

# CHAPTER I

## INTRODUCTION

### 1. Background

As the world becomes more liberalize in trade and investment, many countries intensify their efforts to attract FDI. Host state will offer overall package to attract foreign investor including legal arrangement as a part of the package. Legal arrangements will define the manner of how the investment will share its costs and benefits, including the terms and conditions of foreign investment.

Once a long term and capital investment is being made, the financial successful of the investment project will rely on the investor's ability to achieve projected cash flows, whilst, the investor is vulnerable to host government action that may undermine such financial viability or even expropriate the investor's assets.

Certainly, to investors legal arrangements are important to protect their investment from potential risks and to ensure stability of the regulatory framework governing their activities. International investors can foresee to face a diversity of risks in the course of their investment since all the investments certainly come with risks. In addition to the risks typically associated with all types of investments, international energy investors face a number of additional political risks because of the nature of their investment. That is because the international energy projects, including oil and gas

exploration, for the most part operate in some of the world's more unpredictable and unstable environments which made them volatile by reason of the fact that they face high political risks. Such risks may not only arise at the initial stage of an investment, but also last for the lifespan of an investment project.<sup>1</sup>

Looking to Fraser Institute analysis of the 2016 petroleum survey results indicates even though the inducement for foreign investor to make an investment is considered freely from the reserve size of jurisdictions (historically the primary focus of this survey), survey indicates that jurisdictions with first 1/5 of policy perception index scores, suggesting that the most relevant hurdle to investment are lower than in any other state jurisdictions examined by the survey are almost the jurisdictions located in Canada, the United States, and Europe.<sup>2</sup>

According to the latest survey in 2017, the 10 most attractive jurisdictions for investment globally are Oklahoma, Texas, Kansas, Saskatchewan, Wyoming, North Dakota, Norway-North Sea, Mississippi, Utah, and Montana. All but three of these jurisdictions-Wyoming, Utah, and Montana ranked in the worldwide top 10 in the 2015 survey. The 10 jurisdictions that are the least indulging for investment are (starting with the worst): Venezuela, Quebec, Libya, Bolivia, New Brunswick, California, New South Wales, Ecuador,

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<sup>1</sup> Sarah Peck, and Sarah Chayes. "The Oil Curse: A Remedial Role for the Oil Industry." Carnegie Endowment For International Peace. September 30, 2015. <http://carnegieendowment.org/2015/09/30/oil-curse-remedial-role-for-oil-industry-pub-61445>. Accessed November 8, 2017.

<sup>2</sup> Jackson, Taylor, Kenneth P. Green, and Kyle Sholes. "Global Petroleum Survey ." Fraser Institute. 2016. <https://www.fraserinstitute.org/sites/default/files/global-petroleum-survey-2016.pdf>, p. 2. Accessed November 8, 2017.

Ukraine, and Russia. Fraser Institute analysis of the 2016 petroleum survey results indicates that the increasing of negative sentiment is related to the key factors of petroleum investment decisions which have been increased somewhat in many of the world's regions.<sup>3</sup>

The United States continues to remain as the most attractive country for investment, followed next by Australia, which moved ahead of Canada this year. Canada's fall to the third most attractive region in the world for investment is reflective of Alberta's continued deterioration, as investors continue to view the province as less attractive for investment.<sup>4</sup>

Furthermore, based on Policy Perception Index Rankings Segmented According to Jurisdictions' Proved Reserves Fraser Institute Global Survey 2016, while it is certainly useful to measure the attractiveness of jurisdictions for investment according to regulatory climate, political risk, production taxes, quality of infrastructure, and the other factors which respondents are asked to address, simply ranking jurisdictions according to their Policy Perception Index scores alone does not recognize the fact that decisions to invest in petroleum exploration and development are heavily conditioned by the size of the oil and gas resources that are generally recognized to be available for exploitation.<sup>5</sup>

For the context of an example from a country which have been known for a very long time as a rich-petroleum resources country in Indonesia the history of oil and gas production has a long and relatively successful proven achievement, under the given fact that this particular sector historically

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<sup>3</sup> *Ibid*, p. 11.

<sup>4</sup> *Ibid*, p. 11.

<sup>5</sup> *Ibid*, p. 11.

characterised by its relatively stable movement and well-accepted regulatory framework. Indonesia also known as an international pioneer of setting a standard in many areas of oil and gas industry, including the first establishment of the PSC model and the successful of commercialisation of liquid natural gas.

However, just like what happens in the most part of the world, petroleum industry in Indonesia is now facing a changing stage, alongside with a growing domestic need for gas not only for industrial use but also for consumer use, the starting of liquid natural gas imports and the construction of further liquid natural gas re-gasification facilities, these whole situation is under the atmosphere where the global low crude oil prices still exist. The overall of Indonesia's opportunity profile and production has also shifted away from the beginning is an oil that becomes the leader of the industry and now towards natural gas this is actually becomes a global trend which may eventually formed permanent shift in the industry. Briefly we can say that the era of relatively stable movement in this sector has probably elapsed.

At the present, most of Indonesian oil production is now being extracted from old oil fields, as a result of that situation, Indonesia became a net oil importer in late 2004, and with regards to the positioning of the oil and gas industry right now, almost everyone probably aware that crude oil production in Indonesia has been on a descending trend for the past decade.<sup>6</sup> Government efforts to further stimulate exploration through offering new oil and gas block and a joint study facility, as well as incentives offered in the form of improved

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<sup>6</sup> "Oil and Gas in Indonesia Investment and Taxation Guide." PWC. 2017. <https://www.pwc.com/id/en/energy-utilities-mining/assets/oil%20and%20gas/oil-and-gas-guide-2017.pdf>. Accessed November 8, 2017.

splits, have yet to come successfully even though Indonesia has marked a successful effort in emerging its gas reserves in the past time. As further matters, the global low oil price trend has also made the investment slightly unattractive for companies to invest in a high costly and risky exploration project in Indonesia during the past two years. However, this cannot be used as an excuse any longer because on the global level investment in the upstream oil and gas sector is projected to rise to USD \$450 billion in 2017.<sup>7</sup>

When Indonesian government tendered 14 working areas for oil and gas exploration in 2016, investors were only interested in one of the offerings. Although on the decline, Indonesia's upstream oil and gas sector still accounts for 3.3 percent of Indonesia's GDP.<sup>8</sup> Moreover, it is estimated that for each USD \$1 million that is invested in the oil and gas sector, Indonesian GDP expands by USD \$0.7 million (the so-called multiplier effect). Hence, even though the Indonesian upstream oil and gas industry now only contributes less than five percent to total state revenue, it does not mean that this industry plays an insignificant role in the economy and can therefore not be neglected.

According to the contributors of the Indonesian-Investments by Van der Schaar Investments B.V. in Delft, after we look closely to the Indonesia's upstream oil and gas sector over the past couple of years, there are several conclusions that we can outlined: In 2014 total direct investment realization in Indonesia reached IDR 541.3 trillion (excluding the oil and gas sector). In that same year investment in Indonesia's upstream oil and gas sector stood at IDR

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<sup>7</sup> Simon Flowers. "Global upstream investment – set to rise in 2017." Woodmac. December 8, 2016. <https://www.woodmac.com/news/the-edge/global-upstream-investment-rise-2017/>. Accessed November 8 2017.

<sup>8</sup> <http://www.bi.go.id/sdds/>

275.4 trillion. The first preliminary conclusion here is that investment in the oil and gas sector is actually quite big in relation to total direct investment but not necessary successful because USD \$4 billion was wasted between 2002 and 2016 without finding reserves that were suitable for commercial exploitation. However, in the years 2015-2016 we are seeing two separate trends. While direct investment continued to grow, investment in the oil and gas sector continued to decline. In 2015 total direct investment grew to IDR 574.7 trillion, while investment in the oil and gas sector fell to IDR 206.6 trillion. One year later, this trend persists: in 2016 direct investment grew to IDR 607.3 trillion, while investment in the upstream oil and gas sector fell to IDR 151.2 trillion. Although it is too early to tell, this last figure may decline to IDR 110 trillion in 2017 as investment realization in oil and gas has remained weakening.<sup>9</sup>

A decreasing investment in oil and gas is a major problem for the sustainability of energy sectors in Indonesia since with its limited exploration activities Indonesia will likely failed to significantly boost its oil and gas production. The introduction of the gross split scheme by the Indonesian government at the beginning of 2017 might lead the investment situation to be even more difficult. Through the gross split scheme, which replaced the cost recovery scheme for the new PSC, the Indonesian government will generate earnings from (as part of) gross profit as well as tax revenue from contractors' activities in the upstream oil and gas sector without requiring to reimburse the

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<sup>9</sup> "Upstream Oil & Gas Sector of Indonesia in Alarming State?" Indonesia-Investment. July 31, 2017. <https://www.indonesia-investments.com/business/business-columns/upstream-oil-gas-sector-of-indonesia-in-alarming-state/item8046>. Accessed November 8, 2017.

exploration and production costs to contractors, as it was the case under the current cost recovery scheme.

Globally, the willingness of investors to fund the exploration and exploitation of oil and gas is determined by looking at the regulation aspect in one country. Investors with all the risks that they must bear will ask for certainty in terms of legal framework and regulations from Indonesian government. The main question the investor would ask is whether the regulation is consistent or not. It is mandatory for them since the certainty and consistency of regulation will affect the calculation of their project economics. Investors would also seek for the certainty whether the regulation is honouring the contract sanctity or not, in which it is aligned with the survey result from Price Waterhouse Cooper which indicated the most critical challenges that Indonesian government need to address as follows:

- 1) Greater consistency in the policies and vision for the industry from the Ministry of Energy and Mineral Resources, Ministry of Finance and Ministry of Industry; and
- 2) Certainty in regard to contract sanctity and the terms and conditions surrounding PSC extensions.<sup>10</sup>

As we all know, both international and domestic oil companies struggle with the risk of changes to the fiscal and any other related policy terms of petroleum cooperation agreements signed with the host state which may directly affect the commercial viability of the exploration and exploitation project as previously contended. Investor since the starts of the

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<sup>10</sup> Oil and Gas in Indonesia Investment and Taxation Guide. PWC. 2015. <https://www.pwc.com/id/en/energy-utilities-mining/assets/oil%20and%20gas/oil-and-gas-guide-2015.pdf>. Accessed November 8, 2017.

commencement of their petroleum exploration and exploitation projects trying to find risk mitigation tools for protection against possibility in the future that the host state might review the initial terms of their signed petroleum contract.

Legal arrangements to promote regulatory stability include provisions of general international law, such as those concerning the regulatory taking<sup>11</sup> doctrine, and project specific commitments embodied in foreign investment contracts between foreign investors and host states (stabilization clauses).<sup>12</sup> The host government commits itself not to change the regulatory framework in a way that affects the economic equilibrium of the project, and to compensate the investor if it does so.

According to the “International Primer” published by the Independent Petroleum Association of American in January 2002 in Chapter III, paragraph 2 of the International Primer stated that in the "...context of an international oil and gas venture, political risk can be defined as any factor outside the technical aspects of exploration, development and production operations...other than Acts of God, which may reduce or destroy the value of the oil and gas assets".<sup>13</sup>

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<sup>11</sup> Regulatory taking doctrine under international law, host states have the sovereign right to expropriate assets and to regulate activities within their jurisdiction, based on the principle of permanent sovereignty of states over natural resources. However, international law sets conditions with which host states expropriating foreign investors' assets must comply. Namely, takings must be for a public purpose, in a non-discriminatory way, on the basis of due process, and against the payment of compensation. These requirements are spelled out in a large number of international instruments, bilateral investment treaties, and arbitral awards. They are widely regarded as being part of customary international law, although controversy still exists on the international standard of compensation, see Cotula, Lorenzo. 2008. Article “ Reconciling Regulatory Stability and Evolution of Environmental Standards in Investment Contracts: Towards a Rethink of Stabilization Clauses”. JWELB, p. 2. Accessed November 1, 2017.

<sup>12</sup> *Ibid.*, p.2.

<sup>13</sup> Dr. Alfred J Boulos, "ASSESSING POLITICAL RISK." Proceedings of NAPE@ International Forum, George R. Brown Convention Centre, Houston, Texas. January 28, 2003. <http://www.ipaa.org/wp-content/uploads/2017/01/PoliticalRisk.pdf>. p. 7. Accessed November 8, 2017.



Political risk in any oil and gas investment in a foreign country is including the possibility that the oil company investment will be expropriated, nationalized or otherwise unilaterally changed by the foreign government to the detriment of the oil company,<sup>14</sup> Also there are several recent precedent of host state unilaterally action towards international energy operations in some Latin American countries such as Bolivia, Venezuela, Ecuador, and elsewhere in the face of ever-increasing energy prices are the reminiscing of the 1970s events of nationalization and expropriation of investments of many investors in many host states.

Also considering the importance role of oil and gas sector it must be controlled and administered by state and dedicated for prosperity of the many hence stability and sustainability of oil and gas industry must be maintained. To achieve the purpose, host state commitment in establishing consistent law enforcement, policy, and legal certainty, pursuant to the principle of good corporate governance practice to create a friendly environment for investment in oil and gas sector is a must.

Hence, this thesis will be discussing legal issues behind the growing concern surrounding the needs of stabilization in international energy contracts regarding the fact that political stability and regulatory inconsistency includes as two factors among several other factors which creates an investment barrier according to the Fraser Institute<sup>15</sup> which in fact there is a decreasing number in direct investment in oil and gas globally, in which it is closely related to the nature of relationship between investor and the host state

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<sup>14</sup> *Ibid*, p. 8.

<sup>15</sup> Jackson, Taylor, *op.cit.* p. 6. Accessed November 8, 2017.

which is often exposed to various political, economic risks, especially in developing countries.

In line with the abovementioned issue, according to the Directorate of Trade, Investment, and International Economic Cooperation Ministry of National Development Planning/BAPPENAS Indonesia Strategy there are 7 steps which include in the effort of improving the investment climate and business climate in Indonesia as follows:

- 1) Improvement of legal certainty related to the investment and business
- 2) Simplification of investment and business permitting procedures in the central and regional
- 3) Development of investment services, for example by the development of Central One Stop Services (OSS)
- 4) Incentive and investment facilitation
- 5) Establishment of investment forum
- 6) Improvement of employment climate to be more conducive
- 7) Improvement of fair business competition<sup>16</sup>

As we can see in point 1 according to BAPPENAS the legal certainty is one of the factors that need to be improved to attract the investment comes to Indonesia, it has been a big concerned and a hold back factor for foreign investor in recent years, mostly due to regulation and policy uncertainty. Thus, even though is not a single and dominant factor but legal certainty will potentially become the burden for the foreign investor to make an investment

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<sup>16</sup> Indonesia. Directorate of Trade, Investment, and International Economic Cooperation Ministry of National Development Planning/Bappenas. BKPM - EuroCham Indonesia Economic and Investment Outlook 2017. By Yahya Rahmana Hidayat. 2017. <http://www.eurocham.id/index.php/publications/category/337-bkpm-eurocham-indonesia-economic-investment-outlook-2017.html>. Accessed November 8, 2017.

in oil and gas project in Indonesia where in addition to that the climate of petroleum investment around the globe has not recovered yet from the drastic drop of world crude price. However, it is indisputable that a host state has the sovereign right over natural resources that exist within its territory that allows them to issue new laws and regulations in order to protect the country's social and economic needs and in many cases exercising this sovereign right may negatively affect petroleum investors in their contractual relations with the host state. Thus, it is important to address the needs for the stability of the petroleum investment without damaging host state purpose on protecting social and economic needs of their people.

We will see in the next chapters that stabilization based on contract has been using in so many different techniques and also, we will discuss about stabilization clause based on international investment treaties which and in that context we will see the important roles of international investment arbitration, or the most frequently used alternative being arbitration under the rules of the UN Commission on International Trade Law. We will examine several cases that directly dealt with the stabilization clause in which the claimant parties submitted their disagreement to international investment arbitration.

The Libyan cases are selected to be examined in this thesis due to their important and distinctive character as part of the early arbitration related to stabilization clause in petroleum industry. The Libyan case represents the interesting arbitrator views on how the principle of sovereignty over natural resources should be recognized in the position over *pacta sunt servanda* and

finally The Venezuelan cases are selected due to the interesting fact that the Venezuelan case has relationship not only stabilization protection based on contract but also under the bilateral investment treaty between Venezuela and Netherlands.

## **2. Formulation of Issue**

The purpose of this policy paper is to look into two things:

- 1) How does the arbitral award view the state's sovereignty over the sanctity of the contract?
- 2) How to determine the model of stabilization clause that will be able meet and balancing investors and host states actual interests?

## **3. Objective of Research**

The objectives of this thesis will be focusing on these following matters:

- 1) To be able to determine what is the international arbitration view towards the state's sovereignty over the sanctity of the contract.
- 2) To be able to determine the model of stabilisation clause to the extent that can promote investors and host states interests particularly in preventing the conflict between protecting investor economic rights and legitimate state's public interest.

## **4. Benefit of Research**

This thesis research is expected to have two main benefits that are defined as follows:

1) Theoretical benefits

The results of this study are expected to increase the knowledge of law, especially in the branch of contract law / international energy investment law in the field of petroleum investment industry.

2) Practical benefits

The results of this study are expected to contribute, suggestions or inputs to law practitioners, petroleum industry stakeholders and government as a reference in regulating the authority and liability of investors as legal protection both host state and investors.

**5. Systematic of Writing**

In order to simplify the writing and discussion, this paper will be divided into five chapters, whereas each chapter is related with each and another chapter. Briefly, this thesis will be discussed in the explanation as follows:

1) CHAPTER I BACKGROUND

In the first chapter of this thesis the writer explains the background, formulation of issues, objectives of research, benefit of research and systematic of writing whereas the writer provide the opportunity for readers to be introduced to general petroleum industry and its emerging trend of investments. Readers also will find out that the topic about investment in petroleum industry and the highly risks nature of those investment are very relevant and important to be reviewed considering that Indonesia has been facing a declining stage of new petroleum exploration projects in the past years, as we can see the data of the investment trend in this chapter. In this chapter the writer also outlines the purpose and specific objectives of the

thesis which are linked to solving the problem or filling the knowledge gap identified in the formulation of issues and last but not least this chapter will provide a ‘road map’ for the rest of the thesis.

## 2) CHAPTER II LITERATURE REVIEW

Chapter II is a discussion of concept, framework and basic principle of political risks in petroleum industry together with the explanation of principle of sovereign over natural resources and *pacta sunt servanda*, the overview of petroleum investment contract, and stabilization clause both in contract and treaty, this chapter also will discuss a legal theory from different scholars, written literature and books.

## 3) CHAPTER III RESEARCH METHOD

In this Chapter III will be discussing the legal research method used in writing this thesis, which is divided into the type of research, procedure of collecting research mater, character of analysis, approach of analysis, analysis used and obstacles in research and method to overcome the issue.

## 4) CHAPTER IV ANALYSIS

Chapter four combines the results and analysis of the research. Chapter Four will be divided from analysis of legal concerns on stabilization clause under the international arbitration views, analysis of the stabilization clause based on application under the international arbitration, and finally determine the right model of the stabilization clause based on application and interpretation.

## 5) CHAPTER V CONCLUSIONS AND SUGGESTIONS

Chapter five is a concluding chapter that provides conclusions that practically illustrate the problem as well as to give suggestion and recommendation on the existing issue.

