

ANGLIA RUSKIN UNIVERSITY

**HOST COUNTRY CONTRACTS IN THE ENERGY SECTOR:
'AZERBAIJAN-TURKEY CASE STUDY'**

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A Thesis in partial fulfilment of the requirements of Anglia Ruskin University
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ANGLIA RUSKIN UNIVERSITY ABSTRACT

FACULTY OF ARTS, LAW & SOCIAL SCIENCE

DOCTOR OF PHILOSOPHY OF LAW

HOST COUNTRY CONTRACTS IN THE ENERGY SECTOR: 'AZERBAIJAN-TURKEY CASE STUDY'

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The primary aim of this study is to examine the political risks, particularly of indirect expropriation in long-term energy investment contracts, focusing on stabilisation clauses and examining what driving force(s) influence host states to agree to insert such clauses in their host governmental contracts. The secondary aim of this work is to examine the political structure of Azerbaijan and Turkey and the guarantees available to foreign investors under their laws within those nations from a comparative perspective.

The work dedicates particular attention to how effective internal factors in Azerbaijan and Turkey are in facilitating contractual stability in their respective energy investment projects. This study applies both comparative and empirical research methods, fieldwork and library based research. It seeks to provide a theoretical and comparative understanding of political regimes, foreign investment laws and constitutional guarantees and investment policies in Azerbaijan and Turkey.

The work has provided that the driving forces behind why Azerbaijan and Turkey consented to insert stabilisation clauses in the host government agreements of Baku-Tbilisi-Ceyhan Project (BTC) can be attributed to each of these being in possession of: a weak bargaining position, weak formal and informal institutions, insufficient laws on foreign direct investment, absence of specific petroleum legislations and a keenness to promote investment and economic activities in their regional markets.

It is imperative to lenders and insurers that the host state where the investment will be made is a stable environment. In order to be satisfied that this is the case and to future-proof themselves against risk, they require the insertion of stabilisation clauses in host government agreements. Credit-rating agencies assessments exercise influence over the terms to be agreed and, indeed over the investor's decision whether to participate in a project. Further research into stabilisation clauses might invite the analysis of specific petroleum producing countries from different regions to better understand how internal and external factors are effective in providing stability. The transferability of the research findings could be further strengthened by surveying and interviewing more participants from petroleum companies, non-governmental organisations, law firms, financial institutions, political risk insurance providers, government bureaucrats and international academics.

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ABBREVIATIONS

ACG-Azeri-Chirag- Gunsheli
AfDB-African Development Bank
AMINOIL-American Independent Oil Company
BIT-Bilateral investment treaty
BOTAS-Petroleum Pipeline Corporation
BP-British Petrol
BTC-Baku-Tbilisi-Ceyhan
CERDS-Carter Economic Rights and Duties of States
EBRD-European Bank for Reconstruction and Development
ECAs-Export Credit Agencies
ECHR-European Court of Human Rights
ECT-The Energy Charter Treaty
EIB-European Investment Bank
EPs-Equator Principles
EU-European Union
FDI-Foreign Direct Investment
HGA-Host Government Agreement
HGCs-Host Government Contracts
HSE-Health, Safety and Environment
IBRD-International Bank for Reconstruction and Development
ICJ-International Court of Justice
ICSI- International Centre for Settlement of Investment Disputes
IDA- International Development Association/Agency
IFC-International Finance Corporation
IGA -Intergovernmental Agreement
IAs- Investment Insurance Agencies
IMF-International Monetary Fund
IOC -International Oil Company
JDP Justice and Development Party
LIAMCO-Libyan American Oil Company
MDBs-Multilateral Development Banks
MIGA-Multinational Investment Guarantee Agency

MIT- Multilateral investment treaties
NAFTA- North American Free Trade Agreement
NGO- Non-Governmental Organisation
NOC- National Oil Company
OECD- Organisation for Economic Cooperation and Development
OPEC- Organisation of Petroleum Exporting Countries
OPIC- Overseas Private Investment Corporation
PSCs- Product Sharing Contracts
SOCAR- State Oil Company Azerbaijan
SPV- Special Purpose Vehicle
TANAP- Trans-Anatolian Natural Gas Pipeline
UN- The United Nations
UNCTAD- United Nations Conference on Trade and Development
UNGAR- United Nations General Assembly Resolutions
WTO- World Trade Organisation

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Chapter 1

Political Risks in Host Country Petroleum Contracts

1. Introduction

Petroleum¹ is one of the most crucial natural resources for modern civilisation and has long been a key element in the economic development of a state. For this reason, energy investment is a major player in today's global economy. In a broad sense, foreign direct investment (FDI), between a host government and an investor in the energy sector may encompass a range of energy sources and related activities, such as oil and mineral exploitation or other types of natural resources. The Energy industry as a whole is a key source of growth stimulation for developing states. This is true not only in terms of economic growth, but also in the transfer of knowledge and skills as well as in the provision of employment opportunities. Understandably, developing states are well-disposed towards international investors, and are eager to enter into petroleum investment contracts with the expectation that this will bring the aforementioned benefits to their countries, particularly where the host state is less able to act as a provider of such resources autonomously. Some developing states' domestic law provides a welcoming investment environment in the form of guarantees and stability, while others provide these opportunities by agreeing to investment contracts or treaties drafted by international organisations established to facilitate such agreements.

On a global scale, regardless of their type, all investments face risks and these risks are changing in nature and reach as the world economy globalises. It is of course true that political risk phenomena *per se* are potentially destructive to all industries. However, it is fair to say that due to its high stakes, the energy industry is more acutely exposed and subject to political risk than most sectors. Therefore, the energy sector and its long-term projects require more guarantees of stability than other industries.

Namely, 'the capital-intensive nature of the industry, market price volatility, geographic scope of assets and operations, the high risk nature of exploration and exploitation of natural resources, technology and requirements, environmental concern, downstream brand promotion and protection issues, political sensitivities, scale and diversity of employee base, etc.'² are contributing factors to the political risks international investors face. If these risks are 'known quantities' how is it that the industry so frequently finds itself the target of political risk phenomena and why are

¹In this project, the term of petroleum refers 'gas and oil'. The researcher also will be using the 'Energy' wording which refers also to gas and oil in this work.

²Lovells International Law Firm in Cooperation with association of Corporate Counsel, 'Sino-Foreign Oil and Gas Industry : Legal Risk Comparative Analysis', (November, 2005) 2, available at: <<http://www.acc.com/vl/public/Article/loader.cfm?csModule=security/getfile&pageid=16024>> December, 2010

energy investment projects so frequently a target? Thomas W. Waelde addresses these questions with the following arguments:

Political risk reflects the exposure of technical and business approach to the industry to the often much more volatile, less forecastable, and less manageable events in the political sphere-as contrasted to the supposedly targets and hits the petroleum industry not only due to its strategic character, large capital investment and public visibility, but also because the industry's global nature, imbued with foreign elements resented in nation states, makes it a very suitable target. But politics can also hit the petroleum industry rather accidentally, in particular when this industry is in the way of conflicts between states, between conflicting ideologies, or within a country, between ethnic groups or classes that hate each other.³

In other words, a number of reasons can be listed as to why petroleum projects are vulnerable.⁴ Firstly, some developing countries' economies depend on oil, gas or other types of natural resources. As a result of being oil and gas dependent, the expectation of politicians in petroleum producing and exporting developing countries is extremely high.⁵ If a country obtains more rent or royalties from energy investment projects this will mean that the citizens of the developing state can enjoy increased earning power, and be provided 'more schools more, employment and general wellbeing...'⁶ Secondly, decisions taken by governments play a significant role in the energy sector. In other words, the politically aware citizens of developing states will lobby for more transparent policy and the consideration of public interest by their governments. With the consequence that voters will use the ballot box to express any dissatisfaction with government policy in this regard at the next elections. For this reason, 'governments are likely to play a prominent role in regulating entry, of prices of quality of services, and of other aspects of investor behaviour'.⁷

3 T. W. Waelde, 'Managing the Risk of Sanctions in the Global Oil & Gas Industry: Corporate Response Under Political, Legal and Commercial Pressures', *Texas International Law Journal*, Vol.36 (2001) 183-184

4 M. Erkan, *International Energy Investment Law: Stability through Contractual Clauses* Energy and Environmental Law and Policy Series, (Alphen aan den Rijn, Kluwer Law International, 2011) 27

5 Ibid.

6 J. L. Valera, 'Political Risks for International Oil Companies Investing in Latin America', *OGEI, Journal of Oil, Gas and Energy Law Intelligence* 4 (2006)1, available at: <www.ogel.org/> September, 2011

7 T. H. Moran, 'Political and Regulation Risk in Infrastructure Investment in Developing Countries: Introduction and an Overview'. *CEPMLP Internet Journal volume*, Art.5-6a,4, available at: <<http://www.dundee.ac.uk/cepmlp/journal/html/vol5/vol5-6.html>> February 2011

Thirdly, energy investment projects are lengthy and perhaps risks are inevitable in a relationship that entails such a long-term commitment. According to Valera, ‘the political risk facing international oil companies is directly related to the behaviour of political players in the policy-making process within the host country’⁸. It would not be unreasonable to assert that international politics play as important a role as the internal policy making process.⁹ Evidently, over the course of a project, contractual terms and conditions can be breached as a result of government change or changes in the political system.¹⁰ The new government and/or political system may not welcome investors or respect previously agreed terms. Finally, as mentioned above, some developing states suffer from political¹¹ and economic instability. This destabilising influence renders the energy sector vulnerable.

This study aims to analyse the political risks, particularly indirect expropriation in host governmental long term energy investment contracts, focusing on stabilisation clauses, and examines which driving force(s) influence host states to agree stability in their long term host governmental contracts. It goes on to propose a framework for the role to be played by internal and external forces namely: political regimes, domestic laws (Foreign direct investment, Petroleum and Energy law), (internal); rating agencies, public or private insurers and project finance lenders (external). The secondary aim of this work is to examine political regimes and state guarantees to foreign investors in Azerbaijan and Turkey from a comparative perspective. The work dedicates particular attention to how effective internal factors in Azerbaijan and Turkey are in facilitating contractual stability in their energy investment projects.

1.1 Political risk defined

The era of modern economic understanding was ushered in by Adam Smith with the publication of *The Wealth of Nations* in 1776. Following his research into the political economy approach, he acknowledged that politics and economics are related and undividable.¹² The nexus between political risk and investment would seem to

8 J. L. Valera (n.6 above) 3

9 M. Erkan (n.4 above) 28

10M. Sornarajah, *The International Law on Foreign Investment* (Cambridge, Cambridge University Press, 2010) 69

11 S. C. Wallace, ‘Symposium: Energy and International Law: Development , Litigation and Regulation’, *Tex. Int’l L.J.*36 (2001) 54, available at: <<http://www.tilj.org/>> February, 2011

12 H. L. Lax, *Political Risk in the International Oil and Gas Industry*, (Boston: International Human Resources Development Corporation, 1983) 8

illustrate Smith's conclusion, as all types of foreign investments and capital come with risks.¹³ Since risks are unavoidably attached to any investment, foreign investors, especially in the energy sector, are inevitably faced with a myriad of political risks as part and parcel of an investment scenario. At a global scale, numerous energy projects have been made and are currently being committed to by international investors. Energy projects, such as oil and gas exploration and their transportation through pipelines, can encounter unpredictable economic and political risks.

Norton defines risk as 'the possibility that something may or may not happen'.¹⁴ Kolo and Lax seek to provide a sense of the unpredictability of risks in energy investment projects. According to Kolo, such risks may not only occur in the commencement of an energy investment, risks can emerge at any stage of an investment project¹⁵. Lax, argues that risk is a dynamic concept that centres on the probability of change.¹⁶ He qualifies what constitutes a risk by asserting that investment conditions present from the outset cannot be deemed risks in themselves; rather, risk arises from changes in those conditions.¹⁷ Lax asserts that the risks affecting an investment form the parameters at the time an investment decision is made. Risks can also be a future incidence that may change the rules.¹⁸ As is the case with all key terminologies in the field of social sciences, attempts have been made to provide an accurate definition of political risk phenomena by numerous scholars as well as organisations such as the Organisation for Economic Cooperation and Development (OECD), and the Multinational Investment Guarantee Agency (MIGA). The OECD describes political risk as:

The risk of non-payment is on an export contract or project due to action taken by the importer's host government. Such action may include intervention to prevent transfer of payments, cancellation of a license, or events such as war, civil strife, revolution, and other disturbances that prevent the exporter from performing under the supply contract or the buyer from making payment. Sometimes physical disasters such as cyclones, floods, and earthquakes come under this heading.¹⁹

13 K. M. Quinley, 'Managing Political Risks', *The Risk Report* 24, no. 7 (March, 2002)1

14 S. D. Norton, 'The Natural Environment as a Salient Stakeholder: Non-Anthropocentrism, Ecosystem Stability and the Financial Markets', *Business Ethics: A European Review* Vol. 16, No 4 (October, 2007) 390

15 A. Kolo, 'Managing Political Risk in Transnational Investment Contracts', Centre for petroleum and Mineral Law Policy (CPMLP), Professional Paper, No: PP11, (1994) 2

16 H. L. Lax (n.12 above) 8

17 Ibid

18 K. M. Quinley (n. 13 above) 1

It is apparent that the OECD's definition is broad and comprehensive, as it encompasses all types of investment. Although some risks are outlined in this definition, they are not directly related to any specific sector. It is possible that the OECD has erred on the side of caution in defining political risks by covering all investment areas. MIGA's definition is also broad but still more specific than that of the OECD. According to MIGA, political risk can be defined as a breach of contract by a host government; adverse regulatory changes by host states; restriction on currency transfer and convertibility; expropriation; political violence (war, terrorism, sabotage, and civil disturbances such as revolution) and the non-honouring of sovereign guarantees.²⁰

In doctrine, several definitions of political risks have been provided by scholars such as Comeaux and Kinsella and Boulos. Comeaux and Kinsella present the following scenario as an illustration of risk: 'the laws of a country will unexpectedly change to the investor's detriment after the investor has invested capital in the country, thereby reducing the value of the individual's investment.'²¹ Boulos's definition is narrower than Comeaux and Kinsella's, however more appropriate to this study, as it focuses on the energy sector. According to Boulos, 'political risk in any oil and gas investment will be expropriated, nationalised or otherwise unilaterally changed by the foreign government to the detriment of the oil company.'²² After providing a broad definition of what political risk is, it is also crucial to apply this to a tangible framework. Political risk is categorised in academic literature and assessed by several scholars. The following section explores the categorisation of political risk.

1.2 Classification of Political Risks

Political risk phenomena have been classified by various authors in the field of international business. Wagner's classification separates political risks into two categories. According to this author, the first distinction must be between firm-specific political risk and country-specific political risk.²³ The author states that firm specific political risks target a specific company. However, country specific political risks are

19OECD, 'Glossary of Statistical Terms', available at:
<<http://stats.oecd.org/glossary/detail.asp?ID=5990>> February, 2011

20 World Bank Group, 'World Investment and Political Risk Report' (2010) 19, available at:
<<http://www.miga.org/documents/WIPR10ebook.pdf>>, February, 2011

21 P. E. Comeaux & N. S. Kinsella, 'Reducing Political Risk in Developing Countries: Bilateral Investment Treaties, Stabilisation Clauses, and MIGA & OPIC Investment Insurance', *N. Y. L. Sch. J. Int'l & Comp. L.* 15 (1994) 4

22 A. J. Boulos, 'Assessing Political Risk', available at:
<www.ipaa.org/issues/international/docs/PoliticalRisk.pdf> February, 2011

23 D. Wagner, 'Defining Political Risks', October, 2000, available at:
<<http://www.irmi.com/expert/articles/2000/wagner10.aspx>> September, 2011

countrywide and may have an influence on a company's physical activities, although they do not necessarily have such an intention.²⁴

Table 1 Classification of Political Risks

	Government risks	Instability risks
Firm-specific risks	Discriminatory regulations	Sabotage
	'Creeping' expropriation	Kidnappings
	Breach of contract	Firm-specific boycotts
Country-level risks	Mass nationalization	Mass labor strikes
	Regulatory changes	Urban rioting
	Currency inconvertibility	Civil wars

Sources: Robert Egge²⁵

Another categorisation is provided by Yescombe. According to this author, political risks can be divided into three categories: the first category is investment. The second is change of law and the third is quasi-political risk.²⁶ Other analysts, such as the HIS Energy Group prefer a more detailed approach, HIS sub-divides political risk phenomena into a further three categories. The first of which is political risk, which comprises of war, political unrest violence and instability. The second category is social-economic risk, which consists of economic, energy, environmental and ethnic factors. The third and final category is commercial risk regarding investment, repatriation and fiscal terms.²⁷ While all of these definitions and categorisations of political risk are valid, in the interests of having a clearly delineated frame of reference most appropriate to this study, the researcher will focus on only the following terminologies: expropriation, nationalisation and specifically the most prolific and controversial risk of late: indirect expropriation. The terminological identification of expropriation and indirect expropriation is significant, as one of the central arguments in this subject area surrounds the identification and application of appropriate terminology.

1.3 Host country contracts defined

A host government contract²⁸ in the energy sector can also be regarded as a state contract. In other words, a host government energy investment contract is an agreement created between an investor and the host state (or state-owned agencies) for the purpose of operating a particular investment project in the host country. The term host government contract (HGC) includes the full variety of host government contracts

24 Ibid

25 Robert Egge , cited in D. Wagner (n.23 above)

26 E. R. Yescombe, *Principle of Project Finance*, (Academic Press 2002): 204-205

27 L. Bossley, (HIS Energy Group), 'Political Risk: A Hedge Too Far', *Petroleum Economist* (October, 2002) 33.

between international investor and the host country, usually represented by a state owned company. HGCs can be found most frequently in less-developed regions.²⁹ The fundamental principle that underpins a host government contract is to permit, within established boundaries, a foreign investor to explore and exploit the natural resources of that state. While the host country permits a foreign investor to operate in its territory, it also provides a guarantee to that investor that the operation will not be disturbed by state intervention. Notably, host government contracts are either defined by administrative law or public law contracts.³⁰

2. Expropriation or Nationalisation

The term 'to expropriate' is 'to exercise eminent domain over; to take, by legal action, private land for public purpose'.³¹ What can be understood from this definition is that expropriation is a governmental taking of an individual's property rights. As an individual's property rights are 'taken' by the host government, an important question arises regarding whether this 'taking' is legal or not. International customary law does not prevent a host state from expropriating the private asset as long as the host governments meet with certain conditions. The conditions are outlined as follows: the taking should be for public purpose, as provided by law and should be in a non-discriminatory manner and with compensation.³² Furthermore, expropriation itself can take different forms; it can be direct, where an investment is nationalised by a host government, or indirectly expropriated.³³ Systematic taking of alien investor's property '...within one or more specific sectors of a nation's economy within the framework of socio-economic or political reform is often referred to as nationalisation. The difference

28 Notably, the term of host government contract is used in doctrine interchangeably; Long-term Investment Contracts or Investment Agreements, Petroleum contracts, Oil Contracts, State Contracts, Economic Development Agreements, Foreign Investment contracts, International Investment Agreement, Energy Investment Contracts so on. In this study these terms will be used respectively.

29 G. Goolsby & M. Rowley, 'Building a Cross-Border Pipeline: For multi-national projects, host government agreements can reduce risk and create a stable investment environment', available at:

<<http://www.bakerbotts.com/files/Publication/49e60828-9dbf-4077-a8f5-a5e6961f7930/Presentation/PublicationAttachment/01376ac1-0b41-4395-b5b6-a6982cd19139/Goolsby%20Rowley%20PGT%20March%202007.pdf>> March 2012

30 K. Talus & S. Looper and S. Otillar, 'Lex Petrolea and Internationalization of Petroleum Agreements: focus on Host Government Contracts', *Journal of World Energy Law Business*, Vol.5, No.3 (2012) 183.

31 B. A. Garner, *Garner's Dictionary of Legal Usage*, 3rd edn (Oxford, Oxford University Press, 2011) 72

32 UNCTAD, 'Taking of Property', (Issues on International Investment Agreements (2000) 12-13.

between expropriation and nationalisation is one of scope and extent rather than of a legal nature'.³⁴

2.1 Indirect expropriation

Indirect expropriation is one of the most egregious of political risks that a foreign investor may confront when seeking to invest in a host country. It can be described as a state measure or measures taken by a state, which have a similar or, indeed more detrimental influence than direct expropriation, although the property is not seized and the legal title to property is not affected.³⁵ UNCTAD has described indirect expropriation as '...where a measure that does not directly take property has the same impact by depriving the owner of the substantial benefits of the property.'³⁶ In the light of the aforesaid definition, Erkan argues that in the case of direct expropriation this includes the physical takeover of property by the host government or government authority. Indirect expropriation, by this definition, has four crucial components. According to the author, there ought to be a measure, a state measure or a regulatory measure, as a private asset should not be seized directly; the action or inaction of the state should have the same effect as direct takings; and this action's result should deprive the owners of the substantial benefit of the profit.³⁷ He goes further to state that the UNCTAD definition covers all the probabilities that may interfere with an investor's property rights accruing from the investment.³⁸ This could be any legislation or administrative action or omission in which a host state interferes with the investment in a way that makes it possible to operate.³⁹

Indirect expropriation can take two different forms.

33 OECD working paper, 'International Investment Law: A Changing Landscape' (2005), 45.

34 K. Hober, *Investment Arbitration in Eastern Europe: In Search of a Definition of Expropriation*, (New York, Jurist, 2007) 1

35 OECD, 'Indirect Expropriation and Right to Regulate in International Investment Law' (2004) 3-4; Annex B13 (1) Canada Model BIT.

36 UNCTAD, *Investor State Disputes Arising from Investment Treaties: 'A Review'* (New York and Geneva: UNCTAD series on International Investment Policies for Development, 2005), 41. Hereinafter referred to as 'UNCTAD, 2005' available at:

<http://unctad.org/en/docs/iteijt20054_en.pdf> March, 2011

37 M. Erkan, (n.4 above) 64

38 Ibid

39 Ibid

Creeping expropriation

Creeping expropriation is used to refer to indirect expropriation that arises as a result of a series of state measures either introduced gradually or made to come about at one time. According to Hoffman, creeping expropriation is the most feared and destructive risk, in which the host government utilises a combination of taxes, fees and other charges and devices to increase its share of the project's profits.⁴⁰ The tribunal in *Generation Ukraine* defined creeping expropriation as '...a form of indirect expropriation with a distinctive temporal quality in the sense that it encapsulates the situation whereby a series of acts attributable to the state over a period of time culminate in the expropriatory taking of such property'.⁴¹ UNCTAD defines creeping expropriation as: '...the use of a series of measures in order to achieve a deprivation of the economic value of the investment. In this case, no individual measure in itself would amount to an expropriation.'⁴²

Regulatory expropriation

The definition of regulatory expropriation is: regulatory measures which are generally made in the name of public purpose but deprive the foreign investor of the commercial value of the asset owned to a degree sufficient to be considered expropriation⁴³. In this scenario, the commercial value of an investors' property or assets is reduced by the introduction of new rules or the adaptation of current laws in the areas of taxation, the environment, health and human rights. Energy investment projects require stability, on account of their nature and characteristic features. These projects are vulnerable and need to be based on the development of a long-term relationship of mutual trust and accountability between an international investor and a host state during the life of the project.

If a host state has a negative impact on its investor's assets directly or indirectly or makes unilateral changes to the contractual terms, this long term relationship could

40 S. L. Hoffman, *The Law and Business of International Project Finance* 3rd edn, (Cambridge, Cambridge University Press, 2008) 69

41 *Generation Ukraine, Inc. V. Ukraine*, ICSID Case No ARB/00/9, Award of 16 September, 2003, 44 ILM 404 (2005) Para 20-22

42 UNCTAD, 2005 (n.36 above) 42

43 Ibid

come to a dramatic and costly end. Although political risks cannot be avoided, they can be mitigated or managed.⁴⁴ There are various ways to minimise or manage the political risks inherent in energy investment projects, the first of which is by drafting a fair and flexible contract⁴⁵ which references national law⁴⁶ and international law⁴⁷, as well as inserting contractual clauses⁴⁸, such as arbitration clauses, stabilisation clauses, renegotiation clauses and choice of law clauses. Another means of damage limitation to mitigate political risks is to insure the energy investment through public or private investment insurance mechanisms.⁴⁹

3. Why are Stabilisation Clauses a controversial issue?

A contractual guarantee in the form of stabilisation clauses is widely considered to be a vaccine for political risks.⁵⁰ These contractual mechanisms are inserted by international investors in an investment contract to ensure that the contract shall not be unilaterally altered or terminated by a host government's legislative or administrative activities. During the life span of the contract, the laws and regulations applicable to it may change. It may be the case that some of the changes may have an impact on the economic outcomes or expected profit of the project. Therefore, in order to mitigate such risk, investors require host governments to agree to the insertion of stabilisation clauses in host governmental agreements or international investment agreements. The potential benefit of this clause from the perspective of investors is: a stabilisation clause aims to immunise the foreign investment contract from a variety of issues, such as taxation, environmental controls and other regulations, as well as to deter the destruction of the investment contract itself before the contract terminates.⁵¹

44 A. Kolo (n.15 above) 3

45 Ibid.

46 Energy Law, Foreign Direct Investment Law, Petroleum Law.

47 It could be Multilateral and Bilateral treaties.

48 T. W. Walde & G.Ndi, 'Stabilizing International Investment Commitments: International Law versus Contract Interpretation' *Int'l L.J* 31 (1996) 216

49 For instance, Lloyds, AIG, etc. or through national or multilateral government insurance programs; OPIC or MIGA

50 D. Johnson, *International Petroleum Fiscal Systems and Production Sharing Contracts* (Tulsa, Oklahoma, Penn well Books Publishing, 1994) 171.

51 M. Sornarajah, (n. above 10), 282.

In literature, scholars argue vehemently about whether stabilisation clauses are employed by investors as a legitimate means of safeguarding an investment, or whether, in conflict with their intended role of providing mutually-beneficial protection, the main effect they have is of disenfranchising a host state of its sovereign rights. The dominant view is that inserting stabilisation clauses does not hinder a host state from enjoying the full use of its sovereign right to change or create new domestic laws.⁵² What is meant by this view is that stabilisation clauses cannot restrict or overrule a state's rights and legislative power. Nevertheless, when the impact they have on environmental protection, health and human rights is assessed by Non-Governmental Organisations (NGOs), stabilisation clauses are often subject to criticism. The reason why such clauses often come under fire is that they diminish or reduce the reach of state power in terms of legislative power, judicial decision-making and administrative activity to such an extent that it becomes very challenging for the host government to regulate in the public interest⁵³.

From the perspective of investors and practitioners; inserting such clauses can only be seen as beneficial to a potential investment. From the perspective of governments, agreeing such clauses in a host governmental contract or adopting stability in domestic laws, is a way of welcoming investors with a view to fostering the flow of capital, the transfer of knowledge and so on. However, cash flow and knowhow seem insufficient returns when some of the more negative by-products of stabilisation clauses are offset against them. Therefore, this study focuses on the central question; what driving force(s) influence host states to agree to inset stabilisation clauses in their long term host governmental contracts?

4. Host Government Contracts

There are three main types of host government contracts between host governments and investors, however, the first two of these are much more common: Royalty and tax contracts (sometimes called oil and gas modern concession contracts), Product sharing contracts (PSCs), as well as agreements specifically contemplating a multistate investment (such as a cross-border pipeline development) and Service agreements. Royalty and tax contracts (concessions) are contracts whereby the host government grants the investor the right to explore and exploit natural sources, or run utilities or other public services in an area defined by that government during a specific period of time.⁵⁴ On the other hand, product sharing contracts (PSCs) are the most

52 K. Hober, 'Ownership of the Oil and Gas Resources in the Caspian Sea: Problems and Solutions-International Arbitration and Contractual Clauses', *Stockholm Arbitration Report* 1 (2004) 14

53 A.F.M. Maniruzzaman, 'The pursuit of Stability in International Energy Investment Contracts: A critical Appraisal of emerging Trends', *Journal of World Energy & Business* vol.1. No.2 (2008) 154

54 L. Cotula, 'Investment contracts and sustainable development: How to make contracts for fairer and more sustainable natural resource investments', *Natural Resource Issues* No. 20. *IIED* (2010) 24

common genre of agreement between investors and host states or more commonly, a state-owned national oil company in the petroleum industry.⁵⁵ In this type of contract, although the investors are granted with the right to explore and develop a petroleum field, they are also responsible for covering all exploration costs and investment risks. While the investor explores, develops and produces the petroleum, the exploration and production costs will be divided between the host state and the investor as follows: the investor receives a share of oil to recover costs ('cost oil') and make a profit ('profit oil').⁵⁶ The host country obtains a share of the profit oil.⁵⁷

The final type of host government contracts are Service Contracts. The commonly-applied principle behind this contract type is that the host country hires the services of the IOC as a 'contractor'.⁵⁸ All of the extraction and production rights are retained by the host country⁵⁹ while all the risks in the areas of finance, exploration and development are shouldered by the investor. In this way 'commercial production becomes possible from the contract area, the contractor is reimbursed for its costs and investments and paid a fee for its services from the sale of the oil produced.'⁶⁰ Compared to other types of contracts such as concession and PSAs, service contracts are held to be the type of arrangement whereby the host government exercises the greatest amount of control over a project.⁶¹

The concept of a service contract is primarily based upon a simple formula: the contractor is paid a cash fee by the investor for performing the service of producing petroleum resources.⁶² Under a service contract the ownership of the mineral resources

55 P. D. Cameron, *International Energy Investment Law : The pursuit of stability* (Oxford, Oxford University Press: 2010) 37

56 K. Bindemann, 'Product Sharing Agreements: An Economic Analysis', *Oxford Institute for Energy Studies*, WPM25, October (1999) 1

57 Ibid.

58 E. E. Smith, *International Petroleum Transactions* 2nd edn. (Denver, Colorado :Rocky Mountain Mineral Law Foundation 2000) 480-493

59 Ibid.

60 Ibid.

61 M. Likosky. 'Contracting, Regulatory Issues in the Oil and Gas and the Metallic Mineral Industries', *Transnational Corporations* Vol. 18, No.1 April (2009) 14

62 D. Johnston, *International Exploration Economics, Risk and Contracts Analysis*, (Tulsa, Oklahoma: Penn-Well, 2003) 41.

remain with the host state at all times, including after production.⁶³ Service contracts, in the main, can be divided into two types: *risk service contract* and *pure service contract*. In *risk service* contracts, the foreign investor bears all the exploration risk and the government compensates the foreign investor's services through payments that are dependent on and limited by the amount of proceeds from hydrocarbons produced within the area defined by the agreement.⁶⁴ The downside of this type of contract is that if stores of hydrocarbon are not found in the contract area, then the company is left out of pocket.⁶⁵ Risk service contracts have traditionally been used in states such as Iraq and more recently, in Mexico.⁶⁶ The use of risk service contracts seems to be on the increase, particularly in situations 'where the technology is high demand, but the exploration risk is relatively low.'⁶⁷

The second form of service contracts are *pure service contracts*. In this form, the foreign investor carries out exploration and development work on behalf of the host state for a set fee. Unlike risk service contracts, the host country bears all the risk. These types of contracts are most common in the Middle East, where the host state often has substantial capital reserves; but is lacking in the required expertise to exploit them.⁶⁸ Following an overview of the main types of host government contracts in the petroleum industry, the next logical step is to provide an overview of host governmental contracts in cross-border pipeline petroleum projects.

The diagram below illustrates the categorisation of petroleum agreements.

63 K. Talus & S. Looper and S. Otilar (n.30 above) 188

64 *ibid*

65 J. S. C. Neto, 'Risk-bearing service contracts in Brazil', *Journal of Energy and Natural Resources Law* 3 (1985) 114, cited in M. Likosky (n.67 above)

66 K. Talus & S. Looper and S. Otilar (n.30 above) 188

67 *Ibid*.

68 Iran, Saudi Arabia and the Philippines and Kuwait are the example countries where *pure service* contracts are used; See M. Mazeel, *Petroleum Fiscal System and Contracts*, (Hamburg: Diplomica Verlag GmbH: 2010) 27.

Table 2 Categories of Petroleum Agreements

PSC Contracts	Service Contracts
	Risk Service Contracts Pure Service Contracts

Source: Compiled by Author

4.1 Host Government Contracts in Cross-Border Pipeline Projects

Cross-border petroleum pipelines can be regarded as the blood vessels of the global economy, the sustainable growth of which is increasingly dependent on international investment in energy products and materials.⁶⁹ The term cross-border pipeline refers to a pipeline that has its origin in one sovereign country and that traverses one or more other states along its route.⁷⁰ While these projects are significant for the nations involved for a number of reasons, legal jurisdictional issues are the source of most of the problems they face. Owing to the fact that such projects become subject to the domestic laws of the states in question, operating cross-border petroleum projects across two different jurisdictions is a complex undertaking. Therefore, with a view to achieving a fully integrated international pipeline project, and to give the project a firm foundation the investors of the project and project sponsors require additional contractual support with the power to exercise a binding effect on the host government. This support can be built in via intergovernmental agreements (IGAs) and host government agreements (HGAs). It is apparent that the requirement of the project sponsors is to rule a cross-border project is a 'blending of local law and international law.'⁷¹

69 [S. V. Vinogradov](#), 'Cross-border Oil and Gas Pipelines: Legal and Regulatory Regimes, Association of International Petroleum Negotiators' (AIPN), (2001) 7.

70 M. Dulaney & R. Merrick, 'Legal Issues in Cross-Border Oil and Gas Pipelines', *Journal of Energy and Natural Resources Law*, Vol. 23 (2005) 247

Furthermore, the usability of HGAs and IGAs in tandem in cross-border projects is endorsed by The Energy Charter Treaty (ECT). Notably, in 2003, the Energy Charter Conference confirmed the first addition of Model Agreements (IGA and HGA) in cross-border pipeline projects.⁷² In this respect, the Baku-Tbilisi-Ceyhan (BTC) Petroleum Pipeline project between Azerbaijan, Georgia and Turkey with the BTC co, can be cited as the best example of Model Agreements approved in the Energy Charter Conference. The said treaty is a multinational agreement that has the explicit purpose of managing the transit of energy products and minerals and the goal of increasing the promotion of long-term international cooperation in the energy sector between its member states. To the present day, 53 signatory states have become members of the Charter.⁷³

Following this brief mention of the ECT, the main features of HGAs in cross-border petroleum pipeline projects should also be outlined. HGA (or HGC) is a legal contract between the state and affiliates of project sponsors that identifies both contracting parties' rights and contractual obligations to ensure the success of the proposed investment project.⁷⁴ As a contract, a HGA lists and describes the specific grants, rights, privileges, exemptions, and obligations that the host government proposes to the project sponsors and investors. The contract also outlines the host country's expectations from the agreement in financial and non-financial areas. Tax, duties, and fees constitute the expected economic return of the agreement. The recruitment of employees for the project is an example of a non-financial area. As the legal status of an IGA is that of a treaty; it will prevail over the legal systems of each host state. For this reason, most project sponsors and investors seek to attach HGAs to an IGA in order to elevate it to international status. By internationalising the agreement a favourable position is granted to investors and additional support against the legislative activities of sovereign states.

5. Objectives and Scope of the Research

The objective of this work is to determine the political risks, particularly indirect expropriation, that arise from the unilateral actions of host governments during the life span of energy investment projects, focusing on stabilisation clauses as a political risk

71 *ibid*

72 For the further details, please see The Model Agreements are available at: <www.encharter.org>

73 The government of Afghanistan informed the Energy Secretariat on 19 February, 2013 that the country's domestic procedures for ratifying the ECT were successfully completed. The Treaty will enter into force Afghanistan and the country will be the 54th member states of the ECT. For further information, please see the ECT's official website. ECT (n.72 above)

74 A. Dufey & R. Kazimova, Baku-Tbilisi-Ceyhan Project: Implications of Project Finance Chapter 12 in S. Leader & D. Ong, *Global Project Finance, Human Rights and Sustainable Development* (Cambridge: Cambridge University Press, 2011) 381

manager, and to examine what driving force(s) influence host states to agree stability in their long term host government contracts.

The study introduces comparative and empirical evidence in the context of existing literature on this subject to support its arguments and also discusses the outcomes of empirical investigation. In order to understand how effective internal factors in Azerbaijan and Turkey are in facilitating contractual stability in their energy investment projects, the political regimes and state guarantees to foreign investors in Azerbaijan and Turkey are examined from a comparative perspective. In the interests of accomplishing the above-mentioned objectives, the researcher has intentionally constrained the scope of the research. This work does not seek to address all types of political risk, energy investment contracts and all manner of contractual mechanisms that are used in the management of political risks.

This study focuses on upstream oil and gas contracts and the pipeline projects that are used within the petroleum sector. The upstream petroleum sector is engaged in the quest to find potential underground or underwater crude oil and natural gas fields. The activities employed in the upstream sectors are known as exploration and production. The study excludes electricity contracts, power contracts, and gas and oil sale contracts. Furthermore, it should also be noted that for the purposes of this research, there will only be a brief examination of purely indirect expropriation over other forms of political risks. Nor does the study attempt to provide a detailed legal commentary on the laws of Azerbaijan and Turkey: specific focus is given to political regimes, foreign direct investment laws, constitutional promises, and the BTC agreement.

International energy investors, to avoid the challenge of political risks during the life span of their investment, negotiate with host governments the insertion of one or more of the following contractual clauses in their agreements: stabilisation clauses, renegotiation clauses, choice of law and alternative dispute resolution clauses, or benefit from the power of bilateral or multilateral agreements which provide full protection to investors for the duration of energy investment projects. However, rather than examining all the contractual mechanisms and tools available to reduce political risk, this work concentrates on the insertion of stabilisation clauses in petroleum projects and attempts to find out why host governments give consent to this type of clauses.

This research has the following objectives:

- To furnish a theoretical understanding of the following major political risks: direct and more particularly indirect expropriation in the context of energy investment contracts.
- To identify the strengths and weaknesses of stabilisation clauses inserted in host government contracts and determine whether, in contradiction of their intended guardianship, they instead disenfranchise the sovereign rights of the host state.
- To analyse, through empirical evidence and from a comparative perspective, Azerbaijan and Turkey's political regimes, foreign investment laws, constitutional promises, policies, with particular focus on the BTC agreements.
- To analyse, through theoretical and empirical investigation, the influence of lenders, credit rating agencies and political risk insurers on the relationship between the host state and the investor.

6. The Gap in Conventional Literature

Extensive literature on stabilisation clauses as a political risk device can easily be found. However, much of what is known about stabilisation clauses concerns their role as a political risk manager, their importance in terms of FDI flow in host states, the protection and exemption they grant to foreign investors in energy investment contracts and their potential impact on human rights. Previous studies on stabilisation clauses in petroleum producing countries have tended to concentrate on the political, economic⁷⁵ and regulatory aspects of this device, as well as the relationship between FDI and democracy.⁷⁶ Several studies have attempted to examine their function, validity, effectiveness, and how and why they are used in petroleum contracts.

The possible reasons why so many developing countries agree to insert stabilisation clauses in the investment contracts they are party to have been touched upon by Al-Faruque from an economic perspective. According to this author, an economically weak bargaining position at the initial phase of the negotiations may pressurise host states to agree to accept stabilisation clauses with the prospect of being able to better exploit their resources and in so doing accelerate economic development and improve living standards.⁷⁷ Furthermore, in 2008, the International Finance Corporation (IFC) sponsored an empirical study on stabilisation clauses in host government contracts. The research was led by the United Nations (UN) Special Representative of the Secretary General for Business and Human Rights, Professor John Ruggie and authored by Andrea Shemberg.⁷⁸ This constitutes the first study based on empirical research into modern stabilisation practice, including a number of industries and regions of the world. Andrea Shemberg, in cooperation with the IFC and UN Special Representative, obtained 76 current investment contracts and 12 model contracts from various sectors.

The above-mentioned research found that contracts from non-OECD (Organisation for Economic Co-operation and Development) member countries are

75 Al-Faruque 'Validity and Efficacy of Stabilisation Clauses, Legal Protection vs. Functional Value', *Journal of International Arbitration* 23 (4) (2006) 317-336

76 O. Bayulgen, *Foreign Direct Investment, Oil Curse and Democratization: A Comparison of Azerbaijan and Russia, Business and Politics*. (Cambridge: Cambridge University Press, 2010)

77 Al-Faruque (n.75 above) 335-336

78 The UN-IFC Report was authored by (and research for the report was conducted by) Andrea Shemberg, a legal advisor to Professor John Ruggie.

much more likely than those from OECD countries to insulate the investor from new social and environmental laws, or to provide compensation to the investors for compliance with new social and environmental laws in host governmental agreements.⁷⁹ In contrast to the contracts made by non-OECD countries, the research also found that contracts and models found in OECD states contained stabilisation clauses that protected investors only against new laws that were arbitrary or discriminatory.⁸⁰ The research went on to identify two factors which might provide evidence for the apparent disparity between OECD and non-OECD country practice. In the first instance, it was suggested that the practice of including more extensive stabilisation commitments in non-OECD contracts was related to the perception of investment risk.⁸¹ Secondly, the report asserted that lawyers surveyed during research for the UN-IFC Report had expressed the view that freezing clauses were unlikely to be enforceable under the laws of many developed states.⁸² However, the research did not address the question: what are the driving forces that persuade host states to contain stabilisation clauses in host governmental energy investment contracts? It is also worth mentioning that the research did not cite any evidence that investors or multinational companies have used stabilisation clauses deliberately to discourage the adoption of environmental or human rights laws in a host state.

There is a discernible gap in the literature of an exhaustive inquiry into the reasons why host governments agree to clauses that are of no obvious benefit to them, and that are often appreciably to their detriment. In this regard it is more usually the case that the literature presently available oversimplifies why a host state gives consent to stabilisation clauses, e.g. the prospect of economic gain. However, host government contracts are not merely two-sided relationships. As well as the investor and the host country, there is a third group of external players, consisting of rating agencies, project finance lenders, political risk insurers, all of which may assert an influence over the terms and conditions of the agreement. The extent of influence exerted by each of these parties varies from project to project. This research takes into account not only the internal reasons that may compel host states to agree to stabilisation clauses under their host governmental contracts, but also takes stock of the external factors and their role in advancing the inclusion of such clauses, thereby providing a rounded and fully comprehensive analysis of these contractual scenarios.

Consequently, the research aims to contribute to the literature in two ways. Firstly, this study provides, for the first time, an empirical and comparative work on the internal and external reasons which compel host states to commit to stability clauses. Secondly, its re-assessment of the issues that have arisen from the BTC agreement and of the

79 A. Shemberg, 'Stabilisation Clause and Human Rights: A research Project Conducted for IFC and the United Nations Special Representative to the Secretary General on Business and Human Rights', IFC/SRSG Research Paper, 11 May, 2009 ix

80 *ibid*

81 *ibid*

82 *ibid*

impact on Azerbaijani and Turkish domestic laws of the terms prescribed by this agreement. Through the analysis of the countries' political regimes, FDI laws, Constitutional promises as well as their investment environments, valuable recommendations are provided to both the governments of these countries and foreign investors contemplating entering into contractual agreements or doing business in these selected countries. What differentiates this study from other works is that it compares one specific OECD member country with a non-member state in an attempt to answer the question that Andrea Shemberg did not.

7. Research Questions

The main research question posed in this study is which driving force(s) influence host states to commit to stabilisation clauses in their long term host governmental contracts. In order to answer the main question, the research also raises the following sub questions:

- What is the most hazardous political risk for international energy investors and why do host states interfere in investment projects?
- What constitutes indirect expropriation and what mechanisms can be deployed by foreign investors against such risk?
- To what extent are stabilisation clauses effective in protecting investments or conversely, in contradiction of their intended guardianship, do they instead disenfranchise the sovereign rights of the host states?
- Do stabilisation provisions constitute a threat for environmental and human rights issues?
- Do rating agencies, project finance lenders and political risk insurers play an active role in lobbying for the inclusion of stabilisation clauses in host governmental contracts?
- How effective are different political regimes in promoting FDI and giving consent to stabilisation clauses in Azerbaijani and Turkish host government contracts?
- What reason(s) has/have caused Azerbaijan and Turkey to agree to contractual stability in the BTC host governmental agreements?

8. Methodology

Research methodology is the means used to steadily solve a research problem.⁸³ A researcher ought to be aware of the methods or techniques available to him/her in

83 C. R. Kumar, *Research Methods*, (New Delhi, APH Publishing: 2008) 6.

order to define an effective methodology for the research to be undertaken.⁸⁴ This study applies both empirical and comparative legal research and is based on exploratory and descriptive research of internal and external factors investigated via field work.

In this study, the exploratory research method was adopted during the literature review and the interviews in the pilot study. This method was selected in order to gain insight into and obtain a better understanding about internal and external factors and familiarity with stabilisation clauses as a prequel to more rigorous investigation. The Descriptive method was applied as the researcher attempted to answer ‘what is’ or ‘what was’ questions.⁸⁵ Essentially, this research sought to answer the one central ‘what are’ question by asking: what driving force(s) compel host states to agree to stabilisation clauses in long term host governmental contracts?

The study also adopted empirical legal research. Baldwin and Davis have described empirical research in law as involving: ‘the study, through direct methods rather than secondary sources, of the institutions, rules, procedures, and personnel of the law, with a view to understanding how they operate and what effects they have.’ With reference to this definition, it should be underlined that empirical legal research helps us to comprehend how law works in the real world.⁸⁶ In other words, empirical legal research attempts to discover the impact that law, legal institutions, legal personnel and associated phenomena have on people, communities and societies, as well as the influence that various social, economic and political factors have on law, legal phenomena and institutions.⁸⁷

Initially, library based research was carried out in order to review the literature; thereafter, empirical legal research methodology was applied to conduct interviews with experts in foreign investment law, international oil companies, national oil companies, lawyers, and academics, producing a comparison between the legal regime and system in place. The design of questions was saved until after the literature review, as creating effective interview questions requires a thorough understanding of the issues in hand with a view to formulating potential solutions.

Comparative legal methodology is used to inquire into foreign legal systems in order to seek solutions to the issues of a particular legal system, or to improve the combination of law between national legal systems.⁸⁸ In this context, it is therefore

84 *ibid*

85 L. Bickman & D. J. Rog, *Handbook of applied social research methods*, (London, Sage Publications, 1998) 15

86 D. H. Genn & M. Partington and S. Weeler, *Law in the Real World: Improving Our Understanding of How Law Works, Final Report and Recommendations* (London, Nuffield Foundation, 2006) 1

87 *ibid*

88 *ibid*

important to recognise that comparative law presupposes the existence of the multiplicity of legal regulations and institution and examines to what extent they are alike and divergent.⁸⁹ The role of comparative methodology in this research is to facilitate a comparative analysis of the divergent political regimes and foreign investment laws, and policies of Azerbaijan and Turkey.

This study adopts a functional approach to comparative methodology. Functionalism is the basic methodological principle of comparative law, and perhaps the only fruitful method⁹⁰ that can be applied. According to Ernst Rabel, one cannot compare legal regimes, institutions or systems in a vacuum, i.e. without also understanding how they function and operate in practice.⁹¹ Rabel also argues that one cannot recognize how certain legal regimes or systems function unless one examines them against their legal, economic, cultural, social and historical background.⁹² Rabel emphasises that comparative analysis should be executed in a structured and systematic manner. Consequently, the comparative chapter of this study will adopt the format described above: an exposition of historical and cultural and economic nexus, followed by foreign investment laws and political regimes and institutions, and finally a conclusion presenting a comparative analysis of Azerbaijan and Turkey.

This research engages with the following materials: comprehensive literature, host government agreements, arbitral decisions, and the on-going review of laws and petroleum legislations are the primary sources of this work. Notably, a major hurdle in this study has been the review of energy investment contracts, as they are confidential. This project also utilises secondary materials and data has been gathered from books, journal articles, reports, conference papers, newspapers and statistics. In order to broaden the scope of the information gathered, and to exploit the research tools of our digital age, several online discussion groups have also been monitored.

Why was the BTC Project selected as a case study in this work and why was comparative approach was adopted for Azerbaijan and Turkey?

89 R. Sacco, 'Legal Formants: A Dynamic Approach to Comparative Law', *the American Journal of Comparative Law*, Vol. 39, No. 1. (1991) 5

90 K. Zweigert & Kotz, *An Introduction to comparative law*, 3rd edn., Translated by Tony Weir, (Oxford, Oxford University Press, 1998) 32

91 Ernst Rabel is the founder of function approach to comparative methodology, cited in J. Beckman, *Comparative Legal Approaches to Home Land Security and Terrorism* (Hampshire, Ashgate Publishing, 2007) 7

92 *ibid*

One of the principle reasons why the BTC project was chosen as a case study was due to the availability of information about it. A major hurdle in energy related studies is the restricted availability of information on contractual arrangements between parties. This study selected the BTC project as a case study because project backgrounds, issues arose from the BTC project, Intergovernmental agreements between Azerbaijan-Georgia-Turkey and host governmental agreements of these states with the project consortium are made publicly available. In addition, there is also a significant amount of legal documents produced by NGOs, financial institutions as well as project sponsors involved to the BTC project that is also publicly accessible.

Azerbaijan and Turkey have been selected for the purposes of this study to examine whether their respective political regimes and legal and regulatory structure foster the inclusion of stabilisation clauses in the agreements made for energy investment projects to be undertaken on their territory (whether this be intentionally or through a lack of proper checks and controls). If this proves to be the case, this leads to the question: what is/are the other reason(s) these two countries agreed to contractual stability in the BTC host governmental agreement? There is no doubt that there are considerable differences between these two countries in terms of energy reserves, size, and other economic factors, yet Azerbaijan and Turkey are both Turkic countries party to a number of significant international energy investment projects, and share common ground in terms of language, religion and history.

The reason for choosing these two countries for comparison is twofold: The first reason for drawing comparisons between Azerbaijan and Turkey is that both countries' political regimes are quite different. Evidently, the legal regime of Azerbaijan is an authoritarian presidential system; however, Turkey is ruled by hybrid parliamentary regime. In literature, a number of thoughts are suggested regarding the effectiveness of legal regimes on foreign direct investment and their crucial role for attracting foreign investment. Analysis of these two divergent regimes, political and democratic institutions, laws and foreign investment policy, may provide the internal reasons to understand why these states agree stabilisation clauses in their host governmental contracts.

Secondly, these two Turkic states are both (along with Georgia) party to the BTC agreement. This agreement is arguably the most debated petroleum pipeline project in the energy field, particularly because it contains provisions that place heavy burdens on its host governments. This study explores the issues that arise from the BTC agreement and measures how this agreement and its host governmental contracts have impacted on Azerbaijani and Turkish domestic law.

It is also important to justify why Georgia was not selected, although the country is also party to the BTC project. It was in the interests of the study to select two countries with key differences in political regime and role in the agreement. Georgia and Turkey share the commonalities of having a hybrid political regime and being transit countries under the BTC agreement, while Azerbaijan, as a petroleum producing country with an authoritarian political regime provided the best contrast. Turkey was chosen over Georgia due to the fact that the researcher has better access to information on this country and as a Turkish speaker was better placed to interview Turkish and

Azerbaijani nationals who share this language. Nevertheless, Georgia's bargaining position in the BTC project is examined in chapter 5 of this study.

Interviews

The interviews of this research project applied the qualitative semi-structured interview technique. The semi-structured interview is one of the types of interview methods that are frequently used in law researches. The importance and value of semi-structured interviews are described by Mason. According to this author, semi-structured interviewing is an overarching term used to explain a variety of different forms of interviews most commonly related with qualitative research.⁹³ Mason goes on to state that the defining characteristic of semi-structured interviews are that they are flexible and fluid in structure, especially when compared with structured interviews that include a structured series of questions to be asked in the same sequence and manner to all participants.⁹⁴

The interviews of this work consist of two parts: the first stage took place between May, 2012 and June, 2012, and the second stage took place between November, 2012 and January, 2013. These interviews were undertaken with 20 participants, (16 male and 4 female) in total, including, experts in project finance and political risk insurance, lawyers, company directors, academics and a judge. Interviewees were selected from each country to represent a variety of professional backgrounds relevant to the study. This includes legal backgrounds (lawyers and a judge), commercial backgrounds (company employees in the fields of insurance, finance, foreign trade and accounting), and experts with scientific qualifications (academics in the field of energy and international investment laws).

The interviews of this research were conducted in a variety of locations in Ankara, Baku, Istanbul and London; including offices, meeting rooms and cafes. The choice of venue was given to participants as the researcher wanted them to feel flexible and relaxed during the course of the interview. During the interviews, the researcher used recording equipment and note taking, as preferred by the interviewee. The most effective method was to record the interviews with the use of a portable recording device. The advantages of this method were that it allowed the interviewer to focus their attention wholly on the interviewee, maintain eye contact and demonstrate that they were listening intently, and to be able to adapt their line of questioning without distraction.

Several resources were available to validate the legitimacy of the study, including the participant consent form and participant information letter provided by the supervisors. In July, 2011, the researcher visited the BOTAS Company in Ankara, Turkey. The purpose of this initial visit was to establish contact with a state-owned company in a position to provide valuable practical insights into the proposed area of this research and to grant the researcher the possibility to access this via an internship

93 J. Mason, *Qualitative Researching*, 2nd edn (London, Sage Publishing, 2002) 62

94 Ibid

within the company. Initial contact was made prior to the pilot study with the quality and training department of BOTAS and the researcher was also able to utilise some personal contacts in the field to commend the approval of this request.

For the pilot study, the researcher held interviews with nine participants in May, 2012 and June, 2012. Five of the interviews were conducted during an internship at the state owned company, while the remaining four were carried out in Ankara and Istanbul. The interviewees were company directors, senior experts in international projects and project finance, as well as lawyers and a lecturer. The pilot study of the current project was a preliminary investigation into the interview approach. As well as testing the interview technique, an assessment was also made of the adequacy and capability of the research questions. This was also an opportunity to gather some initial findings on the internal and external reasons that may lead host states to agree to stabilisation clauses. Some of the respondents that participated in the pilot study interviews were subsequently revisited and re-interviewed in order to get further information for the final stage of this study.

The researcher faced some difficulties regarding participant selection. Despite the careful explanation provided by the researcher in both English and Turkish to the Law Department at BOTAS Company, a participant referred from the expropriation department did not meet the interviewee criteria dictated by the research needs. The researcher was of the conviction that interviewing an individual from the expropriation department would be beneficial to this research. However at the start of the meeting the participant mentioned that he worked in the Construction and Expropriation Department and that his background was in engineering. It was instantly clear that his knowledge and experience were not relevant to the scope of this study. Subsequently, in order to avoid further misunderstandings of this kind, the researcher obtained the company employee profiles of those proposed for interview in order to personally assess which employees were most likely to be able to contribute knowledge relevant to this study. This method was very helpful in selecting the right participants for the rest of the interviews.

The researcher also faced some obstacles in obtaining the participant consent of some interviewees and scheduling interviews outside the company. Despite these difficulties, however, the researcher was able to obtain valuable information for this research, by conducting semi-structured interviews. Doing an official internship in a law department housed within a state-owned company was a key to easing any potential difficulties. Nevertheless, as the second round of fieldwork was carried out in more than one country, the researcher needed to make contact with more potential participants. In an attempt to broaden the range of contact, the researcher invited suggestions from the already secured participants of this study. Through their assistance and referrals, the initial contact details of the second round interview participants were gathered. While some participants of the pilot study passed on contact details for employees of the State Oil Company Azerbaijan (SOCAR), others recommended social networking websites for professionals such as Linked-in. The researcher created a profile on the aforementioned websites and successfully made contact with additional prospective interviewees for the second round of interviews. This proved to be a very effective method of gaining contact details and broadening the range of contact.

The pitfall of using the voice recording method was that, as happened in one case, an interviewee declined to give permission for the interview to be recorded in this way as this participant was afraid of the possibility that the information could be shared with other parties and that sharing this information may be seen in some way as breaching the confidentiality of their profession. In this instance, note-taking was as a satisfactory back-up method for recording the interview. Admittedly, using a digital recorder made for a more relaxed atmosphere, because the participants in the interview were free from the distraction of note-taking and could concentrate on the questions.

Qualitative approaches include procedures that are not strictly formal and pre-defined, with an unlimited range and a more philosophical working method than other kinds of research.⁹⁵ For the purpose of this work, a qualitative paradigm is applied. More significantly, qualitative research methodologies are convenient for the purposes of this study in two respects: first of all, the qualitative research methodology can strengthen the researcher's depth of understanding of the issue that is being investigated. Adopting this method is appropriate to the study since there is a need to gain a thorough understanding of the internal and external forces in the usage of stabilisation clauses in host government contracts. The second benefit of applying this research approach in this study is it is flexible and permits the researcher to explore new hypotheses.

Ethical Issues

Studies in social science are frequently concerned with gathering data from individuals. Almost unavoidably, this raises questions regarding the way in which individuals that provide data should be treated by researchers, and such questions are often of an ethical nature.⁹⁶ At this point, the term 'ethics' needs to be explained: Ethics are a system of moral principles that originate from a branch of philosophy that defines what is good for individuals and society.⁹⁷ The term derives from the ancient Greek word 'ethos' that means custom, habit or character.⁹⁸ In the context of research projects, ethics can be defined as the moral principles and rules that researchers in any branch of science must adhere to when conducting research to guarantee that individuals are not pressed in any way to participate or that they meet with harm as a result of participating in the study. There is no doubt that ethical issues are serious concerns that must be taken

95 G. Allan & C. Skinner, *Handbook for Research in the Social Sciences* (Brighton, Falmer Press, 1991) 16

96 P. Oliver, *the Student's Guide to Research Ethics*, 2nd edn. (Berkshire: Open University Press 2003, 2010) 3

97BBC Guide, 'Definition of Ethics', available at:
<http://www.bbc.co.uk/ethics/introduction/intro_1.shtml> July, 2012

98 *ibid*

into account by researchers throughout every stage of their academic work; such as in a pilot study and in the writing up stage. For this study, ethics approval was granted by the Faculty of Research Ethics Panel, Local laws and ethical requirements. Prior to the internship, the researcher fulfilled all the necessary requirements by providing an official letter from the BOTAS Petroleum and Pipeline Company where the internship and some interviews were to take place. Before semi-structured interviews were carried out, a consent form (in English and Turkish) was provided to each of the respondents. The details of the participant consent form were read aloud and explained to them. Each of the respondents of the interviews was required to sign each section of the form in order to ascertain that they were taking part in the research of their own free will. The researcher also verbally inquired whether the respondents would be available for follow up interviews in the two stages of this research process as and when further information was required.

Furthermore, as privacy is a key moral principle in ethics, the researcher took pains to guard the personal right to confidentiality and anonymity, by omitting to mention some respondents by name, where requested. The researcher also informed respondents of the contribution to knowledge that this research project represents and, specifically that the goal of this research project is to promote a better understanding of the reasons host states give consent to stabilisation clauses. All the respondents were also informed that they were under no obligation to participate in the research and that they would be free to withdraw at any time. Finally, the researcher informed the participants that the findings of the research could be sent to them if they wished once the project was completed. The researcher can confidently affirm that that the interviews of the present project did not cause any harm to respondents, whether physical, emotional or psychological.

9. Overview of Azerbaijan and Turkey

9. 1. Political regimes

The Republic of Azerbaijan is located in the south east of the Caucasus, and shares borders with Russia, Georgia, Iran and Armenia. The country gained its independence in 1991, after the collapse of the Soviet Union. The political system of Azerbaijan is based on the principles of the separation of powers. With regard to this principle, the constitution determines that executive power is in the hands of the president of the Republic of Azerbaijan, legislative power is the domain of the parliament of the Republic of Azerbaijan, while judicial power is held by the independent courts of Azerbaijan, the constitution court being the highest court of these. The political regime in Azerbaijan is categorised by scholars in the literature; however, there is little agreement on the matter.⁹⁹ The categories suggested range from neo-patrimonial dictatorship; sultanistic; authoritarian; to decaying semi-authoritarian; sultanistic semi-authoritarian; hybrid and partially democratic¹⁰⁰.

99 O. Bayulgen, *Foreign Direct Investment, and Political Regimes: The Oil Sector in Azerbaijan, Russia and Norway*, (Cambridge, Cambridge University Press, 2010) 97

100 *ibid*

Another Turkic country, Turkey, is located in Western Asia has been a republic since 1923. More specifically, Turkey is a secular parliamentary republic established on the principle of the separation of powers into legislative, executive and judiciary. The constitution is the supreme law and the Constitutional Court is the highest court in the country. The executive branch is dual-headed in Turkey. The president is the head of the state and the prime minister is the head of the Council of Ministers. As determined by the 1982 Constitution, the country's legislative organ rests in The National Grand Assembly (Turkiye Buyuk Millet Meclisi) unicameral parliament which is located in Ankara. Furthermore, the 1982 Turkish Constitution decrees that national courts and judges in Turkey are independent. Turkey is often classed as a hybrid regime.

The Economics Intelligence Unit published a report it called The Democracy Index in 2011. The set of values it proposes can be used to place states within one of the four types of regimes; namely, full democracies, flawed democracies, hybrid regimes and authoritarian regimes in 167 countries. The hybrid regime scores of the 4 to 5.9 and authoritarian regime scores below four. Using the ranking system of the report, the political regime of Azerbaijan is classified in authoritarian regimes and Turkey places in hybrid regimes¹⁰¹.

Table 3 Democracy Index Ranking in 2011

Ranking	Country	Democracy index	Political regime	Government Type
40	1 Azerbaijan 	15	3. Authoritarian regime	Presidential system
88	Tu rkey 	13	5. Hybrid regime	Parliamentary republic

Source: Economics Intelligence Unit

101A Report from Economics Intelligence Unit, 'Democracy Index, 2011' : *Democracy Under Stress*, available at: <www.eiu.com> August, 2012

9.2 Economy

The Republic of Azerbaijan is a dynamic emerging economy with a skilled workforce and the benefit of rich natural energy resources. The energy sector is the backbone of the Azerbaijani economy. Azerbaijan is richly endowed with natural resources and has a long history of oil and gas exploration. Azerbaijan's confirmed crude oil reserves were estimated at 7 billion barrels in January 2012.¹⁰² The oil sector is not new in Azerbaijan. The country is the one of the longest established oil-producing countries in the world which experienced an oil boom at the beginning of the twentieth century and thereafter served as one of the main refining centres within the former Soviet Union. The involvement of international oil companies in petroleum projects in Azerbaijan commenced with the activities of the Nobel brothers in the early 1870s.¹⁰³ 'By 1897, the oil fields in Baku delivered more than 45% of the world's crude oil. And a few years later, by the end of the century, these Russian-run wells accounted for more than half the total world output.'¹⁰⁴ In the context of Azerbaijan's more recent history, the oil sector has played a key role in the economic and political development of the country, strengthening the country's independence, protecting its territorial position and stimulating economic growth by attracting international energy investors.

While it is the case that most former Soviet Union states have been endeavouring to become a part of the global economy as new independent states, Azerbaijan distinguishes itself from its peers through the sheer extent of its success in adapting to the global economy and attracting foreign investors. According to UNCTAD's inward foreign direct investment (FDI) index, Azerbaijan ranked the third highest among 140 countries in the years between 1994 and 1996 and eighth highest from 1998 to 2000.¹⁰⁵ The Azerbaijani government boasts of a successful record for oil and gas policy-making, signing the 'Contract of the Century' in 1994 Azeri, Chirag, and Gunsheli fields (ACG), swiftly followed by the Shah Deniz gas field in 1996 which led to a huge boost in international investment in the petroleum sector. Moreover, another crucial project emerged in 2006 on the signing of the great Baku-Tbilisi-Ceyhan (BTC) pipeline project. The economic aim of this project is to transport oil from Baku to western markets via the cities of Tbilisi and Ceyhan. The political aim is, technically, to end the Russian monopoly of transportation of energy resources from the Caspian Sea.

102 US Energy Information Administration, available at: <www.eia.gov> January, 2012

103 G. Askerov, 'Oil and Gas Pipeline Strategy of a Landlocked Countries: Case of Azerbaijan', *Khazar Journal of Humanities and Social Sciences*, Vol.3 No 4 (2000) 5

104 Robert Ebel, *Caspian Energy Resources: Implication for the Arab Gulf, Emirates Centre for Strategic Studies and Research*, (Lebanon, Ithaca Press: 2000) 2, cited in G. Askerov (n.103 above) 5

105 UNCTAD 2002a, Azerbaijan was ranked the highest in 2004 (UNCTAD, 2006).

Baku-Tbilisi-Erzurum gas pipeline and the Baku-Tbilisi-Kars railroad projects are the other significant international projects that helped the country to transport its energy resources. However, Azerbaijan's landlocked location in the Caspian region and unresolved conflict with Armenia which occupied 20% of the territory of Azerbaijan forced the country to rely on its other neighbours when delivering its oil and gas products to the world market. These issues placed a heavy burden on the Azerbaijani economy.

In an attempt to provide an estimation of the degree of contribution the oil and gas industry make to the Azerbaijani economy, the table below provides the indisputable evidence of hard facts and figures.

Table 4 Significance of the Oil and Gas Sectors to the Economy

Azerbaijan	2003	2004	2005	2006	2007	2008	2009	2010
GDP Growth rate (%)	11.2	10.2	26.4	34.0	25.0	10.8	9.3	5.0
Share of oil and gas sectors in GDP (%)	30.1	31.3	44.1	53.8	55.9	54.1	47.0	48.5
Share of oil and gas sectors in Industrial output (%)	62.1	61.6	75.0	82.8	85.7	89	74.0	75.7
Share of petroleum in gross Export (%)	85.7	82.7	86.5	92.2	94.2	93.1	92.8	92.0
Share of oil and gas sectors in FDI (%)	98.5	97.5	94.2	90.3	90.1	83.9	82.0	81.8

Source: Ministry of Economic Development & State Statistical Committee of Azerbaijan

In the interest of boosting its economy further, Azerbaijan has also established trade partnerships with over 147 countries around the world. Its chief imports are reported to be: food, machinery, electric equipment & parts, vehicles & parts, chemical products and medical and surgery equipment; while perhaps unsurprisingly its principal exports are: crude oil, other products related to oil, natural gas, electricity and chemicals.¹⁰⁶ The following table demonstrates Azerbaijan's major trading partners.

Table 5 Azerbaijan's main Trade Partners, 2011

¹⁰⁶ For further detail please see: The State Statistical Committee of Azerbaijan, available at: <<http://www.stat.gov.az/>>January, 2012

Countries in Import	(%)	Countries in Export	(%)
Russia	16.8	Italy	35.2
Turkey	13.4	France	15.2
Germany	8.7	United States	6.8
United States	6.5	Russia	4.5
China	6.4	Ukraine	3.5

Source: State Statistical Committee of Azerbaijan

During the two decades of its existence as a republic, the country has implemented various codes relating to foreign investment in an attempt to grant space to its market economy for growth. The chief parts of the codes are: law over the protection of foreign investment, the law on investment activity, the law on privatisation of the state property, and related presidential decrees.¹⁰⁷ These laws provide numerous crucial state guarantees to investors, concerning non-discrimination, freedom of capital movements, stability of legislation, compensation for expropriation, and the right of entry to international arbitration.¹⁰⁸ The Azeri government also implemented crucial legislation in the energy sector, notably, the law on energy, the law on use of energy resources and the law on subsoil, and the law on Natural Monopolies.¹⁰⁹

Turkey is a dynamic, growing economy. According to the IMF, the country is an emerging market economy and is mainly developed and industrialised.¹¹⁰ Turkey is an upper-middle income state with relatively few natural resources. The main natural resources it does possess are mineral (coal, chromate, copper, boron), steel and petroleum. The country does not have rich oil reserves; however, its economy is presently in transition from a high degree of dependence on agriculture and heavy industry. Although Turkey is not an oil producing country, it plays a major role as a transit country in international energy projects.

There are a number of significant oil and gas pipeline projects that Turkey takes part in such as the BTC crude oil pipeline, the Trans-Anatolian Natural Gas Pipeline (TANAP) project and the Kirkuk–Ceyhan oil pipeline project. The TANAP project, aims to transfer Azeri natural gas via Turkey to Europe. The project was announced on 17 November, 2011 at the Third Black Sea Energy and Economic Forum in Istanbul. On 26 June, Azerbaijan and Turkey signed up to the project. This major natural gas pipeline

107 Energy Charter, *‘In-depth Review of the Investment Climate and Market Structure in the Energy Sector of Azerbaijan’* (2005) available at: <http://www.encharter.org/index.php?id=141> January, 2012

108 *ibid*

109 *ibid*

110 IMF, ‘World Economic Outlook: Tensions from the Two-Speed Recovery Unemployment, Commodities, and Capital Flows’ (April 2011) 173-174, available at: <http://www.imf.org/external/pubs/ft/weo/2011/01/pdf/text.pdf> January, 2012

project is expected to commence in 2014. The Kirkuk crude oil pipeline project links Turkey and Iraq. However, the pipeline has been sabotaged by the PKK terrorist group (Kurdish Worker's Party) on occasion in the past and is still not in full working order. The relative success of the BTC project renders it one of the most important oil pipeline projects in realising Turkey's national goals in the oil sector. This major oil pipeline project has been in full operation since 2006 and provides a million barrels of oil from Azerbaijan through Georgia to Turkey per day.¹¹¹

According to the United Nations' world investment survey between 2008 and 2010, Turkey is the 15th most attractive country for FDI in the entire world.¹¹² This assessment leads one to question how Turkey has reached its objectives and needs in such a short period. There is no doubt that Turkey's foreign investment policy and new legislative reforms have played an effective role in the attraction of FDI and economic development of the country.

In 2003, Turkey enacted significant legislative reforms¹¹³ to develop the investment environment in Turkey. The new reforms contain three significant legislative acts that intend to remove bureaucratic red tape, ensure equal treatment to both domestic and foreign investors and protect foreign investors' rights to meet international standards. The FDI law provides a definition of foreign investors and foreign direct investment. Moreover, it also identifies integral principles of FDI, such as freedom to invest, national treatment, expropriation and nationalisation, dispute settlement and the other areas related to foreign investment. Furthermore, trade partnership with various countries from different regions plays a crucial role in Turkish economy. The country is a well-known exporter of products such as foodstuffs, clothes and automobiles. In addition, the country exports mineral fuels and oils, tobacco and steel. The table below shows the main trading partners of Turkey.

Table 6 Turkey's Trade with Main Partners (2012)

Countries in Import	(%)	Countries in Export	(%)
European Union	33.7	European Union	29.3
Russia	10.3	Iraq	5.4
China	8.2	Iran	5.0
United States	5.4	United Arab Emirates	4.1
Iran	4.6	Russia	3.3

Source: The Directorial General for Trade of the European Commission

¹¹¹ US Energy, (n. 102 above)

¹¹²The United Nations Conference on Trade and Development, ' *World Investment Prospect Survey 2008-2010*' available at: http://www.unctad.org/en/docs/wips2008_en.pdf> January, 2012

¹¹³Foreign Investment Law no 4875 June 17, 2003

The table clearly demonstrates that in both import and export, the European Union is the largest trade partner of Turkey. The reason why Turkey's best partner EU is because of the Ankara agreement signed between EU and Turkey to implement Custom Union in 1995. According to this agreement, goods can travel between two entities without any barriers (zero tariffs). It is apparent that trade has been a strong driver of the economic growth in Azerbaijan and Turkey; however, both countries still cannot take place in the economically freest countries. While Azerbaijan's economy is the 88th freest economy, Turkey's economy is in the 69th place according to economic freedom index 2013. The following table below provides the economic freedom in Azerbaijan and Turkey from a comparative perspective. Notably, 100 represent the maximum freedom.

Table 7 Index of Economic Freedom in Azerbaijan and Turkey, 2013

Country	Fi na nci al fre ed om	Bu sin ess Fr ee do m	Trad e freed om	Fis cal fre edo m	Gov ern men t Spe ndin g free dom	Mo net ary Fre edo m	Inv est ment Fre edo m	Prop erty Righ ts free dom	Co rrup tion fro m free dom	La bou r fre edo m	Ov er all Ra nk
Azerbaijan	40.0	69.2	77.2	85.5	67.8	73.5	55.0	25.0	24.0	79.4	59.7
Turkey	60.0	68.2	85.2	77.0	64.9	73.3	65.0	50.0	42.0	43.1	62.9

Source: 2013 Index of Economic Freedom, a product published by the Wall Street Journal and Heritage Foundation

10. Baku-Tbilisi-Ceyhan Crude Oil Pipeline Project: Timeline, Importance and Issues

The BTC is a crude oil pipeline project which spans three countries and runs from the Caspian Sea to the Mediterranean coast. The aim of this project is to transport Caspian crude oil from the Azeri-Chirag-Gunashli (ACG) fields in the Caspian basin via Tbilisi in Georgia to a Turkish port on the Mediterranean Sea for delivery to the western market. The project's pipeline which runs underground along its whole length, which measures 1,768 km (1,099 miles) in total: 443 km of which span Azerbaijan, 249 km in Georgia, and 1,076 km in Turkey.¹¹⁴ This mega project was organised by an international consortium (Main Export Pipeline participants) and led by British Petrol. Through this project western governments aimed to end the Russian monopoly over the delivery of oil supplies from the Caspian region.

¹¹⁴ British Petrol available at: <<http://www.bp.com/>> January, 2012



Source¹¹⁵: *British Petrol (BP)*

The first negotiations regarding the BTC project commenced in 1992, just after Azerbaijan declared itself a republic independent of the former Soviet Union. In spring 1992, the Turkish prime minister, Suleyman Demirel visited the new independent Turkic countries, including Azerbaijan and proposed that a pipeline route should be planned for the economic development and strategic integrity of the region. Initially, it was thought a pipeline from Azerbaijan would run through Georgia or Armenia. This was found to present too much political risk due to the unresolved war between Armenia and Azerbaijan over the status of Nagorno-Karabakh and the close military and economic ties of Armenia with Russia. This left as the only option, the circuitous Azerbaijan-Georgia-Turkey route, longer and financially more expensive to build than Armenian route.¹¹⁶

On 29 October, 1998, the President of Azerbaijan, Heydar Aliyev, the President of Georgia, Eduard Shevardnadze, the President of Kazakhstan, Nursultan Nazarbayev, the President of Turkey, Suleyman Demirel and the President of Uzbekistan, Islam Karimov met in Ankara to submit and sign the Ankara Declaration. With this declaration the parties officially acknowledged the importance and necessity of the construction of more than one pipeline, commercially optimising oil and natural gas exports to the rest of the world.¹¹⁷ These countries also confirmed their support for routing the pipeline

115 *ibid*

116 Z. Baran, *The Baku-Tbilisi-Ceyhan Pipeline: Implications for Turkey*, Chapter 6 in S. F. Starr & S. E. Cornell, *The Baku-Tbilisi-Ceyhan Pipeline: Oil window to the West, Central Asia-Caucasus Institute Silk Road Studies Program- A Joint Transatlantic Research and Policy Centre* (2005) 105 available at: http://www.silkroadstudies.org/BTC_6.pdf January, 2012

117 *Hurriyet Daily News*, available at: <http://www.hurriyetdailynews.com/default.aspx?pageid=438&n=timeline-of-the-baku-tbilisi-ceyhan-pipeline-2006-07-13> January, 2012

from Baku to the Turkish Mediterranean port of Ceyhan. Present to witness the declaration was the US Energy Secretary, Bill Richardson.

On 18 November, 1999, at the meeting of the Organisation for Security and Cooperation in Europe in Istanbul, the Inter-Governmental Agreement which formally established the foundations of the BTC project was signed by representatives of Azerbaijan, Georgia and Turkey. The then US president, Bill Clinton counter-signed the accord as a witness. In addition to this intergovernmental treaty, the signatory states also signed Host Government Agreements between the project consortium and Azerbaijan-Georgia-Turkey. The HGAs were ratified by Azerbaijan on 26 May, 2000; in Georgia on 29 May, 2000, and by Turkey on 22 June, 2000.

Stabilisation clauses inserted in host governmental contracts provoked considerable alarm among civil rights groups when it became apparent that such contracts enable BTC sponsors to contract outside the rule of law. Indeed, the provisions of the agreement extend a wide range of privileges and immunities to investors. Moreover, the main purpose of this agreement is to grant immunity to the investor and third parties (such as insurers) from the domestic law of the host state. Notably, the BTC agreement established a unique legal regime contrary to other similar energy investment contracts. It goes without saying that when the economic, environmental and social importance of industries in which stabilisation clauses have been used is considered, it is no surprise that they have been the subject of debate and criticism by civil rights groups associated with promoting sustainable development.¹¹⁸ BP came under fire for its stabilisation clauses because they prevented the three aforementioned host countries from passing new human rights legislation through their national parliaments and required the host states to compensate them for contravening the clause. This restricted the states' capacity to actively honour their obligations to promote or protect human rights under international law.¹¹⁹ Amnesty International made the following criticisms regarding the economic equilibrium clauses inserted in the host governmental agreement signed between BTC investor consortium and the Turkish government:

While Turkey remains bound by its International human rights obligations, it has undertaken in the Host Government Agreement (HGA) to pay the consortium substantial compensation for any changes in law or other actions that will disturb the economic equilibrium of the project. It is thus caught between two sets of requirements – to live up its undertakings to its citizens and to live up to its undertakings to the consortium. Each step in the former direction will carry the price tag of damages – which can easily amount to many millions of pounds. In this way, the HGA creates disincentives for Turkey to become more integrated into international human rights norms. At the very least, it may have to enter reservations exempting the project from

118A. Sheppard & A. Crockett, Are Stabilisation Clauses a Threat to Sustainable Development?, Chapter 14 in M. C. Segger, A. Newcombe and M. Gehring (eds.), *Sustainable Development in International Investment law* (The Hague: Kluwer, 2010) 338-339

119 Amnesty International, *Human Rights on the Line: The Baku-Tbilisi-Ceyhan Project*, (London, Amnesty International, 2003) 5

any new international standards it subscribes to. The effect of being faced with punitive costs for protecting the human rights of those affected by the pipeline is likely to have a chilling effect on Turkey's ability to improve its general human rights record.¹²⁰

In December 2003, the BTC co. published a legal document called 'Human Rights Undertaking'.¹²¹ With regard to this undertaking, compensation clauses in the HGA would not be valid in the event of new laws being adopted or introduced for environmental and human rights issues. It is reasonable to assume that this publication was prompted by the criticism and intended to go some way in appeasing such objections.

11. Structure of the Work

The study consists of three parts which are divided into the following chapters. The work begins with a general introduction to the research.

Chapter 1 includes the definition of key terminology and concepts that central to this study, such as host governmental energy investment contracts, stabilisation clauses. It also provides an overview of political risk, as well as a background to the geographical, economic and political background to Turkey and Azerbaijan. This chapter briefly explores the paradigm of carrying out this study. Understanding political risks is very important in order to assess why energy investment contracts are exposed to conflict and also to understand why stabilisation clauses are used as a form of risk management in host government energy investment contracts. Library-based research is used in this chapter as there is comprehensive literature on the subject.

Chapter 2 identifies the major political risks for foreign investors and explores their origin and causes. The chapter begins by providing a historical background to political risk in the energy sector. This overview aids an understanding of how political risk emerged and evolved over time in the energy industry. Afterwards, a detailed analysis of direct expropriation is provided, and the legal requirements for lawful taking under international law are outlined with reference to recent arbitral decisions regarding expropriation cases. Resource nationalism is also addressed in this chapter, in connection with indirect expropriation. The chapter closes with a comparative analysis of the investment environments of Turkey and Azerbaijan which seeks to identify the risks and opportunities for investors in these states. This chapter seeks to answer the following questions: what is the most hazardous political risk for international energy investors? And why do host states disrupt investment projects? Library-based research informs the analysis of this chapter as well as interviews conducted with state-owned company directors and legal practitioners.

120 Ibid

121 The BTC Human Rights Undertaking, available at:
<<http://subsites.bp.com/caspian/Human%20Rights%20Undertaking.pdf>> January, 2012

Chapter 3 attempts to define what constitutes indirect expropriation and reviews the mechanisms that can be employed by foreign investors to guard against it. The chapter starts by providing an overview of indirect expropriation. It then moves on to address the differences between direct and indirect expropriation. Several case studies are cited in order to illustrate what distinguishes the two phenomena. Afterwards, the types of government measure that may constitute indirect expropriation are addressed. This chapter also seeks to provide criteria for distinguishing between non-compensable government measures and indirect expropriation with reference to the approaches and findings of international investment tribunals. This is exemplified by comparing and contrasting the bilateral investment treaties of Azerbaijan and Turkey and their treaty provisions concerning indirect expropriation. Following this, the tools for mitigating the threat of indirect expropriation are assessed and the question of what mechanism(s) can be used by foreign investors against the risk of indirect expropriation is addressed. The analysis presented in this chapter is informed by library-based research, interview participants' views and a comparison of Azerbaijan and Turkey's treaties' provisions on indirect expropriation.

Part II forms the core of this study and is composed of chapters 4 to 6, inclusive.

In Part II, stabilisation clauses and external factors are examined and exemplified through a comparative study of Azerbaijan and Turkey.

Chapter 4 examines host government contracts and the stabilisation clauses inserted in these agreements by foreign investors as a political risk management device. The chapter addresses several issues including the typology, validity, effectiveness and efficacy of stabilisation clauses. Chapter 4 seeks to examine how stabilisation clauses manage political risk, in particular regulatory change, which is applicable to energy projects, changes of contractual terms and indirect expropriation. This chapter also makes reference to the on-going debate between legal scholars in the field on the validity and efficacy of stabilisation clauses. Through the analysis of this chapter the following questions will be answered: To what extent are stabilisation clauses effective in protecting investments or conversely, in contradiction of their intended guardianship, do they instead disenfranchise the sovereign rights of the host states? And do stabilisation provisions constitute a threat for Environment and Human rights issues? Throughout the course of chapter 4, library-based research and interviews with national and international energy investment companies, lawyers, and academics provide evidence.

Chapter 5 seeks to nominate the external factor(s) which may force host states to include stabilisation clauses in energy investment contracts. This chapter analyses the range of external factors other than the will of investors which may force a host state to agree to have a stabilisation clause included in its energy investment agreements as well as their effect on the regulatory powers of states. Chapter 5 examines the role of rating agencies, project finance lenders, and political risk insurers in relation to the investor and the host state and their influence regarding the inclusion of stabilisation clauses in agreements. Chapter 5 also provides a legal analysis of the BTC agreements from the perspective of Turkey and Azerbaijan and compares their relative bargaining positions in negotiating the contract. This chapter poses the following questions: Do rating agencies, project finance lenders and political risk insurers play an active role in lobbying for the inclusion of stabilisation clauses in host governmental contracts? This chapter draws on library-based research and interviews.

Chapter 6 focuses on internal factors in Azerbaijan and Turkey and whether the legislation, constitutional guarantees and political structure of these countries facilitate stability in energy investment projects. Each country's FDI laws, constitutional promises, and the legal status of their international agreements under domestic law as well as their respective political regimes are taken into account in the analysis. In the case of Turkey, the guarantees available to foreign investors under the country's defunct FDI law (Law for Encouragement of Foreign Capital No. 6224) and the new FDI (FDI Law 4875) laws are compared. Finally this chapter attempts to answer the following questions: How effective are different political regimes in promoting FDI and giving consent to stabilisation clauses in Azerbaijani and Turkish host government contracts? What reason(s) has/have caused Azerbaijan and Turkey to agree to contractual stability in the BTC host governmental agreements? The purpose of the comparison here is to explore the similarities and differences between state guarantees under the countries respective laws, investment policies, and political regimes. Chapter 6 calls upon library-based research, interviews with government bureaucrats, state-owned company representatives, lawyers, a judge and several academics and the comparative method is employed.

Part III

Chapter 7 conclusions and recommendations

Chapter 7 pulls together the strands of the research in order to present the internal and external factors that motivate states to agree to stabilisation clauses. This chapter also proposes recommendations to the Azerbaijani and Turkish governments for the improvement of legislation, political structure and policies in order to be in a stronger position to negotiate energy investment contracts in their own interest.

Chapter 2

Sources of Political Risk

1. Introduction

A host economy with a high degree of political risk tends to discourage FDI flow into its market, as the political instability and unpredictability this brings with it impact on the profitability of foreign investment.¹²² As mentioned in the previous chapter, risk phenomena can be the cause of major losses and/or damage to business operations. This may be due, in part, to the inherent nature of energy projects: they are vulnerable and open to risk. On a global scale, numerous energy projects have been embarked upon and continue to be signed up to by international investors. Energy projects, such as oil and gas exploration and their transportation through pipelines, can be subject to unpredictable economic and political risks. Such risks can arise from international investment energy agreements by the intervention of host states directly or indirectly,¹²³ over the course of the projects. Host states that instigate these risks, may take either entire or specific parts of the property of alien investors. As will be stated below, the petroleum industry is very exposed to political risk and achieving an acceptable level of stability is a *sine qua non* requirement for investors. For this reason, investment agreements include stabilisation clauses which aim to limit or control unilateral state intervention that could lead to unforeseeable conditions and may result in a decreased financial return.¹²⁴

The chapter starts with a sectorial assessment of political risk from a historical perspective. In the third section, an analysis of the historical background of risk aims to shed light on how political risk arose and evolved in the sector. Afterwards, attention shifts to expropriation. The chapter discusses the legal requirements for lawful taking under international law. While analysing expropriation phenomena, recent arbitral decisions with regard to expropriation cases on ICSID agenda will be referenced. An analysis of tribunal decisions facilitates an understanding of how arbitral tribunals operate. Section five of this chapter, focuses on resource nationalism. It is worth examining this notion in this section, as a resurgence of the phenomena has brought

122 B. Kyeonghi & Q. Xingwan, 'An Analysis on Political Risks and the flow of Foreign Direct Investment in Developing and Industrialised Economies' *Economics, Management and Financial Market*, Vol.6 (4), (2011), 64.

123 Z. A. Al-Qurashi, 'International Oil and Gas Arbitration', *OGEL Journal of Oil, Gas and Energy Law Intelligence* Vol. 3, (2005), 63

124 M. Flores, 'A Practical Approach to Allocating Environmental Liability and Stabilizing Foreign Investment in the Energy Sector of Developing Countries', *Colo. J. Int'l Env'tl. L. & Pol'y* 12 (2001): 141,159; See also T. Waelde & G. Ndi, 'Stabilizing International Investment Commitments: International Law Versus Contract Interpretation', *Tex. Int'l L.J.* 31 (1996) 216, 220

with its own unique issues. Next, the risk and investment environments of Azerbaijan and Turkey will be compared. In the course of this chapter the following questions will be answered: what is the most hazardous political risk for international energy investors and why do host states interfere to investment projects?

2. Political Risk in the Energy Investment

The historical background of political risk in the sector and its stakeholders should be viewed as belonging to two distinct timelines: pre and post-World War II. Furthermore, the global growth of the petroleum industry brought international oil companies into contact with more and more non-western countries and their representative governments.¹²⁵ These organisations are referred to as the ‘Seven Sisters’, namely: BP, Shell, Exxon, Mobil, Chevron, Texaco and Gulf. These companies had secured concessions all over the world and particularly in developing countries in the Middle East and Asia.¹²⁶ Pre-World War II, there were a number of non-western states that were under the control of European Colonial rule. At this time, if an oil company acquired and operated its business activities in a non-western country, they would be granted diplomatic protection by the home country of the investor.¹²⁷ After the Bolshevik revolution and the establishment of the Soviet Union, the energy sector found itself confronted with its first expropriation case.¹²⁸ It is apparent that neither diplomatic protection nor home country support were adequate to save energy investors from the risk of expropriation.

In the 20th century, the nationalisation of international energy companies was one of the major political risks present in the energy sector. After World War II, the main concern of petroleum companies was to avoid being exposed to nationalisation by the host government. Numerous nationalisation cases were to emerge following World War II, in Argentina, Algeria, Ecuador, Nigeria, Iran, Iraq, Syria, Libya, Venezuela, Kuwait¹²⁹ and some other developing states. In relation to this phenomenon, an important question needs to be asked regarding which driving forces and which environmental conditions have enabled developing states to nationalise the foreign assets of investors in the 20th century. Firstly, not only political factors drove developing states to nationalise foreign

125 B. Taverne, *Petroleum, Industry and Governments: A Study of the Involvement of Industry and Governments in the Production and use of Petroleum*, 2nd Edn, (Alphen aan den Rijn, Kluwer Law International: 2008) 39

126 A. J. Boulos, ‘Assessing Political Risk’, available at:
<<http://www.ipaa.org/issues/international/docs/PoliticalRisk.pdf>> February, 2013

127 B. Tavern, (n.4 above) 39

128S. J. Kobrin, *The Nationalisation of Oil Production, 1918-1980* in D. W. Pearce, H. Siebert & I. Walter, *Risk and Political Economy of Resource Development*, (London, Macmillan Press: 1984), 137

129 A. J. Boulos (n.5 above)

assets, non-political¹³⁰ reasons also played a substantial role. These non-political reasons are a combination of social and economic factors.¹³¹ Throughout the 20th century, mankind witnessed a divergent stream of ideologies in operation: on the one hand was the well-established system of capitalism but on the other hand collectivism, such as Socialist and Marxist ideas were gaining ground. As it transpired, after the Bolshevik revolution, many developing states adopted these collectivist ideals as policy. These emergent ideologies also motivated nationalisation in non-Communist states.¹³² As a second reason, most petroleum producing countries are developing states and their economies depend on oil and gas; and, bolstered by the new prevailing ideologies and the promise of a better standard of living, these countries' desire to control their own resources grew. As Brownlie emphatically states:

Some countries with more than 90 percent of their income from one single industry, e.g., oil or copper cannot, if they are free of coercion, leave important decisions as to the pace of production, pricing, marketing, selling, etc. to a foreign corporation unfamiliar and maybe uninterested in national policies of the state concerned. This has to be viewed against the background that it is always admitted the alien is considerable as a visitor who as such has a duty to submit to the local law and jurisdiction and that the control and regulation of persons and assets in an aspect of domestic jurisdiction of a State an incident of its sovereignty and independence in the territorial sphere.¹³³

Thirdly, as the colonial period drew to a close, the newly established independent states sought to assert permanent sovereignty over their natural resources.¹³⁴

The principle of permanent sovereignty over natural resources is one of the significant established norms under contemporary international law. The principle emerged in the 1950s as a result of the decolonisation movement, particularly in developing and newly independent states. The main reason why this principle took root quickly in these countries was because the principle provided these states with the moral

130 G. White, *Nationalisation of the Property* (London: Stevens & Sons Limited: 1961)18

131For further details please see K. Katzarov, *The Theory Nationalisation*,(The Hague: Martinus Nijhoff, 1964),1-19; M. Erkan, *International Energy Investment Law: Stabilitythrough Contractual Clauses*, Energy and Environmental Law and Policy Series, (Alphen aan den Rijn, Kluwer Law International: 2011) 39

132 G. M. Ingram, *Expropriation of U.S. Property in South America: Nationalisation of Oil and Copper Companies in Peru, Bolivia, and Chile*, (New York: Praeger Publishers, 1974) 2

133 I. Brownlie, *Principle of Public International Law*, 4th end (Oxford: Oxford University Press) 522

134 A. J. Boulos (n.5 above)

right to regain control over their natural resources within their territory and use them for the benefit of their own citizens. In 1962, the General Assembly approved Resolution 1803, which announced that ‘the right of peoples and nations to permanent sovereignty over their natural wealth and resources must be exercised in the interest of their national development and the well-being of the people of the state concerned’.¹³⁵

With this resolution, the UN sought to link the principle of permanent sovereignty with the state of economic independence and self-determination. For example, the preamble attaches ‘particular importance to the question of promoting the economic development of developing countries and securing their economic independence, [and notes that] the creation and strengthening of the inalienable sovereignty of States over their natural resources wealth and resources reinforces their economic independence...’¹³⁶ The resolution also permitted countries to implement nationalisation measures if deemed only for the good of the general public, security or national interest, which are recognised as overriding individual or private interest both domestic and foreign.¹³⁷ In such cases ‘appropriate compensation’ should be paid by the owner in accordance with domestic and international law.¹³⁸ Under the protection of such policies, many petroleum producing states grew more confident of their own ability to assert control over natural wealth and resources within their territory.

Although a number of significant concepts were expressed in the UN’s Resolution 1803 regarding permanent sovereignty, the resolution has been the subject of some criticism in academic literature. Several inconsistencies of moment have been pointed out by academics. First, it was emphasised that ‘the Resolution fails to clarify who possesses the right of permanent sovereignty.’¹³⁹ The Resolution asserts that the possessor of permanent sovereignty is ‘peoples and nations’.¹⁴⁰ However, ‘this clouds one’s ability to define sovereignty, as it traditionally has been understood, to be the power of a State’.¹⁴¹ Due to this inconsistency, several authors have claimed that the notion of permanent sovereignty over natural resources is not valid as a legal norm,¹⁴² ‘representing an attempt to give legal force and validity to what is essentially a political

135 GA Res.1803, 14 December, 1962, reprinted in 1963, 2 ILM 223

136 Ibid, at 223-224

137 Ibid

138 Ibid

139N. K. Kale, *The International Law of Responsibility for Economic Crimes*, (Hampshire, Ashgate Publishing Company: 2006) 96

140 GA Res.1803, 14 December, 1962, reprinted in (1963), 2 ILM 223

141 P. J. O’ Keefe, ‘ The United Nations and Permanent Sovereignty Over Natural Resources,’ *Journal of World Trade Law* Vol. 8 (1974) 239-282

goal.¹⁴³ Irrespective of its legal value or validity, Resolution 1803 embodies the principle of permanent sovereignty and explicitly illustrates the view of the United Nations on the permanent sovereignty issue.¹⁴⁴

Fourthly, the establishment of the Organisation of Petroleum Exporting Countries (OPEC) was one of the most significant and ground-breaking events in the petroleum industry. The creation of this organisation bolstered the confidence of Member States in their negotiations with international energy investors. Following the establishment of OPEC, Member Countries of this organisation increased the weight of investor obligation by adopting OPEC Resolution XVI in 1968 and XXIV in 1970.¹⁴⁵ The purpose of these resolutions was to grant more control in the exploration, exploitation and development of natural wealth and resources to the host state. Moreover, as a result of these declarations, Member States had an opportunity to renegotiate for existing traditional concession contracts from a new bargaining position, strengthened by their improved economic circumstances. A fourth reason why host states seek to nationalise the foreign asset may be found in the resource-producing state's move to maximize revenue from oil and gas production by unilaterally changing the terms of the original contract.¹⁴⁶

2.1 Obsolescing Bargain and Political Risk

In the literature, the phenomenon is called 'obsolescing bargain'; this theory was first outlined by Raymond Vernon. According to Vernon, in obsolescing bargaining theory, the degree of political risk is measured by the relative market power of the multinational companies and host governments and their bargaining relationships in terms of the natural product cycle.¹⁴⁷ The theory correlates the power of multinational companies and host governments to the stages of their relationship, concentrating on the shift in power that arises over time.¹⁴⁸ Since, at the initial stage of the bargain, the oil companies are in the position with most leverage, they are in a position to use this

142 K. N. Gess, Permanent Sovereignty Over Natural Resources, *International and Comparative Law Quarterly*, Vol. 13 (1964) 398

143 Please see P.J. O' Keefe (n. 20 above) 245

144 N. K. Kale, (n.18 above) 97

145 In 1968 and 1971 OPEC made resolutions XVI. 90 of 1968 and XXIV 135 of 1970

146 A. F. M. Maniruzzaman, 'the Issues of Resource Nationalism: Risk Engineering and Dispute Management in the Oil and Gas Industry', *Texas Journal of Oil, Gas and Energy Law* Vol. 5 (2009) 82

147 R. Vernon, 'International Investment and International Trade in the Product Cycle', *Quarterly Journal of Economics* 80 (1966) 190

advantage to the detriment of the host states. Oil companies have the technology, know-know and capital to extract the natural resources, rendering host states dependent on them to gain access to their own resources. This provides international energy investors with the option to invest and extract natural resources in any developing country free of obligation from an unchallenged position of control where the nationalisation risk does not exist.

In relation to obsolescing bargaining theory, fluctuations in oil prices have always played a defining role in the bargaining relationship between host governments and energy investors. When prices increase, petroleum companies are more disposed to expose themselves to risk. This lends host governments a considerable advantage in shaping the terms of the investment relationship.¹⁴⁹ Conversely, when oil prices decrease, negatively impacting on the potential profitability of energy projects this consequently diminishes the bargaining position of a host state in investment terms negotiation.¹⁵⁰ At the start of the 20th century, the petroleum industry witnessed a period in which oil companies enjoyed virtually unbridled control of the industry holding governments to ransom as possessors of the technology and capital needed to access their valuable resources. During this Golden Age for investment companies price-setting and price regulation of crude oil prices remained firmly under their control. Nevertheless, as mentioned above, during the 20th century, new players entered the game following the United Nation's declarations regarding Permanent Sovereignty over Natural Resources and OPEC resolutions. The following table gives an overview of how oil prices were affected by relative bargaining positions and political risks during the course of the 20th century. The table below illustrates the effect of oil prices on the investment environment.

Table 8 Effect of Oil Prices on the Investment Environment

Years	Crude Oil Prices	Balance of Power in Favour	Investment Environment
1950-73		Multinational Corporations	Open (Major Concession)

148 S. S. Andersen & A. Maya, *The Taming of the Shrewd: Small State Meets Multinational Oil Companies*, working paper (Bedriftsøkonomisk Institutt, 1990), 51.

149 O. Bayulgen, *Foreign Direct Investment, Oil Curse and Democratization: A Comparison of Azerbaijan and Russia, Business and Politics*, (Cambridge: Cambridge University Press: 2010)17-18

150 Ibid

1973-84		Governments	Restricted Expropriation/Nationalisation
1985-99		Multinational Corporations	Open (Deregulation/Privatisation)
1999-2008		Governments	Restricted (Creeping Expropriation)

Source: O. Bayulgen¹⁵¹

It is apparent that between 1985 and 1999, the interventionism trend of host states was largely attributed to deregulation and privatisation programs. In order to obtain a considerable share of investment capital, oil producing states found themselves engaged in fierce competition during those years.¹⁵² It goes without saying that multinational companies benefitted from competition between petroleum producing countries, because the competition led the states to relax formerly inhibitive rules around foreign investment into their countries and also led them to amend existing legislation on petroleum and introduce new laws. In this respect, the significant amendments of oil producing states to petroleum legislation and their new incentives effectively reduced the risk of expropriation/nationalisation in the 20th Century.

2.2 Political Risks in the New Era

In the years that spanned the close of the twentieth century and the dawn of the new Millennium, the energy industry found itself exposed to a range of new risk scenarios. The past century and the beginning of the new era ‘...have brought the issues of political risk into focus in a different global economic and political context than the earlier days of the international oil and gas industry’¹⁵³. In the 20th Century political risk associated with government interventionist policy was more common.¹⁵⁴ In the 21st Century some political risks such as expropriation and confiscation are no longer considered a major threat¹⁵⁵ to the energy investment sphere. In academic literature, Boulos best describes why the political risk of nationalisation is no longer a major problem in the energy industry.

151 O. Bayulgen (n.28 above) 19

152 O. Bayulgen (n.28 above) 20

153 *ibid*

154 D.W Conklin, ‘Analysing and Managing Country Risk’, *Ivey Business Journal*, 2002, 66(3) 36-41

155 S. Wilkin, ‘Managing Today’s Political Risks’, *The Risk Management Letter* 22, no.6 (2001)1-2 cited in M. Erkan (n.10 above) 49

According to the author, there are several factors that have lessened the risk of nationalisation in recent years: First, the key role of the World Bank, the International Monetary Fund (IMF), International Finance Cooperation (IFC) and other multi-national organisations has a tendency to considerably reduce a host state's free rein to nationalise. The second reason is that of privatisation. In a general sense, when nationalisation cases are considered, national oil companies nationalise the foreign oil companies' asset.¹⁵⁶ 'Privatisation changes the basis for nationalisation; the state transforms National Oil Companies into private enterprises to compete in the market for international oil and gas ventures and obviates the need to nationalise foreign companies'.¹⁵⁷ A final reason for the lessening of political risk of nationalization in today's world is that the objectives of nationalization have in the most part been achieved. The author goes on to state that in the OPEC takeover of production in the early 1970s, for example, host governments through nationalization, buy-in participation or government checks and controls have achieved their goal of gaining control over oil and gas resources. Even with State control, the emergence of privatization and market-oriented economies further neutralized the political risk of nationalization.¹⁵⁸

After careful consideration of Boulos's words, privatisation phenomena should be briefly described. Privatisation represents the decision of governments to dismantle financially inadequate state-owned companies and sell them to private investor(s). The main benefit of privatisation is to favour the survival of a former state-owned company or companies in the context of a competitive market. Therefore, the immediate benefit of privatisation to the state is to rid itself of its responsibility towards a failing company. However, the ensuing issues that arise from privatisation scenarios can be manifold and complex in nature. Several assumptions can be made regarding the privatisation of a state-run oil company. The first of these is that if the privatised state-owned company manages to turn itself around and become profitable it is exposed to the risk of enforced state nationalisation.¹⁵⁹

The second is that following privatisation of the state company, 'the acquiring company would seek to recoup their investment by increasing the prices...' ¹⁶⁰ In such a

156 A. J. Boulos (n.5 above) 5

157 Ibid

158 ibid

159 T.C. Tucker, 'Investment Projects Abroad', In Canadian Counsel on International Law, Extra-Territoriality and Foreign Investment, Proceeding, 12th Annual Conference, Ontario, (1983) 110-111

160 C. A. Smoots & F. Sellner 'Long Term Agreements in Energy and Water in Developing and Transition Countries', *Transitional Dispute Management Online Journal* 1 (2004)1, available at: <www.transitional-dispute-management.com> January, 2013

scenario, what would the states reaction be? In literature, Smoots and Sellner best sum up this hypothetical situation: ‘...no contract and no host country’s promises can save a privatisation’.¹⁶¹ The authors add ‘If the privatising state is extremely poor, no matter what promises were made, increased price will either not be permitted or will not be paid to the acquiring company’.¹⁶²

In order to provide a 21st century context to the risk of expropriation and/or nationalisation, the interview participant views in this study and recent survey on political risks should be drawn upon. According to one of the interviewees, ‘there are a number of political risks such as civil war, direct or indirect expropriation and nationalisation that should rightly be regarded as the major political risks that foreign investors might face over the course of their energy projects. However it is difficult to state categorically that expropriation/nationalisation risk is very common in the 21st Century’.¹⁶³ He goes further to state that ‘it is true that it is not very common to see civil wars, direct or indirect expropriation or nationalisation in the modern developed world. Such risks usually only appear in natural resource rich developing states, such as Bolivia, Venezuela, Ecuador, Kazakhstan or other similar countries which are ruled by dictatorships’.¹⁶⁴

Another respondent disagrees with the previous participant and states that the phenomena of expropriation and nationalisation continue to pose a danger for investors¹⁶⁵. The legitimacy of the latter respondent’s view is validated by the recent expropriation case in Argentina. In April 2012, the president of Argentina, Cristina Fernandez, announced that the government had expropriated the Spanish Oil Company, Repsol’s subsidiary YPF. Fernandez claimed that YPS’s expropriation was aimed at ‘recovering sovereignty’ over natural sources. Having furnished this recent example, the same interviewee went on to explore whether these actions are taken by governments and used as a weapon against energy investors with the real purpose of protecting sovereignty over natural sources or not. According to the interviewee, ‘...the YPF Company recently uncovered precious natural gas sources in Argentina. Until this exploration, the company had always been regarded as an inconsequential company by the Argentinean government. Following the discovery of invaluable natural resources, the company’s value soared and, as a result, it was expropriated by the government.

161 Ibid

162 Ibid

163 Interviewee no.1 Anonymity Guaranteed, 8 May 2012

164 Ibid

165 Interviewee no. 5 Anonymity Guaranteed, 11 May 2012

Expropriation of a foreign company by the state meant that any profit would be absorbed by the state.¹⁶⁶

In light of the interviewees' views, it can be asserted that, compared to the previous century, the risk of expropriation is in relative decline¹⁶⁷. However, this should not be taken to be understood that expropriation and nationalisation risks do not pose a threat to international energy investors. It is evident that since the beginning of the new century, the sector has been subject to a "silent disruption".¹⁶⁸ For instance, in 2004, Yukos, which is one of the principal and most successful Russian oil companies, was re-nationalised.

In the same manner, in 2006, Bolivia's President Evo Morales announced that Bolivia's oil and gas sector would be nationalised.¹⁶⁹ In 2007, Kazakhstan's parliament revised the Law on Subsurface and Use, granting governments the unilateral right to halt pending review subsoil use contracts if they were deemed to jeopardise the country's national or economic security.¹⁷⁰ In 2010, Venezuela announced its intention to nationalise oil drilling rigs belonging to the U.S. Company Helmerich & Payne.¹⁷¹ Finally, in April, 2012, Argentinean congress nationalised the country's biggest oil company, YPF.¹⁷² In order to identify the most hazardous risk in the energy industry and gauge the level of importance of each political risk, a survey was conducted by Erkan. In the author's research, each participant was required to rate the level of risk of divergent destabilising events from 1 to 5. 1 representing the most significant and 5 is the least significant political risk.

Table 9 Main Political Risks to International Petroleum Projects

166 Ibid

167 K.M. Quinley, 'Managing the Political Risk' *The Risk Report*, volume XXIV, no.7. (March, 2002) 2

168 L. Pugliaresi, 'Silent Disruption Limiting Oil Supply', *Oil and Gas Journal*, July 7 (2008) 24 available at: <<http://www.ogj.com>>February 2013

169 R. Kennedy, 'Privatization and Nationalization in Oil and Gas: Foreign Policy and Oil Contracts in Kazakhstan and Azerbaijan', (2011) 3-4 available at: <http://www.polsci.uh.edu/faculty/rkennedy/WorkingPapers_files/NUPIPrcjct2011p.pdf> February, 2013

170 R. Kennedy (n.48 above) 4

171 Ibid

172 Fernandez justifies the renationalization of YPF - which was privatized in the 1990s after decades as a state-owned company available at: <<http://www.reuters.com/article/2012/05/04/us-argentina-ypf-idUSBRE8421GV20120504>>February 2013

<i>Types of Political Risks</i>	<i>Categories (% Share)</i>				
	1	2	3	4	5
War	18.56	11.34	16.49	24.74	28.87
Nationalisation	25.96	28.85	28.85	11.54	4.81
Direct Expropriation	15.69	30.39	30.39	21.57	1.96
Indirect Expropriation	50.91	23.64	16.36	7.27	1.82
Unilateral Change of Contractual Terms	30.56	36.11	19.44	7.41	6.48
Currency Transfer	4.95	16.83	33.66	26.73	17.82
Sabotage	7.37	8.42	20.00	34.74	29.47
Kidnapping	5.10	9.18	20.41	24.49	40.42

*Source M. Erkan*¹⁷³

It is immediately apparent that indirect expropriation was considered by participants to be the most significant destabilising contemporary political risk with over 50% share¹⁷⁴. Indirect expropriation is followed by unilateral change of contractual terms (30.56%) and nationalisation 25.96%, with war, perhaps surprisingly, constituting only 18.56.¹⁷⁵ When considered outside of a specific geographic context, or, at least within the framework of their own experience, the participants considered indirect expropriation to be the most menacing of all risks. Nevertheless, according to the author, ‘if we focus on specific countries such as Nigeria or Iraq, kidnapping or sabotage or war could be described as the dominant political risks’.¹⁷⁶

3. Direct Expropriation

It may be appropriate to focus on the term of ‘taking’ as a key to unlocking the topic itself. Although it may be the case that international law was clear in the past about the outright taking of property the phenomenon that the term describes has now become more complex and multi-faceted and this has not been reflected in its

173 M. Erkan, (n.10 above) 50. In the author’s book, 1 is for the most important risk and 5 is the least important risk.

174 *ibid*

175 *Ibid*

176 *Ibid*

definitions in literature. Providing this definition is a hurdle that needs to be overcome before embarking on a broader analysis of the concept and cases of expropriation. To this end, the question of what constitutes ‘taking’ must be answered.¹⁷⁷ The terms: expropriation, nationalisation and confiscation are used interchangeably and often with reference to quite different forms of government intervention of a private property. It will be instrumental to establish clear distinctions between these terminologies. According to Sornarajah, ‘confiscation is a capricious term for taking the property by the ruler or ruling the coterie of the state for personal gain’.¹⁷⁸ The author extends the definition to assert that such taking can be seen primarily in countries ruled by dictatorships and oligarchies¹⁷⁹. The term confiscation is also used to define ‘the state taking of private property where such a measure is penal as a part of the sanction to be visited on the owner because they violate required regulatory or criminal standards.’¹⁸⁰ Notably, confiscatory taking is motivated by caprice; therefore, it should be recognised as unlawful taking¹⁸¹ and, as a consequence of being unlawful, the taking does not trigger the payment of compensation.

Expropriation and nationalisation are used to define the unconcealed host government direct taking of private wealth.¹⁸² In a general sense, if the property is taken by the host state and compensation is paid to foreign investors, the taking is regarded as expropriation. With regard to this, The Iran-U.S. Claims Tribunal defined the expropriation phenomenon in the renowned petroleum case of *AMOCO International Finance Corporation vs. The Government of the Islamic Republic of Iran*, as the ‘compulsory transfer of property rights.’¹⁸³

177M. Sornarajah, *The International Law on Foreign Investment*, (Cambridge, Cambridge University Press: 2010) 365

178 Ibid

179 Ibid

180 World Investment Report, *FDI Policies for Development: National and International Perspectives*, (New York, Geneva, United Nations Publication: 2003), 112 (Hereinafter ‘UNCTAD 2003’) available at <http://unctad.org/en/Docs/wir2003_en.pdf>May, 2011

181 M. Sornarajah, (n. 56. above) 365

182 S. C. Wallace, *The Multinational Enterprise and Legal Control: Host State Sovereignty in an Era of Economic Globalisation* (The Hague: Kluwer Law International, 2002) 980. Notably, the author meant by wealth is private property and other related acquired rights.

183 15 Iran-US CTR. 189, at 222-223, Award No. 310-56-3 (14 July, 1987)

In practical terms, this ‘taking’ occurs when a host government seizes a company’s development rights or facilities and its produce for the host country’s own use, particularly for the purpose of the host country’s national interest.¹⁸⁴ In this context, nationalisation can also be identified as a risk: nationalisation is regarded as the ‘evil twin’ of expropriation and manifests itself when the host state expropriates and hands the property or development rights over to a national company.¹⁸⁵ In other words, it can be said that nationalisation is a large scale ‘taking’. Admittedly, the definition of nationalisation and expropriation is complex and can be easily confused. Therefore, The Iran-U.S. Claims Tribunal in the AMOCO case defined nationalisation as: ‘...the transfer of an economic activity from private ownership to the public sector. It is realised through expropriation of the assets of an enterprise or of its capital stock, with a view to maintaining such enterprise as a going concern under the state control’.¹⁸⁶

Furthermore, with regard to the definition, several authors in the field have also attempted to isolate the two notions. According to Domke, ‘The term ‘expropriation’, though usually applied to measures taken in individual cases, is sometimes used in instances where ‘nationalisation’ as a measure of general change in the state’s economic and social life would be more appropriate’.¹⁸⁷ According to Ingram’s distinction, ‘The most meaningful distinction is that expropriation refers to the taking of one or several properties within a single area of economic activity, whereas nationalisation refers to the government’s taking of all properties within the area’.¹⁸⁸ Hobber agrees with Ingram’s distinction and goes on to affirm that the difference between nationalisation and expropriation is defined by scope and extension, as Hobber argues that the nature of the two is essentially the same.¹⁸⁹ Direct expropriation or nationalisation was both actions taken frequently by host governments in the 20th Century, and have more recently given way to indirect expropriation.¹⁹⁰

3.1 The right to expropriate versus property ownership

184 S.W. Anderson, ‘Expropriation, Nationalisation, Risk Management’, Davis Graham & Stubbs, LLP, A Report by Touch Briefing (2008) 20

185 Ibid

186 The Iran-U.S (n. 62 above)

187 M. Domke, ‘Foreign Nationalisations: Some Aspects of Contemporary International Law’, *AJIL*, vol.55 (1961), 588

188 G.M. Ingram, (n.11 above) Vii

189 K. Hobber, ‘Investment Arbitration in Eastern Europe : Recent Cases on Expropriation’, *Am.Rev.Int’l Arb.*14 (2003) 377,381

190 S. Ripinskyi & K. Williams, *Damages in International Investment Law* ,(British Institute of International and Comparative Law 2008) 64

There is no doubt that the right to own property is one of the absolute rights that mankind in most modern civilisations lays claim to. Throughout history a wide range of philosophers and scholars, from divergent backgrounds and standpoints, which supported the idea of private ownership, have emphasised this indispensable right in their manifestos. For instance, John Locke, an English philosopher is a distinguished example from this school of philosophers. Part of his manifesto deemed the protection of individual property rights to be the central determination of political society. To this end, it is significant to inquire whether a sovereign state has the right to expropriate property within its territory by applying its own laws or not.

In the case of expropriation, one of the respondents asserted that ‘expropriation is a legal instrument in law systems; this right derives from its sovereignty.’¹⁹¹ If this right is to be seen as a direct expression of sovereignty, it can be assumed that the owner’s consent is not required and that a sovereign power has the right to expropriate the private owner’s property. Another significant consideration to be taken into account is that of the nationality of the owner. In a broad sense, the expropriation right of states is recognised and articulated in international law regardless of the patrimonial rights involved or of the nationality of the owner in whom they are vested.¹⁹² It should be noted that the majority of authorities support the idea of a state’s obligation to pay full compensation to its own citizens and foreign individuals in their territory in the case of individual and general expropriation cases.

In summary, all evidence suggests that a sovereign state can lawfully exercise its right to take property irrespective of the nationality of its owners and without their consent. Nevertheless, if the property and its ownership rights belonged to a foreign investor and the relationship between the investor and the host state were based on an investment contract, would a state still be able to expropriate the foreign investor’s property? In order to answer this question and add breadth to this discussion, two important principles should be mentioned. The first is the *pacta sunt servanda* (sanctity of contracts) principle. The concept of *pacta sunt servanda* is accepted as a positive norm in general international law.¹⁹³ With regard to this principle, states cannot expropriate alien property without obtaining consent from the aforesaid alien investor.¹⁹⁴ Consequently, the state ought to respect this fundamental principle when exercising the right to expropriate.¹⁹⁵

191 Interview no.7 with Lawyer, 6 June 2012

192 G. Amador & L.B. Sohn and R. R. Baxter, *Recent Codification of the Law of State Responsibility for Injuries to Aliens*, (USA: Kluwer Academic Publishers, 1974) 46

193 J. L .Kunz, ‘The Meaning and the Range of the Norm of the *Pacta Sunt Servanda*,’ *A.J.I.L.* 39 (1945) 180 cited in A. F. M Manirruzzaman, ‘State Contracts with Aliens: The Question of Unilateral Change by the State in Contemporary International Law’, *Journal of International Arbitration* Vol.9 no 4, (1992) 142

194

In addition to the implications of this obligation, is the inclusion of contractual clauses in contracts, particularly stabilisation, or other relevant contractual clauses. It is worth mentioning that the absolute application to *pacta sunt servanda* in international investment contracts between states and aliens has given rise to a serious legal debate among both scholars and practitioners.¹⁹⁶ Before moving on, it would be appropriate to highlight the issue of whether or not a state can limit its sovereign rights via a contract. This subject should be discussed briefly, as a precursor to a more in-depth discussion in chapter 4, as part of an examination of the validity of stabilisation clauses. If a state is free to bind itself by a treaty with another sovereign state, then can it fetter itself with similar restrictions via a contract with an investor?¹⁹⁷ The basis of this notion is that the insertion of specific contractual clauses in an investment contract, such as stabilisation clauses or arbitration clauses has an effect similar to that of internationalising the contract¹⁹⁸.

According to this theory, if the contract between a state and an alien company is internationalised, the commitment resides within an external system which has been regarded as the transnational law of business, a general principle of law and *lex mercatoria*.¹⁹⁹ In this respect, it can be said that inserting such contractual devices in an investment contract with clauses to limit the state's ability to take the property, by extension, means that that same state is no longer able to expropriate the property.²⁰⁰ Other scholars disagree with the notion that a state can bind itself in this way and focus instead on the principle of state sovereignty and the succession of law norm.²⁰¹ According to this principle, 'the legislative capacity of lawmakers cannot be bound, nor can be executed, nor can public powers of the government be fettered by a contract with a private individual or corporation, i.e., no parliament can bind its successor through a contract mechanism.'²⁰² Nevertheless, it has been provided that

195 *Texaco vs. Libya Award* 53 ILR (1979), para. 68

196 A.F. M. Manirruzzaman (n.72 above) 141

197 E. Paasivirta, Internationalization and stabilization of Contracts versus State Sovereignty, *British Year Book, Int. L.*, 60 (1989) 315

198 G. Handi, *Year Book of International Environmental Law*, Vol. 17, (Oxford, OUP: 2006) 155

199 Ibid

200 M. Erkan (n.10 above) 65

201 G. Handi (n.77 above)

202 J. Otto & J. Cordes, *The Regulation of Mineral Enterprises, A Global Perspective Economics, Law and Policy*, (Westminster, Colorado, Rocky Mountain Foundation : 2002) IV-22 cited in G. Handi, (n. 77 above)

expropriation is a natural right which derives from sovereignty and a sovereign power can exercise this right in accordance with their law and as long as they meet certain requirements of international customary law. This notional right to expropriate prompts the question: why would a state need to expropriate property?

The answer is simple, to provide better living standards to its citizens and accelerate its development. While a state is striving to reach its targets and sustain its development, it should not disregard the property ownership of alien individuals and their vested possession. Consequently, sovereign rights are not everlasting or unlimited; when contracts are entered into in the international sphere, specific constraints are a must to maintain the mutual trust between states and foreign individuals for the sake of protecting property rights. As mentioned before, there are certain requirements under the umbrella of international law. An analysis of legal requirements is essential to understand not only direct expropriation, but also significant to comprehend indirect expropriation; therefore, the following section will focus on basic liabilities for sovereign states for lawful taking under international law.

3.2 Legal Requirements for lawful taking under the International law

In the previous section, it was established that a sovereign power has the right to take the property of a foreign individual, as an expression of its permanent sovereignty over its natural resources. However, this should not be taken to mean that the state has unlimited rights to take property. States are, nevertheless, subject to certain restrictions under international law. In order to regard an expropriation as lawful, the state must meet certain criteria under international law.²⁰³ These requirements are referred to as public purpose, non-discriminatory, due process of law and prompt, adequate and full compensation. Even though there is some discussion with regard to public purpose, due process of law and the formula compensation, relating to the boundaries of such conditions among scholars, these requirements have been broadly addressed by multilateral investment treaties (MITs),²⁰⁴ bilateral investment treaties (BITs),²⁰⁵ and some investment agreements.²⁰⁶

In addition, these requirements were also articulated in the World Bank Guidelines on the Treatment of Foreign Direct Investment²⁰⁷ and the United Nations General Assembly Resolutions (UNGAR).²⁰⁸ The following sub-sections outline the basic requirements for expropriation.

a) *Public Interest / Purpose*

As stated above, an expropriation may only be made in the public interest. The necessity of public purpose in order to legitimise a taking has long been considered part of customary international law.²⁰⁹ This requirement was first formulated by Grotius²¹⁰

203 S. P. Subedi, *International Investment Law: Reconciling Policy and Principle* (Oxford: Hart Publishing, 2008) 102

‘as a limit on the sovereign right of eminent domain’.²¹¹ The purpose of taking can be based of various reasons. For example, expropriating government may wish to build up new roads, hospitals or schools or want to supply electricity, water or sewerage suburb areas. In the same vein, the government may also want to expropriate foreign investor’s property to protect its cultural heritage. According to Salacuse, the concept of public interest is very broad; therefore, it cannot be subject to a precise definition.²¹² Although there is no specific definition of public interest under international law, it may be claimed that any ‘taking’ by a host government is done in the public interest, such as developing the national economy, executing its development plans or protecting foreign currency reserves.²¹³ In other words, the term public purpose is broadly understood to mean that an expropriation measure should be in the interests of public utility, security,

204 Significant and influential examples of MITs that incorporate such requirements should be pointed: The first example of MITs is that the European Energy Charter Treaty (ECT). Article 13(1) (a) of this treaty: ‘Investments of investors of a contracting party in the area of any other contracting party shall not be nationalised, expropriated except where such expropriation is: a) For a public which is public interest; b) Not discriminatory; c) Carried out under the due process of law; and d) Accompanied by the payment of prompt, adequate and effective compensation’. Second significant example of MIT, which has the same approach as ECT, is North American Free Trade Agreement (NAFTA). The agreement entered into force, January 1, 1994, reprinted in 32 ILM 289 and 605 (1993). Art. 1110(1) (a) of this Agreement: No Party may directly or indirectly nationalize or expropriate an investment agreement of an investor of another Party in its territory or take a measure tantamount to nationalization or expropriation of such an investment (‘expropriation’) except: a) For a public purpose; b) On a non-discriminatory basis; c) In accordance with due process of law; d) On payment of compensation. Art. 1105 (1) [providing for minimum standards of treatment, including fair and equitable treatment and full protection and security].

205 Lawful taking requirements are also explained in a number of bilateral investment treaties (BITs). Please see 2004 U.S Model BIT. Article 6(1) of the 2004 Model BIT states: Neither Party may expropriate or nationalize a covered investment either directly or indirectly through measures equivalent to expropriation or nationalization (‘expropriation’), except: a) For a public purpose b) in a non-discriminatory manner; c) On payment of prompt, adequate, and effective compensation; and d) In accordance with due process of law and Art.5 [Minimum Standard of treatment] (1) through (3).

206 With regard to basic requirements in BITs and MITs, similar conditions can also be found in some international agreements. For instance, Baku-Tbilisi-Ceyhan (BTC) Petroleum Pipeline Agreement. According Article 9.4 of this agreement: ‘ in the event that the State Authorities should ever carry out any act of Expropriation is: (i) for a public purpose which is an overriding public purpose; (ii) not discriminatory; (iii) carried out under the due process of law; and (iv) accompanied by the payment of compensation as provided.’.

207 The World Bank: Guidelines on the Treatment of Foreign Direct Investment, (1992) 31 I.L.M.1363, fourth Guideline.

national interest or the general welfare of society rather than individual or private gain.²¹⁴

Expropriation must truly target social and /or economic improvements and more importantly national interest must prevail over individual or private interest.²¹⁵ It seems reasonable at this point to pose the question: can a state genuinely determine what is in the public interest? In general, the tendency of authors in the literature is to deem that the determination of what is in the public interest broadly lies within the discretion of the expropriating government. In the case of public purpose, it can be said that verifying a breach of public purpose requirement is not an easy task.²¹⁶ Baade points out this issue. According to the author, 'it seems perfectly logical to require that nationalisation be in the public interest. The question is, of course, whose public interest, as determined by whom. Since international law quite patently leaves all sovereign states free to choose their own economic and social systems, the answer can be only that the test has

208 UNGAR No. 1803 Of 1962 on Permanent Sovereignty over Natural Resources which provide that nationalisation should be for purposes of public utility, security and national interest. However, it should be underlined that basic requirement do not exist in the Charter on Economic Rights and Duties of States (CERDS) UN Resolution 3281 of 1974.

209 P. Malanccuk, *Akehurst's Modern Introduction to International Law*, 7th edn (New York, Routledge Publishing: 1997) 235; please also see: K. Hober, *Investment Arbitration in Eastern Europe: In Search of a Definition of Expropriation* (New York, Juris Publishing: 2007) 38

210M. Sornarajah, *The Pursuit of Nationalized Property* (The Hague, Kluwer Academic Publishers: 1986) 174

211 Ibid

212 J. W. Salacuse, *The Law of Investment Treaties*, (Oxford, Oxford University Press: 2009) 57

213 Ibid.

214 A. Akinsanya, *The Expropriation of Multinational Property the Third World* (New York: Praeger Publishers, 1980) 20

215 S. C. Wallace, *The Multinational Enterprise*(n.61 above) 983

216 N. Rubbins & N. S. Kinsella, *International Investment, Political Risk and Dispute Resolution: A Practitioner's Guide* (New York: Oceania Publication, 2005) 177; see also M. Erkan (n.10 above) 72

to be the public interest of the taking state, as conclusively determined by it.’²¹⁷ In this regard, it should be noted that ‘at the very least, there must be some demonstrable public interest and the determination must be made in good faith’.²¹⁸

The scope of the public purpose requirement and its measure has been endorsed and identified by international tribunals, such as in the *Aminoil* and *Amoco* cases. Aminoil is an American independent oil company, which operated its business activities in Kuwait, one of the member states of OPEC. The company feared that its business operations and activities would be terminated and the company would be ousted by the application of the public purpose requirement formula. As a result, the company was forced to renegotiate with the Kuwaiti government. Aminoil and the Kuwaiti government failed to reach an agreement regarding future payments. Following this, the parties entered into a discussion around the possibility of nationalising the Aminoil Company’s assets. Nevertheless, this second attempt at negotiations also ended in failure, at which point the Kuwaiti government performed unilaterally by promulgating Decree Law no. 124 and terminating the concession contract between the parties. After the termination of the concession contract, the government of Kuwait nationalised the company’s assets and provided that fair compensation ought to be paid as a result of the taking.

The dispute between the parties was over whether Decree Law No. 124 of 1977 was a valid act of nationalisation or not. While the government of Kuwait argued that this was a valid act of nationalisation, the Aminoil Company claimed that it was not. In relation to this dispute, several objections were also submitted by the company to convince the tribunal that nationalisation was invalid. According to the company, the nationalisation was illegal as the taking was not made by the Kuwait government for a *bona fide* public purpose.²¹⁹ Secondly, the company also claimed that the government of Kuwait issued Decree Law with the intention of terminating its contractual relation, and nationalised the company.²²⁰ Ultimately, the tribunal rejected the company’s objection with regard to Decree law No. 124 and stated that the law implemented by the Kuwait government was imposed with the goal of fulfilling its national program and was therefore justifiably motivated by public purpose.²²¹

217 H. W. Baade, ‘Permanent Sovereignty over Natural Resources’, in *Essays on Expropriations* eds. R. S. Miller & R.J Stanger (Ohio: Ohio State University Press, 1967), 23 cited in M. Erkan (n.10 above) 71

218 A. Newcombe & L. Paradell, *Law and Practise of Investment Treaties: Standards of Treatment.*, (The Netherlands: Kluwer Law International, 2009) 372

219 *American Independent Oil Company vs. Kuwait* Award, 24 March, 1982 21 ILM 976, para. 85, 1019 (Hereinafter Aminoil Arbitration)

220 Aminoil Arbitration, 24 ILM (1982) 976, para., 106, 1025

221 Aminoil Arbitration 24 ILM (1982) 976, para., 85 & 86, 1019

By making reference to the resolution in the *Aminoil* Case, the tribunal also addressed the scope and measure of public purpose in the *Amoco* Case. The tribunal stated that ‘a precise definition of the ‘public purpose’ for which an expropriation may be lawfully decided has neither been agreed upon in international law nor even suggested’.²²² The tribunal also highlighted that states have complete discretion in determining their public interest.²²³ The tribunal went on to point out that ‘an expropriation, the only purpose of which would have been to avoid the contractual obligation of the state or of an entity controlled by it, could not, nevertheless be considered as lawful under international law.’²²⁴ It is apparent that through this statement the tribunal wished to emphasise that the taking should not be based on avoiding contractual commitments; as in this case the expropriation could be considered to be an unlawful taking and regarded as an unlawful expropriation under the international law.

The lessons that can be learned from the aforementioned cases are that states are free to decide whether public interest justifies an expropriation. However, it has also been emphasised that an expropriation should not be executed as a means to avoiding contractual obligation. Finally, a host state has the right to expropriate an alien investor’s property and it is admissible that there may be financial implications in an expropriation and that as a consequence of the expropriation the host state may benefit financially;²²⁵ however the purpose of the taking should not be based on specifically political reasons²²⁶.

b) ***Non-Discrimination***

Non-discrimination requirement is the second condition of lawful expropriation in the context of international law. What constitutes the concept of non-discrimination? There are several components for this, among which are nationality, race, ethnicity and religion. Notably, if the measure of the host state is based on race discrimination, the discrimination violates the *jus cogens* norm under international law, automatically rendering the taking illegal²²⁷. If a state’s measures are motivated by one of these reasons, then the taking is regarded as an unlawful expropriation and therefore, contrary

222 *Amoco Int’l Fin. Corporation Vs. Government of the Islamic Republic of Iran*, 15 Iran-U.S.C.T.R. 189, 233

223 *ibid*

224 *Ibid*, para., 145

225 Z. A. Al-Qurashi (n. above 2) 106

226 H.V. Houtte, *The Law of International Trade*, 2nd edn (London, Sweet &Maxell, 2002) 249

227 M. Sornarajah, (n.56 above) 409

to the rule of international law. In addition to this, a host state's treatment of foreign investors should be equivalent in manner to its treatment of investors from the same state.

The principle of non-discrimination requirement is recognised as reflecting customary international law and, has found its way into numerous multilateral²²⁸ and bilateral²²⁹ treaties and arbitral decisions²³⁰. Notably, as far as BITs and MITs are concerned, many of them state that expropriation measures must not be discriminatory. However, although they make this provision in principle, they do not define or exemplify what constitutes the discriminatory actions of host states. In this respect, it may be observed that treaties would benefit from being more explicitly and consistently worded to facilitate interpretation and render their terms more easily comparable.

In the Third Restatement of the Foreign Relations Law of the United States, the American Law Institute has summarized:

Discrimination implies unreasonable distinction. Takings that invidiously single out property of persons of a particular nationality would be unreasonable; classifications, even if based on nationality, that are rationally related to the State's security or economic policies might not be unreasonable.²³¹

With regard to this statement, in doctrine phenomena considered to be 'unreasonable' are also discussed by several legal scholars. According to Manirruzzaman, the existence of discrimination ought to be determined by assessing the

228 For Instance, see North American Free Trade Agreement (NAFTA) Art. 1110 (1) (b) and the Energy Charter Treaty (ETC) Art. 13 (1) (b)

229 Most BITs included that provisions to the effect that expropriations shall be on a "non-discriminatory manner" please see Art. 5 (1) of the United Kingdom model BIT – Turkey (1991); see also Art.5(1) of the United Kingdom-Czechoslovakia (1990)

230 There is a number of case decisions held by Arbitral Tribunals. For instance, 'in the *BP vs. Libya* case, a ground for holding of the asset of British oil company illegal was that it was "discriminatory in character", 53 I.L.R.297, 329 (1979). In the *Liamco Award*, the arbitrator held that "purely discriminatory nationalization is illegal and wrongful." *Libya vs Libyan Am. Oil Co.*, 20 I.L.M. 1, 20 58 (1981); see also The Norwegian Ship-owners Claims, 1 R.I.A.A. 307, 309 (1992) (Stating that 'the United States are responsible for having thus made a discriminating use of the power of eminent domain towards citizen of a friendly nation, and they are liable for the damaging action of their officials and agent towards these citizens of the Kingdom of Norway'), cited in A.F.M Manirruzzaman, 'Expropriation of Alien Property and The Principle of Non-Discrimination in International Law of Foreign Investment: An Overview', *J. Transnat'l & Pol'y* 8 (1998), 59

231 Restatement (Third) of the Foreign Relations Law of The United States, 712, com (f) 200

individual particular circumstances of each precise case²³². He concludes: ‘thus, the legal notion of discrimination is more contextual than hypothetical’²³³. Brownlie suggests that the concept ‘calls for more sophisticated treatment in order to identify unreasonable (or material) discrimination as distinct from the different treatment of non-comparable situations’.²³⁴ What becomes apparent is that it is no small matter to determine whether the actions of a government are discriminatory or non-discriminatory in many cases, given their complexity. Perhaps, in this case, an action test is needed.²³⁵ Brownie defines the test as a measurement of a government intention²³⁶.

Arguably, Manurrizaman’s assessment seems the most rational and reasonable approach. According to that author:

...the principle of non-discrimination in both customary and conventional international law must be understood in the context to which it is applied. The principle has no blanket application in disregard of the factual circumstances concerned; in applying it, the judge or arbitrator must weigh cautiously all the relevant circumstances. It remains to be seen whether a future Multilateral Agreement on Investment will clarify and settle the many issues arising in the context of non-discrimination.²³⁷

c) ***Due process of Law***

The requirement of due process of law means that expropriation must be in accordance with appropriate legal procedures. Due process of law embodies both substantive and procedural elements.²³⁸ For instance, if a foreign investor’s property is taken by a host state, the measures taken must be free from arbitrariness, and safeguards and remedies at an administrative level and through the judiciary system must be viewed holistically.²³⁹ Furthermore, nearly all BITs²⁴⁰ and MITS²⁴¹ require due process of law. Nevertheless, it may be assumed that where the wording of due process of law is

232 A. F. M. Manirruzzaman, (n.108 above) 67

233 Ibid

234 I. Brownlie, (n 12 above) 531

235 M. Erkan (n.10 above) 73-74

236 I. Brownie, (n. above 12) 515

237 A. F. M. Manirruzzaman (n.108) 67

238 I. F. I., Shihata, *Legal Treatment of Foreign Investment: The World Bank Guidance*, (Dordrecht, Kluwer Academic Publishers, 1993) 299

239 Ibid

integrated in a BIT, its use is not clear and it is therefore distinguishable from what might be the case in internal law.²⁴²

d) ***Compensation***

As far as the business world is concerned, there is no doubt that the prospect for an investor of having its property expropriated by a host state and the profit loss entailed is a bleak one. It is probable that, if a survey were conducted of energy investors of all nationalities, regarding the perceived necessity of compensation, the vast majority would declare themselves in favour of the compensation principle which obliges states to pay adequate compensation for the injury caused.²⁴³

However, in reality, compensation for expropriation is one of the most controversial subjects in international law.²⁴⁴

Moreover, there is a discrepancy between lawful expropriation and unlawful taking. As mentioned above, the traditional view is that compensation should be paid for the expropriated property of a foreign investor. The sovereign state must pay this in accordance with general international law.²⁴⁵ If a state wishes to expropriate an alien property lawfully, compensation is payable to the value of the property taken. However, for an unlawful expropriation, the state must compensate for the damages that result

240 R. Dolzer and M. Stevens, *The International Centre for Settlement of Investment disputes: Bilateral Investment Treaties* (Netherlands, Kluwer Publishers: 1995) 106

241 Please see Art. 13(1) (c) of ECT and Art. 1110 (1) (a) of the NAFTA

242 R. Dolzer & M. Stevens, (n.119 above) 106

243 J. W. Salacuse, (n.91 above) 58. It should be noted that there are some exemptions with regard to compensation for expropriation. Professor Brownlie highlights these exceptions in his words: ‘ The most widely accepted of which exception are as follows: under treaty provisions; as a legitimate exercise of police power, including measures of defence against external threats ; confiscation as a penalty for crimes; seizure by way of taxation or other fiscal measures; loss caused indirectly by health and planning legislation and concomitant restrictions on the use of property; destruction of property of neutrals as a consequence of military operation, and the taking of enemy property as part payment of reparation for the consequences of an illegal war.’ Please see I. Brownlie, (n.12 above) 511-512

244 M. Sornarajah, (n.56 above) 413

245 G. Sacerdoti, ‘The Source and Evolution of International Legal Protection for Infrastructure Investments confronting Political and Regulatory Risks’, *CEPMLP Online Journal* Vol. 5 Article 7 (2000), available at: <<http://www.dundee.ac.uk/cepmlp/journal/html/vol5/vol5-7.html>> February 2013

from the taking of the property. It is conceivable that a sovereign state might venture to take property unlawfully on the assumption that the compensation payable will be equivalent to that of the value of the property. In such scenarios, damage in fact includes not merely *damnum emergens* (value of the property) and *lucrum cessans* (lost profit) as a result of the taking, but it also covers consequential damage that is directly related to the taking of the property²⁴⁶, i.e. the future earnings.

There is a disagreement between states on the subject of the appropriate standard of compensation for expropriation²⁴⁷. There are two competing norms views with regard to this. One is that formulation of ‘prompt, adequate and effective’ compensation view which is also called the ‘Hull Formula.’²⁴⁸ The Hull formula has been referred to in numerous bilateral and multilateral investment agreements and couched in a variety of terms.²⁴⁹ Reference has been made variously to ‘fair market value’, ‘genuine value’ ‘market value’ of the expropriated investment.²⁵⁰ Many western states and several arbitral tribunals have adopted and promoted the theory that the expropriation of foreign investor’s private property is lawful if ‘prompt, adequate and effective compensation’ is supplied to the investor²⁵¹. The second theory is that of ‘appropriate compensation’ or ‘equivalent compensation’ which means that a state ought to pay the full value, or the appropriate market value, of the expropriated property to the alien investor. The term of ‘appropriate compensation’ or ‘equivalent compensation’ view has been generally approved in declaration of the United Nations General Assembly Resolution 1803.²⁵² With regard to Article 4 of the Resolution, expropriation, nationalisation, or requisition ought to be based on the grounds of public utility, security or national interest and also requires that the host state should provide ‘appropriate compensation’ in accordance with both municipal and international law.²⁵³ Similarly, Article 2 of Charter Economic Rights and Duties of States (CERDS)²⁵⁴ include the term ‘appropriate compensation’.

246 R. St. J. MacDonald, *Essays in Honour of Wang Tieya*, (Dordrecht, The Netherlands, Kluwer Academic Publisher: 1994) 59

247 J. W. Salacuse (n.91 above) 58

248 ‘Hull Formula’ which was used by Secretary of State Cordell Hull, over the course of Mexican Expropriation. Please see R. Dolzer, ‘New Foundations of the Law of Expropriation of Alien Property’, 75 *AJIL* (1981) 558-559

249 A. K. Bjorklund & I. A. Laird and S. Ripinsky, *Investment Treaty law: Remedies International Law Emerging Jurisprudence of Investment Law: Current Issues III* (London: The British Institute of International and Comparative Law, 2009) 10

250 Ibid

251 I. Brownlie, (n.12 above) 509

252 Article 4 of the United Nations General Assembly Resolution 1803

Moreover, it would not be unfair to claim that this is a breakthrough in terms of the support it affords to the protection of the sovereignty of developing states.

Furthermore, the representatives of several European countries and that of the U.S. representative, equated 'appropriate' compensation to the serving of 'prompt, adequate and effective' compensation.²⁵⁵ However, the perception of this concept held by their counterparts from developing states differed vastly. Developing states were firmly of the opinion that compensation should be in accordance with the national treatment principle satisfied by the standards of 'appropriate compensation'.²⁵⁶ And thus an ideological battle between developing and developed states emerges, founded on the very differences that define them. On the one side, developing states wish to determine the measure of compensation by seeking recourse to their own legal systems to resolve legal struggles they engage in with western investors. However, on the other hand, industrialised states with most control over the international economy seek protection from the international legislation they help define. Consequently, the debate continues on the compensation issue. Perhaps a national welcoming plan for investors may be the only solution, as developing states need to be able to attract capital.

Valuation methods of Investor compensation

The valuation methods are used in the calculation of investor compensation in cases of expropriation/nationalisation.²⁵⁷ There is no doubt that every tribunal has a responsibility to determine and calculate 'the quantum of damages, whether it is applying a fair market value, full restitution, or any other standard to assess loss'.²⁵⁸ It is

253 B. A. Boczek, *International Law: A Dictionary*, (The U.S, Scarecrow Press: 2005) 148

254 Article 2 of CERDS states that '...nationalize, expropriate or transfer ownership private property, in which case appropriate compensation should be paid by the State adopting such measures, taking into account its relevant laws regulations and all circumstances that the State considers pertinent'.

255 The United States Representative at the UN supported the 1803 resolution asserted that 'the requirements of Article 4 of 'appropriate compensation' ...in accordance with international law 'would be interpreted as meaning..... Prompt, adequate and effective compensation'. Cited in E. Helgeson, *Iran-U.S Claims Tribunal Reports*, Vol.33 (Cambridge, Cambridge University Press: 1997) 243

256 B. A. Boczek (n.132 above) 148

257 J. W. Salacuse (n.91 above) 325

258 K. Yanaca-Small, *Arbitration Under International Investment Agreements: A Guide to the Key Issues*, (Oxford, New York, Oxford University Press: 2010) 562

often said that ‘valuation is more art than science’.²⁵⁹ Perhaps one of the reasons for this saying is that ‘many diverse, seemingly scientific valuation methods can be applied in different ways to arrive at different result’.²⁶⁰ There are four principle methods are applied by tribunals in determining valuation of the expropriated property.

Book value method

Book value refers to ‘the difference between a company’s assets and liabilities as recorded on its financial statements, or the amount at which the expropriated tangible assets appears on the balance sheet in accordance with the generally accepted accounting principles’.²⁶¹ The Book value method was frequently applied by investment tribunals in the petroleum nationalisations that emerged in the 1970s.²⁶² Despite these historic applications, the book value method has also disadvantages. According to Rovine, ‘The disadvantages of the book value method are its reliance on historical figures that may not have any relevance in the valuation context.’²⁶³

Replacement value method

Another technique for measuring the value of tangible assets is the replacement value method. This method is ‘the amount it would have cost to replace the specific assets seized based upon the market conditions.’²⁶⁴ It should be borne in mind that the replacement value method is ‘available only of the asset in question is replaceable, which signifies that unique business opportunities and assets with unique qualities cannot be valued using this method’.²⁶⁵

Liquidation value method

259 J. W. Salacuse (n.91 above) 325

260 Ibid

261P. D. Friedland and E. Wong, ‘Measuring Damages for the Deprivation of Income Producing Assets: ICSID Case Studies, *ICSID Rev.-F.I.L.J* Vol. 6 (1991) 408

262 M. Sornarajah,(n. 56 above) 451

263A. W. Rovine, *Contemporary Issues in International Arbitration and Mediation: The Fordham Papers 2007*, (Leiden, The Netherlands, Martinus Nijhoff Publishers: 2008)77

264*Iran-US Calims Tribunal*, Award No. 258-43-1 (Oct 8. 1986) para 43-44 cited in H. Mafi, *Contraversial Issues of Compensation in Cases of Expropriation and Nationalisation: Awards of the Irant-United States Claims Tribunal*, *International Journal of Humanities*, Vol.18 (1) (2011) 99

265 I. Marboe, “ Compensation and damages in International Law: The Limits of Fair Market Value”, *Journal of World Investment and Trade*, vol. 7 (2006) 723

This type of method refers to ‘the amounts at which individual assets comprising the enterprise or the entire assets of the enterprise could be sold under conditions of liquidation to a willing buyer less any liabilities which the enterprise has to meet.’²⁶⁶

Discounted cash flow method

Another commonly used method is the discounted cash flow method. This type of technique is an income based method of valuing an on-going enterprise or a long term contractual right, for instance to exploit natural resources.²⁶⁷ According to Sornarajah this type of valuation technique:

‘...requires the projection of the future receipts expected by the enterprise after deducting the cost associated with the making of the receipts. The World Bank Guidelines states that this is the method which should be applied where the company that is taken is a going concern. This introduces standards of compensation through the back-door and makes the distinction between lawful and unlawful takings meaningless. To the extent that the method requires future factors to be taken into account, those who seek its application must show that the taking involved was an unlawful taking’.²⁶⁸

4. Rise of Resource Nationalism

In the historical background section, attempts were made to identify the driving forces which constitute direct taking, in the context respectively of the 20th century and in the new millennium. There is no doubt that the majority of direct expropriation cases arose, and continue to arise, as a consequence of ‘resource nationalism’. For this reason this section aims to examine the link between ‘resource nationalism’ and indirect expropriation, with relation to the more recent trend of governments interfering indirectly in investments made by foreign parties. In order to discover this link, the following questions need to be addressed: what is the definition of ‘resource nationalism’? And, what form does the antagonistic behaviour of host states take?

Resource nationalism can be defined as a national governments’ claim of ownership rights over their natural resources within their own land, usually in ways that contradict liberal paradigms for safeguarding alien investments, and work against the interest of international energy investors.²⁶⁹ Resource nationalism is a notion that deems

266 The World Bank Guidelines on the Treatment of Foreign Direct Investment, Guideline IV: 6 (iii) cited in S. Ripinskyi & K. Williams, (n. 128 above) 224

267 J. Crawford, *The International Law Commission’s Article on State Responsibility: Introduction, Text and Commentaries* (Cambridge, Cambridge University Press: 2002) cited in A. W. Rovine (n.142 above) 78

268 M. Sornarajah (n.56 above) 451

269 D. Moran & J. A. Russell, *Energy Security and Global Politics: The Militarization of Resource Management*, (New York, Routledge: 2009) 235

natural resources to be the property of a sovereign state rather than of a petroleum company or an individual who has property rights over an area.²⁷⁰ This view holds that the asset of ‘natural resources’ equates with “national patrimony” and consequently should be used for the benefit of the nation rather than for private gain’.²⁷¹ The question of how this concept leads to the antagonistic behaviour of host states is the other significant point requires further examination.

According to Stevens, there are two components that drive resource nationalism to take into consideration: the first component is that of limiting the control of international investors’ business activities over natural resource, as they take too large a share of the cake. The second driver is the perception among ordinary nationals that they have a significant claim to the natural resources of their territory and that the benefit of those resources should be felt through the improvement of their economy.²⁷² As outlined in the previous section, a sovereign state can rightfully expropriate a foreign investor’s property and their assets as long as they meet certain expropriation criteria under international law. The driving forces behind resource nationalism lie in the economic conditions of the host state, its level of development and ideologies that may take hold among its political class. These factors can be summarised as follows:²⁷³

- Fast-growing populations whose social, educational and health needs are not being satisfied.
- Evolving politics. A government that comes to power on a nationalist platform or that is more critical of foreign investment may be more likely to change the terms of foreign investment.
- The need for jobs.
- A lack of infrastructure and social services.
- Out-dated or inappropriate laws.
- A lack of transparency in the licence and concession award process.

270 D. R. Mares, ‘Resource Nationalism and Energy Security in Latin America’, Baker Institute, Scholar For Latin American Energy Studies, James A. Baker III Institute for Public Policy, Rice University, Working Paper (2010), 6 available at <http://www.bakerinstitute.org/publications/EF-pub-MaresResourceNationalismWorkPaper-012010.pdf> > January 2013

271 Ibid

272 P. Stevens, ‘National oil companies and international oil companies in the Middle East: Under the Shadow of Government and the Resource Nationalism Cycle’, *Journal of World Energy Law & Business* 1 (2008) 5

273 Practical Law Company, ‘Resource nationalism: A Return to the Bad Old Days?’ (2012) 2 available at: http://www.cliffordchance.com/content/dam/cliffordchance/PDFs/Resource_Nationalism_-_A_Return_to_the_Bad_Old_Days.pdf > January 2013

- Exploitative contracts. Some foreign investors have taken advantage of political instability, corruption or a kleptocratic state to negotiate terms that are often opposed by the population or a new government.
- High commodity prices and competition for a depleting supply of natural resources.

While the bullet points above summarise the main drivers of resource nationalism which put pressure on states to enact a ‘taking’,²⁷⁴ it should be noted that the rise of oil prices in the sector is an equally powerful catalyst. What happens when oil prices rise? In such scenarios, the sovereign state seeks to impose new terms and conditions to the current contract or implements new regulations of energy investment projects or else they seek to maximise the profit. It is clear that, instead of taking the property, the government attempts to interfere in the project by implementing new rules or regulating new tax codes or changing the contractual terms of the contract. This, in practice, constitutes indirect expropriation.

Resource nationalism has become a more popular measure and consequently a more frequent occurrence in a significant number of countries.²⁷⁵ As mentioned in the previous section, the main factors behind host government expropriation in the 20th Century were rooted in socio-political conditions. Perhaps, the same elements are still the cause of the resurgence of resource nationalism in the 21st Century. In academic writing, most scholars purport to believe that there is a nexus between resource nationalism and high oil prices. To this end, it should be asked: have times changed? According to Yergin, the chairman of Cambridge Research Associates: ‘We have seen a return to a 1970s style of resource nationalism, riding along the crest of high prices.’²⁷⁶ Similarly, Leonardo Maugeri, a senior executive for strategy at Eni, Italy's chief oil company, state that ‘It's quite natural that during a period of high prices that the phenomenon of resource nationalism returns.’²⁷⁷ Stevens also calls attention to the nexus between high oil prices and resource nationalism. According to him:

Because of this pervasive role of oil prices, the ‘resource nationalist’ cycle is self-feeding. A period of ‘resource nationalism’ inevitably leads to less investment and a shortage of crude oil. This supports high prices encouraging

274 Ibid

275 For instance, the recent high profile nationalizations in Russia, Venezuela, Democratic Congo, South Sudan, Myanmar, Turkmenistan, Iran, Guinea, Zimbabwe, Iraq, Kazakhstan, Angola, Nigeria and Libya, Bolivia. According to the Maplecroft's research, these are countries where the resource nationalism is high in 2012 available at: <http://maplecroft.com/about/news/pr_2012.html> February, 2013

276 J. Mouawad, ‘As Profits Surge, Oil Giants Find Hurdles Abroad’, The New York Times, (6 May, 2006) available at: <http://www.nytimes.com/2006/05/06/business/worldbusiness/06oil.html?_r=1&> February, 2013

277 Ibid

further 'resource nationalism' as the obsolescing bargain kicks in and the need for capital and technology by the owner of the resources to expand capacity diminishes.²⁷⁸

From the perspective of sovereign states, it is admissible that their expropriation decision is lawful as a political expedient option, even if it is not the best solution, in a long-term investment project. Nevertheless, what is less acceptable is the technique and the approach taken to enforce the sovereign authority of states. It must be borne in mind that if the political expedient option is used by states as a last resort for the sake of improving their natural resources, the resurgence of resource nationalism could give rise to disputes between states and international energy investment companies and may result in a dramatic and very costly outcome for those states. It is true that, as a consequence of the rise in cases of indirect expropriation in recent years in the sector, resource nationalism has been identified as one of the major risks for international energy investors in the natural resource industry.²⁷⁹ Indirect expropriation will be examined more thoroughly in the following chapter.

Before this chapter draws to a close, an assessment of the potential for survival resource nationalism has in the energy sector of the 21st Century should be attempted. According to Hoyos, international oil companies' executives are keen to forge concession agreements with developing states, in possession of rich natural resources, as they are aware that today's power balance is unlikely to change in the immediate future.²⁸⁰ Similarly, Christophe de Margerie, chief executive of Total Petroleum Company agrees with this assessment of changes in the cycle and states that '... the new world will stay even if the price of oil drops a bit.'²⁸¹ Professor Paul Stevens' assessment is not different to that of Margerie and Hoyos. According to Stevens:

Last time, when 'resource nationalism' dominated in the 1970s, the cycle took from the early 1970s to the mid-1980s to begin to work its way through. This time it could take longer given that the exogenous drivers of the cycle are particularly strong, especially the disillusion and despair of the dispossessed in those countries which have the resources.²⁸²

278 P. Stevens (n.151 above) 27

279 The Ernst & Young Group, 'Business risks facing mining and metals 2011–2012' available at:
<[http://www.ey.com/Publication/vwLUAssets/Business_risks_facing_mining_and_metal_ls_2011-2012/\\$File/Metal_Mining_paper_02Aug11_lowres.pdf](http://www.ey.com/Publication/vwLUAssets/Business_risks_facing_mining_and_metal_ls_2011-2012/$File/Metal_Mining_paper_02Aug11_lowres.pdf)> February, 2013

280 C. Hoyos, 'The new Seven Sisters: Oil and Gas Giants Dwarf Western Rivals', The Financial Times (11 March, 2007), available at:
<<http://www.ft.com/cms/s/2/471ae1b8-d001-11db-94cb-000b5df10621.html#axzz2HwYIFxVC>> February, 2013

281 Ibid

282 P. Stevens (n.151 above) 28.

5. A Comparison of Investment Environments in Azerbaijan and Turkey

Azerbaijan

Azerbaijan is one of the few Turkic countries that officially welcomes private investors, conscious of the crucial role they can play in growth of the country economy. After gaining its independence in 1991, the country, in order to signal its willingness to collaborate and cooperate, signed a number of multilateral international treaties and became a member of several key international organisations. For example, the country is currently a member of the Energy Charter Treaty (ECT), the International Centre for Settlement of Investment Dispute (ICSID), the World Bank group (mainly at the IBRD, IFC and MIGA) and the International Monetary Fund (IMF). On the other hand, the country is not yet a member of the World Trade Organisation (WTO) or the Organisation for Economic Cooperation and Development (OECD). Notwithstanding this, since 1994, Azerbaijan has attracted a considerable amount of private investment into its territory through the Production sharing Agreement (the agreement popularly known as ‘the contract of the century’) signed with nine western international oil companies.

The involvement of international oil companies will inject \$7.4 billion of investment into the country’s economy over the next three decades.²⁸³ It should be noted that Azerbaijan is not the possessor of the largest oil reserves of all the former Soviet States in the Caspian region; however, of these, the country has been the most willing and the most successful in attracting foreign investors into its territory. According to the attraction of foreign direct investment index, designed by the United Nations Conference on Trade and Development (UNCTAD), the country ranked third amongst the 140 countries assessed during the years between 1994 and 1996 and subsequently ranked eighth between 1998 and 2000.²⁸⁴

Over the past two decades Azerbaijan has witnessed substantial economic and political progress. According to the State Statistical Committee of Azerbaijan, GDP increased from \$5.2 billion in 2000 to \$63.4 billion in 2001 and GDP per capita reached \$ 7,003 in 2011.²⁸⁵ It is apparent that the long-term oil sector contracts signed in the period leading up to this had played their part in this economic boom. One interview respondent noted that ‘Azerbaijan’s ample natural hydrocarbon resource and attempts to

283 N. Sagheb & M. Javadi, ‘Azerbaijan’s Contract of the Century’, *Azerbaijan International*, Winter (1994) available at: http://www.azer.com/aiweb/categories/magazine/24_folder/24_articles/24_aioc.html > February, 2013

284 United Nations Conference on Trade and Development (UNCTAD) 2002a, Azerbaijan was ranked the highest in 2004 (UNCTAD 2006).

provide a stable environment to petroleum investors increase its appeal. This stability is provided by Azerbaijani product-sharing agreement laws (PSAs), or other types of HGAs, because 60-70% of the country's economy depends on the hydrocarbon sector and in order to appeal to investors, they have to create a stable environment. The dependency seems to carry on for years.²⁸⁶

The country signed a total of 32 production sharing agreements (PSAs) with western international oil companies between 1994 and 2013. As this type of contract includes contractual clauses, such as stabilisation and arbitration clauses, they are the contract of preference of the international oil companies operating in Azerbaijan. One interview respondent noted that 'oil companies have never faced expropriation or nationalisation events in Azerbaijan. And their contracts have never been forced by the Azerbaijani authorities to renegotiate the terms and conditions of the oil contracts'.²⁸⁷ It is evident that the authorities in Azerbaijan are keenly aware of the importance of their relationships with these companies to the future prospects of their economy, and are therefore compliant in avoiding the renegotiation of contract terms and desist from nationalising the investors' projects.

Despite this recent picture of stability in the Azerbaijani oil sector, the country presents challenges to other sectors which find themselves plagued with government bureaucracy, weak legal institutions, corruption, a lack of transparency in transactions, cronyism. Such debilitating phenomena remain significant obstacles to economic progress, hindering both domestic and private investment.²⁸⁸ The high level of corruption is the singularly most prohibitive impediment to the attraction of investment to Azerbaijan. Corruption in Azerbaijan is by no means a new issue; its legacy can be traced back to the Soviet Union era. In 2004, the Azerbaijani government enacted the Anti-Corruption Act and formed a state commission on combating corruption. Nevertheless, the government's deployment of obstructive bureaucracy and the bribery inherent in government institutions often impede the applicability of this law. According to the Transparency Initiatives Corruption Index (2011), Azerbaijan ranked 134th place out of 180 countries with a score of just 2.4.²⁸⁹ Corruption is rampant in the regulatory, tax and dispute settlement system. This issue naturally raises questions around the reliability and transparency of governance in potential investors' minds and is a strong disincentive against doing business in Azerbaijan.

285 The State Statistic Committee of the Republic of Azerbaijan, available at: <<http://www.azstat.org>> February, 2013

286 Interviewee no. 15 with Anonymity Guaranteed, 15 November, 2012

287 Interviewee no. 16 with Lawyer, 22 November, 2012

288 The PRS Group, 'Azerbaijan Country Report', August, 2012, (USA, The PRS Group Inc. : August 2012) 1

289 Transparency of International, available at: <<http://www.transparency.org/cpi2010/results>> August, 2013

Turkey

Turkey's investment environment has undergone extensive restructuring since the 1980s with the objective of creating a more liberal business environment. Economic reforms during the 1980s assisted the country's global economic integration. Alike Azerbaijan, Turkey is also party to a number of international conventions and international organisations. For instance, the country is a member of the World Bank group, ICSID, the ECT and the IMF. However, unlike Azerbaijan; Turkey is also a member of the WTO and the OECD. Turkey's attempts at liberation and integration into the world economy continued well into the 1990s. For instance, the Custom Union Agreement made with the EU in 1995 allowed the freedom of movement of goods between the European Custom Area and Turkey free of any restrictions or tariffs. Similarly, the agreement with the WTO in 1995 enabled the country to improve its trade policy and thereby achieve better integration into the world economy. Despite these major developments, Turkey was one of the lowest receivers of FDI of all emerging countries during the 1990s as both economic and non-economic factors created such a chaotic investment environment in Turkey.

The economic factors behind this were: i) inefficient bureaucracy and a high level of corruption; ii) high cost of the entry and functioning procedures for foreign investors; iii) chronically high inflation and economic instability; iv) lack of inflation-accounting and internationally acceptable accounting standards; v) lack of intellectual property rights; and vi) insufficient laws on FDI.²⁹⁰ The non-economic causes were namely: i) political instability; ii) regional crises (for example the Iraq war in the Gulf region); iii) social unrest in south-east of the country and terrorist attacks. In view of this unstable investment environment, it is easy to entertain the possibility that a government may breach the property rights of investors not only in the energy sector but also in other industries in which foreign investors may be involved. Nevertheless, as one interview respondent noted: 'no taking has ever happened in the energy or other sectors in Turkey, even though the country was confronted with economic, political challenges in the past.'²⁹¹

Since the general election in 2002, Turkey's economy and its investment environment has changed significantly. The economic stability policy spearheaded by the Justice and Development Party enabled the country to deal with high inflation and the issues surrounding stability in a short timeframe. It goes without saying that the role of the FDI law passed in 2003 made a huge contribution to the transformation of Turkey's investment environment. The law aimed to 'encourage FDIs in Turkey, protect foreign investor's rights; bring investors and investment in line with international standards, establish a notification-based rather than approval-based system for FDIs and increase the volume of FDI through established policies.'²⁹² According to UNCTAD,

290 Y. Vural & M. Zortuk, 'Foreign Investment as a Determining Factor in Turkey's Export Performance', *Eurasian Journal of Business and Economics* 4(7) (2011) 15

291 Interview no 3 Anonymity Guaranteed, 14 May 2012

292 S. Togan, *Economic Liberalisation and Turkey*, (USA, Routledge: 2010) 45

the World Investment Report 2010, Turkey was the 32nd most attractive country for FDI in the world and the 15th most attractive FDI destination amongst emerging countries.²⁹³ With the help of the recent economic upturn and regional energy projects, such as Baku-Tbilisi-Ceyhan (BTC), and Trans Anatolian Pipeline (TANAP)²⁹⁴ projects (expected to start in 2014) between Azerbaijan and Turkey, seems to make the country is set to become an absolute regional strategic power in the Caucasus.

In terms of the issues foreign investors in Turkey may still face, compared with Azerbaijan, while bureaucracy can be similarly obstructive, corruption, while it exists, is less of a concern. According to the Transparency initiatives Corruption Index (2011), Turkey is ranked 56th place in the world and scores 4.4 points.²⁹⁵ Other impediments to international business relations include the slowness of the judicial system, weakness in corporate governance, the unpredictability of local-government decision-making and frequent changes in the legal and regulatory environment.²⁹⁶ The Turkish parliament modified the Law of Obligation and enacted a new Commercial Law in 2011. Through these reforms, Turkey aspired to a more transparent, equal, fair and contemporary investment and business environment.

One interview respondent offered a general comment on Turkey's appeal to investors: 'our country does not abound in oil and gas resources however; other sectors such as the automotive and textile industries and, agriculture are better investment environments for foreign investors in Turkey.'²⁹⁷ Another respondent touched upon the hurdles that foreign investors face in Turkey: 'bureaucracy and red tape were the major problems that private investors faced in the past. Of course that does not mean that we do not have these issues. They still exist but they have been become relatively minor over the course of the past decade. In order to give the business environment the chance to prosper, conform with global standards, and remove bureaucratic hurdles the

293 UNCTAD, The World Investment Report 2010 :Investing in a Low Carbon Economy(New York and Geneva: 2010) available at:
<http://unctad.org/en/docs/wir2010_en.pdf> August 2013

294 TANAP is a transnational gas export pipeline project which aims to transfer Caspian gas to Europe. Azerbaijan and Turkey signed an intergovernmental agreement on the implementation of the TANAP gas pipeline project on 26 June 2012. Through this pipeline project, both Azerbaijan and Turkey aim to game maker in the region.

295 Transparency of International (n.168 above)

296 Investment Climate in Turkey, 2012 available at:
<<http://www.state.gov/e/eb/rls/othr/ics/2012/191254.htm>>August, 2013

297 Interview no.1 (n. 42 above)

government formed the Coordination Council for the Improvement of the Investment Climate.²⁹⁸

6. Conclusion

The chapter conducted an exploratory analysis of the motivations for host states to interfere in investment projects. The most hazardous political risks for international energy investors were also identified. The historical background of political risks in the energy industry was used as a starting point. The author observed that the energy industry witnessed a number of divergent risks, such as a high level of expropriation or nationalisation and confiscation in the 20th Century. Admittedly, political risk has always been a major hindrance to foreign investors in the energy sector and is likely to continue to be so for the foreseeable future. It may be part of the inherent nature of energy projects – expropriation, nationalisation and confiscation are all risks that foreign investors faced during the life span of their projects in the 20th Century. Although direct expropriation or nationalisation were frequent occurrences in the 20th Century, nowadays, direct taking is no longer regarded as a major issue as there has been a more recent shift in host state activity in favour of indirect expropriation.

With regards to direct expropriation, it was found that, under international law, the expropriation notion is not an unlawful action *per se*. There is no major obstacle to prevent states from expropriating local or foreign investors' property as long as the state's actions meet certain conditions. These requirements are commonly referred to as: public purpose, non-discriminatory, respecting due process of law and prompt and adequate compensation.²⁹⁹ The conditions regulated under international customary law and the state's own legal system is the main criteria for lawful expropriation. It should be borne in mind, that although expropriation is a legal right, such sovereign power should be used only as a last resort against alien investors' property ownership. It has been mentioned above, if the property is expropriated by a sovereign power, and the taking does not meet the exact criteria as defined by international law, then the taking will be deemed wrongful. In addition, resource nationalism was addressed and the ideological, political and economic factors that have driven the rise in resource nationalism in recent years.

The chapter went on to examine the link between resource nationalism and indirect expropriation. It was found that the rise of oil prices plays a significant role today as was the case in the past. As a result of high oil prices, governments interfere

298 Interview no. 8 with Lecturer, 4 June, 2012

299 S. P. Subedi (n.82 above) 102

either in the investment contract by changing its terms and conditions or implementing new regulations or changing the tax provisions for the sake of making more profit. This is referred to as indirect expropriation. Recent oil price rises along with political and economic factors have prompted a resurgence of resource nationalism in developing states. States, instead of taking property directly, more recently prefer to interfere in projects indirectly. It is currently the case that the most hazardous political risk is indirect expropriation. The simple answer to why governments interfere in investment projects is: to maximise their profit and improve sustainable developments for their country. While the methods of governments may sometimes be questionable; however, the exploitative mind-set of profit-driven energy companies is also unsustainable. Perhaps, the solution is to promote fairer contract terms and a more even-handed system for the sharing of profit between the parties.

In the last section of this chapter, the investment environment of Azerbaijan and Turkey was also examined. It was found that both countries have their strengths and weaknesses in terms of their ability to provide a secure investment environment. Azerbaijan is an oil dependent country and the Azerbaijani governments focus on this sector is to the detriment of its growth in other sectors. Force of contract negotiation, expropriation or nationalisation has never emerged in Azerbaijan. Based on this evidence, it can be concluded that the rise of oil and gas prices in recent years have not triggered resource nationalism in Azerbaijan. However, outside the oil sector, there are some major problems which render doing business in Azerbaijan problematic, these include inefficient bureaucracy, a high level of corruption and a lack of transparency in legal and political processes. A private investor would be likely to face a debilitating combination of these factors over the course of their business project. It would be advisable for the government, as part of its efforts to tackle these issues, to accelerate its membership of international organisations such as the WTO and the OECD.

The situation of political and economic instability endured by Turkey in the 1990s seems to be a thing of the past. Single party governance during the 2000s has secured economic growth and continuity in its policies. As the country does not have rich natural resources, resource nationalism is not a consideration for Turkey. Similar to Azerbaijan, no expropriation or nationalisation actions against foreign investors have been found to have occurred in Turkey. The country's chief weaknesses lie in its overburdened judiciary system and its cumbersome bureaucracy.

In the next chapter, indirect expropriation phenomena will be analysed.

Chapter 3

Indirect Expropriation

1. Introduction

As demonstrated in the previous chapter, the protection of a foreign investor's property ownership against direct expropriation or nationalisation has long been a consideration for international corporations, and, up until the 1980s, was one of the most disruptive kinds of government interference in investment projects. From the start of the new millennium a shift occurred with the emergence of indirect expropriation soon becoming the single most significant threat to investment contracts in the energy sector as well as the most impactful form of intervention a state could set in motion.³⁰⁰ This type of government intervention may result from measures that a host country enacts in order to gain greater control over commercial activities in its territory by adopting new regulations, even where such a regulation does not specifically target at an investment.³⁰¹ In contrast with direct expropriation which has the aim of physically taking the private property, 'indirect expropriation cases are those where, by means of administrative or legislative procedures, the state in question causes a unilateral change in contract conditions such that the investor is unable to recover the expected quasi rents³⁰² of the business under the original contractual framework.'³⁰³

International tribunals and scholars in conventional literature have focused on the notion of direct and indirect expropriation in their decisions, and in their various publications. Although, there are numerous sources regarding this phenomena '... the doctrine and case law on expropriation in international law remain somewhat unsettled. Several factors may explain why this is so. These include the diversity of interest at play, divergence in cultural, economic and legal concepts of property, different understandings of the role of the state, and a general heterogeneity in state practice'.³⁰⁴ Nevertheless, the question of what is the most hazardous political risk in the energy sector was answered in the previous chapter and it was found, through the analysis of

300 R. Dolzer, 'Indirect Expropriation: New Developments?', *11 N.Y.U. Environmental Law Journal* (2002) 64-65

301 S. H. Nikiema, 'Indirect Expropriation', Best Practices Working Paper Series, (Canada, International Institute for Sustainable Development Publication: 2012)
1 available at: <http://www.iisd.org/pdf/2012/best_practice_indirect_expropriation.pdf>
January, 2013

302 Quasi rent is defined as the investment expected cash flow that the stakeholder will not be able to recover if he/she abandons the operation.

303 M. A. Abdala & P. T. Spiller, 'Damage Valuation of Indirect Expropriation in International Arbitration Cases', *14 Am. Revs. Int'l Arb.* (2003) 449

interview responses, a recent survey on expropriation and literature that, currently, the risk energy investors most widely regard with unease is indirect expropriation.

In light of these findings, this chapter explores indirect expropriation and attempts to define exactly what constitutes indirect expropriation and what measures can be utilised by foreign investors to counteract the threat of indirect expropriation. The chapter also examines the Bilateral Investment Treaties (BITs) of Azerbaijan and Turkey and conducts a comparative analysis of whether their treaty provisions are current enough to define indirect expropriation.

1.1 An Overview of Indirect Expropriation

‘An indirect form of expropriation in which a government measure, although not on its face affecting a transfer of property, results in the foreign investor being deprived of its property or its benefits.’³⁰⁵ In other words, while indirect expropriation does not technically undermine the investment title of the alien investors it however considerably diminishes that foreign investor’s ability to run their business activities freely or reduces the benefit that they expect to obtain from the investment. When does indirect expropriation occur? Broadly, indirect expropriation occurs ‘through interference by a state in the use of that property or with the enjoyment of the benefits even where the property is not seized and the legal title to the property is not affected’³⁰⁶ what is the approach of BITs and MITs to indirect expropriation phenomena? In general, all BITs and MITs provide articles which refer to expropriation.

Evidently, The North American Free Trade Agreement (NAFTA), Article 1110 supplies that ‘no party may directly or indirectly nationalise or expropriate an investment of an investor of another party in its territory or take a measure tantamount to nationalisation or expropriation of such an investment.’³⁰⁷ In a similar way, The Energy Charter Treaty under Article 13 precludes host states from taking any measures ‘having effect equivalent to nationalisation or expropriation.’³⁰⁸ This is clearly a reference to indirect expropriation. Further references can be found abundantly in BITs and the academic literature. In academic literature, indirect expropriation is interchangeably referred to as ‘*de facto*’, under the guise of, ‘wealth deprivation’, ‘constructive’, ‘regulatory’, ‘consequential or creeping expropriation’. Modern BITs

304 L. Fortier & S. L. Drymer, ‘Indirect Expropriation in the Law of International Investment: I Know it When I See It’, *ICSID Review – Foreign Investment Law Journal* 19, no. 2 (2004) 293-294

305 A. Newcombe & L. Paradell, *Law and Practise of Investment Treaties: Standards of Treatment*, (The Netherlands: Kluwer Law International, 2009), 323

306 C. Yannaca-Small, ‘Indirect Expropriation and the Right to Regulate in International Investment Law’, Organisation for Economic Co-operation and Development, (2004) 3-4 available at: <http://www.oecd.org/investment/internationalinvestmentagreements/33776546.pdf>> January 2013

generally ‘...refer to direct and indirect expropriation and measures ‘tantamount’ or ‘equivalent’ to expropriation’.

However, it should be noted that investment treaties steer clear of providing a definition of what exactly indirect expropriation is. Instead of simply defining indirect expropriation, they prefer to employ the aforementioned terms as given to understand indirect expropriation.³⁰⁹ This begs the question as to how exactly the identification of indirect expropriation is to be made. The classification of host government measures ought to be determined via a case by case examination of the precise facts.³¹⁰ It is true that in the *Fieldman* case, the NAFTA tribunal provided ‘that each determination under Article 1110 is necessarily fact specific.’ This case by case approach is also supported by the modern BITs. For instance, the 2004 Canada BIT model stated that ‘The determination of whether a measure or series of measures of a Party constitute an indirect expropriation requires a case-by-case, fact-based...’³¹¹

2. Distinguishing between Direct and Indirect Expropriation

In the context of direct expropriation, the government measure aims to transfer the legal rights of an alien investor’s ownership to the host country or to the benefit of a third person by applying a sovereign law system.³¹² Thus, ‘the taking can be readily

307 NAFTA agreements come into force, on the first of January in 1994, reprinted in 32 ILM 289 and 605 (1993). It is significant to cite the dispute settlement between investor and state under NAFTA Chapter 11. NAFTA Chapter 11 actions can be brought not only by investors party to the NAFTA agreement, but actions can also be brought by any company in one of the NAFTA countries. For instance, Sony, United States, as an alien investor could bring a chapter 11 case against the United States. Cited in, G. C. Hufbauer & J. J. Schott, *NAFTA Revisited: Achievements and Challenges*, (U.S, Institute For International Economics: 2005) 206.

308 ECT is a significant instrument for the promotion of international cooperation in the energy industry. ECT was signed in December 1994 and entered into force on 16 April 1998. The Article 13 of the Agreement can be found from the official website of the organisation; <<http://www.encharter.org>> January, 2013

309 J.W. Salacuse, *The Law Of Investment Treaties*, (New York, Oxford University Press: 2009) 150

310 A. Reinnisch, ‘the Legality of Expropriation’, Chapter 11 in P. Muchlinski & F. Ortino and C. Schreuer, *The Oxford Hand Book of International Investment law*, (New York, Oxford University Press: 2008) 438

311 Please see Canadian 2004 Model BIT, Annex B 13(1)

312 A.W. Rovine, *Contemporary Issues in International Arbitration and Mediation*, (The Netherlands, Martinus Nijhoff Publishers: 2007) 35; see also M. Sornarajah, *The International Law on Foreign Investment*, (Cambridge: Grotius Publications: 1994) 282.

discerned by examining the *lex situs*³¹³ of that property'.³¹⁴ However, in the case of indirect expropriation, the property rights of the investor are violated in a more subtle way than occurs in a case of direct expropriation. The significant divergence in indirect expropriation is that a host government measure may, in essence, have the same impact on the property interests of the international investor, as a direct taking.³¹⁵ More importantly, even though the government measure does not dispute, alter or affect the legal title of the property, its revenue producing potential is dramatically reduced by the acts attributable to the host state.³¹⁶ In other words, 'the state measure focuses on creating a negative impact on the alien investor's property interests, while avoiding engaging in the more explicit act of physically taking the property'³¹⁷.

Moreover, what is the basic foundation of the investor's property interest? A commercial interpretation of the property interests of an alien investor to compensation for expropriation (indirect) is upheld in some cases; such as *Pope & Talbot* and *SD Myers*³¹⁸ and is also supported by scholars in legal literature. According to Wealde and Kolo 'The key function of property is less the tangibility of 'things', but rather the capability of the combination of rights in a commercial and corporate setting and under a regulatory regime to earn a commercial rate of return.'³¹⁹ After providing a

313 *Lex Situs* means law of the place where the property is located. Please see B.A. Garner, *A Dictionary of Modern Legal Usage*, 2nd edn., (New York, Oxford University Press: 1995) 526

314 J. Paulsson & Z. Douglas, Indirect Expropriation in Investment Treaty Arbitration, in N. Horn & S. Kroll, *Arbitrating Foreign Investment Disputes*, (The Netherlands, Kluwer International Law: 2004) 151

315 A.W. Rovine, (n.13 above) 39

316 J. Paulsson & Z. Douglas (n.15 above) 152; Please see also the tribunal's standing in the case of *Compañía Del Desarrollo De Santa Elena, S.A. VS. Costa Rica*, Final Award (ICSID Case No.ARB/96/1, Feb. 17, 2000), 15 ICSID Revs. FILJ (2000) 457, section 77, available at: <http://www.worldbank.org/icsid/cases/santaelena_award.pdf> January 2013. The tribunal asserted in this case that 'there is ample authority for the proposition that a property has been expropriated when the effect of the measures taken by the state has been to deprive the owner of title, possession or access to the benefit and economic use of his property'

317 Interview no. 20 with Foreign Trade Expert, 26 November 2012

318 A. Kawharu, *Property Rights and Sustainability: The Evolution of Property Rights to Meet Ecological Challenges*, edited D. Grinlinton and P. Taylor (The Netherlands, MartinusNijhoff Publishers: 2011) 350

319 T. W. Waelde & A. Kolo, 'Environmental Regulation, Investment Protection and "Regulatory Taking" in International Law', *International and Comparative Law Quarterly* 50 (2001) 835

definition of the modern understanding of property, can it be asserted that any measures taken by a host state are subject to compensation claims?

According to a widely recognised international principle, ‘... A state is not liable for economic injury which is a consequence of bona fide ‘regulation’ within the accepted police power of state.’³²⁰ The identification of host government acts of direct expropriation is reasonably straightforward, as compared to indirect taking. In addition, expropriation or nationalisation is normally performed on a given date and on the basis of an explicit national policy.³²¹ However, the determination of indirect expropriation is more complex, thus a host state act cannot easily be held to account. Furthermore, indirect expropriations frequently are upheld ‘...under the guise of a policy in which the deprivation of the owner’s property is not an explicit purpose, and they do not necessarily have a clear date when it can be said that the owners have been deprived of their title to the expropriated property.’³²²

As mentioned in the previous chapter, the direct expropriation of an alien investor’s property can take various forms, ranging from the outright nationalisation of all economic sectors of an industry as a part of a host state’s economic policy to the specific taking of a private property under the terms of a legislative or administrative act.³²³ Indirect expropriation includes creeping and regulatory expropriation. It should be noted that distinguishing these two forms is fraught with complication.³²⁴ Unlike straightforward expropriation, indirect expropriation manifests itself through the impact of laws and regulations that subject the alien investor to discriminatory taxes, legislation, impinge on control of business management and enforce the cancellation of licences and permits among other side effects.³²⁵

320 *Sedco Inc. vs. National Iranian Oil Co.*, Interlocutory Award 9 Iran-U.S Cl. Trib. Rep.248,275(1985); see also J.M. Wagner, ‘International Investment, Expropriation and Environmental Protection’, *Golden Gate U.L. Rev* 29(1999) 517

321 Please see, World Investment Report, FDI Policies for Development: National and International Perspectives, (New York, Geneva, United Nations Publication: 2003) 111, available at: <http://www.unctad.org/en/docs/wir2003_en.pdf> January 2013

322 *ibid*

323 OECD, *Private Sector Development and in the Middle East and North Africa: Supporting Investment Policy and Governance in Iraq*, (OECD Publication: 2010) 67

324 M. Sornarajah, *The Pursuit of Nationalised Property* (The Netherlands, Kluwer Academic Publishers:: 1986) 278–294 Cited in World Investment Report (n.22 above) 111

325 R. Schaffer, F. Agusti and B. Earler, *International Business Law and its Environment*, 7th edn, (The U.S , South Western Cengage Learning: 2009) 611

The measures taken by a host government should be considered with a fact-based determination as to ‘whether the sovereign state has engaged in a taking or merely exercised its right to regulate industry’.³²⁶ The creeping and regulatory expropriations which constitute indirect expropriation are subject to compensation as far as comprehensive literature and arbitral awards report. However, one must take into account that the right to compensation for indirect expropriation is riddled with paradox.³²⁷ In general, most sovereign states avoid paying compensation to alien investors for the impact of regulatory alterations ‘... resulting from legislative, executive and judicial decisions, although such changes may cause losses as or more severe than outright expropriation.’³²⁸ In light of this overview of the subject, it is opportune to discuss exactly what constitutes indirect expropriation.

3. The Types of Host state Measures May Constitute Indirect Expropriation

The question of which measures taken by a host state constitute indirect expropriation under international law is a complex one. The subject matter has not yet been given a definitive delineation either by international tribunals or legal scholars. A number of examples can be listed of the measures which may be taken by a host state over the course of an investment project, however, the determination of which regulatory measure is non-compensable and which one is remains vague. It is true that not all state measures interfering with property are regarded to constitute expropriation under international law.

With regard to state measures, Brownlie has asserted that ‘state measures, *prima facie*³²⁹ a lawful exercise of powers of governments, may affect foreign interest considerably without amounting to expropriation. Thus, foreign assets and their use may be subjected to taxation, trade restrictions involving licences and quotas or measures of devaluation. While special facts may alter the interpretation of cases, in principle, such measures are not unlawful and do not constitute expropriation.’³³⁰ By highlighting such examples, the author touches on the police power notion. Although the notion will be examined separately, it is also worth mentioning briefly how it is addressed in legal discourse.

326 Ibid

327 A. Newcombe, ‘Regulatory Expropriation, Investment Protection and International Law: When Is Government Regulation Expropriatory and When Compensation Should Be Paid?’ LLM Master Thesis, University of Toronto (1999) 8

328 Ibid.

329 The definition of *prima facie* is at first sight; as it seems at first.

330 I. Brownlie, *Principle of Public International Law*, 6th Edn. (Oxford, Oxford University Press: 2003) 509

Police power notion has been identified in several conventions and case law has recognised the criteria of non-compensable takings in the context of police power. For instance, the first protocol of The European Convention of Human Rights deemed the regulatory measures taken by governments as non-compensable. In fact, while Article 1 of the convention states that: ‘Every natural or legal person is entitled to the peaceful enjoyment of its possessions. No one should be deprived of his possessions except in the public interest and subject to the conditions provided for by the law and by the general principles of international law.’ It also goes on to state that the preceding provisions shall not, however, in any case impair *the right of a state to enforce such laws as it deems necessary to control the use of property in accordance with the general interest or to secure the payment of taxes or other contributions or penalties*’ (Italic added).³³¹ In the light of the above given quotation it is fair to conclude that Article 1 of the protocol, specifically references the police power notion.

Similarly, the Harvard Draft Convention on the International Responsibility of States for Injuries to Aliens provides that: ‘An uncompensated taking of an alien property or deprivation of the use or enjoyment of the property of an alien which results from the execution of laws; from a general change in the value of currency; from the action of the competent authorities of the State in the maintenance of public order, health, morality; or from the valid exercise of belligerent rights or otherwise incidental to the normal operation of the laws of the State shall not be considered wrongful’.³³² The given provision has also found a place in the *Saluka Investment* case.

The arbitral panel said that the above quoted passage in the Harvard Draft Convention is subject to four important exceptions:

- (a) It is not a clear and discriminatory violation of the law of the State concerned;
- (b) It is not the result of a violation of any provision of Articles 6 to 8 [of the Draft Convention];
- (c) It is not an unreasonable departure from the principles of justice recognised by the principal legal systems of the world;
- (d) It is not an abuse of the powers specified in this paragraph for the purpose of depriving an alien of his property³³³

331 Please see the First Protocol to the Convention for the Protection of Human Rights and Fundamental Freedoms, Paris, (March 20, 1952), cited in Human Rights Review 2012, available at: <http://www.equalityhumanrights.com/uploaded_files/humanrights/hrr_firstprotocol.pdf> February 2013

332 *Saluka Investment BV (Netherlands). vs. The Czech Republic* (A partial Award) of 2 March 2006, para, 256 available at: <http://www.pca-cpa.org/showpage.asp?pag_id=1149> December 2012

333 Ibid, para, 257

The tribunal proceeded to conclude that ‘these exceptions do not, in any way, weaken the principle that certain takings or deprivations are non-compensable. They merely remind the legislator or, indeed, the adjudicator, that the so-called ‘police power exception’ is not absolute’.³³⁴ Moreover, the 1967 OECD Draft Convention on the Protection of Foreign Property also recognises the police power notion in the following statement: ‘...measures taken in the pursuit of a State’s ‘political, social or economic ends’ do not constitute compensable expropriation.’³³⁵ As previously mentioned, a similar contribution was also provided in the United States Third Restatement of The Law of Foreign Relations.³³⁶

State measures are not exhaustive, a number of state measures can be exemplified, however, in practice the following measures are the most frequently applied by host governments: excessive or discriminatory taxation,³³⁷ interference of contract rights,³³⁸ interference with management rights³³⁹ revocations of licence or denial of government permits.³⁴⁰

3.1 Excessive or discriminatory taxation

334 Ibid, para, 258

335 OECD Draft Convention on the Protection of Foreign Property, (12 October 1967), 71 *ILM* 117

336 Restatement of Third of Foreign Relations Law of United States vol. 1 (1987), section 712 comment (g). According to Restatement of Third of Foreign Relations Law’s section 712 ‘A state is not responsible loss of property or for other economic disadvantage resulting from bona fide general taxation, regulation, forfeiture for crime, or other action of the kind that is common accepted as within the police power of states, if it is not discriminatory...’

337 Please see the case of *Revere Copper and Brass Inc. VS. Overseas Private Investment Corporation*, 24 August 1978, 56 ILR 268

338 Please see *CME Czech Republic BV VS. Czech Republic* (Partial Award) 13 September 2001

339 Please see *Starrett Housing Corp. vs. Iran*, 19 Dec. 1983, 4 Iran-US CTR 122; *Tippetts, Abbott, MacCarty, Stratton vs. TAMS-AFFA Consulting Engineers of Iran*, 22 June 1984, 6 Iran-IS CTR 219; *PSEG Global, Inc. et al vs. Republic of Turkey* (ICSID Case No: ARB/02/5), (2007), Award 19 January 2007

340 See *Goetz and Others vs. Republic of Burundi*, 2 September 1998, 6 ICSID Reports 5, *Middle East Cement Shipping and Handling Co. S.A. vs. Arab Republic of Egypt*, 12 April 2002, 7 ICSID Reports 178; *Metalclad Corporation vs. United Mexican States*, 30 August 2000, ICSID Reports 209

Host states may use their power to impose taxes as a means to limit and curtail the business activities of alien investors within their territory. To this end, it can be said that the freedom to regulate tax is a sovereign right and cannot be subject to any limitation or restriction. Indeed, there is no rule or restriction imposed or recommended on this measure by international law³⁴¹. However, ‘while taxation is onerous, it may be a legitimate means of raising public revenue, it is possible for taxes to be so high that they are confiscatory and thereby constitute expropriation.’³⁴² Disproportionate tax increases or discriminative or abusive taxation in the petroleum industry are not new phenomena.³⁴³ Furthermore, excessive or repetitive tax measures are instruments frequently applied by a variety of state authorities, with government conspiracy,³⁴⁴ ‘under cover of what appears on the surface, and at first sight, to formally be the proper application of tax audit, tax assessment, and tax collection procedures.’³⁴⁵

The *Yukos* case³⁴⁶ is a good example of this practice; however, it is also the most dramatic case to have occurred in recent years. In the *Yukos* case, the Russian Federal Government required the tax authorities to carry out a re-assessment of the tax returns from the Yukos Company, which is privately owned. After the re-assessment, penalties and interest charges amounting to 100% of total sales were imposed on the company by the Russian tax authorities and were collected over a three year period. As a result of these penalties and charges, the company was economically and legally crippled and fell victim to bankruptcy. Numerous claims were brought by the shareholders of the company, through the Energy Charter Treaty (ECT) dispute settlement process; however, the case is still pending.³⁴⁷ As mentioned above, this is not the first example of an excessive tax regime to be recorded, when the ICSID agenda is examined, it will be evident that there are several cases relevant to this subject.³⁴⁸

341 M. Sornarajah., *The International Law on Foreign Investment*, 3rd edn, (Cambridge: Cambridge University Press, 2010) 405

342 J. W. Salacuse (n.10 above) 301

343 T. Waelde, ‘International Law of Foreign Investment: Towards Regulation by Multilateral Treaties’ CEPMLP Research Paper CP1/2000, University of Dundee, 19.

344 M. Sornarajah, *International Law on Foreign Direct Investment*, 2nd edn. (Cambridge: Cambridge University Press: 2004)393

345 M. Sornarajah (n. 45 above) 342

346 *Yukos Universal Limited (Isle of Man) vs. The Russian Federation*, PCA Case No AA 227, UNCITRAL

347 For further information about the *Yukos* case, please see also P. D. Cameron, *International Energy Investment Law: The Pursuit of Stability*, (Oxford, Oxford University Press : 2010) 189

Furthermore, as was mentioned in the previous chapter, oil and gas prices have soared dramatically over recent years. The increase of price in the petroleum industry spurred petroleum producing states on to introduce new taxes for the petroleum sector or increase pre-existing tax rates. In the interests of obtaining a larger share of the cake, or as a result of resource nationalism, some host states in Latin America have frequently indulged in tax-hiking measures. The Venezuelan Hydrocarbons Law³⁴⁹ best illustrates this tactic.

The late president of Venezuela, Hugo Chavez, announced radical new government measures with regard to hydrocarbon law and imposed a new tax regime specifically directed at the petroleum industry.³⁵⁰ The government measures were served as an ultimatum to western petroleum companies i.e. ‘pay up or get out’. In accordance with the new tax regime all alien oil and gas companies had to pay ‘income tax at rate of 50% instead of the previous “preferential rate” of 34%.’³⁵¹ There is no doubt that the sudden enforcement of such tax reforms had a major impact on international alien petroleum companies in Venezuela.

3.2 Interference in contract rights

Governments can take action for reasons of public policy; however such reasons should not alter or adversely affect the contractual rights of investors. In other words, a state measure should not prevent an alien investor from benefitting from the contractual arrangements they originally entered into.³⁵² As mentioned in the previous chapter, international customary law protects an alien investor’s contractual rights against

348 Please see the following cases regarding taxation; *Revere Copper and Brass Inc. vs. Overseas Private Investment Corporation*, 24 August 1978, 56 ILR 268 ; *Sedco, Inc. vs. National Iranian Oil Co.*, Interlocutory Award 9 Iran-US C1. Trib. Rep. (1985); *Philips Petroleum Co., Iran vs. Islamic Republic of Iran*, 21 Iran-US C1. Trib.Rep.79

349Decreto con Fuerza de Ley Organica de Hidracarburos (Decree with Force of Organic Law of Hydrocarbons), Decree No. 1,510, 2 Nov., 2001, Official Gazette No. 37, 323

350Freshfields Bruckhaus Deringer, ‘Venezuela: Proposed Measures Against Oil and Gas Investors’, (May 2005) 1 also available at:

<<http://www.freshfields.com/uploadedFiles/SiteWide/Knowledge/Venezuela%20-%20proposed%20measures%20against%20oil%20and%20gas%20investors.pdf>>

March 2013

351 Ibid.

352 S. Ripinskyi& K. Williams, ‘*Damages in International Investment Law*’, (British Institute of International and Comparative Law, 2008) 9

expropriation. Similarly, investment treaties include expropriation provisions which protect alien investors' contractual rights against any type of expropriation. Nevertheless, it should be noted that investment treaties, must be examined on a case by case basis to determine whether the investment treaty embodies contract rights under the treaty's definition of investment.³⁵³ As mentioned above, the violation of a contract may lead to the loss of the contractual rights of an investor and deprive him/her of any benefit issuing from the investment. To this end, a significant question ought to be asked: does every violation of contract amount to indirect expropriation? This is not the case, even if contractual rights are breached³⁵⁴. There are various tribunal decisions that prove that not every instance of state interference in contractual rights is deemed to amount to indirect expropriation. For instance, in the NAFTA case of *Waste Management Inc. vs. United Mexican States*, the tribunal distinguished between the cautious expropriation of a right under a contract and non-compliance by the state with its contractual commitments:

The mere non-performance of contractual obligations is not to be equated with a taking of property, nor (unless accompanied by the other elements) is it tantamount to expropriation. Any private party can fail to perform its contracts, whereas nationalization and expropriation are inherently a governmental act.³⁵⁵

A comparable decision was upheld by the tribunal in the ICSID case of *Parkerings-Compagniet As vs. Lithuania*. On consideration of this case a cumulative condition is required by the tribunal in order to deem that the contractual rights are expropriated by the state interference. These cumulative conditions are as follows

First, a breach of an agreement will amount to an expropriation only if the State acted not only in its capacity of party to the agreement, but also in its capacity of sovereign authority, that is to say using its sovereign power. Second, a breach of contract, of there should be one is, itself, not always sufficient to amount to an indirect expropriation within the meaning of the BIT. An investor faced with a breach of an agreement by the State counterparty should, as a general rule, sue that party in the appropriate forum to remedy the breach. Third, the breach of the Agreement, in case the termination of the agreement, must give rise to a substantial decrease of the value of the investment.³⁵⁶

As *Parkerings-Compagniet* had not met the conditions required by the tribunal, the company's claim regarding the expropriation of contractual rights was rejected.

353 Ibid

354 J. W. Salacuse (n.10 above) 304

355 *Waste Management Inc. vs. United Mexican States (Waste Management II)* ICSID Case No. ARB (AF)/00/3 NAFTA Award 30 April, 2004

356 *Parkerings-Compagniet As vs. Lithuania*, ICSID Case No ARB/05/08 Award September (2007) paras 443-456

3.3 Interference with management rights

The exercise of management control over an investment is a significant right of an alien investor. If an alien investor's actual control over its own management is removed, thereby causing disruption to its commercial activities due to governmental intervention, then this unlawful state interference can be deemed indirect expropriation. When can such a situation emerge and in what way does such a government action affect the investor? As mentioned above, this governmental action eliminates the actual management control of the investor '...by either physically and/or legally impeding the investor to continue his or her management tasks or by replacing the investor-controlled management by government appointed-management.'³⁵⁷ The direct effects this can have include temporary losses in business revenues, potential delays to scheduled projects and a number of other knock-on effects to business planning, staff morale and so on not to mention the taking of an international company. How can this occur? For instance, a host government may arrest or deport the alien investor or other persons who are in charge of the business activities of the company.

The *Biloune vs. Ghana* case illustrates this point. Mr Biloune, a Syrian national established a company of which he was a 60% shareholder. The company held an agreement with their Ghanaian partners to build a hotel resort complex. After a substantial part of its construction had been completed, business activities were halted and the construction demolished by decision of the government authorities. Afterwards, Mr Biloune was arrested and expelled from the country. This was a clear-cut case of expropriation. The Tribunal stated that:

The conjunction of the stop work order, the demolition, the summons, *the arrest, the detention*, the requirement of filing assets declaration forms, and *the deportation* of Mr Biloune without possibility of re-entry had the effect of causing the irreparable cessation of work on the project. Given the central role of Mr Biloune in promoting, financing and managing MDCL, his expulsion from the country effectively prevented MDCL from pursuing the project. In the view of the Tribunal, such prevention of MDLC from pursuing its approved the project would *constitute constructive expropriation (italic added)* of MDCL's contractual rights in the project and, accordingly, the expropriation of the value of Mr Biloune's interest in MDCL, unless the respondents can establish by persuasive evidence sufficient justifications for these events.³⁵⁸

357 A. Reinnisch, (n.11above) 453; see also M. Sornarajah (n.42 above) 400; J.W. Salacuse (n.10 above) 304

358 *Biloune and Marine Drive Complex Ltd. vs. Ghana Investments Centre and the Government of Ghana*, UNCITRAL ad hoc Tribunal, Award on Jurisdiction and Liability, 27 October 1989, 95 ILR183, 209 (*italic added*)

As there was no strong evidence found to support the Government of Ghana's actions, the tribunal concluded its statement with the following words: 'the Government of Ghana, by its act and omission, culminating with Mr Biloune's deportation, constructively expropriated MDCL's assets, and Mr Biloune's interest therein.'

3.4 Revocations of licence or denial of government permits

The cancellation of permits and licences of foreign investors is regarded as regulatory taking. If such a regulatory taking is made without due process of law, which is one of the main criteria of lawful taking, then this taking becomes discriminatory and could amount to a compensable taking. Indirect expropriation and, generally speaking, granting licences and permits to foreign investors are privileges that arise from an agreement. If an alien investor's licence or permits are cancelled, one can categorically affirm that the said alien investors' business activities will be unfavourably affected. It is worth mentioning here that generally, modern investment treaties provide protection against a cancellation of licences and permits.³⁵⁹ The *Goetz* case best illustrates the issue of the cancellation of licences or permits. In the *Goetz* case, Goetz's free zone status was cancelled by Burundi, without any formal taking of property. The ICSID tribunal held that 'the government's action fell within the concept of measures having the effect of being similar to expropriation, i.e., they constituted a direct expropriation'³⁶⁰. Although the award, decision and the confines of international arbitral tribunals will be analysed in detail and their contribution to answering the question of what constitutes indirect expropriation will be discussed in the following sections; however, it would be appropriate to mention briefly the environmentally motivated cancellation of licences and permits.

The revocation of licences on environmental grounds is a growing occurrence. In order to protect the environment, sovereign states prefer to cancel investor's licences or permits. Although such revocation of licences finalise the foreign investment, they are not usually held to be a compensable taking.³⁶¹ In the case, *Murphyores Ltd vs. The Commonwealth*,³⁶² a concession right was provided by the Australian government to two American companies for sand-mining on Fraser Island, close to the Great Barrier Reef. Shortly after the start of the operation, an environmental study was conducted in the area which found that sand mining jeopardised the ecological balance of the Great Barrier Reef and recommended that all operations should urgently be halted. The Australian government revoked all the licences it had previously granted and terminated all sand mining activities. In the ensuing case, the Australian High court ruled that the actions of the Australian government did not constitute a compensable taking; and consequently any related compensation claims were rejected.

359 For instance, US 2004 BIT model.

360 *Goetz vs. Burundi*, ICSID Case No. ARB/95/3 at 26

361 M. Sornarajah (n.42 above) 403

362 See *Murphyores Ltd vs. The Commonwealth* (1976) 16 CLR 1

An issue that causes great concern among alien investors is the possibility of facing unexpected regulatory or administrative actions with the aim of environmental protection after the contract is signed.³⁶³ At this point two significant factors should be evaluated. First, whether the new environmental regulations in the administrative law system have discriminatory intent, or are designed to attain other ends other than those they purport to.³⁶⁴ It is also necessary to pose the question: can the host state cancel the licences and permits of alien investors on environmental grounds? According to Sornarajah 'the cancellation is usually a punitive measure for not abiding by the purpose behind the regulation or conditions to which the licence is subject.'³⁶⁵

What then is the real purpose of host governments in such cases? Perhaps, the actual purpose is to force the investor out and give them no other option but to sell the investment to the host state. If this is the case, the actions of the host state are unlawful; this deliberate regulatory action '...constitutes indirect expropriation and requires compensation...' ³⁶⁶ The second possibility is that the administrative system of the host state imposes new environmental regulations in order to protect the environment and/or the health of its citizens and, in order to do so, resorts to revoking the licence and permits of investor. Can a regulatory action of this kind be deemed indirect expropriation? The simple answer is 'no', a measure thus motivated would be classed as legitimate police power regulation. In the *Sedco* case the international tribunal asserted that it is 'an accepted principle of international law that a State is not liable for economic injury which is a consequence of *bona fide* 'regulation' within the accepted police power of states.'³⁶⁷

4. Criteria for Distinction between Legitimate Regulation (Non-Compensable Regulation) and Indirect Expropriation

In section three, it was stated that while some state measures may amount to indirect expropriation and therefore warrant the payment of compensation is due, other types of state interference may not constitute indirect expropriation, as they are simply examples of the host state exercising its sovereign right to regulate. This prompts the question: in what respects can legitimate regulation be distinguished from indirect expropriation? Unfortunately this question is at the heart of an unresolved issue on the

363 G. Verhoosel, 'Foreign Direct Investment and Legal Constrains on Domestic Environmental Policies: Striking a Reasonable Balance between Stability and Change', *Law & Pol'y Int'l Bus.* 29 (1998):451-478

364 For instance, governments may impose some restrictions on investors or cancellations of licence and permits of investors make them to sell the investment.

365 M. Sornarajah (n.42 above) 402

366 J.M. Wagner, (n. 21 above) 418

367 *Sedco Inc. v National Iranian Oil Co.*, *Interlocutory Award* 9 Iran-U.S Cl. Trib. Rep. 248 , 275 (1985)

agenda of international investment law. More importantly, although international investment tribunals and legal scholars are not necessarily at loggerheads, they have nonetheless failed to provide ‘...a definitive test establishing when measures attributable to the host state breach the dividing line between legitimate regulation and compensable indirect expropriation.’³⁶⁸ As mentioned above, making an exact distinction is not always straightforward, as there is no formula available to determine the boundaries between legitimate regulation and indirect expropriation.³⁶⁹ This is due to the fact that host government measures are broad in scope and do not neatly fit into contractual formulae³⁷⁰.

The case of *Generation Ukraine, Inc. vs. Ukraine* exemplifies the difficulty in distinguishing between non-compensable regulation and indirect expropriation:

Predictability is one of the most important objectives of any legal system. It would be useful if it were absolutely clear in advance whether particular events fall within the definition of an “indirect” expropriation. It would enhance the sentiment of respect for legitimate expectations if it were perfectly obvious why, in the context of a particular decision, an arbitral tribunal found that a governmental action or inaction crossed the line that defines acts amounting to an indirect expropriation. But there is no checklist, no mechanical test to achieve that purpose. The decisive considerations vary from case to case, depending not only on the specific facts of a grievance but also on the way the evidence is presented, and the legal bases pleaded. The outcome is a judgment, i.e. the product of discernment, and not the printout of a computer programme.³⁷¹

Over the years, many scholars and arbitral tribunals have attempted to provide a watertight definition for the sort of interference that may be said to constitute indirect expropriation. Professor Christie furnished perhaps the most articulate description. According to the author:

it is evident that the question of what kind of interference short of outright expropriation constitutes a ‘taking’ under international law presents a situation where the common law method of case by case development is pre-

368 Z.A. Al Qurashi, ‘Investment Protection under International Petroleum Agreements: an Analysis of Pertinent Arbitral Jurisprudence’, PhD Thesis, University of Dundee (2004) 145-146

369 J. Paulsson & Z. Douglas (n.15 above) 145

370 J. Paulsson & Z. Douglas (n.15 above) 146

371 *Generation Ukraine, Inc. vs. Ukraine*, ICSID Case No ARB/00/9, Award of 16 September 2003, ILM 44 (2005): 404, para. 20.29

eminent the best method, in fact probably the only method, of legal developments.³⁷²

In order to draw an accurate division between legitimate non-compensable regulations and indirect expropriation requiring compensation, arbitral tribunals have thus far distinguished the two phenomena with reference to the following criteria: i) the degree of interference with the alien investor's property right ii) the purpose and context of the state measure, iii) the legitimate expectation of the investor and iv) proportionality.

4.1 The Degree of Interference with Investor's Property Rights

The approach which entails an assessment of the degree of interference with an investor's property rights is commonly consulted by arbitral tribunals and legal academic literature. This has become known as 'sole effect' doctrine. The determining element of whether an indirect expropriation has taken place, according to this assessment, is solely as a result of the effect of the governmental regulatory measure on the investment³⁷³. More fundamentally, *sole effect* doctrine disregards the purpose of the government's regulatory measure – the main consideration of this doctrine is the severity of the economic impact of the measures on the investment and the duration of host government control³⁷⁴.

4.1.1 Severe economic impact and loss of effective control

When the outcomes of international tribunals are compared, it can be surmised that they generally treat the severity of the economic impact incurred by a host governmental regulatory action as an imperative principle in determining whether the measure taken by the government constitutes an indirect expropriation and is subject to compensation or not. International tribunals have frequently rejected the compensation demands of investors, as the measure taken by the host state was not substantial and/or did not deprive investors all or most of the economic benefits that they expect from the investment³⁷⁵. The CMS vs. Argentina tribunal is a good case in point. CMS, a US based

372 G.C. Christie, 'What constitutes a Taking of property Under International Law?', Brit. Y.B. Int.1 L. 38 (1962) 307-338

373 M. Solanes & A. Jouravlev, Revisiting Privatization, Foreign investment, International Arbitration, and Water, (Santiago, Chile, United Nations: 2007) 60 available at: <<http://www.eclac.cl/publicaciones/xml/0/32120/lcl2827e.pdf>> February, 2013

374 P. D. Cameron (n. 48 above) 223; see also M. Erkan, *International Energy Investment Law, Stability through Contractual Clauses*, (Alphen aan den Rijn, Kluwer Law International: 2011) 87; J. W. Salacuse (n.10 above) 308

375 C. Yannaca-Small, (n.7 above) 55; see also UNCTAD, Taking Property, Series issues on International Investment Agreements (New York and Geneva, United Nations: 2000) 36; See also; *Metalclad Corp. vs. United Mexican States*, (ICSID Additionally Facility Case No. ARB (AF)/9701, 30 August, 2000, para. 13

transmission company, claimed that the Argentinian government's decision to suspend a tariff adjustment formula for gas transportation for the duration of an economic crisis in the country, constituted an indirect expropriation.

After consideration of the investor's claim, the tribunal affirmed that 'the essential question is to establish whether the enjoyment of the property has been effectively neutralised' as 'the standard... where indirect expropriation has been contended is that of substantial deprivation'.³⁷⁶ In this case, even though the tribunal recognised that the measure taken by the government provoked a dispute which impacted on the company's business operations, the tribunal decreed that there was no substantial deprivation and hence the expropriation provision of Argentina-US BIT was not violated by Argentinean government. The tribunal also underlined that 'the investor is in control of the investment; the government does not manage the day-to-day operations of the company; and the investor has full ownership and control of the investment'.³⁷⁷

Conversely, in the *Starrett Housing Corp. vs. Iran* case, the expropriation claim was based on the appointment of Iranian managers to an American housing project. The tribunal found that an indirect expropriation occurred through the appointment of an Iranian manager to the company operation. The tribunal held that 'it is recognised by international law that measures taken by a state can interfere with property rights to such an extent that these rights are rendered so useless that they must be deemed to have been expropriated, even though the state does not purport to have expropriated them and the legal title to the property formally remains with the original owner'.³⁷⁸

Furthermore, in the *Tippetts vs. TAMS-AFFA* case, the Tippetts had established a partnership with an Iranian company before the advent of revolution in the country. In the wake of the revolution, the Iranian government appointed a new Iranian manager to the partnership. In this case, the tribunal did not regard the appointment of an Iranian manager *per se* as an expropriation. However, the tribunal regarded the actions of the manager to constitute an expropriation. The tribunal held that:

While assumption of control over property by a government does not automatically and immediately justify a conclusion that the property has been taken by the government, thus requiring compensation under international law, such a conclusion is warranted whenever events demonstrate that the owner was deprived of fundamental rights of ownership and it appears that this deprivation is not merely ephemeral...³⁷⁹

376 *CMS Gas Transmission Company vs. The Argentina Republic*, ICSID Case no. ARB/01/8 Award (12 May, 2005) 262

377 Ibid at 263

378 *Starrett Housing Corp vs. Iran*, Interlocutory Award No ITL 32-24-1, (Dec 19, 1983), reprinted in 4 Iran-US CTR 122 at 154

379 *Tippetts, Abbett, McCarthy, Stratton v TAMS-AFFA*, Award No 141-7- 2 June 29, 1984, reprinted in 6 Iran-US CTR 219

A similar approach was taken by the tribunal in the case of *Metalclad Corp. vs. United Mexican States*. *Metalclad* is an American waste disposal company which had acquired land for the development and operation of hazardous waste landfill in Mexico. In the said case, the Metalclad Company fulfilled all of the legal requirements defined by environmental and planning regulations and the project construction permit was granted by the federal government of Mexico. Nevertheless, although the Mexican federal government initially agreed to grant the permit, the municipality of Guadalcázar successively overturned this decision. Under the NAFTA Agreement, the severe economic impact and loss effective control criteria placed the state's actions in the category of expropriation defined by article 1110. The tribunal referenced this article in its award and stated that '... incidental interference with the use of the property which has the effect of depriving the owner in whole or significant part, of the use or reasonably to be expected economic benefit of property even if not necessary to the obvious benefit of the state...' ³⁸⁰ In delivering its final decision, the tribunal stated that the host government action deprived the company's ability to use its property for its own purpose, the evidence of this deprivation sufficed to determine that expropriation had taken place. ³⁸¹

Also handled by NAFTA tribunals was the *Pope & Talbot vs. Canada* case, *Pope & Talbot* is an American investor with a Canadian subsidiary that manufactured and exported softwood lumber from mills in British Columbia to the United States. The investor claimed that Canada's export control regime breached NAFTA Article 1110. The company went on to assert that the export control regime was a measure tantamount to expropriation because its effect deprived the investor of its ability to sell products in its traditional and natural market in the US. Canada refuted these assertions, and in its defence claimed that the implemented regulation was non-discriminatory and was an expression of the state's police power and therefore non-compensable. The tribunal found that although the implementation of an export control regime did impact on the profits of *Pope & Talbot*, the investor was still technically able to sell its products abroad at a profit because sales abroad were not completely prohibited as a result of the regulatory measure of the state. In relation to the Canadian contention, the tribunal stated that: '... mere interference is not expropriation; rather, a significant degree of deprivation of fundamental rights of ownership is required.' ³⁸² The panel concluded 'that the degree of interference with the investment's operations due to the Export Control Regime did not rise to the level of expropriation (creeping or otherwise)' ³⁸³

³⁸⁰*Metalclad Corp. vs. United Mexican States*, (ICSID Additional Facility Case No. ARB (AF)/97/1), 30 August 2000, para 103

³⁸¹ P. D. Cameroon (n.48 above) 224; see also M. Erkan (n.75 above) 90

³⁸²*Pope & Talbot, Inc. vs. government of Canada*, interim Award (26 June 2000) at para 96

³⁸³*Ibid*, para. 102

Similar elements or the lack thereof, came into play in *Marvin Roy Feldman Karpa (Feldman) vs. United Mexican States* case³⁸⁴ in which the tribunal rejected a claim of indirect expropriation. *Marvin Roy Feldman Karpa*, is a US national who lodged a claim on behalf of the CEMSA, which is a registered alien trading company and exporter of cigarettes from Mexico. When Mexico subsequently withdrew its attractive tax rebate, *Feldman* claimed that he was ‘no longer able to engage in his business of purchasing Mexican cigarettes and exporting them, and has thus been deprived completely and permanently and potential economic benefits from that particular activity’.³⁸⁵ As an owner of the trading company, Fieldman claimed that this action of the Mexican government constituted indirect expropriation and violated Article 1110 of NAFTA. The tribunal found that expropriation did not occur because ‘the regulatory action has not deprived the Claimant of control of his company, interfered directly in the internal operations of the company or displaced the Claimant as the controlling shareholder...Thus, this tribunal believes there has been no taking...’³⁸⁶

In *Occidental Exploration and Production Co. (OEPC) vs. The Republic of Ecuador*,³⁸⁷ Occidental claimed that the host country’s refusal to refund to Occidental the value added tax, to which it was entitled under Ecuadorian law, constituted indirect expropriation of its investment. The tribunal investigated this claim and concluded that there had been no indirect expropriation. The tribunal cited the precedent of the *Metalclad* case to assert that the measure in question did not constitute indirect expropriation since ‘the criterion of ‘substantial deprivation’ as not fulfilled, since in fact there has been no deprivation of the use of the investment, let alone measures affecting a significant part of the investment.’³⁸⁸

There are a number of such cases in the archives of NAFTA and ICSID tribunals. One that is particularly worthy of note is the first case which is based on an indirect expropriation claim under the Energy Charter Treaty. In the *Nykomb Synergetics Technology AB vs. Latvia* case,³⁸⁹ Nykomb claimed that the non-payment of double

384 *Marvin Roy Feldman Karpa (CEMSA) vs. United Mexican States of Mexico* (2002), ICSID Case No ARB (AF) 99/1, Award, IIC 157 (2002)

385 Ibid para 109

386 Ibid, para. 152

387 *Occidental Exploration & Production Co. vs. The Republic of Ecuador*, Final Award, LCIA Case No UN3467 of 1 July 2004, 43 ILM 1248 (2004)

388 Ibid, para 89

389 *Nykomb Synergetics Technology AB vs. Latvia*, Award, SCC Case No 118/2001, IIC 182 (2003), 16 December 2003.

tariffs constituted an indirect expropriation. The ECT tribunal found that regulatory takings may amount to expropriation or its equivalent ‘the decisive factor for an action to be deemed as crossing the line drawing the borderline towards expropriation must primarily be the degree of possession taking or control over the enterprise the disputed measures entail’.³⁹⁰ The tribunal found that in the existing case ‘there is no possession taking of Windau or its assets, no interference with the shareholders’ rights or with the management’s control over and running of the enterprise – apart from ordinary regulatory provisions laid down in the production license the off-take agreement, etc.’³⁹¹

4.1.2 Duration of Host Government Control

The section above sought to assess the scope of interference with property rights by posing the following questions: how much of the property is affected by the state measure? How much is the value of investment diminished in the light of tribunals’ decisions? The duration of the measure taken by the host state is another significant benchmark. This is crucial because the measure simply tests whether the regulations had a severe enough economic impact on the investor’s property rights but this may have been a relatively short-lived problem.³⁹² Some arbitral tribunals have taken into consideration the length of time for which the host state exerted influence over the investor’s property. In the *S. D. Myers vs. Canada* case, the NAFTA tribunal stated that ‘an expropriation usually amounts to a lasting removal of the ability of an owner to make use of its economic rights, although it may be that, in some contexts and circumstances, it would be appropriate to view a deprivation as amounting to an expropriation, even if it were partial or temporary’.³⁹³ In the present case, the NAFTA tribunal disregarded the expropriation claim made regarding a temporary export ban on hazardous waste for disposal, as the duration of the state measure was eighteen months. The tribunal decreed that this was insufficient to constitute indirect expropriation.

A parallel can be found in the case of *BG Group vs. Argentina*³⁹⁴ The tribunal adjudicating in this case also came to the conclusion that no expropriation had occurred as the measure taken by the Republic of Argentina would not have had a permanent impact upon BG, and also because no substantial deprivation was endured by BG’s shareholdings.³⁹⁵

390Ibid para 33.

391 Ibid

392 In doctrine, Professor Christie touched upon the importance of time factor in his article. Please see G. C. Christie (n.73 above) 331

393*S. D. Myers Inc. vs. Government of Canada*, Partial Award, 13 November 2000, 40 ILM (2001) 1408, para. 283

394*BG Group Plc. vs. the Republic of Argentina*, UNCITRAL Arbitration, Final Award, IIC 321 (2007), 24 December 2007.

395 Ibid, paras 270-271

4.2 The Purpose Test

The second test utilised by tribunals to determine whether indirect expropriation has occurred or not is the ‘character of governmental measure’, also known as the ‘purpose approach’. ‘Proponents of this theory consider the governmental measure as a challenge to the investor in a contextual framework that allows, indeed requires, a weighing and balancing of factors including the purpose as well as the effect of the measure.’³⁹⁶ In a broad sense, if the intention of a government is legitimate in that it is made for a public purpose such as public health, safety, morals or environmental protection, the measure is normally deemed a police power exercise which merits no compensation.³⁹⁷ It should be borne in mind that if governmental measures are imposed for public benefit, this cannot amount to indirect expropriation, unless the government demonstrates clear intent to deprive the alien investor.

Furthermore, as mentioned in the second chapter, while states may limit their sovereign rights by signing up to international agreements and contracts; these limitations should not be regarded as all-encompassing as sovereign states do retain their policing power to adopt measures to regulate their economic, financial, environment, human rights and other relevant interests for the public benefit. With regard to the police power notion, it is fair to say that host governments are free to exercise their powers to restrict international investors’ property rights without the payment of compensation in pursuance of a legitimate purpose. To this end, could it be claimed that such regulatory measures taken by the host state are to the detriment of foreign investors in realising the profit expected from their investment? The answer is not straightforward, because while international law recognises the police power of a state, due to its sovereignty, ‘foreign investment law recognises the concept of regulatory expropriation.’³⁹⁸ The implications of this grey area continue to present challenges in host government and investor relationships and for those who attempt to legislate and uphold the law.

Much attention has been given to this tension in international tribunals and several attempts have been made in tribunals to settle disputes by claiming regulatory expropriation. It should also be noted that finding evidence and proving a state’s discriminatory intention is no mean feat.³⁹⁹ The *Sea-Land case*⁴⁰⁰ best illustrates this difficulty. In this case, the tribunal set out the standards by which the government’s

396 L. Fortier and S. L. Drymer (n.5 above)313; P. D. Cameron (n.48 above) 227; C. Yannaca-Small, (n. 7 above) 64

397 G.C. Christie (n. 93 above) 338 see also P. D. Cameroon (n.48 above) 227

398 S.P. Subedi, *International Investment Law: Reconciling Policy and Principle*, 2nd edn (US and Canada, Hart Publishing: 2012) 157

399 P. D. Cameroon (n.48 above) 227

actions would be judged as follows: ‘*a finding of an expropriation would require, at very least, that the Tribunal be satisfied that there was deliberate governmental interference with the conduct of Sea Lands’ operations, the effect of which was to deprive Sea-Land of the use and benefit of its investment*’.⁴⁰¹ (Italic added). The tribunal ruled no expropriation had occurred in this case.⁴⁰²

The purpose test was also applied in the context of NAFTA jurisprudence in the *S. D Myers vs. Canada* case⁴⁰³ ‘but in conjunction with an effects test’.⁴⁰⁴ *S. D. Myers* is a US hazardous waste disposal company which operated a PCB waste treatment service in Ohio. The Canadian Ministry of the Environment had banned the commercial export of waste from a synthetic chemical compound of PCB under its Environmental Protection Act. The company claimed that the Canadian ban amounted to expropriation because the ban deprived the company of business opportunities and violated NAFTA Article 1110. The Canadian government contended that the ban was a measure taken in the interests of the environment. The NAFTA UNCITRAL tribunal accepted that ‘international law makes it appropriate for tribunals to examine the purpose and effects of governmental measures’; however, ‘it must look at the real interests involved and *the purpose and effects of the government measure*’.⁴⁰⁵ (Italic added).

A similar verdict was reached by the ICSID tribunal in the *Olguin vs. Paraguay* case. The tribunal stated that ‘expropriation therefore requires a teleological driven action for occur it to occur; omissions, however egregious they may be, are not sufficient for it to occur; omissions; however egregious they may be are not sufficient for it to take place’.⁴⁰⁶ Taking into consideration the latter two cases, it is apparent that the tribunals accepted the purpose approach by referring to the purpose and effect of the government measure. Notably, although these last two cases can be good examples of the purpose approach, there are also some counter examples of tribunals with regard to this test. For instance, in *the Philips Petroleum Co. Iran vs. Islamic Republic of Iran* case, the tribunal stated that ‘a government’s liability to compensate for expropriation of

400 *Sea-Land Sevs. Inc. vs. Iran*, 6 Iran-US CI. Trib. Rep. 149 (1984), 166.

401 Ibid

402 ibid

403 *S. D. Myers. Inc. vs. Government of Canada*, Partial award of 13 November 2000, 40 ILM 1408 (2001) para.285

404 *P. D. Cameroon* (n.48) 227

405 *S.D Myers. Inc. vs. Government of Canada* (n.104 above) paras 281, 285

406 *Olguin vs. Republic of Paraguay*, ICSID Case No.Arb/98/5 26 Jul. 2001, para 84

alien property does not depend on proof that the expropriation was intentional'⁴⁰⁷. A comparable decision was reached in the *Metalclad vs. Mexico* panel, where the tribunal asserted that there is no need to decide or regard the motivation or intention of the adaptation of the Ecological Degree.⁴⁰⁸

4.3 Legitimate Expectations of Investor

The investor's reasonable and legitimate expectations test is the other significant criteria which tribunals evaluate. The aim of this test is to ascertain whether or not an investor's legitimate expectation has been adversely affected. It should be borne in mind that the indirect expropriation claim 'must be objectively reasonable and not based entirely upon the investor's subjective expectations.'⁴⁰⁹ More importantly, it is the responsibility of the investor, to provide evidence that 'his/her investment was based on a state of affairs that did not include the challenged regulatory regime.'⁴¹⁰ It has been asserted that this doctrine is commonly linked with fair and equitable treatment standards; nevertheless, it plays a significant role in determining the law applicable to indirect expropriation.⁴¹¹ It goes without saying that each alien investor expects to attain specific economic benefits from the investment they made. Generally speaking, most governments in today's business world actively invite investors and create expectations by introducing new laws or announcing new welcoming programmes. Such announcements and favourable laws may be the major driving factors in an investor's decision to pursue a venture in a host country. The following cases under NAFTA and ICSID best illustrate how tribunals regard the legitimate expectation criteria when assessing alleged indirect expropriation.

As mentioned above, in the *Metalclad* case, the company had met all the necessary requirements and the project construction permit had been granted by the Mexican federal government. Naturally, the company had counted on the guarantee given to it before the project commenced. As a result, the tribunal held that 'these measures, taken together with the representations of the Mexican federal government, on which *Metalclad* relied, and the absence of a timely, orderly or substantive basis for

407 *Philips Petroleum Co. vs. Islamic Republic of Iran* (n.49 above)

408 *Metalclad Corp. vs. United Mexican States*, (ICSID Additional Facility Case No. ARB (AF)/97/1), 30 August 2000, para 111

409 *C. Yannaca-Small*, (n.7 above) 68

410 *Ibid*

411 *P. D. Cameroon* (n.48 above) 226; See also *A. Reinisch* (n.11) 448

the denial by the municipality of the local construction permit, amount to an indirect expropriation.⁴¹²

The tribunal delivered a similar verdict in the *TECMED* case.⁴¹³ In this case, the Spanish company Tecnicas was required to renew its licence in order to continue operating in the landfill; however, the Mexican State agency refused the licence renewal request of the investor. The ICSID tribunal found that the measures taken by the Mexican state agency amounted to expropriation and held that ‘even before the claimant had made its investment, it was widely known that the investor expected its investments in the landfill to be long term and that it took this into account to estimate the time and business required to recover such investment and obtain expected return...such expectations should be considered legitimate...’⁴¹⁴

In the *Methanex Corp vs. United States of America* case,⁴¹⁵ the tribunal’s approach exhibited key differences to the *TECMED* case. In that case, the Claimant alleged that the ban levied by the Californian government on the sale and use of the gasoline additive methyl-tertiary butyl ether (MTBE) had been tantamount to an expropriation. Therefore the loss of the company needed to be compensated. In its defence the US asserted that the prohibition of the MTBE was necessary and justifiable because the substance in question can contaminate drinking water, thereby categorising their claim as motivated by public purpose. The tribunal rejected the investor’s claim and provided instructive statements in the context of the legitimate expectation of investors. In this regard, the tribunal held that with reference to international law, non-discriminatory measures were taken by the host state for the public purpose that did not constitute expropriation as long as specific commitments were provided by the state ‘to the then putative foreign investor contemplating investment that the government would refrain from such regulation’.⁴¹⁶ It is apparent that the tribunal did not concentrate on, in the first instance, whether an expropriation had taken place, it instead focused its attention on determining whether the measure taken by the Californian government was for public purpose and could therefore be deemed legitimate.

4.4 The Proportionality Test

412*Metalclad* (n.109 above), para 107

413*Tecnicas Medioambientales TECMED SA vs. The United Mexican States*, ICSID Case No. ARB (AF)/00/3,(2004) (*TECMED* Hereinafter)

414 *Ibid* para 150

415*Methanex Corporation vs. United States of America*, Final Award on Jurisdictions and Merits, 2 August 2005.

416*Methanex*, Part IV Chapter D, para 7

Another significant test is the proportionality of the measures taken by the host government. In determining whether a host government's measure constitutes an indirect expropriation, tribunals have also examined whether the measure taken by the government is reasonably proportional to the purpose the government seeks to attain.⁴¹⁷ The focus of this analysis is the impact of the measure taken against alien investors versus the impact on host state nationals.⁴¹⁸ As was stated by the tribunal in the *TECMED* case, there had to be 'a reasonable relationship of the proportionality between the charge or levy imposed on the foreign investor and the aim sought to be realised by any expropriatory measure'.⁴¹⁹

Moreover, the proportionality test is frequently referred to in the jurisprudence of the European Court of Human Rights (ECHR). In *James and Others vs. The United Kingdom*, the court stated that: 'Not only must a measure depriving a person of his property pursue, on the facts as well as in principle, a legitimate aim 'in the public interest,' but there must also be a *reasonable relationship of the proportionality between the means employed and the aim sought to be realised*... [t]he requisite balance will not be found if the person concerned that a measure must be both appropriate for achieving its aim and not disproportionate thereto.'⁴²⁰ (Italic added). Even though the proportionality test is applied most frequently in the context of ECHR, the investment arbitral tribunals have also applied the test in determination of indirect expropriation, such as the *TECMED* case and more recently the *Azurix* case.⁴²¹

5. Sole effect versus Police Power

Throughout section four, selected case studies have served to illustrate how a number of arbitral tribunals have adopted differing approaches to distinguish between non-compensable regulatory measures and indirect expropriation. Taking into account this overview it is fair to state that not one of the principles applied clearly prevailed over the others and it can be concluded that is difficult to predict what an investment tribunal's approach will be from one case to the next. It can be claimed that having no precise criteria at hand creates an uncertain atmosphere in international investment law. This uncertainty is '...not only a problem for the investment or state involved arbitration, but that also undermines the legitimacy of investment law as a whole, as it

417 J. W. Salacuse (n.10 above) 313

418 Ibid

419 *TECMED* (n. 114 above) para 122

420 *James and Others vs. The United Kingdom Case* (21 February 1986) Series A No. 98, para 50

421 *Azurix Corp. vs. Argentine Republic*, (ICSID Case No.Arb/01/12), Annulment Proceeding, Decision of the Ad Hoc Committee, Sept. 1, 2009

remains unclear what rights investment law grants to foreign investors and to what degree it interferes with the sovereignty of states to regulate their economic order⁴²².

What can be asserted with conviction is that, generally speaking, the sole effect test and the purpose approach are more frequently applied than any of the other available methods in tribunals and for this reason an important question needs to be addressed regarding these two approaches: should investment tribunals concentrate on merely the sole effects of the measure taken by the host state or they ought they to focus on police power doctrine?

According to Dolzer, the effect of the host state measure ought to be the sole criterion⁴²³ and little weight should be given to the purpose of the state in establishing the measure.⁴²⁴ Conversely, Al-Qurashi argues that sole effect doctrine should not be the unique approach and exclusive criteria applied by tribunals.⁴²⁵ In other words, investment tribunals should not pay less attention to or single out the police power approach, because focusing on one specific principle may lead tribunals to more frequently reach verdicts that disadvantage the host state. Naturally, in the long term, any measures taken by the host state could be seen as a threat for investors and interpreted as having an impact on an alien investor's property rights. For this reason, before investing in a foreign country, investors should be aware of the risks that arise from regulatory change which may affect their business operations or property rights.⁴²⁶

Generally speaking, it is clear that tribunals aim to reach conclusions regarding the discussion of whether the state measure constitutes indirect expropriation and the host government is liable to pay compensation as a consequence of bona fide domestic regulation. What has been found in this section is that there is inconsistency between these two approaches. Perhaps the fairest approach from the point of view of both parties is to give due consideration of both doctrines in determining whether the actions amount to indirect expropriation.

6. Bilateral Investment Treaties of Azerbaijan and Turkey and their treaty provisions concerning indirect expropriation

422 M. Perkams, The Concept of Indirect Expropriation in Comparative Public Law- Searching for Light in the Dark, Chapter 4 in S. W. Schill, *International Investment Law and Comparative Public Law*, (Oxford, Oxford University Press: 2010) 111

423 R. Dolzer (n.1 above) 64 ; A. Reinisch, (n.11 above) 405

424 J.W. Salacuse (n.10 above) 316

425 Z. A. Al-Qurashi, 'Indirect Expropriation in the Field of Petroleum', *Journal of World Investment and Trade* 5, No.6 (2004) 897,907 cited in M. Erkan,(n.75 above) 93

426 Ibid

The Bilateral Investment Treaty (BIT) is one of the most significant tools to attract foreign direct investment in a developed or developing country. Each developed state regards the BIT as a catalyst for economic growth and development of their countries. In addition to their attempts to attract investors into their territories, they commit to providing a favourable investment environment to investors from their own country. In that respect, it can be stated that through BITs, industrialized countries obtain legal promises or indeed protections for domestic investors based on international law. Unlike national domestic laws on FDI, that can also suggest safeguards and encouragements to alien investors but are liable to change with a change of government, no state can unilaterally modify international law or provisions exist under BITs.⁴²⁷ The first BIT to be signed was between Pakistan and Germany on 25 November, 1959. Since 1959, 2,800 BITs have been concluded around the world.⁴²⁸

The life span of such treaties can be ten to twenty years, with continuing coverage normally for 20 years after the termination on investment agreements made whilst they are in force.⁴²⁹ Despite the fact that 2,800 BITs to date have been entered into between many diverse states, the safeguards and guarantees they include are more or less similar. They are designed to cover the following five elements: 1) protection from expropriation without compensation; 2) most favoured nation provisions; 3) national treatment provisions; 4) fair and equitable treatment; 5) methods of dispute settlement. However, save a few exceptions, the vast majority of BITs do not define indirect expropriation even though it is possible that state actions may constitute indirect expropriation. It could be concluded that rather than depending on tribunals to determine whether or not a state action constitutes indirect expropriation, it might be more appropriate and help avoid future deliberation if states determined in their BITs what possible state action may be classed as indirect expropriation as well as providing a clear definition of indirect expropriation.

The following sub-sections examine the BIT models of Azerbaijan and Turkey to investigate whether their BITs provisions define indirect expropriation or illustrate what possible state actions may cause indirect expropriation.

Azerbaijan

Since 1991, Azerbaijan has enacted a significant number of laws and initiatives designed to facilitate foreign investment in its territory. To become part of a global economy, participate in international organisations' activities and sign international agreements have been the goals Azerbaijani governments aspired to. Azerbaijan signed its first raft of BITs with a number of developed and developing countries during 1990s. By 1999, the country had signed 17 BITs with its neighbours and major trading partners outside the Caucasus region that included some OECD countries, such as Turkey,

427 S. P. Subedi (n. 99 above) 81-82

428 World Investment Report (2011) 100 available at:
<<http://www.unctad-docs.org/files/UNCTAD-WIR2011-Full-en.pdf>> April 2013

429 Ibid

Germany, France and the United Kingdom. Between 1999 and 2013, the country has concluded 28 more BITs, with some EU member states as well as other non-EU states such as Egypt, Qatar and Israel. In total, Azerbaijan has concluded 45 BITs. The main objective of these agreements was to supply fair, foreseeable, transparent and non-discriminatory principles for foreign investors in its territory. The general characteristic of Azerbaijan's BITs was stated by interview respondents. Most of the respondents emphasised that Azeri BITs treat both national and foreign investors equally.⁴³⁰ They also provide unrestricted transfer of profits, dividends and royalties, compensation in the event of expropriation or nationalisation, exemptions from performance standards and application of international arbitration should a dispute arise.⁴³¹

Notably, all Azeri BITs include an expropriation clause and specifically address 'direct and indirect' expropriation phenomena. For instance, the Azerbaijan-Finland BIT (2003) addresses this in Article 6 of the treaty:

Investments by investors of a Contracting Party in the territory of the other Contracting Party shall not be expropriated, nationalised or subjected to any other measures having the effect, either directly or indirectly, equivalent to expropriation or nationalisation (hereinafter referred to as "expropriation") except for a public interest, on a non-discriminatory basis, under due process of law and against prompt, adequate and effective compensation.⁴³²

It is clear that this expropriation clause explicitly recognises the existence of both direct and indirect expropriation. However the article does not define exactly what single or combination of actions may be deemed indirect expropriation or exactly which outcomes may constitute an indirect expropriation. As stated above, traditional BITs do not proffer a definition for the possible state actions that may constitute indirect expropriation. Moreover, it should also be noted that since 1994, (the first BIT entered into with Turkey), to the present, no indirect expropriation case has emerged against Azerbaijan. In addition to BITs, Azerbaijan has also signed a number of agreements in parallel to prevent double taxation.⁴³³ Azerbaijan's concluded BITs include provisions consistent with Azerbaijani foreign investment law (1992). During the examination, it was realised that the law on foreign investment provides investment security through national treatment provisions and free transfer of funds (after payment of taxes), which in harmony with the BITs signed by Azerbaijan. It is to be recommended that

430 Interview no 16 with Lawyer 21 November ,2012; Interview no 17 with Lawyer 22 November, 2012; Interview no 20 (n.18 above) 26 November ,2012

431 Interview no 19 with Lecturer, 23 November 2012

432 Article 6 of Azeri-Finland BIT (2003) available at:
<http://unctad.org/sections/dite/ija/docs/bits/finland_azerbaijan.pdf> August 2013

433 Azerbaijan has signed to prevent double taxation treaties with 38 countries. For further detail, please see the list of the countries, available at:
<http://unctad.org/Sections/dite_pcbp/docs/dtt_Azerbaijan.PDF> August 2013

Azerbaijan continues to enter into more BITs to further accelerate the flow of investment into its territory.

Turkey

The main goal for Turkey when entering into BITs is to increase the flow of capital and technology into its territory, and provide safeguards to international investors within the framework of the legal system.⁴³⁴ In order to attain the most liberal FDI regime possible, Turkey has entered into BITs with 82 countries since 1962. The first BIT was signed with Germany and was followed by a BIT with the US in 1986. While 74 BITs have so far been approved by the Turkish Parliament, the remainder are yet to enter into force. The defining feature of the Turkish BIT model is their key provisions' compatibility with international investment protection standards, such as: (i) application of national treatment; (ii) most favoured national treatment to alien investor; (iii) guarantee of free transfer of profits; (iv) the terms and conditions of expropriations; (v) compensation for losses; (vi) provisions for international arbitrations. It should be noted that like Azerbaijan, the Turkish BIT model also specifically addresses direct and indirect expropriation. For instance, according to Article 3 (1) of Yemen-Turkey BIT (2011):

Investments shall not be expropriated, nationalized or subject, directly or indirectly, to measures of similar effects except for a public purpose, in a non-discriminatory manner, upon payment of prompt, adequate and effective compensation, and in accordance with due process of law and the general principles of treatment provided for in Article II of this Agreement.⁴³⁵

Similar to the Azerbaijani BIT model, the above-given Turkish BIT's provision specifically references the phenomenon of indirect expropriation. However both countries BITs do not identify what indirect expropriation is or name the possible state actions that may constitute indirect expropriation. The China-India BIT model⁴³⁶ could serve as useful future reference for Turkey and Azerbaijan in this respect as it

434 Republic of Turkey Ministry of Economy, available at: <http://www.economy.govs.tr/index.cfm?sayfa=tradeagreements&bolum=bilateral>> August 2013

435 Article 3(1), Agreement between the Republic of Turkey and The Republic of Yemen Concerning the Reciprocal Promotion and Protection of Investments, available at: UNCTAD's official website; Please see (n. 128 above)

436 Please see Section III (Article 5) of Protocol to the Agreement between the Republic of India and the People's Republic of China on Promotion and Protection of Investments.

'With regard to the interpretation of expropriation under Article 5, the Contracting Parties confirm their shared understanding that:

1. A measure of expropriation includes, apart from direct expropriation or nationalization through formal transfer of title or outright seizure, a measure or series of measures taken intentionally by a Party to create a situation whereby the investment of an investor may be rendered substantially unproductive and incapable of yielding a return without a formal transfer of title or outright seizure.

successfully defines indirect expropriation phenomena and references the state actions that can be deemed to constitute indirect expropriation.

It is worth noting that before current Turkish FDI Law No. 4875 was enacted in 2003, the country used the Law for the Encouragement of Foreign Capital No. 6224 until 2003. According to one interview respondent who works as a lecturer:

Despite the fact that the old FDI law provided some guarantees to foreign investors, no provisions were made for expropriation. For this reason, BITs signed before new laws were passed were not in compliance with the provisions of old FDI law. However, on the adoption of new FDI, this problem was dealt with because the new law regulates against expropriation. It can be affirmed with confidence that the provisions of new law and the clauses exist in BITs are in harmony and comply with each other.⁴³⁷

During the last decade, Turkey has accelerated the number of BITs it has entered into with not only developed countries but also developing states from different regions, such as Afghanistan, Jordan, Yemen, Thailand and the Philippines. Entering into bilateral relationships with developed and developing countries, demonstrates the Republic of Turkey's efforts to develop its economy as well as improve its political relationships. In order to boost its BITs, the country has also entered into a number of supplementary agreements with several countries in parallel to its BITs. For example, in order to prevent double taxation, Turkey has signed double taxation prevention treaties with 76 countries. The benefit of these agreements is that tax paid in one of the two countries can be offset against tax payable in the other; thus preventing double taxation.

2. The determination of whether a measure or a series of measures of a Party in a specific situation, constitute measures as outlined in paragraph 1 above requires a case by case, fact based inquiry that considers, among other factors:

- i. the economic impact of the measure or a series of measures, although the fact that a measure or series of measures by a Party has an adverse effect on the economic value of an investment, standing alone, does not establish that expropriation or nationalization, has occurred;
- ii. The extent to which the measures are discriminatory either in scope or in application with respect to a Party or an investor or an enterprise;
- iii. The extent to which the measures or series of measures interfere with distinct, reasonable, investment-backed expectations;
- iv. The character and intent of the measures or series of measures, whether they are for bona fide public interest purposes or not and whether there is a reasonable nexus between them and the intention on to expropriate.

3. Except in rare circumstances, non-discriminatory regulatory measures adopted by a Contracting Party in pursuit of public interest, including measures pursuant to awards of general application rendered by judicial bodies do not constitute indirect expropriation or nationalization.' The agreement is available at:

<http://unctad.org/sections/dite/ia/docs/bits/India_China.pdf> August 2013

437 Interview no 8 with Lecturer. 4 June 2012 and 8 November 2012

Besides, in order to foster greater freedom of movement for its expatriates, Turkey has also signed social security agreements with 22 countries.

Unlike Azerbaijan, Turkey has had an indirect expropriation claim lodged against it. As a result of the growing demand for electricity, the country decided to liberalise its energy sector during the 1980s. According to this policy, Turkey allowed private companies to establish facilities for the generation of electricity that they could then sell to the government, and also offered incentives to the companies including Treasury Guarantees. In 1994, PSEG,⁴³⁸ a US based company, signed a Concession and Implementation Contract with the government of Turkey for the establishment of a coal fire power plant and an adjacent coal mine. Subsequently, a dispute arose between the parties as to whether the Concession Contract included a final agreement of key terms and what those terms were. In the meanwhile, the legal frame work of the agreement also underwent a change with the enactment of Law No. 4828 in 2001, which eliminated the possibility of the Claimants obtaining a Treasury Guarantee for the project (the corresponding legal provisions were annulled by the Turkish Supreme Court in 2002). According to the claimant all these events, viewed in conjunction, reflected Turkey's intent to damage the Claimant's investment. The Tribunal found that Turkey was in violation of the fair and equitable treatment obligation but dismissed all other claims. In determining the compensation payable, the Tribunal rejected the 'fair market value' standard because no expropriation had been found and because there was no damage to productive assets.

7. Tools for Mitigating Indirect Expropriation Risk

As proposed in the first chapter of this study, rather than concentrating on all the mechanisms or forms of protection which can be deployed by an alien investor against political risks, the study turns its focus to stabilisation technique. Although the following chapter specifically focuses on stabilisation clauses per se, it is also worth briefly mentioning stabilisation clauses along with other legal instruments used in the management of indirect expropriation risk. There are a range of devices available to the host state for it to utilise against alien investors: states may introduce new laws and regulations which terminate or change the condition of a previously agreed contract. More dramatically, the state may use its sovereign powers to unlawfully expropriate the alien investor's property directly or indirectly as well as the property rights of the foreign investor. In order to defend themselves from such violations by the state, there are also some mechanisms available to alien investors to protect them against those measures taken by the host state that affect their business operations. The stabilisation clauses inserted in a host government contract are one way of managing risk.⁴³⁹ In the interests of gaining practical insights from a range of perspectives to add breadth and depth to the discussion the question of which mechanisms can be used by foreign investors against indirect expropriation risks was posed to the interview participants.

438PSEG *Global* (n.40 above)

439 P. D. Cameron, 'Stabilisation in Investment Contracts and Changes of Rules in Host Countries: Tools for Oil & Gas Investors', *AIPN, FINAL REPORT*, 5th July (2006) 9

The respondents considered the question from divergent perspectives. One of the respondents stated that ‘energy investments are based on profit, efficiency and sustainability just like any other type of investment. Therefore, in order to be in a favourable position in the contract and protect the investment against indirect expropriation, foreign investors may require stabilisation clauses from host states’⁴⁴⁰. If it is the case that inserting a stabilisation clause plays an effective role in reducing risk, how the balance of power can be managed between an investor and a sovereign state is an issue worthy of attention. A solution was forwarded by another interviewee who is a lawyer in the field of energy investment. According to this interviewee ‘a fairly drafted contract that includes a stabilisation clause as well as the use of modern models of investment treaties can give assurance against indirect expropriation risk... most states already supply guarantees against unlawful expropriation through their national laws, but energy investors still may not wish to rely merely on these protections’.⁴⁴¹

As a result, the stabilisation clause appears to be one of the most significant mechanisms, albeit deployed in combination with other legal securities, to mitigate indirect expropriation risk in international investment contracts. From the perspective of the investor, inserting such clauses in an investment contract has the benefit of safeguarding their rights, however, accepting such clauses and agreeing to them in long term investment contracts may serve as a disincentive for host governments in as much as it attempts to limit the use of its police power.

8. Conclusion

A significant proportion of chapter three was devoted to examining documented examples of indirect expropriation phenomena. It has been acknowledged that the definition of indirect expropriation is a conundrum in the sphere of international investment law. Modern investment treaties go some way to resolving that conundrum. As previously mentioned, while traditional treaties do not provide a definition of indirect expropriation, some modern investment treaties make mention of indirect expropriation under the definition of investment. This kind of definition of investment covers not only tangible assets but also takes into account the intangible rights of the investors. The interpretation that can be made of this fact is that the expropriation clauses in the BITs ‘may not only protect physical property, such as land and buildings, but also intangible forms of property, such as contractual rights, intellectual property rights, and government business concession.’⁴⁴²

Furthermore, there are various state measures, as described above that may constitute indirect expropriation, such as an excessive or discriminatory tax regime, interference with the management rights of the investor, interference with contractual

440 Interview no. 3 Anonymity Guaranteed, 14 May 2012

441 Interview no.7 with Lawyer, 6 June 2012

442 J. W. Salacuse, *The Three Laws of International Investment: National, Contractual and Interventional Frameworks for Foreign Capital*, 1st edn., (Oxford, Oxford University Press: 2013) 394

rights, revocation of licence and denial of permits. These are all typical examples of indirect expropriation. It should, however, also be noted that, more recently, measures related to environmental or human rights issues have also been used by states as justification for interference in the energy sector. Regardless of the differences between any given type of state intervention and the reasons behind the indirect taking, the fact is that the alien investor's return on investment may be significantly reduced by these forms of state intervention. In an effort to find a resolution to these issues, investment arbitral tribunals have turned their focus to the problem and, as a result of this have created invaluable guidance on the issues arising from indirect expropriation. Nonetheless, the impact of the state measure on the profit that investors expect is not always considered by the investment tribunals, in particular in the case of regulatory taking. In other words, the question of distinguishing non-compensable regulatory state measures and indirect expropriation is, as of yet, an unresolved one and continues to act as a major obstacle in international law. As outlined previously, there are several tests which are applied by arbitral tribunals. From an examination of case law, it became evident that the classification of government measures depends on the specific facts and circumstances of each case. The tests applied by the tribunals concentrate on the severe economic impact on the investment, the legitimate expectation of the investor, the character of the government measure, i.e. the purpose and context of the measure and proportionality criteria. It should also be noted that these tests are not exact formulas that are consistently applied by tribunals. From examples of case law, the only common conclusion that can be drawn regarding regulatory taking is that the state's regulatory activity should not be unlawful and must be fair and proportional. There are two main doctrines perhaps most frequently employed in the determination of whether a government measure constitutes an indirect expropriation or not. These are sole effect doctrine and police power doctrine.

There is no definite evidence that investment tribunals more frequently apply a particular approach. In other words, no one doctrine has been favoured over others in case law. What can be said is that perhaps sole effect doctrine tends to come down on the side of the investor. It could be suggested that during the determination process, tribunals ought to consider not only sole effect doctrine as it suggests a bias in favour of investors, but that police power doctrine should also be regarded, as this understanding is based on the state's right to regulate. Perhaps this combination of doctrines constitutes the fairest approach, removing the uncertainty around the question of distinguishing non-compensable regulatory measure and indirect expropriation. It must be taken into account that, as is always the case in law, law systems can be subject to revision, and indeed can be altered by a state at any time if it adopts various regulatory measures. It is fair to assume that the adoption or revision of an existing legal system is more frequent in developing states than would be the norm in developed countries. However, in order not to leave themselves exposed to the effects of such changes, alien investors should be conscious that those changes may occur at any time and that is advisable for them to seek specific guarantees to protect their investments.

The Bilateral Investment Treaties of Azerbaijan and Turkey were also examined during this chapter. It was found that both countries have entered into a number of BITs with different countries. It is to be recommended that Azerbaijan extend its bilateral treaty investment relations with a large number of states in order to attract more investors into its territory. In this respect, Turkey is comparatively much more established. Moreover, the provisions regarding expropriation in both countries' BITs

are not descriptive in defining indirect expropriation and what measures may or may not constitute indirect expropriation. It is true that most BITs do not adequately address this; however, if Azerbaijan and Turkey follow the some existing modern BIT model, such as that of China-India or other similar treaties which explicitly define indirect phenomena, they would thereby improve their prospects for attracting capital into their economies. Generally speaking, if countries around the world inserted an explicit and comprehensive definition of the term indirect expropriation, rather than simply alluding to it in their BITs, this would be of great assistance to tribunals in determining what state action may/may not constitute indirect expropriation.

As a political risk manager, stabilisation clauses represent one of the best guarantees of all those contractually available in the petroleum industry. The following chapter will lend its focus to the stabilisation clause in detail.

Chapter 4

Stabilisation Clauses: A Shield of Investment Agreements against Risks

1. Introduction

The insertion of stabilisation clauses in international investment agreements is the contractual feature most frequently required by foreign investors in their quest to obtain a stable investment environment. The motivation behind this lies in the scale and scope of the investment and the complex nature of economic development agreements. Over the course of an energy investment relationship an investor may sink billions of pounds into the venture meanwhile, as evidenced in chapter three, the host country has a high degree of control over the fate of the investment made within its territory. The inclusion of stabilisation clauses is intended to guard the investment against the damage incurred by unilateral changes to, or termination of, energy investment contracts at any point in the course of the project.⁴⁴³ In other words, by agreeing to such clauses the host state reassures the foreign private investor that certain aspects of its laws will be ‘frozen’ and the contractual arrangement will not be altered or terminated by the legislative or administrative activities of the host government during the life span of the project. Although stabilisation clauses would appear to grant some guarantees to foreign investors, it is important to test this assumption by posing the questions: to what extent are stabilisation clauses effective in protecting investments or conversely, in contradiction of their intended guardianship, do they instead disenfranchise the sovereign rights of the host state? And do Stabilisation Provisions constitute a threat for Environment and Human rights issues?

Successively, the typology, and the validity of stabilisation clauses under domestic and international law will be examined and their efficacy evaluated. This chapter also analyses the decisions of arbitral investment tribunals with regard to issues of validity. Such an analysis will contribute to an understanding of the legal and functional value of stabilisation clauses and an assessment of their effectiveness in protecting foreign investors’ business in energy investment projects. The notion of ‘state sovereignty’ will

443 Please generally see: T. Waelde & G. Ndi, ‘Stabilizing International Investment Commitments: International Law Versus Contract Interpretation’, *Tex. Int’l L. J.* 31 (1996); P. D. Cameron, *International Energy Investment Law: The pursuit of Stability* (Oxford: Oxford University Press, 2010) 68; see also P. D. Cameron, ‘Stabilisation in Investment Contracts and Changes of Rules in Host Countries: Tools for Oil & Gas Investors’, AIPN Research Paper Final Report 2006; A. Al-Faruque, ‘The Rationale and Instrumentalities for Stability in Long-Term State Contracts: The context for Petroleum Contracts’, *The Journal of World Investment & Trade* 7, no.1 (2006) 85; A. F. M. Maniruzzaman, ‘The Pursuit of stability in International Energy Investment Contracts: A Critical Appraisal of the Emerging Trends’, *Journal of World Energy Investment Law & Business* 1. No. 2 (2008) 121, 156; see also A. F. M. Maniruzzaman, ‘Stabilisation of Investment Contracts and Change of Rules by Host States: Tools for O & G Investors’ AIPN Research Paper First Draft, (2005-2006) 4; M. Erkan, *International Energy Investment Law: Stability Through Contractual Clauses* (The Netherlands: Kluwer Law International, 2010) 101

be another key area of focus in this chapter. The criticisms made by the NGO and the legal documents issued by the project consortium to the BTC project agreements will also be examined in this chapter. The host government agreements that determined this project's terms, conditions as well as the context of drafts are controversial and had a significant impact on the participating countries' ability to exercise their sovereign powers.

2. General Implications of Stabilisation Clauses

In doctrine, several commentators have sought to offer definitions for this contractual article. According to Brownlie, 'the term 'stabilisation clause' relates to any clause contained in an agreement between a government and a foreign legal entity by which a government party undertakes neither to annul the agreement nor to modify its terms, either by legislation or by administrative measures.'⁴⁴⁴ A similar description has been provided by Bernardini. According to this author, stabilisation clauses are an attempt to defend an alien investor by 'restricting the legislative or administrative power of the State, as sovereign in its country and legislator in its own legal system, to amend the contractual regulation or even to annul the agreement'.⁴⁴⁵ In the case of *Amoco Int'l Fin. Corporation vs. Government of the Islamic Republic of Iran*, a definition was provided by the tribunal. The tribunal defined stabilisation clauses as 'contract language which freezes the provision of a national system of law of chosen as the law of the contracts of any future alterations of this system'.⁴⁴⁶

In light of the above given definitions, the purpose of stabilisation clauses should be explored. According to Sornarajah, 'the aim of the stabilisation clause was to ensure that future changes in the legislation of the host state did not vary the terms of the contract on the basis of which entry was made'.⁴⁴⁷ The author goes on to state that inclusion of such clauses in an investment contract provide immunity to an alien investor from a wide range of potential threats to their interests, for instance, 'taxation, environmental controls and other regulations as well as to prevent the destruction of the contract itself before the contract expires'.⁴⁴⁸ Furthermore, in Cotula's words, the purpose of the stabilisation clause is to 'stabilise the terms and conditions of an

444 I. Brownlie, *Principles of Public International Law*, 6th edn (Oxford: Oxford University Press, 2003) 526

445P. Bernardini, 'Stabilization and Adaptation in Oil and Gas Investments', *Journal of World Energy Law & Business*, Vol. 1, No. 1, (2008) 100

446*Amoco Int'l Fin. Corporation vs. Government of the Islamic Republic of Iran*, 16 Iran-U.S. Cl. Trib. Rep. 189, 239 (1987)

447 M. Sornarajah, *The International Law on Foreign Investment*, 3rd edn (Cambridge: Cambridge University Press, 2010) 281

448 M. Sornarajah, (n.5 above) 282

investment project, thereby contributing to manage non-commercial (that is fiscal, regulatory) risk.⁴⁴⁹

In a similar vein, according to Professor Cameron, in international energy contracts, the term stabilisation applies to all of the mechanisms, contractual or otherwise, designed to protect, during the life span of the contract, the benefit of certain economic and legal conditions which host states and foreign investors considered to be suitable at the time they were agreed.⁴⁵⁰ The question of why alien private investors seek to freeze the contractual terms and conditions and the law of host states by inserting such clauses during the life span of the contract is also explained by Sornarajah:

The foreign cooperation stood at a disadvantage in any agreement it made with the host state, as the host state had the legislative power to alter the impact on the contract of any event that took place within its territory or to affect any contractual right or right to property that was located within its territory. Such a power flowed from its sovereignty. It was in the interest of foreign corporation to naturalise this power.⁴⁵¹

What can be understood from the above given definitions is that stabilisation clauses satisfy alien investors' expectations and provide a wide range of protections from discriminatory changes which may adversely affect the terms and conditions of energy investment contracts. In synthesis, it can be concluded that inserting stabilisation clauses in an investment contract creates a shield for international investors against government interference. With regard to this issue, an interview participant who works as a lawyer in the area of international investment law, stated that 'inserting stabilisation clauses in an energy investment contract can go a long way in ensuring the fairness of such contracts to investors and in limiting the potential for the misinterpretation of terms subsequent to the signing of the contract.'⁴⁵²

It is clear that the interview participant's perception of the functioning of stabilisation contracts correlates with the principle upon which stabilisation clauses are founded. However, it should also not be disregarded that although the main purpose of a stabilisation clause is to deter the application of subsequent alterations of host state legislation to the contract; stabilisation clauses may go as far as to discourage the host state from adopting new laws or reforming its legal system at all. How and where this affects environmental or human rights are the issues yet to be tackled in this chapter.

449L. Cotula, 'Regulatory Takings, stabilisation Clause and Sustainable Development, Session 2.2: The policy framework for investment: the social and environmental dimensions', OECD Global Forum on International Investment 27-28 March (2008)5 ,available at: <<http://www.oecd.org/investment/globalforum/40311122.pdf>> March 2013

450 P. D. Cameron, *The pursuit of Stability* (n.1 above) 70

451 M. Sornarajah, (n.5 above) 281

452 Interview no.10 with Lawyer, 5 November 2012

The following sub-section examines the types of stabilisation clauses with regard to the different types of contracts that may exist between a host state and an investor.

3. Typologies of Stabilisation Clauses

The stabilisation clauses that may be inserted into investment contracts may be categorised into four significant types. The first type of stabilisation clause is the freezing clause. This clause is designed to insulate alien investors from subsequent unilateral host governmental actions during the life span of the agreement.⁴⁵³ Such clauses are intended to ‘fix’ or ‘freeze’ the governing law of the contract between parties, the fiscal regime and other available indispensable investment conditions.⁴⁵⁴ This ‘fixing’ or ‘freezing’ of the law is applicable to the contract once the contract is made and is applied throughout the life span of the project.⁴⁵⁵ Notably, this clause creates one of the following two scenarios, either: the state accepts that any changes to legislation enacted after the date of the contract will not apply to the contract, or where there is a discrepancy between the provisions of the contract and any new legislation – any new legislation inconsistent with the clause will not apply to the contract.⁴⁵⁶

This type of stabilisation clauses has also been called a ‘stabilisation clause in *stricto sensu*’. This is a more immoderate version which attempts to impose a definitive check on the legislative power of the host countries. A more thorough comprehension of the workings of the stabilisation clause in *stricto sensu*, can be attained through the provision of an example. The concession agreement between the State of Iran and the Anglo Iranian Oil Company, in 1933 provided that: ‘The concession shall not be annulled by the Government of and the terms therein contained shall not be altered either by the general or special legislation in the future or by the administrative measures or any other acts whatever of the executive authorities’.⁴⁵⁷

453 A. Sheppard & A. Crockett, Are Stabilisation Clauses a Threat to Sustainable Development? Chapter 14 in M. C. C. Segger, & A. Newcombe and M. W. Gehring, *Sustainable Development in International Investment law* (The Hague: Kluwer, 2010) 336

454 T. W. Waelde & G. Ndi, *Stabilizing International Investment* (n.1 above) 260

455 A. Al-Faruque. ‘ Validity and Efficacy of Stabilisation Clauses: Legal Protection vs. Functional Value’, *Journal of International Arbitration* 23, no.4 (2006): 317, 319

456 D. Clinch & J. Watson, ‘Stabilisation Clause Issues and Trends’ Herbert Smith LLP 2010, available at:
<<http://www.lexology.com/library/detail.aspx?g=c5976193-1acd-4082-b9e7-87c0414b5328>> March 2013

457 Anglo-Iranian Oil Co. Case, ICJ Pleading, (1952) 86 cited in Z. A. Alqurashi, ‘International Oil and Gas Arbitration’, *OGEI, Journal of Oil, Gas and Energy Law Intelligence* Vol. 3, (2005), 181-182. (Hereinafter, Z. A. Alqurashi, ‘Oil and Gas Arbitration’)

Another type of stabilisation clause is often referred to as the *intangibility* clause. In the context of this type of clause, the government may not modify or abrogate the contract unless both parties achieve mutual consent. In other words, the host states are not allowed to alter the contract without first obtaining the consent of the investor. This type of clause freezes the contract between the parties, but not the law of the host state in a dispute. It is noteworthy, that this type of clause does not include any explicit waiver of legislative sovereignty rather it aims to preclude unilateral modification of the contract by the host country.⁴⁵⁸ In this regard it is worth supplying some illustrative examples of the intangibility clause. Article 33 of the concession agreement between the Ruler of Abu Dhabi and three Japanese companies provided as follows: ‘The mutual consent of the Ruler and the companies shall be required to annul or modify the provisions of this agreement.’⁴⁵⁹ Another notable example of an intangibility clause can be found in an oil contract between the Government of Qatar and Holcar Oil Company. Article 33 of this oil is a textbook example of this type of stabilisation clause. It provides that: ‘without prejudice to the Government’s prerogative of sovereign powers the mutual consent of the Parties hereto shall be required to annul, amend or modify the provisions of this Agreement.’⁴⁶⁰

In light of the latter two examples, it is apparent that the intangible clause requires mutual consent of the parties in order to modify the terms and conditions of the agreement. When the nature of the intangibility clause is considered, requirement for consent from the parties seems fair and consensual; otherwise the contract would be altered at any time by the host state. More importantly, the main differences between the two types of clauses described thus far, is that while the stabilisation clause in *stricto sensu* aims to protect the investor from any host government legislative activities which may affect the contract, the latter clause protects investors and prevents host states from acting as a unique authority to modify the contract, by requiring mutual consent.

The third type of stabilisation clauses are hybrid clauses. This type of stabilisation clause takes its place in the category of stabilisation clauses which can be regarded as ‘traditional’. Stabilisation clauses in *stricto sensu* and intangibility clauses are the main components of hybrids. An exemplary case study of how such clauses can be found in

458 A. Al-Faruque, ‘Stability in Petroleum Contracts: Rhetoric and Reality’, PhD Thesis, University of Dundee (2005) 108

459 Article 33 of The Concession Agreement between the *Ruler of Abu Dhabi and Maruzen Oil Co. Ltd.; Daikyo Oil Co. Ltd. And Nippon Mining Co. Ltd.*, 6 December 1967, Selected Documents of the International Petroleum Industry, 1967, p. 137 cited in Z. A. Alqurashi, ‘Oil and Gas Arbitration’ (n.15 above) 181

460 Exploration and Product Sharing Agreement between the Government of Qatar and Holcar Oil Co., 1 Jan. 1976, Art., 33, Selected Documents of the International Petroleum Industry, 1967, 249, cited in M. Erkan (n.1 above) 105

combination in a concession agreement is the agreement between Libyan Am. Oil. Co and the Libyan Arab Republic. The contract provided that:

1) The Government of Libya, the Commission and the appropriate provincial authorities will take all steps necessary to ensure that the Company enjoys all the rights conferred by this Concession shall not be altered except by mutual consent of the parties.

2) This Concession shall throughout the period of its validity be constructed in accordance with the Petroleum Law and the Regulations in force on the date of execution of the Agreement of Amendment by which this [paragraph] (2) was incorporated in to this Concession Agreement. Any amendments to or repeal of such regulations shall not affect the contractual rights of the Company without consent⁴⁶¹.

Stabilisation clauses in *stricto sensu*, intangibility and hybrid clauses are all forms of freezing clause which are, in turn, categorised as traditional types of stabilisation clause. Generally speaking, the purpose of traditional stabilisation clauses is to negate the applicability of a law or fiscal regime. In other words, these traditional stabilisation clauses are intended to neutralise the power of a host country by safeguarding an agreement from alteration or threat by any subsequent legislative activities undertaken by the host state without first achieving mutual consent. Reference to the UN resolution on the principle of permanent sovereignty over natural resources helps demonstrate the inconsistency with internationally sanctioned principles these types of clauses can represent.

The resolution regards sovereignty as a unique and inalienable right of the state and asserts the free will of states to exercise their power over their natural resources and stipulates that such power cannot be restricted by a contract. When juxtaposed with the freezing effect traditional stabilisation clauses exert over the applicable law and fiscal regime of the contracting state there is an obvious conflict. This contradiction presents questions about the validity and efficacy of stabilisation clauses which will be explored in more detail in the following section; following an assessment of the second category of stabilisation clauses.

Another type of stabilisation clause provides that the agreement between the parties shall be performed consistently with 'good will' or in 'good faith', hence precluding unilateral alteration or termination.⁴⁶² What this means is that the host state should avoid unilaterally altering or terminating the contract by using its legislative and executive power.⁴⁶³ Furthermore, these type of clauses may be seen '...in either a broad form or a narrow form that stabilises only limited aspects of the contract, such as the

461 *Liamco v. Libya*, 62 I.L.R., 170

462 C. T. Curtis, 'the Legal Security of Economic Development Agreements', *Harv. Int'l L. J.* 29 (1998)347; M.T. B. Coale, 'Stabilization Clauses in International Petroleum Transactions', *Denv. J. Int'l L. & Pol'y* 30 (2002) 223; M. Erkan (n.1 above) 106

463 M. Erkan (n.1 above) 106

applicable tax regime.⁴⁶⁴ Another genre of stabilisation clauses is the economic equilibrium clause which can be categorised in modern stabilisation clauses. The purpose of this type of clause is to restore economic balance between the host state and investor through the application of the renegotiation mechanism.⁴⁶⁵ Such clauses are often called interchangeably: economic equilibrium clause, economic stabilisation clause or balancing clauses.⁴⁶⁶ An accurate definition of these clauses was provided in the Baku-Tbilisi-Ceyhan Agreement:

Economic Equilibrium means the economic value to the Project Participants of the relative balance established under the Project Agreements at the applicable date between the rights, interests, exemptions, privileges, protections and other similar benefits provided or granted to such Person and concomitant burdens, costs, obligations, restrictions, conditions and limitations agreed to be borne by such Person.⁴⁶⁷

It is fair to say that the main difference between freezing clauses and economic equilibrium clauses is the latter's aim to stabilise the economic return of the investor rather than stabilise the legal or fiscal structure. In this type of clause, the state is allowed to make changes and introduce new laws that may have an impact the project.⁴⁶⁸ However, in this scenario, the host government and foreign investor agree on the economic benefit the investor may expect from the project and pledge their willingness to renegotiate the contract to safeguard the investor's economic position; otherwise the host government will be bound to pay compensation to the foreign investor. In other words, the economic equilibrium clauses provides that 'if any government action adversely affects the economics of the project for the companies, then the terms of the agreement will be readjusted to keep the companies in the same financial position as provided by the contract on the date it was signed.'⁴⁶⁹In contractual

464 S.M. Schwebel, *Justice in International Law: Selected Writings of Judge Stephen M. Schwebel*, (Cambridge, Cambridge University Press: 1994) 401-415

465 T. Waelde & G. Ndi, *Stabilizing International Investment* (n.1 above), 266

466 Please see, P.D Cameron, *Tools for Oil & Gas Investors* (n.1 above) 74 also see A. Al Faruque (n.16 above) 100. It should be noted that in order to avoid any terminological ambiguity, the 'stabilisation clauses' in this work cover all forms of stabilisation clauses.

467 Generally see the BTC agreements, Appendix 1 of the Georgian HGA; Appendix 1 of the Turkish HGA and Appendix 1 of the Azeri HGA

468 According to Shemberg, these Exemptions are not specifically emphasised in the contract. A. Shemberg, 'Stabilisation Clause and Human Rights: A Research Project Conducted for IFC and the United Nations Special Representative to the Secretary General on Business and Human Rights' IFC/SRSG Research Paper, 11 May, (2009) Vii.

469 R. D. Bishop, 'International Arbitration of Petroleum Disputes: The Development of *Lex Petrolea*', *YCA* 23 (1998) 1161

practice, traditional freezing and economic equilibrium clauses are frequently applied simultaneously⁴⁷⁰ within the same contract as well as separately.⁴⁷¹

There is no doubt that when the freezing type is used on its own, it can be every effective. Nevertheless, when these two clauses are employed in unison the economic equilibrium provision ‘lays down the outcome of the host state’s breach of promise contained freezing clause that it makes to the contracting partner.’⁴⁷² According to some legal scholars, economic equilibrium clauses can be divided into the following three categories:⁴⁷³ 1) Stipulated economic balancing. 2) Non-specified economic balancing. 3) Negotiated economic balancing. Stipulated economic balancing decrees that the adjustment made can be automatic or achieved in the manner provided for in the agreement.⁴⁷⁴

The Model Offshore Production Sharing Agreement of Pakistan best illustrates this category:

(a) The Government undertakes to uphold the fiscal stability of this Agreement and specifically guarantees that the payments to Government stipulated in Articles 6.6, 6.9, 9.1, 9.6, XIII, XXIV shall not be amended or changed with respect to the application of this Agreement.(b) Where any agency or authority of the Government imposes any tax, cess, fee, duty, levy, or other ancillary payment in addition to the guaranteed payments in Article 31.1(a) as required by the laws of Pakistan other than those concerning health, safety and environmental and related matters of public interest, Government Holdings shall consult with Contractor on appropriate measures in order to compensate Contractor for such unfavourable impacts caused by such amendments. After having quantified the unfavourable impacts, the

470 A. Shemberg, (n.26 above)19-20

471 A. F. M. Maniruzzaman, ‘International Energy Contracts and Cross-Border Pipeline Projects: Stabilisation, Renegotiation and Economic Balancing in Changed Circumstances’, *OGEI, Journal of Oil, Gas and Energy Law Intelligence Vol.4-Issue 4* November (2006) 1

472 Ibid

473 F. C. Alexander, ‘The Three Pillars of Security of Investment Under PSCs and Other Host Government Contract’, Ch.7 of Institute for Energy Law of the Centre for American and International Law’s 54th Annual Institute on Oil and Gas Law (publication 640, Release 54), Lexis Nexis Mathew Bender, February 2003, 7.1,7.19; See also P.D Cameron, *Tools for Oil & Gas Investors* (n.1 above) 31; A. F. M. Maniruzzaman, *International Energy Contracts and Cross-Border Pipeline Projects* (n. 29 above) 1; M. Erkan, (n.1 above) 204

474 F. C. Alexander (n. 31 above) 7.19; P. D. Cameron, *Tools for Oil & Gas Investors* (n.1 above) 31; A. F. M. Maniruzzaman, *International Energy Contracts and Cross-Border Pipeline Projects* (n.29 above) 1; M. Erkan, (n.1 above) 204

Government Holdings share of Profit Oil and Profit Gas shall be adjusted in such a manner that the overall fiscal balance is maintained.⁴⁷⁵

According to Manirruzzaman, ‘in stipulated Economic Balancing provisions various prescriptions for affecting the balance are stipulated.’⁴⁷⁶ To this end, it can be said that in the above given agreement ‘the Pakistani Model Contract stipulates for the adjustment of the government holdings share of the profit oil and profit gas.’⁴⁷⁷ In the case of non-specified economic balancing, there is no need to supply in the agreement for the manner of such adjustments or to stipulate that it ought to be the result of mutual agreement of the contracting parties.⁴⁷⁸ The Azerbaijan PSA of 1998 offers a practical example:

[In] the event that any Governmental Authority invokes any present or future law, treaty, intergovernmental agreement, decree or administrative order which contravenes the provision of this agreement or adversely or positively affects the rights or interests of Contractor hereunder, including, but not limited to, any changes in tax legislation, regulations, or administrative practice, or jurisdictional changes pertaining to the Contract Area, the terms of this Agreement shall be adjusted to re-establish the economic equilibrium of the Parties, and if the rights or interests of Contractor have been adversely affected, then SOCAR [The National Company] shall indemnify Contractor (and its assignees) for any disbenefit, deterioration in economic circumstances, loss or damages that ensue therefrom.⁴⁷⁹

With regard to the above cited contract, Cameron asserts that ‘the role of SOCAR in the contract underlines an important point. In a number of cases the host country’s NOC will play a central role in the operation of fiscal stabilisation. It may provide for adjustment by paying any additional taxes out of its share of profit petroleum or royalty under a PSA or it may reimburse the IOC directly out of general revenues. Under a rate of return system, the NOC could pay from its share of royalty and/or excess profits tax.’⁴⁸⁰

475 [Undated] Art. XXXI cited in A. F. M. Manirruzzaman, (n.29 above) 4, for further details please see footnote n. 8 of the author’s article.

476 A.F.M. Manirruzzaman, *International Energy Contracts and Cross-Border Pipeline Project* (n. 29 above) 6

477 Ibid

478 F.C. Alexander (n.31 above) 7.19; P. D. Cameron, *Tools for Oil & Gas Investors* (n.1 above)31; A. F. M. Manirruzzaman, *International Energy Contracts and Cross-Border Pipeline Projects* (n. 29 above) 2; M. Erkan, (n.1 above) 204

479 The Azerbaijan Union Texas/Commonwealth Production Sharing Agreement, 1998, Art 22(2), cited in M. Erkan(n.1 above) 205

480 P. D. Cameron, *Tools for Oil & Gas Investors* (n.1 above)36; M. Erkan, (n.1 above) 204

As a third category, negotiated economic balancing offers the opportunity to contracting parties to meet and discuss how amendments ought to be made to the contract in the event of host state intervention which has the potential to adversely affect the original equilibrium of the contract.⁴⁸¹ The following serve as examples of the practical application of the negotiated economic balancing type of economic equilibrium clauses.

Article 17.1 of the Vietnam Model Product Sharing Contracts of 2004:

If after the effective date, existing laws and regulations are amended or annulled new laws and regulation are introduced in Vietnam,...in any case adversely affecting the economic rights or benefits expected by the contractor from this ... *the parties shall meet and consult promptly with each other and make such changes to this contract* as are necessary both to maintain the Contractor's rights, benefits and interests hereunder and to ensure that any revenues or incomes or profits,... derived or to be derived under this contract... shall not in any way be diminished as a result of such changes...⁴⁸² (emphasis added)

The Egyptian concession agreement 2002, which includes the following provisions:

In case of changes in existing legislation or regulations applicable to the conduct of Exploration, Development and production of Petroleum, which take place after the Effective Date, and which significantly affect the economic interest of this Agreement to the detriment of or which imposes on CONTRACTOR an obligation to remit to the A.R.E. (Arab Republic of Egypt) the proceeds from sales of CONTRACTOR's Petroleum, CONTRACTOR shall notify EGPC (the NOC) of the subject legislative or regulatory measure. *In such case, the Parties shall negotiate possible modifications to this Agreement designed to restore the economic balance thereof which existed on the Effective Date.* The Parties shall use their best efforts to agree on amendments to this Agreement within ninety (90) days from aforesaid notice. These amendments to this Agreement shall not in any event diminish or increase the rights or obligations of CONTRACTOR as these were agreed on the Effective Date. Failing agreement between the Parties during the period referred to above in this Article XIX, the dispute may be submitted to arbitration, as provided in Article XXIV of this Agreement.⁴⁸³ (Emphasis added)

481 F. C. Alexander (n. 31 above) 7.19; P. D. Cameron, *Tools for Oil & Gas Investors* (n.1 above) 31; A. F. M. Manirruzzaman, *International Energy Contracts and Cross-Border Pipeline Projects* (n. 29 above) 2; M. Erkan, (n.1 above) 205

482 Article 17.1 of the Vietnam Model Product Sharing Contracts of 2004, cited in A. Faruque (n.16 above) 100

483 Concession Agreement of 2002 for Petroleum Exploration and Exploitation between Egypt & Egypt General Petroleum Corporations & Dover Investments Limited (East WadiAraba Area Gulf of Suez) Barrows Company Inc., cited in P. D. Cameron, *Tools for Oil & Gas Investors* (n.1 above) 31-32; See also A.F.M. Manirruzzaman, *International Energy Contracts and Cross-Border Pipeline Projects* (n. 29 above) 4; M. Erkan(n.1 above) 206

An additional example of the negotiated economic balancing category can be found in the Qatar Model of Exploration and Production Sharing Agreement, 1994:

Whereas the financial position of the Contractor has been based, under the agreement, on the laws and regulations in force at the Effective Date, it is agreed that, if any future law, decree or regulation affects Contractor's financial position, and in particular if the customs duties exceed . . . percent during the term of the Agreement, both Parties shall enter into negotiations, in good faith, in order to reach an equitable solution that maintains the economic equilibrium of this Agreement. Failing to reach agreement on such equitable solution, the matter may be referred by either Party to arbitration pursuant to Article 31.⁴⁸⁴

The use of a stabilisation clause by contracting parties as a method of economic balancing is in frequent use not only in petroleum production sharing contracts but also in cross-border pipeline projects. The BTC Agreement also contained an economic equilibrium provision no less typical than the previously cited examples:

The State Authorities are to take all actions available to them to restore the Economic Equilibrium established under the Project Agreements if and to the extent the Economic Equilibrium is disrupted or negatively affected, directly or indirectly, as a result of any change (whether the change is specific to the Project or of general application) in host government's law (including Taxes, health, safety and the environment), including changes resulting from:

- The amendment, repeal, withdrawal, termination or expiration of the host government's law;
- The enactment, promulgation or issues of the host government's law;
- The interpretation or application of the host government's law (whether by courts, the executive or legislative authorities, or administrative or regulatory bodies);
- The decision, policies or other similar actions of judicial bodies, Tribunals and courts, the State Authorities;
- Jurisdictional alterations; and
- The failure or refusal of judicial bodies, Tribunals and courts, and/ or the State Authorities to take action, exercise authority or enforce the host government's law (a 'change in law')

The foregoing obligation[s] of the State Authorities to take all actions available to restore the Economic Equilibrium are to include the obligation to take all appropriate measures to resolve promptly by whatever means may be necessary, including by way of exemption, legislation, decree and/or other authoritative acts, any conflict or anomaly between any Project Agreement and the host government's law.⁴⁸⁵

484 Article 34.12 Equilibrium of the Agreement, Borrows Company Basic Oil Laws and Concession Contracts, Middle East, Supplement 124 (1994) 1 cited in P. Bernardini (n.3 above), 110; See also M. Erkan (n.1 above) 206

485 Article 7.2 (x) of The Georgian HGA; Article 21.2 of The Turkish HGA; Article 20.2 of The Azeri HGA

Undoubtedly, economic equilibrium clauses are more convenient than the freezing clause type of stabilisation clauses in terms of their ease of application and functionality. In order to better understand their special character, a comparison should be made in this respect. Traditional stabilisation clauses are designed to protect alien investors by freezing the legal situation in the host state on the point of signing the contract. Due to their function of freezing the legal regime in the host state, such clauses constitute a challenge to the principle of state sovereignty.⁴⁸⁶ Conversely, economic balancing clauses do not pose such a threat to the principle of state sovereignty and instead provide a flexible and dynamic contractual framework for the parties over the course of the investment project in case the host country changes the economic conditions by sovereign act.⁴⁸⁷

In recent years, the use of economic equilibrium clauses in energy investment contracts has surged in popularity worldwide⁴⁸⁸ ‘mainly because of their flexibility and versatility.’⁴⁸⁹ Key to this popularity is the fact that while this type of clause does not strip the host state of its legislative freedoms it still allows the investor room for manoeuvre. From the perspective of the host government the state can maintain its sovereign power over natural resources and can adopt new laws to improve its sustainable development goals. For international investors, the application of such a clause can provide protection and prospects than freezing clauses. Professor Manurizzaman explains why the use of economic equilibrium clause has taken root. According to the author:

The reason for the increasing tendency of International Oil Companies (IOCs) to favour economic balancing provision lies in the fact that if the State’s unilateral acts adversely affect the contract the available remedies could be more favourable under the freezing clauses. Thus the breach of a freezing clause itself may result in only lump sum damages which could be far below what the IOC would consider would be necessary to ‘keep it whole’, whereas in economic balancing clauses the provision for ‘Government Pays’, ‘Government indemnifies’ is design to ‘keep whole’ the IOC on an on-going basis.⁴⁹⁰

486 Please see the validity issue of traditional stabilisation clauses in the section 4 of this chapter.

487K. B. Berger, ‘Renegotiation and adaptation of International Investment Contracts: The Role of the Contract Drafters and Arbitrators’, *Vand. J. Transnat’l. L.* 36(2003) 1360-1361 ; M. Erkan (n.1 above) 208

488 P.D Cameron, *Tools for Oil & Gas Investors* (n.1 above) 31

489 L. Cotulo, Investment Contracts through development Lens, in E. Blanco & J. Razzaque, *Natural Resources and the Green Economy: Re-defining the Challenges for People, States and Corporations*, (Leiden: MartinusNijhoff Publisher, 2012) 31.

490 A. F. M Maniruzzaman, *A Critical Appraisal of Emerging Trends*, (n.1 above) 126

It should not be disregarded that in the event of unilateral action by the host government, the parties of the investment contract are under obligation to renegotiate in good faith for the sake of re-establishing the original economic balance.⁴⁹¹

This discussion would be incomplete without mention of the functionality of such clauses. According to Nwete, economic equilibrium clauses play a significant role in the contract because they ‘reconcile the needs of the government and the investor by ensuring stability and flexibility through the adaptation of the petroleum contract to a change in circumstance, while at the same time maintaining the economic equilibrium of the project.’⁴⁹² Setting aside the flexible and dynamic nature of economic equilibrium clauses, it is important to ascertain whether those clauses are effective enough in every possible circumstance. According to Nwete, economic equilibrium clauses are not efficient enough at dealing with changes in circumstances brought about by unexpected events outside a change in law or regulations, for instance marginal discovery or fluctuations in price.⁴⁹³ For this reason, equilibrium clauses ought to distinguish external events from the events that arise from state action.⁴⁹⁴

The next section examines the legal value and function of stabilisation clauses in the energy investment agreements.

4. Legal Importance and Functional Value of Stabilisation Clauses

Throughout section three the main concepts and arguments around the validity and effectiveness of stabilisation clauses were discussed with the benefit of scholarly opinion, case law and the view of interview participants in this study. Furthermore, ‘questions concerning state responsibility for measures affecting contractual rights of an alien (individual or corporation) depend primarily on the law governing the particular contractual relationship between state and alien.’⁴⁹⁵ It is true that stabilisation clauses in an investment contract freeze the content of the applicable law, because when alien investors negotiate with a host state, the foreign investor often feels the need to protect itself from the legislative power of its contractual partner.⁴⁹⁶ For that reason, this section

491 Ibid

492 B. Nwete, ‘To what Extent Can Renegotiation Clauses Achieve Stability and Flexibility in Petroleum Development Contracts’ *I.E.L.T.R.* (2006) 56

493 B. Nwete (n.50 above) 59

494 M. Erkan (n.1 above) 208

495 F. V. G. Amador, ‘State Responsibility in Case of Stabilization Clauses’, 2 *J. Transnat’l L. & Pol’y* 23 (1993) 23

496 E. Gaillard & J. Savage, *Fauchard Gaillard Goldman On International Commercial Arbitration*, (The Hague, The Kluwer International, 1999) 795

will also point out the validity and effectiveness of stabilisation clauses under the applicable law.

4.1 Validity of Stabilisation Clauses

There is no obstacle to a host state entering into a contractual relationship which contains stabilisation provision as long as the clause complies with its constitutional and legislative requirements.⁴⁹⁷ Stabilisation clauses may be regarded as a valid provision in a contract if the contract is legitimately signed by a host state or a state-owned company. However, in some cases a problem may occur if the contract is not signed properly by the contracting state itself.⁴⁹⁸ According to Waelde, a state, that grants contractual guarantees in the absence of legal authority, may result in *ultravires*:

Contractual drafting techniques cannot modify and expand the powers existing under constitutional and other law for government and legislature to make commitments not to exercise their sovereignty and legislative rights. No argument can be advanced by a foreign investor that he had a legitimate expectation in the validity of such clauses negotiated in the face of questionable legal validity to the extent that he can easily (applying due legal diligence) ascertain their invalidity under their national law . Clauses negotiated under the shadow of *ultravires* and constitutional invalidity cannot generate valid rights simply by appearance or legitimate reliance on the state agency's contracting powers.⁴⁹⁹

For this reason, the validity, or the extent of validity, of stabilisation clauses should be deemed in the context of the specific circumstances of each case.⁵⁰⁰ Taking into account the considerations outlined above, it is opportune to examine an important court decision. In the *SPP Ltd vs. Egypt* case,⁵⁰¹ a joint venture project was signed between the state authorities and the foreign investor. Technically, the state authorities entered into the contract on behalf of the host state. The tribunal held that the host state was not the signatory party of this contract, because the officials and agents signed the contract on behalf of the minister and host state. Thus, the state was not responsible for the unauthorised or *ultravires* acts of its officials and agents. Somewhat controversially, the reason the court gave for deeming the act of the host government officials to be

497W. Peter, *Arbitration and Renegotiation of International Investment Agreements*: 2nd Revised and Enlarged Edition (The Hague: Kluwer Law International, 1995) 221

498 Ibid

499 T. Waelde & G. Ndi *Stabilizing International Investment* (n.1 above) 242

500A. F. Manirruzzaman, 'National Laws providing Stability of International Investment Contracts: A Comparative Perspective', *Journal of World Investment and Trade*, 1-9 (2007) 7 (Hereinafter, A. F. Manirruzzaman, National Laws providing Stability)

501*SSP Ltd vs. Egypt* (1983) 22 ILM 752

ultravires was that the government agents and officials in question lacked the authority to commit to such contractual obligations on behalf of the state.⁵⁰² El-Kosheri and Riad support this argument: ‘the legality of the stabilization clauses can only be established on the basis of a public law rule which authorizes the contracting governmental party to include such clauses in the development agreement and to be bound thereby’.⁵⁰³ In summary, it can be said that stabilisation clauses inserted in a contract would not be regarded as valid unless agreed to and signed by an authority explicitly invested with the authority to do so.

Before examining the validity of stabilisation clauses under national and international law, it is significant to mention the relationship between applicable law and stabilisation clauses. An interaction exists between applicable law clauses and stabilisation clauses since they both modify the law governing the contract, albeit in different ways.⁵⁰⁴ There is no doubt that international law principles are, by definition, those that will be applied by an arbitrator in the context of investor-state disputes or agreements, unless the parties of the contract or agreement have specifically determined the applicable law in the agreement in the case that such a disagreement should arise.⁵⁰⁵ Thus, it has been suggested that stabilisation clauses in addenda to an investment agreement governed by domestic law will lack the validity of stabilisation clauses.⁵⁰⁶ It should be noted that this issue is not a paradox, because parties are able to agree on a specific law to govern the contract, by a choice of law clause which indicates that international law is applicable to the agreement.

To this end, it can be said that determination of the applicable law of an energy investment contract is of significant importance to both the alien investor and the host state. While host states would often prefer their national law to apply to the energy investment contract, it is in the interests of the alien investor that the legal order imposed is the one that is best able to provide a stable and predictable legal environment.⁵⁰⁷

502 M. Erkan, (n.1 above) 109

503 A. El Kosheri & T. Riad, ‘The Law Governing a New Generation of Petroleum Contracts’, *ICSID Rev.* 1(1986): 259, 266; see also W. Peter, (n.55 above) 222; M. Erkan (n.1 above), 109

504 A. Al-Faruque, ‘Typologies, Efficacy and Political Economy of Stabilisation Clauses: A Critical Appraisal’, *OGEL, Journal of Oil and Gas Energy Law Intelligence* Vol. 4, Issue 5 November (2007) 33, available at: <www.gasandoil.com/ogel/>December 2010

505 E. Witten, ‘Arbitration of Venezuelan Oil Contracts: A Losing Strategy?’ *4Tex. J. Oil, Gas & Energy L.* (2009) 55, 64

506 F.V. G. Amador, (n.53 above), 48-49

Naturally, each party in such a situation would seek to convince the other to adopt the law which offers them the most security and confidence. Therefore, reaching a consensus on the applicable law between parties is often no mean feat and relies on the bargaining power and negotiating skills of each party. This competing interest in the choice of law can be a cause of disputes between contracting parties, however, it should be taken into consideration that when conflict arises with regard to choosing the applicable law, both parties may choose ‘a combined solution of domestic law and international rules’.⁵⁰⁸ In fact, the legal validity and effectiveness of stabilisation clauses included in investment contracts or agreements is a complex issue.⁵⁰⁹ The difficulty has been explained by Waelde and Ndi as ‘...one of the most complex issues in international economic law in view of the fact that standards of arguments from international law (state responsibility, law of treaties) of national law, of conflict of law, both international and national conflict of laws and possibly of an ‘international *lex mercatori*’ come together and can be arguably applied.’⁵¹⁰ Thus the following sub-sections examine the issue of the validity of stabilisation clauses under national and international laws.

4.1.1 The Validity of Stabilisation Clauses under Domestic Law

Historically, most disputes arose from concession contracts governed by the national law of the contracting state.⁵¹¹ Nevertheless, more recently, a new approach known as ‘internationalised’ contract has taken root. Since it includes stabilisation clauses, it cannot be subject to the domestic law of the contracting state.⁵¹² Nevertheless, it should not be forgotten that even if the contract between the parties is governed by international law, this will not provide full guarantees of stability for the contract because the sovereign right to intervene in a contract when significant interests are at stake is recognised in international law.⁵¹³ To this end, it can be said that if the contract

507 R. Dolzer & C. Schreuer, *Principles of International Investment Law*, 2nd edn. (Oxford: Oxford University Press, 2012) 81

508 F. N. Botchway, *Natural Resource Investment and Africa's Development*, (Cheltenham: Edward Elgar Publishing Company, 2011) 124

509 T. Waelde & G. Ndi, *Stabilising International Investment* (n.1 above) 238

510 Ibid.

511M. T. B. Coale, (n.20 above) 223. It is note worth that according to recent survey there are a number of petroleum contracts governed by the host state's law. Please see M. Erkan (n.1 above) 110.

512M. E. Dickstein, ‘Revitalizing the International Law Governing Concession Agreements’, 6 *Int'l Tax & Bus. Law*, (1988) 54

513 A. Faruque, (n.13 above)334 ; C. Greenwood, *State Contracts in International Law: The Libyan Oil Arbitrations*, Brit. Y. B. Int'l L. 63 (1982) 53

between the parties is governed exclusively by the domestic law of the contracting state, 'constitutional and legal constraints on the contractual capacity of that state may have significant legal implications for the validity and enforcement stabilisation clause'⁵¹⁴ In addition, it is worth noting that many countries have established significant legal principles that 'have the effect of invalidating a stabilisation clause and making it of no legal effect.'⁵¹⁵

The established principle which invalidates stabilisation clauses in national law is that the executive organ or parliament of the state may not be constrained or prevented by a contract from performing functions vital to its existence.⁵¹⁶ This legal principle is adopted in English Common Law and is applicable in many states which have adopted the common law system as part of their internal law. The establishment of this principle was in the *Apmhitre vs. The King*: 'It is not competent for the government to fetter the execution of an action, which must necessarily be determined by the needs of the community when the question arises. It cannot by contract, hamper its freedom of action in matters which concern the welfare of the State'⁵¹⁷ and is also applicable in many common law states. It is fair to assume that if the contract is subject to the national law of the contracting state which is, in turn, governed by common law, the courts of such countries will deem a stabilisation clause to be invalid.⁵¹⁸

It should be noted that the insertion of a stabilisation clause in an agreement is not necessarily the best way to provide stability for host states because such stability can also be bestowed upon investors through legislative enactments.⁵¹⁹ At first glance, it

514 A. Faruque (n.13 above) 333

515 A. D. Nwokolo, 'Is There a Legal and Functional Value For Stabilisation Clause in International Petroleum Agreements?' available at: http://www.dundee.ac.uk/cepmlp/car/html/car8_article27.pdf > May. 2011

516 T. Waelde & G. Ndi, *Stabilising International Investment* (n.1 above) 238; see also A. F. M. Maniruzzaman, 'State Contracts with Aliens: the Question of Unilateral Change by the State in Contemporary International Law', *Journal of International Arbitration* 9, no.4 (1992) 141

517 *Raderiakiebolaget Ampitrite v. The King* [1921] 3 K.B. 500, 5003-504

518 T. W. Waelde & G. Ndi, *Fiscal Regime Stability and Issues of State Sovereignty in Taxation of Mineral Enterprises*, J. Otto edn., (London: Graham and Trotman Ltd, 1995) 76 (Hereinafter, W. Waelde & G. Ndi, *Fiscal Regime*)

519 The petroleum industry has witnessed a significant number of developing states' specific laws or provisions which support stability under their national law system. Generally speaking, they made provisions for stability for hydrocarbon laws or specific codes in order to attract alien investors into their countries. For instance, Timor-Leste, Papua New Guinea, Peru, Panama, Ivory Coast, Bolivia, Venezuela, Columbia and

could be assumed that if the domestic law of the host state recognises international agreements with stabilisation clauses, the clause is valid under the law of that state. Nevertheless, even if the state authorises stabilisation clauses inserted in international agreements, such statutory guarantees can be revoked or altered on the basis of public need and in the exercise of the host state's power of sovereignty.⁵²⁰ According to Waelde: 'the legislator can take what he has given; in other words, nothing would prevent the national legislature to retroactively cancel and revoke rights awarded, subject possibly, to constitutional and other legal consequences, e.g. the duty to pay compensation under national law.'⁵²¹

As discussed above, a stabilisation clause protects the contract from legislative or regulatory changes. However, the question of how such changes made by the legislative power in the interpretation of the same provision would be evaluated is unclear.⁵²² In some cases, such changes made by the legislating power, may indeed have effects similar to the enactment of a new provision.⁵²³ The recent case of *Duke Energy vs. Peru*⁵²⁴ neatly illustrates the relationship between a stabilisation clause and a change in the interpretation of domestic tax law. In this case, the claimant asserted that the Peruvian Government had imposed a tax assessment which breached the guarantee of stability that was provided in a Legal Stability Agreement. According to the tribunal's view, the continuity of the existing provisions not only covered a change of specific laws or regulations, but it also encompassed changes in interpretation. The tribunal finally held that the Peruvian government was liable for its breach of the tax stabilisation to which it had previously agreed.

Consequently, the legal status of stabilisation clauses is commonly rendered invalid by most domestic law systems. If a guarantee of stability is regarded as valid under national law, their continuity is determined by the legislature of the host state.⁵²⁵ As previously mentioned, the security stabilisation clauses offer may be granted by the

Kazakhstan are good examples of countries which provide stability and enable stabilisation provisions under their legal system. The information is also available in A. F. Maniruzzaman, *National Laws providing Stability* (n. 58 above)1

520 T. Waelde & G. Ndi *Stabilising International Investment* (n.1 above) 239

521 *ibid*

522 J. E. Vinuales, *Foreign Investment and the Environment in International Law*, (New York: Cambridge University Press, 2012) 342.

523 *ibid*

524 *Duke Energy International Peru Investments No 1 Ltd vs. Peru* ICSID Case No ARB/03/28, Final Award, 25 July 2008

525 T. Waelde & G. Ndi (n.1 above) 239.

host state to the investor under their internal law. However, it should be borne in mind that although the stabilisation clause is granted by the host government, as some authors have pointed out, the rules of the game may always change after the match started.⁵²⁶ For instance, host states may subsequently invalidate the stabilisation clause with retroactive effect.⁵²⁷ When such a situation occurs under domestic or international law, the protection of property rights against direct and indirect expropriation would become an imminent priority.⁵²⁸

In light of this discussion, it is reasonable to conclude that most developing states which grant concession agreements seek to govern the contract in accordance with their national law system. Even if the host state's governmental action does not breach the contract and complies with domestic law, the government may wield the greater authority of its sovereignty against contract terms no longer in its interests to honour and may change the contract with or perhaps without compensation to alien investors. It goes without saying that knowledge of this fact boosts the host state's confidence when a dispute arises between the parties. Contrary to the wishes of the host state, international energy investors may seek to internationalise the agreement and convince the host government that international law should be the governing law of the contract. In these circumstances, the typical behaviour of petroleum investors is to err on the side of caution by doing whatever necessary to ensure that should a dispute arise, potential misinterpretation of stabilisation clauses in national courts by local judges that may render the clause invalid are avoided. Another reason why investors wish to internationalise the contract is that if a dispute arises between the contracting parties, a private investor may want to defend its case under the dispute resolution mechanisms of international law with a selected independent arbitrator in an unbiased environment.

4.1.2 The Validity of Stabilisation Clauses under International Law

Undoubtedly, international law is able to offer a high degree of protection to both the host state and a private investor when conflict arises between the parties. Nevertheless, such protection may not be benefitted from by either of the parties unless it is selected as the governing law of the agreement.⁵²⁹ Thus, private investors may attempt to control the effects of host state legislation to some degree by insisting that the state accepts that not only the host state's domestic law should be applicable but also the general principles of international law.⁵³⁰ In this respect, by providing proper recognition to a state's interest in applying its own domestic law, such a choice fetters

526 A. Shapira & M. Tabory, *New Political Entities in Public and Private International Law, With Special Reference to Palestinian Entity*, (The Hague: Kluwer Law International, 1999) 315

527 T. Waelde & G. Ndi *Stabilising International Investment* (n.1 above) 239

528 Ibid

529 J. Crawford & W. Johnson, 'Arbitrating with Foreign States and Their Instrumentalities', *Int'l Fin. L. Rev.* 5 (1986) 11, 12 cited in T. Waelde & G. Ndi *Stabilising International Investment* (n.1 above) 241.

the state's ability to modify or enforce the law arbitrarily, to the detriment of the private investor.⁵³¹ In their quest to achieve a better level of protection, private investors frequently seek to internationalise the agreement. In that respect, there is a need to argue whether the insertion of a stabilisation clause in a host government contract is valid under international law when international law is selected as the governing law of the contract and where international investment tribunals stand regarding this question.

As far as the validity of stabilisation clauses under international law are concerned, two significant concepts exist: the doctrine of sanctity of contracts (*pacta sunt servanda*) and the principle of the state's permanent sovereignty over natural wealth and resources.⁵³² Three divergent views have surfaced in discussions regarding the validity of stabilisation clauses under international law; however, no dominant view has emerged as prevalent to settle the issue. Notwithstanding the facts that a significant number of arbitral practices have taken place and a prescriptive approach to the validity issue of stabilisation clauses under international law has been drafted.

4.1.2.1 The theory of Internationalised Contracts

The theory of the internationalisation of contracts poses some of the most difficult questions that bear relation to both public and private international law.⁵³³ The theory suggests that no matter whether the parties decide which law governs the contract; international law may override their choice and is automatically applied in the event of a dispute.⁵³⁴ In other words, the rights and obligations of the contracting parties are governed in accordance with international law rules. One school of legal scholars has articulated the opinion that the principle recommending the choice of international law as the governing law of the contract is to render applicable specific international norms, in particular the doctrine of the sanctity of contract (*pacta sunt servanda*).⁵³⁵

The foundation of this view is that any unilateral breach of contract, including stabilisation clauses made by the host state under the contract directly holds the contracting responsible under international law.⁵³⁶ Therefore, the contractual rights of

530 M. L. Moses, *The principles and Practice of International Commercial Arbitration*, (New York: Cambridge University Press, 2008) 63

531 A. Redfern & M. Hunter, *Law and Practice of International Commercial Arbitration*, (Bath: Sweet & Maxwell: 2004)92 cited in M. L. Moses (n.88 above) 63

532 T. W. Waelde (n. 83 above) 31

533 A. F. M. Maniruzzaman, *State Contracts with Aliens* (n.74 above) 309

534 Ibid

535T. Waelde & G. Ndi *Stabilising International Investment* (n.1 above) 239.

536 A. D. Nwokolo(n.73 above), 11 ; For the further discussion on this view see also L. T. Kissam& E.K. Leach, 'Sovereign Expropriation of Property and abrogation of

investors cannot be unfavourably affected by the unilateral action of the host state. In order to avoid any unilateral modification ‘investors and his counsel should attempt to internationalise the contract.’⁵³⁷ To this end, it can be said that the internationalisation of contracts is a method to ‘deny effect’ to unilateral changes made by states, the legal justification being the ‘unrestricted application of the principle of *pacta sunt servanda*.’⁵³⁸ The *pacta sunt servanda* principle was articulated by Professor Wehberg, who stated ‘the principle is valid exactly in the same manner, whether it is in respect of contracts between states or in respect of contracts between states and private companies.’⁵³⁹

It is apparent that according to supporters of this view, international law is the rightful governing law of the contract and that stabilisation clauses have a binding effect and are valid under international law. They imply that any unilateral actions made by host states which violate contractual obligations should be regarded as unlawful, deeming this to be in accordance with the ruling of international law. The view of the second group of scholars differs from the first group of writers, as the second group of commentators believe that internationalising contracts is in conflict with the principle of permanent sovereignty.

4.1.2.2 Permanent Sovereignty over Natural Resources Norm

Some legal scholars hold the view that stabilisation clauses with the intended aim of freezing the applicable law are invalid under international law because the state has the right to modify or abrogate the contract entered into with a foreign investor.⁵⁴⁰ This second group of writers’ view is rooted in the principle of the state’s permanent sovereignty under the United Nations General Assembly and in the following

Concession Contracts’ *Fordham Law Review* 28 (1959) 177-178, and C. Greenwood (n.71 above), 61; K. Carlston, ‘Concession Contracts and Nationalization’, *Am. J. Int’l L.* 52 (1958) 260,260.

537 E. Paasivirta, ‘Internationalisation and Stabilization of Contracts Versus State Sovereignty’, 60 *BYIL* (1989) 315, 317

538 D. Suratgar, ‘Considerations affecting Choice of Law Clauses in Contracts Between Governments and Foreign Nationals’, *Indian Journal of International Law*, 2 (1962), 273, 302

539 H. Wehberg, ‘Pacta Sunt Servanda’, *American Journal of International Law*, 53 (1959), 775, 786

540 M. Sornarajah, ‘International Contract Law?’, *J. World Trade L.* 15 (1981) 187, 189 cited in T. J. Pate, ‘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’, *University of Miami Inter-American Law Review*, Vol 40, No. 2 (2009) 351 ; see also T. W.Waelde & Ndi *Stabilising International Investment* (n.1 above) 244

pronouncement: ‘The description of this sovereignty as permanent signifies that the territorial State never loses its legal capacity to change the status or the method of exploitation of those resources, regardless of any arrangement that have been made.’⁵⁴¹ The crux of the matter, in this view is that by being a part of an agreement which includes stabilisation provisions, this creates binding obligations on states; therefore, they cannot waive their sovereign rights under the principle of permanent sovereignty.⁵⁴² In other words: ‘Indeed a State is able to bind itself towards another State to exercise its sovereign power to legislate insofar as this would lead to a violation of duties which it has established by agreement of an international character. But this does not entail the consequences that a state can by a contract with an individual or with a company limited by shares bind itself to abstain from a full exercise of its right to legislate.’⁵⁴³

This view holds that stabilisation clauses are invalid under international law because such clauses cannot prevent a state from exercising its sovereign power for the public good. As mentioned in the second chapter, the exercise of such power may be relevant to human rights, environmental protection or any other issues which could be considered vital to the interests of the state and the protection of its citizens and natural environment. The principle of the State’s permanent sovereignty over natural wealth and resources is a *Jus cogens* norm; therefore no derogation is allowed.⁵⁴⁴ As the constitution is hierarchically the highest law in a state; it therefore may not be possible to say that a state cannot bind itself by a contract made with an alien investor and restrain its legislative power.⁵⁴⁵ In other words, the legislature cannot be bound by its own preceding legislation and always possesses the right to change it.⁵⁴⁶ On the topic of permanent sovereignty of states over their natural resources and wealth, divergent views exist which have been the subject of animated debate by scholars. Before setting out these views, the effects of the resolutions of the UN on natural wealth and resources and The Charter of Economic Rights and Duties of States (CERDS) of states on the binding force of host government contract should be reviewed.

541 E. Jimenez de Arechaga, ‘State Responsibility of Nationalisation of Foreign Owned Property’, *N.Y.U.J. Int’l L. & Pol.* (1978) 179-180

542 T. W. Waelde & Ndi *Stabilising International Investment*, (n.1 above) 244

543 M. Wolff, Some Observations on the Autonomy of Contracting parties in Conflict of Laws, in: *Transactions of the Grotius Society*, vol. 35 (1949) 143-150 cited in E. Paasivirta (n.95 above) 319

544 I. Brownlie, (n.2 above) 489.

545 M. Sornarajah, (n.10 above) 282

546 *ibid*

As mentioned in the second chapter, the principle of the permanent sovereignty of states over natural resources in their territory was formally recognised and documented by the UN General Assembly Resolution, 1803.⁵⁴⁷ Article (1) of the resolution declares that '[t]he right of peoples and nations to permanent sovereignty over their natural wealth and resources must be exercised in interest of their national development...' what is understood from this article is that states are free to exercise extraction of their natural resources and free to sell them to second or third parties. Furthermore, Article 4 of the resolution bestows upon states the right to nationalise, expropriate or requisition property as long as such activities are done for a public purposes, security or national interest and prompt and adequate compensation is paid. Article (8) of the resolution clearly declares that '*[international] investment agreement freely entered into by, or between, sovereign States shall be observed in good faith*; States and international organisations shall strictly and conscientiously respect the sovereignty of peoples and nations over their natural wealth and resources...' ⁵⁴⁸. (*Italic added*). To this end it can be said that the principle of permanent sovereignty does not affect the binding power of host government contracts made with private investors

Moreover, CERDS was adopted by the UN General Assembly in 1974 and it also embraces the principle of permanent sovereignty. While Article (1) states that '[e]very State has the sovereign and inalienable right to choose its economic system as well as its political...systems in accordance with the will of its people, without outside interference, coercion or threat in any form whatsoever,'⁵⁴⁹ the Article (2)⁵⁵⁰ specifically addresses nationalisation and references the principle of permanent sovereignty of states.

547 Article 1 of the Resolution 1803

548 Article 4 of the Resolution 1803

549 Article 8 of the Resolution 1803

550 General assembly Resolution 3281 (XXIX), 29 UN GAOR Supp. (No.31) 50, UN Doc. A/ 9631 (1974), Article 2 asserts that :

1. Every State has and shall freely exercise full permanent sovereignty, including possession, use and disposal, over all its wealth, natural resources and economic activities.

2. Each State has the right:

(a) To regulate and exercise authority over foreign investment within its national jurisdiction in accordance with its laws and regulations and in conformity with its national objectives and priorities. No State shall be compelled to grant preferential treatment to foreign investment;

(b) To regulate and supervise the activities of transnational corporations within its national jurisdiction and take measures to ensure that such activities comply with its laws, rules and regulations and conform with its economic and social policies. Transnational corporations shall not intervene in the internal affairs of a host State. Every State should, with full regard for its sovereign rights, cooperate with other States in the exercise of the right set forth in this subparagraph;

Taking into consideration the relevant articles of Resolution 1803 and CERDS, it can be stated that the principle of permanent sovereignty is one of the most significant in international law. With regards to the question posed above, several views have emerged. According to El-Sheikhe, the contractual agreement between state and private investor cannot be regarded as an alienation of a state's sovereignty, however, but as a partial and temporary exercise of sovereignty.⁵⁵¹ According to Peter, UN resolutions on the principle of permanent sovereignty of states over their natural resources do not prevent a contracting state from binding itself by stabilisation provisions.⁵⁵² However, according to Sornarajah, when the principle of the permanent sovereignty of states is regarded, stabilisation clauses should be deemed as invalid under international law because the acceptance of such principles puts '...a constitutional limitation on the state in international law to deal with its natural resources.'⁵⁵³ Erkan criticises Sornarajah's view and argues that perhaps it would be extreme to regard stabilisation clauses as invalid.⁵⁵⁴

4.1.2.3 Moderate Opinion

The third group of commentators recognise the validity of stabilisation clauses under international law and their significance in international agreements; however they express doubt regarding the capacity of such clauses to provide absolute protection to private investors.⁵⁵⁵ According to some authors, stabilisation clauses inserted in economic development agreements or investment contracts bind and constrain host governments for a long period of time and are contrary to the principle of permanent sovereignty; 'however, a stabilisation clause limited in time, area and scope, aimed at maintaining unchanged certain material terms and the fiscal regime for a reasonable

(c) To nationalize, expropriate or transfer ownership of foreign property, in which case appropriate compensation should be paid by the State adopting such measures, taking into account its relevant laws and regulations and all circumstances that the State considers pertinent. In any case where the question of compensation gives rise to a controversy, it shall be settled under the domestic law of the nationalizing State and by its tribunals, unless it is freely and mutually agreed by all States concerned that other peaceful means be sought on the basis of the sovereign equality of States and in accordance with the principle of free choice of means.

551 A. El Sheikh, *The Legal Regime of Foreign Private Investment in Sudan and Saudi Arabia*, 2nd edn (Cambridge: Cambridge University Press, 2003) 334.

552 W. Peter (n.55 above) 222

553 M. Sornarajah, 'The Myth of International Contract Law', *Journal of World Trade Law* 15 (1981): 210 cited in M. Erkan (n.1 above) 120

554 *ibid*

555 T. W. Waelde & Ndi *Stabilising International Investment* (n.1 above) 244-245

period, is not incompatible with the principle of permanent sovereignty.⁵⁵⁶ To this end, it can be said that a guarantee given for a specific period of time against nationalisation would be one of the ways of providing guarantees.⁵⁵⁷ It is the commentators' belief that the freezing function of stabilisation clauses is only the tip of the iceberg.⁵⁵⁸ When interpreting the validity of stabilisation clauses, the whole range of conditions to its existence globally need to be taken into consideration. Such conditions can be the economic and social environments, political factors or the historical relationship between the parties.⁵⁵⁹

The doctrinal writings referenced above demonstrate that there is continuing controversy among legal scholars regarding the validity of stabilisation clauses under international law. No dominant view seems to have prevailed as yet. Although consensus has not been reached amongst academic writers on the validity issue, a considerable amount of arbitral awards have been granted in this respect. Therefore, the following section will merely concentrate on the response of arbitral tribunals to challenges to the validity of stabilisation clauses.

4.1.2.4 Arbitral Awards Concerning Validity of Stabilisation Clauses

The validity of stabilisation clauses and their relationship to the principle of the permanent sovereignty of host states have been the subject of a significant number of arbitration cases in the petroleum industry. The most frequently referred arbitral decision is the case of *Texas Overseas Petroleum Co. / California Asiatic Oil Co. Libyan Arab Republic*.⁵⁶⁰ Texaco and Calasiatic are two American petroleum companies which were both granted fourteen oil concessions from the Royal Libyan Government between the years of 1955 and 1968.⁵⁶¹ In 1973, following the advent of a revolution in Libya, the new revolutionary government, in a dramatic move, nationalised 51% shares

556 P. De Waart & P. Peters and E. Denters, *International Law and Development*, (Dordrecht, The Netherlands: Kluwer Academic Publishers, 1988) 81

557 A. Redfern, 'The Arbitration Between the Government of Kuwait and AMINOIL' 58 *BYIL* (1985) 100 cited in Z.A. Alqurashi, *Oil and Gas Arbitration* (n.15 above) 216 ; see also E. Paasivirta (n.95 above) 337

558 R. Higgins, 'Legal Preconditions for Foreign Investment', IBA-SERL Seminar Proceeding, Mathew Bender, New York (1986) 233-235 ; See also E. Paasivirta (n.95 above) 338 ; T. W. Waelde & Ndi *Stabilising International Investment* (n.1 above) 245

559 Ibid

560 *Texas Overseas Petroleum Co. / Californian Asiatic Co. vs. Libyan Arab Republic*, 17 ILM. 1 (Int'l Arb. Trib. 1977)

561 C. Greenwood (n.71 above) 29.

of these two companies' interest in the concession.⁵⁶² When Texaco and Calasiatic started the arbitration proceeding as the nature of concession agreements require, 49% of the companies' interests were also nationalised by the same revolutionary Libyan government.⁵⁶³

Furthermore, the new revolutionary government did not respond to the companies' request to submit arbitration; however when the companies under clause 28 (3) asked the President of the International Court of Justice (ICJ) to appoint a sole arbitrator,⁵⁶⁴ the new Libyan government objected on the grounds that the dispute that had arisen between the parties could not be the subject of arbitration as the nationalisation measure taken by the government was an expression of its sovereignty.⁵⁶⁵ Professor René-Jean Dupuy who was the sole arbitrator in the given case, examined the whole issue in detail and cited a number of reasons why compensation should be paid to TOPCO. The arbitrator first rejected the claim of the Libyan government and stated that a concession agreement is not an administrative contract.⁵⁶⁶ Professor Dupuy then started to examine the validity and binding effect of stabilisation clauses. Before proceeding to examine the arbitrator's decisions with regard to this subject, it is relevant to cite article 16 of the concession agreement. In this case, the concession agreement between the parties contained a stabilisation clause in the Article 16:

1. The Government of Libya will take all the steps necessary to ensure that the Company enjoys all the rights conferred by this Concession. The contractual rights expressly created by this concession shall not be altered except by mutual consent of the parties. 2. This Concession shall throughout the period of its validity be construed in accordance with the Petroleum Law and the Regulations in force on the date of execution of the agreement of amendment by which this paragraph (2) was incorporated into this concession agreement. Any amendment to or repeal of such Regulations shall not affect the contractual rights of the Company without its consent.⁵⁶⁷

Taking into consideration the above given provision, the arbitrator found that Clause 16 did not, in principle, impair the sovereignty of the Libyan state, since its entire sovereign legislative and regulatory powers are preserved and such power can only be exercised with respect to citizens or aliens with whom the state has not

562 Ibid

563 *Texaco, vs. Libyan Arab Republic* (TOPCO) award, 53 I.L.R, 389 (1977)

564 R. B. Von Mehren & P. N. Kourides, 'International Arbitrations between States and Foreign Private Parties: The Libyan Nationalization Cases', 75 *Amt. J. Int.l.* 476 (July 1981) 489, cited in M. T. B. Coale (n.20 above) 233

565 Ibid

566 Ibid

567 53 ILM 3, 4 (1973- 74)

undertaken contractual obligations.⁵⁶⁸ Professor Dupuy went on to assert that the Libyan state, through the exercise of its sovereignty had undertaken obligations under an agreement governed by international law.⁵⁶⁹ In this respect, the arbitrator held that: ‘The recognition by international law of the right to nationalize is not sufficient grounds to empower a State to disregard its commitments, because the same law also recognizes the power of a State to commit itself internationally, particularly by accepting the inclusion of stabilization clauses in a contract entered into with a private party.’⁵⁷⁰

The arbitrator, Dupuy, based on the above given reasoning, recognised the validity of stabilisation clauses with the following words:

Thus, in respect of the international law of contracts, nationalization cannot prevail over an internationalized contract, containing stabilization clauses, entered into between a State and a foreign private company. The situation could be different only if one were to conclude that the exercise by a State of its right to nationalize places that State on a level outside of and superior to the contract and also to the international legal order itself, and constitutes an act of government which is beyond the scope of any judicial redress or any criticism⁵⁷¹.

In light of the arbitrator’s assessments, it can be said that two significant points emerged in the TOPCO arbitration. Firstly, the arbitrator internationalised the contract between the parties and he interpreted the stabilisation clauses as a basis to do so. In other words, the arbitrator of the present case held that when the contract is internationalised, the contracting parties act as equals and the host state is responsible for the guarantees that have been provided to the private investor.⁵⁷² Secondly, Professor Dupuy asserted that stabilisation clauses are fully valid and effective as long as the parties concerned have freely entered into them. From the perspective of the arbitrator, it is beyond question that sovereign states may adopt or modify their laws. However, it should be noted that newly adopted laws or changes do not have the power to overturn freely agreed obligations under an international agreement. For this reason, when the host state agrees to stabilisation provisions, it makes a binding legal commitment not to exercise its sovereign power over the course of the investment project. In the case of any changes or the adoption of new laws drafted by the host government, such unilateral actions would be regarded invalid under international law and the contracting state would be in breach of the stabilisation clauses.

⁵⁶⁸ 17. I.L.M.1, 24-25 (1978)

⁵⁶⁹ 17 ILM 3, 24 para. 71 (1978)

⁵⁷⁰ 17 ILM 3, 24-5 para. 71 (1978)

⁵⁷¹ 17.I.L.M. 3, 25, para.73 (1978)

⁵⁷² C. Greenwood (n.71 above) 29.

Significantly, the decision given by the arbitrator was severely criticised by some authors who believe that the arbitrator's 'interpretation is too rigid and provides unlimited guarantees to private investors'.⁵⁷³ It is an accepted fact that the petroleum sector is fragile and requires some stability; however considering the length of a typical energy investment project, they assert that it would be naive not to expect any unilateral actions from host states. The validity of stabilisation provisions was also examined extensively by the international tribunal in the case of *Government of State of Kuwait vs. the American Independent Oil Company (AMINOIL)*⁵⁷⁴. In this case, the ruler of Kuwait granted a sixty-year oil concession to American company AMINOIL for the exploration and exploitation of petroleum starting in 1948. The agreement between the parties included a stabilisation provision that read as follows:

The Sheikh shall not by general or special legislation or by administrative measures or by any other act whatever annuls this Agreement except as provided in Article 1. No alteration shall be made in the terms of this Agreement by either the Sheikh or the Company except in the event of the Sheikh and the Company jointly agreeing that it is desirable in the interest of both parties to make certain alteration, deletion or addition to this agreement.⁵⁷⁵

In 1961, a supplemental agreement modified the concession agreement between the parties that was signed in 1948 and provided additional financial benefit to the host state and also contained a renegotiation clause. In 1974, the OPEC countries adopted the 'Abu Dhabi formula', which triggered the increase of tax regime⁵⁷⁶ applicable to the agreement. Naturally, the company did not wish to accept the changes to its existing tax regime. Finally, in 1977, the government of Kuwait promulgated the Decree Law No. 124 which terminated the concession agreement between the parties⁵⁷⁷. Thereafter the government of Kuwait acted unilaterally and nationalised the company's assets. The AMINOIL Company instituted *ad hoc* arbitration and claimed that the government of Kuwait's unilateral action breached the stabilisation provision of the agreement inserted in 1948.⁵⁷⁸

573 Z. A. Al-qurashi (n.15 above) 209

574 *American Independent Oil Company vs. Kuwait Award*, 24 March, 1982 21 ILM 976 (1982), hereinafter AMINOIL.

575 AMINOIL 21 ILM, 976, 1020, para. 88 (1982).

576 T. Begic, *The Applicable Law in International Investment Disputes*, (Utrecht, Eleven International Publishing, 2005)87

577 AMINOIL 21 ILM, 998

578 T. Begic (n.134 above) 87

Discussion around the validity of stabilisation clauses become the most significant issue in this case. A number of arguments were put forward by the contractually linked parties. On the one hand, AMINOIL argued that the concession agreement between the parties was terminated wrongfully because the contract contained a stabilisation clause.⁵⁷⁹ The company asserted that the nationalisation act of Kuwait was a violation of the principle of *pacta sunt servanda* under international law; therefore this unilateral act of the host state was an unlawful expropriation. On the other hand, the Government of Kuwait defended itself against these claims by alleging that the clauses which had been inserted in the agreement had a colonial character and particularly imposed upon Kuwait, despite the fact that the country was still under the protection of the British.⁵⁸⁰

Another argument set forth by the Kuwaiti government was that ‘stabilisation clauses – initially valid and effective – were annulled by the emergence of a subsequent factor in the shape either of the Kuwait Constitution of 1962, or of a public international law rule of *jus cogens* forming part of the law of Kuwait.’⁵⁸¹ The tribunal rejected these arguments and held that there is no rule under international law that prevents states from undertaking to proceed to nationalisation during a limited period of time.⁵⁸²

Moreover, the tribunal also examined the question of whether stabilisation clauses are able to prohibit nationalisation. In this respect, the tribunal stated that ‘no doubt contractual limitations on the State’s right to nationalize are legislatively possible, but what that would involve would be a particularly serious undertaking which would have to be expressly stipulated for, and be within the regulations governing the conclusion of State contracts; and it is to be expected that it should cover only a relatively limited period.’⁵⁸³ In light of the tribunal’s response to this question, it should be noted that the tribunal did not consider that the nationalisation was unlawful because ‘the case of nationalisation is certainly not expressly provided against by the stabilisation clauses of the concession’.⁵⁸⁴ The tribunal also added that even if the stabilisation clauses originally sought to prohibit nationalisation they had ceased to do so due to the fact that the character of the concession agreement had changed and stabilisation clauses had lost

579 G. Delaume, ‘Comparative Analysis as a Basis of Law in State Contracts: The Myth of the Lex Mercatoria’, 63 *Tul. L. Rev.* 575, 606 (1989) Cited in M.T.B. Coale (n.71 above) 236

580 S.K.B. Asante, ‘Stability of Contractual Relations in the Transnational Investment Process’, *Int’l & Comp. L. Q.* 28(1979) 401, 403

581 AMINOIL 21 ILM, 976, 1021 para. 90(2) (1982).

582 AMINOIL 21 ILM, 976, 1021-22, para.90(2) (1982).

583 21 ILM, 976, 1023 para.94-95

584 *ibid*

their previous possessive absolute character.⁵⁸⁵ Consequently, the tribunal reached the conclusion that the takeover of the AMINOIL enterprise was not inconsistent with the concession contract, provided that the nationalisation did not possess any confiscatory character.⁵⁸⁶

What makes this decision significant is that several key questions were answered by the tribunal. The existence of stabilisation clauses under the concession agreement between the contracting parties made tribunals consider the nationalisation right of a host state where a stabilisation clause had been applied. The tribunal recognised the validity of stabilisation clauses in principle; however the tribunal disregarded the prohibition against changing the agreement in any way except in the event of mutual consent.⁵⁸⁷ Furthermore, the tribunal expressed that stabilisation clauses should cover only a ‘relatively limited period’. To this end, the approximate length of ‘a relatively limited period of time’ needs to be ascertained. When the concession agreement between the parties is considered, the contract in question was signed almost thirty years previously. It would have been useful for the tribunal to suggest parameters for the timeframes – they instead referred to this in quite general terms.⁵⁸⁸

Another historical but significant oil industry arbitration case is *Aramco vs. Saudi Arabia*.⁵⁸⁹ Aramco is an American petroleum company which had been granted permission, by the Saudi government, to extract and transport petrol from Saudi Arabia to other countries. Aramco complained that the Saudi Government had also entered into an agreement with the Saudi Arabian Maritime Tankers Ltd., which was headed up by the well-known Greek businessman, Aristotle Onassis and enjoyed, over thirty years, the right to transport all the extracted petrol from Saudi Arabia⁵⁹⁰. Aramco claimed that

585 The tribunal said that: ‘The concession had ... changed its character and become one of those contracts in regard to which, in most legal systems, the state while remaining bound to respect the contractual equilibrium enjoys special advantages.... The tribunal wishes however to stress here that the case is not of a fundamental change of circumstances (*rebus sic stantibus*) within the meaning of Article 62 of the Vienna Convention on the Law of Treaties. It is not a case of a change involving a departure from a contract, but of change in the nature of the contract itself, brought about by time, and the acquiescence of the parties’ at 21 *ILM*, 976, 1024 para. 98-101(1982)

586 AMINOIL 21 *ILM*, 976, 1024 para. 102 (1982)

587 T. Begic (n.134 above) 87

588 Z.A. Al Qurashi (n.15 above) 217

589 *Saudi Arabia v. Arabian American Oil Company (Aramco)* 27 I.L.R. 117 (1958)

590 M. R. Samartano, *International Arbitration Law and Practice*, 2nd edn (The Hague: Kluwer International Law, 2001) 160

an oil concession agreement was signed between the Kingdom of Saudi Arabia and Aramco in the year of 1933; therefore, the right to extract the oil and its transfer belong to Aramco.⁵⁹¹ This conflict led the contracting parties to arbitration in 1955. As the concession agreement between the parties included stabilisation clauses, the tribunal examined the clauses and held that '[b]y reason of its very sovereignty within its territorial domain the State possesses the legal powers to grant rights by which it forbids itself to withdraw before the end of the concession...'⁵⁹². In 1958, the tribunal reached a verdict, ruling in favour of Aramco, and asserted that the government of Saudi Arabia is bound by the concession agreement with Aramco and that the subsequent agreement with Onassis's company had violated that agreement⁵⁹³. The tribunal also recognised the validity of stabilisation clauses under international law.

It should be noted that there are a number of arbitral decisions with regard to the validity issue of stabilisation clauses. In most cases, the tribunals provided appreciable details and good reasoning when they refer to validity of such clauses under international law. However, in the *British Petroleum Exploration Company (Libya) Ltd vs. The Government of the Libyan Arab Republic*⁵⁹⁴ case, the arbitrator did not refer to stabilisation clauses in his judgement. This case was the first of a series of Libyan nationalisation cases. The stabilisation clauses were contained in Article 16 of the concession agreement. The arbitrator of the present case determined that an agreement was a contractual relationship belonging to the category of administrative contracts and that by virtue of the stabilisation clause, Libya had limited its 'freedom to change or terminate the concession by unilateral act unless it could be shown that the changes was truly in the public interest.'⁵⁹⁵ In his decision, the arbitrator did not make reference to the stabilisation clause existing in Article 16. Therefore, this case does not represent a legitimate example of the validity issues surrounding stabilisation clauses.

The most recent arbitration involving the Libyan nationalisation case series was the *Libyan American Oil Company (LIAMCO) v. the Government of the Libyan Arab Republic* case⁵⁹⁶. The sole arbitrator in the present case found that the stabilisation

591 P. D. Cameron *The Pursuit of stability*, (n.1 above) 109

592 27 I.L.R. 117, 168 (1958)

593 P. D. Cameron *The Pursuit of stability*, (n.1 above) 110

594 *British Petroleum Exploration Company (Libya) Ltd v. Government of the Libyan Arab Republic* 53 I.L.R. 297 (1973-1974) 53

595 R. C. A. White, 'Expropriation of the Libyan Oil Concessions-Two Conflicting International Arbitrations', 30 *Int'l & Comp. L.Q.* 1 (1981) 11, cited in M. T. B. Coale (n.71 above) 234.

596 *Libyan American Oil Company (LIAMCO) v. the Government of the Libyan Arab Republic*, Award of 12 April 1977, 62 I.L.R. 140, (1977); 20 I.L.M.1 (1977).

clause inserted in Article 16 ‘justified not only by the said Libyan petroleum legislation, but also by the general principle of the sanctity of contracts recognised also in municipal and international law’.⁵⁹⁷ The arbitrator went on to compare the consistency of stabilisation clause with the principle of non-retroactivity of laws, which denies retrospective effects to a new legislation and asserts the respect of vested rights (*droits acquis*) acquired under a previous legislation’.⁵⁹⁸ Afterwards, he mentioned that ‘the rights of a state to nationalise its wealth and national resources is sovereign, subject to the obligation of indemnification for premature termination of concession agreements’.⁵⁹⁹ During the examination of LIAMCO’s concession agreements, the arbitrator found that these concession agreements were valid and binding; therefore, they could not be validly terminated unless there was ‘mutual consent of the contraction parties, in compliance with the said principle of the sanctity of contracts and particularly with the explicit terms of Clause 16 of the Agreements’.⁶⁰⁰ The award, however, was not in harmony with the opinions of the arbitrator regarding the validity of the stabilisation clause⁶⁰¹. Therefore, it is difficult to assess how the stabilisation clause influenced the award in this case⁶⁰².

Interview Participants’ views

In order to gain a practical understanding of the tension that can exist between the sovereignty of a state and the inclusion of stabilisation clauses in host government contracts, the researcher conducted several interviews. The participants selected were: a director of a state owned company, a lecturer in international business and a lawyer (also an employee of the state owned company). During the course of the interviews, the vast majority of the participants emphasised the point that the insertion of stabilisation clauses in energy investment contracts plays a significant role in managing and mitigating political risk. As previously mentioned, while some authors in conventional literature believe that the inclusion of such clauses may suppress the sovereign rights of host states, others hold the opposite view. Taking this into account, the researcher asked the following question: to what extent are stabilisation clauses effective in protecting investors’ investments, or whether, in contradiction of their intended guardianship, do they instead disenfranchise the sovereign rights of host states?

597 LIAMCO 20 ILM 31 (1977)

598 LIAMCO 20 ILM 61 (1977)

599 *ibid*

600 LIAMCO, 62 I.L.R. 62

601 M. T. B. Coale (n.71 above) 234

602 F. V. Garcia. Amador, (n. 53 above) 44

While all of the participants agreed how effective stabilisation clauses are in political risk management, they did not agree on the question of whether the inclusion of stabilisation clauses disenfranchise the sovereign rights of host states or not. One of the interviewee stated that ‘...there is no doubt that stabilisation clauses protect foreign investors’ investment rights and profits against major political risks over the course of the project. Nevertheless, this protection or exemption should not be regarded as a *capitulation* offered to foreign investors or to foreign countries that disenfranchise the sovereignty of the host state’⁶⁰³ (*italic added*)

The participant quoted a Turkish proverb to illustrate his point: ‘in Turkish we call this concept *‘balancing the scales’* (*italic added*)⁶⁰⁴. By this, the respondent is referring to the importance of balance and measure, because if the weight is left off the scale, the measure will be off balance and justice will be skewed. The same respondent also emphasises that ‘petroleum agreements are long term projects, after the contractually agreed period all petroleum resources and rights automatically revert to the host state. Thus, breaching investment contracts by claiming that a stabilisation clause is a way of capitulating and disenfranchising the sovereign rights of host states puts an extra burden on the country and disadvantages future generations.’⁶⁰⁵ With these words the respondent underlines the importance of contractual commitment. This wording is known as the *pacta sunt servanda* principle. Cameron echoes the words of the Turkish proverb in asserting that ‘a state has the sovereign power to unilaterally revise its relationship with the foreign investor, the result of a stabilisation mechanism which applies to such unilateral action is that the host government would have to pay lump sum damages.’⁶⁰⁶

Contrary to the view of the previous participant, another interviewee states that stability and the balance of benefits are two significant phenomena for energy investment projects. The respondent goes on further and emphasises that ‘...*to give something without expectation is the philosophy of god*’ (*italic added*)⁶⁰⁷. The point he is making is that if a host state is in a weak bargaining position and keen on encouraging foreign investors, the state must provide certain exemptions to investors and put them on the bargaining table. To this end, it can be assumed that in the event of finding itself in a weak bargaining position, the host state is more likely to agree to a stabilisation clause. Another participant underlined that ‘providing exemptions may contravene the sovereign rights of a host state; however, acceptance of such clauses may be a necessary evil to secure the contribution of a foreign investor.’⁶⁰⁸ With regard to the latter two viewpoints, it can be emphasised that the bargaining position of host states is not static;

603 Interview no. 1, Anonymity Guaranteed 8 May 2012

604 Ibid

605 Ibid

606 P. D. Cameron , *The Pursuit of Stability* (n.1 above) 89

607 Interview no.7 with Lawyer-6 June 2012

this position is constantly in flux according to the social and political conditions of the time. As outlined in the second chapter, when petroleum prices are unstable or on the rise, due to political, social or economic factors, it would be challenging to persuade a host state to agree to a stabilisation clause. Another interview respondent touched upon whether inclusion of stabilisation clauses disenfranchises a state's sovereignty or not. According to this interview respondent:

Technically speaking, stabilisation clauses are powerless against state sovereignty because each nation has the right to change their fiscal system to maximise their economic interest from oil and gas related projects or enact new laws with the purpose of improving their domestic laws. The issue lies in how stabilisation provisions work in practice. My view is that the economic needs of developing states and political pressure made by the home nations of investors inhibit host states from using the powers appertaining to them as a sovereign state during energy investment projects.⁶⁰⁹

Echoing this view, another respondent noted that 'the structure and scope of stabilisation clauses vary from one country to another. Geographical, political and economic factors are the main drivers that shape the content and context of stabilisation clauses. Nevertheless, no matter what types of stability provisions are included in an agreement these clauses cannot truly overrule the sovereign, legislative and regulatory powers of states.'⁶¹⁰

4.2 Efficacy of Stabilisation Clauses

4.2.1 Doctrinal Assessments

The functional value and efficacy of stabilisation clauses in host governmental contracts has been the subject of some debate in conventional literature. Some authors believe that there is no point in expecting a functional protection from stabilisation clauses because international law prohibits arbitrary and unlawful intervention by a state in an international agreement.⁶¹¹ The reasoning behind this view is that there is no hindrance to the state from taking unilateral action, such as expropriating or nationalising the assets of an investor, as long as such actions are made lawfully, by meeting certain conditions decreed by international law.

Another group of commentators oppose the previous view and argue that stabilisation clauses serve as a secondary protection mechanism; despite the fact that international law bestows protection upon investors against arbitrary and unilateral state

608 Interview no. 8 with lecturer 4 June 2012 and 8 November 2012

609 Interview no 19 with Lecturer, 23 November 2012

610 Interview no 18 with Lawyer, 21 November 2012

611 T. W. Waelde & Ndi *Stabilising International Investment* (n.1 above) 238

intervention. According to the supporters of this view, the function of stabilisation clauses is to provide alien investors extra protection against any ‘*prima facie* lawful grounds which international law recognises for affecting changes to the concluded agreement.’⁶¹² Similarly, according to Peter, the stabilisation technique has been regarded as ‘a strict yardstick for contract performance with its corresponding counterpart of legal consequences for breach of contract.’⁶¹³

The third view to be found in literature is that the inclusion of stabilisation clauses in an investment agreement has a financial function, particularly in the event of their violation. The foundation of this view is that even if a stabilisation clause is deemed not to have any effect on the host states right to unilaterally change the terms and conditions of the previously agreed agreement, the violation would provide the private investor a special right to compensation as a result of the inclusion of the stabilisation clause.⁶¹⁴ It is important to emphasise that the amount of compensation would be higher than those of other contractual violations should stabilisation provisions be excluded.⁶¹⁵ Such compensation would cover prospective gains, or lost profits (*lucrum cessans*).⁶¹⁶

5. Do Stabilisation Provisions constitute a threat to Environmental protection and Human rights?

In recent years, the petroleum industry has witnessed new concerns in the areas of environmental protection and human rights. It has been vehemently argued that stabilisation provisions in a contract can have a ‘chilling effect’ on law reform in a host state, particularly in the field of human rights⁶¹⁷ and environmental protection.⁶¹⁸ The foundation of this argument is that stabilisation clauses demotivate or discourage host states from introducing new laws focussing on environmental and social policy. A recent empirical study in this area found that ‘contracts from non-OECD countries are more likely than those from OECD countries to insulate the investor from new social and environmental laws or to provide compensation to the investor for compliance with new

612 A. D. Nwokolo (n.73 above) 14

613 W. Peter,(n.55 above) 226.

614 *ibid*

615 *ibid*

616 *Ibid*

617 For further reading, see A. Shemberg (n.26 above)

618 L. Cotula, ‘Reconciling Regulatory Stability and Evolution of Environmental Standards in Investment Contracts: Towards a Rethinking of Stabilisation Clauses’, in S. Leader & D. Ong, *Global Project Finance, Human Rights and Sustainable Development*,(Cambridge, Cambridge University Press: 2011) 162

social and environmental laws.⁶¹⁹ As previously mentioned, theoretically, sovereign states are free to exercise their sovereignty by regulating domestic issues such as the environment, tax, human rights, health and safety and all other areas under the jurisdiction of police power. In this respect, it is vital to discuss whether the inclusion of stabilisation commitments forces the host state to relinquish international treaty obligations in the area of human rights or environmental issues, and whether such regulatory measures taken by host states violate stabilisation commitments.

It is inevitable that such a lucrative industry with the potential to have significant impact on local and regional environmental, social and economic concerns is so exposed to criticism. In other words, considering cases in which a stabilisation clause has been applied, 'it is unsurprising that they have been subjected to scrutiny by persons and organisations concerned with promoting sustainable development.'⁶²⁰ This criticism is founded on the fact that the adoption of such clauses has the potential to have a grave impact on the contracting state's legislative power, administrative acts, and the judicial decisions of its independent courts. It is, therefore, difficult for a host state to regulate significant issues in the interest of its citizens.⁶²¹ In doctrine, some authors argue that traditional stabilisation clauses are inflexible and that they have a restrictive effect on host state policy.⁶²² Therefore, they assert, the scope of stabilisation clauses should be limited to non-fiscal areas, such as environmental, human rights.⁶²³ According to Leader, 'host-state regulation to promote the full realisation of human rights is outside the scope of the stabilisation clause.'⁶²⁴ What is meant by the words of the author is that state sovereignty is limited by the international obligation to realise fundamental human rights.⁶²⁵

In the *Texaco* case, the arbitrator held that host states may forgo their sovereign rights during the life span of the investment agreement, should a definitive event such as nationalisation occur. However, as far as international treaty obligations are concerned, host states do not have the prerogative to refuse to take the measures that international

619 A. Shemberg (n.26 above) v

620 A. Shepperd & A. Crocket, (n.11 above) 338

621 A. F. M. Maniruzzaman, *A Critical Appraisal of the Emerging Trends* (n.1 above) 156

622 A. F. M. Maniruzzaman, *A Critical Appraisal of the Emerging Trends* (n.1 above) 126

623 L. Cotula (n.176 above) 163

624 Ibid

625 Ibid

law obliges.⁶²⁶ In other words, state sovereignty is limited by international obligations regarding the areas of human rights and environmental concerns. It is true that the general tendency in the petroleum industry is not to insert strict stabilisation provisions in the contract and exclude non-fiscal areas.⁶²⁷

For the latter question, it can be said that there is nothing to hinder a sovereign state from exercising its sovereign rights for public good or in the public interest. Nevertheless, ‘the functional value of stabilisation clauses cannot be discounted.’⁶²⁸ Furthermore, since stabilisation clauses do not distinguish between compensable taking or indirect expropriation and non-compensable regulation, legal proceedings would be inevitable to settle this matter in the event that any such measure were taken by a host state. A solution to this problem has been suggested in conventional academic literature by several authors. According to Sheppard & Crocket, ‘...stabilisation clauses are often narrower in scope than many critics assert, or fear’.⁶²⁹ The authors believe that ‘those criticism and fears can be assuaged – and the legitimate concerns of investors and lenders that the host government does not denude the project of economic value by changing the rules can be addressed – by appropriate drafting and the incorporation of the international law norms of fair and equitable treatment and legitimate expectation.’⁶³⁰ Cotula also states that, ‘best contractual practice clearly defines the scope of stabilisation clauses to ensure that social and environmental matters are not stabilised. This can be done not only by wording the clause around arbitrary, discriminatory or similar treatment, but also explicitly stating that public purpose measures are outside the scope of the clause.’⁶³¹

Recent state practice supplies good guidance in this matter. For instance, the 2004 US Model BIT contains the following provision: ‘Except in rare circumstances, non-discriminatory regulatory actions by a Party that are designed and applied to protect legitimate public welfare objectives, such as public health, safety and environment, do not constitute indirect expropriation.’⁶³² In the same vein, Article 12 of the Draft of the Norway Model BIT (2008) contains the following provision: ‘Nothing in this

626 The environmental matters Principle 2 of the 1992 Rio Declaration on Environment and Development 13 June 1992, 31 ILM 874 (1992)

627 However, it should also be noted that Shemberg’s recent research demonstrates that freezing clauses are still in use to some extent particularly in mining sector. Please see A. Shemberg (n. 26 above) 6-7.

628 A. F. M. Maniruzzaman, *A Critical Appraisal of the Emerging Trends* (n.1 above) 156

629 A. Sheppard & A. Crocket (n.11 above), 343

630 *ibid*

631 L. Cotula *Investment Contracts through development Lens* (n.47 above), 33.

Agreement shall be constructed to prevent a Part from adopting maintaining or enforcing any measure otherwise consistent with the Agreement that it considers to ensure that investment activity is undertaken in a manner sensitive to health, safety or environmental concerns.⁶³³

BITs offer good guidance by furnishing specific terms for these highly sensitive areas. Similarly, if environmental and human rights and other public interests of a host state were provided for in the contracts and singled out from the scope of stabilisation commitments, then the action of the host state would not amount to indirect expropriation and could not be claimed by an investor to be in violation of the stabilisation clause.

6. The BTC Pipeline Project (I): Reactions to the Project

The BTC pipeline project has been subject to the criticism of public interest groups who see the legal framework of the HGA as placing the interests of the BTC consortium over human rights, the environment and state sovereignty. One of the claims made by these groups was that Azerbaijan, Georgia and Turkey had agreed to exempt the BTC pipeline project from the rule of local laws, except for obligations arising under the Constitution, and to surrender their right to impose more stringent environmental and social laws over the forty to sixty year term of the project.⁶³⁴ According to Non-governmental organisations (NGOs), this undertaking facilitates the transfer of the financial burden of the investor to the government if the host states' governments 'instituted more stringent legislative standards that impacted the project'.⁶³⁵

The economic equilibrium form of stabilisation clauses in the HGAs were also subject to NGOs' criticism. The public interest groups claimed that the BTC consortium contract was unlawful on the grounds that it would hinder host governments from delaying project execution should any environmental or social (for example, health) concerns arise, except in the case of national emergency.⁶³⁶ This constraint prevents the

632 United States Model Bilateral Investment Treaty, 2004, Annex B Expropriation Section (b) available at: <<http://www.state.gov/documents/organization/117601.pdf>> April 2013

633 It should be noted that due the disagreement on the Norway BIT Model, it did not come into existence.

634 Article 7.2 (x) and 9 (iii) HGA Azerbaijan; Article 7.2 (x) and 9.1(iii) of Georgian HGA and Turkish HGA Article 7.2 (x) and 10.1 (iii)

635 USAID, Multilateral Development Bank Assistance Proposals: Likely to have adverse impacts on the Environment, Natural Resources, Public Health and Indigenous Peoples, (September 2002-October 2004) 29, available at: <http://www.bakuceyhan.org.uk/USAID_MDB_report_Sept02-Oct04.pdf> July, 2013

636 Ibid; see also Azeri HGA, Article 5.2 (iii)

host state from honouring its international obligations with regards to human rights and the environment, moreover, it actually penalises the host government with heavy compensation for doing so.⁶³⁷ This effectively inhibits national development during the term of the project that may constitute an improvement in standards of living in that host state.⁶³⁸ Another concern voiced by NGOs, relates to the privileged status of IGA and HGAs. This establishes the IGA and each HGA as the prevailing legal regime under international law and the laws of each of the three countries, overriding all conflicting domestic law, present and future, thereby rendering ineffectual the constitution. Under the ‘frozen and extremely weakened regulatory environment, the governments are thus less able to respond to new environmental and other threats or to evolving understanding of risk’.⁶³⁹ For instance in the case of Georgia, the HGA was invoked to override the Georgian National Water Act in areas where such an override was required in order to grant the pipeline right-of-way.⁶⁴⁰

Furthermore, the project agreements also overrode key provisions in Turkish Expropriation Law which require the price for expropriated property to be negotiated: instead, it was compulsorily purchased, under the emergency law normally invoked only in times of national disaster or war, under the terms of the agreements.⁶⁴¹ BP has countered that the exemptions it obtained were nothing out of the ordinary and are common to the other concession agreements. The Company states: The creation of a prevailing legal framework is not unusual and has been used by extractive projects even in nations with highly developed legal systems, such as Chile, Canada and Australia.’ BP defensively attested that ‘The prevailing Legal Regime is designed to supplement the existing framework, rather than replace existing laws and regulations.’⁶⁴²

637 Amnesty International, Human Rights on the line: the Baku-Tbilisi-Ceyhan Pipeline Project, May, 2003 (London, Amnesty International Publication: 2003) 13-16 available at: <http://www.amnesty.org.uk/uploads/documents/doc_14538.pdf>May, 2013

638 Ibid

639 N. Hildyards& G. Muttitt, ‘Turbo charging Investor Sovereignty: Investment Agreements and Corporate Colonialism’, available at: <<http://www.thecornerhouse.org.uk/sites/thecornerhouse.org.uk/files/HGAPSA.pdf>> July, 2013

640 USAID, Multilateral Development Bank Assistant Proposals, (September, 2002-October, 2004) 28 available at: <http://www.bakuceyhan.org.uk/USAID_MDB_report_Sept02-Oct04.pdf>July, 2013

641 N. Hildyards & G. Muttitt, (n.197 above)

642BP, Response to NCP Request Filed by Friends of the Earth against Project, unpublished, March (2004) 9 cited in N. Hildyards& G. Muttitt, (n.197 above)

6.1 Joint Statement, the Security Protocol and the BTC Human Rights Undertaking

As a response to the criticisms about the potential impact of the BTC agreements' legal framework on the autonomy and policy making discretion of the host states,⁶⁴³ the project sponsors published several legal documents: *Joint Statement, the Security Protocol and the BTC Human Rights Undertaking*. A joint statement delivered in May 2003, addressed the standards (environmental, health, safety and social) which would govern project implementation.⁶⁴⁴ These standards serve as a baseline for the assessment of changes in law and a ceiling for the limitation of the effects of future legislation.⁶⁴⁵ This was executed by interpretation of the IGA which 'commits each state to the application of environmental standards that are no less stringent than those generally applied within member states of the European Union from time to time. The HGA and other BTC Agreements give effect to this commitment, and provide a dynamic benchmark that will evolve as EU standards evolve.'⁶⁴⁶

In July 2003, the protocol relating to the Provisions of Security for the East-West Energy Corridor (*Security Protocol*) was published to establish the manner in which the host governments of the three signatory states propose to meet their security commitments under the HGAs.⁶⁴⁷ Furthermore, in September 2003, the BTC Company produced another legal document, the BTC Human Rights Undertaking (HRU), which is a legally binding unilateral deed under English Law. The undertaking modified the terms of the stabilisation clauses, excluding previously agreed clauses from being applied to legal changes in the area of human rights, health, safety, and the environment. What it means is that the project consortium acquiesces not to assert claims that are inconsistent with host countries' regulations, provided that this is:

'reasonably required by international labour and human rights treaties to which the relevant Host Government is a party from time to time [or]... required in the public interest in accordance with domestic law in the relevant project state from time to time, provided that such domestic law is not more

643A. Dufey, and R. Kazimova, Baku-Tbilisi-Ceyhan Project: Implications of PF in S. Leader and D. Ong, *Global Project Finance , Human Rights and Sustainable Development*, (Cambridge, Cambridge University Press, 2011) 382

644 P. D. Cameron, *The Pursuit of Stability* (n.1 above) 404-405

645 Ibid

646 Joint Statement, para 7, available at: <<http://subsites.bp.com/caspian/Joint%20Statement.pdf>> August, 2013

647 A. Dufey, and R. Kazimova (n.201 above) 382

stringent than the highest of European Union standards as referred to in the Project Agreements, including relevant EU directives (EU Standards),... those World Bank Group standards referred to in the Project Agreements, and standards under applicable international labor and human rights treaties.’⁶⁴⁸

Through this undertaking, the BTC Company also agrees not to seek compensation under the economic equilibrium clause ‘in connection with... any action or inaction by the relevant Host Government that is reasonably required to fulfil the obligations of the Host Government under any international treaty on human rights (including the European Convention on Human Rights), labour, or HSE in force in the relevant Project State from time to time to which such Project States in then a party.’⁶⁴⁹

The BTC Company hereby provided guarantees that it would not apply the compensation clauses in the IGA and HGAs if one the host states involved in the project legislated in the interests of human rights, environment, health and safety. From that perspective, it might be said that the Human Rights Undertaking represented a breakthrough and was an innovative work, commissioned by the BTC Company as an overt demonstration of their sensitivity towards Human Rights issues. As this action resulted in a restriction of the reach of the stabilisation clause in the BTC agreements, host states were thereby rendered freer to legislate. However, the scope of the stabilisation clause in HGAs is still considered a murky issue by project investors. Distinguishing between legitimate regulations and compensable regulatory actions of states remains challenging. However, the solution seems to lie in the referencing of bilateral international treaties as a benchmark to define whether a host state measure falls within the exception delineated by this Human Rights Undertaking. Bilateral investment treaties do not address the distinction between legitimate regulations and compensable regulatory actions. Arguably, previous attempts made by international arbitral tribunals in distinguishing compensable from non-compensable regulatory actions of host states may help by providing a frame of reference to define whether a host state’s regulatory measure may fall within the exception established by BTC undertaking.

7. Conclusion

Most host government contacts contain stabilisation clauses against discriminatory changes which may adversely affect the terms and conditions of the contract from the perspective of the host state. When these clauses are inserted in a contract they reduce political risk for the investor and preserve the fiscal regime,⁶⁵⁰ thus, they are the most preferred risk management method by investors in the energy

648 Human Rights Undertaking, Section 2. (a) available at:
<<http://subsites.bp.com/caspian/Human%20Rights%20Undertaking.pdf>> August, 2013

649 Ibid, Section 2 (d)

650 J. N. N. Emeka, ‘Anchoring Stabilisation Clause in International Petroleum Contracts’, 42 *Int’l Law* (2008) 1317

industry.⁶⁵¹ In addition, the validity of stabilisation clauses was assessed during this chapter. If domestic law is chosen by the parties to govern the contract, then stabilisation clauses may be exposed to the constitutional and legal restrictions of the host country when the host state makes legislative changes and modifies the governing law. In other words, a right bestowed upon the investor by the state can be taken away at any time by sovereign authority. On the other hand, in order to limit the effects of potentially damaging host government legislation, foreign investors may obligate the host country to agree that the contract should be governed by international law as well as domestic law.⁶⁵²

In such a case, a validly entered into stabilisation clauses may legitimately fetter the host state's ability to modify or unilaterally change the contract or to nationalise assets.⁶⁵³ It is apparent that this view of stabilisation clauses challenges the principle of the permanent sovereignty of states. In addition, well-established norms of International law and a UN resolution recognises that a host country has full control and power to regulate its natural resources.⁶⁵⁴ This means that stabilisation clauses are not the unique defence against nationalisation actions of a government. It is true that in the case of AMINOIL, the tribunal held that a stabilisation clause does not forbid a host state from nationalising the property, but it protects against confiscation. To this end it can be said that there is no power that may hinder a host state from exercising its public interest, as this right is founded in a state's sovereignty. Nevertheless, these clauses should not be regarded as impotent and without legal effect. They are binding and enforceable, because the insertion of such clauses raises the legitimate expectation of a foreign investor. As the legitimate expectation of investors is linked with stabilisation clauses, the violation of stabilisation clauses damages the legitimate expectation of an investor which may in turn seek to be compensated by the host state.⁶⁵⁵

Although stabilisation clauses have been subject to criticism, largely regarding whether they are valid under national and international law, such clauses are still regarded as an essential risk management technique against sovereign risks such as 'nationalisation, expropriation, or the obsolescence bargain in which the host state can use changes in circumstances to improve new requirements on investors.'⁶⁵⁶ However, contemporary practice in the area of stabilisation clauses has moved from the traditional freezing genre of the stabilisation clause to a hybrid combination mechanism combining

651 T. Waelde & G. Ndi, (n.1 above) 234,

652 M. L. Moses (n.88 above) 63

653 Z. A. Alqurashi (n.15 above)235

654 T. Waelde & G. Ndi, (n.1 above) 261

655 Z. A. Alqurashi (n.15 above)234

656 A. Shemberg, (n.26 above) vii.

stabilisation with renegotiation provisions. This combination is called economic equilibrium clauses. The components of economic stabilisation clauses are versatility and stability.⁶⁵⁷ As evidenced during the examination of economic equilibrium clauses, these clauses ‘while indeed showing a willingness of the parties to change, can, at the same time represent a very effective means of stabilising the contract.’⁶⁵⁸ It is irrefutable that economic equilibrium clauses are highly effective in reducing indirect expropriation risk and the unilateral change of contractual terms.

Stabilisation clauses inserted in investment contracts cannot fetter a host state from engaging in legislative activities in the areas of environmental and human rights. As examined in the *Texaco* case, sovereign states may forgo their sovereign rights and fetter themselves, for instance, they can promise not to nationalise the foreign investor’s property. However, it should never be forgotten that a state cannot make promises to foreign investors regarding the non-assignable and inalienable rights which derive from international treaty obligations. When drafting contracts, the best solution is to limit the scope of stabilisation clauses to matters which do not impact on human rights and environmental concerns.⁶⁵⁹ Recent BITs prove that state measures related to environmental and human rights cannot amount to indirect expropriation, so cannot be claimed to be a violation of stabilisation provisions.

Reactions to the BTC project agreements were also explored during this chapter. Following vociferous criticism from several NOGs, the BTC project consortium was forced to back-track and subsequently issued several legal documents to redefine its position. Through the Human Rights Undertaking, the BTC Company declared that the consortium will not require compensation if Azerbaijan, Georgia or Turkey were to adopt new laws designed to protect human rights, the environment, and in the interests of health and safety. Though it may seem that this undertaking narrowed the scope of the stabilisation clause, to date, there has been no attempt made by the signatory states to adopt new laws in the area of human rights and environment to put this hypothesis to the test. More importantly, the human rights undertaking issued by BP, was just a unilaterally executed deed poll. Strictly speaking it is not a legal contract as it applies to only one party. In the BTC case, the deed poll only binds the consortium. In this regard, it could be said to have the status of a documented promise. Debatably, if human rights and environmental exceptions (defined areas in BTC undertaking) were annexed to each HGA and agreed by each state, this may have constituted the fairest and perhaps the most favourable solution for both parties. It should, however, be noted that a measure taken by a signatory state can always be subject to a dispute.

After examining the stabilisation clauses, the following next two chapters will analyse the driving force(s) influence host states to agree to insert such clauses in their host governmental contracts. While chapter 5 merely focusing on external matters,

657M. Erkan (n.1 above) 220, in the author’s book, the elements of economic equilibrium clauses are called ‘flexibility and stability’.

658 W. Peter, (n.55 above) 241

659 L. Cotula (n.176 above) 162

chapter six will examine internal reasons which have forced Azerbaijan and Turkey to accept stability provisions in the HGAs of the BTC project.

Chapter 5

Lenders, Political Risk Insurers and Credit Rating Agencies

1. Introduction

Project finance is a financing for a project arranged in such a way that financial lenders count merely on the assets and cash flow of the project for interest and loan repayment.⁶⁶⁰ Project finance has been one of the most popular funding models for the oil and gas industry for decades. There are a number of equity investors involved in project financing including sponsors, commercial banks and other financial lending institutions. Although project finance is the most common financing model in large-scale oil and gas projects, it is not suitable for all investment scenarios. More fragile business environments, unpredictable government behaviour and other political risk phenomena can render the financing of an international energy project challenging.

The purpose of this chapter is to examine whether credit rating agencies, project finance lenders and political risk insurers play an active role in ensuring that stabilisation clauses are inserted in energy contract agreements. It should be noted that chapter five does not aim to analyse project financing from every perspective or in all its guises, as this would be beyond the scope of this research. However, the chapter will touch upon the definition project finance and why project finance is used. This chapter will go on to assert that there is a link between rating agencies, risk insurers and financial institutions and that this triumvirate effectively facilitate the ability of an investor to back host states into a corner in order to make them agree to stabilisation clauses. Therefore, each of these entities will be examined in turn in terms of how they work and what requirements they impose in the context of an investment scenario.

After setting the scene by presenting these key players and the role they play in international investment projects and how this facilitates the inclusion of stabilisation clauses, the BTC pipeline project will be used as a case study. Examining the legal framework of the BTC agreement provides a real-life investment scenario where an assessment can be made of whether external factors had an influential role on investors and host states in the inclusion of stabilisation clause in a host government contract.

1.1 Project Finance Defined

There is not, in fact, one universally accepted definition of project finance amongst scholars or practitioners. It is possible that the reason for this lies in the dynamic and continuously changing nature of project finance. According to Nevitt and Fabozzi, the term project finance refers to a method of ‘a financing of a particular economic unit in which a lender is satisfied to look initially to the cash flows and earnings of that economic unit as the source of funds from which a loan will be repaid

660 A. C. Inkpen & M. H. Moffett, *The Global Oil and Gas Industry: Management, Strategy, and Finance*, (Tulsa, Oklahoma: Penn Well Corporation: 2011) 286

and to the assets of the economic unit as collateral for the loan'.⁶⁶¹ What is referred to as the economic unit in this definition is a legally and financially free business corporation. In addition, the definition also indicates that the repayment of the loan is principally dependent on the cash flow generated by the economic unit.⁶⁶² Another definition for project finance is provided by Easty. According to the author, 'project finance involves the creation of a legal and economically independent project company financed with non-recourse debt (and equity from one or more corporate sponsors) for the purpose of financing a single purpose, capital asset usually with a limited life.'⁶⁶³ Merna and Owen define project finance as:

Each project is supported by its own financial package and secured solely on that project facility. Projects are viewed as being their own discrete entities and legally separated from their founding sponsors. As each project exists in its own right, SPV's are formulated. Banks lend to SPV's on a non or limited recourse basis, which means that loans are fully dependent on the revenue streams generated by the SPV' and that the assets of the SPV are used as collateral. Hence although there may be a number of sponsors forming the SPV, the lenders have no claim to any of the assets other than the project itself.⁶⁶⁴

The following subsection describes the participants of project finance.

1.2 Who are the main Project Finance Participants?

Generally speaking, there is no one unique project finance model that is applicable to all industries. In other words, as project financing has a complex structure, not all projects follow the same financing method. The following figure best illustrates which types of projects are originated primarily by a host government and which by private sponsors can generally be made on sector by sector basis.⁶⁶⁵

Table 10 Breakdown of Key Project Originators

661 P. K. Nevitt & F. J. Fabozzi, *Project Financing*, 7th edn (England, Euro-money Institutional Investor PLC: 2000) 1

662 A. Merna & Y. Chu and F. F. Al-Thani, *Project Finance in Construction: A Structured Guide to Assessment*, (Oxford, Willey Blackwell: 2010) 11

663 B. C. Easty, *Modern Project Finance*, (USA, John Wiley & Sons, Inc: 2004) cited in A. Merna & Y. Chu and F. F. Al-Thani, (n.3 above) 12

664 A. Merna and G. Owen, *Understanding the Private Finance Initiative-The New Dynamics of Project Finance* (Hong Kong, Asia Law and Practice, 1998) cited in T. Merna & F. F. Al-Thani, *Corporate Risk Management* 2nd edn. (England, John Wiley & Sons Ltd: 2008) 111

665 J. Dewar, *International Project Finance: Law and Practice* (Oxford, Oxford University Press: 2011) 23

Project Sector	Likely Project Originator
Ports	Government
Rails	Government
Roads/tunnels/bridges	Government
Hospitals	Government
Schools	Government
Water/waste	Government
Power	Government/Private Sponsor
Leisure amenities	Government/Private Sponsor
Oil and Gas	Private Sponsor
LNG	Private Sponsor
Mining	Private Sponsor
Petrochemical	Private Sponsor
Telecoms/satellites	Private Sponsor

*Source*⁶⁶⁶: John Dewar

When the classic model of project finance is considered, in oil and gas pipeline projects the following participants involve: a parent company or a group of companies in a consortium (project sponsors), special purpose vehicle (SPV), host government, financial institutions (multilateral, regional development banks, bilateral, and commercial banks).

Project Company: A Project Company is a core legal entity that will own, develop, construct, operate and maintain a single project. The project company is generally regarded as a special purpose vehicle (SPV). In other words, the SPV is ‘a legally and economically independent project company financed with non-limited recourse debt for the purpose of financing a single purpose, capital asset usually with a limited life’.⁶⁶⁷ A sponsor company sets up a SPV for the sole purpose of achieving the limited goals of construction and operation of a particular pipeline, dam, hydroelectric etc. projects in a host country. Therefore, they are subject to the laws of that country ‘unless appropriate commission can be so that key government officials can grant

666 Ibid

667 A. Merna & Y. Chu and F. F. Al-Thani, (n.3 above) 14

exceptions to the project'.⁶⁶⁸ Furthermore, depending on the sponsor companies in question, an SPV can be seen in different ways. If the project involves more than one sponsor, a state corporate entity, partnership construction trust, or a contractual joint venture may be formed. According to Smith and Walter, the existence of more than one sponsor may be necessitated by the following factors⁶⁶⁹:

- The oil or gas resource is jointly owned
- The government of the country where the project is located mandates joint venture with local interests
- The size of the project is so massive that it yields greater economies of scale than several smaller units
- The capabilities of the sponsors are complementary
- The project obviously exceeds the technical, human, or financial resources of a single company
- There is a clear need for risk sharing

The role of SPVs, sovereign ceiling and collateralisation

The principal purpose of the SPV is to maximize project income levels.⁶⁷⁰ In addition to this, some scholars have drawn attention to the reasons why setting up a SPV is considered necessary in an investment scenario. According to Norton, 'setting up a SPV is to afford reassurance (or 'ring-fencing') to investors, enabling cash flows to be de-linked from the credit of the originator/seller. The SPV will receive foreign earnings paid into an account in its name rather than that of the originator; after interest payments have been made to investors the balance will be 'passed through' to the originator'.⁶⁷¹ According to Paoli, 'the reason for forming a SPV is that it can in certain limited circumstances enable the originator to 'pierce the sovereign ceiling', meaning that it is able to raise capital at a lower cost than can the government of the country where it exists'.⁶⁷² All things considered, SPVs are basically 'robot companies in that they have

668 A. Fight, *Introduction to Project Finance*, (Oxford, Elsevier: 2008) 12

669 R. C. Smith & I. Walter, *Global Banking*, (New York: Oxford University Press, 1997) 61

670 S. Leader & D. Ong, *Global Project Finance, Human Rights and Sustainable Development*, (Cambridge, Cambridge University Press: 2011) 115

671 S. D. Norton, 'Securitisation in the Extractive Industries: Stakeholder Sensitivities, Environmental Protection and the Cost of Capital', Issue 53, *Greenleaf Publishing* (November, 2007) 62

672 B. De Paoli, 'Costs of Sovereign Default', *Bank of England Quarterly Bulletin* 46.3 (2006): 297-308 cited in S. D. Norton (n. 12 above) 62

no workers, make no substantive economic decisions, have no physical location, and cannot go bankrupt'.⁶⁷³ Generally speaking, *collateralisation* refers to a property or other assets that a borrower offers a financial institution to protect a loan. If the borrower cannot make the payment of the assured loan, then the lender can seize the collateral to recover its injuries. Norton emphasises that the SPV established by the project sponsors is a shell corporation and emphasises the necessity of SPV collateralization. According to the author:

The originator may sometimes retain the first loss tranche under the securitization, having the same economic effect as collateralisation, but without constituting a guarantee within the strict legal sense. Collateralisation may be required to compensate for risks accruing to the issue. Without such collateralisation the greater the level of perceived risk, the lower the rating assigned to the issue by the bond rating agencies, Standard & Poor's and Moody's, Fitch and DBRS and the higher the rate of interest that must be paid by the originator.⁶⁷⁴

Sponsor Company: The project sponsor is the entity that takes an active role in managing the project. As the owner of the SPV, the project sponsor can be a parent company, group of companies (consortium), or a subsidiary of another company that initiates a project.⁶⁷⁵ The project sponsor supplies management, operational and technical knowledge and experience to a particular project. The project sponsor may be required to provide some guarantees to cover certain liabilities or undertake the risks of the project.⁶⁷⁶ Furthermore, no project can be maintained without the absence of Project Company.

Host Governments: A host government is the government of the state in which an investment project is executed. There is no doubt that the role played by a host government is significant in project financing. For example the political motivation and sustained political support of a host government are indispensable to project financing. In order to demonstrate this willingness, host governments enter into agreement with sponsors, 'providing guarantees and the security of project facilities as well as financial and other assurance'.⁶⁷⁷ The host government's role and lenders' assessment criteria will be discussed in detail in the section devoted to the assessment of project risk in host countries.

673G. B. Gorton and N. S. Souleles, '*Special Purpose Vehicles and Securitization*', Chapter 12 in M. Carey and R. M. Stulz, *The Risks of Financial Institutions*, *National Bureau of Economic Research Conference Report*, University of Chicago Press (2007) 550

674 S. D. Norton, (n. 12 above) 63

675 A. Slivker, 'What is Project Finance and How does it work?', The University of Iowa centre for International Finance and Development (April, 2011) 5 available at: <<http://ebook.law.uiowa.edu/ebook/uicifd-ebook/what-project-finance-and-how-does-it-work-0>> May, 2013

676 A. Fight (n.9 above)

Financial Institutions: There are numerous financial institutions that have some involvement in project finance transactions. Furthermore, there is an even greater variety of capital support structures that a financial organisation can provide for a project. Most projects around the world, particularly in developing states, are financed through some mixture of multilateral banks, export credit agencies and other financial agencies (bilateral agencies or commercial banks). These organisations were set up to supply financing for governmental and private sector transactions in developing states where the political risks are high and often serve to inhibit financial institutions from providing loans. Yet, in spite of the importance of direct funding provided by official agencies, their most crucial role is that their capability in diminishing the political risks for private-sector lenders and thereby to attract them to contribute in financing developing country projects.⁶⁷⁸

2. The Main Financial Institutions in Project Financing

2.1. Multilateral Development Banks (MDBs)

Multilateral development banks (MDBs) are international institutions established by international agreement between multiple countries whose aim is to promote investment development among all its member nations by providing loans and grants.⁶⁷⁹ These development goals concentrate on, primarily, the economic and social benefits to be had through investment as well as supplementary issues such as the protection of the environment and sustainability.⁶⁸⁰ Project loans include large infrastructure projects, such as pipeline construction in energy investment projects, highways, power plants, port facilities as well as social projects. Multilateral banks operate both globally and regionally. The World Bank Group is the principal globally active, multilateral body that provides loans and grants to private sector financing through its affiliates International Finance Corporation (IFC) and Political Risk Insurance through the Multilateral Investment Guarantee Agency (MIGA).

677 T. Sorell, 'Project Financing in Developing Countries, New Corporate Social Responsibility, Human Rights, and Multinationals', *Essex Human Rights Review* Vol.5 , No 1. (1 July, 2008) 2

678 B. Sheppard, 'The Role of Multilateral Banks and ECAs', in R. Morrison, *The principle of Project Finance* (England, Gower Publisher: 2012) 81

679 For instance, Article 1 (section 1) of the Agreement Establishing the Inter-American Development Bank, as stated: 'the purpose of the Bank shall be to contribute to the acceleration of the process of economic and social development of the regional developing member countries, individually and collectively.' Available at: <<http://www.iadb.org/leg/documents/pdf/convenio-eng.pdf>> May 2013

680 J. Dewar, (n.6 above) 218

For the most part, other multilateral development agencies are more often regional in scope. Some examples of these are: European Investment Bank (EIB), European Bank for Reconstruction and Development (EBRD), the African Development Bank (AfDB), the Inter-American Development Bank and the Asian Development Bank (ADB). MDBs are also providers of policy based loans. Traditionally, this type of loan is granted by the International Monetary Fund (IMF) and which requires the typically developing countries who wish to borrow to implement specified economic and financial policies. The purpose of this international organisation is ‘to foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment, sustain economic growth and reduce poverty around the world’.⁶⁸¹ Despite the fact the organisation states as one of its key aims the creation of a permanently strong economic environment, the IMF does not involve itself directly in the financing of investment projects. In the interests of economy, the following section examines only briefly the players in global finance actors under the World Bank Group. Other regional institutions will be provided in a list format.

2.1.1 World Bank Group

The World Bank Group is a term which encompasses the following institutions: the International Development Association (IDA), the International Financial Corporation (IFC), the Multilateral Investment Guarantee Agency (MIGA) and the International Centre for Settlement of Disputes (ICSID). The International Bank for Reconstruction and Development (IBRD) and the World Bank are used interchangeably in literature, but are more widely known as the World Bank which was set up on 27 December 1945. Notably, since its establishment, the World Bank has pursued this objective in several ways.⁶⁸² The following bullet points demonstrate the main objectives of the World Bank:

- To assist in the development of member countries by facilitating the investment of capital for productive purposes;
- To promote private foreign investment by means of guarantees or participation in loans and other investments made by private investors;
- To promote the long-range balanced growth of international trade and the maintenance of equilibrium in balance of payments by encouraging international investment for the development of the productive resources of members, thereby assisting in raising productivity, the standard of living and conditions of labour in their territories;
- To conduct its operations with due regard to the effect of international investment on business conditions in the territories of members and, in the immediate post-war years, to assist in bringing about a smooth transition from a wartime to a peacetime economy.⁶⁸³

681 Please see Official Website of International Monetary Fund (IFM), available at: <<http://www.imf.org/external/about.htm>> May 2013

682 I. F. I. Shihata, ‘The Settlement of Disputes Regarding Foreign Investment: The Role of The world Bank, With Particular Reference to ICSID and MIGA’, 1 *Am. U.J. Int’l L. & Pol’y* 97 (1986) 1

683 Article (1) of Agreement of the International Bank for Reconstruction and Development, July 22, 1944 available at: <<http://web.worldbank.org/>> May 2013

With this outline of the main purposes and objectives of the World Bank in mind, it is significant to examine examples of the Bank's specific role in oil and gas related projects. The World Bank requires a governmental guarantee of repayment of its loans.⁶⁸⁴ For this reason, the bank's financial assistance is not directly extended to the private financing of a project. Therefore, its loans are provided to host governments. It should be noted, however, that the Bank's involvement in an oil and gas project encourages private sector involvement in large-scale oil and gas projects.⁶⁸⁵ For instance, the World Bank's involvement could provide extra security to the other lenders or international investors who participates the project. The World Bank's guarantees cover risks arising from non-performance contractual obligations or *force majeure*.⁶⁸⁶ Furthermore, the Bank can extend guarantees against political risks, such as expropriation, nationalisation, foreign currency transfer, etc. More significantly, the World Bank's policy effect or closeness to the host government assists to facilitate legal and administrative preparation of package.⁶⁸⁷

The International Development Agency (IDA)

The International Development Agency (IDA) was established in 1960. It aims to reduce poverty by providing subsidised credits (loan) and grants, technical assistance, and policy advice to the less developed countries.⁶⁸⁸ The organisation has 172 member states which contribute financially every three years.⁶⁸⁹ IDA membership is available

684 S. Sinclair, *World Bank Guarantees for Oil and Gas Projects*, in *The World Bank, Natural Gas: Private Sector Participation and Market*, (Washington, The World Bank Publications: 1999) 87

685 H. Razavi, 'Oil and Gas Financing by the World Bank', *Energy Policy* vol.23 No.11 (1995) 1001

686 H. Razavi, *Financing Energy Projects in Emerging Economies*, (Tulsa, Oklahoma, Penn-Well Books: 1996) 35-36. The term *Force majeure* means 'superior force' has developed into an international doctrine. In project financing, transaction documents ought to contain clauses which specify the events that excuse performance and the legal consequences of each event. These events commonly in *force majeure* clauses and refer specific risks. For instance, war, strikes, lockout, expropriation, requisition, confiscation or nationalisation, changes in law etc. cited in P. K. Nevitt & F. J. Fabozzi, (n.2 above) 25

687 H. Razavi (n.27 above) 35-36

688 Low or less income countries, are the states with annual per capita income \$1,025 or less. Please see World Bank's income group assessment (n.24 above)

689 IDA official website, what is IDA, available at:
<<http://www.worldbank.org/ida/what-is-ida.html>> May 2013

only to countries who are also members of the World Bank. While IBRD targets middle income⁶⁹⁰ countries and assesses their creditworthiness, IDA does not consider the creditworthiness of states. Since, the IDA does not borrow funds on the credit markets; the organisation does not adopt interest rates on its borrowing charges, as does the IBRD.⁶⁹¹ The IDA is regarded to be the soft lending window of the World Bank, while IBRD is considered to be the hard lending window.⁶⁹²

International Financial Corporation (IFC)

The International Finance Corporation (IFC) is a member of the World Bank Group, focused exclusively on promotion of private sector investment in developing countries. The institution was established in Washington in 1956 and currently has 184 member countries around the world.⁶⁹³ The objective of the IFC is not merely to support private projects that it is involved in but also to attract foreign investment and finance. In contrast to the World Bank, which supplies capital to host governments, the IFC provides loan to private companies and will not accept repayment from the government of host state.⁶⁹⁴ In addition, unlike the World Bank, which provides guarantees to investors to stimulate the economy of its client country, the IFC does not provide direct guarantees against political risks protection to its B loan syndicate banks. Furthermore, the IFC has two different types of loans, A and B. While the former is financed through the IFC's own funds, the latter is financed by external funds. The type B Loan offers commercial banks and other financial institutions the opportunity to take part in an investment project financed by the IFC. These loans play a key role in IFC's effort to mobilize cross-border funding for private sector investment in developing states.⁶⁹⁵ The IFC's direct support is significantly improved through its syndication of commercial banks loans. According to Ochieze, 'a syndicate of banks should be chosen from as wide a range of countries as possible, to discourage the host government from taking

690 According to World Bank's income group assessment, Middle income countries, are the states with per capita income \$1,026 - \$4,035 a year, available at: <http://data.worldbank.org/> May 2013

691 S. L. Hoffman, *The Law and Business of International Project Finance*, 3rd edn (Cambridge, Cambridge University Press: 2008) 260

692 W. R. Cline & N. P. Sargen, 'Performance Criteria and Multilateral Aid Allocation', *World Development* Vol.3, Issue 6, June (1975)383-391

693 For further information please see <http://www1.ifc.org/> May 2013

694 H. Razavi ,(n.27 above) 44

695 International Finance Corporation, Partnering with IFC Syndication: access, cooperation and risk mitigation, available at: <http://www1.ifc.org/> May 2013

action to expropriate or otherwise interfere with the project and thus jeopardise its economic relations with these countries.⁶⁹⁶

The IFC enjoys special privileges: 'the institution is exempt from payments from local taxes; its loan has never been rescheduled for political risks; it has accessed for high policy maker and so on.'⁶⁹⁷ When it syndicates the loan, the IFC is the lender of record and brings commercial banks under its own 'umbrella'. Hence, the commercial bank loans treated in the same way as the IFC's loan.⁶⁹⁸ Indeed, the IFC takes responsibility for administrating the loans and collecting payments from borrower.⁶⁹⁹ IFC also takes the responsibility for appraising the project and coordinating the preparation of legal and contractual package. With the IFC taking all the lead responsibilities, commercial banks find it more convenient and secure to participate in financing projects in developing countries.⁷⁰⁰

Multinational Investment Guarantee Agency (MIGA)

MIGA is another member institution of the World Bank Group. MIGA has headquarters in Washington DC and operates as an independent international institution with 'full juridical personality'⁷⁰¹ under the umbrella of international law and domestic laws of its member countries.⁷⁰² It was established in 1988 and currently has 179 member states. In June of the same year, MIGA defined its Operational Regulations.⁷⁰³

696C. Ochieze, Lender Liability: 'To what extent can a lender protect itself?', CELMP Annual Review, Feb 2007 available at: <<http://www.dundee.ac.uk/>> January 2011

697 H. Razavi (n.27 above) 44

698M. H. Bouchet & E. Clark and B. Gros Lambert, *Country Risk Assessment: Guide to Global Investment Strategy*, (England, John Wiley & Sons Ltd: 2003) 203

699 H. Razavi, (n.27 above) 44

700 Ibid

701 MIGA Convention, Article 1. Convention Multilateral Investment Guarantee Agency, opened signature 11 October, 1985, 24 I.L.M. 1985 (entered into force 12 April, 1988)

702 J. W. Salacuse, *The Three Laws of International Investment: National, Contractual, and International Frameworks for Foreign Capital*, (Oxford, Oxford University Press: 2013) 266

703 Operational Regulations of the Multilateral Guarantee Investment Agency, June 22, 1988 (As amended by the Board of Directors 2012) 1227 available at: <<http://www.miga.org/documents/Operations-Regulations.pdf>> May 2013

These serve to set out the main principles ‘as to the nature and type of political risk guarantees that MIGA may issue, the eligible investors and investments that may obtain such guarantees, and the basic terms and conditions that must be included in MIGA guarantee contracts.’⁷⁰⁴ The objective of the organisation is to promote and encourage private investment in emerging economies. In order to fulfil its mission, the organisation provides investment guarantees against political risks to alien investors and lenders.⁷⁰⁵ The political insurance scheme covers five non-commercial areas: a) currency inconvertibility and transfer restriction; b) expropriation; c) war; civil disturbances; d) breach of contract violation through host government’s intervention; and e) non-honouring of state financial obligations product. As noted previously, as well as the World Bank Group there are a host of other multilateral organisations with a more regional scope. A full list of these is provided below.

Table 11 List of other Multilateral Development Institutions

<i>Name of the Institution</i>	<i>Abbreviation</i>
African Development Bank	AFDB
African Development Fund	ADF
Andean Development Corporation	CAF
Arab Bank for Economic Development in Africa	BADEA
Arab Fund for Economic and Social Development	AFESD
Arab Investment and Export Credit Guarantee Corporation	DHAMAN
Arab Monetary Fund	AMF
Arab Organisation for Agricultural Development	AOAD
Asian Development Bank	ADB
Caribbean Development bank	CDB
Central American Bank for Economic Integration	CABEI
Central African States Development Bank	CASDB
East African Development Bank	EADB
European Bank for Reconstruction and Development	EBRD
European Interment Bank	EIB
European Investment Fund	EIF
Financial Fund for the Development River Plate Bain	FONPLATA

⁷⁰⁴ J. W. Salacuse, (n.43. above) 266

⁷⁰⁵ MIGA’s official website <<http://www.miga.org/investmentguarantees/index.cfm>> May 2013

Fund for Co-operation, Compensation And Development (Economic Community of West African States)	ECOWAS Fund
International Fund for Agricultural Development	IFAD
Islamic Development bank	IsDB
Nordic Development Fund	NDF
Nordic Investment Fund	NIF
OPEC Fund for International Development	OPEC
Saudi Fund for Development	SFD
United Nations African Institute for Economic Development and Planning	IDEF
West African Development Bank	BOAD

Source: Compiled by Author

2.2 Export Credit Agencies (ECAs)

Nowadays, almost every industrialised state has at least one official export credit agency. However, many well developed countries around the world may boast of two agencies: one for finance and one for guarantees and insurance.⁷⁰⁶ ECAs and Investment Insurance Agencies (IIA) are mutually referred to as ECAs, they provide government backed loans guarantees and insurance to support corporations seeking business opportunities in less developed states and emerging markets. ECAs typically supply short-term trade financing, medium-term financing for capital goods, and insurance or guarantees against political risk for export transaction and long-term investments.⁷⁰⁷ Such insurance or guarantees may cover either or both commercial and political risk. For instance, if the SPV, established in the host state, imports installations or equipment which are indispensable to construct and run the project, most ECAs are willing to provide political risk coverage, total coverage or direct loans to exporting companies operating in their home country.⁷⁰⁸ It should be noted that all major ECAs as well as MIGA and other private insurers are members of the Berne Union (International Union

⁷⁰⁶E. D. Gianturko, *Export Credit Agencies: The unsung Giants of International Trade and Finance*, (USA, Greenwood Press: 2001) 63

⁷⁰⁷ B. Sheppard (n.19 above) 82

⁷⁰⁸ S. Gatti, *Project Finance in Theory and Practice: Designing, Structuring and Financing Private and Public Projects*, 2nd edn. (California, Academic Press: 2012) 206

of Credit and Investment Insurers). The main role and purpose of the Berne Union, is to: ‘work to facilitate cross-border trade by helping exporters mitigate risks through promoting internationally acceptable principles of export credit financing, strengthen the global financial structure, and facilitate foreign investments.’⁷⁰⁹ The following table demonstrates the most significant ECAs in the project finance market and their country of origin. The table also includes brief information about these ECAs.

Table 12 List of Major ECAs Operating Today with Their Home County

<i>Country</i>	<i>Institution</i>	<i>Abbreviation</i>
<i>Canada</i>	Export Development Canada: Providers, principally of export financing and insurance support.	EDC
<i>China</i>	Export-Import Bank of China: A bank which has the primary mission of promoting foreign trade and investment. The Institution’s commercial activity is to fund mainly export credit infrastructure projects such as pipelines roads, and railways.	China Eximbank
<i>Finland</i>	Finn Vera: The institution provides guarantees to the buyer or the borrower (commercial), or to the buyer’s or borrower’s country (political risk).	FinnVera
<i>France</i>	Compagnie Française d’Assurance pour le Commerce Extérieur: The organisation provides commercial and political risk insurance.	COFACE
<i>Germany</i>	KfW IPEX-Bank: A government-owned institution which operates more like a commercial bank than an Export Credit Agency. ⁷¹⁰	IPEX
<i>Italy</i>	SACE: an entity which operates like an insurance and financial institution and supports Italian companies’ export and internationalisation activities.	SACE
<i>Japan</i>	Japan Bank for International Cooperation: JBIC provides export financing as well as financial assistance including concessionary long-term, low interest funds needed for the efforts of developing states. ⁷¹¹	JBIC
<i>Japan</i>	Nippon Export and Investment Insurance: the institution provides insurance against commercial and political risk.	NEXI
<i>Korea</i>	Export-Import Bank of Korea: provides bilateral loans.	KEXIM

709 J. K. Jackson, The Bern Union: ‘An Overview, Congressional Research Service Report’ , (April 2013)² available at: <<http://www.fas.org/sgp/crs/row/RS22319.pdf>> May 2013

710 For further information see the official website of the institution. Available at: <<https://www.kfw-ipex-bank.de/Internationale-Finanzierung/KfW-IPEX-Bank/>> May 2013 ; see also J. Dewar,(n.6 above) 215

711 For further reading see S.L. Hoffman (n.32 above) 272

Korea	Korea Export and Insurance Corporation: As an export credit insurance agency, it provides insurance against commercial and political risks.	KEIC
Norway	Garanti-Instituttet for Eksportkreditt: An organisation which supplies loan guarantees to support export financing.	GEIK
UK	Export Credits Guarantee Departments: In the UK, export financing is supplied by the commercial lenders. The organisation guarantees payment to a UK financial institution to support UK goods and services, assuring exporters against payment risks resulting from commercial and political risks.	ECGD
US	Export-Import Bank of the United States: As an independent legal entity, US Eximbank has three guiding principles; support US exports through financing, achieve a reasonable guarantee of repayment and provide financial support. ⁷¹²	US Eximbank

Source: Compiled by Author

2.3 Bilateral Agencies

Bilateral Agencies are the third type of official agencies that play an active part in project finance transaction. Most bilateral institutions were established to promote international economic development through loans, guarantees, equity investments and in some cases political risk insurance. According to Shepard, Bilateral agencies are a more heterogeneous group than MDBs or ECAs because they cannot be restricted to a single category.⁷¹³ For instance, the US finance development institution known as the Overseas Private Investment Corporation (OPIC) is broadly known for its political risk insurance programme which offers cover against certain political risks, including inconvertibility, expropriation, and political violence. In addition to its political insurance programme, the organisation also provides project finance on a limited recourse basis for private investment projects through direct loans and loan guarantees. The borrower must be either a wholly owned US company or a joint venture in which the US sponsor firm is a participant. The following table catalogues the most important bilateral agencies playing a key role in the project finance market.

Table 13 Bilateral Agencies that are the most important for the project finance market.

Institution	Abbreviation	Country
Promotion et de Participation Pour la Coopération Economiques	PROPARCO	France

⁷¹² Ibid

⁷¹³ B. Sheppard (n.19 above) 82

KfW Bankengruppe (Originally Kreditanstalt für Wiederaufbau)	KfW	Germany
Deutsche Investition- und Entwicklungsgesellschaft (a subsidiary of KfW)	DEG	Germany
Nederlandse Financierings-Maatschappij voor Ontwikkelingslanden	FMO	Netherlands
Commonwealth Development Corporation	CDC	UK
Overseas Private Investment Corporation	OPIC	USA
United States Agency for International Aid	USAID	USA

Source⁷¹⁴: B. Shepherd

2.4 Commercial Banks

Commercial banks are the other most significant players in project finance transactions. A loan may be granted through the domestic commercial bank of the country where the project is to be undertaken or else through international commercial banks. Obtaining a grant from a domestic bank may be advantageous for project sponsors because of the bank's knowledge of local law and 'customs as well as the ability to offer loans in the local currency.'⁷¹⁵ It should, however, be noted that some developing countries' domestic bank markets may not be sufficiently developed to provide the capital required for a long-term investment project.⁷¹⁶ Furthermore, the attractiveness of commercial banks for investors in project finance is perhaps the flexible terms they offer on the repayment of loan that they may offer to investors. A loan granted by an international commercial bank usually has a specific period within which it is repayable in accordance with a pre-range reimbursement schedule.

Notably, this specific term loan includes flexibility 'as to when repayments will begin, when the loan will be repaid, in equal or variable payments over time and the frequency of interest payments in order to align the project's projected revenue streams and operating costs with the borrower's repayment obligations'.⁷¹⁷ In the energy sector, the participation of international commercial banks consists in their provision of syndicated loans. As mentioned above, IFC and some MDBs have a sizeable remit in putting together syndicated loans for developing countries. According to Razavi, the IFC's participation offers international commercial banks convenience and reassurance

714 Ibid

715 D. Nordstrom & S. Dickens and M. Brown & K. Stirling, 'Multisource Project Financing', chapter 4 in R. Morrison, *The Principle of Project Finance*, (England, Gower Publishing Limited:2012) 40

716 Ibid

717 Ibid

as follows: 1) The IFC handles all the technical and legal matters including risk mitigation measures; 2) ensures that a default on repayment to any of the participating banks will be viewed as a default on the entire syndicated loan and thereby, a default on repayment of the IFC loan; and 3) is responsible for administration of the syndicated loan and all matters related to the disbursement and repayment of the loans.⁷¹⁸

Basel III, Capital Adequacy and Risk

As outlined above, financial institutions play a key role in financing national and international investment projects. It would seem that their influence over a state's economy in this respect to be taken for granted. Nevertheless, despite their influential role in an energy-producing nations' economy, the banking industry is inherently unstable and its structure has been historically sensitive to economic change. Generally speaking, the crisis in the banking industry can be divided into three timelines in the 20th Century. The first major financial crisis, the Great Depression was a feature of the 1930s. Thereafter, the saving and loan crisis occurred in the banking sector during the 1980s and 1990s and the final and perhaps the most dramatic of contemporary financial crises broke in 2007. Capital adequacy has always been the most vitally important pillar of international banking regulation. Capital adequacy can be defined as 'the legal requirement that a financial institution (such as a bank) should have enough capital to meet all its obligations and fund the services it offers.'⁷¹⁹ As will be discussed below, all the Basel accords adopted by Basel committee have strived to establish a mutual international regime for the regulation of banks 'by drawing up a series of minimum standards for the assessment of the amount of capital adequacy that banks should hold.'⁷²⁰

In the mid-1970s, the ten groups of countries' central banks established the Basel Committee to facilitate consistent cooperation among countries and improve the quality of banking supervision throughout the world. By the late 1980s, the Basel Committee on Banking Supervision developed 'a risk based capital adequacy standard that would lead to international convergence of supervisory regulations governing the capital adequacy of international active banks'.⁷²¹ The adoption of the Basel I accord by the Basel Committee on Banking Supervision established the first international applicable set of regulatory capital adequacy standards to offer built-in stability to the international banking system. It was adopted by a number of bank regulators around the world.⁷²² In 2004, banking regulators in the United States and other countries produced a version II

718 H. Razavi, (n.27 above) 98

719 J.O. E. Clark, *Dictionary of International Banking and Finance Terms*, (Canterbury, Financial World Publishing: 2001) 61

720 K. Young, 'The Basel Committee on Banking Supervision' in T. Hale & D. Held, *Handbook of Transnational Governance* (Cambridge, Polity Press: 2011) 40

721 H. V. Greuning & S. B. Bratanovic, '*Analyzing Banking Risk: A Framework for Assessing Corporate Governance and Risk Management*', 3rd Edn. (Washington D. C, The World Bank: 2009) 123

of the Basel accord because ‘it had become clear to regulators that the methods used to calculate the requirements in Basel I were not sufficiently sensitive in measuring the risk exposures. It was also clear that the regulatory capital needed in the increasingly complex and dynamic banking system could not be determined accurately and consistently under the Basel I framework’.⁷²³ Basel II proposed a three pillar approach. The first pillar covers minimum capital requirements, the second pillar the supervisory review of capital adequacy and the third pillar market discipline.⁷²⁴ Nevertheless, the banking sector found itself exposed to high levels of risk once more in the financial crisis of 2007. This prompted the committee to develop a third iteration of the accord to address weaknesses retrospectively identified in the Basel II accord.

Basel III is a consultative document entitled, ‘*Strengthening the Resilience of the Banking Sector*’ which was first published in 2009, by the Basel Committee.⁷²⁵ The main objective of the Basel III accord is to amend the liquidity and capital adequacy minimum ratios proposed under Basel II. The new liquidity and capital adequacy ratios proposed in the current version of the accord aim to future-proof banking organisations against such crippling crises.

Basel III aims to establish appropriate levels of liquidity for financial institutions and provide assurances of solvency through bank level regulation, ‘which will help raise the resilience of individual banking institutions to periods of stress’ and address system-wide risk.⁷²⁶ Under Basel III, the minimum requirement for capital adequacy would be raised from of 2% (under the Basel II) of banks’ net assets to 4.5%. This constitutes a concerted attempt to improve the capital adequacy and liquidity of commercial and investment banks. The following bullet points clearly demonstrate how the Basel III proposals sought to strengthen the regulatory regime applied to banks:

722 B. P. Delahaye, Basel III : ‘*Capital Adequacy and Liquidity after the Financial Crisis*’, Harvard Law School LLM thesis (2011)3

723 W. W. Eubanks, Status of the Basel III Capital Adequacy Accord, *CRS Report for Congress*, 28 October (2010) 1

724T. Koffer, Basel III-Implications for Banks’ Capital Structure: What Happens with hybrid capital instrument?, (Hamburg, Anchor Academic Publishing: 2013) 4

725 Bank for International Settlement, Basel Committee on Banking Supervision, Consultative Document, *strengthening the Resilience of the Banking Sector* available at: <<http://www.bis.org/publ/bcbs164.pdf>> March, 2014

726 Basel III: A global regulatory for more resilient banks and banking system; Banks for International Settlement; Revised June, 2011, available at: <<http://www.bis.org/publ/bcbs189.pdf>> March, 2014

- Enhancing the quality and quantity of capital.
- Strengthening capital requirements for counterparty credit risk (and in CRD III for market risk) resulting in higher Pillar I requirements for both.
- Introducing a leverage ratio as a backstop to risk-based capital.
- Introducing two new capital buffers: one on capital conservation and one as a countercyclical capital buffer.
- Implementing an enhanced liquidity regime through the Net Stable Funding Ratio and Liquidity Coverage Ratio.⁷²⁷

3. The role of lenders in the inclusion of Stabilisation Clauses

As touched upon in the introduction, the political and social stability of a host state is undoubtedly the most significant concern for investors and lenders. No matter within which jurisdiction the project is located, the laws and regulations of the host country have the potential to affect every aspect of the Project Company's activities.⁷²⁸ The project sponsor who seeks financial aid for a specific investment project prepares a project finance proposal and submits it to the lender. The lender conducts a project analysis in an attempt to comprehend the general scope of the project, rationale and the purpose of the investment project in order to ensure that the project proposal is sound and worth participating in.

From the information provided by the project analysis, the lender can identify and assess potential risks that can be managed or avoided. Indeed, it is well-known that risk of some degree is unavoidable and there will always be the potential for an unforeseen risk to arise during the course of an investment project. Nevertheless, project finance lenders assess the legal and business environment of a host country with the information available to them before committing to capital investment in a specific project. An Account Manager in a private insurance company interviewed, furnished the following explanation:

The financing of a project will be based on its financial performance and risks. The financial performance and strength of the project will be evaluated using certain measures such as debt coverage ratio (sponsors' ability to meet their debt payments); the Rate of Return on equity (ROR typically between 15% and 20%); expected cash flows, costs and revenues of the project, etc. A financial model will typically be produced to assess the project. Lenders will then assess the political risk, foreign exchange, regulation, industry, customers/suppliers, etc.⁷²⁹

According to an interview participant who works as a senior expert at international pipeline projects in Turkey:

⁷²⁷ The Basel Accord and Capital Requirement Directive (CRD), available at: <<http://www.fsa.gov.uk/about/what/international/basel>> March, 2014

⁷²⁸ J. Dewar, (n.6 above) 7

⁷²⁹ Interview no. 13 with an Account Manager, 5 December, 2012

In the Nabucco gas pipeline project, the five shareholders of the Nabucco international project company (BOTAS, Turkey; BEH, Bulgaria; FGSA, Hungary; OMV, Austria and Transgaz, Romania) initially considered three countries, Iran, Iraq and Azerbaijan. The main lenders IFC and EIB and EBRD found that Iran posed too great a degree of risk, because of the constant threat of the government's provocative behaviour. For Iraq, the lenders consideration was no more favourable than Iran, due to the on-going war and political uncertainties in the region. Therefore they ended up deciding to invest in Azerbaijan, as the country had relative legal and political stability and provided an attractive business environment for investors.⁷³⁰

While legal issues are one of the potential problem areas that lenders will take into account, there are, nevertheless, other significant factors to take into consideration that may be technical or environmental in nature. The following section explores these non-commercial considerations.

Host government Policy: There is no doubt that, in the interests of the sustainability of the project, the lender will wish to have made a thorough assessment of the following: the interest/or intention of the host country regarding the project, the host state's investment policy and the long term viability of host government policy. Host government policy must be deemed to be in harmony with the interests of project sustainability and the host state will be expected to clearly state its intentions in a way that is not easily open to misinterpretation or misunderstanding. Most importantly of all, host state policy must be stable, and supported by immutable sources of law. From the lenders perspective, this requirement is easily understandable, as naturally a lender will wish to have a clear agreement on in exactly what circumstance 'the project company will bear the risk of the host country government, changing policy and interfering with the success of the project'.⁷³¹ One interviewee emphasised that the inclusion of stabilisation clauses can be initiated by either party. He stated that:

Many of the investment agreements models or governments future policy in specified areas, (for example oil and gas) are negotiated or decided by the World Bank's reform program in a less developed countries. For this reason, inclusion of stabilisation provisions integrated in the contract is not the sole decision of investors, it may be part of the mutual policy agreement between the World Bank group and host state.⁷³²

⁷³⁰ Interview no 2 Anonymity Guaranteed , 9 May 2012

⁷³¹ J. Delmon , *Private Sector Investment in Infrastructure: Project Finance, PPP Projects and Risks*, 2nd edn (The Netherland, Walters Kluwer: 2009) 136

Permitting: Operation of an investment project necessitates the authorisation of a wide range of permits and consents to the project company. Such permits and approvals need to be in place in order for the project sponsor to develop, construct, start up and operate the project. In the absence of these permits and approvals ‘the project would be unfinanceable because it would exist in a state of uncertainty, subject to potential unacceptable changes’.⁷³³ The project finance lender will monitor whether the permit is issued and the consents have been given or will be given in the ordinary course without undue expense, delay or conditionally.⁷³⁴

Nationalisation and Expropriation: A sovereign state has the right to expropriate or nationalise private property registered or located within its boundaries unless just and timely compensation is provided by a host government to an alien investor.⁷³⁵ According to an interview respondent:

Implementation of specific legislations creates a secure investment environment and trusted guarantees. Lenders wish to be reassured that if direct or indirect expropriation or nationalisation does occur, a substantial sum will be offered in compensation to the project company. Therefore, both lenders and investors are motivated to look for these conditions.⁷³⁶

Change in law: It is a fact that the repayment of loans granted for a specific project may span decades. During this repayment period, a project may be exposed to risks in the form of changes in law, as a result of government change or a change in political regime. According to Delmon, ‘one of the most significant risks posed by a change in law is the modification of performance requirements, including output and environmental requirements during the concession period, increasing the cost of output and potentially having a negative impact on productivity. Such changes may have a substantial impact on the profitability of the project.’⁷³⁷ As this kind of change may pose a threat to the economic health of the project, most host states, particularly developing countries, agree to freeze the application of laws to the project company through stabilisation clauses. If any changes are made by the government in violation of such

732 Interview no 8 with Lecturer, 4 June, 2012 and 8 November, 2012

733 S. L. Hoffman (n.32 above) 375

734 J. Dewar, (n.6 above) 10

735 I. Browlie, *Principles of Public International Law*, 4th edn (Oxford, Oxford University Press: 1990) 123. For further information about expropriation or nationalisation, please see chapter 2 of this work.

736 Interview no. 4 Anonymity Guaranteed , 14 May, 2012

737 J. Delmon (n.72 above) 136

stabilisation clause, compensation must be paid to the investor. Another interview participant gave a similar response to the previous interviewee. According to the respondent:

...No lender will want to bear the change in law risk in any circumstance, only an investor would bear the risk of a change in law. I do not know of any lenders who would confirm any investment project that contains high risk and low profit expectations. In any case, they are reluctant to grant funds for an investment project where change in law is likely in the absence of stabilisation clauses for currencies' volatility, expropriation, tax changes, etc...⁷³⁸

Another interview participant put it this way:

Lenders, insurers, investors are all members of a royal family but lenders are king. This interest group, especially lenders will seek to discourage host states from introducing new laws or new regulations that will affect or raise the project costs and they have a huge influence on host states and investors. In order to secure investments, host states agree to stabilisation clauses proposed by sponsors in an investment contract that render them liable to bear any costs arising from any changes in law that have an economic impact on the investment project.⁷³⁹

Environmental and Social Considerations: Environmental and social issues are the other significant concerns that lenders take into account before investing capital in a specific project, for the simple reason that these can also have a direct impact on the loan repayment. This means that if the environmental and social risk of a project is high, lenders may not leap at the prospect of financing the project. Consequently, environmental and social risk assessments are required by lenders for almost all energy investment projects. In fact, 'the lenders will, more often than not, want a very comprehensive assessment to be concluded before any attempt is made to appraise the project.'⁷⁴⁰ The question of what lenders require of a project company for projects that are deemed to be exposed to high environmental or social risk is answered by Dewar. According to the author, project finance lenders will generally:

...require as a minimum, the project company to undertake to comply with all environmental and social laws and regulations binding it. The lenders will also likely require the development of, and compliance with, an agreed environmental and social risk management plan. This is both to insulate the

738 Interview no. 15 Anonymity Guaranteed, 25 November, 2012

739 Interview no. 13 (above 70)

740 O. Joe, Can Environmental & Social Impact Assessment Enhance The Ability of Energy Projects to Secure Funding? CEPMLP Working Paper, available at: <http://www.dundee.ac.uk/cepmlp/car/html/CAR10_ARTICLE12.PDF> May, 2013

project company, and the lenders, from legal risk but also to preserve the lenders' reputation as responsible parties.⁷⁴¹

4. Political Risk Insurance Providers

Traditionally, the risk that international investors faced over the course of the project was divided into the following two categories by business analysts: commercial risk and political risk. Commercial risk includes more regular economic activity such as 'fluctuations in commodity price, the failure of a new technology to perform as expected, or the advent of a new competing product that makes the investor's product obsolete'.⁷⁴² Political risk cover provides for political risk that emerges due to a host country's adverse action or inaction. The concept of political risk includes, for instance, currency convertibility and transfer restriction, expropriation, civil unrest, war and terrorism, breach of contract and non-honouring of sovereign financial obligations.

Accordingly, political risk insurance is a contractual agreement between an investor and an insurer to compensate the investor's financial loss continued to the investment by reason of the host country's adverse action or inaction, such as expropriation or war and terrorism. The Political risk insurance that emerged in the aftermath of the Second World War was developed primarily by governments and governmental agencies in capital exporting countries to motivate their entrepreneurs to invest in foreign countries around the world. Most of the OECD member states as well as non-member countries of this organisation have national agencies that supply their domestic firms with export credit and political risk insurance. The national political risk insurance providers comprise of national (ECAs) and investment insurance entities and which focus on cross-border investment. The following section addresses political risk insurance through government agencies.

4.1 National Political Risk Insurance Providers

Several capital exporting countries have formed government corporations that have in turn become global providers of political risk insurance. OPIC, founded in 1971, is a prime example. This organisation's primary goal was to stimulate US investment into developing countries, through the provision of political risk insurance and project finance.⁷⁴³ According to OPIC's 2011 annual report, in its 40 years the agency has supported almost \$200 billion of investment across in excess of 4000 projects in developing states, located in a variety of different regions around the world.⁷⁴⁴ OPIC provides the following services:

741 J. Dewar, (n.6 above) 13

742 J. W. Salacuse, (n.43. above) 245

743 A. Van de Putte & D. F. Gates and K. Holder, 'Political risk insurance as an instrument to reduce oil and gas investment risk and manage investment returns', *Journal of World Energy Law and Business*, Vol.5, No.4 (2012) 291

744 Overseas Private Investment Corporation, 'Annual Report (2011): Investing with Impact for 40 Years'. Washington (2011)4, available at:

- 1) Project finance in the form of direct loans and loan guarantees;
- 2) Insurance against a broad range of political risks, including expropriation (including creeping expropriation), nationalisation, revolution, currency inconvertibility and political violence, terrorism; and
- 3) Pre-investment services, including investment missions to key markets;⁷⁴⁵
- 4) Losses caused by material changes in project agreements unilaterally imposed by the host state.⁷⁴⁶

Several other developed countries also have their own export credit agencies with similar insurance programmes to OPIC, and also actively promote investment abroad. These include Japan's Bank for International Cooperation, Germany's Hermes Kreditversicherung-AG, France's Compagnie Française d'Assurance pour le Commerce Extérieur, and Export Development Corporation of Canada. In parallel to these export credit agencies, MIGA also provides insurance to international investors. However, what differentiates MIGA from these national export credit agencies is that MIGA is an internationally based investment insurance company.

4.2 Private Political Risk Insurance

Political risk insurance is also provided through private insurance companies. The largest private political risk insurer in the US is called American International Group (AIG). Other significant political risk insurers in the private market include: Lloyd's of London, Aon, Sovereign Risk Insurance Ltd, Zurich Emerging Market Solution, and Export Insurance Company. In particular, they provide political risk insurance coverage against currency inconvertibility and transfer restriction; confiscation, expropriation, nationalisation; political violence; default on obligations such as loans, arbitral claims, and contracts. Over recent years, the insurance market has grown rapidly due to a mushrooming of the number of private insurers offering political risk coverage. These private insurers' entrance to the market has created a highly competitive environment with national insurance providers and private corporations vying to offer coverage for the most attractive investment projects.

In an attempt to understand the relative importance of political risk insurance and host governmental guarantees in practice to lenders and foreign investors, interviewees were asked to give their estimation of this. The vast majority of interviewees responded

<<http://www.opic.gov/sites/default/files/051912-annualreport-FINAL.pdf>> May, 2013

745 H. Himberg, 'The view from the Overseas private Investment Corporation (OPIC)', *Energy Policy*, vol.23 No. 11, (1995) 978

746 M. Kantor & M. D. Nolan and K. P. Sauvart, *Reports of Overseas Private Investment Corporation Determinations*, Vol.1 (Oxford, Oxford University Press: 2011) xxi.

that political risk insurance is a sine qua non requirement on top of host government guarantees where risky energy projects are concerned. However, one interviewee, who works for a private insurance company in London, expounded upon this as follows:

In the case of an investment project in an emerging market or politically volatile country, political risk insurance is perhaps the most important requirement for multinational enterprises, and more specifically lenders. I think lenders and companies believe that through insurance the political risk can be efficiently mitigated. Lenders particularly focus on political risk insurance in their due diligence.⁷⁴⁷

Another interview participant also explained why political risk insurance is indispensable to lenders. According to the respondent ‘Lenders will definitely require political risk insurance from a sponsor company to protect their loan’s timely repayment. If certain elements are not covered, they would not grant a loan to a project.’⁷⁴⁸

4.3 Risk Premium Calculation

The concept of risk premium calculation is a ‘function that takes as an argument a risk and returns the premium that should be charged for it’.⁷⁴⁹ In today’s political risk insurance market every risk insurance providers applies a different methodology in determining and calculating the risk premium. The question is which method they use and how they calculate risk premium? It goes without saying that political risk is dynamic but also a complex issue. For this reason it is difficult to fit every type of political risk in a specific and fixed premium. According to Rolfini and Paciotti, ‘some of PRI providers simply use the OECD categories apply a fixed premium rate depending on the risk category. Some other political risk insurers have a flat premium rate, relying on the existence of a BIT agreement and not reflecting the actual level of risk faced by the guarantee holder’.⁷⁵⁰ Technically, political risk insurers establish an essential scoring system and categorise every country in terms of political risk and allocate a premium rate to every risk group.⁷⁵¹ In the calculation of the risk premium, a cap and floor is assigned in terms of basis points for every scoring⁷⁵². It should be noted that ‘within every premium range the final rate can be increased or decreased according

747 Interview no 14, Anonymity Guaranteed, 8 December, 2012

748 Interview no. 13 (n. 70 above)

749 A. Tsanakas & E.Desli, Measurement and Pricing of Risk in Insurance Markets, *Risk Analysis*, Vol. 25, No. 6, (2005) 1654

750 R. Rolfini & S. Paciotti, Political Risk Insurance : A technical Approach, SACE Working Paper N. 14, (November 2010) 21

751 Ibid

to variables such as: a) type of investment b) size of the investment c) tenor of the investment d) exposure and level of portfolio concentration in the host country'.⁷⁵³

5. The Role of Political Risk Insurance Providers in the Inclusion of Stabilisation Clauses

To attract foreign investors, most states, particularly developing countries, are willing to accept stabilisation clauses when they enter into a contractual relationship with a project sponsor (investor). Furthermore, there is no hindrance inherent in such a clause to states exercising their sovereignty or protecting public interest by passing new laws and regulations during the project. For this reason, political risk insurance providers will not insure losses incurred by investors as a result of such changes, as these sovereign rights are recognised under international law. Jenney notes that political risk insurers have always been intended to cover unlawful regulatory takings of host state, but not legitimate takings.⁷⁵⁴ In some cases, particularly in the context of expropriation claims: 'it may be necessary to make use of contractual dispute resolution mechanisms to benefit from insurance protection due to the requirement that covered investors take all reasonable measures to prevent expropriation action.'⁷⁵⁵ According to Hoffman, political risk insurers may provide cover against the risk that stabilisation clauses are rejected or revoked, via arbitral award default coverage.⁷⁵⁶

Similarly, Jenney suggests that political risk insurers:

...could provide arbitral award default coverage of contractual stabilisation clauses. For political risk insurers, international arbitration also serves to sort out the political actions of the host government from its legitimate contractual claims. Arbitral panels can sort out fact-specific questions with respect to regulation, including in connection with investment agreements containing stabilisation clauses protecting against the effects of regulatory changes.⁷⁵⁷

752 Ibid

753 Ibid

754 F. E. Jenney, 'A Sword in a Stone: Problems (and a Few Proposed Solutions) Regarding Political Risk Insurance Coverage of Regulatory Takings' in T. H. Moran, & G. T. West and K. Martin, *Political Risk Management: Needs of the Present Challenges for the Future*, (Washington, the World Bank Group: 2008) 178-179

755 J. Dewar, (n.6 above) 97

756 S. L. Hoffman (n.32 above) 70

It should be noted that arbitral award default coverage of stabilisation clauses is designed to protect the insured benefits of an agreement containing international arbitration mechanisms.⁷⁵⁸ If the arbitral court's decision favours the investor, the failure of the contracting state to make the awarded payments will trigger the insurance cover concerned.⁷⁵⁹ In other words, a political risk insurer who pays an expropriation claim must in turn lodge a corresponding claim against the host government to recover its debt.⁷⁶⁰

This means that if the contract contains stabilisation clauses and the government goes ahead with a change of law and neglects to pay compensation, political risk insurers may foot the bill initially, but will make sure that the government ultimately pays for its unlawful actions.⁷⁶¹ By seeking reimbursement, political risk insurers simply aim to balance their books, but some attention should be given to what compels host governments to pay their dues. An examination of the legal standing of public or private insurance companies in reimbursement claims and the extent of insurers influence on arbitration panels will contribute to a better understanding of this.

Subrogation rights: Subrogation is a doctrine that 'when one has been compelled to pay a debt which should have been paid by another, he is entitled to a cession of all the remedies which the creditor possessed against that other.'⁷⁶² The subrogation right is stated explicitly in insurance policy wording but, even if this right is not mentioned in the policy, it is, in any event, applicable.⁷⁶³ This right derives from the indemnity doctrine and refers to the right of an insurer, who has paid the loss, to pursue the wrongdoer on behalf of the insured party.⁷⁶⁴ As this right provides an opportunity for insurers to reimburse the capital that they have paid to investors as a result of their loss. The question remains that, if the host government makes changes in law for the sake of

757 F. E. Jenney, (n. 95 above) 113

758 R. Kazimova, 'Insurance as a Risk Management Tool: A Mitigating or Aggravating Factor?' Chapter 9 in S. Leader and D. Ong, (n. 11 above) 259

759 R. Kazimova (n.99 above) 260

760 F. E. Jenney, (n.95 above) 182

761 R. Kazimova, (n.99 above) 260

762 H. N. Sheldon, *Law of Subrogation*, (Washington D.C, Beard Books: 2000) 10

763 P. Handy & B. McCarthy, 'Subrogation Principles and Practice', The chartered Institute of Loss Adjusters, (September, 2010) 1, available at: <<http://www.cila.co.uk>> May 2013

764 R. Kazimova (n.99 above) 260

public interest, will the government still have to pay compensation to insurer? The question was answered in Kazimova's work. According to the author 'What started as a good intention, though, turned out not to be so good, as what insurers, being shielded by subrogation rights, effectively did was introduce incentives for themselves to compensate easily for losses of investors even when host governments initiate changes in law for a public purpose'.⁷⁶⁵ This shows that in any case, political risk insurance providers can have a direct negative impact on a host government. Foreign investors who are concerned about political risk in a host country can purchase insurance through public and private organisations. It is insurance agencies in the public sector who wield the most power over host governments via their influence in investment insurance decisions at arbitral tribunals.⁷⁶⁶ One interview respondent noted that:

No national political risk insurance provider wants its investors to be exposed to unlawful regulatory changes in law in a foreign country. Their insurance policy often covers violations to stabilisation provisions in the contract. While these insurers are acting in the capacity of insurance providers to international investors, they are endowed with no small influence over the host state. This inhibits the host country from reforming or altering its law even if such changes would be in the public interest.⁷⁶⁷

Taking into account the respondent's opinion above, the decision in *Enron Corporation and Ponderosa Assets vs. Argentina*⁷⁶⁸ investment arbitration serves as a good point of reference as to how OPIC insurance coverage and determinations have affected investor state disputes. In *Enron*, the investor relied on a prior claims determination made by OPIC establishing that an expropriation has occurred.⁷⁶⁹ Nevertheless, the *Enron* arbitral tribunal rejected the OPIC determination as influential authority on the question of whether an expropriation had taken place, noting that the OPIC determination 'responds to a different kind of procedure and context that cannot influence or be taken into account in this arbitration.'⁷⁷⁰ While the investment tribunal declined the investor's claim in this case, the *Enron* tribunal; however, decided that

765 R. Kazimova (n.99 above) 261

766 M. Kantor & M. D. Nolan and K. P. Sauvart (n. 87 above) xxiii

767 Interview no. 14 (n.88 above)

768 *Enron Corporation and Ponderosa vs. Argentina*, Award, ICSID Case No ARB/01/3 (2007); see also *Generation Ukraine, Inc. vs. Ukraine*, Award, ICSID Case No ARB/00/9 (2003)

769 *Enron Corporation and Ponderosa v Argentina*, Award, ICSID Case No ARB/01/3 (2007) at 235; see also M. Kantor & M.D. Nolan and K. P. Sauvart (n.87 above) xxiii

770 *Enron Corporation and Ponderosa vs. Argentina*, at 247

Argentina had violated its treaty obligations to supply Enron fair and equitable treatment.⁷⁷¹

ECAs support their own nationals by providing finance and political risk insurance when they invest in a foreign country. The major issue is that whenever the host state takes administrative measures, the claim is carried by the investor to a dispute settlement process before a determination is made about whether the actions of the host government breach stabilisation clauses or not. The claims made by investors are often accepted political risk insurers and compensation is paid to them. Admittedly, in an environment where such bias exists, objectivity about the rightfulness of a claim is difficult to achieve.

6. Credit Rating Agencies

Several Credit Rating Agencies (CRAs) including Standard & Poor's (S&P's), Moody's and Fitch play a significant role in financial markets. They analyse and evaluate the default risk of lending to corporate and sovereign borrowers.⁷⁷² Conducting assessments of debt ratings is traditionally within the scope of the rating agencies. 'Credit ratings are carried out for debt issues and take into account the borrower's default risk, the nature of the debt obligation, the protection that the issue affords of the debt obligation, the projection that the issue affords, and its relative position in bankruptcy.'⁷⁷³

Furthermore, ratings are also available for project specific financing. Rating for a specific project financing is relatively new but is a rapidly growing area.⁷⁷⁴ Project ratings are provided by the rating agencies with the aim of assessing and expressing as a value the level of certainty with which the project finance lenders can expect to obtain timely reimbursement of principle and payment of interest, in accordance with the project terms.⁷⁷⁵ This type of rating mainly concentrates on the capability of financing entity, whether a developer or special purpose vehicle, can make timely repayment of principle and interest to bondholders.⁷⁷⁶ Previously, rating agencies delivered their own

⁷⁷¹*Enron Corporation and Ponderosa vs. Argentina*, at 268

⁷⁷² M. Elkhoury, 'Credit Rating Agencies and Their Potential Impact on Developing Countries', United Nations Conference on Trade and Development, Discussion Paper, No. 186 (January, 2008) 1

⁷⁷³ H. Razavi, (n.27 above) 104-105

⁷⁷⁴ Ibid

⁷⁷⁵ S. Thompson, 'Credit rating and project finance default: An important risk management instrument', *Public Infrastructure Bulletin* Vol.1:Iss.8, Article 10. (2012) 2, available at: <<http://epublications.bond.edu.au/pib/vol1/iss8/10>> May, 2013; see also S. L. Hoffman, (n. 32 above) 432

opinion on the debt rating for a specific project, in doing so they took into consideration the factors summarised in the following section.

a) Sovereign Risk Analysis: In the sovereign risk analysis, the main consideration is usually the stability of the foreign currency of the state where the project will be executed. The Government of a host state can pose a number of risks to an international project. For instance, 'it could restrict the project's ability to meet its debt obligations by way of currency restrictions; it could interfere with project operations; and, in extreme cases, even nationalise the project'.⁷⁷⁷

b) Currency Risk Analysis: In this type of analysis, agencies concentrate on the potential for currency depreciation, as this is particularly indispensable in a project that cannot adjust revenues to offset exchange rate changes.⁷⁷⁸

c) Political Risk Analysis: The laws and regulations, of the country where the project will be undertaken are also investigated as part of the credit rating process.⁷⁷⁹ It goes without saying that a stable legal system is a powerful argument in proving to project creditors that a host country is willing and able to provide a stable and secure environment for a project.

d) Legal (Contract) Risk Analysis: The legal structure of the project itself is a key area of focus for a rating agency during the assessment process. According to Thompson, 'structural features that are often assessed in this regard include, but are not limited to: the choice of law of the contract documents, and thus legal jurisdiction, documentation risk and international credit arrangement'.⁷⁸⁰

As mentioned above, credit sovereign rating is an activity owned by rating agencies. The main users of country sovereign risk rating are international investors, and more precisely financial institutions. Broadly speaking, they consider: 'the overall economy of a country, which includes the balance of payments, foreign debt, foreign investment, public and private investment, and foreign currency reserve, development of financial markets and capital market transparency, political stability'.⁷⁸¹ During the

776 *ibid*

777 'Standard & Poor's Rating Direct: Updated Project Finance Summary Debt Rating Criteria', September (2007) 14 available at:
<<http://www.maalot.co.il/publications/MT20120529105458.pdf>>May, 2013

778 *ibid*

779 *ibid*

780 S. Thompson (n.116 above) 2

781 T. Siddaiah, *Financial Services*, (New Delhi, Pearson: 2011) 258

determination process, rating agencies apply both qualitative and quantitative methods to understand the economic and political dynamics of the country.⁷⁸² For instance, whether the state has a high, low or middling income and how stable the political institutions in that country are, on the whole, when all of the political and economic components of the assessment are taken into consideration. Consequently, it can be said that sovereign credit rating assists investors, particularly, foreign institutional investors and those proposing foreign direct investment, to gain a comprehensive oversight as well as gaining specific insights into the financial, legal and political structure and wellbeing of the country it is contemplating committing its investment to. Perhaps even more crucially, it can aid an investor to foresee, mitigate or avoid risks inherent in the financial, legal and political makeup of the potential recipient of its investment and the project proposed.

In sovereign credit rating, two types of risk are assessed by the agencies: *country risk* and *sovereign risk*. While country risk is a risk triggered by actions in a specific country, that are to some extent within the control of the government concerned, sovereign risk is the risk of providing a loan specifically to the government of a particular state.⁷⁸³ It is worth noting that the two risks often have strong correlations and hence, they may be referenced interchangeably.⁷⁸⁴ Sovereign rating is an opportunity for many developing states to attract foreign investors to their countries and to demonstrate attractive qualities such as the transparency of their financial system and how accountable their political institutions are the country is accountable. Therefore, the notes provided by these agencies (S&P's, Moody's and Fitch etc.) have a direct influence on the flow of foreign investment to these countries.

7. The Role of Credit Rating Providers in inclusion of Stabilisation Clause

Taking the information provided above into account, it can generally be stated that credit rating agencies assessments are available for large corporations (companies) or for a specific project financing. The ratings are also available for countries to demonstrate their ability and keenness to service their debts. Notably, as the purpose of this section is to determine the role of credit rating agencies in the inclusion of stabilisation clauses, the question of whether credit rating agencies notations or assessments are effective in the inclusion of such clauses was posed to interview participants. The vast majority of interviewees agreed that the notations are based on general assumptions and assessments for companies or countries when they rate a project debt; therefore, the notations of agencies play a persuasive and influential role on the decision of lenders to provide funds to the project and also play a definitive role in the terms and conditions of the investment contract. Of the interested parties interviewed, the following participants' views went furthest in explaining the role rating

782 M. Frenkel & A. Karmann, *Sovereign Risk and Financial Crises*, (Heidelberg, Springer: 2004) 91

783 T. Siddaiah, (n.122 above) 258

784 *ibid*

agencies play in the inclusion of stabilisation clauses, as well as the significance of their assessments for developing countries.

One respondent who works in a commercial bank in Istanbul stated:

Banks generally have a 'Risk team' producing reports on countries, companies, using sources from Fitch, S&P, and Moody's and generate their own view for a project. Therefore, the assessment made by a rating agency for a specific project, transforms the 'unknown' to the 'known' and may have a positive effect on a bank's willingness to provide a loan to that project.⁷⁸⁵

The second respondent's views tallied with the previous interviewee in terms of his view of the significance of the ratings; however he stressed the limitations of country risk assessments to predict the future:

Their (*rating agencies*) assessments of a specific project have a significant influence on lenders. However, that does not mean that rating agencies have the ability to provide guarantees to lenders that a host government will always be loyal and adhere to its stabilisation commitments when political and economic or even social circumstances are in flux. In my experience, these assessments are taken into account along with other considerations to inform a judgement call regarding the risks implicit in an investment project.⁷⁸⁶
(*Emphasises added*)

8. Baku-Tbilisi-Ceyhan Pipeline Project (II)

This pipeline project demonstrates the unique policies of landlocked energy exporters, the quest for exporters to choose appropriate transit countries, and the nexus of political and economic interests in the establishment of major multiple-state energy export projects.⁷⁸⁷ The BTC's crude oil pipelines traverse three sovereign states; this necessitates a complex legal framework and extensive coordination. Nevertheless the project constitutes the single largest FDI in each of its signatory countries.⁷⁸⁸ A breakdown of the stakeholders and their interests in this project is helpful to a comprehension of the scale and reach of this project.

⁷⁸⁵ Interview no. 12 with Senior Assistant Specialist at Commercial Loan Division, 9 January, 2013

⁷⁸⁶ Interview no. 9 with Account manager 25 June, 2012 and 2 January, 2013

⁷⁸⁷ B. Shaffer, *Energy Politics*, (Pennsylvania, University of Pennsylvania Publishing: 2009) 54

Table 14 Owner and Sponsor Groups of Baku-Tbilisi-Ceyhan Pipeline Project

Company	Country	Percentage of Ownership
British Petroleum (BP)	United Kingdom	30.10
SOCAR	Azerbaijan	25.00
Unocal Ltd.	United States	8.90
Statoil	Norway	8.71
TPAO	Turkey	6.53
ENI	Italy	5.00
Total	France	5.00
Itochu	Japan	3.40
Inpex	Japan	2.50
ConocoPhillips	United States	2.50
Hess Corporation ⁷⁸⁹	United States	2.36

Source⁷⁹⁰: Chevron

8.1 Interest of Stakeholders in BTC Project

British Petroleum (BP): This Company is the owner and largest shareholder with 30.10% interest in the project. The role of the company in the project is to take crude oil from a landlocked area in the Caspian Sea in Central Asia and transfer it to the Mediterranean. As well as having the biggest share in the project, it's fair to say that BP is the most powerful company involved in the project. Perhaps, the project would not have been run easily without consortium and without the financial aid of international organisations. 'If BP were running the BTC project alone, it would largely use its own funds and rely upon relatively minor participation by the financial institutions, solely for the purpose of reducing political risks and to ensure an extra dimension of expert, external monitoring.'⁷⁹¹

788 D. Blatchford, 'Environmental and Social Aspects of the Baku-Tbilisi Ceyhan Pipeline', chapter 7 in S. Frederick Starr & S. E. Cornell, Baku-Tbilisi Ceyhan Pipeline: Oil Window to West, *Central Asia-Caucasus Institute Silk Road Studies Program* (2005) 119 available at: <www.silkroadstudies.org> June, 2013

789 It should be noted that as a shareholder of the project, Amerada Hess announced September 7, 2012 that the company sold its stake to ONGC Videsh Ltd. (OVL), Indian state owned company. For further detail, please see, Oil and Gas Online Journal, <<http://www.ogj.com/articles/2012/09/hess-to-sell-interests-in-acg-fields-btc-line-to-ongc-for-1-billion.html>> June, 2013

790 Chevron Official Website, available at: <http://www.chevron.com/chevron/pressreleases/article/05252005__presidentsofazerbaijangeorgiaandturkeyinauguratebtc.news> June, 2013

791 'The-Baku-Tbilisi-Ceyhan Pipeline: A Briefing for BP Staff', BP February 4, available at: <http://www.bakuceyhan.org.uk/correspondence/bp_handout.pdf> June, 2013

IFC and Other Stakeholders: Financing cross-border pipeline projects is not a straightforward undertaking as each participant naturally has different interests and expectations from the transaction. According to Dufey and Kazimova, ‘The complexity of risk allocation linked to project finance implies that developing countries rarely have an unlimited ability to accept allocation of risk, so they have secure their positions with credible assets and/or payment guarantees from other parties.’⁷⁹² In cross boundary projects of this scale it is necessary to involve multilateral financial institutions such as the IFC and ECAs.⁷⁹³ Since the advent of the financial crisis, the role played by financial institutions has become even more fundamental.⁷⁹⁴ Financing projects without consortium participation, support from financial institutions, and support from well developed countries (for instance the US) would be complex to say the least and perhaps even impossible. Approximately 30% of the costs of the BTC project are being granted by equity contributions.⁷⁹⁵ The remaining 70% were funded by third parties, including multilateral development banks, ECAs, political risk insurers from several countries as well as a syndicate of fifteen commercial banks.⁷⁹⁶

In the late 1990s, commercial studies, and diplomatic initiatives, were set in motion to attempt to uncover the energy transportation challenges and difficulties of the Caspian region.⁷⁹⁷ British Petrol (BP) and its partners formed a working group to assess export routes for the extracted crude oil from the Azeri-Chirag-Guneshli field under the Caspian Sea. Based on their findings, the working group concluded that carrying Caspian crude oil by pipeline would be the most economically efficient way of transporting oil from the Caspian region to Europe and the United States. Ilham Shaban, an oil analyst stated that ‘the pipeline is of strategic importance not only to Azerbaijan, but to the other new independent states as well. This is a reliable route to world markets.’⁷⁹⁸

792 Dufey A., and Kazimova, R., ‘Baku-Tbilisi-Ceyhan Project: Implications of Project Finance’, Chapter 12 in S. Leader and D. Ong, *Gobal*, (n.11 above) 373

793 S.L Hoffman, (n.32 above) 256

794 Thomson Reuters, ‘Back in the Funding Mix: Multilaterals Report, 2009’, *Project Finance International*, cited in A. Dufey, and R. Kazimova (n.133 above) 373

795 BP Press in Baku, ‘BTC signs Project Finance Agreements’, Press release, 3rd February, 2004, available at:
<http://www.winne.com/news/2004/february/btc_signs_project.php> June, 2013

796 Ibid

797 J. Elkind, ‘Economic Implications of the Baku-Tbilisi-Ceyhan Pipeline’, Chapter 3 in S. Frederick Starr & S.E. Cornell (n. above 129) 119

An intergovernmental agreement was signed between Azerbaijan, Georgia and Turkey, in Istanbul, in November, 1999 to legitimise the international scope of the BTC pipeline project. In October, 2000, BP and its BTC partner companies also committed to Host Government Agreements with these three states. In July 2001, the investment bank Lazard Brothers, incorporated in the UK, was selected by BP to advise the most convenient financing structure for the BTC project. The BP also assigned an American law firm, Sullivan & Cromwell, to deal with the legal side of the financing structure. In August 2002, the BTC sponsor groups signed the required agreements in London to officially form the BTC Company. As the project costs amounted to billions of dollars, the BTC Company approached a wide range of financial institutions to seek capital loans.

In December 2002, BP announced that finding a loan for the project might be delayed by at least six months due to on-going negotiations with lenders, as a number of concerns had been voiced of both a social and environmental nature as well as the expression of some doubt regarding the validity of the predicted economic returns of the project. In 2003, the BTC project consortium officially approached the IFC and the EBRD with the hope of thereby obtaining the sought for project loan. The loan in question was approved in the same year after a series of complex talks and negotiations. Financing agreements were finally signed by the IFC, the EBRD and the BTC lender group on February 3rd, 2004.⁷⁹⁹ One interviewee stated that ‘the involvement of both the IFC and the EBRD in the same project was a major milestone for the whole financial picture of the BTC project, because their participation provided the sought for guarantee against political and economic risk’.⁸⁰⁰ Another interview participant noted that:

the involvement of the EBRD in the BTC project was hugely beneficial from the perspective of that project in that it established a legitimate structure for the project in terms of environmental, social and good governance concerns, but I should underline that from the perspective of the EBRD the project also represented a potential first step towards establishing further energy projects in Caspian region in the future.⁸⁰¹

Another respondent stated that ‘Azerbaijan, Turkey and Georgia are frequent recipients of technical, social and financial support provided by the World Bank. Funds were supplied via the World Bank’s affiliate, the IFC. The role of the IFC in the project was defined as that of ‘the guardian of stability’ in the context of the BTC project

798 Ilham Shabani, BBC News, ‘Caspian Pipeline Dream Becomes Reality’, 17 September, 2002 available at: <<http://news.bbc.co.uk/1/hi/world/europe/2263611.stm>> June, 2013

799 For further information, please see official website of BP, available at: <<http://www.bp.com/genericarticle.do?categoryId=2012968&contentId=2016340>> July 2013

800 Interview no 20 with Foreign Trade Expert, 26 November, 2012

801 Interview no 19 with Lecturer, 23 November, 2012

consortium and of the 15 commercial banks involved'.⁸⁰² Another interviewee stated that 'the IFC oversees the drafting of project contracts and actively recommends clauses intended to safeguard the stability of the project agreement in order to ensure the return of the funds lent by them.'⁸⁰³ This last point demonstrates the influential role the IFC has in the establishment of a legal framework for such agreements. This role will be explored further in the section dedicated to the legal framework of BTC agreements.

The financing package agreed and signed by the parties includes 208 finance documents, with over 17,000 signatures from 78 different parties. In addition, it represents a major milestone in the establishment of financing arrangements for this major cross-boundary pipeline project. The BTC major pipeline project was financed according to protocols of project finance structure. As mentioned earlier, the term 'project finance' is used to refer to a non-recourse or limited recourse financing structure, in which debt, equity and credit enhancement are combined for the construction and operation of the refinancing of a particular facility in a capital-intensive industry in which lenders base credit appraisals on the projected revenues from the operations of the facility, rather than the general assets or the credit of the sponsor of the facility, and rely on the assets of the facility, including any revenue-producing contracts and other cash flow generated by the facility, as collateral for the debt.⁸⁰⁴ Taking this into consideration, the financing methods applied in the BTC project conform to the limited-recourse project finance model. Dufey, and R. Kazimova explain that:

For sponsor guarantees to fall away, a number of specifications had to be met, one of which was pipeline operations. This relates to evidence that the BTC Co. could operate the pipeline to the planned capacity for a period of time, i.e., that the company could reach peak capacity. This extended further to whether the pipeline was complying with environmental and social standards, and that there were no material breaches of BTC Co. obligations. This was dealt with through environmental and social audits by lenders' consultants, which took place in May and June 2007, and the certification was completed after dealing with various issues that arose from that process in September of the year. Until then the lenders had recourse to the sponsors' assets. Thereafter, the loan became non-recourse.⁸⁰⁵

Azerbaijan

802 Interview no 6, Anonymity Guaranteed 14 May, 2012

803 Interview no 2 (above 71)

804 S. L. Hoffman, 'A Practical Guide to Transactional Project Finance: Basic Concepts, Risk Identification, and Contractual Considerations', *The Business Lawyer*, Vol. 45, No.1 (1989) 181

805 Dufey A., and Kazimova, R., (n.133 above) 375-376
'Thereafter, the loan became non-recourse' this quotation belongs to one of the respondents who participated the authors' interviews.

As an oil producing country with a relatively small economy, the main objective of Azerbaijan was to be in a position to sell its oil reserves to the Western world. Broadly speaking, the overarching significance of the BTC project for Azerbaijan is its potential to 'decrease its dependence on Russia in terms of export routes for oil and gas as well as to build new economic political and security links with Turkey, Azerbaijan's ally, and subsequently with Western Europe.'⁸⁰⁶ This sentence is supported by President Aliyev's words in his opening ceremony speech. The president said 'I do not doubt that the BTC will be of use both to Azerbaijan and our neighbours. This pipeline will, first of all, help solve economic and social problems, but the role of the pipeline in strengthening peace and security in the region is also not small'.⁸⁰⁷ Moreover, via this project the country expects to benefit from oil revenues over a 20 year period from the resources of the Azeri-Chirag-Gunesli offshore oilfield.

With SOCAR's 25% stake in BTC Co, the Azeri government bears direct responsibility for ensuring the successive construction and operation of the pipeline; however, since its share in overall project cost responsibilities is 30%, Azerbaijan does not bear the full cost burden of the project alone.⁸⁰⁸ The downside of this arrangement is that there is a limitation to the extent to which it can exercise sovereign control over the project.⁸⁰⁹ Although this may at first appear to be detrimental to the interests of the country almost all the interview participants were of the conviction that territorial integrity was of key significance to Azerbaijan as an objective of the BTC project set aside from any economic gains to be had. Indeed, one respondent went so far as to assert that:

The country's on-going territorial dispute with Armenia over the Nagorno-Karabkh region doubled the significance of the BTC project and was a key reason for the enthusiastic support of the Azeri government at that time. This was because the profit gained from the project would be spent to improve the county's military might so that the country could reclaim the land of Nagorno-Karabkh from Armenia.⁸¹⁰

The respondents view is supported by a citation from the President of Azerbaijan himself who somewhat dramatically equated the successful realisation of the project for Azerbaijan to diplomatic doom for his rival country 'If we succeed with this project, the

806 S. E. Cornell & F. Ismailzade, (n. above 129) 63

807 M. Tran, 'Caspian Oil Pipeline Opens', Wednesday, 2005, The Guardian, available at: <<http://www.guardian.co.uk/business/2005/may/25/oilandpetrol.news1>> July, 2013

808 E. J. Omonbude, *Pipelines and The Role of the Transit Country: Economics, Challenges and Solutions*, (England, Palgrave Macmillan: 2013) 73

809 Ibid

810 Interview no. 20 (n. 141 above)

Armenians will find themselves in complete isolation, and this will further darken their already bleak future.⁸¹¹

Georgia

Despite being a country bereft of significant mineral resource, its opportune geographical location rendered Georgia a beneficiary of the economic and political gains to be had from the BTC pipeline project. The government of Georgia adopted the BTC project as a country strategy with the stated goal of elevating the living standards of its people and thereby raising them from widespread poverty while from a strategic political perspective, improved relations with the United States and the protection this might afford from Russian threat was also a highly attractive by-product of Georgia's involvement in this project. In the same opening ceremony, echoing the words of Aliyev, President Mikheil Saakashvili described the BTC project as a 'geopolitical victory' for Caspian Basin countries. He was alluding to the fact that securing independent energy export sources would allow both Georgia and Azerbaijan to more effectively defend themselves against geopolitical pressure previously aggressively asserted by Russia.⁸¹²

Furthermore, Georgia is expected to receive US\$ 62.55 million in transit fees,⁸¹³ to reflect its status as a transit country in the BTC project. As a transit country, Georgia is not a BTC Co. contributor, and there is no evidence of Georgian influence in the rest of the financial package prepared for BTC project.⁸¹⁴ Moreover, since the country does not financially subsidise the construction, operation, or maintenance of the BTC pipeline project, Georgia has an advantage in terms of obsolescing bargain. Since, it is the only country that can grant the right of passage of the pipeline through Turkey. Naturally, this endowed the country with a strong bargaining position from which to re-negotiate transit fees on an annual basis to their advantage.

Turkey

Turkey participated in the project through its state-owned oil company, Türkiye Petrolleri Anonim Ortaklığı (TPAO). The aforesaid company is an equity participant of BTC Co. While Turkey has the role of transit company in common with Georgia, unlike

811 The conversation between Brad Sherman and President Ilham Aliyev can be found in: Sherman Joins Amendment to Block Funds For Railroad Route Bypassing Armenia, available at: <<http://bradsherman.house.gov/2006/06/pr-060614a.html.shtml>> June, 2013

812 T. Babali, Implications of The Baku-Tbilisi-Ceyhan Main Oil Pipeline Project, (Winter, 2005) 46, available at: <<http://sam.gov.tr/wp-content/uploads/2012/02/TuncayBabali.pdf>> June, 2013

813 V. Papava, 'The Baku-Tbilisi-Ceyhan' Pipeline: Implications for Georgia, in S. Frederick Starr & S. E. Cornell, (n.129 above) 87

814 E. J. Omonbude (n.149 above) 74

the latter country, Turkey bears some of the costs of the project and subsidises the construction, operation, and maintenance of the pipeline. Turkey is expected to receive approximately US\$200 million in transit fees rent per year in the initial years of the project, with the possibility of this rising to a projected US\$290 million per year from year 17 to year 40.⁸¹⁵ The BTC project has also had the added advantage of reducing oil tanker traffic on the Bosphorus, thereby providing greater ecological security to the city of Istanbul and the surrounding area. Turkey placed more emphasis on the strategic importance of its participation in the project than any of the other participants. In fact, the direct economic benefit of the project was not even a topic of discussion during the initial negotiations between the parties.⁸¹⁶ An interview respondent shed light on the benefits Turkey stood to gain as follows: ‘The BTC project did not provide any great benefit, in an economic sense, to Turkey. The strategic common interests, security and know-how, and reducing oil demand from Russia were the main benefits that Turkey obtained from the BTC agreement. With the BTC project, we strengthened our connections to the West and created a market for Azerbaijani oil and gas.’⁸¹⁷

8.2 Equator Principles and the BTC Project

Equator Principles (EPs) is a ‘risk management framework, adopted by financial institutions, for determining, assessing and managing environmental and social risk in investment projects and is primarily aimed to supply a minimum standard for due diligence to support responsible risk decision making’.⁸¹⁸ In other words, the EPs are simply a ‘set of voluntary rules aimed at the development of socially responsible projects that reflect sound environmental management practice’⁸¹⁹. In 2003, a group of ten large international institutions developed the EPs as a response to the criticism of NGOs regarding the human rights negligence and environmentally damages alleged to have been incurred during the course of international projects operating during the 1990s. Seventy-nine financial institutions have adopted the EPs to date.⁸²⁰

815 K. Hristova, BTC Pipeline: Background Guide , (April, 2009) 4, available at: <<https://www.mtholyoke.edu/org/model-un/fcmun/fcmun09/bg/btc.pdf>> July, 2013

816 Z. Baran, The Baku-Tbilisi-Ceyhan Pipeline: Implications for Turkey, in S. Frederick Starr & S. E. Cornell, (n.129 above) 103

817 Interview no.5 Anonymity Guaranteed , 11 May, 2012

818 Please see: <<http://www.equator-principles.com/index.php/about-ep/about-ep>> February, 2014

819 C. Girardone & S. Snaith, Project Finance Investment and Political Risk: an empirical investigation, in S. Leader & D. Ong, (n.11 above) 115

820 Please see (n.159 above)

The BTC project was the first major opportunity to test the Equator principles as before this major crude oil pipeline project could go ahead of sensitive environmental and social matters were in need of resolution. According to the EP's preamble, the projects are categorised as A, B and C (respectively, high, medium and low environmental and social risk).⁸²¹ The \$3.6 billion BTC project was the first to be classed as an 'A' category EP. Nevertheless, the effectiveness of the EPs in managing the risks identified came under fire from several NGOs who reported numerous breaches of the EPs. It was generally felt that the BTC project sponsors were not sincere in their support of the EP application. According to Muttitt:

The Equator Principals can be used in two ways – to exclude financing of projects which fail to meet certain minimum standards, and set markers for improving projects' standards. In the BTC case, the banks failed on both counts. One of the most disturbing breaches of the Equator Principles by the project was in the project sponsors' decision not to apply the World Bank's safeguard policy on Indigenous Peoples. That policy requires publication of a specific plan to ensure that ethnic minorities are not adversely affected by a project, and compliance with the policy is a clear requirement of the Equator Principles. The impact of this failure is perhaps most startling in Turkey. There the BTC pipeline will be guarded by notorious Gendarmerie which has been repeatedly criticised by the Council of Europe and the European Court of Human Rights, and has been associated with displacement and destruction of villas, torture, and 'disappearance' especially against Kurdish people.⁸²²

8.3 Legal Framework of the BTC Agreements

The BTC oil pipeline project is subject to a bespoke legal regime that was established between the BP Company and the three host states, namely, Azerbaijan, Georgia and Turkey. The overreaching legal framework is based on an intergovernmental agreement (IGA). Three Host Government Agreements (HGAs) were also annexed to the IGA, one between each host state and the BTC Company. In practice, this meant that versions of the IGA were ratified and adopted in each host state's parliament and consequently became legally binding under international law and controlling domestic law in Azerbaijan, Georgia and Turkey. Another key legal document to become subject to BTC Agreements is the Lump Sum Turnkey Agreement.⁸²³ LSTA is a contractual agreement in which a fixed price is agreed for the implementation of a project or part of a project.⁸²⁴ Through this agreement, the risk and

821 ibid

822G. Muttitt, *Disaster in the Pipeline: The Baku-Tbilisi-Ceyhan* (May, 2004) 2 available at: <<http://www.carbonweb.org/documents/disaster.pdf>> 27 February, 2014

823 Please see, <<http://subsites.bp.com/caspian/BTC/Eng/agmt5/agmt5.PDF>> July, 2013

824 F. K. Crundwell, *Finance for Engineers: Evaluation and Funding of Capital Projects*, (London, Springer: 2008) 14

responsibilities for the construction of the project are transferred to the constructor. As a state owned petroleum Pipeline Company, BOTAS defined LST agreement with the BTC Co, contained in appendix 2 of the Turkish HGA. This agreement effectively transfers the risk and responsibilities for the construction of the project to the constructor. In two signatory states, Azerbaijan and Georgia, BTC Company and BP, as an operator, directly supervise and control all aspects of the pipeline construction. In Turkey, BOTAS, the Turkish state owned pipeline Construction Company was the manager of the construction and operation of the pipeline.

8.3.1. Intergovernmental Agreements (IGA)

The overarching objective of the IGA in the context of the BTC Pipeline Project is ‘to give the project’s legal and commercial terms the support and framework of international law’ to ‘ensure principles of freedom of transit of petroleum.’⁸²⁵ The IGA is a treaty subject to public international law ‘through which the host states formally agree to ensure the safety and security of project personnel, facilities, assets, and in transit petroleum.’⁸²⁶ In practice, the IGA serves as an umbrella legal document for the BTC pipeline project, with the goal of providing a prevailing regime for the pipeline project within each contracting state’s domestic law. The following bullet points set out the key terms of the IGA between Azerbaijan, Georgia and Turkey:

- A commitment from each signatory state to present the IGA, the HGAs and the other related documents to its national parliament for ratification/or adoption in order to make it effective under its Constitution and render it the prevailing legal regime in its state;⁸²⁷
- A general assurance from each host state to support and encourage the pipeline project, including: guaranteeing freedom of petroleum transit, guaranteeing the performance by state entities of certain project contracts⁸²⁸ and granting exclusive land rights to the project;⁸²⁹
- A commitment from each host government to provide security for the pipeline;⁸³⁰

825 IGA Agreement among the Azerbaijan Republic, Georgia and The Republic of Turkey, is available at: (n.179 above) website.

826 A. Dufey, ‘Project Finance, Sustainable Development and Human Rights, Case Study 1: The Baku-Tbilisi-Ceyhan (BTC) Pipeline’, International Institute for Environmental and Development, Environmental Economics Programme,(April 2009) 15; see also A. Dufey, and R. Kazimova (n.133 above) 379

827 IGA, Article II(1)

828 IGA, Article II (4) (ii) and (iii)

829 IGA, Article II (4) (iv)

- General commitment from each state to cooperate and coordinate each other's activities, and work with the project consortium to formulate and establish uniform technical services, health and safety standards and environmental safeguards for the project;⁸³¹
- Confirmation that the only taxes imposed on the project would be those set out in the HGAs and an agreement on how to allocate taxable profits between the project states;⁸³²
- A statement that the project was not intended to or required to operate in the service of the public interest in each state's territory and agreements in whole or part, as a concession contract or a special administrative contract granting a concession.⁸³³

The first five bullet points demonstrate that in order to enable 'freedom of transit pipeline', the signatory states assured the consortium that they would restrict their future regulatory developments, expediting the expropriation of land spanned by the pipeline, and that they would indemnify the project consortium from the liability for human rights violation, resulting from pipeline security measures. Furthermore, the last bullet point asserts that the BTC mega project will not be used for the public purpose of the signatory states and that project agreements annexed to the IGA could not be deemed as concession contracts. This last point is of note and somewhat controversial, as if Azerbaijan, Georgia or Turkey decided to expropriate a land for the consortium, the expropriation would need to be justified by public purpose. However, the clause explicitly illustrates that the project is not intended to operate in the service of public interest in the host states. By definition, this would mean that due to the absence of public purpose, any expropriation activity by the countries would technically be illegal.

George Goolsby, the head lawyer for the US Baker Botts law firm working on the BTC project, explained the legal tactics of the consortium members' lawyers as follows, 'the foreign companies want confidence... Without having to amend local laws, we went above or around them by using a treaty.'⁸³⁴ In fact, as a result of the strategy described by George Goolsby, if any dispute were to arise between the states in the future, the consortium would automatically be granted the protection of international law. In other words, rather than relying merely on HGAs, the lawyers created a protective regime designed to safeguard the BTC consortium's interests in any

830 IGA, Article V (1)

831 IGA, Article IV

832 IGA, Article V

833 IGA, Article II (8)

834 Quoted in D. Eviatar, 'Wild-Cat Lawyering', *American Lawyer* 4. November, 2002 cited in A. F. M. Maniruzzaman, 'International Energy Contracts and Cross-Border Pipeline Projects: Stabilisation, Renegotiation and Economic Balancing in Changed Circumstances', *OGEL, Journal of Oil, Gas and Energy Law Intelligence Vol.4-Issue 4* November (2006) 10

circumstance they could foresee. In this respect, it is worth mentioning the view of an interview respondent: ‘the framework of the IGA and HGA was crafted by company lawyers; however, the part played by the IFC, the EBRD, commercial capital providers and export credit agencies was instrumental, especially in the development stage of this legal regime.’⁸³⁵ Another respondent noted that ‘oil companies and financial institutions require so-called stability, transparency and a strong legal system; however in reality, such an environment is against the interests of investing capitalists. In BTC agreements, the consortium’s transnational lawyers designed the legal documents, but we will never know what was negotiated behind closed doors between financiers and investors and government representatives.’⁸³⁶

In order to better comprehend why the consortium imposed an IGA on host states, the *Doe vs. Unocal*⁸³⁷ case should be referenced. Over the past decade, various communities and indigenous people have brought legal actions to US federal and state courts against international petroleum companies ‘for *inter alia*, environmental pollution and their alleged role in authorising, and sometimes funding, commissions of human rights abuse along pipeline corridors including forced labor, rape and murder in the course of forced labor, genocide, and extrajudicial killing.’⁸³⁸ While drafting the legal framework for the BTC IGA and other related agreements, the lawyers took into account the outcomes of the, *Doe vs. Unocal* lawsuit. This case caused some alarm for the BTC consortium. In the Unocal case, ‘A Burmese villager plaintiff had claimed that Unocal was ‘secondarily liable for forced relocation, forced labor, rape, torture, and murder endured by his community at the hands of security forces along the company’s Yandana natural gas pipeline.’⁸³⁹

In December 2004, after eight years of litigation, Unocal agreed to settle the claims in a Californian state court.⁸⁴⁰ The BTC consortium must have taken this legal action into account, and in order not to face the same operational and political risk as *Unocal*, the BTC consortium excluded itself from any liability arising from the operation of the pipeline. As Waters clearly states, ‘Azerbaijan, Georgia, and Turkey warrant to each other that they are not subject to any domestic or international legal obligation which would conflict with the pipeline project and so human rights will come

835 Interview no 3 with Lawyer 14 May, 2012

836 Interview no 2 (n. 71 above)

837 *Doe vs. Unocal Corp.*, 395 F.3d 932, 937, (9th Cir. 2002)

838 A. S. Reyes, Protecting the Freedom of Transit of Petroleum: Transnational Lawyers making (up) International Law in Caspian, *Berkley J. Int’l Law*, Art.3, Vol.24 (2006) 849-850

839 *ibid*

840 *Ibid*

out the loser under the ‘no conflict’ warranty of the IGA.’⁸⁴¹ If the BTC agreements ‘enforced could effectively indemnify the involved oil companies from future judgments against them for pipeline-related human rights violations’.⁸⁴²

8.3.2 Host Government Agreements (HGAs)

HGAs are regarded as a private law contracts, as they are signed between a private investor and a host state. In practice, such agreements can provide excessive control to international oil and gas companies over the domestic law of host countries. As mentioned previously, if a host state’s regulatory and legislative changes have a negative impact on investor activities and their expected resultant revenues, foreign investors can legitimately claim compensation for the losses and inconveniences incurred. Traditionally, concession agreements are subject to the domestic law of the host country. In contrast, ‘the HGAs for the BTC pipeline have been drawn up under (and therefore rest within) the framework of what is in effect an international investment treaty. The companies therefore claim that HGAs automatically assume the status of international public law while simultaneously remaining private contracts.’⁸⁴³ In this respect, it can be said that treaty status has been apportioned to HGAs in the context of the BTC project and HGAs’ provisions are deemed to prevail over the domestic law of three sovereign states. In other words, BP lawyers successfully managed to internationalise concession contracts and endow the company with a privileged status in the three countries in which it was operating.

EBRD noted that ‘in general; a treaty takes precedence over inconsistent domestic law, even subsequent domestic law.’⁸⁴⁴ one respondent noted that ‘in the countries where there is not a well-established legal system a stabilisation clause is a must. For example, after the establishment of the Commonwealth of Independent States’ (CIS), during the early to mid-1990s, the countries were not yet in possession of a sound legal system and the atmosphere of instability in their politics and economies were the main concerns that prompted transnational oil companies’ countries to include stabilisation clauses in their investment contracts.’⁸⁴⁵

841 C. P.M. Waters, ‘Who Should Regulate the Baku-Tbilisi-Ceyhan Pipeline?’, *Georgetown International Law Review* 16 (2004) 404

842 A. S. Reyes, (n.179 above) 850

843 N. Hildyards & G. Muttitt, ‘Turbo-Charging Investor Sovereignty: Investment Agreements and Corporate Colonialism’, (2006) 46-47 available at: <http://www.thecornerhouse.org.uk/sites/thecornerhouse.org.uk/files/HGAPSA.pdf> July 2013

844 B. Carpenter & W. Labedi, ‘Striking a balance: Intergovernmental and host government agreements in the context of the Baku-Tbilisi-Ceyhan pipeline project’, LIT Online, EBRD, 2004, <www.ebrd.com/pubs/legal/OL04e.pdf> August, 2013

845 Interview no 1 Anonymity Guaranteed, 8 May, 2012

Taking the facts above into account, it is evident that any failure, on the part of Azerbaijan, Georgia or Turkey to maintain their pre-existing ‘economic equilibrium’, would render them liable to pay compensation to the project consortium. Such economic equilibrium clauses ‘boost the investor’s confidence and ensure that the long-term investment will yield the expected results, by shielding the contract from some of the many risks associated with the investment.’⁸⁴⁶ In summary, it can be concluded that a sovereign state is still within its rights to make changes in its law, fiscal regime or take other host governmental measures and the insertion of such a clause does not necessarily immunise an international oil company from any such change.⁸⁴⁷ However, it ‘guarantees the investor compensatory benefit, should such change or act affect the economies or financial premises of the project.’⁸⁴⁸

However, stabilisation in the form of economic equilibrium clauses in the HGAs of the BTC project, illustrate that the intended cover as well as the related effects of such a clause are much wider than they should be.⁸⁴⁹ What it is meant by this is that if a host state directly or indirectly jeopardises the economic equilibrium of an investment project, they have to pay compensation to the project consortium as a result of any changes, ‘including measures having their original in international treaties to which the host state [host states] is a party and measures aimed at improvements in environmental and social protection, [except when the intervention is justified by imminent, material threats to health, safety and environment].’⁸⁵⁰

In light of this fact, it can be asserted that the economic equilibrium stabilisation clause effectively relegates the international treaty obligations designed to protect the environment and human rights to measures only applicable in extreme circumstances. Nevertheless, all three host states accepted contractual terms in which such an economic equilibrium clause in the form of stabilisation will have effect for the next 40 to 60 years with the proviso that this duration can be further extended by the consortium twice, for a ten year period each.

846B. O. N. Nwete; ‘To What Extent Can Stabilisation Clauses Mitigate the Investor's Risks in a Production Sharing Contract?’ *Oil, Gas & Energy Law Intelligence* (OGEL), Vol.3 (March, 2005) 118

847 A. S. Reyes (n.179 above) 857

848B. O. N. Nwete (n. 187 above)118

849 A.S. Reyes (n.179 above) 858

850 For instance see Turkish HGA 5.2 (ii), Azeri HGA 5.2 (iii); for further reading see HGA Amnesty International, Human Rights on The Line: The Baku-Tbilisi-Ceyhan Pipeline Project (2003) 10, available at: <http://www.amnesty.org.uk/uploads/documents/doc_14538.pdf> May, 2013

Several interview respondents noted that BP and the other member oil companies dictated to their lawyers the exact terms and conditions of the arrangement they sought to achieve, as successfully obtaining investment loans and insurance from the World Bank group and EBRD and the other ECAs depended on them future-proofing the stability of the investment environment. Other group respondents mentioned that designing strong stabilisation commitments was the chief work of project lawyers. Nevertheless, the World Bank group, the EBRD, the European Union and the United States have also used their policy-making powers on host states during the construction of the legal architecture that provide the framework for their complex and clause-rich agreements.

9. Conclusion

In the course of this chapter, the role of lenders, political risk insurance providers and credit rating agencies in project financing regarding the inclusion of stabilisation clauses was examined. As a case study, this chapter lent particular attention to the BTC pipeline project.

The motivation for investors to include stabilisation clauses derives from a multitude of considerations. On contemplating the provision of a loan to a specific project, all the circumstances which may affect or delay the repayment of credit are taken into account. Change of law, the introduction of new regulations, expropriation or nationalisation, currency volatility, changes in tax regime and all manner of political risks all have the potential to endanger an investment.

In the face of political risks, the inclusion of stabilisation clauses have become a *sine qua non requirement* for investors applying for substantial loans to fund projects of the scale of trans-national pipeline projects. The lenders, in turn, require that these risks be managed and mitigated to secure the prospect of repayment. Furthermore, while lenders may appear to be backstage players, not directly involved in the project, it has been revealed that from behind the scenes this party is highly influential and that the requirement for a host state to commit to not introduce new laws that may affect the sustainability and cost of the project often derives from this source.

The critical importance of insurers in an investment project is self-evident, as neither investors nor lenders would ever consider committing to a project without cover to protect the loan from political risk. Furthermore, in order to shield their clients from political risk, insurers provide arbitral award default coverage of stabilisation clauses. This coverage provides insurance cover to the investor in the event that the host state fails to make a compensation payment triggered by the violation of a stabilisation clause incurred by a change in law. It was also found that national insurance agencies hold subrogation rights against host states, enabling pressure from another third party to be applied to the host state. Insurers are free to apply pressure to the host state to make compensation payments to their clients even before an arbitral tribunal's decision is reached. In cases where a host government caves into this pressure, this may appear to be an admission of guilt and thereby prejudice the arbitrator and, it can be argued the outcome.

The final external factor examined was credit rating agencies and their role in the inclusion of stabilisation clauses. Rating agencies assess and evaluate the risk of lending to sovereign countries and international corporations. Ratings are also available for specific project financing. These agencies take into account a number of project-related areas such as sovereign risk analysis, currency risk analysis, political risk, and contract risk analysis in the assessment they make. What was discovered through the knowledge contribution of interview participants is that the notations of agencies are based on very comprehensive considerations, the results of which heavily influence lenders' decisions about whether to participate in a project. Although the terms and conditions are established by project investors, rating agencies' assessments also play a part in defining the legal framework of the agreements. Rating agencies will take into consideration whether a stabilisation clause is included in the agreement in their contract analysis assessment, and this will invariably have a positive impact on the results and the ensuing impression made on the investor. However, it is beyond the scope of rating agencies to actually guarantee lenders that the host government will adhere to stabilisation commitments in the contract, as political and economic conditions may always be subject to change in that country. For this reason, all aspects of the assessment should be closely examined by lenders when they make overall country risk assessment.

The BTC pipeline project was chosen as a case study as its scale and complexity provide a wealth of material for analysis. The interview respondents furnished a rich tapestry of insights into the motivational factors for the participating states' involvement from each of their perspectives. It was observed that each signatory state's interests and bargaining positions have their unique points. In the case of Azerbaijan, the project is regarded as critical to territorial integrity and economic improvement. Azerbaijan saw the economic benefits to be gained from involvement in the project as a means to invest in their military might and thereby gain power over the Nagorno-Karabakh region. In the case of Georgia, the BTC project was to serve as a catalyst for economic growth and the improvement of living standards in the country. The project was also seen as a strategic means for gaining political protection from their Russian neighbours. Georgia held a strong bargaining position as the only country able to secure pipeline transit in the region should a dispute arise between Armenia and Azerbaijan. Meanwhile, from the perspective of Turkey, the improvement of strategic relations with diplomatic partners in the EU and the US outweighed the economic benefits to be had.

The analysis demonstrated the multifaceted nature of the agreements forged for a complex mega project of this kind. Through the IGA, the consortium aimed to establish a prevailing legal regime for the pipeline in Azerbaijan, Georgia and Turkey's national law. Although the main purpose of this was supposed to be to grant the pipeline freedom of transit, unfortunately the signatory states ultimately assigned their sovereign rights to the consortium in their territories. The IGA restricted the states' future regulatory activities, accelerated expropriation activities deemed without public purpose, and indemnified the consortium from the responsibility for human rights violation. It was also observed that *Unocal* constituted an alarming case for the BTC Company. Indeed, the case established a precedent for the BTC Company; who briefed their lawyers to craft an impervious legal regime to indemnify the consortium against any case against them rooted in a violation of human rights.

Also discussed were the HGAs annexed to the IGA. It is a well-established principle that HGAs are private law contracts and subject to a host country's domestic law. However, in the BTC project, the lawyers' internationalised these agreements thereby enabling them to prevail over each country's domestic law. This may be taken as evidence that the consortium wished to circumvent the judicial courts and legal systems of Azerbaijan, Georgia and Turkey. However, the main purpose of this work is to find out whether external factors played a role in imposing stabilisation clauses or not. It was found that the stabilisation clause was inserted by the lawyers of the consortium. Although lawyers designed the legal documents, in doing so they were merely executing the wishes of their client. For the consortium, the insertion of strict stabilisation clauses was used to convince the World Bank group, the EBRD and the other ECAs to provide loans and insurance for the BTC project. The EU, US, the World Bank and the EBRD also used their policy power on host states during the creation of legal agreements.

Chapter 6

Political Structures and Foreign Direct Investment Laws in Azerbaijan and Turkey

1. Introduction

The attraction of foreign capital through foreign investment is a major undertaking for host states. In the petroleum sector, cheap labour, large oil and gas reserves and a welcoming investment environment are all considered basic criteria by alien investors. In addition, foreign investors will also seek legal, fiscal and constitutional guarantees that their property and contractual rights are well protected over the course of their investment activities. The interaction between domestic law and international rules is at the centre of the legal regulations of Foreign Direct Investment (FDI)⁸⁵¹ In fact this interaction has motivated many developing states to revise their legal regulations on FDI.

The governments of Azerbaijan and Turkey have both secured political stability and established an appealing investment environment via adjustments to their domestic law, as well as signing up to bilateral and multilateral international investment treaties over the past decade. Turkey has liberalised its previously restrictive foreign investment policy to give encouragement to international investors. In fact, Turkey went as far as to adopt a new law pertaining to FDI in 2003. The implementation of this new legislation sought to address the need to have a well-established FDI Law amenable to alien investors that would be more compatible with global requirements, as well as reflecting the changing role of Turkey in the Caspian and Middle East Region. Since the establishment of the Republic of Azerbaijan, its legal authorities have been active in passing various laws with regard to foreign direct investment, most significantly: the Law on the Protection of Investments (1992), the Law on Investment Activity (1995), the Law on the Privatization of State Property (2000), and the Law on International Arbitration (2000). These laws have provided foreign investors with currency convertibility, guarantees regarding the stability of the legal framework, the right to repatriate funds and free access to international arbitration.

As previously mentioned, both countries, along with Georgia, are signatory parties of the BTC agreements. The rigid legal framework of the agreements, as explored in the previous chapter, is often detrimental to the interests of the host country. While it is reasonable to expect that these countries need to legislate and regulate in the interests of safeguarding foreign investment in order to attract it in the first place, why they went as far as to give consent to potentially debilitating stabilisation clauses in their HGAs in the BTC agreement is still in question. The purpose of this chapter is to discover the internal factors that persuaded Azerbaijan and Turkey to accept stabilisation clauses in their investment contracts.

851 A.A. Fatouros, 'Towards and International Agreement on Foreign Direct Investment' 10 *ICSID Review-Foreign Investment Law Journal* (1995) 191- 192

Attention will be given to the specific guarantees available to foreign investors in Azerbaijani and Turkish Foreign Investment Laws and the legal status of international agreements in their national law systems. In addition, the respective countries' political regimes will be analysed and compared. This chapter will seek to answer the following questions: How are the divergent political regimes effective in promoting FDI and giving consent to stabilisation clauses in Azerbaijani and Turkish host government contracts? What reason(s) has/have caused Azerbaijan and Turkey to agree to contractual stability in the BTC host governmental agreements?

2. Azerbaijan

Since the fall of the Soviet Union, most former soviet states have been anxious to become a part of the global economy while still maintaining their new status as sovereign states. Among the CIS countries, Azerbaijan's performance was the most appreciable in terms of attracting FDI into its country, particularly in the oil sector. 'The long awaited production from offshore fields developed by the Azerbaijan International Oil Consortium (AIOC), completion of the major Baku-Tbilisi-Ceyhan (BTC) and South Caucasus (Shah Deniz) oil and gas pipelines and global demand for oil and gas, have all exercised a significant influence on the Azerbaijani economy in recent years.'⁸⁵² As referenced in this chapter's introduction, a series of laws regarding the protection of foreign investment have been put in place in Azerbaijan. For instance, the Law on the Protection of Investments (1992) includes significant safeguards for private investors. In the same vein are the Investment Activity Law (1995), the Privatisation Law, the second Privatisation Program and the Law on International Arbitration (2000). These are sufficient examples to demonstrate the extent of Azerbaijan's ambition in securing alien investors. In addition to these incentives, a number of bilateral investment and other treaties were signed to create a more favourable investment climate and provide further guarantees to private investors.

2.1 The Law on Protection of Foreign Investments (15 January 1992)

Definition

The Azeri Law on the Protection of Investment, Article 2 defines foreign investors as:

The following persons and entities might be foreign investors in the Azerbaijan Republic: a) foreign legal entities b) foreign citizens, stateless citizens and citizens of the Azerbaijan Republic permanently living abroad, if they have been registered as participants of economic activity in the country of their citizenship or permanent residency c) foreign states d) international organizations.⁸⁵³

852 Baker & McKenzie, 'Doing Business in Azerbaijan' (2013) 4, available at: <<http://www.bakermckenzie.com/BKAzerbaijanDBI13/>> July, 2013

853 Article 2, Law of the Azerbaijan Republic About Protection of Foreign Investments (1992)

The Law on the Protection of Investment in the first place defines foreign investors, in which category it includes 1) foreign entities, 2) governments, 3) international organisations, and 4) individuals permanently residing outside Azerbaijan. The legal condition as stated in the article is that alien investors can undertake their investment activities uninhibited by Azerbaijani law. Under Azerbaijani law, the foreign investments of the investor are protected by the following articles:

Legal Protection of Foreign Investors

Article 5 provides for national treatment or non-discrimination among foreign investors. In other words, the ‘not-less favoured’ regime automatically applies to private investors within the territory of the Republic of Azerbaijan, unless otherwise stipulated by an applicable international, and, unless otherwise provided by Azerbaijani foreign investment law, by default foreign investors who enjoy the same rights as domestic investors, and upon whom may additionally be bestowed preferential rights that might not be ceded to domestic investors.⁸⁵⁴

Stability of Legislations

Article 10 of Azerbaijani Law on the Protection of Foreign Investment regulates guarantees against changes in legislation. In the context of this article, the law provides for protection against adverse changes in the law for the 10 year period subsequent to the investment.⁸⁵⁵ In other words, if a law adopted by the Azeri parliament adversely affects an investor’s investment, the application of that change is subject to a 10 year moratorium. Notably, the moratorium has the force of law, thus it is enforceable and it has a binding effect over all Azeri state bodies. Article 10 also clearly states the reach of such guarantees with changes in legislation in the area of national security, defence, public health, environmental protection, as well as affecting credits and finances as falling outside the scope of the moratorium.⁸⁵⁶ This article clearly states that stabilisation clauses are available under the foreign direct investment law of Azerbaijan.

Repatriation of profits and Convertibility

Under article 14 of the legislation, private investors are entitled to repatriate profits in convertible currency after the payment of applicable taxes and other charges that are due.⁸⁵⁷ This article makes it clear that Azerbaijan is keenly aware of and willing

854 Article 5, Law of the Azerbaijan Republic on the Protection of Foreign Investments (1992)

855 Article 10, Law of the Azerbaijan Republic on the Protection of Foreign Investments, (1992)

856 *ibid*

857 Article 15, Law of the Azerbaijan Republic on the Protection of Foreign Investments (1992)

to legally recognise one of the most crucial interests of private investors with perhaps its only condition being the payment of taxes. Nevertheless, the repatriation of profits can entail a long bureaucratic procedure. Despite the fact that by law foreign entities/companies are free to transfer their capital out of Azerbaijan, in practice there are some constraints made by the National Bank of Azerbaijan, mostly related to the transfer of money to offshore accounts.⁸⁵⁸

Expropriation/Nationalisation

Article 11 of the legislation regulates the advent of expropriation/nationalisation in Azerbaijan. This Article clearly states that in normal conditions foreign investments will not be subject to expropriation or nationalisation in Azerbaijan. However, the article also stresses that expropriation may take place if deemed in the interests of public purpose by the Supreme Council of Azerbaijan. Confiscation is also possible according to this article; however this type of taking must be executed only in circumstances of natural disaster, epidemics, and other extraordinary situations by decision of the cabinet of Ministers. In both expropriation and confiscation cases, private investors have the right to receive prompt, adequate and effective compensation. It should be noted that no expropriation or nationalisation cases have emerged in Azerbaijan thus far against foreign investors.

Settlement of Disputes

Article 42 of the legislation regulates the settlement of disputes between foreign investors, foreign institutions and state organs of Azerbaijan. According to this provision:

Disputes or disagreements arising between foreign investors and enterprises with foreign investments and state bodies of the Azerbaijan Republic, enterprises, public organizations and other legal entities of the Azerbaijan Republic, disputes and disagreements between participants of the enterprise with foreign investments and such enterprise itself are to be settled in Law Courts of the Azerbaijan Republic or, on agreement between the Parties, in the Court of Arbitration, including those abroad.⁸⁵⁹

According to this article, a dispute between a foreign company undertaking its activities in the territory of Azerbaijan and a local entity may be settled in accordance with the arbitration method by national or international courts as long as both parties can incorporate this in their agreement. The law also provides for disputes between private investors and state authorities or legal bodies with regards to the amount of damages that may be decided upon by an international arbitral tribunal, if parties have given consent to arbitration. It is clear that the settlement of dispute mechanism exists in law; however, ‘effective means of protecting and enforcing property and contractual

858 United Nations, *Foreign Direct Investments in Central Asian and Caucasian Economies: Policies and Issues, Papers and proceedings presented at the Regional Round Table on Foreign Direct Investment for Central Asia*. (New York, United Nations Publications: 2003) 75

859 Article 42, Law of the Azerbaijan Republic About Protection of Foreign Investments (1992)

rights are by no means assured.’⁸⁶⁰ In addition to this, it is worth mentioning that Azerbaijan has been a party of the Convention on the Recognition and Enforcement of Foreign Awards since 1999. On becoming a party to this treaty, the government adopted the Law on International Arbitration (2000) and the Law on the Civil Procedure Code (2000).

There is some doubt around whether these laws are actually the major steps they might at first appear, in terms of the guarantees they offer to foreign investors. With regards to this doubt, one interview respondent stated that ‘the Law on International Arbitration provides recognition and enforcement of foreign arbitral awards in Azerbaijan; however in practice, the enforcement of foreign arbitral awards in Azerbaijan is not a well-oiled process because local courts have had little opportunity to gain experience with commercial arbitration cases in general’.⁸⁶¹ Another interviewee noted that ‘although the FDI Law provides for the possibility of application to local arbitration in international commercial issues, in reality Azerbaijani courts are not perceived to be the best venue to resolve disputes by foreign investors. The reason for this is perhaps the transparency or reliability issue.’⁸⁶² What it is meant here is that there is no evidence that government officials officially intervene in the economic court system, however in practice economic courts are weak, judges are inexperienced and corruption is widespread with the result that judges’ decisions are often inconsistent.⁸⁶³

Concession Agreements

Technically speaking, there is no Law on Concession or institutional legal framework for concession in place in the Azerbaijani legal system. The Law on the Protection of Foreign Investment and The Civil Code refers to Concession agreements; however the laws do not actually define the concession concept itself. Under Article 40 of the Foreign Investment Law of Azerbaijan, concession rights are granted by the Cabinet of Ministers of the Republic of Azerbaijan and approved by the supreme council;⁸⁶⁴ however, there is no definition for the term concession, and the rights granted for concession are limited to natural resources only, while the article applies merely to private investors.

860Global Investment Centre, *Azerbaijan: Mineral, Mining Sector Investment and Business Guide: Strategic Information and Regulations* Vol.1 (USA, International Publications: 2012) 37

861 Interview no.16 with Lawyer, 21 November, 2012

862 Interview no. 17 with Lawyer 22 November, 2012

863 Global Investment Centre (n.10 above) 37

864Article 40 (1), Law of the Azerbaijan Republic on the Protection of Foreign Investment (1992)

In the interests of increasing its attractiveness to foreign investors, Azerbaijan would be well advised to add to this article a definition of ‘concession’ and the scope of the concession ought to be explicitly extended beyond the scope of natural resources. Indeed, in the long-run it is essential that the government of Azerbaijan implements a proper concession law if they wish to continue to attract foreign investors into the country, not only from the oil industry but from any sector. Despite the fact that these laws provide a considerable amount of protection to foreign investors, broader guarantees have also been provided by the Azerbaijani government, establishing a separate legal framework through Production Sharing Agreements (PSAs) for alien investors in the oil industry.

2.2 Legal status of PSAs in Azerbaijani legal system

In order to accelerate the flow of foreign investment, the president, Hayder Aliyev created a new PSA model with the oil industry in mind. Since 1994, Azerbaijan has concluded a total of 32 PSAs: internationally recognised mechanisms that include stabilisation and arbitration provisions as a means to providing a secure investment environment to oil companies. Moreover, as opposed to standard tax and royalty PSAs in Azerbaijan this is ‘a physical mechanism for rendering to the Azerbaijani states its share of profits while allowing foreign energy companies to recoup their investments.’⁸⁶⁵

The question as to why Azerbaijan adopted this model was raised by the former president of the State Oil Company of Azerbaijan (SOCAR). According to Sabit Bagirov, the main reason why Azerbaijan preferred PSAs was that, as a newly founded state, especially one with a lack of its own financial capital, it was unable to apply other types of contract models that would be beneficial to it as a country.⁸⁶⁶ More importantly, immediately following its establishment, the country suffered from a low credit rating and was consequently unable to obtain long term loans from foreign credit institutions to fund its oil and gas projects.⁸⁶⁷ Furthermore, as mentioned in the analysis of host government agreements, various different PSA models have been adopted by petroleum producing countries around the world.

What distinguishes Azeri PSAs from the other types is that when SOCAR officials and foreign company representatives reach a mutual agreement on a PSA, the approval of the president is subsequently required. On obtaining this approval, the contract is then sent to the Azerbaijani parliament for ratification. Once the parliament has ratified

865 D. I. Hoffman, Energy, ‘Wealth and Development in Central Asia and the Caucasus’, *National Bureau of Asian Research* Vol. 10, No 3 (August, 1999) cited in R. Ebel & R. Menon, *Energy and Conflict in Central Asia and the Caucasus*, (Boston, Roman & Littlefield Publishers PLC: 2000) 58

866A. Ciaretta & S. Nasirovm, ‘Development trends in the Azerbaijan Oil and Gas Sector: Achievements and Challenges’, *Elsevier Energy Policy* Vol. 40, (January, 2012) 15

867 Ibid

the contracts, it is then returned to the president for final confirmation. After the signature of the president and declaration to the public, the contract is accepted as having the force of law and prevails over existing or future laws or decrees whose provisions diverge from or are inconsistent with this contract. In other words, while some petroleum producing countries regard PSAs as a type of pure contract, in Azerbaijan all PSAs have the power of law and have a higher legal status than other existing laws in the Azerbaijani legal system.

Moreover, giving PSAs were first granted the status of law in 1994 by the Agreement on Joint Development and Production Sharing for the Azeri-Chirag-Gunesli (ACG). After the ratification of this PSA from the MilliMajlis (the Parliament of Azerbaijan), it was estimated that the elevated legal status of PSAs would be temporary and would be regulated by stringent domestic legislation designed to govern energy projects related to the oil and gas industry. One respondent noted that ‘the PSAs have to be ratified in parliament because there is no specific petroleum law that governs such agreements or an independent regulatory institution to administer such agreements in Azerbaijan.’⁸⁶⁸ It should be noted that the legal framework for the regulation of oil and gas agreements is based on the *Subsoil Act* of 13 February, 1998 and the *Energy Act* of 24 November, 1998. As these laws are in effect a collection of uncoordinated laws that furnish a general framework for energy resource legislation in Azerbaijan, in many cases their provisions are inconsistent with each other. In fact, there is no particular wording to state whether the general Energy Act has priority over the Subsoil Act or not.

In Azerbaijan, a different tax regime is applicable to PSAs. If a contractor has entered into a PSA in the oil and gas industry in Azerbaijan, such an agreement will stipulate the tax protocols relevant to that particular investment. The tax regime for PSAs in Azerbaijan is called the Oil consortia; it applies to the contractor and all the other project participants of a PSA. Currently, all of the PSAs to which Azerbaijan is party supply a grand total of profit tax of around 25 % or 35%, depending on the party’s negotiations when the contract was signed. The PSAs also offer protection against future increases in the profit tax rate. The investors are exempted from all the other taxes to which foreign investors are ordinarily subject to outside the oil sector. In addition, Azerbaijan has enacted a new code on tax-related Host Government Agreements (HGAs) which governs the activities of the BTC consortium on the BTC pipeline project in Azerbaijan.⁸⁶⁹ Investors operating outside the jurisdiction of PSAs and HGAs are subject to a statutory tax system. All evidence suggests that the Azerbaijani PSA model grants investors a stable model with full protection through the stabilisation clause and the other relevant contractual clauses.

2.3 The legal status of International Agreements under the Azerbaijani legal system

Article 148 (I) of the Azerbaijani Constitution regulates normative legal acts in the legislative system. According to the said article, the legislative system consists of ‘1) the Constitution; 2) acts accepted by referendum; 3) laws; 4) orders; 5) decrees of the Cabinet of Ministers of the Azerbaijan Republic and 6) normative acts of central

868 Interview no 18 with Lawyer, 21 November, 2012

869 The new Tax Code came into force 1 January, 2001

executive power bodies.⁸⁷⁰ In the second section of Article 148 (II) ‘international treaties, wherein the Azerbaijan Republic is one of the parties, constitute an integral part of the legislative system of the Azerbaijan Republic.’⁸⁷¹ This article is far from determining the legal status of international law in the Azerbaijani domestic legal system.

The article only goes as far as to assert the importance of international treaties in the national legal system in a general way. However, it should not be assumed that the Constitution disregards this matter. Several of its articles attempt to clarify this. For instance, Article 151 of the Constitution states that ‘whenever there is disagreement between normative legal acts in the legislative system of the Azerbaijan Republic (except the Constitution of the Azerbaijan Republic and acts accepted by means of a referendum) and interstate treaties wherein the Azerbaijan Republic is one of the parties, provisions of international treaties shall apply.’⁸⁷² Taking this article into account, some crucial points should be highlighted. First, it is clear that Article 151 covers only interstate agreements. Article 130/III (6) of the Azerbaijani Constitution places intergovernmental treaties within the hierarchy of the domestic legal system. According to Article 130/III (6):

III. The Constitutional Court of the Azerbaijan Republic based on inquiry of the President of the Azerbaijan Republic, the National Assembly of the Azerbaijan Republic, the Cabinet of Ministers of the Azerbaijan Republic, the Supreme Court of the Azerbaijan Republic, the Procurator’s Office of the Azerbaijan Republic, and the High Assembly of the Autonomous Republic of Nakhichevan, takes decisions regarding the following: [...]
6) the correspondence of interstate treaties of the Azerbaijan Republic, which have not yet become valid, to the Constitution of the Azerbaijan Republic; the correspondence of intergovernmental treaties of the Azerbaijan Republic to the Constitution and laws of the Azerbaijan Republic.⁸⁷³

It is clear from this article that intergovernmental agreements place lower in the hierarchy than the Constitution and general laws. In other words, in light of Article 130 III-(6) unlike interstate treaties, intergovernmental agreements do not have prevalence over domestic law. Furthermore, Article 130/X clearly states that ‘Laws and other acts, individual provisions of these documents, intergovernmental agreements of the Azerbaijan Republic cease to be valid in terms specified in the decision of the Constitutional Court of the Azerbaijan Republic, and interstate agreements of the Azerbaijan Republic do not come into force.’⁸⁷⁴

870 Article 148 (I) of Azerbaijani Constitution

871 Article 148 (II) of Azerbaijani Constitution

872 Article 151 of the Azerbaijani Constitution. It is worth explaining that the definition of interstate treaty is a treaty between two states or an agreement between a state and an international organisation.

873 Article 130/III (6) of Azerbaijani Constitution

What is clear from Article 130/X is that the Constitution asserts the superiority of national laws over intergovernmental treaties and confirms that if there is a conflict between the provisions of intergovernmental treaties and domestic laws, intergovernmental treaties can be revoked on the decision of the Constitutional Court of Azerbaijan. Giving annulment rights to the Constitutional Court and invoking international treaty provisions, when they are in conflict with national law, is by no means a standard or necessary way of protecting domestic law from an international perspective. Indeed, Article 27 of the Vienna Convention on the Law of Treaties clearly states that ‘a party may not invoke the provisions of its internal law as justification for its failure to perform a treaty.’⁸⁷⁵ Notably, Azerbaijan has not ratified the convention, but as the convention has become international customary law.⁸⁷⁶

2.4 Political System of Azerbaijan

Political Regime

As mentioned in chapter one, there is a very little consensus on exactly what form of political regime exists in Azerbaijan. Many assessments have been made in an attempt to reach a conclusion in this matter resulting only in a long list of proposed definitions, among which: ‘neo-patrimonial dictatorship, sultanistic, authoritarian, semi-authoritarian, sultanistic semi-authoritarian, hybrid, and partially democratic.’⁸⁷⁷ Despite there being no mutual agreement amongst scholars on the most accurate description of the political regime, it is widely acknowledged that Azerbaijan belongs to the category of presidential republics due to the existence of state institutions and general elections for the presidency and for the parliament (both elected for five year terms), which are, in a broad sense, defining feature of a democracy.

Although these formal institutions have remained continuously in place over a period of 22 years, Azerbaijan still exhibits many characteristics that fit the traditional definition of authoritarianism.⁸⁷⁸ According to Linz, authoritarian regimes are ‘political systems with limited, not responsible, political pluralism; without elaborate and guiding ideology, but with distinctive mentalities; without extensive or intensive political mobilisation, except at some points in their development; and in which, a leader or occasionally a small group exercises power within formally ill-defined, but actually

⁸⁷⁴Article 130/X of Azerbaijani Constitution

⁸⁷⁵Article 27 of the Vienna Convention on the Law of Treaties

⁸⁷⁶C. Abdulzade, ‘The Status of International Treaties in the Legal System of Azerbaijan’, *Review of Central and East European Law* 32 (2007) 243

⁸⁷⁷O. Bayulgen, *Foreign Investment and Political Regimes: The oil Sector in Azerbaijan, Russia and Norway*, (Cambridge, Cambridge University Press: 2010) 97

⁸⁷⁸A. Filetti, ‘Why so much Stability?: An Overview of the Azerbaijani Political System’, *Turkish Policy Quarterly*, Vol. 11, No.3 (2012) 157

quite predictable limits.⁸⁷⁹ Moreover, a report recently published by Freedom of House asserts that Azerbaijan places in the non-free category due to its insufficient performance in the areas of civil liberties and political rights. The table below demonstrates Azerbaijan's country scores for 2013.

Table 15 the Freedom of House Country Report on Azerbaijan, 2013

Country	Azerbaija n
Status	Not Free
Freedom Rating	5.5
Civil Liberties	5
Political Rights	6

*Source*⁸⁸⁰: Freedom of House Country Report, 2013

Inadequate institutional checks and controls, and a lack of political competition due to the absence of strong opposition political parties in Milli Majlis are two of the key factors behind Linz's definition. The following subsection will examine these factors and their nexus with the necessity for Azerbaijan to agree to stabilisation clauses in the contracts it signs and to provide robust stability in its laws.

Dependency of the judiciary on the Executive

Article 99 of the Azerbaijani Constitution states that executive power in Azerbaijan belongs solely to the president.⁸⁸¹ The main duties of the president are specified by Article 109. For instance, that the president appoints the prime minister and the cabinet, issues decrees, announces referendums and signs off laws previously passed from the Azerbaijani parliament. The president has the ability to dissolve the MilliMajlis and call parliamentary elections. Notwithstanding the fact that the Azerbaijani 1995 iteration of the Constitution provided for a 'system of government based on a nominal division of powers between a strong presidency, a legislature with the power to approve the budget

879 J. J. Linz, 'An Authoritarian Regime: The Case of Spain,' in E. Allardt & Y. L. Cleavages, *Ideologies and Party System* (Helsinki: Westermarck Society, 1964) 255 cited in A. Filetti (n.28 above) 157-157

880 Freedom of House, Reports on Azerbaijan,
<<http://www.freedomhouse.org/report/freedom-world/2013/azerbaijan>> July, 2013;
notably, the institution's ratings indicate that 1 is the highest and 7 is the lowest.

881 Article 99, The Constitution of the Republic of Azerbaijan

and impeach the president, and a judiciary with limited independence, in reality these state institutions bolster rather than moderate the power of the executive.⁸⁸²

Article 109 of the Constitution indicates that the president submits proposals to the parliament of Azerbaijan regarding the appointment of the judges of the Constitutional Court, the Supreme Court and the Court of Appeal as well as for the judges of other courts in the Azerbaijan Republic. In addition to, the president also has the power to appoint prosecutors, pending the consent of the MilliMajlis. It is apparent that ‘the legislative realities are such that judges effectively operate under direct control of the presidential administration’.⁸⁸³ It can logically be concluded that the probability that the criteria for appointment to the position of judge or prosecutor may depend heavily on being part of the president’s inner circle, demonstrating loyalty to this figure and sharing his politics is high.⁸⁸⁴

Dependency of MilliMajlis (Parliament) on Executive

Technically, Article 95 and 96 of the Constitution of Azerbaijan provide that MilliMajlis works independently as a legislative branch from the executive authorities. However, in reality the powers of the parliament and the scope of its functions are vastly overshadowed by presidential powers.⁸⁸⁵ Since the establishment of Azerbaijan, four parliamentary elections have taken place: in 1995, in 2000, in 2005 and in 2010. Over the past almost two decades, all of the elections held in Azerbaijan have been reported to present serious irregularities and even cases of fraud. As a result, the country has met with severe criticism by international organisations who have branded the elections as unfair, non-democratic and not free.⁸⁸⁶ Article 82, stipulates that MilliMajlis should consist of 125 members using a mixed majority-proportional electoral system and that parliamentary elections be held every five years.⁸⁸⁷ It should be noted that constitutional modifications ratified in 2002 removed the proportional representation of

882 O. Bayulgen (n.27 above) 98; see also Article 119 of The Constitution of the Republic of Azerbaijan

883 S. Bagirov, ‘Azerbaijan’s Oil Revenues: Ways of Reducing The Risk of Ineffective Use’, *Research Paper* (January, 2007) 55-56 Unpublished manuscript.

884 Ibid

885 R. Badalov & N. Mehdi, ‘The political institutions of Azerbaijan: A dichotomy between text and reality’, in A. Arakelian, *Constitutional/Political Reform Process in Georgia in Armenia and Azerbaijan: Political elite and Voices of the People*, (Tbilisi, International Institute for Democracy and Electoral Assistance and Caucuses Institute for Peace Democracy and Development: 2005) 145

886 Article 82 of The Constitution of the Republic of Azerbaijan

887 ibid

25 seats in the parliament; all 125 seats are now selected via the majoritarian system.⁸⁸⁸ 'This basically means that fragmented and weak opposition parties will be further under-represented in future parliaments.'⁸⁸⁹

As a result of this, the parliament becomes more dependent on and resultantly obedient to the executive. In other words, whenever the executive organ introduces new laws, MilliMajlis is forced to adopt and pass these laws quickly. This fact can be directly linked to the speedy acceptance of PSAs which include stabilisation provisions. As these types of contracts are accepted as law following their ratification, regardless of whether a PSA includes strong stabilisation provisions which favour foreign investors over the state, they have a strong chance of gaining acceptance in parliament. More importantly, as there are limited seats for opposition parties, even if a claim is made by them about the inconsistency of PSAs with existing law, the claim would probably be rejected or ignored by Constitutional courts. As Constitutional courts are not independent, they would consequently avoid making decisions which might contradict the policy of the executive branch.

Absence of Strong Opposition Political Parties

In addition to weak political institutions, the political party system in Azerbaijan is also underdeveloped. Azerbaijan is a single party dominant state. The New Azerbaijani Party is currently the ruling party in the country and has enjoyed an full power since 1993. There are around 40 political parties in Azerbaijan; nonetheless there are only six opposition political parties⁸⁹⁰ in the Azerbaijani Parliament. However, the political parties in opposition are consistently small, underfunded and 'often harassed and excluded from decision making process.'⁸⁹¹ Moreover, the character and policies of these opposition parties is largely determined by the interests of their leaders, in other words, party politics and ideology do not play a significant role in Azerbaijani politics.

Weak Civil Society and Interest Groups

There are a number of interest groups in Azerbaijan, concentrating on issues such as gender inequalities, human rights in the Karabakh war, legal awareness and ecological problems. While civil society organisations are officially allowed to operate, their development in Azerbaijan has been hampered on one hand by their relative

888 R. Badalov & N. Mehdi (n. 35 above) 156

889G. Guliyeva, 'Democratization and the rule of law in Azerbaijan: Europe's relevance', in C.P.M. Waters, *The state of Law in the South Caucasus, Euro Asian Studies* (New York, Palgrave Macmillan: 2005) 48

890Yeni Azerbaijan Party (New Azerbaijan Party), Azerbaijan Democratic Party, Civil Solidarity Party, Motherland Party, Equality Party, Azerbaijani Popular Front Party.

891Bertelsmann Stiftung, 'Azerbaijan Country Report' (2012) 9 available at: <<http://www.bti-project.de/fileadmin/Inhalte/reports/2012/pdf/BTI%202012%20Azerbaijan.pdf>> August 2013

newness and inexperience and on the other by their limited or non-existent financial resources. Alike political parties of the opposition, they receive little public support and are often regarded with suspicion, mostly due to the fact that they rely heavily on financial aid from international donor associations. Moreover, the influence of civil society organisations on government policies is very limited. For example, although the foundation of trade unions and the right to strike is officially allowed by law, the vast majority of trade unions remain closely allied with the government, and most major industries are state owned. For these reasons it is fair to say that trade unions are not truly autonomously functioning entities, which is compounded by the fact that in Azerbaijan they have no active role in the political decision making process.⁸⁹²

How active is the political regime in promoting FDI and giving consent to stabilisation clauses in investment contracts in Azerbaijan?

Since its establishment as a republic, providing a stable and flexible investment environment for alien investors has always been a touchstone of Azerbaijani oil and gas industry policy. Given the compatibility of their interests, and lack of hindrance in pursuing them, political leaders and private investors in Azerbaijan are effectively in cahoots. An assessment of the Azerbaijani political structure has revealed that there is a distinct lack of robust bodies, political or otherwise likely to present a case against this policy let alone be in a strong enough position to veto it. In any case, there is no precedential evidence to suggest that they would win the backing of the Azeri general public. The absence of credible opposition has enabled the elite few in life-long positions of power to make investment decisions and define policy with complete free rein. This has given them carte blanche to provide direct, uninhibited, and to a degree, unregulated access to foreign investors during the decision making process of oil and gas agreements. In Azerbaijan, the president enjoys unique authority and ultimate power in dictating energy investment policy on behalf of the whole country.

As some form of administrative and operational body was required to run refineries and pipelines and oversee the international consortia that develop them, the State Oil Company of Azerbaijan (SOCAR) was formed in 1992. Apart from being a state-owned oil company, SOCAR, initially functioned as a government ministry and SOCAR's president carried the rank of minister, and consequently was in direct contact with the president. It is clear that formal government hierarchy and administrative bodies were bypassed and SOCAR was the sole body tasked with the responsibility to maintain investment activities and deal with contract design and negotiations. It is also worth underlining that SOCAR's management board and its president have always been selected from the exclusive group who have ties of kinship with President Aliyev or are in some way close to his family.

For instance, Ilham Aliyev,⁸⁹³ appointed vice president of SOCAR in 1994, was the son of the then president, Heydar Aliyev. Natig Aliyev,⁸⁹⁴ who was the president of

892 Freedom of House Report, 2013 (n.30 above)

893 Ilham Aliyev has been the president of Azerbaijan since 2003.

894 Natig Aliyev has been the energy minister of Azerbaijan since 2005.

SOCAR during Aliyev's reign, shares the same name but is not a direct relation of the president. He was, nevertheless regarded as one of the loyalist elite in President Aliyev's regime. Crucially, important strategic decisions regarding Azerbaijani hydrocarbon development were made within this inner circle, independent of the usual formal government hierarchy. This method enabled President Heydar Aliyev to avoid any potential political divisions which may have constituted a threat to his control over energy resources. It is clear that unlike the other Turkic countries which have rich natural resources, but are hampered in their actions by complex bureaucratic procedures, Azerbaijan circumvented such obstacles by ring-fencing decision-making for the energy sector and assigning it to a select group of compliant cronies, thereby achieving the outward appearance of stability.

As previously related, once the parties reach a mutual agreement on a contract, the president's approval is subsequently required. The contract is then sent to the MilliMajlis for ratification. An interview respondent touched upon a crucially important subject by explaining: 'ratification of these contracts is a mere formality, no production sharing contract was ever rejected or returned by the parliament.'⁸⁹⁵ In line with this view, another respondent noted that 'a country that is ruled by one man is more appealing to investors than one run by a democratic regime, because it is in a position to provide contractual flexibility in every respect which supplies a great number of opportunities to foreign investors.

Conversely, in modern democracies, it is difficult to gain approval for foreign investment contracts that include stability provisions, because political parties in opposition and complex legal structures do not permit governments to get such agreements through parliament with the same ease.'⁸⁹⁶ In an attempt to pinpoint the motivations of the Azeri government in approving such binding stabilisation provisions, in the case of the BTC agreement, the interviewees were probed further. One of the respondents provided that 'the consortium approached the negotiation and enactment of host government agreements for the BTC project calmly and amicably because they knew that the strong presidency had already disabled or eliminated opposition parties and civil society groups that may have affected the contractual arrangement process.'⁸⁹⁷ Another interviewee provided that 'since 1994, SOCAR have signed many PSAs with different western oil companies. Some agreements were on major export pipeline agreements such as BTC and Baku-Tbilisi-Erzurum. Azerbaijan was politically and economically weak when the HGA of BTC was signed; therefore, during Heydar Aliyev's presidency, governments have always avoided any conflict that might arise

895 Interview no.16 (n.11 above)

896 Interview no.8 with Lecturer 4 June, 2012 and 8 November, 2012

897 Interview no.19 with Lecturer 23 November, 2012

during the negotiation of contracts with major Western oil companies.’⁸⁹⁸ Yet another interviewee responded that:

In theory, democracy is a symbol of political stability and advancement that should provide confidence, assurance and guarantees of stability to foreign investors in the petroleum sector, as to every type of investment. However, negotiation with a democracy necessitates the consideration of many conflicting issues which does not make for quick wins and often entails compromise. The simplicity and straightforwardness of authoritarian regimes is succour to negotiation-weary investors, especially in the high-stakes petroleum sector.⁸⁹⁹

Another respondent spelled out the implication in simple terms, ‘SOCAR’s strong position and its close relation to the political regime have always enabled foreign investors to negotiate the content and context of agreements in the knowledge that they are dealing with compliant partners.’⁹⁰⁰

3. Turkey

Unlike Azerbaijan, Turkey is not a petroleum rich country, however, its role in the transit of oil and importance for the security of energy supplies to Europe is irrefutable. Although the country acts as an energy hub for the western world, its transit role in the BTC project did not make a significant contribution to its economy, Turkey’s interest in involvement was largely strategic. Taking into account the country’s rapid economic growth over the last decade, despite the global economic crisis, it would not be wrong to surmise that Turkey’s bargaining position would be likely to alter if new oil and gas projects were executed in the Caucasus. Furthermore, the Republic of Turkey is presently the sixth major economy in Europe and it is estimated by some economists that the country is set to reach fourth position by 2050.⁹⁰¹

The conditions responsible for prompting such impressive economic growth over this challenging decade is possibly having the right liberalisation plans in the FDI sphere, the adoption of new FDI law, and sound government institutions. During the examination of Turkey, two divergent laws on FDI will be focused upon, because when the BTC agreement was signed, Turkey was using The Law for the Encouragement of Foreign Capital No. 6224, adopted on 18 January, 1954. The new Law on FDI: no 4875

898 Interview no. 18 (n. above 18)

899 Interview no.7 with Lawyer 6 June, 2012 and 12 November, 2012

900 Interview no. 20 with Foreign Trade Expert, 26 November, 2013

901 M. Broad, ‘Turkey Booms, but where are the Brits?’, BBC News, 17 May, 2013, available at: <<http://www.bbc.co.uk/news/business-22562237>>August, 2013

was adopted on 17 June, 2003, and has granted much-welcomed safeguards to alien investors. For this reason, a legal comparison should be made.

3.1 Foreign Direct Investment Law No. 4875 (June 2003)

Definition

Article 2 (a) of Turkish FDI Law, 4875 defines foreign investors as: ‘Real persons who possess foreign nationality and Turkish nationals resident abroad and foreign legal entities established under the laws of foreign countries and international institutions, who make foreign, direct investment in Turkey.’⁹⁰² The article clearly divides foreign investors into two categories. The first includes real persons who have foreign nationality and Turkish nationals who are residents abroad. The second is foreign legal entities formed under the laws of foreign states and international institutions. Compared to the newer Turkish FDI Law 4875, the previous Law for the Encouragement of Foreign Capital No. 6224, did not provide an exact definition of a foreign investor. In the absence of a clear definition, perhaps a private investor would have been regarded during the term as a person who had a foreign nationality or a legal entity formed according to a foreign legal system.

Legal Protection of Foreign Investor

The Freedom of Investment and National Treatment principle is regulated under Article 3 (a) of FDI Law 4875. According to Article 3 (a) ‘Foreign investors are free to make foreign direct investments in Turkey; and foreign investors shall be subject to equal treatment with domestic investors.’⁹⁰³ Similar to new FDI law, the previous legislation stipulated a non-discrimination principle under Article 10. According to Article 10, ‘all rights, exemptions, privileges and facilities recognised for domestic capital and enterprises shall be equally applicable to foreign capital and foreign enterprises engaged in comparable fields of business.’⁹⁰⁴ It is clear that both articles provide non-discriminatory principles.

Stability of Legislation

This subject will be revisited more comprehensively in the comparative analysis of this chapter, however at this point it is worth noting that unlike Azerbaijani foreign investment law, neither the new FDI Law nor the old Turkish FDI Law includes any stability provisions.

902 Article 2 (a) Foreign Direct Investment Law No. 4875, June 17, 2003

903 Article 3 (a) Foreign Direct Investment Law No. 4875, June 17, 2003

904 Article 10 Law for the Encouragement of Foreign Capital No. 6224, 18 January, 1954

Expropriation/Nationalisation

Regulations regarding expropriation and nationalisation are specified in the sub-paragraph of (b) of the Article (3) of FDI Law 4875 in Turkey. According to the (b) section of this article private property or assets of the alien investors cannot be expropriated and nationalised except for public purpose, the consideration of which are paid in accordance with the due process of law.⁹⁰⁵ There is no doubt that the article complies with international law standards; however, some ambiguity in this article is to be found in the absence of a definition for public interest. Notably, although previous foreign investment law did not regulate protection against expropriation or nationalisation *per se*; the Turkish Constitution of 1982 regulates this principle.⁹⁰⁶

For as long as the Law for the Encouragement of Foreign Capital No. 6224 was in place, there was no specific article to regulate expropriation or nationalisation cases or any article to determine the compensation due. During that time, Expropriation Law No 2942 was applied for expropriation and compensation.⁹⁰⁷ The valuation of the property or asset and determination of the compensation still applies the rules stipulated by the Expropriation Law of Turkey. It should be noted that when the BTC project agreements were signed the absence of specific articles on expropriation/nationalisation in the Law for the Encouragement of Foreign Capital No. 6224, would have been regarded as a major cause of concern by the project consortium. It should be noted that the country has, as of yet, had no cases lodged against it regarding expropriation or the nationalisation of foreign investors' property.

905 Article 3 (b) Foreign Direct Investment Law No. 4875, June 17, 2003

906 According to Article 46 of the Constitution: 'The State and public corporations shall be entitled, where the public interest requires it, to expropriate privately owned real estate wholly or in part and impose administrative servitude on it, in accordance with the principles and procedures prescribed by law, provided that the actual compensation is paid in advance. The compensation for expropriation and the amount regarding its increase rendered by a final judgement shall be paid in cash and in advance. However, the procedure to be applied for compensation for expropriated land in order to carry out land reform, major energy and irrigation projects, and housing and resettlement schemes and a forestation, and to protect the coasts and to build tourist facilities shall be regulated by law. In the cases where the law may allow payment in instalments, the payment period shall not exceed five years, whence payments shall be made in equal instalments. Compensation for the land expropriated from the small farmer who cultivates his own land shall in all cases be paid in advance. An interest equivalent to the highest interest paid on public claims shall be implemented in the instalments envisaged in the second paragraph. Article 47 of the Constitution also states: 'Private enterprises performing public services may be nationalized when this is required by the exigencies of public interest. Nationalization shall be carried out on the basis of real value. The methods and procedures for calculating real value shall be prescribed by law.'

907 Turkish Expropriation Law No 2942, November 8, 1983

Repatriation of Profits and Convertibility

Another principle framed within Article 3(c) of the new FDI Law is the transfer of funds. According to this article 'Foreign investors can freely transfer abroad: net profits, dividends, proceeds from the sale or liquidation of all or any part of an investment, compensation payments, amounts arising from license, management and similar agreements, and reimbursements and interest payments arising from foreign loans through banks or special financial institutions'.⁹⁰⁸ It is apparent that through this transfer of fund principle, Turkey aimed to create an environment within which business transactions could take place freely and efficiently. Indeed, in practice, it is fair to say that foreign investors do not generally experience difficulty in obtaining foreign exchange, and no foreign exchange restrictions are actively enforced in Turkey. The previous FDI law also provided safeguards for the free transfer of profits, fees and royalties, and repatriation of capital; however, in some respects the old law was more restrictive when it is compared to the new legislation.

Article 4(a) of the old FDI Law no.6224 regulated the availability of transfer of profits for foreign investors in the following ways: 'Net profits accruing in favour of the owner of the principal capital out of income are calculated in accordance with the tax laws in force, in case of a partial or total liquidation of an enterprise established under the present law, the share accruing in favour of the owners of the principal foreign capital at reasonable prices, the proceeds obtained from the sales, at a reasonable price and whether in whole or in part, of the principal foreign capital invested in a business founded or working under the terms of the present law, repayment instalments and interest payments, as they become due and payable in accordance with the respective foreign loan agreements.'⁹⁰⁹

In addition to this, the now defunct FDI Law's Article 4(b) stated that, if considered necessary, the Ministry of Finance or the Committee may be rendered able to order the examination of the accounting books and tax declarations of an enterprise formed under this legislation, in order to determine the amount available for transfer and order an inquiry in order to ascertain whether the sale of capital shares or of liquidation sale of assets, or credit loans are executed in good faith.⁹¹⁰ Furthermore, Article 4(c) of the old FDI law states that 'Upon applications for the transfer of profit shares, sales proceeds, loan repayment instalments and interest payments of the sorts classified as transferable in Paragraph (a) of this Article, the Ministry of Finance will grant permission for the same.'⁹¹¹ What is stated in Article 4 of paragraph (a) is that profits and capital funds could only be transferred abroad in the national currency of the principal foreign capital at the current official exchange rate.

908 Article 3 (c) Foreign Direct Investment Law No. 4875, June 17, 2003

909 Article 4(a) Law for the Encouragement of Foreign Capital No. 6224

910 Article 4(b) Law for the Encouragement of Foreign Capital No. 6224

911 Article 4(c) Law for the Encouragement of Foreign Capital No. 6224

All evidence suggests that the old FDI law was very restrictive in transferring the shares of private investors because the law stipulated very detailed terms regarding transferable profit as well as appointing the Ministry of Finance or the Committee to control whether the amount was available for transfer or not and check whether alien entrepreneur's operations were executed with good faith or not. Admittedly, it is impossible to find such detailed repatriation of profit rules as well as bureaucratic checking authority in modern FDI laws because the expectation of alien investors is to be left unbridled to operate their business and transfer their profits free of these bureaucratic hurdles. In addition, the law provides that profits and capital funds could only be moved abroad in the domestic currency of the principal foreign capital at the current official exchange rate. This rule is not compatible with international investment standards which allow an alien investor the freedom to repatriate its profit by choosing the currency that most benefits them.

Foreign petroleum companies operating in Turkey met with some obstacles in transferring their profits due to the insufficiencies of The Petroleum Law of 1954. The said law posed some major issues for foreign investment scenarios and needed to be amended in a number of areas. In June, 2013, the Turkish parliament adopted a new Turkish Petroleum Law.⁹¹² With this new law it aimed to remove the barriers with which foreign oil companies has previously struggled as well as harmonising Turkish law with EU standards. The removal of the repatriation of registered capital was one of the major incentives offered by the new law.⁹¹³ It should be noted that as Azerbaijan does not have a formally adopted petroleum law, the FDI law of the country regulates the repatriation of profit.

Settlement of Disputes

Settlement of dispute procedure is outlined by Article 3(e) of the new FDI Law No. 4875. This article grants an alien investor the option to either apply to the authorised national local courts or to international arbitration to settle a dispute. The article clearly states 'For the settlement of disputes arising from investment agreements subject to private law and investment disputes arising from public service concessions contracts and conditions which are concluded with foreign investors, foreign investors can apply either to the authorized local courts, or to national or international arbitration or other means of dispute settlement, provided that the conditions in the related regulations are fulfilled and the parties agree thereon.'⁹¹⁴

Providing an opportunity to apply to the arbitration process in local courts and international tribunals is a major step. One interview respondent, who works as a judge in Turkish local commercial court, gave a very frank view on this matter:

912 Turkish Petroleum Law No 6491 June 11, 2013

913 Article 14 of Turkish Petroleum Law No 6491 June 11, 2013

914 Article 3 (g) Foreign Direct Investment Law No. 4875, June 17, 2003

If I were an investor, I would not pursue the arbitration process in Turkish local courts because the court system is overburdened and the decision making process is very slow. I, personally, sometimes have to deal with hundreds of complex cases in the course of a week. Under these conditions, it would be difficult to make a considered decision. The government should improve the judicial system by establishing specialized courts.⁹¹⁵

In contrast with the new law, the Law for the Encouragement of Foreign Capital No. 6224 did not provide any article which enabled foreign investors to apply to international arbitration to settle their disputes. Nevertheless, it should not be assumed that this impeded the resolution of disputes entirely, as Turkey is a signatory country for some international agreements on arbitration. For instance, the Washington Convention on the Settlement of Investment Disputes (ICSID) is one of the multilateral agreements to which Turkey is a party. In addition, the BITs that Turkey entered into also enable foreign investors to use the international arbitration process to settle their investment disputes. Taking all of this into consideration, it is probably fair to say that foreign investors did not face major obstacles if their home country entered into BITs with Turkey. Nonetheless, through Article 3(c), the boundaries of arbitration applications have been widened in the Turkish Legal System for the first time and any issues regarding the uncertainty and confidence issue of private investors addressed. All in all, foreign investors are free to apply to arbitration to settle any disputes arising from concession contracts as well as disputes arising from agreements subject to private law. It should be noted that when the Turkish HGA of the BTC project was signed, there was no opportunity for the consortium to apply to international arbitration, because the legal status of concession contracts was that of administrative contracts that could only be arbitrated in accordance with Turkish law.

3.2 Concession Agreements

There is no specific concession law in the Turkish legal system; however concessions have been commonly used for a long time and are referenced in several laws⁹¹⁶ which, however, do not go as far as to provide a definition of the concept in the context of Turkish law. Until 1999, Constitutional amendments and Concession agreements between private parties and state entities were subject to the jurisdiction of administrative law in Turkey, and therefore, any dispute arising out of the concession contracts between a project company and the relevant administration were resolved by the administrative courts, and not by international arbitration courts. For this reason, international arbitration on concession had always been very problematic and was a hindrance to the raising of necessary finance from international markets required for energy projects.

Prior to Constitutional amendments, Article 155 of the Turkish Constitution provided that concession agreements were subject to the review of the High

915 Interview no. 11 with a Commercial Court Judge 11 January, 2013

916 For instance, BOT Law No. 3996; Law No. 4501 on International Arbitration Relating to Concessions; International Arbitration Law No. 4686

Administrative Court (Danistay), in Turkey. In other words, Danistay was the unique authority and had exclusive power of jurisdiction over concession agreements. This constituted a paradox, as although no definition for concession existed in the Turkish Constitution, it did provide for the appointment of the high administrative court as a unique authority for these types of agreements. The necessity of taking the major step of allowing international arbitration was eventually acknowledged by the Turkish Government and several amendments were made to the Turkish Constitution to this end.

In August 1999, Article 47, 125 and 155 of the constitution were revised, allowing public entities to enter into private law contracts with private parties for the performance of public services. The following provisions were added to Article 125: ‘Concession agreements concerning public services may provide that the disputes arising from such agreements are settled by national or international arbitration.’⁹¹⁷ Moreover, with the amendment of Article 155 of the Constitution, the role of the highest administrative court (Danistay) in reviewing the concession agreements and settling disputes was changed. According to these changes, the administrative court, could only give its opinion on the correct resolution. Such opinions would no longer be mandatory or legally binding and should be given within a limited period of time.⁹¹⁸

Article 47 of the Turkish Constitution was also altered to ‘Nationalisation and Privatisation’. Before the constitutional amendment was executed, Article 47 did not provide for privatisation. This amendment inserted the concept of privatisation in that article. Article 47 sets out the principles and procedures by which the privatisation of a state owned business may occur, and outlines which economic enterprises and other public legal entities are governed by the statute. The said article states: ‘which of the investments or services that carried out by the State, state economic enterprises or other public corporations may be performed by or delegated to real or corporate bodies through private law contracts are prescribed by law.’⁹¹⁹ What is meant by this article is that the requirements and the procedures for privatisation of public investments and services are regulated by statute and the privatisation of such investments and services are governed by private law. Article 47, 125 and 155, can be interpreted as a concerted effort, by Turkish Parliament, to remove impediments to winning foreign investment. The only outstanding piece of legal work that remains is a watertight concession law.

3.3 Legal Status of International Agreements under Turkish Legal System

The 1982 Constitution determines the status of international treaties under Article 90(5): ‘International agreements duly put into effect bear the force of law. No appeal to the Constitutional Court shall be made with regard to these agreements, on the grounds that they are unconstitutional.’⁹²⁰ In May, 2004, the Turkish Parliament adopted Law

917 Article 125 of Turkish Constitution, 1982

918 Article 155 of Turkish Constitution, 1982

919 Article 147 of Turkish Constitution, 1982

920 Article 90 (5) of Constitution, 1982, Ratification of International Treaties

No. 5170 which amends several provisions of the Turkish Constitution. Amongst other things, perhaps the most noteworthy amendment was to the legal status of international treaties. The new law inserted a new sentence into Article 90: ‘In the case of a conflict between international agreements in the area of fundamental rights and freedoms duly put into effect and the domestic laws due to differences in provisions on the same matter, the provisions of international agreements shall prevail.’⁹²¹

On the adoption of this new law, the question of superiority between international treaties on human rights over domestic law was laid to rest. Even if the provisions of an international treaty related to human rights were in conflict with the provisions of domestic law, the international agreement would automatically prevail over domestic law. While this can legitimately be considered an advance in human rights provision in Turkey, this amendment has generated several inconsistencies within the Turkish constitution because Article 90 itself does not determine the hierarchical status of international treaties (other than human rights).

Therefore, even if any provisions of BITs, IGA or HGA are in conflict with provisions made by national law, these agreements will take precedence over national law. International treaties other than human rights should not have superiority over domestic law when they are in conflict with the provisions of domestic law. Evidently, the Turkish Constitutional Court regards international treaties to be at the same level as domestic laws, and in the case of a conflict between the provisions of an international agreement and a domestic law, the same principles as those applied in determining the superiority between two domestic laws would apply in order to determine which one prevails.⁹²² These standards are that: the specific provision prevails over the general one; the newer provision has superiority over the older one; and the explicit provision prevails over the implicit one. If such agreements were in conflict with the provisions of constitution, what would be the status of these agreements? In such scenarios, it cannot be considered that they have superiority over the constitution because no law can be in conflict with Constitutional provisions or have a higher status than the Constitution.

3.4 Political System in Turkey

Political Regime

Since its establishment, the political regime of Turkey has hovered between authoritarian regime and democracy. For this reason the definition of Turkey’s political regime has always been under debate. The regime combines both democracy and authoritarianism; or rather it is a hybrid regime. According to Marshall and Jagers, ‘Hybrid regimes possess a wide mixture of democratic and authoritarian characteristics. The ruling elites generally keep themselves in power, despite the presence of some

921 Ibid

922 Turkish High Court Decision No: E.1996/55, K: 1997/33 dated 27 February, 1997.

institutional features of a democracy. Elections are often not competitive and political liberties may be constrained.’⁹²³

In fact, according to the Economist Intelligence Unit’s democracy index classification, Turkey is categorised under hybrid regimes.⁹²⁴ This means that the country does not place in the category of full democracies or in flawed democracies; however, it is also not classed as an autocracy. This assessment is echoed by the Freedom of House’s country report, which categorises Turkey as a partly free country. The table below exhibits the Freedom of House’s recent country rating for Turkey.

Table 16 the Freedom of House Country Report on Turkey, 2013

Country	Turkey
Status	Partly Free
Freedom	3.5
Rating	
Civil Liberties	4
Political	3
Rights	

*Source*⁹²⁵: Freedom of House, 2013

Turkey has had a parliamentary system in place for 93 years. In addition, the country has been a secular state since 1937 and has boasted a multiparty system since 1946. Turkey also has many components of a democracy such as a regularly held general election, universal suffrage and free competition between political parties. Despite this, Turkish democracy was challenged by military intervention on a total of four separate occasions, in the years of 1960, 1971, 1980 and 1997. The bureaucratic elite and the military have always held on to their self-projection as the guardians and

923 M. G. Marshall and K. Jagers ‘Polity IV Project: Political Regime Characteristic and Transition, 1800-2012,’ Societal-systems Research Inc., University of Maryland, available at: <<http://www.systemicpeace.org/polity/polity4.htm>>August, 2013

924 Economist Intelligence Unit’s Index of Democracy, 2011, available at: <http://www.sida.se/Global/About%20Sida/S%C3%A5%20arbetar%20vi/EIU_Democracy_Index_Dec2011.pdf>August, 2013

925Freedom of House, available at: <<http://www.freedomhouse.org/report/freedom-world/2013/turkey>>August, 2013; It should be noted that the organisation’s rating indicates that 1 is the highest and 7 is the lowest.

protectors of Turkey against Islamic and separatist groups in and around Turkish territory. This belief has impacted on the feasibility and lifespan of formal political institutions in Turkey. After the adoption of a multi-party system in 1946, most of the governments formed in Turkey have been coalitions of two or three political parties. Indeed, between 1991 and 2002 seven different coalition governments⁹²⁶ were formed with the longest duration of a single government being three and a half years, in part due to internal divisions and also because much-needed steps to promote investment in Turkey were not taken. A chaotic investment environment was a mainstay of the coalition years. The current government, the Justice and Development Party (JDP), elected in 2002, was the first party since 1991 to be formed by a single majority party and that succeeded in retaining strong public support.

Military intervention and some constraints on the Executive

The 1982 Constitution explicitly states that the Turkish political regime is based on a parliamentary regime, indeed the constitution has introduced a *sui generis* system with regard to the legal power invested in the presidency.⁹²⁷ It is a combination of a parliamentary presidential and a semi-presidential system, and is not purely a parliamentary system.⁹²⁸ Moreover, the presence of this dual-headed structure has been problematic, precisely when there has been conflict between the prime minister and the president. When the president and the parliamentary majority have differences of opinion, compromise has proven difficult to achieve and when such scenarios have occurred they have often resulted in deadlock of the political system.⁹²⁹ The record of the last president, Ahmet Necdet Sezer, (2000-2007) is testament to this. Sezer used his right to veto draft law a full 73 times. Naturally, this had an effect on government morale, its external image, and in practical terms, affected the parliament's productivity and delayed the enforceability of new legislation in the Turkish legal system.

As mentioned in the political regime section, no Turkish government could have been said to have been stable and secure until 2002, due to a succession of military coups. On the advent of each of the four coups, the government was forced to resign

⁹²⁶ It is worth mentioning that during the analysis, only the coalition governments which governed the country during the economic downturns (1994, 1999 and 2001) will be examined to understand the economic and political conditions in the country when the BTC agreements were signed.

⁹²⁷ B. Kuzu, 'Türkiye İçin Başkanlık Sistemi' (in Turkish) *Liberal Düşünce Dergisi*, C.1, S.2 (1996), cited in R. Turk, 'Feasibility of Presidential System in Turkey', *Turkish Journal of Politics* Vol.2 No.1 (2011) 35

⁹²⁸ *ibid*

⁹²⁹ P. Uran, 'Turkey's Hast Constitutional Amendments Devoid of Rational Basis: From a Political Crisis to a Governmental System Change', *Journal of Politics and Law*, Vol.3, No.1 (March, 2010) 6

while the military held sway until a general election could be organised to elect a replacement. The Military's right to usurp the government, while retaining its own powers was effectively legitimised by the 1982 Constitution, as the military is only accountable to the prime minister and not to the secretary of defence and, to date, this remains the case. It is a feature of modern democratic constitutions that the place of the military in the hierarchy of authority should be under the secretary of defence. After the 1980's military coup, the army designed a Constitution in 1982 for the country to determine the future domestic and foreign policy of the Republic of Turkey. Unfortunately the version of the Constitution drafted by the military powers is still in force. However, thanks to the Helsinki Submit in December 1999, Turkey's candidacy to the EU was approved by the member states and the country was consequently forced to make substantial reforms in its law system to comply with EU regulations.

The EU warned that the existing power of Turkey's military forces was a cause for concern and recommended that some reforms crucial to Turkey's chances of entering the union be made. These suggested reforms were: the transformation of the role and composition of the National Security Council; the reduction of the number of military representatives from civilian boards; and an amendment concerning the powers of military courts.⁹³⁰ Amongst the constitutional reforms, the amendments regarding the composition of the National Security Council was the most significant⁹³¹ because the representatives of the council prior to this had a direct influence on the executive branch and played an active role in policy-making in Turkey.

As a result of this reform, however, the bureaucratic mechanisms previously available to the military were disabled and its control over both domestic and foreign policy-making in Turkey mitigated. It is notable that a lack of resolve on the part of the coalition government of the time in pushing through these reforms, and the long bargaining process that ensued, meant that two more years passed before the reforms were put in place in 2001. The grapple-hold the military long enjoyed over Turkish politics has gradually diminished in force since the electoral victory of the AK Party in 2002. The party has been elected democratically three consecutive times. Erdogan's government can now be said to be in effective control of the country's governance, despite some constraints experienced in the early years of its governance due to the continuing military influence. The erosion of Military power has been most notable from 2009, since which the government has been particularly active in implementing its own policy. However, behind the scenes, the power struggle continues.

Unfair and Limited Competition

The organisation of the electoral system in Turkey is the best explanation for why there have been so many coalition governments with the consequent effects on decision-making processes in the country, particularly during the late 1990s. The electoral system has also been criticised for placing political parties which represent minority groups in the country at an unfair disadvantage. In Turkey, a 10% threshold has been applied in

930 G. Ozcan, 'The Changing Role of Turkey's Military in Foreign Policy Making', UNISCI Discussion papers No. 23 (May, 2010) 30

931 Ibid

general elections since the creation of the 1982 Constitution. This threshold is higher than any corresponding rate in Europe, and can be said to constitute a major obstacle to the sustainability of Turkish democracy. Rates in the EU include 8 % in Liechtenstein 5% in Germany, Romania, and the Czech Republic, 4% in Austria, Spain and Bulgaria, and 3% Sweden and Greece. Under such an exacting threshold system, only three or four of the stronger political parties can successfully pass the threshold barrier and thereby exercise their elected powers and have a hand in policy-making. Votes in favour of a multitude of other political parties are rendered effectively void. Until this threshold rate is addressed through Constitutional amendments; it will be difficult to talk about a pluralist democracy in Turkey.

Weak Coalition Government Years, Economic Downturns and Lethargic Legislative Activity

In the years between 1991 and 2002, Turkey was administered by a series of seven different incohesive governments whose ineffectiveness at agreeing legislation had a negative impact on development of the country. The last of these was composed of: *Demokratik Sol Party* (left-wing), *MilliyetciHaraketPartisi* (nationalist) and *AnavatanPartisi* (centre-right). Perhaps surprisingly, when the incompatibility of their political views is taken into account, these parties consented to set about forming a government and ruling the country. As is commonly the case in countries with less mature democracies, the coalition governments found it very difficult to implement macro-economic discipline and establish an environment of political stability conducive to long term economic growth.⁹³² This was yet another repetition of the failure to provide economic stability of a coalition government in Turkey and was to provoke the third major economic downturn in Turkey in less than a decade.

The first of these economic crises occurred in 1994, with no external factors at play, the crisis was attributable solely to the economic blunders of *DogruYol* (*True Path*) and *Sosyal Demokrat Halkci* (*Social Democratic Populist*) parties' coalition government in power from 1992 to 1995. The second crisis was deeper and emerged in late 1999, while the last crisis closely followed in 2001. The last two crises were to manifest themselves during the term of the coalition government of *Demokratik Sol Party* (the Democratic Left Party), *Milliyetci Haraket Partisi* (the Nationalist Action Party) and *Anavatan Partisi* (the Motherland Party). Following the 1999 economic downturn, the coalition government forged a stand-by agreement with the International Monetary Fund (IMF) in exchange for which it was required to initiate radical economic reforms in accordance with the stabilisation program proposed by the IMF.⁹³³ In line with this programme, the Turkish coalition government started to implement a number of laws designed to remove barriers to international trade, such as international arbitration, changes in the banking system, changes in the tax system, limitations to public sector employment, wage and salary rises and pledged to accelerate the privatization program in Turkey. These reforms must have sufficed to satisfy the IMF of Turkey's commitment to economic responsibility and its desire to modernize as a long

932 Z. Onis, 'Crises and Transformations in Turkish Politics', *Turkish Policy Quarterly*, Vol. 9, No. 3 (2010) 57

933 Turkey made its last debt payment to the IMF in May 2013

term stand-by agreement was signed between the Republic of Turkey and the IMF in 1999.

In November 1999, the government of Turkey hosted the European Security and Cooperation Organisation (ESCO) in Istanbul and signed the Intergovernmental Agreement of the BTC project along with Azerbaijan and Georgia. The country was accepted as a candidate country to the EU in the same year and was required to implement a series of political reforms. The same coalition government oversaw the inclusion of Turkey in the G20. Policy reforms and an improved relationship with the West gave the sense that things were on the up until 2001, when the country faced a dramatic repetition of economic breakdown. The same coalition government that had seemed to offer so much promise two years earlier had fallen into disarray due to a disagreement between the president and the prime minister. In February, 2001, at a meeting of the National Security Council, the then President, Ahmet Necdet Sezer, flung the Constitution Book onto his desk and warned the then, Prime Minister, Bulent Ecevit, that the government should respect the rules and activities of the Constitution. According to some observers, the president was poised to raise allegations of corruption against certain members of the cabinet.⁹³⁴ This fierce public showdown between president and prime minister served to emphasise the fragility of the country's political cohesion and its economy was to be the next victim of this, as was the coalition government itself, as elections were called early, on 1st November, 2002.

Absence of strong opposition political parties

Since the 3rd November, 2002, Turkish politics have been shaped by a single party regime. Under the JDP, the country has reached a state of economic and political stability and taken its place among the fastest growing countries in the world, even while it was surrounded by economic and political crisis in neighbouring countries. On the other hand, there are those that believe that the party's policies have turned the country from a democratic regime into an authoritarian state. In part, this view is propagated by the speed at which the government approve international agreements or implement domestic law. A defining feature of JDP rule has been that laws and agreements pass quickly through parliament as the vast majority of seats (327 seats out of 548) in parliament are held by them, so consensus is much easier, than was the case in the past, to achieve.

Questions have also arisen regarding the transparency of government undertakings and its sense of accountability to Turkish society. In June 2013, the *Gezi Park* demonstration, which started out as a local issue protest, rapidly erupted into a national revolt with manifestations in all major Turkish cities. While the protestors themselves represented a wide range of political affiliations, one of their chief demands was for the government, as well as other opposition political parties, to create a more participatory decision making system, particularly regarding matters that have a direct impact on the lives of Turkish citizens, with demands ranging from gender equality to the adoption of new petroleum laws. When Turkish Petroleum Law No 6491 was

934 M. Hic & A. H. Gencer, *Turkish Economy and Politics: From 1923, the Foundation of the Republic until 2002*, (Istanbul, Beykent University Press: 2010) 192

adopted in June 2013, the ‘Gezi Park’ mass demonstration was in full flow. A generous view would be that this can be taken as an example of the efficiency of government function even in times of crisis, however, the lack of public consultation that took place for such disruptive activity, planned in residential areas, can also go some way to provide an understanding for the frustration and disenfranchisement that fuelled the demonstrations in the first place.

Weak Public Interest Groups

The transition to democracy was directly shaped by the bureaucratic and military elites, rather than public interest groups during the 1990s in Turkey.⁹³⁵ More recently, partly as a result of the on-going EU accession process, civilian organisations have increased in number and activity. However there is still a long way for them to go before they can enjoy the same levels of influence as their western European counterparts. This is due a lack of financial resources.⁹³⁶ For example, according to the newly adopted Turkish Petroleum Law No 6491, the Council of Ministers is the unique authority able to provide licences to petroleum companies to explore and extract petroleum resources in a specific region. However, in most modern democracies, governments have a duty to first inform public interest groups and invite their assessments of how this will affect the region before granting licences to foreign investors. The local knowledge of such groups and the crucial communication links they can provide by being on the ground, informed and being economically, politically and socially aware can be a huge asset to both government and society if properly harnessed. Effective consultation with such groups is emblematic of a transparent and accountable regime. It is indicative of the distance the Turkish government still needs to travel that although there are hundreds of unions and chambers of commerce in Turkey, their role in shaping government policy is negligible.

How effective is the political regime in promoting FDI and giving consent to stabilisation clauses in Turkish investment contracts?

An analysis of the political regime in Turkey illustrates the significance of political institutions in the attraction of FDI. The series of coalition governments’ ineffective performance in legislative activities; the emergence of three economic crises in under a decade; the president’s excessive power to veto government decisions, the military’s disproportionate control of domestic and foreign policies and the weakness of public interest groups all contributed to the bleak picture of Turkish development in the decade from 1992 to 2002 in Turkey. This situation of political and economic instability accounts for the weak bargaining position Turkey found itself in when it was on the point of signing the BTC agreements. This can be contrasted with the leverage that

935 Please See, T. Cetin, ‘The Role of Institutions over Economic Change in Turkey’, Chapter 2 in T. Cetin & F. Yilmaz (Eds.), *Understanding the Process of Economic Change in Turkey: An Institutional Approach*, (Turkey, Nova Science Publishers: 2010) 25

936 G. Seufert, S. Togan and C. Colino, ‘Sustainable Governance Indicators, Turkey’ Report, *Bertelsmann Stiftung* (2011) 55 available at: <http://www.sgi-network.org/pdf/SGI11_Turkey.pdf> August, 2013

Turkey enjoys comparatively under the current political regime. Retrospectively, the first decade of the new millennium can be seen as a turning point for Turkey's standing in the international arena. Strengthened political and economic stability, a flexible investment environment, newly adopted laws and an increase in the number of signed BITs with partner states are the key factors to which the country's accession to a key world player can be attributed. Does that mean that Turkey is likely to agree to stabilisation clauses in its petroleum agreements in the future?

Respondents were fairly unanimous in stressing the relative stability of the country's political and economic environment and in underlining the increased harmony and efficiency in the functioning of state institutions. In this respect, it is fair to assert that a single party regime has improved the stability and sustainability of the Republic of Turkey. However, one interviewee argued that 'Turkey is a motivated country but not a transparent or accountable country.'⁹³⁷ The respondent went further to state that 'political factors may inform Turkey's foreign investment policy, for instance, new legislation or fiscal regimes over the course of an investment project.'⁹³⁸

Another respondent expressed a similar view. According to this interviewee:

Turkey is located in a diplomatically fragile area; therefore political and economic events in neighbouring states can easily influence country's politics. The advent of the recent Arab Spring and the on-going civil war in the south-east of Turkey vividly demonstrate the vulnerability of Turkey's geographical and diplomatic position. Nevertheless, despite these looming internal and external risk factors, the successful political programme of the current government regarding FDI has made Turkey the fastest growing economy in Europe. Maintaining a strong majority vote is very important to eliminate the presence of coalitions or strong opposition groups or a coalition government that could dilute government decision making. These could be the factors that help Turkey appear stable and welcoming to foreign investors. However, there is no guarantee that a state with unconstrained powers would resist taking action detrimental to foreign investors in the long term, if politically motivated.⁹³⁹

937 Interview no. 15 Anonymity Guaranteed 15 November, 2012

938 Ibid

939 Interview no. 5 Anonymity Guaranteed 11 May, 2012

4. A Comparison of Guarantees Available under FDI Laws and Political Regimes in Azerbaijan and Turkey

In Turkey, FDI Law 4875 has introduced a number of safeguards for alien investors not provided for by the version it replaced. There is still scope for improvement in order to render it truly comprehensive. For instance, Article 2 of the new law defines the foreign investor; however the article does not explicitly outline the status of those individuals who hold Turkish citizenship and live permanently or temporarily in Turkey, but who are at the same time shareholders in a foreign entity registered abroad. Arguably, perhaps the second paragraph of Article 2 could be interpreted as referring to a Turkish national who is resident abroad or in Turkey; a shareholder of a foreign legal entity formed in accordance with a foreign legal system is also accepted as foreign investor. Similarly, notwithstanding the fact that Article 3 of the new FDI determines the legal justification (public purpose) for expropriation and nationalisation of a property or an asset, public purpose should be explicitly referenced, or at least relevant examples should have been provided. Although previous FDI law did not regulate protection and nationalisation, no expropriation or nationalisation cases have ever emerged in Turkey.

The new FDI law allows for disputes to be settled either in local or international tribunals. This option has been provided to alien investors; however, considering the backlog of cases in local courts, the vast majority of investors would prefer to settle their disputes in international courts. For this reason, reform in the judicial system is urgently called for. Furthermore, there is no article that regulates concession contracts in the FDI law of Turkey. Indeed, there is no specific concession law in the country. Despite its aspiration to EU membership, it still does not have a proper concession law. Although Constitutional law refers to concession agreements, and points out that they are subject private law, the country urgently requires the implementation of a proper concession law.

The legal status of international treaties under the Turkish legal system is another issue that needs to be addressed. Article 90 of the Turkish Constitution clearly states that international agreements on human rights have a higher status in the legal hierarchy than domestic law. Even where conflict arises between the provisions of domestic laws and international treaties, the latter prevails. However the article does not clarify the status of international treaties in areas other than human rights, thereby creating an ambiguity that can be exploited to infer that every international treaty has a higher status and prevails over national law. In terms of law technique, international treaties other than human rights should not prevail over domestic laws. If treaties and domestic law provisions are head to head the same principles as those that are applied in determining the superiority between two domestic laws should be applied in order to determine which prevails. Consequently, an amendment to Article 90 of the Constitution is needed to determine the legal status of international agreements other than human rights.

Unlike Azerbaijan, the political regime in Turkey is of a hybrid nature. Military influence and the president's prerogative to exercise the power of veto have limited the scope of the executive branch. While the former has diminished in significance, the latter remains unchanged. It is more standard in a parliamentary system for the president's duties, responsibility and legal power to be limited. In Turkey, the president's right to veto often results in delays to the adoption of new laws. Perhaps the

best model for Turkey is a presidential parliamentary regime because in this type of regime, the governments' life span is relatively longer and their legislative process is generally more efficient than in a standard parliamentary regime. More significantly, a presidential regime would be a safeguard against military influence or direct intervention in the executive in Turkey because military intervention may often emerge when the socio-economic balance changes or in the case of policy deadlock between the president and prime minister. The 10% threshold is an additional stumbling block for Turkish democracy. In order to create a system that gives representation to minorities as well as the overwhelming majority in the context of a country with a number of under-represented minority groups, a constitutional amendment needs to be drafted to limit the current threshold. The presence of a single party government does not pose any issues for the workability of democratic institutions in Turkey in itself; however the fact that civil society organisations, public interest groups and political opposition political parties are still weak means is a cause for concern.

Azerbaijan has established an open and liberal investment regime for private investors through its legislation. The 1992 FDI law includes a number of safeguards for alien investors; however a well written modern FDI law is urgently required. Equal treatment principle (applicable to domestic and foreign investors), guarantees against expropriation and nationalisation, dispute settlement mechanisms, repatriation of profits and convertibility are all forms of protection provided by current Azeri FDI law. It is worthy of note that no expropriation and nationalisation cases have yet been brought in Azerbaijan. Nevertheless, although FDI law regulates the free transfer of profits, some restrictions are imposed by the National Bank of Azerbaijan. Furthermore, unlike Turkey, Azerbaijan provides stability of legislation under its FDI Law. Article 10 provides a ten-year stability guarantee for alien investors in the event that the Azerbaijani government makes changes in law. Notably, this rule is not applied to changes related to the tax system.

The existing settlement of dispute mechanisms in Azerbaijan, coupled with Azeri FDI law, enable investors to resolve their disputes either in local courts or international arbitral tribunals. Unlike Turkey, where local courts are simply overwhelmed with cases, in the Azeri local court system and mechanisms for dispute resolution are still evolving and the rights of investors may not be dealt with the expected impartiality due to institutionalised corruption and the fact that judges often struggle to keep up-to-date with new legislation, resulting in inconsistent rulings. In relation to these weaknesses in the judiciary system, the enforcement of foreign arbitral awards is also inconsistent, despite the fact that the country is a member of the New York Convention formed in 1958.

In contrast with Turkey, Azeri FDI law does regulate concession contracts, but the extent of this regulation is limited to national resources and the article regulates these contracts but does not provide a proper definition of the concept of concession contracts. In addition, like Turkey, Azerbaijan does not have a concession law within its legal system.

Considering the dependence of the Azerbaijani economy on the oil sector, it seems paradoxical that it does not have a petroleum law and that oil agreements are executed through PSAs. When these types of agreements are passed by parliament and ratified by the president of the country, they take on the status of laws and prevail over existing

domestic law. Conventionally, oil and gas agreements are regulated through the *Subsoil Act* and the *Energy Act*. While these laws provide a general framework for the exploitation of energy resources in Azerbaijan, their provisions are inconsistent with each other and do not match or reference the provisions provided under PSAs. Surprisingly, there is no single ruling which determines whether the general *Energy Act* takes precedence over the *Subsoil Act*.

In both countries, international treaties related to human rights automatically have a higher status than domestic law. Meanwhile, the legal status of international treaties other than those that pertain to human rights is ambiguous. It would seem that they take precedence over national legislation; however, intergovernmental agreements do not have a prevailing status over domestic law in the Azerbaijani Constitution. Why the Azerbaijani government gave the BTC IGA a prevailing status is an outstanding question.

The Azerbaijani political structure is based on a presidential parliamentary system. However, due to the fact that the regime is unconstrained and uncompetitive; the Azeri state is widely regarded as authoritarian. The country ranks considerably lower than Turkey in with regards to personal liberty, civil rights and political rights. Although it has provided for a separation of powers, political institutions are not free. State bodies are controlled by an elite group close to the president. Furthermore, corruption in the country is endemic, particularly within the judicial system, while judges and prosecutors are assigned by the president, with the selection process determined by their closeness to the president and his family. Parliament itself is also under the influence of the executive branch.

Whenever new laws or PSAs are introduced by the executive, draft laws pass with suspicious speed through parliament. In Azerbaijan, there are no veto players within the state as the MilliMajlis (parliament) is a symbolic institution and there are no strong opposition political parties. Like their Turkish counterparts, public interest groups in Azerbaijan are weak and do not enjoy a consultative role in decision making processes. According to an interviewee ‘in practice, Turkey can be regarded as a country wedged between the Middle East and Central Asia and also appear to be a country not naturally inclined to truly democratic politics, in that the majority party is often absolutist and unresponsive to criticism in its policy making, however, what differentiates Turkey from Azerbaijan is its close relationship with member states of the European Union.’⁹⁴⁰

5. Conclusion

Through the analysis of chapter six, the guarantees available to private investors under the respective FDI laws and political regimes of Azerbaijan and Turkey were examined. The clear picture that emerges from an examination of the guarantees available to foreign investors under the FDI law of Azerbaijan and Turkey is that both countries’ present laws share the goal of providing a friendly investment environment. Providing a stable legal framework in FDI law and a predictable legislative and

940 Ibid

regulatory framework in PSAs have been key accomplishments of the Azerbaijani government. However, taking into account the country's commercial potential, Azeri FDI law is arguably an insufficient pull factor for foreign investors outside the oil sector. While on the one hand law on FDI offers assurance to investors regarding non-discriminatory treatment, stability in legislation, protections against risks such as expropriation and nationalisation, dispute settlement mechanisms, repatriation of profits and convertibility, on the other hand, corruption, red tape, an inexperienced and inefficient judiciary, and a poor track record for the enforcement of foreign arbitral awards detract from Azerbaijan's appeal. In addition, the country's heavy dependence on the petroleum sector has the potential to trigger social unrest and ensuing economic instability.

As stated above, Azerbaijan relies heavily on its rich oil resources and provides a number of guarantees through its PSAs. Paradoxically, the country has no petroleum legislation to execute and arrange these contracts. Instead, the contracts are drawn up as a result of negotiation between oil companies and the country's state owned petroleum company SOCAR. The Intergovernmental agreement is a treaty *per se* and is an umbrella legal document of the BTC pipeline project that aimed to create a prevailing regime for the pipeline project in each contracting state's domestic law. As mentioned above, in some cases where immediate actions are required, the Constitution of Azerbaijan enables the government to enter into intergovernmental agreement with other states.

On signing the intergovernmental agreement of the BTC project, Azerbaijan resorted to measures conventionally compatible with a situation of national emergency. In such situations, it is acceptable to enable the executive branch to enter into an intergovernmental agreement. Whatever the case, according to the Azerbaijani Constitution, what is not acceptable under any circumstance is that intergovernmental treaties be given prevailing status over domestic law. In doing so, in the case of the BTC intergovernmental agreement, the government ignored the hierarchical position of its national law as defined by its own Constitution.

The Azerbaijani HGA that was annexed to the IGA in the BTC project has the status of law as it was added to the treaty. The problem here is that the HGA is a concession or commercial contract and should be subject to private law and therefore cannot be regarded as an international treaty. The reason why the BTC Consortium's lawyers applied this method was perhaps lies in concerns regarding the weakness of the country's legal system and international arbitration for this type of agreements was not possible when the HGA was signed.

In essence, Azerbaijan consented to a stabilisation clause because this was the will of the authoritarian regime. The regime did not invite comment on this from the parties that would normally be consulted in a more developed and freer regime. The overriding objective of the regime was to secure investment for this project so important to their economic prosperity and political independence and their determination that this project go ahead silenced any other concerns. Indeed, the overwhelming will of authoritarianism serves as a guarantee to foreign investors, providing to them the security that the continuation of the project is so clearly in the interests of the regime it will use all of its might to ensure that it goes ahead.

Turkey managed to liberalise its economy by adopting new FDI legislation in 2003. The Law on the Encouragement of Foreign Capital it replaced also recognised the principle of national treatment to alien investors and the free transfer of profits derived from that investment. However, the old law did not provide guarantees against expropriation or nationalisation or a settlement of dispute mechanism. In the absence of these legal protections, doing business on Turkish territory was perceived to be too high a risk by many investors. This goes some way to explain why Turkey gave consent to a stabilisation clause in the HGA for the BTC agreement.

Article 90 of the Turkish Constitution regards international agreements and their related legal documentation (HGA) as having prevailing status over domestic law. It has been also emphasised that in the case of a conflict between the provisions of an international agreement and a domestic law, the same principles as those that are applied in determining the superiority between two domestic laws apply in order to determine which one prevails, and that is simply that only those that pertain to human rights can be given superior status.

The legal status of HGAs in the BTC project is another anomaly. These types of contracts are subject to administrative law or private law and not to international law. Notably, in most civil law systems, these types of contracts are subject to administrative law and the awarding authority is administrative courts. More significantly, when HGA and IGA agreements' impact on Turkey's national sovereignty is considered, these agreements should not have had a prevailing status over domestic law because their provisions contradict the state sovereignty principle provided by the Turkish Constitution. Indeed, the Turkish government and the political parties represented in Parliament should have considered this before they approved the BTC agreements.

The Intergovernmental Agreement of the BTC project was signed on 18 November, 1999. It is revealing that only nine months later, constitutional amendments were executed in Turkey to change the status of concession agreements from administrative contracts to private agreements so that they could become subject to international arbitration. It is conceivable that the BTC Consortium perceived the status of concession contracts under the Turkish legal system to be an obstacle which may have prompted them to privately lobby for the amendment of the Turkish Constitution before a host government agreement was signed between the consortium and Turkey. In order to ensure that access to international arbitration could be gained, and to facilitate the adoption of the concession contract (which clearly did not have public interest as its goal), it was imperative that Turkey amended articles which regulated the status of concession contracts.

There is a long list of other contributing internal factors that facilitated Turkey's acceptance of a stabilisation clause in its host government agreement for the BTC project among which are: the weak coalition governments' ineffective performance in legislative activities; its series of economic crises; the military's influential role on the executive branch and the weakness of public interest groups. In that respect, it can be said that a politically and economically chaotic and unstable environment influenced not only the attraction of foreign capital into the country but also adversely affected the country's bargaining position in BTC agreement.

Chapter 7

Conclusions and Recommendations

1. The Research Findings and Conclusions

Oil and gas related energy projects and the agreements forged to enable them to go ahead are inherently open to political risk. In fact, these projects are more vulnerable and susceptible to risk than perhaps any other sector in the business world. International investors in the petroleum industry have always been advised to equip themselves against a range of phenomena that may endanger their investment. In the twentieth century, common disruptors were mass expropriation, nationalisation and confiscation. These takings were motivated simply by high oil prices and the temptation of the economic gain to be had. The phenomena of the last century have lingered on into the present, although the frequency of their occurrence has lessened somewhat. The recently reported case of nationalisation in Argentina is a reminder to the investment community that such takings cannot be relegated to history. In the past two decades, resource nationalism has resurged and is linked to indirect expropriation. The explanation for this trend lies in a myriad of ideological, political and economic factors as outlined in chapter two, and perhaps most predictably, in the rise of oil prices.

Azerbaijan and Turkey have been described as one nation with two states with reference to their shared cultural heritage, although in many respects the latter has made more significant steps towards modernity in recent decades. Despite the economic and political challenges faced by each of these countries in the 1990s, neither state has ever attempted to expropriate or nationalise an alien investor's property rights or assets in their territory. According to interview respondents and literature, foreign investors seems to have found a friendly investment environment in both countries, however a host of unresolved issues can be found at the confines of the shielded oil sector, mainly: weaknesses in the judiciary system, corruption, bureaucratic inefficiencies as well as transparency issues all of which render doing business in these countries problematic.

Elsewhere, recent resource nationalism trends in Latin America (Bolivia, Venezuela) and in Russia have shown that the governments of these countries interfere either in the investment agreement either by changing the terms and conditions of that agreement, or by implementing new regulations or changing tax provisions with the goal of extracting more profit from their natural resources. The interviews conducted for this study, recent empirical studies and the information gathered from comprehensive literature were used to demonstrate that the most perilous contemporary political risk in the energy sector was found to be indirect expropriation. For this reason, a well drafted agreement which includes strategic contractual clauses designed to safeguard the financial commitment and smooth-running of the project has become a *sine qua non* requirement for investors. Stabilisation clauses have become the device of choice to fulfil this purpose.

In cases of indirect expropriation, the project is intervened in or indeed taken over by the host state with either unilateral state actions or with subtle state actions. In these scenarios the state aims to change the terms and condition of the agreements. However

the latter occurs slowly and aims to exclude investors from the project gradually. Imposing a discriminatory tax regime, interference with the management rights of the investor, interference with contractual rights, revocation of licence and denial of permits are all typical examples of indirect expropriation. It has also been found that measures related to environmental or human rights issues have also been used by host states as justification for interference in the energy sector.

A reliable litmus test to distinguish between non-compensable regulatory state measures (in the area of environment, human rights, health and safety) has not yet been identified by tribunals and consequently remains a significant and unresolved issue in the agenda of international law. Furthermore, the analysis of bilateral investment treaties of Azerbaijan and Turkey showed that expropriation or nationalisation clauses exist in both states' BIT models. Nevertheless, the definition of indirect expropriation could not be found in their bilateral investment treaty models. Although both countries have recently entered into such agreements with different countries; there is no evidence that they have adapted or improved their treaty models.

There are various contractual mechanisms included in oil and gas contracts to minimise risk, many specifically targeting indirect expropriation to protect foreign private investors and to have a stabilising effect on the host state investment environment. Stabilisation clauses are one of the most frequently applied contractual clauses in international investment agreements, taking their place alongside arbitration clauses and choice of law clause. There is no doubt that stabilisation clauses preserve the fiscal regime over the course of the project and reduce the political risk which may affect the economic return of the investment. Stabilisation clauses are valid under international law.

However the validity of these clauses under national law is still a conundrum because laws or legal constraints in the constitution of the state may have significant legal implications for the validity and enforcement of stabilisation clause. For this reason, international energy investors seek to internationalise contracts. Nevertheless, it should not be forgotten that even if the contract between the parties is governed by international law, the law will not offer full assurances of stability for the contract because it is recognised in international law that a sovereign power has the right to intervene in a contract when significant interests are at stake. This should not be taken to mean that stabilisation clauses have no effect in risk management against unlawful expropriation or nationalisation or indirect expropriation. They have a legal value and effect against any state actions that can be deemed illegitimate or unlawful.

The cited international arbitral awards verified that stabilisation clauses are valid and enjoy legal status in international law. The question is whether stabilisation provisions can preclude host states from lawful expropriation or nationalisation. There is no hindrance to states from interfering in an on-going project by nationalising or expropriating the property of an investor, if the grounds of the intervention are rooted in public interest and as long as adequate compensation is paid.

Sovereign states may fetter legislative activities and promise that the property of foreign private investors will not be nationalised or that unilateral action will not be undertaken during the life span of the project agreement. However host states cannot be required to forgo their sovereign rights in the areas of human rights and environmental concerns because these are the non-assignable and inalienable rights which stem from

international treaty obligations. The reasonable solution would seem to be to narrow or limit the scope of the stabilisation clause in the areas of human rights and the environment. Recently adopted, modern BITs seem to have successfully excluded measures relating to these areas and, in some cases, explicitly assert that measures taken in these areas cannot amount to indirect expropriation.

Despite the provisions for host state sovereignty outlined above, in the agreement signed for the BTC project, the Republic of Azerbaijan, Georgia and Turkey effectively abandoned these irrevocable rights by agreeing not to implement any measures in the area of human rights and environment, health and safety during the life span of the project agreements. They agreed that the adoption of new laws in the aforementioned areas would constitute a violation of their commitment to stability in the project agreement. These commitments naturally came under fire from NGOs and the companies involved in the project responded by issuing a legal document called the Human Rights Undertaking. This undertaking guarantees that the consortium participating in the BTC project will not require compensation if these states adopt new laws in the area of human rights and the environment or in the interests of health and safety.

By the Human Rights Undertaking, the BTC Company gave guarantees that it would not apply the compensation clauses in the IGA and HGAs if one of the host states involved in the project legislated in the interests of human rights, environment, health and safety. From that perspective, it might be said that the Human Rights Undertaking represented a breakthrough and was an innovative work, commissioned by the BTC Company as an expression of their sensitivity towards Human Rights issues. As this action resulted in a restriction of the reach of the stabilisation clause in the BTC agreements, host states were thereby rendered freer to legislate. In addition, the BTC consortium attempted to limit the scope of the stabilisation clause in certain areas by this undertaking. Notwithstanding, it is the case that, to date, none of the signatory states of the project has proposed or passed new laws in the areas of human rights and the environment to test this hypothesis.

This study has argued that internal and external driving forces trigger the inclusion of stabilisation clauses in investment agreements. The findings relating to external factors demonstrate that lenders, political risk insurance providers and credit rating agencies play a significant role in the insertion of stabilisation provisions in investment agreements. In the event of risks, such as change of law, introduction of new regulations, expropriation or nationalisation, the inclusion of stabilisation clauses is held to be an indispensable contractual requirement for investors. The inclusion of stabilisation clauses also better an investor's chances of securing the substantial loans required to fund major projects, such as trans-national oil and gas pipeline projects. Indeed, the financial institutions able to grant such funds demand that risks are managed to secure the prospect of repayment. Moreover, it was found that financial lenders have a 'behind the scenes', nevertheless, highly influential role in deterring host states from introducing new laws that may affect the sustainability and the cost of the project. On their part, it was observed that lenders would never consider to fund or commit to a project without political risk insurance cover.

It was established that insurers involved in projects provide arbitral award default coverage of stabilisation provisions as a safety net for their clients in the event a host state fails to pay compensation triggered by the violation of stabilisation provisions.

National insurance institutions can wield subrogation rights against host states to pressurise them to make payment. In practice, this means that insurers may use their third party rights to compel the host state to reimburse overdue compensation payments in situations where insurers have provided the missing funds to the investor in lieu of the host state's payment. While this third party right is recognised in law, not uncommon, practice of asserting this right before an arbitral tribunal has passed judgement on whether the state's action actually violated stabilisation provisions is questionable, however.

The final external factor presented by this study was the role of credit rating agencies in indirectly advocating the insertion of stabilisation clauses. It was observed that the chief role of these organisations in an investment scenario is to evaluate the risk of lending for sovereign countries and multinational organisations. In this evaluation, the legal framework that underpins the investment agreement between host state and foreign investor may also be taken into consideration. It was made evident that the existence of a stabilisation clause in an agreement maximises the chances of that project winning the commitment of lenders who will consult the information made available to them by credit rating agencies.

The study has provided that the reach of the stabilisation clause in the form of economic equilibrium is much broader than is conventionally acceptable in the BTC project. In this context, whenever a host state affects the economic equilibrium of the project as a result of changes in law they have to pay compensation to the consortium, even when those changes are made in the interests of human rights and the environment. This effectively inhibits the host countries in question from honouring their international law obligations and can be characterized, at the very least, as over-zealous protectionism on the part of the investors and other stakeholders. Although the project consortium lawyers were directly responsible for preparing the legal framework for each contract; these legal professionals were merely following the requirements of their clients. The consortium, for its part, sought to satisfy the World Bank group (particularly the IFC and the MIGA amongst others), the EBRD and the other ECAs, in order to receive the project loan and to gain insurance for this major project. It was also found that diplomatic power of the European Union, the United States, the World Bank, and the EBRD were also highly influential on Azerbaijan, Georgia and Turkey during the during the creation of the legal agreements.

The research has also assessed the bargaining position held by each state and noted its interests in the BTC project. In the case of Azerbaijan, as the most significant possessor of natural resource, the country's bargaining position was relatively stronger than Georgia and Turkey. However, Azerbaijan's on-going dispute with Armenia over the Nagorno Karabakh territory was a major drawback from the perspective of investors. Azerbaijani expectations of the BTC project were both financial and territorial and the two were interwoven. It was hoped by the Azeri authorities that any economic benefit gained from the project could be used to fund military action against Armenia so that the country could definitively win power over the Nagorno Karabakh region.

The singular strength of Georgia was its unique position, in light of the dispute between Armenia and Azerbaijan, to act as a conduit country for the natural resources. The weakness of the country was an on-going Russian threat, as were its fragile economy and poor standard of living. For Georgia, the BTC project had both strategic and economic value. In the case of Turkey, the potential enhancement of its strategic

partnership with its diplomatic partners in the EU and the US overshadowed any economic benefits to be had. In any case, Turkey's prospects for financial gain for the project were more modest than those stood to be had by Azerbaijan and Georgia.

The political structure and guarantees available to foreign investors in Azerbaijan and Turkey were the internal driving forces that led them to agree to stabilisation clauses in the BTC project. In the case of Azerbaijan, the 1992 law on FDI provided guarantees to foreign private investors regarding non-discriminatory treatment, legislative stability, protections against risks such as expropriation and nationalisation, dispute settlement mechanisms, repatriation of profits and convertibility. However, in practice, investors face major challenges in dispute settlement, particularly in terms of achieving the repatriation of their profits. In addition, FDI law does not define the term 'concession' and those concessions to be had are limited to natural resources. In fact, there is no concession law, as such in domestic legislation. In Azerbaijan, endemic corruption, obstructive bureaucracy and the inexperience of judges all contribute to a very low rate of foreign arbitral award enforcement. In the oil sector, guarantees and assurance are given to foreign investors via PSAs. When these agreements are signed by the president, they take on the status of law and enjoy prevailing status over domestic law. Somewhat surprisingly, no existing petroleum legislation was found to regulate these types of contracts. In addition, it was observed that the legal status of intergovernmental treaties do not possess a privileged status over domestic law. By signing the IGA of the BTC project, the government of Azerbaijan technically breached the hierarchical status of national laws over intergovernmental treaties asserted in its own constitution.

An analysis of the political structure of Azerbaijan has evidenced that the President of the country is the absolute power. The judicial branch is weak and the legislative organ is under the influence of the executive branch. The absence of strong veto players, strong political parties or opinion-leading public interest groups left the actions of the executive unchecked.

In the case of Turkey, the law on FDI, implemented in 2003, can be seen as a breakthrough. The law provides a number of safeguards to foreign private investors, in the interests of exactness it would be advisable for several minor amendments to be made, particularly regarding the provision of definitions of 'investor' and 'expropriation'. Comparisons between the Law on the Encouragement of Foreign Capital and the new FDI Law demonstrated that guarantees against expropriation or nationalisation and the settlement of dispute mechanism were not available under prior FDI law in Turkey. It can be surmised that when the BTC project agreements were signed, these omissions must have been regarded as an unwanted complication for the consortium. Furthermore, international agreements and host government contracts have a higher status in legal hierarchy than domestic law. Notably, a HGA is a concession contract and subject to either administrative or private laws. Before the project agreements of the BTC projects were signed this type of contract would have been subject to national administrative law. The disputes that arose from concession contracts between foreign investors and the relevant administration used to be managed by national courts rather than by international arbitration courts in the past. Proof that this was seen as a major hurdle is provided by the fact that the project consortium lobbied the Turkish authorities to make constitutional changes to the status of concession contracts in order to render them subject to private law. It was also found that there is no law on concession in Turkey.

An analysis of Turkey's political regime has provided that several factors contributed to Turkey's weak bargaining position on signing the BTC agreement. These included: a series of weak coalition governments' unsuccessful performance in legislative activities; a chaotic investment environment marred by two dramatic economic crises in a short period; the president's strong veto power in government decisions coupled with the military's excessive control over executive domestic and foreign policies; all unchecked by any significant pressure from public interest groups. While more recently, the stranglehold of the military over politics has diminished, the exclusive veto powers of the president still constitute a barrier to the modern concept of democracy. The 10% threshold imposed by the 1982 Constitution still constitutes a major problem for the country's future. In addition, public interest groups and political opposition parties are still weak and do not play an active role in decision making.

2. Recommendations

Recommendations deriving from the findings of the present study are as follows:

With respect to indirect expropriation and Stabilisation clauses:

(1) What has been gathered from comprehensive literature, empirical studies and the interviews conducted for this study is that in all probability the energy industry will continue to be exposed to political risk. What can be done to shield investors from political risk? A risk assessment of the host state needs to be carried out, taking into account both historical factors and its current situation with a view to foreseeing the potential disruption to operations oil companies could experience as a result of these. Such an analysis would enable investors to determine which contractual clauses would be most effective in mitigating those risks.

(2) Although indirect expropriation is inarguably the most menacing destructive and form of risk; there are means in existence to prevent its occurrence and to mitigate its effects. The insertion of stabilisation clauses in the investment agreement is generally the most effective in discouraging host states to interfere the project unlawfully.

(3) A sovereign state should be free to exercise its sovereignty by regulating on matters that have a direct effect on the standard of living and safety of its citizens and its territory such as the environment, human rights and health and safety. Stabilisation commitments in investments agreements cannot force a host state to relinquish its international treaty obligations in these areas. For this reason, stabilisation clauses should be fair and flexible. More significantly, the aforementioned areas of jurisdiction should be singled out from the scope of any stabilisation commitment. Referencing the inalienable rights of a host state to freely legislate in these areas independently of any other commitment in the investment agreement would help avoid any ambiguity and would inhibit an investor from lodging indirect expropriation claims on this basis.

(4) Developing countries' economies are mostly fragile and unsteady. Therefore contract drafters should take this factor into their account. Inserting a broad stabilisation clause may lead host state to breach the terms and conditions of the contract and triggers

resource nationalism in that country. Rather than designing a firm contract, energy investors should attempt to bring flexibility and stability together in one clause.

(5) When international tribunals are evaluating whether a measure taken by a host state amounts to expropriation it would be advisable for them to apply both sole effect doctrine and police power notion in order to achieve a balanced assessment, as the use of only the former would suggest a bias in favour of alien investors, while the latter takes into consideration the state's right to regulate. Perhaps this combination of doctrines constitutes the fairest approach, removing the uncertainty around the question of distinguishing a non-compensable regulatory measure from indirect expropriation.

(6) Most of the cited cases demonstrate that the inclusion of stabilisation clauses in investment agreements is valid and has legal standing in international law. These decisions can serve as useful future reference for cases examining the validity of stabilisation clauses under international law; however it would not be appropriate to regard the outcomes of any of these tribunals from a 'one size fits all' perspective as each case should be considered by tribunals taking into account each stabilisation provision's *sui generis* character.

With respect to Azerbaijan and Turkey:

(7) Pervasive corruption, obstructive bureaucracy, issues regarding transparency and weaknesses within the judiciary system are the concerns that foreign investors are issues foreign businesses meet with when doing business with Azerbaijan. The recently adopted anti-corruption law is undeniably a breakthrough but the government could go further to demonstrate its commitment to change and maximise its potential to attract foreign investment by initiating an anti-corruption campaign. In addition, it would be advisable for the government to work with the WTO and the OECD with this objective in order to benefit from their knowhow and to make it known in the international arena that the country is seriously committed to change. Under the guidance of these organisations, Azerbaijan would be very visibly working towards bribery in international business and with their advice could implement effective anti-corruption laws and criminalise the bribing of public officials.

(8) The Azerbaijani government should extend the reach of their BITs by entering into agreements with more states. This measure would increase their chances of attracting international investors into the country. It is to be recommended that both Azerbaijan and Turkey modify their BIT models as the current iterations do not define the phenomenon of indirect expropriation. Should this omission be addressed, it would provide further reassurance to potential investors that the countries' acknowledge their concerns and are committed to transparent dealings.

(9) The definition of a foreign investor in Turkish FDI law should be amended as currently it does not explicitly provide for the situations of those individuals who hold Turkish citizenship and lives permanently or temporarily in Turkey, while at the same time have the status of a shareholder of a foreign entity incorporated abroad. It can be recommended that the article defining foreign investors should be amended to read: a *Turkish national who is a resident abroad or in Turkey; a stakeholder of a foreign legal entity formed in accordance for a foreign legal system is also accepted as foreign investor.*

(10) Azerbaijan's FDI is dated and is unspecific and incomprehensive. Turkey's FDI is, arguably, adequate in comparison, but would still benefit from some minor amendments. For instance both states' FDI laws regulate for expropriation phenomena in stating that a taking can be made only for public purpose. However neither of the states provides a definition of public purpose. The researcher would suggest that the insertion of the following sentence, or a differently-worded sentence to the same effect, would achieve greater clarity: *Public purpose in this article includes cases of persons that will cover any business or corporation or individuals. Their property shall be expropriated for purposes useful for the general public are roads, parks, schools, hospitals, other public buildings.*

(11) The Azerbaijani government should either establish a specific institution for the training of economic court judges to educate them in the settlement of disputes in international commercial cases and provide practice of the same or judges should be drafted onto a compulsory training program abroad. The latter would enable native professionals to gather knowledge of how judges deal with commercial cases abroad that can be adapted to suit the needs of Azerbaijan. In the case of Turkey, the government should establish specialised courts designed to deal solely with disputes between domestic entrepreneurs and international investors. This would alleviate the load of overburdened local courts and reduce the waiting times for cases to be dealt with, meaning there would be a greater chance that such cases could be dealt with in a Turkish court, rather than being escalated to international courts.

(12) Governments of both countries should urgently implement a well-drafted concession law. This would establish a legal reasoning for the types of contracts based on concession. Similarly, host government contracts entered into for the BTC project are commercial or concession contracts; thus they should be subject to administrative law. Both governments should make constitutional modifications to remove the right of international investors to apply to international arbitration for these types of concession agreements.

(13) The Azerbaijani government should urgently implement petroleum and pipeline legislation. If a new specific petroleum law is implemented, there may be an argument for its reach not extending to previously signed PSAs but future agreements should definitely be provided for. It is of great significance, from the perspective of Azerbaijan's international reputation and in terms of properly exercising its rightful powers that the government limit the activities of the SOCAR Company in defining PSAs. In this respect, new petroleum laws should explicitly restrict SOCAR's powers.

(14) The legislative organ in Turkey should immediately add a paragraph to Article 90 of the Turkish Constitution to emphasise the legal status of international treaties other than human rights. An amendment to Article 90 should provide an equal hierarchical weighting for both international and domestic laws. In the case of conflict between the provisions of national and international treaties, perhaps the best method is to follow the same principles as those that are applied in determining the superiority between two domestic laws in order to determine which one prevails.

(15) The legislative branch of Azerbaijan should implement new petroleum laws to run the country's PSAs. The existing Subsoil Law and Energy Act should also be restructured by the legislative organ because these laws are uncoordinated and the provisions are mostly inconsistent with each other. In a hierarchical sense, the Energy

Act should have superiority over the Subsoil Law. Nevertheless, there is no particular wording to state whether the general Energy Act has priority over the Subsoil Act or not. Therefore, the legislative branch should not take for granted the correct application of these laws and, instead ought to articulate a clear hierarchical distinction between these two laws. In the case of Turkey, the recently adopted petroleum law seems to accelerate FDI flow into the country, as it is more flexible than the previous petroleum law in operation. On the other hand, the new petroleum legislation could go a lot further in terms of the protection offered to indigenous people and the environment. It would be advisable to take a consultative approach, seeking the advice of NGOs and actively soliciting public opinion.

(16) The Turkish government, and other political parties in parliament, should strive to reach a consensus on the need for reform of the political structure and conduct a referendum. Perhaps the most appropriate model for Turkey is the presidential system. This type of political regime may provide more transparent and accountable governance in the country.

(17) Both Azerbaijan and Turkey should prepare a reform package which invite and encourage public interest groups to participate in decision making processes. Perhaps the most important step that can be taken is to make funds available to these organisations to enable them to raise their profile and attract membership to ensure they are truly representative of the civilian population. In order to execute these reforms, both governments should collaborate with the EU.

(18) With the exception of Azerbaijan, which does not have a threshold restriction under its constitution, constitutional amendments should be made, particularly by Turkey, to reduce the threshold from 10% to at least 5 % or remove this completely. A survey of the average threshold restriction in modern democracies would guide the Turkish government towards a more reasonable limit.

In conclusion, indirect expropriation cannot be entirely eradicated; however the risk of it can be mitigated somewhat through the insertion of stabilisation clauses. The stabilisation technique used against indirect expropriation seems to have been applied for many years by energy investors because such risk emerges not only economic reasons but also politic and legal issues. The resulting evidence, obtained through the knowledge of the sector held by interview participants, is that apart from economic protectionism, a set of key internal and external factors actively conspire to induce the inclusion of such clauses. Generally, it is difficult to ascertain whether the driving forces discussed in this work are the same ones that influence every host state to accept stabilisation clauses in each oil and gas project. However, selected countries in the BTC project have successfully proved the influence of these key factors.

The researcher of the present study hopes that the research has successfully addressed the questions posed and that the analysis provided stimulates further studies into other related issues which have not been discussed or to apply methodologies not utilised for this work. This research has conducted an empirical investigation through interviews and a comparative analysis of Azerbaijan and Turkey to understand how internal and external forces have been influential on these countries to agree

stabilisation clauses in the BTC project. Further research into stabilisation clauses might look afield to petroleum producing countries from other regions to better understand how internal and external factors conspire to promote the inclusion of stability in their investment contracts. The transferability of the research findings could be enhanced by extending the sample of interview participants in international petroleum companies, non-governmental organisations, law firms, financial institutions, insurers, government bureaucrats and academics from all over the world. Additionally, further research into stabilisation may also focus on landlocked oil and gas importer Turkic countries in the Caucasus region and may introduce the question of how their geographic disadvantages affect their bargaining position in the contract negotiation with western oil companies.

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APPENDIX

Interview No	Name	Position	Place of participation	Date of participation
1	Anonymity Guaranteed	Anonymity Guaranteed	Ankara	8-5-2012
2	Anonymity Guaranteed	Anonymity Guaranteed	Ankara	9-5-2012
3	Anonymity Guaranteed	Anonymity Guaranteed	Ankara	14-5-2012
4	Anonymity Guaranteed	Anonymity Guaranteed	Ankara	14-5-2012
5	Anonymity Guaranteed	Anonymity Guaranteed	Ankara	11-05-2012
6	Anonymity Guaranteed	Anonymity Guaranteed	Ankara	14-5-2012
7	Batuhan Uzel	Lawyer	Istanbul	6-6-2012 & 12-11-2012
8	Zeki Sahin	Associated Professor of International Business and Economics Law at the Faculty of Law of Cankaya University	Ankara	4-6-2012 & 8-11-2012

9	Seyfi Yildiz	Account manager	Istanbul	25-06-2012 & 2-1-2013
10	Ozer Arda	Lawyer	Istanbul	5-11-2012
11	Didem Toros	Commercial Court Judge	Ankara	11-1-2013
12	Can-Okan Civaci	Senior Assistant Specialist at Commercial Loan Division	Istanbul	9-1-2013

The Republic of Turkey

Interview No	Name	Position	Place of participation	Date of participation
13	Nadia Rahmoune	Account Manager	London	5-12-2012
14	Anonymity Guaranteed	Anonymity Guaranteed	London	8-12-2012

The United Kingdom

Interview No	Name	Position	Place of participation	Date of participation
15	Anonymity Guaranteed	Anonymity Guaranteed	Baku	15-11-2012
16	Rashad Abbasov	Lawyer	Baku	21-11-2012
17	Samir Kazimov	Lawyer	Baku	22-11-2012
18	Murat Abdullayev	Lawyer	Baku	21-11-2012
19	Serhat Eskiyoruk	Assistant Professor of Commercial Law at the Faculty of Law	Baku	23-11-2012
20	Taylan	Foreign Trade Expert	Baku	26-11-2012

	Kandemir			
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The Republic of Azerbaijan