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**Research Report**

## Obsolescence of the obsolescing bargain: Why governments must get investor-state contracts right

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## **Columbia FDI Perspectives**

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### **Obsolescence of the obsolescing bargain:** **Why governments must get investor-state contracts right\***

by

Karl P. Sauvant and Louis T. Wells \*\*

In 1975, one of us co-authored a book on mineral agreements subtitled “Promises as Prologue.”<sup>1</sup> The premise was that agreements that purported to be binding for 25-30 years would be frequently renegotiated to adjust the allocation of benefits among the parties.

The “obsolescing bargain” concept<sup>2</sup> contended that international investors hold most of the cards when contracts are initially negotiated because host countries are so eager to attract them. Once investments are made, especially in natural resources and infrastructure, tables are turned and host countries hold the cards. The original bargain would become obsolete: having sunk money into a project, investors had little power to object to renegotiation, unless they controlled downstream markets or held special technologies.

Governments have sought larger benefits through renegotiations triggered by unanticipated windfalls to investors, from mineral prices or unexpectedly rich discoveries—or, simply, because they received less revenue than they anticipated. Also, new governments could blame predecessors for “giving away the store.” Another side to broken promises arose when prices were falling: investors would ask governments for more favorable terms, threatening mine closure, unemployment and loss of export revenues if they had to abide by contracts.

Thus, for example, when mineral prices rose and governments that had failed to build automatic adjustments into their agreements sought to revise them as in the past, investors turned to international arbitration to insist that promises were promises: *pacta sunt servanda*. Venezuela, for instance, had agreed terms for its Orinoco Belt heavy crude in the mid-1990s, when prices of a barrel of oil hovered around US\$20 and lower; by mid-2005, oil prices were above US\$60. The new Venezuelan government (from 1998) did not see sufficient benefits accruing to the country and insisted on revisions to provide the state with significant ownership. ExxonMobil and ConocoPhillips refused, and their facilities in Venezuela were nationalized. Both companies filed claims under bilateral investment treaties—for US\$15 billion and US\$30 billion, respectively.<sup>3</sup>

As the number of arbitrations and size of awards grew under the IIAs, investors discovered their power. ICSID alone had registered 745 cases by the end of 2019, with 59% of them registered during the 2010s.

Nearly a quarter arose in oil, gas and mining, and about half in infrastructure.<sup>4</sup> The still-contested ConocoPhillips ICSID award exceeded US\$8 billion.

Certainly, not every investor has refused to renegotiate. In Venezuela, Chevron renegotiated and continued to operate. In Liberia in 2006, after briefly protesting that it had an enforceable agreement, Mittal accepted changes in its only recently concluded iron-ore contract when the new government of President Sirleaf took over. Yet, the government was constrained in what it could obtain because the investor held the option of international arbitration.

One lesson for governments is clear: mistakes, vague terms and failures to account for future conditions and concerns can no longer easily be corrected later. Governments must get contracts right from the beginning. Resource contracts need mechanisms to cover the prospects of future windfalls: progressive royalties or income taxes, or production-sharing formulas that adjust government take. They also need working provisions, so investors lose mining rights for failure to meet deadlines for production and target production rates. Agreements should anticipate potential problems with transfer pricing, debt financing, etc. The scope and duration of any stability clauses must be limited, anticipating that taxes and environmental and social concerns might be subjects of future legislation. Ideally, contract terms should be subject to occasional review.

Negotiating truly binding promises in complex agreements requires government expertise that matches that of international investors. This includes that of lawyers; financial analysts; industry, market and environmental experts; and sometimes others. Most governments cannot afford to build all the needed expertise in-house. Just as companies bring in outside legal help, investment bankers and consultants, governments can seek negotiation expertise from such organizations as the [African Legal Support Facility](#), the [CONNEX Support Unit](#) and the [International Senior Lawyers Project](#). Final decisions, however, always rest with government officials, who are sensitive to local political economy concerns—but they must know that promises are no longer prologues: bargains they strike now will no longer be easily changed later.

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<sup>1</sup> David N. Smith and Louis T. Wells, *Negotiating Third World Mineral Agreements* (New York: Basic Books, 1975).

<sup>2</sup> Raymond Vernon, *Sovereignty at Bay* (New York: Basic Books, 1971).

<sup>3</sup> [Juan Carlos Boué, "Conoco-Phillips and Exxon-Mobil v. Venezuela: using investment arbitration to rewrite a contract," ITN, Sep. 20, 2013.](#)

<sup>4</sup> [ICSID, "ICSID caseload: statistics," issue 2020—1, pp. 7, 12.](#)

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