Risk and return in the oil and gas sector in 2012

Industry analysts expect 2012 to be a year of considerable capital investment in the oil and gas sector;

In a survey of senior oil and gas executives conducted by the Economist Intelligence Unit, a solid majority of respondents said they were planning to invest more in 2012 than in 2011. Increased energy demand (notwithstanding the continued global economic malaise) and concerns about supply, including related to unrest and political tensions in the Middle East, have pushed the price of Brent to a six-month high of $118 per barrel (as at 10 February 2012). Asian nations have entered into resource partnerships with Gulf and African producers to ensure supplies and investment in storage and downstream infrastructure at home - the cost of acreage in North America is increasing rapidly despite a dip in natural gas prices and shut-ins of capacity, and deep-water and unconventional resource exploration and production require increasing capital intensity.

But, as companies push into new frontiers (geographically to find resources not restricted to state-owned hydrocarbon companies and technologically to extend field life and push into new resources), the risk profile expands. Environmental and regulatory risks are ever-present for unconventional resource plays. France’s on-again-off-again approach to shale resources illustrates the tension. And one risk that investors may wish to consider particularly carefully in 2012 is enhanced political risk. Resource nationalism or simply energy sector reforms in many countries are challenges that will require particular attention in 2012.

The oil and gas sector is, of course, no stranger to nationalisations or the adjudication of the lawfulness of such nationalisations by international tribunals (notable cases in the late 1970s and early 1980s include the three seminal Libyan oil arbitrations - BP v Libya, Liamco v Libya and Texaco v Libya and Aminol v Kuwait). In the past two to three decades, investors in the oil and gas and mining sectors have become more accustomed to political risk manifesting itself
in regulatory interference and pressure to renegotiate commercial terms than to the more dramatic decline in natural resource commodity prices. Where such pressures significantly reduce an investor’s expected returns, deciding between the potential benefits of an arbitration versus on-going access to a resource in an increasingly competitive market for access is not easy. For example, the Algerian government in 2008 and 2009 changed investment laws by decree to require majority Algerian participation in joint ventures, introduce a government ‘call option’ on many equity transfers and require accelerated reinvestment in Algeria of tax advantages, sharply reducing equity returns. Investments with positive returns went into the red overnight. For now, international energy investors appear to be negotiating within the new dispensation. Other African nations have announced broad natural resource contract ‘review and benchmarking’ exercises that seem likely to lead to negotiations for revisions to economic terms. However, the past few years have also seen something of a return of more formal nationalisations, alongside increased regulatory risk. Throw into the mix political instability, such as in North Africa, and it is easy to see how political risk is likely to remain at the forefront of many investors’ minds in 2012. In focusing on risk mitigation in 2012, oil, gas and mining sector investors we have spoken to are closely assessing the investment treaty protections that they may have under public international law and focusing on the underlying resource access contracts and exit or other monetisation terms – not necessarily to sue, but to have a strong negotiating lever to avoid suit and head off political pressure to change investment terms.

Investors in the oil and gas sector are increasingly turning to investment treaties for substantive protections against alleged unlawful state interference with their investments, including expropriation, and the procedural right to have treaty disputes with host states adjudicated in international arbitration. Such claims are sometimes brought in tandem with proceedings in domestic or other international fora. Two high-profile ongoing investment treaty arbitrations in the oil and gas sector illustrate this phenomenon.

The Yukos arbitrations relate to actions taken by Russia between 2003 and 2006 relating to Yukos Oil. Once the largest oil company in Russia, it went into bankruptcy in 2006. Investors in Yukos have brought claims against Russia alleging that measures taken by Russia, including the imposition of billions of dollars in tax penalties on Yukos, were arbitrary and discriminatory and constituted an expropriation of their investments in parallel proceedings (the European Court of Human Rights held in September 2011, that Yukos was denied a fair trial in contesting the tax liabilities imposed on it in 2004. The court deferred the question of damages). The investment treaty claim of one of the investors, RosInvestCo, was upheld by an arbitral tribunal under the UK-Russia bilateral investment treaty in September 2010, with an award of damages to the claimant. The treaty claims of three other investors in Yukos, Yukos Universal (Isle of Man), Hulley Enterprises (Cyprus) and Veteran Petroleum Trust (Cyprus), which collectively owned over 60% of Yukos’ shares, are ongoing. On 30 November 2009, the arbitral tribunal issued interim awards on jurisdiction and admissibility, upholding jurisdiction under a multilateral investment treaty, the Energy Charter Treaty. The rulings on the merits of those cases are eagerly anticipated, not least given the fact that approximately US$100bn in damages is claimed, making these among the largest ever claims under an investment treaty.

The dispute between Exxon Mobil and Venezuela relates to Venezuela’s 2007 nationalisation of the Cerro Negro project in the Orinoco oil belt. This gave rise to a contractual claim, reportedly in excess of US$6bn, commenced under ICC arbitration rules by a subsidiary of Exxon Mobil against PDVSA, Venezuela’s state oil company. Exxon Mobil revealed in January 2012 that its subsidiary was awarded US$907m in the proceedings. In addition, Mobil commenced a parallel arbitration against Venezuela under the Netherlands-Venezuela bilateral investment treaty, which is ongoing. The International Centre for Settlement of Investment Disputes (ICSID) tribunal, (ICSID is an arbitration centre established in 1966 under the auspices of the World Bank), held in June 2010 that it has jurisdiction to hear that dispute and the merits proceedings are ongoing. Such is the financial significance of this dispute that it has been argued that it was behind Venezuela’s actions to terminate the Netherlands-Venezuela bilateral investment treaty in 2008 and file a notice of denunciation to withdraw from ICSID on 24 January 2012.

Given the value of natural resources to many governments’ plans for development and long-term reform and economic diversification and the continued existence of agreements that are perceived to be ‘overly friendly’ to international investors, it should be expected that political risk will continue to be a lively consideration for investors in the oil and gas sector in 2012. Against the background of certain investors turning to international arbitration under treaties for protection against state measures that they deem contrary to their rights and host states’ treaty obligations, we expect there to be more ‘reopener’ negotiations in which the possibility of a treaty suit can be a notable negotiating tool. Finally, the prudential need to assess international law and its impact on energy sector development before concluding agreements for significant investment has never seemed clearer. Prudent investors will increasingly seek specialist advice to ensure that they have investment treaty protection to mitigate against political risk for their investments.

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