Stabilization provisions in oil and gas contracts: A must?

Dr. Carole Nakhle
CEO, Crystol Energy; Director Access for Women in Energy

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Long term fiscal stability a popular mantra

- "*To support such a capital intensive project, it is essential that it is built upon a **stable** and competitive fiscal regime for both oil and gas*" ExxonMobil (2012)

- "*Public policies for extractive industries management should include a **stable** and predictable tax system plus transparent governance of collected revenues*" (IMF, 2015)

- "*Our aim is to set a direction of travel for the long term that helps cement **stability** and certainty*" (UK Treasury, 2014)

- *"Responsive fiscal terms defined in legislation and/or the contract, anticipate multiple profitability scenarios (whether influenced by price, cost, volume, quality, etc.) and equitably rebalance the sharing of financial benefits, foster fiscal **stability** and contribute to the durability of the contract"* (OECD, 2019)

Contractual renegotiation

- *pacta sunt servanda (*strict sanctity of contract) widely accepted but under no legal system is absolute

- Contract renegotiation generally occurs under all or some of the following circumstances:

  - Changes to price levels

  - Changes to production levels

  - Changes to investment levels

  - Perception of unfair balance between parties of the risk/reward allocation

  - Allegations of having agreed to incomplete/ambiguous contract

Inherent instability

- **Government fair share**
- Governor of Alaska: “Getting *fair* value for our known resource is the only way we can be self-sustaining”
- Liberia: “the fiscal regime shall create incentives for responsible investors while providing *a fair and equitable return* to” the country

- **But what is fair?**
- 50%-50%? 60%-40%? 70%-30%?

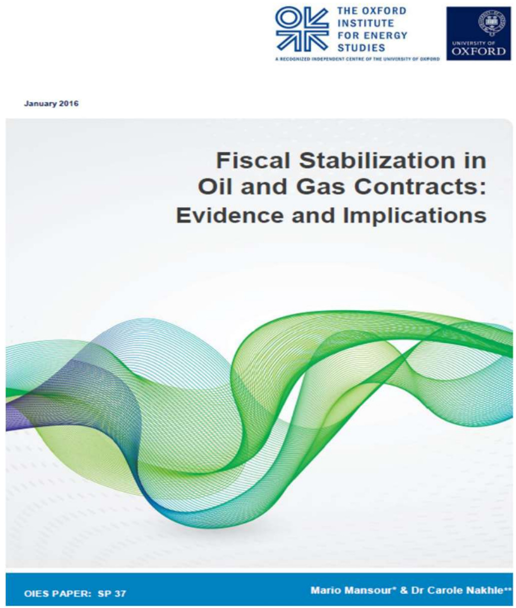
- **Dynamics of what constitutes a ‘fair share’ of the rent fundamentally unstable**
- A government share of 50% when oil price is 50$/bl suddenly becomes unfair for the government when the oil price jumps to 100$, and unfair to the industry if prices go down to 20$

Stabilization clauses

- **Lock in the contract terms for contract duration**

- Cover a broad range of host country laws
  - labour; environment; tax

- Fiscal stability clauses (FSCs) deal exclusively with taxes and royalties
  - May cover some or all taxes and fees



Mansour & Nakhle (2016) https://www.oxfordenergy.org/publications/fiscal-stabilization-in-oil-and-gas-contracts-evidence-and-implications/

Why do companies want FSC?

- To neutralize political uncertainties and fiscal risks
  - Legally binding guarantee
  - Stabilization clause: contractual risk-mitigating device

- "*Oil companies are so vulnerable to potential changes in fiscal terms that they behave much more conservatively if they cannot limit this risk. Conversely if they can mitigate, reduce or eliminate certain elements of risk they can be more aggressive in their investment efforts*" (Johnston, 2010, p.5).

- Lenders view FSC as essential to the bankability of a project, particularly in emerging markets
  - At least the fiscal terms should be stabilised

Why do governments offer FSC?

- Feature of developing countries

- To compensate for the perception of higher political/regulatory risk
  - Especially when combined with higher geological risk
  - Psychological boost to reduce investors' risk premium
  - Superior to tax exemptions and tax holidays

- Tax competition

- Offered by governments in weak bargaining position

Less compelling under certain conditions

- History of sound fiscal management
- Corporate tax rates in line with international rates
- Low tariff rates
- Non-imposition of distortionary taxes
- Non-discrimination between domestic and foreign investors
- Low level of corruption
- Transparent tax policy process
- Efficient tax administration

Variations of FSCs

Full Freezing Clauses freeze fiscal and non-fiscal law with respect to investment for the duration of the project	**Limited Freezing Clauses** freeze a more limited set of legislative actions
Full Economic Equilibrium Clauses protect against the financial implications of all changes of law, by requiring compensation or adjustments to the deal to compensate the investor when any changes occur.	**Limited Economic Equilibrium Clauses** protect against financial implications of some limited set of changes in law or after specified costs are incurred. They require compensation or adjustments to the deal to compensate the investor only when the covered changes occur.
Full Hybrid Clauses protect against the financial implications of all changes of law, by requiring compensation or adjustments to the deal, including exemptions from new laws, to compensate the investor when any changes occur	**Limited Hybrid Clauses** protect against financial implications of some limited set of changes in law or after specified costs are incurred. They require compensation or adjustments to the deal, including exemptions from new laws, to compensate investor only when the covered changes occur.

Source: Shemberg (2009)

Are FSCs sufficient to mitigate political and fiscal risks?

- Effectiveness questionable:
  - In countries which lack administrative capability to enforce FSCs
  - Where government policy, investment laws and judiciary lack credibility
    - More complex to enforce

- Contractual devices alone not sufficient for managing risks
  - Oil/gas contracts are inherently incomplete
  - Impossible to perfectly predict all states of nature in the future and account for them in the contract

- Reinforced by:
  - Competitive and progressive fiscal systems
  - Inclusion of broad stakeholder base

Recommendations

- FSCs will remain a key feature of oil contracts in developing countries
  - Economic balancing more popular than freezing

- Rather than negotiating different FSCs with different investors, countries better off designing one model to offer to all investors

- FSC can be offered at a premium:
  - Afghanistan: income tax @20% but 30% if stabilized

Too much faith in fiscal stabilisation?

- Blind faith in the usefulness of stabilization and its effectiveness rather misplaced

- FSC can have a positive impact on investment but
  - their effectiveness questionable
  - on their own, unlikely to suffice

- Importance of overall institutional framework

Thank you!

carole.nakhle@crystolenergy.com

@carole_nakhle

@CrystolEnergy

@AccessWIE