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Obsolescing Bargain and Economic Equilibrium in International Energy Investment Contracts

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Abstract

This article examines the concepts of obsolescing bargain and economic equilibrium in international energy investment contracts. Equilibrium means the balance of interests that the parties' contract embodies. Part of the idea of equilibrium is to entrench a way to keep their interests in harmony. Equilibrium is the point that host governments and foreign investors reach at the time when they strike the bargain. The equilibrium is stable if it is resilient to events which challenge it and have the potential of disrupting the balance. The point to the obsolescing bargain model is that the equilibrium is inherently unstable and therefore, there is a need for a proper framework surrounding the investment contract in order to reinforce the stability of the equilibrium. This is the key point the obsolescing bargain model makes in relation to the instability of the contractual equilibrium. If we look at it such relationship as a one-off set of rights and duties, then it is unstable. But, instead if we look at the equilibrium as a relationship that is dynamic and evolves, then it can be stable. This article underscores the significance of maintaining equilibrium in the relation of foreign investor and host state to avoid obsolescing bargain and international investment disputes.

Keywords

Economic equilibrium, foreign investor, host state, international energy investment contracts, obsolescing bargain, risk of expropriation, international investment disputes, contractual flexibility, allocation of risk, contractual stability

1. Introduction

Investment is one type of human action by which the investor seeks to earn monetary profit. The investor seeks to gain economic profit at a future date, namely, a time at which the investor predicts the revenues of the performed project would be more than previous costs of the investment and interests. Risk and uncertainty are important characteristics of long-term international energy investment contracts. The viability

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of long-term international energy investment contracts is dependent upon the effective and efficient distribution of risk and reward between the parties. While retaining the potential for flexibility in the face of future pressures for alteration. Therefore, they cannot be seen as if they were discrete commercial transactions, namely, a one-off transaction between the parties. Unlike discrete commercial transactions, their performance extends over time, which makes them susceptible to changes of contract conditions which require flexibility and, possibly, adjustments to the contractual framework. Hence, a contractual relationship in an energy transaction is only sustainable if it incorporates an ability to accommodate changing expectations in changing circumstances, based on the ongoing balance and adjustment of contractual rights and obligations in an altered framework.

The legal characterisation of international energy investment contracts as long-term contracts in the field of natural resources thus, implies that parties' purposes may be challenged by fundamental changes of circumstances. In addition, commercial stability in the context of such agreements becomes even more acute than other long-term contracts. Since a party is usually a government and, in consequence, suffers from a special type of uncertainty not present in ordinary transactions, arising out of the political pressures and social objectives that influence the actions of governments.[1]

The aim of this article is to set out an analysis of the interaction between the obsolescing bargain and the economic equilibrium in international energy investment contracts. This article uses two theoretical concepts – the obsolescing bargain, and the economic equilibrium – to explore the character of international energy investment contracts. These ideas encapsulate key characteristics of international energy investment contracts that distinguish them from other types of investment contracts, and provide us with a framework within which we can analyse the adequacy of the existing system of international investment law in adequately providing for these characteristics.

The significance of equilibrium in international energy investment contracts may hardly be overemphasised.[2] The stability of the regulatory regime has an important role for foreign investors in making a decision. Investors assess the investment climate in the host country including, inter alia, stability of contractual arrangements, the legal commitment of the host state to commercial balance and the original expectations of the parties as to their rights and duties based on the concluded contract. As well as the stability of the regulatory scheme which will assist in ascertaining the profitability of the venture. In international energy investment contracts a stable and balanced contractual context which preserves the economic equilibrium of the contract can only exist under an overall fair scheme for the allocation of risks and benefits based on the original commercial balance that was contemplated at the time of contracting.[3]

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[1] George Bermann, *Contracts between States and Foreign Nationals: A Reassessment* in *International Contracts*, 195 (New York: Matthew Bender, 1981).

[2] The concept of equilibrium will be discussed in the next sections.

[3] Pat O'Malley, *Uncertain Subjects: Risks, Liberalism and Contract* 29 Economy and Society 460-484 (2000).

The lack of a fair and efficient scheme in the host country for distribution of economic benefits and allocation of the risks associated with the business project may result in disreputation of the host state and this could come to be regarded as a deterrent factor in the energy industry.

The next sections examine the necessary practices for contracting into long-term agreements. The response of legal rules to these practices will be discussed. When a foreign investor decides to invest in a host country he should begin to use methods to minimise the risk of host state interference with the investment. This paper concentrates upon available legal models that the contracting parties can take up for their relationship, and argues the model which can reduce exposure to expropriation risk for the foreign investor. The article looks at the obsolescing bargain model, the interplay between obsolescing bargain and risk of expropriation, the notion of contractual equilibrium and the factors which form and disturb the equilibrium.

2. The Obsolescing Bargain in International Energy Investment Transactions

2.1. The Interaction between Obsolescing Bargain and Expropriation Risk

Investors whether domestic or foreign, face a variety of risks. In hindsight there can be no risks, only history. The future, however, is uncertain because neither natural events nor human action can be foreseen with certainty.[4] The risk of expropriation -as disruption of equilibrium- is a threat to the profitability of a project that derives from some sort of governmental action or inaction. Foreign investors will face interference risk as a result of the host states sovereignty, through which the government controls its territory. The host government could unexpectedly raise taxes, impose new regulatory conditions and seize the investor's property. This type of risk is known as regulatory or expropriation risk.

Expropriation can take a number of forms, which can be either direct or indirect. Moran, has defined direct expropriation as the taking of property owned by a foreign investor by a host state in its territory.[5] Indirect expropriation, which is the contemporary risk to foreign investment, is government interference which does not formally transfer title from the investor, but damages or destroys his ability to control or benefit from the investment. In essence, a series of State acts deprive the investor of the substantial part of the use and benefits of the property.[6] There are several reasons for

[4] Hans Hermann Hoppe, *On Certainty and Uncertainty, Or: How Rational Can Our Expectations Be?* 10 (1) The Review of Austrian Economics 49 (1997).

[5] Theodore H. Moran, *Political and Regulatory Risk in Infrastructure Investment in Developing Countries: Introduction and Overview* 5 (6) CEPMLP Journal 5(1999).

[6] Noah Rubins and Stephen Kinsella, *International Investment, Political Risk and Dispute Resolution, A Practitioner's Guide*, 12 (New York: Oceana Publication, 2005); Hamid R. Younesi, *Indirect Expropriation in the Petroleum Industry: The Response of International Arbitrations* 6 Petroleum Business Review 57 (2021).

government interference with international energy projects which create the risk of expropriation.[7] Amongst the principal reasons for the risk of expropriation is that the host state seeks to obtain a greater share of the return from a successful operation. This may be by raising taxes or tightening other provisions in the investment contract without necessarily taking over ownership of the investment or driving the investor out of business.[8]

As a result, the business relationship between foreign oil company and host government resembles a model of what has been called an 'obsolescing bargain'.[9] According to this model, foreign investors seek contractual terms and conditions that are capable of protecting their investment in the host state territory, and the economic interests arising out of it. The host governments agree to these terms in order to attract the investment, but once the project is successful they have fewer incentives to want to continue to compensate investors with the same degree of generosity, given that from their perspective the initial risk and uncertainty have dissipated.[10] From the government's perspective, the bargain is in effect obsolete.

At the beginning of a project, foreign investors tend to demand additional concessions or higher returns as a result of the perceived risks of entry and the intensive exposure of the start-up phase. Once the investment is under way, however, the host government is less prepared to maintain the start-up conditions, since the risk often will have declined, along with the cost of financing. Where a project is long-term with heavy capital investment (sunk costs) at the start, and uses assets that are not easily sold or converted to other purposes, the government has a great deal of leverage over the foreign investor, who cannot credibly threaten to abandon his investment plans if conditions deteriorate. Once the investment has been made and the initial risk has passed, host states are less constrained from interfering with energy projects in pursuit of political, economic and environmental goals. This can be done either through direct action upon the contract, or through a variety of regulations.[11] In addition, host governments may place controls on the industry in a manner that hampers its profitability.[12]

2.1.1. Bargaining Relationship

The duration of international energy investment contracts for exploration and exploitation of natural resources is always extended; thirty years is common, and even longer periods are often found.[13] This is mostly due to technical reasons. However,

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[7] Ludwig von Mises, *Human Action*: *A Treatise on Economics*, 106 (Alabama: The Ludwig von Mises Institute, 1998).

[8] Moran (n 5), 5; Rubins and Kinsella (n 6), 3-15.

[9] See also next section for the detailed discussion.

[10] Moran (n 5), 7-14.

[11] Moran (n 5), 6; Rubins and Kinsella (n 6), 4-7.

[12] Ibid., 1-7.

[13] Ibid., 46-48; Daniel Yergin, *The Prize: The Epic Quest for Oil, Money and Power*, 14 (New York: Free Press, 1992); Raymond Mikesell, *Conflict in Foreign Investor-Host Country Relations: A Preliminary Analysis*, in *Foreign Investment in the Petroleum and Mineral Industries: Case Studies*

almost once the agreement is concluded, powerful forces go to work and create incentives for the government to resile from the original bargain. The reasons for such will be discussed further below.

The main factor is the inevitable change that time brings to such long-term contracts between a foreign oil company and a host country. The change in the project could take place after the initial exploration has been completed.[14] Exploration and exploitation of petroleum resources are overwhelmingly complex and beyond the capability of the developing host state. They have financial risks and need technical expertise. Therefore, the short-term strategy of the host country is to offer favourable conditions to foreign oil companies to make investment agreements. However, when the energy project succeeds it takes the limelight. The returns to the foreign investor at this point do not seem appropriate for the perceived risk and the host state demands more out of the energy project.

There are also other factors operating to make the investment contract obsolescent. As a result of resource nationalism, host governments may seek a show of independence from the foreign investor. However, in order to avoid presenting an image in which the government action is arbitrary, the government could pursue its purpose through forced renegotiation.[15] In addition to political reasons, the economic incentives have an important role in transactional disequilibrium. Where government's revenue increases from an energy project, its reliance on these funds would create long-term demand. Therefore, the risk that revenues could one day fall off and the fact that it is dependent on the sustained presence of the foreign investor for the performance of the project may threaten the host government. This could be sufficient to explain why the government seeks to tighten the terms of the bargain with the foreign investor and interfere with the investment.

3. Nature of Conflict in International Energy Investment Transactions

The obsolescing character of the bargain creates potential for significant conflict, because of its impact on the investor's interests. Host governments could react to bargain perceived as obsolescent by interfering in different ways such as imposing taxes and new regulations and implementing new environmental standards. These interventions could influence the market and affect the initial bargain. Such interventions and governmental actions would alter and impose new contractual commitments on the foreign investor. Generally speaking, the conflict which could arise in foreign

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of Investor-Host Country Relations, 35 (Baltimore: The Johns Hopkins University Press, 1971); Thomas Waelde, *The Current Status of International Petroleum Investment: Regulating, Licensing, Taxing and Contracting* 1 CEPMLP Journal 5 (1995); Daniel Johnston, *International Petroleum Fiscal Systems and Production Sharing Contracts*, 67 (PennWell Books, 1994).

[14] Hamid R. Younesi, *The Implementation of Relational Contract Theory in International Investment Contracts* 27(4) Journal of International Trade Law & Regulation 256 (2021).

[15] Raymond Vernon, *Sovereignty at Bay: the Multinational Spread of U.S Enterprises*, 48 (London: Longman, 1971).

investor and host government relations might be due to either issues concerning division of net revenues derived from operations between the host government and the international energy company, or the legal form of control of the operations such as percentage of foreign ownership, and management of the venture.

Additionally, the governmental action could lead to a conflict by the change of contractual terms or the imposition of taxes and other conditions affecting operations. The sovereign state may change the law and revoke the guarantees given to the foreign investor by such laws. The international energy company assesses estimated probabilities to risk, including, the possibility that a host government could subsequently change the contractual terms, and return before making investment in the host country. After the investment has proved successful, the host government may seek to capture a large share of returns. In the host governments' view 'there is no reason why the oil companies should earn greater profits than is necessary to induce them to continue investing in the industry and to compensate them for their initial risks. In other words, if excess profits are to be earned, a producing country can complain of exploitation to the extent to which it is unable to obtain them for itself because of the superior bargaining power of the oil company; if it could obtain them, the use of its resources would thereby become more profitable to the country'.[16] As far as the international energy company receives a sufficient return on the invested capital plus normal profits, including an allowance for relevant risk, it will continue its presence in the host country territory.[17]

4. Temporal Variation in Bargaining Power

The allocation of profits that is contemplated by the original agreement reflects the bargaining positions of the contracting parties. This arrangement in a long-term relationship is subject to renegotiation due to the change in variables involved. At the outset, when the area is unexplored, the risk of exploration is high and because of uncertainty in outcome of expensive investment, the host government seeks to induce a foreign oil company to bring its capital and technical and managerial skills to the host country territory to undertake the exploration. As a result, the bargaining of foreign investors *as class* is stronger than that of the host government. The host government has bargaining power against individual investors, but not against foreign investors as class. Here, in this point in time, the bargaining position of the individual foreign investor is stronger than the host government. The host state is a risk avoider and the foreign investor is a risk taker. This situation will ascertain the contractual terms of the agreement according to which parties will receive their shares on the revenue. However, once the investment has been made and exploration proves

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[16] Edith Tilton Penrose, *Profit Sharing Between Producing Countries and Oil Companies in the Middle East* 69 Economic Journal 255 (1959); See also, the OPEC Declaratory Statement of Petroleum Policy in Member Countries, Res. XVI.90, OPEC Bulletin (August 1968), 1-5.

[17] Mikesell (n 13), 38; Susan Strange, *States and Markets*, 192 (London: Pinter Publishers, 1998).

successful, the bargaining power shifts in favour of the host government. In addition to the sunk investment, another important factor that could strengthen the bargaining position of the host government is the said successful exploration. Once the original contract has been made and the existence of reserves is proven, it will considerably reduce the risk of additional investment in the same or adjacent area.[18] Therefore, the host government could offer a new contract to other foreign investors or state entities to operate in its territory.

However, the host state and the foreign investor have common interests which their mutual action will further. Yet, they act in many aspects divergently for their interests and compete against each other to maximise their own benefits. Meanwhile, they have common benefit and damage and their interest lies in maximisation of joint profits. In this situation, the role of the relational model in a long-term relationship between the foreign investor and the host government is outstanding. This can provide contractual flexibility and security for the foreign investor and therefore will attract foreign investment which is a prerequisite for operations in the host country. Under a stable framework, it is much easier to foresee the bargaining power of each party and it would therefore reduce likely conflict. In this context, contracting parties could renegotiate and do their best to achieve a possible solution.

As discussed above, once the initial bargain has obsolesced this could result in destructive investment disputes. Therefore, examining the bargaining relationship between foreign investors and host governments is the most effective approach in understanding contractual economic equilibrium, to identify the major factors disturbing such balance and to offer a solution to mitigate investment disputes. In order to study the bargaining relationship between the host government and an international energy company, discussing their major interests is necessary. The host state has several interests, including, health, welfare, and environmental interests, employment of local labour and adequate returns on the energy resources.[19]

For the foreign investor, the first interest is a reliable legal and financial framework which is predictable. Whilst the foreign investor takes the risk of exploration, it seeks to minimise the risk of host government interference (regulations, tax, environmental and labour requirements) through complex contractual arrangements. Another interest is profit maximisation. International energy companies are risk takers and seek large profits. Whilst they make investment in the host country and accept the exploration risk, they seek to accrue large earnings and maximise their benefits over a long-term relationship. This could clearly show that the contracting parties have diverging objectives and interests. In the foreign investor and the host government relationship, conflict is usually rooted in division of benefits. In order to understand the consequence of this, we will need to consider the full implications of the obsolescing character of the bargain represented by the initial international energy investment contracts.

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[18] Ibid., 40.

[19] Richard Bentham, *Legal Status of State Petroleum Companies*, in *Petroleum Investment Policies in Developing Countries*, 58 (London: Graham & Trotman, 1998); Johnston (n 13), 67.

5. The Obsolescing Bargain Model (OBM)

This concept was initially framed and developed by Raymond Vernon in his book, *Sovereignty at Bay*. The Obsolescing Bargain Model (OBM) explains the changing nature of the relationship between host states and foreign energy companies. The concept has been widely adopted by scholars.[20] In the OBM, the host government and foreign investor have several conflicting objectives and their interests are considerably different. It is asserted that 'national states are trying to generate much welfare for their residents as they can, while MNEs try to maximise their value. This creates bargaining situation'.[21] The initial bargain is in favour of the foreign investors but once the investment is made the bargaining power shifts to the host government. In this situation, the host government could set up and impose new conditions on the foreign investor. This would affect the distribution of benefits and could result in a conflict. Therefore, as the original bargain obsolesces, scholars called this process the OBM. This has been widely used to explain nationalisation and expropriation of natural resources.

As we have seen, the foreign investor for certain reasons is vulnerable to regulatory actions. The host government's regulatory measures reduce the investor's benefits by increasing costs –for example, environment regulation improving environment standards- and the foreign investor due to the nature of agreement that a party is government suffers from vulnerability. Unlike a purely commercial transaction, the investor's ability to respond to such measures is limited, because it is a long-term contract with a sovereign State which has sovereign power over natural resources and the investment has been made in its territory. This can be explained by the 'exit, voice, loyalty' framework that I discuss in the following paragraph. This model was initially introduced by the economist Albert Otto Hirschman.

In the host government and international energy company relationship, the occurrence of obsolescing bargain could be identified through the analysis of an international energy company's response. In the case of a change of contractual terms and where an issue arises out of the bargaining relationship, according to Hirschman's model three options are available to the international energy company; exit, voice and loyalty.[22] Hirschman's theory explores a situation where an institution is in decline, which in this context, means that a party's commitment to the contract has potentially

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[20] Theodore H. Moran, *Multinational Corporations and the Politics of Dependence: Copper in Chile*, 34 (Princeton: Princeton University Press, 1974); Theodore H. Moran, *Multinational Corporations: the Political Economy of Foreign Direct Investment*, 15 (Lexington: Lexington Books, 1985); Raymond Vernon, *Sovereignty at Bay Ten Years After* 35 International Organisation 517 (1981); Robert Grosse, *The Bargaining Relationship between Foreign MNEs and Host Governments in Latin America* 10 The International Trade Journal, 467 (1996).

[21] Tamir Agmon, *Who Gets What: the MNE, the National State and the Distributional Effects of Globalisation* 34 Journal of International Business Studies 416 (2003).

[22] Albert Otto Hirschman, *Exit, Voice and Loyalty: Responses to Decline in Firms, Organisations, and States*, 60 (Cambridge: Harvard University Press, 1970); Vlado Vivoda, *The Return of the Obsolescing Bargain and the Decline of Big Oil: A Study of Bargaining in the Contemporary Oil Industry*, 48 (Adelaide: Flinders University, 2008).

been eroded due to the taking place of changes. The changed circumstances result in the transaction not working for them in the way that they expected. Hirschman suggests that the party in such a case has the option of exit which is to abandon the transaction and walk away. In the context of an energy investment transaction it means, for example, a host government may try to expropriate or for a foreign investor to shut down the oil well and leave the country. Whether a party chooses exit or loyalty it depends on voice.

The international energy company could remain loyal, continue the contract and not seek to bargain (low voice option). Alternatively, a foreign investor may choose the voice option, raise its concerns and seek a renegotiation (high voice option). The international energy company then could make a new cooperative agreement with the host government and continue its operations, or if they failed to reach such an agreement they could exit the host country (exit option).

The voice option is dependent on the parties' bargaining power. If the international energy company has low voice, remains loyal and does not raise any concerns it demonstrates that its bargaining power is weak and it does not have an alternative option to exit. However, where the international energy company is heavily invested in the host country and capitals are sunk, the hostage effect will take place.[23] Since energy investment agreements need large scale investments, leaving the host country (exit option) is accompanied with constraints and is therefore the last resort. Where an international energy company has high voice, it can raise its concerns and bargain with the host government. This shows that the international energy company has other options available to exiting the host country and the operations will not be profitable for the company. Thus, the international energy company in this case has bargain vis-à-vis the host government.

Whilst the occurrence of conflict might be inevitable, it highlights the importance of the role of bargaining model and maintaining the contractual equilibrium which are grounded in cooperation, flexibility and stability of relationship between the host government and the foreign investor. The parties' interests lie in the continuation of the contract to maximise total revenue over the life span of the contract. The equilibrium point is where no party takes action against the other, nor forces the other party to take action. As a result, the parties' financial returns will not be reduced. This is the point in which parties could continue their long-term relationship. However, consistent with the existing model of contracting, the response of the law is expropriation and nationalisation that are extreme approaches to a long-term relationship. The foregoing analysis could sufficiently explain the importance of economic equilibrium of the contract in a stable and flexible framework. This model is capable of avoiding conflict between the foreign investor and the host government.

[23] Theodore H. Moran, *Foreign Direct Investment and Development: The New Policy Agenda for Developing Countries and Economies in Transition*, 141 (Washington, Institute for International Economics, 1998); Hamid Younesi (n 14), 256.

6. The Role of Contractual Equilibrium in International Energy Investment Transactions

An 'equilibrium' refers to a balance of interests between one or more parties who are dealing with each other. In the context of a long-term energy investment transaction, the equilibrium in question is the balance of interests that the parties' contract embodies. This equilibrium gives rise to legitimate expectations as to what the parties expect to get out of the transactions, which, if the contract is to be successful, must be stable. Maintaining the stability of the equilibrium requires a way of maintaining the interests in harmony or, at the least, in balance. Parties' incentives will change as the contract evolves and their interests start pulling in different directions. Hence, part of the idea of equilibrium is to entrench a way to keep their interests in harmony. That is what the equilibrium is, a balance achieved between interests and the surrounding set of techniques to ensure that those interests stay in harmony.

Equilibrium is the point that parties reach at the time when they strike the bargain. The equilibrium is stable if it is resilient to events which challenge it and have the potential of disrupting the balance. The equilibrium is unstable if it is easily disrupted. The equilibrium may be unstable; it does not have to be stable. The point to the OBM is that the equilibrium is inherently unstable and therefore, there is a need for a proper framework surrounding the contract in order to reinforce the stability of the equilibrium.[24] This is the key point the OBM makes in relation to the instability of the contractual equilibrium. The point which we made in this paper is that how can the equilibrium be reconceived in a way that provides stability. If we look at it as a one-off set of rights and duties, then it is unstable. But instead if we look at the equilibrium as a relationship that is *dynamic* and *evolves* it can be stable.

In the context of long-term investment agreements, the concept of stability refers to the preservation of the underlying expectations of the parties reflected by the agreement. Stability is a feature of the equilibrium. Contractual stability indicates preservation of the equilibrium for the application of legitimate expectations of the parties throughout the duration of the business venture, arising out of the contractual relationship. Legitimate expectations will involve not only the profitability of the project but will also cover economic, and social purposes that parties seek to achieve. It will also require the continuity of the contractual relationship for the achievement of desired purposes under the contract that is made by the parties.[25]

However, in this context, maintaining the equilibrium requires taking into account changes of circumstances, keeping the contract dynamic and adapting the contract towards unpredictable circumstances that may be inevitable in long-term energy investment transactions. This ensures a reasonable degree of adaptability, particularly

[24] Leo Kissam and Edmond Leach, *Sovereign Expropriation of Property and Abrogation of Concession Contracts* 28 Fordham Law Review 190 (1959); Rainer Geiger, *The Unilateral Change of Economic Developments Agreements* 20 International Comparative Law Quarterly 75 (1974).

[25] Ian Macneil, *Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical, and Relational Contract Law* 72 Northwestern University Law Review 854 (1978).

concerning the fiscal regime and stability in continuing the contractual relationship, via the modification of contractual terms which may be necessary to take account of changed contexts which could not have been anticipated at the time of the conclusion of the contract.[26] Maintaining a contractual equilibrium will prevent destructive investment disputes.[27] The notion of equilibrium thus emphasises both *dynamism* and *certainty* of contract terms. Indeed, it is not solely a static equation that merely stresses on immutability of contractual terms, but it also denotes a dynamic framework which is able to maintain the stability of contractual arrangements against a changing background. Thus, coping with political, social, economic and regulatory changes through adaptation and adjustment of the contractual arrangement in light of the original equation, which has been created out of the parties' original expectations and manifested in the contract. Modern concepts of stability and flexibility are not in conflict, but rather recognise that the need for accommodation of change will lead to more stability in long-term investment contracts.[28] Therefore, as discussed above, contractual equilibrium in energy investment transactions is maintained, while the stability of contractual terms has been structured in a dynamic framework. Such a framework guarantees that parties earn interests and protects the parties' legitimate expectations over the life span of the project.

6.1. The Underlying Factors in Disruption of Contractual Equilibrium

International investment agreements are performed in the legal and political environment of the host state. The very same State or State entity also participates in the venture as a contracting party. The government may seek to change the contract, in its capacity as a sovereign State, for the public interest. These all have implications on the equilibrium of international energy investment contracts. It will be therefore useful to analyse the main factors giving rise to disequilibrium.

6.1.1. Long Duration of Contract

In addition to normal commercial risks of international commercial transactions, the long duration of international energy investment contracts, subjects these contracts to the risk of changes in the regulatory, political, economic and investment climate in the host country. The operation of the different phases of an energy project requires a long period due to technical and administrative reasons. Over the life of the project, operating conditions and overall surrounding circumstances may be changed through, inter alia, 'obsolescing bargain'. In international energy investment contracts, the

[26] Thomas Waelde, and George Ndi, *Stabilizing International Investment Commitments: International Law Versus Contract Interpretation* 31 Texas International Law Journal 215 (1996); Hamid R. Younesi, *The Pursuit of Stability in International Petroleum Contracts: The Role of Stabilisation Clauses in Minimisation of Disputes* 5 International Business Law Journal 659 (2021).

[27] Rubins and Kinsella (n 6), 3-15.

[28] David Campbell and Hugh Collins, *Discovering the Implicit Dimensions of Contracts*, in *Implicit Dimensions of Contract, Discrete, Relational and Network Contracts*, 25 (Oxford and Portland Oregon: Hart Publishing, 2003).

projects need large capital, technology and expertise for implementation. As a result, a shift of bargaining power from the foreign company to the host government will occur.[29]

At the beginning, the foreign investor with capital and technology in hand considers the potential host country, and thus is in a strong bargaining position. On the other side, the host state needs the foreign investment and technology to explore and develop its natural resources to flourish economically and promote public wealth. It is therefore in a relatively weak position. However, once the bulk of the investment has been made, and the foreign investor has brought its capital and technology to the host country, the bargaining leverage could gradually shift from the foreign investor to the host state. The concept of obsolescing bargain denotes the change of host government's capabilities and the energy company's position over time and will illustrate rebalancing of the relationship between them. In a shifting bargain, international energy projects with large capital and technology may face structural vulnerability to the dynamism of the obsolescing bargain. In addition, the fact that foreign investors are concluding agreements with sovereign states, and entering into very long-term relationships has implications on the equilibrium. The regulatory interference of the government and change of surrounding conditions can damage the equilibrium.

6.1.2. Legal Characteristics of International Energy Investment Contracts

In the energy industry, disequilibrium mostly occurs due to the fact that the host government is one of the contracting parties and could interfere with the concluded agreement. The host government always keeps its presence either directly or indirectly in the regulation of the energy industry. It has to be underlined that international energy investment contracts involve continuing obligations in the form of performance over a long period of time.[30]

The host state may interfere with the investment contract, alter its contractual obligation, withdraw licences or even terminate the agreement where public interests require. Its implication for the OBM which provides an important mechanism for the process of obsolescence and for the equilibrium of international energy investment contracts -in as much as the real issue is of possibility that the State exercises its sovereign powers- is very important. It highlights the significance of commercial certainty and the necessity of stability in international energy investment contracts. This demonstrates the significance of maintaining contractual equilibrium.

6.2. The Underlying Factors in Formation of the Contractual Equilibrium

The notion of equilibrium is formed by certain factors that will be discussed in this section.

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[29] Peter Cameron, *International Energy Investment Law: The Pursuit of Stability*, 36 (Oxford: Oxford University Press, 2010).

[30] Henry Cattan, *The Law of Oil Concessions in the Middle East and North Africa*, 4 (New York: Oceana Publications, New York, 1967).

6.2.1. The Legitimate Expectation of the Contracting Parties

The contract law of both civil and common law countries is based on the idea of legitimate expectation.[31] The legitimate expectations of the parties are core contractual obligations arising out of mutual understanding of the parties from the contract. The legitimate expectation of the parties in long-term investment agreements expresses that the host government expects adequate financial reward and the foreign investor expects to receive a return from the investment. It applies the principle of fairness to the situation where an investor has an expectation or interest in a State authority retaining a long-standing practice or keeping a promise. Disappointed expectations can be relevant to a claim under international investment law.[32] The concept of legitimate expectation is one of the main factors shaping the contractual equilibrium and, hence, preservation of legitimate expectation has a crucial role in the determination of whether or not the equilibrium is disrupted. It also involves the expectation that unilateral variation of contract terms shall not frustrate the underlying purposes of the contract.[33] It is generally agreed as one of the important standards of long-run investment agreements. However, there is no worldwide standard to define legitimate expectation. It is grounded in objective standards of a fair treatment of the parties in the context of contract.[34] Legitimate expectation may be constituted by the existing contractual context, further amendments and parties' behaviour.[35] On some occasions, circumstances may arise such that the legitimate expectation of the parties dictates that the contract should be terminated for mutual benefits, in particular, when performance of contract seems to be onerous for both parties. The doctrine of 'efficient breach' illustrates the conditions under which the contract could be terminated demanded by legitimate expectation of the parties. This doctrine expresses that where the costs of performance of the contract exceed the benefit to all parties and a breach becomes desirable, then termination of contract is more efficient than performance due to maximising the parties' benefits.[36] Therefore, legitimate expectation is not an abstract principle but rather is a context-dependent and flexible concept, which may be well fitted into the *dynamism* of a long-term agreement.[37] Additionally, legitimate expectation should be interpreted as a flexible approach to contractual obligations of

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[31] Geo Quinot, *Substantive Legitimate Expectations in South Africa and European Administrative Law* 5 German Law Journal 14 (2004).

[32] Rudolf Dolzer and Christoph Schreuer, *Principles of International Investment Law*, 105 (Oxford: Oxford University Press, 2012).

[33] Catherine Mitchell, *Leading a Life of its Own? The Roles of Reasonable Expectation in Contract Law* 23 (4) Oxford Journal of Legal Studies 639 (2003); Stephen M. Waddams, *Good Faith, Unconscionability and Reasonable Expectations* 9 Journal of Contract Law 55 (1995); *Joseph Charles Lemire v. Ukraine*, ICSID Case No. ARB/06/18 (2011), 25-30.

[34] Mitchell (n 33), 641.

[35] *The Government of the State of Kuwait v. The American Independent Oil Company* (AMINOIL) (1982) 21 International Legal Materials 976.

[36] Roderick Bagshaw, *Inducing Breach of Contract*, in *Oxford Essays in Jurisprudence*, 135 (Oxford: Oxford University Press, 2000).

[37] Mitchell (n 33), 640.

the parties to be in line with the mutual interests of the parties based upon justice and fairness.[38]

The significance of the concept of legitimate expectation regarding contractual equilibrium is discussed above. In addition, this concept is important in international investment law. The legitimate expectation on the part of the foreign investor has received more attention recently. The concept of legitimate expectation is part of the general principles of law.[39] Legitimate expectations play a key role in the interpretation of the *equilibrium*, which the parties have agreed upon and the fair and equitable treatment standard. It has an important role in the law of indirect expropriation in investment law. The general nature of the concept of legitimate expectation makes it difficult to draw mechanical conclusion from it. However, it can be used in a number of settings. In particular, contractual obligations of the host government and the legal framework provided by the government are important sources of expectations on the part of the foreign investor.[40]

International tribunals have relied on legitimate expectations of foreign investors in a number of cases regarding indirect expropriation. For example, in *Metalclad v. Mexico*[41], the foreign investor had acted in reliance on assurances to the effect that he had all the necessary permits. However, the project was foiled by a refusal of the government to grant a construction permit. The arbitral tribunal put much emphasis on legitimate expectation of the investors created by the host state's assurances. It concluded 'these measures taken together with representation of the Mexican government, on which Metalclad relied, amount to an indirect expropriation'[42]. In a similar way, the tribunal in *Tecmed v. Mexico*[43], in determination of whether the investment had been expropriated, found that 'upon making its investment, the Claimant had legitimate reasons to believe that the operation of the landfill would extend over the long term. The Claimant's expectation was that of a long-term investment relying on the recovery of its investment and the estimated return through the operation of the landfill during its entire useful life'[44].

The legitimate expectation of the investor is based on the legal framework and on any undertakings and representations made explicitly or implicitly by the host government.[45] The legal framework on which the foreign investor is entitled to rely will consist of legislation, treaties, assurances contained in licenses, decrees, and in con-

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[38] Waddams (n 33), 55; Terence Daintith, *Petroleum Licences: A Comparative Introduction*, in *The Legal Character of Petroleum Licences: A Comparative Study*, 11 (Dundee: University of Dundee, Centre for Petroleum and Mineral Law Studies, 1981).

[39] Campbell Mclachlan, Laurence Shore and Matthew Weiniger, *International Investment Arbitration: Substantive Principles*, 235 (Oxford: Oxford University Press, 2017).

[40] Ibid., 240; Cameron (n 29), 170-175.

[41] *Metalclad v. Mexico*, Award of 30 August 2000, 5 ICSID Reports (2002), 209.

[42] Ibid., para 107.

[43] *Tecnicas Medioambientales Tecmed S.A. v. The United Mexican States*, Award 29 May 2003, 43 International Legal Materials 133 (2004).

[44] Ibid., para 149.

[45] Rudolf Dolzer, *New Foundations of the Law of Expropriation of Alien Property* 75 American Journal of International Law 553 (1981); Hamid R. Younesi, *The Taking Over of the Foreign Investor's*

tractual obligations.[46] A reversal of assurances by the host state that have led to legitimate expectation will violate the principle of fair and equitable treatment.[47] For instance, in *CME v Czech Republic*,[48] the claimant alleged that interference in the contract rights by the regulatory authority had created conditions enabling the foreign investor's local partner to terminate the contract on which the investment depended.

The tribunal concluded that these actions were in violation of the investor's legitimate expectation. It found that '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'[49]. The cases discussed above clearly speak to the central role of stability and legitimate expectations in current understanding of investment law. The concept of legitimate expectation and compliance with contractual obligations are closely related. They are both important factors of a contractual equilibrium, a point that parties have agreed on and the parties' rights and obligations are in harmony. In international investment law, breach of the principle of legitimate expectation could result in indirect expropriation and under bilateral and multilateral investment treaties, such a breach could be a violation of the principle of fair and equitable treatment.

6.2.2. The Credibility of the Host Government

In long-term investment contracts reputation is an important factor for the assessment of the investment climate. Reputation is defined as reliability and credibility of a contracting party. Where the host government complies with contractual arrangements it will increase its credibility, and improve its reputation. On the contrary, breaches of contractual commitments will give rise to reputational costs, as it would not only affect the relationship with the aggrieved foreign investor but will also have negative impact on all potential investors assessing the investment climate, reputation and reliability of the government in the host country. In this context, reputation is not only a non-economic value but is also a valuable source of transaction. Moreover, the host government's reputation is an important device for international institutions, banks and foreign companies to assess whether the bulk of the investment should be made or not.[50]

Generally speaking, a sound investment climate that provides stability for investment agreements will bring about economic growth which in return reduces poverty.[51]

Property by the Host State in International Petroleum Agreements: How International Arbitration Practice Is Responding 5 Petroleum Business Review 37 (2021).

[46] Ibid., 559.

[47] Stephen Vasciannie, *The Fair and Equitable Treatment Standard in International Investment Law and Practice* 70(1) British Year Book of International Law 99 (2000).

[48] *CME v Czech Republic*, Partial Award, 13 September 2001, 9 ICSID Reports 121.

[49] Ibid., para 611.

[50] Thomas Waelde, *Contract and Enforceability in International Business: What Works?* 5 Oil, Gas & Energy Law Journal (OGEL) 7 (2002).

[51] *A Better Investment Climate for Everyone,* 15 (World Bank, Oxford University Press, World Development Report, 2004).

With regard to international energy investment contracts it will maximise the wealth for the host government's nationals as one of the major purposes. The lack of stability in this context, as well as unilateral change of contract will increase transaction costs, such as negotiation, enforcement, and dispute resolution costs.[52] A stable framework which frames contractual commitment is beneficial to both the host State and the foreign investor. The lack of stability in contractual regime will result in uncertainty and price fluctuations in the energy market. The international energy company in a stable contractual relationship will reach an expected rate of return and the host state is assured of a certain amount of production and that economic growth will not be adversely affected.

6.2.3. The Contractual Balance of Financial Interests

In analysis of equilibrium of international investment contracts, the main purpose of the concept of stability is to maintain the contractual equilibrium, in a dynamic sense, as designed at the time of conclusion and it should not be frustrated or changed by the unilateral action of a party. Any action that gives rise to disequilibrium in the original economic contractual arrangement will result in instability. The concept of legitimate expectation of the parties is an underlying source of equilibrium.[53] The economic equilibrium of contracts is grounded in stability and flexibility in a timely and coexistent manner. The host state could change the international energy investment contract on the basis of public interest to maximise the wealth and economic growth for the society. However, host government shall preserve the contractual equilibrium by the payment of compensation to the injured foreign investor. This will restore the equilibrium in the bargaining model. Moreover, where fundamental changes of circumstances substantially affect the original contractual arrangements, the parties in such an occasion should adapt the contract and adjust the business relationship to preserve the original economic equilibrium of the contract. The principal idea in the concept of equilibrium is to maintain the contract dynamic and financial viability over the life span of the business venture. International arbitral awards have materially developed and discussed the economic equilibrium of international investment contracts.

The tribunal in *Mobile Oil* held that the contract which determined contractual rights and obligations of the contracting parties 'must be construed, not only pursuant to its initial terms, but also as to the manner in which it was performed and de facto or de jure amended during its life.'[54] The tribunal has also held that 'all circumstances

[52] Donald Renshaw Harris and Čento G. Veljanovski, *The Use of Economics to Elucidate Legal Concepts: The Law of Contract*, in *Contract and Organisation*: *Legal Analysis in the Light of Economic and Social Theory*, 111 (Berlin and New York, 1986).

[53] Larry A. DiMatteo, *The History of Natural Law Theory: Transforming Embedded Influences into A Fuller Understanding of Modern Contract Law* 60 University of Pittsburgh Law Review 872 (1999); Claude Duval, Honore Le Leuch, Andre Pertuzio and Jacqueline Lang Weaver, *International Petroleum Exploration & Exploitation Agreements: Legal, Economic and Policy Aspects*, 61 (New York: 2nd ed., Barrows, 2009).

[54] 16 Iran-US Claims Tribunal Report, para.161, 54 (1987).

affecting the exercise of such rights and the performance of such obligations, as they could be observed or foreseen at the time of conclusion of agreement, are also relevant in order to determine the legitimate expectation of the parties when they concluded such an agreement.'[55] Indeed, both original contractual terms and subsequent behaviour of the parties make up the contractual equilibrium. The co-operative subsequent behaviour is used to define the intended purposes of the parties, and ambiguous requirements of the agreement. The arbitral tribunal has taken into account all relevant factors in the parties' behaviour in order to determine the contractual rights and obligations of the parties in light of expectation from the agreement.

In case of change of circumstances, subsequent behaviour of the parties could be helpful in adjustment and modification of the agreement in light of the designed purposes for the investment contract. In the AMINOIL arbitration, the tribunal held that economic equilibrium of the contract was formed by the changes in the business relationship over the life of the contract. The tribunal held that contractual equilibrium could be explained as the legitimate expectation that included economic calculations, the weighing up of rights and obligations, of chances and risks in petroleum agreements. The tribunal stated that contractual equilibrium cannot be ignored neither in adaptation of the contract, during the course of the contract, nor in assessment of awarding compensation.[56] In addition, the tribunal held that for the assessment of the equilibrium it is not only the original text of the contract, but also the amendments, the interpretations, the behaviour manifested along the course of its existence, that indicate how the legitimate expectation of the parties can be modified according to the circumstances.[57]

Therefore, the tribunal held that a dynamic approach to contractual equilibrium denoting economic equilibrium of the contract should be defined by original contractual terms covering commercial balances, in a dynamic manner and with reference to the current contractual context not only in *stricto sensu*. Thus, in determining economic equilibrium of the contract, the original contractual terms of the agreement, further changes and the adjustment of the commercial relationship by the contracting parties should be observed. Contractual equilibrium theory provides an analytical framework for evaluating commercial context and consequences of change in international investment agreements. This includes change of expectation of parties from the original contractual arrangement, not in vacuum, but in a realistic context. The contract equilibrium significantly highlights the role of stability in assessing contractual relationships and maintaining legitimate expectations.

6.3. The Key Devices in Maintaining Contractual Equilibrium

The contractual equilibrium is grounded in different elements such as investment climate, initial agreement and the host state's general policies in which contracts are

[55] Ibid., 54; Mclachlan and Shore (n 39), 235.
[56] *AMINOIL Award*, 21 International Legal Materials, para.148, 1034 (1982).
[57] Ibid., para.149, 1034.

created. This discussion aims to conceptualise the ways in which contracting parties can rebalance and restore the impaired equilibrium.

6.3.1. The Efficient Contractual Risk Allocation System

The dynamism of international investment contract reflects that contractual arrangements should predict potential contingencies that might occur in the future. Such factors could create risks in the relationship. The underlying factor of economic equilibrium of the contract includes identifying those risks, conflicting areas, and minimising the associated risks by legal devices. The determination and planning of risks, management, and the efficient allocation of risks are crucial to the contractual equilibrium. Where prediction of all future risks at the time of contracting is not an easy task for the contracting parties, planning the distribution of risk in a fair and the least burdensome method to allocate optimally all associated risks under a contractual approach will maintain flexibility and stability of the business relationship. It will in return guarantee contractual equilibrium. Hence, in international investment contracts, allocation of risks by mutual consent of the contracting parties in a fair way is of great importance. The host government and foreign investor may explicitly or implicitly agree to adjust risk allocation by further events to guarantee financial viability of the contract and to maximise economic interests of the project.[58]

The adjustment of contractual arrangements based on a mutual plan, where circumstances changed is an essential requirement for sustainability of long-term commercial relationships in the field of energy exploration. Flexibility and adjustment of the contractual relationship may reduce uncertainty and in this context can enhance '*the dynamic stability*'. In addition, identifying a risk does not mean that its extent and terms are foreseen. As a result, the dynamic stability can be seen as 'an open ended approach and leave a wide margin for the further variation of terms and adjustment.'[59]

Flexibilisation of contractual terms enables the parties to adapt and re-organise their commercial relationship in the event of changed circumstances. The parties can maintain the original contractual equilibrium by an efficient risk management strategy based on a mutual cooperation and use of risk sharing techniques such as renegotiation clauses. These mechanisms can increase the clarity, minimise uncertainty, and enhance the flexibility of contractual terms to require the parties to act in good faith and fairness.[60] Hence, where the surrounding circumstances undergo fundamental

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[58] Robert Scott, *Risk Distribution and Adjustment in Long-Term Contracts* in *The Complex Long-Term Contract (Structures and International Arbitration)*, 52 (Heidelberg, 1987); Richard Bentham, *The Acquisition of Natural Resource interests by the State in the United Kingdom and in International Law* 5 Journal of Energy and Natural Resources Law 49 (1987).

[59] P.D.V. Marsh, *Contract Negotiation Handbook*, 19 (Aldershot: 3rd ed., Gower Publishing, 2001); David Campbell & Donald Harris, *Flexibility in Long-Term Relationships: The Role of Co-operation* 20 Journal of Law and Society 166 (1993).

[60] Nagla Nassar, *Sanctity of Contracts Revisited: A Study in the Theory and Practice of Long-Term International Commercial Transactions*, 25 (Martinus Nijhoff Publishers, 1995); Scott (n 58), 83; Vasciannie (n 47), 146.

changes which disrupt the original contractual equilibrium or expectation, adjustment of contractual rights and obligations based on an efficient risk allocation system, may restore the economic equilibrium of the contract. It will keep the contract viable, and provide a context for a durable commercial relationship.

6.3.2. The Role of Fairness and Cooperation in Restoration of Contractual Equilibrium

It is well established that fairness has a significant role in contractual stability and performance of the contract. Sustainability and enforceability of the contractual arrangement are based on the principles and rules of the contract being just and being justly applied.[61] The concept of fairness includes both substantive and procedural dimensions. Procedural aspects of fairness cover legal issues such as incapacity, absence of duress, and fraud. The substantive aspects of the concept of fairness involve three different situations: First, in cases involving the fairness of price, the criterion is likely to be connected to the market price; second, for challenges to ancillary terms, it refers to a combination of ideas of balance of advantages and conformity to legitimate expectation; third, in connection with subsequent events which arguably render the contract unfair in its application, the comparison lies with the original balance of advantage at the time when the contract was formed.[62]

In long-term investment agreements, the concept of fairness is not only an instrument of the original balance of contractual relationship, but it is also essential for sustainability of the contract.[63] In the long-term contractual relationship, relevant factors and rules of the game that determine economic profitability, allocation of risk and distribution of financial interests could be changed. It can jeopardise the contract if the parties want to merely stick with the original fairness and will not be proactive to adjust the contract by fairness in the changed context. Therefore, the durability of long term investment contracts, inter alia, international energy investment agreements, depends upon the application of the principle of fairness from the formation of contract, over its performance, until its completion for the achievement of desired goals. In a relationship of the host state and the foreign energy company, substantive fairness should be seen over the life of the contract. This will underpin the contractual stability and maintain contract efficiency in relation to utility maximisation.[64] The requirement of fairness is served to shape a legitimate framework for addressing potential disputes and the establishment of a high degree of mutuality of expectation in international investment contracts.[65] The contract in the absence of fairness can be unstable as it can be a reason for the host state's interference in the contact on the

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[61] DiMatteo (n 53), 907; Patrick Atiyah, *Contract and Fair Exchange* 35 University of Toronto Law Journal 1 (1985).

[62] Hugh Collins, *The Law of Contract*, 22 (4th ed., Lexis Nexis Butterworth, 2003).

[63] Spencer Nathan Thal, *The Inequality of Bargaining Power Doctrine: The Problem of Defining Contractual Unfairness* 8 Oxford Journal of Legal Studies 17, 21 (1988).

[64] Francis Buckley, *Three Theories of Substantive Fairness* 19 Hofstra Law Review 2, 33 (1990).

[65] Thomas Franck, *Fairness in International Legal and Institutional System*, 440 (Clarendon Press, Oxford, 1995).

public interest basis. Yet, on the other hand, the private party may seek termination or a change of contractual arrangements.

Although contractual cooperation is not a legal duty, it may be projected into the contract by the principle of good faith. It has an important role for the stability of the business relationship in a long-term context. The cooperation is seen as a contract law principle denoting that insertion of duty to cooperate is a contractual obligation.[66] In long-run investment agreements cooperation of the parties on the basis of good faith is essential to maximise the interests. The necessity of cooperation in a long-term relationship in the field of energy is highlighted for the stability of the oil price, its major role in maximisation of economic benefits and mitigating investment disputes. Therefore, it will increase contractual stability and reduce commercial uncertainty.

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[66] 'Cooperation may form a term of the contract, either expressly or impliedly.' See Elisabeth Peden, *Cooperation in English Contract Law-to Construe or Imply?* 16 Journal of law 56 (2000).