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Evaluating Stabilization Clauses in Venezuela's Strategic Association Agreements for Heavy-Crude Extraction in the Orinoco Belt: The Return of a Forgotten Contractual Risk Reduction Mechanism for the Petroleum Industry

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I. INTRODUCTION

International energy sector investments in developing countries are complex and fraught with risk. Usually, in the initial

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bargaining stage, the interests of the investor—frequently international oil companies (IOCs) together with project financiers—on one side, and those of the host state and their national oil companies (NOCs), on the other, are diametrically opposed. While the IOCs seek contractual stability, financial predictability, and an enforceable international dispute resolution mechanism, the host state wants to ensure regulatory and legislative flexibility, maximum tax benefits, and local law and court adjudication.

To facilitate the negotiations, both parties had traditionally been in a relationship of mutual dependency. While the host country owns the natural resources, the IOCs have the technology, capital, management and equipment. The latter, however, come only at high costs, which normally take the form of immovable infrastructure that can be financed over considerable time. In the petroleum industry, where price fluctuation in the international markets is likely to occur over time, what once appeared to be an apparently profitable arrangement for the host country can suddenly turn undesirable a few years later. This phenomenon is known as the "obsolescing bargain" and is generally described as the dilemma the investor faces when trying to guarantee that the host state will not act opportunistically once the investment has been made.

In order to mitigate the risks associated with this problem, the IOCs have attempted to implement a number of legal and financing techniques, such as insuring against perceived risks, defending against these risks by using political and state-to-state leverage, and structuring around the overall risk through complex

1. Admittedly, the North-South dependency relationship may be changing given the emergence and growing importance of NOCs in the Middle East, Asia and other countries, such as Saudi Aramco, Gazprom, NIOC, Pemex, Sonatrach, INOC (Iraq), PetroChina, KPC, Petrobras, Petronas, Yukos, Lukoil, and NNPC. See generally Energy Forum of the James A. Baker III Institute for Public Policy at Rice University and Petroleum Energy Center of Japan, "Strategies and Influence of Emerging National Oil Companies on World Energy Markets," http://www.rice.edu/energy/research/nationaloil/docs/PECNOCstudyprotocolfinal.pdf (last visited Oct. 11, 2008). It is also important to note that several NOCs have been investing heavily in developing regions of the world, in some circumstances replacing the role the traditional U.S. and European private companies played. See, e.g., Juan Vega, China's Economic and Political Clout Grows in Latin America at the Expense of U.S. Interests, 14 MINN. J. GLOBAL TRADE 377 (2005).


offshore securitization techniques.\textsuperscript{4} Other contractual risk reduction mechanisms have traditionally involved the negotiation of international arbitration clauses and addition of choice of law provisions, as well as the inclusion of so-called "stabilization clauses," whereby the host state promises not to alter existing terms or enact legislation or executive regulations tending to undermine the substance of the agreement.\textsuperscript{5} The use of stabilization clauses had at one point been reported to have declined. More recently, however, stabilization clauses and complex contract drafting appear to be making a comeback, as evidenced by the fact that oil agreements are being entered into even by high-risk transition economies.\textsuperscript{6}

Historically, the balance in bargaining power in the petroleum industry between the host state and the IOCs has depended largely on the price of oil.\textsuperscript{7} During the spikes in the price of oil, such as during the 1970s, host states saw their positions strengthened with respect to foreign investors, which led to widespread nationalizations. Then, in the 1990s, when the price of oil declined, many countries modified their positions and granted increased benefits to the IOCs, mostly in the form of fiscal incentives.\textsuperscript{8} However, with the price shock of early 2008—when prices peaked at $147 in July—a number of Latin American countries adopted hard-line positions with respect to the Western oil companies that were heavily invested in the region, reminiscent of the nationalizations in the Middle East and Africa in the 1970s. This was especially true of the governmental tactics employed by the colorful leaders of Venezuela, Bolivia and Ecuador. As oil prices dropped in late 2008, down to about $32 a barrel during the month of December, host states in need of technological and financial assistance to stabilize their oil dependent economies may have to once again reverse their approach towards the IOCs. As a conse-

\textsuperscript{4} Thomas Waelde & George Ndi, Stabilizing International Investment Commitments: International Law Versus Contract Interpretation, 31 Tex. Int'l L.J. 215, 243; see also Coale, supra note 2, at 219.

\textsuperscript{5} See F.V. Garcia-Amador, State Responsibility in Case of "Stabilization" Clauses, 2 J. Transnat'l L. & Pol'y 23 (1993).

\textsuperscript{6} Waelde & Ndi, supra note 4, at 216.

\textsuperscript{7} Thomas Walde, Renegotiating Acquired Rights in the Oil and Gas Industries, 1 J. of World Energy L. & Bus., 65 (2008).

\textsuperscript{8} This phenomenon has also been described as a privatization-nationalization cycle that has seemingly prevailed in a number of resource rich countries in Latin America. See, e.g., Amy L. Chua, The Privatization-Nationalization Cycle: The Link Between Markets and Ethnicity in Developing Countries, 95 Colum. L. Rev. 223 (1995).
quence, IOCs should be in a position to be able to negotiate for stabilization clauses and other risk reduction mechanisms more effectively than they may have during the past several years.

The case of Venezuela, currently the ninth largest oil producer in the world and the fourth largest supplier of crude oil to the U.S., serves as a prime example to highlight the cycles between pro-foreign investor policies and nationalistic, anti-Western practices. In Venezuela, the cycle has extended for the past four decades, from the first term of President Pérez in the 1970s when, due to high world energy prices caused by the oil embargo of 1973, Venezuela effectively nationalized its oil industry for the first time, to Pérez's second term in the 1990s, when low energy prices led to the policy called "Apertura Petrolera" (or Oil Opening), under which foreign oil companies were granted highly favorable terms, to nationalizations and increased regulatory restrictions in the middle of the present decade under President Chávez's reign. In particular, the most interesting case has been that of the four Strategic Association Agreements entered into between some of the IOCs and Venezuela for heavy-crude extraction in Venezuela's Orinoco Belt in 1993 and 1997. These agreements involved some of the most important private IOCs and required some $17 billion of foreign investment. Given Venezuela's prior history, IOCs had adopted various stabilization techniques in their international agreements with the hope of forestalling, or at least dealing with, governmental interference. Notwithstanding, these agreements were unilaterally terminated by Venezuela in 2006, resulting in the negotiation of new agreements in most cases and in two pending arbitral disputes before the International Centre for Settlement of Investment Disputes (ICSID) against Venezuela by two of the IOCs.

The purpose of this study is to examine the validity of stabilization clauses under international law as it applies to the petroleum industry and then to evaluate the usefulness of such clauses in protecting IOCs that have made important investments with high sunk costs in countries with elevated degrees of political risk. Further, this article will consider the different types of stabilization clauses used in the past and their modern resurrection. The

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four heavy-crude projects to develop Venezuela's Orinoco Belt and the stabilization clauses contained therein serve to illustrate the theoretical concepts analyzed in the present study. Finally, certain conclusions will be reached as to the current and future implementation of stabilization clauses, as well as the interplay of this contractual risk reduction mechanism *vis a vis* the bargaining power of both IOCs and host states.

II. VALIDITY OF STABILIZATION CLAUSES UNDER INTERNATIONAL LAW

The first basic question that must be answered is whether stabilization clauses are valid under international law and whether these clauses will be recognized by arbitral tribunals? Like many legal issues, the answer depends on who you ask.

Several commentators have declared that stabilization clauses with an intended purpose of freezing applicable law are invalid under international law. The argument is roughly as follows: sovereignty over natural resources is a *jus cogens* norm from which no derogation is permitted. Derogation would include any agreement to contract out of rules of general international law (e.g. an international petroleum extraction agreement under which the host state agrees to not expropriate the assets of the investor during the next sixty years). Hence, a stabilization clause would be invalid and a state, making use of principles of public international law, could make continuous use of its sovereign powers to terminate agreements without compensation.

This view especially arose during the debates concerning sovereign rights over natural resources in the discussions held at the General Assembly of the United Nations under the guise of the

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10. A number of commentators maintain that states are incapable of binding themselves under international contracts with private parties. *See, e.g.*, Muthucumaranaswamy Sornarajah, *International Contract Law?*, 15 J. WORLD TRADE L. 187, 189 (1981). This study does not address these positions, rather only those that refer directly to the validity of stabilization clauses specifically. The invalidity of stabilization clauses had also found support in several early arbitrations. *See, e.g.*, International Fisheries Co. v. United Mexican States (U.S. v. Mex.), 4 R.I.A.A. 691 (1931) and North American Dredging Co. of Texas v. United Mexican States (U.S. v. Mex.), 4 R.I.A.A. 26 (1926).


12. *Brownlie, supra* note 11, at 527.

"New International Economic Order" ("NIEO"). In 1974, developing countries gave voice to their opinion with a degree of antagonism against what was considered to be a "form of economic colonialism" in the General Assembly of the United Nations ("UNGA"). Thus, UNGA Resolution 3171 gave states the right to expropriate as "an expression of their sovereignty in order to safeguard natural resources . . . and determine the amount of possible compensation and the mode of payment." Furthermore, UNGA Resolution 3201 declared that "no State [will] be subjected to economic, political or any other type of coercion to prevent the free and full exercise of [its] inalienable right." The nationalistic sentiment of developing states was only exacerbated by the oil arbitration awards decided in the 1970s, which in a number of cases resulted in outcomes with a significant gain to the investor. The consequence of the fundamental differences between the developing and developed countries over the discussion leading up to the NIEO resulted in a stalemate. As a result, and arguably with tremendous opportunity costs for both sides, useful investments were not made. The World Bank and its promotion of the ICSID Convention, for instance, was one step in favor of bridging the ideological divide between developing and developed nations.

16. UNGA Res. 3171, Dec. 17, 1973, was approved by an overwhelming majority: 108 countries voted in favor, one against, with 16 abstentions.
19. Detlev Vagts, Foreign Investment Risk Reconsidered: The View from the 1980's, 2 ICSID Rev., 6 (1987). There is little doubt that expropriations and nationalizations are both deemed valid acts under international law so long as these state actions are accompanied by prompt, adequate and effective compensation. See Antonio Cassese, International Law 523 (2d ed. 2005). The present article, however, does not directly address issues related to expropriations or nationalizations, but rather focuses on situations arising in the investor-state relationship in the context of stabilization clauses and when host states take actions that are short of outright expropriation or nationalization.
On the other hand, the validity of stabilization clauses under international law finds support in a number of arbitral awards.\textsuperscript{21} The most widely cited decision is the case of \textit{Texaco Overseas Petroleum Co. and California Asiatic Oil Co. v. The Government of the Libyan Arab Republic} (hereinafter "TOPCO").\textsuperscript{22} In this case, Clause 16 of the Deeds of Concession contained a stabilization clause that indicated that "the contractual rights expressly created by this concession shall not be altered except by mutual consent of the parties."\textsuperscript{23} Another provision of the agreement provided additional protection by stabilizing the applicable legislation and regulations as of the date of the execution of the agreement.\textsuperscript{24} The arbitrator, Professor René-Jean Dupuy, found that the stabilization clause had not impaired the legislative sovereignty of Libya. In fact, Libya had used its sovereign power "to commit itself internationally, especially by accepting the inclusion of stabilization clauses entered into with a foreign private party."\textsuperscript{25} Similarly, in \textit{Saudi Arabia v. Arabian American Oil Co.},\textsuperscript{26} the tribunal concluded that stabilization clauses were binding, especially considering that the state possesses legal powers to grant rights by which

\textsuperscript{21}A more complete treatment would begin with a discussion of the applicability of the principle of \textit{pacta sunt servanda} to international agreements, good examples of which are the arguments of the Swiss Government in Losinger and Co. (Switz. V. Yugo), 1936 P.C.I.J. (ser. C) No. 78, and the French Government in Certain Norwegian Loans (Fr. V. Nor.), 1957 I.C.J. 9, 15 (July 6). Notwithstanding, this discussion is omitted from this article.

\textsuperscript{22}\textit{Texas Overseas Petroleum Co. v. Libyan Arab Republic}, 53 I.L.R 389 (Int'l Arb. Trib. 1978) ("TOPCO").

\textsuperscript{23}\textit{Id.} at 476.

\textsuperscript{24}Royal Decree of December 1961, which became an integral part of the contract on the basis of the Agreement of 1963, states the following: "This 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 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." \textit{Id.}

\textsuperscript{25}\textit{Id.} at 477.

it forbids itself to withdraw before the end of the concession.\textsuperscript{27}

In the case of \textit{Libyan American Oil Co. v. Libyan Arab Republic} (hereinafter "LIAMCO"),\textsuperscript{28} the Deeds of Concession, having been drafted on the basis of a model agreement, contained the same Clause 16 as in the TOPCO Case. The arbitrator in LIAMCO found that the stabilization clauses incorporated in this contract were binding under international law, and that they were justified both by Libya's own domestic legislation, as well as by the general principle of the sanctity of contracts recognized in both municipal and international law.\textsuperscript{29} Interestingly, the arbitrator also found that the stabilization clauses were consistent with the principle of the non-retroactivity of law, which is, according to the arbitrator, a legal maxim consistent with Islamic law, based on the Koranic verse: "We never punish until we have sent a messenger (XVII,15)."\textsuperscript{30}

In \textit{Revere Copper & Brass Inc. v. Overseas Private Investment Corp.},\textsuperscript{31} the validity of a tax stability clause that imposed a ceiling for taxes on profits and royalties with respect to the extraction of aluminum was in question. The arbitrators found that the clause was valid on the basis that a government "may for certain periods of time impose limits on the sovereign powers of the State, just as it does when it embarks on international financing by issuing long term government bonds on foreign markets."\textsuperscript{32} The arbitrators found that the commitments were binding under international law having been entered into in an unqualified legal manner. Hence, the clause would remain valid notwithstanding that the legislative branch had the authority to change the terms of the agreement according to the national constitution of Jamaica.\textsuperscript{33}

The arbitration between \textit{AGIP Spa v. Government of the Popular Republic of the Congo}\textsuperscript{34} involved an oil distribution agreement that contained two stabilization clauses requiring that the government not apply to the company certain ordinances or decrees which would tend to change "the private joint-stock com-

\begin{itemize}
\item \textsuperscript{27} Id.
\item \textsuperscript{29} Id. at 56.
\item \textsuperscript{30} Id. at 31.
\item \textsuperscript{31} Revere Copper & Brass Inc. v. Overseas Private Inv. Corp., 17 I.L.M. 1321, 1322 (Int'l Arb. Trib. 1978).
\item \textsuperscript{32} Id. at 1342.
\item \textsuperscript{33} Id.
\item \textsuperscript{34} AGIP Spa v. Gov't of the Popular Republic of the Congo, 67 I.L.R. 318 (Int'l Arb. Trib. 1977).
\end{itemize}
pany character," and requiring that the government not "modify unilaterally the Company's Articles of Association." In April 1975 the Government of the Congo issued Order No. 6/75 nationalizing the company and transferring its assets to Hydro-Congo, the state oil corporation. The arbitrators found that the unilateral dissolution of the company was a repudiation of the stabilization clauses which had resulted from the common will of the parties expressed at the level of the international juridical order and which did not infringe on the sovereignty of the Popular Republic of the Congo. The stabilization clauses had the effect of preventing the government from invoking certain powers against a party with which it had contracted not to do so.

In the events leading to the ICSID arbitration American Independent Oil Company v. Kuwait the parties had entered into a Concession Agreement containing a stabilization clause under which the government promised not to alter the terms of the agreement through legislation. The arbitrators called into question the *jus cogens* argument that countries have permanent sovereignty over natural resources, and added that it is "useful that host States should . . . be able to pledge themselves not to nationalize a given foreign undertaking within a limited period, and no rule of public international law prevents them from doing so." Although the tribunal recognized the legitimacy of stabilization clauses, it found that in this particular case the expropriation was not covered by the stabilization clause because it did not make specific reference to nationalization. It should be noted that the tribunal's insistence on an express reference to nationalization in the stabilization clause has been the subject of considerable criticism. For future consideration, the tribunal suggested that in order for a state to be effectively bound by a stabilization clause, the agreement should expressly stipulate the undertaking in

35. *Id.* at 338.
36. *Id.*
37. *Id.* at 343.
39. *Id.* at 520. Article 17 of the agreement read as follows: "The Shaikh shall not by general or special legislation or by administrative measure 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 Shakih 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."
40. *Id.* at 588.
41. *See, e.g.*, TAIDA BEGIC, APPLICABLE LAW IN INTERNATIONAL INVESTMENT DISPUTES 89 (2005).
detail, and should only cover a "relatively limited period of time." [42] Finally, in the first of two decisions handed down by the Iran-United States Claims Tribunal, *Mobil Oil Iran Inc. v. Islamic Republic of Iran*, [43] the tribunal found that contractual provisions in relation to the long term supply and purchase of petroleum products precluded a sovereign during the stated period from exercising the rights it otherwise possessed under international law to take an alien's property without just compensation." [44] Also consistent with this decision was the case of *Phillips Petroleum Co. Iran v. Islamic Republic of Iran*. [45] Phillips had entered into a Joint Structure Agreement with the National Iranian Oil Company (NIOC) to participate in the exploitation of petroleum resources, which was later unilaterally terminated by NIOC and then declared null and void *ab initio* by the Iranian legislature. The tribunal found that compensation for the annulment was owed independently of whether the expropriation had been formal or de facto, and regardless of the fact that the rights involved were intangible contract rights. [46]

A number of commentators have criticized the historical cases mentioned *supra*, several of whom coincide in arguing that stabilization clauses are invalid under international law. In particular, the criticisms tend to center on the notion that the practice of international commercial arbitration is biased so as to consistently favor the economic interests of the developed countries. [47] Others argue that arbitral awards decided against the host states have been forced upon them, since the states consented to arbitrate out of a sense of subrogation. [48] Lastly, another group of

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44. Id. at 186.
46. Id. at 139.
47. See Amr Shalakany, *Arbitration and The Third World: A Plea for Reassessing the Bias Under the Specter of Neoliberalism*, 41 Harv. Int'l L.J. 419, 422 (2000). However, Jan Paulsson for instance has indicated that while it may be true that in the beginning of the 20th century, and until the 1950s, arbitrations conducted by various international tribunals or commissions evidenced bias against developing countries, this is no longer the case: "the dice are loaded no more." See Jan Paulsson, *Third World Participation in International Investment Arbitration*, 2 ICSID Rev. 19, 21 (1987).
authors point to the transformative process of international arbitration whereby the alleged ascendancy of U.S.-based international law firms and their frequent representation of claimants and respondents, the predominance of proceedings in English, and the increasing popularity of foreign lawyers receiving their LL.M. degrees in the U.S.\textsuperscript{49} is all leading to the "Americanization"\textsuperscript{50} of the international arbitration process, and perhaps of standards of fair compensation under international law in general.

Nevertheless, the status of the law today would appear to be that a state, in the exercise of its sovereign powers, may bind and temporarily limit its authority by contract. Hence, stabilization clauses, restraining the host state from unilaterally amending the terms and conditions of an agreement through legislation, regulation or other means, should be found to be valid by future arbitral tribunals.\textsuperscript{51}

### III. THE IMPORTANCE OF THE CHOICE OF LAW CLAUSE AND THE VALIDITY OF STABILIZATION CLAUSES

International law is not \textit{per se} the law that will be applied by an arbitrator in the context of an investor-state agreement or dispute, unless the parties have specifically indicated that it is the applicable law.\textsuperscript{52} Hence, it has been suggested that a stabilization clause inserted in an ordinary state contract governed by municipal law will lack international validity because the validity of such a clause rests on the international character of the agreements.\textsuperscript{53} This problem, however, will be moot provided that the parties' choice of law clause clearly indicates that international law is applicable to the agreement. Accordingly, if the agreement contains an express choice of law clause that has the effect of removing the contract from the domestic forum of the contracting state, subjecting it to a hierarchically superior legal order, stabilization


\textsuperscript{50} Kevin Jacobs & Matthew Paulson, \textit{The Convergence of Renewed Nationalization, Rising Commodities and “Americanization” in International Arbitration and the Need for More Rigorous Legal and Procedural Defenses}, 43 \textit{Tex. Int'l L.J.} 359, 370 (2008); see also Shalakany, \textit{supra} note 47, at 422.

\textsuperscript{51} Garcia-Amador, \textit{supra} note 5, at 49.

\textsuperscript{52} Emily Witten, \textit{Arbitration of Venezuelan Oil Contracts: A Losing Strategy?}, 4 \textit{Tex. J. Oil, Gas & Energy L.} 55, 64 (2009).

\textsuperscript{53} Garcia-Amador, \textit{supra} note 5, at 48-49.
It should be noted that some commentators sustain the position that choice of law clauses may not be valid under international law. Under NIEO, for instance, agreements and disputes would always be governed by the domestic laws of the host nation, and even more so where the contract involved the exploitation of mineral resources in the host state. However, it would seem that the overwhelming majority of scholars and arbitral precedent support the view that choice of law clauses selecting the application of a law different from the domestic law of one of the parties has the effect of “internationalizing” or “delocalizing” the contractual relationship, and thus found to be perfectly valid.

**IV. Are Stabilization Clauses Useful?**

Historically, outright expropriation or conduct of a host state depriving a foreign entity of benefits derived from property interests without just compensation within the host state was seen as the greatest threat to foreign investors. In general, however, today it would seem that the days of the Calvo Clause, the Drago Doctrine, the Hull Rule, and the massive wave of expropriations of foreign ownership have ended, at least for the time being. In contrast, the greater threat in the last decade has more often come in one of two forms.

The first, a “forced sale,” occurs when the host state enters into a negotiation with an investor to purchase its interests, but then undermines the investor’s bargaining position such that there can be no true sale and rather the investor ends up accepting a lower price than would have resulted from a freely

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54. Coale, supra note 2, at 227.
55. Sornarajah, supra note 10, at 189.
56. Garcia-Amador, supra note 5, at 48-49.
negotiated sale under equitable conditions.\textsuperscript{59} In the context of Venezuela, for instance, the agreement between the national government and Verizon Communications to purchase its 28.5% controlling share in the country's principal telephone company, CANTV, in 2007 for $572.25 million was seen by many as a below-market price.\textsuperscript{60} Unfortunately, stabilization clauses may offer little protection with respect to forced sales.

The second type of threat that investors face is that of "creeping expropriation," which normally occurs when states exercise their right to regulate or when the state uses its police powers. It is described as the "slow and incremental encroachment on one or more of the ownership rights of a foreign investor that diminishes the value of its investment."\textsuperscript{61} This form of state action may create the greatest problems for investors as often such practices are difficult to prove, compensation will often not be forthcoming, and the host state will suffer less harm to its reputation as may occur in a situation of outright expropriation. Hence, the investor will often have less bargaining power in these cases. Nevertheless, for this type of threat it is suggested that stabilization clauses do have an important role to play, but provided that they are sufficiently explicit as to the kinds of detrimental state practices.

\textbf{A. The Right to Regulate}

Despite the foregoing considerations, even if a state enters into an agreement with a stabilization clause, the state will still be able to regulate certain matters. The ability to regulate has been especially recognized when it is based on protection of the environment or the public welfare.\textsuperscript{62} But if this right to regulate exists, what is the value of a stabilization clause? Will the addition of a stabilization clause to the agreement make any difference? Is it just a drafting technique to make the contract "doubly

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The evolution of a state's right to regulate has been recognized in several important arbitral awards. In *Sedco, Inc. v. National Iranian Oil Co.*,\(^64\) the tribunal noted that a state will not be liable for economic injury that is a consequence of a bona fide regulation within the accepted police power of states.\(^65\) More recently, in a case decided by a tribunal under existing treaty obligations of NAFTA, *Methanex Corp. v. United States of America*,\(^66\) the U.S. was not found liable for regulations implemented by the State of California banning the use of a fuel additive (MTBE and ethanol) that the state had considered dangerous to public health.\(^67\) Also, in *EnCana v. Republic of Ecuador*,\(^68\) despite acknowledging certain limitations on the state, the tribunal held that "in the absence of a specific commitment from the host state, the foreign investor has neither the right nor any legitimate expectation that the tax regime will not change...during the period of the investment."\(^69\)

A state's right to regulate is limited, however. The state must act in good faith and it is to treat the foreign investor in a fair and equitable manner. Both notions have primarily been developed in arbitral awards resolving investor-state disputes. In *S.D. Myers*,\(^70\) the tribunal found Canada liable for expropriation for its regulatory restrictions even though motivated by genuine environmental concerns, as the regulations in question were rather deemed to be part of a strategy to protect national business interests. In contrast, in the *Methanex* case the tribunal noted that the ban was "motivated by the honest belief, held in good faith and on reasonable scientific grounds, and that the [disputed additive] contami-

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63. Credit for this question is given to Thomas Waelde and George Ndi. See Garcia-Amador, *supra* note 5, at 33.


65. *Id.* at 275.


67. *See id.*


69. *See id.*, at ¶ 173.

nated groundwater was difficult and expensive to clean up."71

Importantly, taxation measures, which are a common element in petroleum industry disputes, have also been deemed to fall within a state's police powers.72 However, in certain circumstances, changes in the tax structure of certain contractual arrangements or agreements may be deemed expropriatory. Three recent awards, all dealing with the denial of tax rebates, held that tax measures may have an expropriatory effect on the foreign investor.73

Most published awards have developed the meaning of "fair and equitable treatment" as it exists under treaty obligations, but often it is considered to be the existing standard under customary international law and, hence, equally applicable in the context of investor-state agreements.74 In Enron Corp. & Ponderosa Assets, L.P. v. Argentina75 the tribunal considered the meaning of fair and equitable treatment under the U.S.-Argentina bilateral investment treaty ("BIT") and found that one of the principal goals of the treaty was to seek a stable framework for investment. Therefore, stability was "a key element" of fair and equitable treatment under the treaty. Similar importance was given to regulatory stability by the tribunal in OPEC v. Ecuador76 in holding that "stability of the legal and business framework is thus an essential element of fair and equitable treatment."77 In PSEG Global v. Turkey78 the "roller-coaster effect" of Turkey's continuing legislative changes was found to be a breach of the fair and equitable treatment obligation, as investor's basic expectations of stability cannot be met "in a situation where the law kept changing

77. Id. at ¶ 183.
78. PSEG Global v. Turkey, 2007 WL 1215067 (ICSID 2007).
continuously and endlessly."\textsuperscript{79}

In \textit{Siemens v. Argentina},\textsuperscript{80} fair and equitable treatment was said to be treatment in an even-handed and just manner, conducive to fostering the promotion and protection of foreign investment.\textsuperscript{81} The tribunal excluded bad faith or malicious intent of the host state as a necessary element in proving the failure to treat an investment fairly and equitably, as that would be inconsistent with the purpose and expectations created by the BIT.\textsuperscript{82} However, it remains uncertain whether similar pro-investor treatment would be given to contract language similar to the rather vague and general terms found in the treaties.

In \textit{MCI Power Group v. Ecuador},\textsuperscript{83} the tribunal rejected the investor’s fair and equitable treatment claim and emphasized that the “legitimacy of the expectations for proper treatment entertained by a foreign investor protected by [a treaty] does not depend solely on the intent of the parties, but on certainty about the contents of the enforceable obligations."\textsuperscript{84} One can only assume that had the investor had the desire and leverage to memorialize its expectations in a well-drafted stabilization clause, the tribunal may have reached a different result.

\textbf{B. Contractual Provisions}

In a recent ICSID award in the case of \textit{Parkerings-Compagneit v. Lithuania},\textsuperscript{85} involving an agreement without a stabilization clause for the design and planning of a parking facility in Lithuania, the tribunal stated that “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 the investor made its investment.”\textsuperscript{86} The tribunal went on to note that “the Claimant could (and with hindsight should) have sought to protect its legitimate expectations by introducing into the investment agreement

\textsuperscript{79}. \textit{Id.}
\textsuperscript{80}. \textit{Siemens A.G. v. Argentine Republic, 2007 WL 1215068 (ICSID 2007)}.
\textsuperscript{81}. \textit{Id. at ¶ 290}.
\textsuperscript{82}. \textit{Id. at ¶ 291}.
\textsuperscript{84}. \textit{Id.}
\textsuperscript{86}. \textit{Id. at ¶ 332}.
a stabilization clause or some other provision protecting it against unexpected and unwelcome changes.\textsuperscript{87} It appears that the tribunal recognized that because the parties had not included a stabilization clause, the investor assumed the business risk that Lithuania might modify its legislation or approve regulations that would adversely affect the investment.\textsuperscript{88}

Given these considerations, it would seem that the stabilization clause and the state’s bona fide right to regulate are not mutually exclusive, “rather the stabilization clause puts a rider on such exercise which is an assertion of good faith in a contractual relationship.”\textsuperscript{89} A stabilization clause may prove effective in memorializing the expectations of the parties in more detail than a treaty or a municipal law. Thus, stabilization clauses, especially if thoughtfully negotiated and drafted, could allow tribunals to avoid reliance on the gray-area standards of good faith, and fair and equitable treatment, which are, in many instances, likely to be excessively subjective standards. Furthermore, a stabilization clause should allow a tribunal to recognize a contractual breach with greater ease and precision, thus avoiding the sensitive issue of having to decide when a regulation has exceeded the bounds of fair and equitable treatment toward an investor and, thus, becomes an instance of expropriation. Finally, when there is a breach of an obligation involving an explicit state promise to respect the agreement, the breach logically becomes a more serious act or omission, entailing a higher degree of responsibility that may affect any award for damages.\textsuperscript{90} It is primarily for these reasons that a number of commentators agree that the inclusion of a stabilization clause is a useful tool for providing additional protection against detrimental action by a host state.\textsuperscript{91}

V. THE ROLE OF INTERNATIONAL TREATIES

International treaties can either be seen as complementing or completely replacing the need to bargain for a stabilization clause in an investor-state agreement. A BIT, for instance, may be important in giving treaty status to a stabilization provision contained

\textsuperscript{87} Id. at ¶ 336.
\textsuperscript{88} Steven Smith et al., \textit{International Commercial Dispute Resolution}, 42 Int'l Law 363, 385 (2008).
\textsuperscript{89} Maniruzzaman, \textit{supra} note 74, at 34.
\textsuperscript{90} See Garcia-Amador, \textit{supra} note 5, at 49-50.
in a host government’s petroleum regime by way of the “fair and equitable treatment” standard established in most BITs. In this respect, BITs may be seen as partly replacing the need to incorporate into a contract with a host state an internationalization regime of stabilization and arbitration as they may contain duplicative provisions. This, however, does not obviate the benefits of providing for stabilization clauses in the agreements themselves.

Well-negotiated “investment contracts are potentially the most effective investment protection instruments available” as they allow the investors to draft terms especially designed for their investment needs. An investor who seeks to use a BIT to protect against regulatory change will typically have to argue its case under the treaty’s general expropriation provisions and will not be able to avail itself of the more specific contract-based commitments of legal stability provided to investors in a well-drafted investment contract. Hence, an investor that is concerned about significant political risk will wish to negotiate a specific agreement rather than remain subject to the general rules applicable to the rest of the investor community. Nevertheless, BITs will still play an important role, especially for those investors unwilling or unable to avail of their own negotiating strength.

VI. CLASSIFICATION OF STABILIZATION CLAUSES

Assuming the ability of the contracting parties to negotiate, and their respective bargaining power and desire to tailor a particular international petroleum agreement, concession arrangement or production sharing agreement, the drafters can choose to use different types of stabilization clauses. The traditional formula was to provide for a rigid structure that would effectively “freeze” the laws and regulations applicable to the agreement. An example of this classic approach can be found in the Libyan concession agreements of the 1970s, discussed supra. It has been

94. Jason Webb Yackee, Do We Really Need BITs? Toward a Return to Contract in International Investment Law, 3 ASIAN J. WTO & INT'L HEALTH L. & POL'Y 121, 133.
95. Id. at 134.
96. See Waelde & Ndi, supra note 4, at 243.
reported that less extensive forms of "freezing" are still in use today, including current agreements with Angola, Cambodia, Guyana, Iraq, Kazakhstan, Malta, Poland and Tunisia.\[^{98}\]

During the past two decades, parties have tended towards employing one of several more modern formulas. The reasons for this are threefold: 1) the classic approach may not be compatible with the host country's constitutional framework; 2) the enhanced capacity of the NOCs and the increase in petroleum prices have tended to reduce the bargaining power of investors; and 3) the increased awareness for host states to retain the right to regulate particularly environmental matters.\[^{99}\] Given these considerations, recent stabilization provisions have tended to adopt a middle ground, allowing for unilateral action by states while at the same time indicating a variety of ways to reestablish the economic equilibrium of the contract.

The different types of stabilization provisions can be categorized into the following four groups in order of their potential benefit to the foreign investor:

<table>
<thead>
<tr>
<th>The Classic Freezing Clauses</th>
<th>Provides for the greatest investor protection, stipulating that the laws and regulations applicable to the agreement are those in force at the time of the execution of the agreement.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stipulated Economic Balancing</td>
<td>Implies that the contract terms are to remain in effect but with a clear stipulation that new laws will nevertheless apply to the IOC; however, if the new laws affect the stabilization provision, the agreement is to be automatically amended, in principle without negotiation, so that the economic balance between the parties will be restored.</td>
</tr>
</tbody>
</table>

\[^{98}\] See Cameron, supra note 92, at 28.
\[^{99}\] Id. at 95-99.
 Provides that any new law will be applicable to the IOC but that if a new law affects the stabilization provision, the agreement will be automatically amended so that the economic balance between the parties will be restored; however, in this case the provision only stipulates that the amendment is to result from mutual agreement without specifying the nature of the amendment.

Provides for the weakest form of stability for the IOC, indicating that any new laws will apply to the IOC and that the agreement will be automatically amended to reflect such new laws, but that such amendments are to stem from new negotiations between the parties with the goal, but not the assurance, of restoring the economic balance between the parties.\textsuperscript{100}

VII. THE VENEZUELAN CONTEXT

A. The Situation in Latin American

During the last decade, some Latin American countries appear to have entered into yet another phase of the privatization-nationalization cycle that has seemingly plagued the region ever since their independence as Spanish and Portuguese colonies.\textsuperscript{101} This cyclical approach between left-leaning nationalistic governments and rightist, pro-private investment regimes has been well documented in the contexts of Mexico, Argentina, Brazil, Uruguay, and Venezuela.\textsuperscript{102}

In 2006, for instance, President Evo Morales of Bolivia announced the nationalization of the natural gas industry affecting the interests of Spain and Brazil.\textsuperscript{103} Initially, Bolivia's position

\textsuperscript{100} The final three categories were coined by Frank C. Alexander, Jr. See Frank C. Alexander, Jr., "The Three Pillars of Security of Investment Under PSCs and Other Host Government Contracts," Chapter 7, of Institute for Energy Law of the Centre for American and International Law's Fifty-Fourth Annual Institute on Oil and Gas Law (Publication 640, Release 54), Lexis Nexis Mathew Bender (2003), Sec. 7.03[1].

\textsuperscript{101} See Chua, supra note 8.

\textsuperscript{102} Id.

\textsuperscript{103} Supreme Decree 28701 declared that the 180 day negotiation period had ended
was that no compensation would be paid, but now apparently some payment is to be made, although the terms of payment remain unclear.\(^{104}\) The government of Ecuador terminated Occidental’s contract while also deciding to impose an additional 50% levy on oil revenues, justified by the high price of oil in the international market.\(^{105}\) And finally, in Venezuela, President Hugo Chávez has both imposed a number of forced sales in some circumstances, as well as outright nationalizations.\(^{106}\) In the case of Venezuela the nationalization-privatization cycle has been exacerbated by the extreme dependency of the local economy on the exportation of oil\(^ {107}\) and its condition as a petro-state has led to the increased role of the public sector, weakened public and private institutions, centralized concentration of power, and increased corruption.\(^ {108}\)

**B. Venezuela’s Petroleum Industry**

In 2009, Venezuela’s proven reserves were calculated at approximately 99 billion barrels, the largest reserves in South America;\(^ {109}\) additionally, Venezuela boasts that it could have the

and that all oil and gas resources in the country were nationalized. Decreto Supremo 28701 de Nacionalización de los Hidrocarburos, 1 de Mayo de 2006 (Bol.). Article 5 of Law No. 3058 required that all foreign companies operating in Bolivia had to enter into new contracts with the state oil company (YPFB) within 180 days. Ley de Hidrocarburos, Ley No. 3058, 17 de Mayo de 2005 (Bol.).


106. Among the affected foreign investments in Venezuela to date are the following: the interests of Verizon in the largest telephone company (CANTV), the interests of AES in the largest electric company (Electricidad de Caracas), the interests of CMS Energy in Seneca, the interests of the Mexican Cemex, and the four heavy crude investments in the Orinoco river basin. Brian Ellsworth, FactBox: Venezuela’s Nationalizations Under Hugo Chávez, REUTERS, Apr. 4 2008, http://www.reuters.com/article/worldNews/idUSN0438985820080404.

107. “Oil generates about 80 percent of the country’s total export revenue, contributes about half of the central government’s income, and is responsible for about one-third of the country’s gross domestic product.” Cesar J. Alvarez & Stephanie Hanson, Venezuela’s Oil-Based Economy, COUNCIL ON FOREIGN RELATIONS, Feb. 9, 2009, http://www.cfr.org/publication/12089.


largest reserves in the world. In 2007 Venezuela had net oil exports of around 1.9 million barrels per day, which placed it as the seventh largest exporter in the world and by far the largest in the Western Hemisphere. Venezuelan crude oil, however, is generally characterized as both "heavy," meaning less than 30° API gravity, and sour, meaning greater than 0.7% sulfur content by weight. Hence, in order to convert Venezuela's crude into higher value petroleum products, specialized refineries are needed, and capacity is relatively limited.

Venezuela's oil industry dates back to 1913 when the first oil well was drilled and when two foreign companies with long ties to Venezuela, Royal Dutch Shell and Rockefeller's Standard Oil (now ExxonMobil), became the first producers in the country. By 1929 Venezuela was the second largest oil producer in the world. In the 1950's world oil prices began to suffer due to an over-supply of oil in the international market, given increased production from the Middle East. The following decade saw the birth of the Organization of Petroleum Exporting Countries (OPEC), promoted by Venezuela as a founding member (along with Saudi Arabia), which has evolved into a powerful cartel.

C. Venezuela's First Nationalization

In 1973, a "young, energetic extrovert" from the Western State of Tachira, Carlos Andrés Pérez, centered his campaign for president on the notion that the Venezuelan state should control the extraordinary riches that lay under Venezuelan soil. His
campaign slogan, "Democracy with Energy," was one of the keys to his electoral victory. The day Pérez was sworn into office coincided with the end of the OPEC oil embargo initiated by the Arab OPEC members as a consequence of the Israeli victory in the "Yom Kippur War," which had caused the "first oil shock" and prices to soar from $3.50 to $10 per barrel from late 1973 to early 1974. The windfall in oil income motivated Pérez to effect an ambitious plan of nationalizing Venezuela's core hydrocarbon and metallurgical industries.

By late 1974 Pérez had nationalized the iron ore industry and laid the basis for a major state steel industry. However, the key objective was the nationalization of the petroleum industry, effected through the enactment of the "Organic Law that Reserves to the State the Industry and Trade of Hydrocarbons" of 1975 (hereinafter the "Nationalization Law"). The Nationalization Law provided that for reasons of "national convenience and interest" all activities and pending projects related to the hydrocarbons industry would now belong to the state and that the "concessions granted to private companies are hereby extinguished." At the time Venezuela had fourteen concession agreements with foreign oil companies. In 1976 the government was flush with cash given three years of high oil prices, and agreed to pay compensation to all of the oil companies.

Pérez was also responsible for the creation of Venezuela's NOC, Petróleos de Venezuela, S.A. (PDVSA), which initially operated as a holding company and managed the fourteen private com-

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118. Carlos Andrés Pérez Rodríguez, supra note 117.
121. Id. Legally, what occurred was the anticipated reconversion of the prior concession agreements, although this was tantamount to nationalization.
122. Carlos Eduardo Padrón, Proceso de Apertura Petrolera, in TEMAS DE DERECHO PETROLERO 19, 25 (Juan Cristóbal Carmona Borjas coordinator, 1998) (Venez.).
panies that had in effect been nationalized. From 1976 through 1991 PDVSA was the sole operator of Venezuela's oil. Although the Venezuelan government was the sole shareholder, PDVSA was for at least the first decade professionally managed and enjoyed operational autonomy, including with respect to its earnings. As a consequence, in this period PDVSA gained a strong reputation for competence and efficiency, while investing heavily in refineries and distribution channels in the U.S. and Europe, thereby creating a vertical integration that was key to Venezuela's market penetration, given its particular mix of largely heavy crude.

D. The "Apertura Petrolera," or the Oil Opening

During the mid and late 1980s Venezuela's economy had begun to suffer dramatically. One principal factor was the decrease in oil prices, which fell below $10 a barrel by mid-1986 as a result of slowing global demand, but also due to OPEC's inability to enforce production quotas on its members. The high oil prices of the 1970s had also led to increased exploration and production efforts by non-OPEC actors. In this context, and based on deficit spending in the late 1980s, by the time of the 1988 presidential election, Venezuela was on the verge of a financial crisis, in a period of inflation, and unable to make payments on its $33 billion foreign debt. Pérez, who was again eligible to run for president under the 1961 Constitution, having spent two five-year presidential terms out of office, based his campaign on reminding the electorate of the "economic miracle" of his earlier presidency.

The energy policy of Pérez's second presidency, beginning in early 1989, was, however, quite different. Seeking to increase production, the government sought to find an escape hatch in the Nationalization Law approved during Pérez's first term and by

126. See generally Riding, International Report, supra note 124.
127. Marsh, supra note 123, at 460.
128. España & Manzano, supra note 115, at 57.
130. Carlos Andrés Pérez Rodríguez, supra note 117.
which it could once again invite foreign investors to assist in exploration and extraction activities without relinquishing ownership of Venezuela's natural resources, as this would have been illegal under the law.\footnote{131} Article 5 of the Nationalization Law allowed the executive to enter into service agreements with private parties so long as 1) the state was "guaranteed control" of the undertaking, 2) the agreement was for a limited time, and 3) the two houses of Congress approved the agreements.\footnote{132} With respect to defining state control, the Supreme Court determined that control was essentially a legal rather than an economic concept, thus allowing the executive branch to permit foreign investors to have direct participation, as well as shareholder control, in the service agreements to be executed later.\footnote{133} This was the model that was used for the next wave of large-scale foreign investment in Venezuela's petroleum industry.

The following ten-year phase, known as the "Apertura Petrolera" or Oil Opening, occurred in several stages.\footnote{134} First, smaller, less capital-intensive projects were put up for bid during three rounds in 1991, 1992 and 1997. Initially designed to apply new technologies for secondary recovery of older oil deposits, these later became the Operational Service Agreements, with an increasingly expanded scope. Simultaneously, plans were also laid for more complex projects intended to exploit and upgrade Venezuela's extremely heavy crude in the Orinoco "tar" belt.\footnote{135} Requiring large amounts of capital and sophisticated technology, two bidding rounds were held in 1993 and 1997 resulting in the signing of four Strategic Association Agreements ("SAA").\footnote{136} Of these, two were entered into in 1993 (Sincor and Petrozuata) and the

\begin{itemize}
\item \footnote{131}{Padrón, supra note 122, at 33.}
\item \footnote{132}{Ley Orgánica que reserva al Estado la Industria y el Comercio de los Hidrocarburos, 1.769 D.O., 29 de Agosto de 1975, p. 123, art. 5 (Venez.), available at http://www.bibliojuridica.org/libros/1/339/12.pdf.}
\item \footnote{133}{Lagoven, S.A. (Corte Suprema de Justicia [Supreme Court] Apr. 23, 1991) (Venez.), reprinted in Oscar R. Pierre Tapia, 4 JURISPRUDENCIA DE LA CORTE SUPREMA DE JUSTICIA 113 (1991).}
\item \footnote{134}{See Miranda Wainberg, From "Apertura Petrolera" to "Apertura Gas Natural"? The Case of Venezuela, CENTER FOR ENERGY ECON., http://www.beg.utexas.edu/energyecon/new-era/case_studies/Apertura_in_Venezuela.pdf (last visited Feb. 13, 2009).}
\item \footnote{135}{See Elisabeth Eljuri & José Ignacio Moreno, Los Convenios de Asociación para la Exploración a Riesgo y Producción de Hidrocarburos Bajo el Esquema de Ganancias Compartidas, in TEMAS DE DERECHO PETROLERO 67, 69 (Juan Cristóbal Carmona Borjas coordinator, 1998) (Venez.).}
\item \footnote{136}{Padrón, supra note 122, at 33.}
\end{itemize}
other two in 1997 (Hamaca and Cerro Negro). The SAAs are the principal focus of the remainder of this analysis.

The four SAAs were highly capital intensive, requiring investments well over $2 billion each\(^{137}\) for a total investment of approximately $17 billion. All of these projects involved the extraction of extra-heavy crude oil from the Orinoco belt, a 21,000 square mile area in the south of the country, and its transportation, once partially upgraded, through pipelines to specialized refineries located at Jose on the Caribbean coast in the north, which were also integral parts of the SAAs.\(^{138}\) These four projects have been described as being among the most complex in the world.\(^{139}\)

In this context, it is important to note that the four SAAs were the result of transparent public bidding procedures televised on national television.\(^{140}\) Moreover, they were the object of intense national debate and obtained the required approvals from both the executive and legislative branches, as well as the office of the comptroller general. At the time these agreements were entered into, this procedure was hailed as an exemplary process conducted by a state oil company and with proper political approval.\(^{141}\)

By virtue of the sizeable investments required of the foreign investors, all four agreements included significant incentives for the investors.\(^{142}\) With respect to taxation, the foreign investors were taxed at the non-oil income tax rate of 34% rather than the oil tax rate of 67%.\(^{143}\) This was justified on the basis that the investors were merely service providers, as they could not count their allotted fields as part of their reserves and all marketing of the output was reserved to PDVSA.\(^{144}\) Regarding royalties, the two

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137. Marsh, supra note 123, at 463.
139. Id.
141. Id.
142. It has been noted that the incentives were highly beneficial to the foreign investors. This may have been required to entice the same oil companies whose operations had been nationalized during the 1970s to return to Venezuela. See Tim Padgett, Chávez's Not-So-Radical Oil Move, Time, May 1, 2007, http://www.time.com/time/world/article/0,8599,1616644,00.html.
144. See generally Marsh, supra note 123, at 462-66. Article 54 of the 1995 Venezuelan Income Tax Law allowed for a special rate for service providers.
SAAs negotiated in 1993 (Sincor and Petrozuata) had guaranteed royalty rates of 1% for the first ten years and a royalty of 16.66% thereafter. The two other SAAs negotiated in 1997 (Hamaca and Cerro Negro) were free from all royalties. Also, it was provided that Venezuela's NOC, PDVSA, would serve as the guarantor against state intervention. PDVSA was to compensate the foreign investors for any "adverse economic situation resulting from adoption of governmental decisions or changes in the legislation which causes a discriminatory treatment." However, this compensatory mechanism would only be applicable as long as the price of oil and the foreign investors' profits remained below a certain economic baseline.

E. The Cerro Negro Project

Before describing the situation of the Cerro Negro project it is necessary to point out that in doing the research for the present analysis two general difficulties were encountered. First, the agreements reviewed are relatively vague with respect to the respective rights and obligations of the IOC and the host government. It has been reported that given the nature of the bargaining process and the often piecemeal production of the documentation, it is a common experience that upstream petroleum regimes tend to result in poorly drafted agreements. Second, full and complete access to the four agreements was difficult to achieve. However, it has been reported that the texts of the four agreements were generally similar, particularly with respect to the rights and duties of the parties in case of disputes. In any case,

146. Id. at 465.
147. It is reported that in the case of Petrozuata, for instance, for governmental actions affecting profits generated above a price of $25 per barrel PDVSA would not need to pay compensation. See Marsh, supra note 123, at 465.
148. Alexander, Jr., supra note 100.
149. In part this may be due to the tensions created by the two pending arbitration proceedings before ICSID. Visits to the Ministry of Energy and Petroleum in Venezuela proved largely unsuccessful, perhaps for precisely these reasons. Also, during confidential conversations with local and international outside counsel, as well as in-house counsel, located both in and outside of Venezuela, it was suggested that the companies that have now renegotiated new terms with the Venezuelan government are cautious of their respective bargains and have kept all related information and documentation confidential.
150. Report of the Special Commission to Investigate the Irregularities Detected by the Ministry of Energy and Petroleum Committed in the Formulation, Celebration and Execution of the Operating Agreements, Strategic Association Agreements and the International Negotiations, Special Report given before the National Assembly,
for the purposes of the present study the agreement known as the Cerro Negro SAA is perhaps the most illustrative.\textsuperscript{151}

The Cerro Negro SAA, entered into in 1997, was an agreement between what was then Mobil Oil Corp., Mobil Producción e Industrialización de Venezuela Inc., and Lagoven, a subsidiary of PDVSA that at the time was one of the four principal operating subsidiaries.\textsuperscript{152} The agreement covered a series of activities, including exploration, production, transportation and partial upgrading of 100,000 barrels per day of crude from the Orinoco belt.\textsuperscript{153} The term of the contract was for thirty-five years. It also provided for the construction of upgrading facilities in the Cerro Negro area, the construction a further refining facility at the Jose Industrial Complex on the Caribbean coast, and a transportation infrastructure of pipelines and tanks.\textsuperscript{154} Because of the extensive infrastructure construction required, the Cerro Negro project did not come on stream until June 2001.

The Cerro Negro SAA contained a relatively weak and convoluted stabilization clause with an emphasis on maintaining the applicable tax structure. The stabilization clause itself provided that in the event that the "Foreign Party" deemed that an event that would cause a material adverse impact had occurred, it would notify PDVSA. Then, but only if PDVSA concurred that a unilateral adverse event had occurred, PDVSA would cooperate with the Foreign Party to pursue legal action and "negotiate in good faith compensatory damages and/or possible modifications to the Agreement designed to restore the economic benefit that the Foreign Party would have received had the [event] not occurred."\textsuperscript{155}

Significantly, though, a unilateral adverse event constituting a breach of the agreement was defined as a change in applicable

155. Cerro Negro SAA, supra note 151, at cl. 15.1(a).}
laws or regulations that would be discriminatory or "unjust and is applicable to the Project or any Foreign Party . . . and is generally not applicable to entities, both public and private, engaged in extra heavy crude oil upgrading in the Republic of Venezuela; or, with respect to tax rates, foreign exchange controls or condemnation of assets of . . . a Foreign Party."156 However, the agreement seemed to at least provide for greater stability with respect to tax treatment by specifically indicating that the income tax imposed on the project could not result in a material adverse impact, which was defined as a variation of at least 4% in the disputed amount. Furthermore, with respect to municipal taxes, the agreement made PDVSA responsible for any burden affecting the Foreign Party's gross revenue in the event that the aggregate municipal tax exceeded 4%.157

The stabilization clause in the Cerro Negro agreement may be classified as falling under the Negotiated Economic Balancing category. Similar clauses are contained in concession agreements awarded by Egypt in 2002, production sharing agreements entered into by Vietnam in 1996, operating agreements signed by Mozambique in 1998 and exploration agreements entered into by Kazakhstan in 1997.158 However, by requiring that the Foreign Party first notify PDVSA, and then only if the latter concurred with the Foreign Party as to the occurrence and nature of the unilateral event would PDVSA be required to undertake good faith negotiations, made the Cerro Negro stabilization clause a weaker provision than others in this category.159

Some degree of comfort was provided by the arbitration clause, however.160 The relevant clause stated that if PDVSA did not agree with the investor as to the unilateral treatment or if there was deemed to be a breach of the minimum required thresh-

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156. Cerro Negro SAA, supra note 151, at "Definitions," "Discriminatory Action."
158. See Cameron, supra note 92, at 32-35.
159. Nevertheless, it is reported to be among the most typical kind of commitment. See id. at 32.
old, either party could commence arbitration proceedings within 90 days. The arbitration clause, though, did not give the arbitrators the ability to rewrite the agreement but rather only to award damages and to make "recommendations on amendments to the Agreement that would restore the economic benefit that the Foreign Party would have received."

F. The Plan for "Full Oil Sovereignty" Over Petroleum Resources

Since 1999 Venezuela's oil policy has been oriented toward recovering the state's control over its natural resources and "ultimately, this is where the power of oil-exporting countries [continues] to comes from." Pursuant to this, in 2001 a new Organic Law of Hydrocarbons (the "Hydrocarbons Law") was enacted by President Chávez under the extraordinary decree-law powers he had at the time largely without consultation outside of the government and reportedly only with the presence of one representative from the private sector. The new law established higher royalty and tax rates for all hydrocarbons activities, but at the time of its entry into force it only applied to future agreements. The Hydrocarbons Law established that all activities related to the exploration, extraction, collection, transportation and initial storage of hydrocarbons (collectively defined as the "Primary Activities") can only be carried out by the state, directly or indirectly, through

161. Cerro Negro SAA, supra note 151, at cl. 15.1(b).
162. Id.
163. The policy of Full Oil Sovereignty has been summarized as follows: "The policy of Full Oil Sovereignty [is] a fundamental strategy of the Bolivarian Government of Venezuela. [It] shall propel the domestic social development because the State will receive additional revenues that will be invested in programs with national, popular and revolutionary foresight. The defense of our national sovereignty starts with the reaffirmation of our ownership of our hydrocarbon resources and with the rescue of the control of the oil activity, from the point of view of the tax and legal systems, along with the effective participation of Petróleos de Venezuela (PDVSA) in the business." See 141st Extraordinary Meeting in Caracas OPEC: Bastion of Oil Sovereignty, The New PDVSA CONTACT NEWSLETTER, June 2006, available at http://www.pdvsa.com/interface.en/database/publicacion/1381/53.PDF.
wholly-owned state companies or through mixed companies, but which are controlled and more than 50% owned by the state.\textsuperscript{167}

By 2004 President Chávez was in his sixth year in office and oil prices had risen from around $18 per barrel in 1999 to close to $50 in mid-2004.\textsuperscript{168} In September 2004, Chávez announced that applicable royalties would be increased to 16.66%. Then in May 2006, despite assurances in 2002 that the Hydrocarbons Law would only apply to new projects,\textsuperscript{169} Chávez announced that the tax rates stipulated in the Hydrocarbons Law would apply retroactively to the four SAAs, thus raising the applicable income tax rate from 34% to 50%.\textsuperscript{170} It was estimated that these combined policies would reduce net revenues for the foreign investors operating in the Orinoco belt by up to 60%.\textsuperscript{171}

On April 12, 2005, the Venezuelan Ministry of Energy and Petroleum (MEP) declared that the SAAs were illegal and notified the foreign investors that they would have to "migrate" their projects into mixed companies in which the state would have at least a 51% interest.\textsuperscript{172} The government's position was that a unilateral modification of the SAAs was legally permitted because these were null and void \textit{ab initio}, and contrary to the requirements of Article 5 of the 1976 Nationalization Law.\textsuperscript{173} Importantly, the government considered that the SAAs granted the foreign

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167. \textit{Id.} at art. 9, 22.
172. The forced migration of the SAAs had been preceded a year earlier by the same forced migration of the Operating Service Agreements resulting in the formation of seventeen new joint ventures all dominated by PDVSA, with at least a 60% controlling participation. Later the government changed its position to insist on a minimum participation of 60% on the part of PDVSA for the SAAs, as well. See \textit{MINISTRO RAFAEL RAMÍREZ DISCUTIO EL MODELO DE EMPRESA MIXTA EN LA COMISIÓN PERMANENTE DE ENERGÍA Y MINAS DE LA AN, PETRÓLEOS DE VENEZUELA, S.A.}, Mar. 22, 2006, available at http://www.pdvsa.com/index.php?tpl=interface.sp/design/salaprensa/readnew.tpl.html&newsid_obj_id=2380&newsid_temas=1.
\end{flushleft}
investors' activities that were "reserved to the state" and that given the high production volumes and profits accorded to the foreign investors under the SAAs, for these reasons the SAAs were more than "simple service or operating agreements permitted under the law."\textsuperscript{174}

Negotiations regarding the terms and conditions for the so-called "migration" into mixed companies were complex, involving political tensions, a number of rival parties, and requiring the foreign investors to take considerable losses, or at least forego significant future profits.\textsuperscript{175} There were also considerable time constraints as the parties worked under a March 31, 2006 deadline set by the MEP. The documentation being negotiated included the contract for conversion into mixed companies, the bylaws of the mixed companies, future business plans, operating policies and procedures, and a contract for the sale of hydrocarbons by the mixed companies to PDVSA, which alone was permitted to market petroleum products.\textsuperscript{176} On March 18, 2006, the four SAAs were terminated by law.\textsuperscript{177} Then on March 31 the decisions creating the mixed companies and approving their bylaws by the congress were published in the Official Gazette, thus formally completing the "migration" process.\textsuperscript{178}

Only ExxonMobil and ConocoPhillips refused to reach agreements with PDVSA, the MEP and the Venezuelan government. In contrast, ChevronTexaco, Statoil, Total, ENI, BP and Sinopec all agreed to new terms and currently hold stakes in their respective mixed companies.\textsuperscript{179} It has been estimated that if the contracts had remained in force, the companies stood to make an additional $7.7 billion, while the total losses to all foreign investors are in the

174. Id.
177. Ley de Regularización de la Participación Privada en las Actividades Primarias Previstas en el Decreto No. 1.510 con Fuerza de Ley Orgánica de Hidrocarburos, Official Gazette No. 38.419, (2006). Article 1 of this law established that the law would regulate all contracts entered into during the so-called "apertura petrolera." Article 4 established that the agreements subject to the framework of the law would be terminated.
neighborhood of $3.7 billion. On October 10, 2007, ExxonMobil filed a demand for arbitration before ICSID, and although it had been reported that ConocoPhillips continued to attempt a negotiated settlement, on December 13, 2007, it also filed for arbitration before ICSID.

VIII. CONCLUSIONS

Reducing the uncertainty of extractive sector investment contracts also tends to reduce the cost of such investments for the investors and host states, because investors often take political and economic risks into account in the pricing of their investments. Moreover, such investments generally require considerable external financing from lending institutions and capital markets, which are sensitive to investment security. Naturally, given the opposing interests of the parties involved in a cross border energy sector investment, the IOCs will try to negotiate the most protective form of stabilization clause, while the host states and their NOCs will bargain to the contrary. Ideally, however, the parties will seek to work together to reduce risks and, hence, lower the costs of financing large infrastructure projects entailing the high sunk costs normally associated with petroleum projects. In this respect, stabilization clauses continue to play a relevant and useful role as a form of contractual risk reduction.

Resource industries—and oil in particular—move in cycles. When oil prices are high it has been more feasible for governments to embark on a nationalization cycle by expropriating, renegotiating contracts, and raising taxes, as Venezuela has done in recent years. Also, when prices are high enough most of the oil companies have still preferred to continue with even a reduced participation rather than to exit, as has been the case for a majority of the major oil companies operating in Venezuela.

180. Reed, supra note 175.
181. See Mobil Corp. v. Bolivarian Republic of Venezuela, ICSID Case No. ARB/07/27 and ConocoPhillips Co. v. Bolivarian Republic of Venezuela, ICSID Case No. ARB/07/30. It should be noted that the SAAs did not provide for ICSID arbitration, but rather for arbitration in New York under the rules of the International Chamber of Commerce. However, the ICSID claims have been brought under applicable BITs. See Eljuri & Moreno, supra note 135, at 77.
184. Walde, supra note 7, at 65.
185. Id.
Intriguingly, however, during the preparation of the present study, oil prices have fallen from an all time high of $147 per barrel in July of 2008 down to around $32 per barrel as of December 2008 and with the prospect of a worldwide recession, it is anticipated that oil prices may trend even lower.\textsuperscript{186} Hence, with oil prices close to a fifth of what they were at their peak, and with the trend in world demand toward further decline,\textsuperscript{187} the leverage of host states will most likely diminish.\textsuperscript{188} IOCs will continue to invest as they compete for available resources, but during the next foreign investment cycle in countries like Venezuela, it would seem reasonable to assume that IOCs should be able to negotiate enhanced legal and, perhaps, financial assurance, as well as predictability, from host states.\textsuperscript{189} Indeed as oil prices drop, Venezuela has been faced with embracing Western oil companies once again as it encourages companies such as ChevronTexaco, Royal Dutch/Shell and Total to bid on a series of new projects.\textsuperscript{190}

In this context, stabilization clauses are a significant tool with which IOCs can hope to achieve this objective by reducing uncertainty. For the host state, stabilization clauses represent a contractual alternative that permit varying degrees of flexibility with respect to restricting their ability to make legislative and regulatory changes without giving away too much of their sovereignty. In the future both parties should be able to benefit from the advantages offered by this contractual risk reduction mechanism, particularly with respect to capital intensive projects in countries with elevated degrees of political risk.

Based on the considerable evidence of the potential benefit to both IOCs and host governments of employing well-conceived stabilization clauses in, especially, basic resource-related contracts as a means of optimizing the productive relationship to the long-term advantage of both parties, the question remains as to types


\textsuperscript{188} See, e.g., Walde, \textit{supra} note 7.

\textsuperscript{189} During the bottom of the so called "resource cycle," when commodity prices are low, the host state will have less bargaining power and will adopt promotional and concessionary measures by granting tax incentives and investment guarantees. \textit{Id.}

of provisions, and the specific terms and conditions of the stabilization clauses, that could offer the optimum outcome. While evidently these factors have to be geared to the specific elements and circumstances of each project, nevertheless it would beneficial to both IOCs and host governments to attempt to conceive the kinds of situations that could arise, as well as the conditions that would be minimally acceptable, in any particular context. This type of analysis would generally be on several planes, taking into account the economic context and prospects, the financial expectations of the project, legal conditions and safeguards, operational and managerial aspects, and possibly others. Thus, it is to be presumed that if the potential parties to such contracts develop their own rational guidelines to these factors, they would be in a position to make more efficacious investment decisions, as well as to negotiate more successful investment agreements.