such as maintaining or restoring economic equilibrium, should be preferred, subject to a no-gain no-loss rule. However, authorization of arbitrators in the event of a failure of the parties to agree on the amendment is essential for constraining the use of unconstrained bargaining power and the smooth operation of transit pipelines.

7.2.5 Creating a Fast, Binding and Enforceable Dispute Resolution Mechanism

The inefficiency of the ECT conciliation mechanism demonstrates that there is an absolute need to create a dispute resolution mechanism in the ECT through an amendment, particularly for smooth operation of pipelines that are constructed and operated by state parties.

The fast-track arbitration that is proposed in the Road Map of the Energy Charter is a good proposal. Although Russia asserted that it would not become a party to the ECT in 2009, the transit pipelines of the southern corridor, such as the BTC pipeline and the SCGP, traverse countries that are parties to the ECT. If Russia and EU were to remove their obstacles, Russia would become a party to the ECT. Therefore, there is still a need for a fast arbitration mechanism that is binding and enforceable.

All of the Contracting Parties to the ECT should appoint their arbitrator to the ECT before any dispute arises, in order to create a list of arbitrators. Moreover, independent energy institutions should appoint arbitrators to become chair of the arbitral tribunal and to provide objectivity. Disputes should be referred to the tribunal within one week and should be resolved through a binding arbitral decision within a month, according to the rules of Article 7. The tribunal should decide on the compensation that should be paid to the affected party.

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