

**TAKE OR PAY CONTRACTS AS INVESTMENT DRIVERS FOR GAS
DEVELOPMENT PROJECTS IN DEVELOPING COUNTRIES: ARE THERE
CO PILOTS?**

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ABSTRACT: The development of gas projects all over the world is a capital intensive business. The investment is usually front-loaded while returns can only be realised on completion of the project. Little doubts exist however, as to the potential rewards from such projects. The contractual structure of these projects is usually based on the traditional long term contracts so as to ensure supply security and secure project revenue. A fundamental provision of such long term contracts is the Take or Pay obligation which ensures the cash flows to investors and provides the collateral security for the lenders. To this extent therefore, the Take or Pay obligation provides the “warm glow in the stomach” for both investors and lenders. But can the obligation alone drive the investment or are there other factors quite capable of influencing the investment decision? This paper seeks to examine this issue through a detailed evaluation of the concept of the Take or Pay obligation. It chronicles its features and provides the rationale for its justification as an investment pilot for gas development projects in developing countries. The paper goes further to identify other investment drivers and provides the justification as to why such drivers are co-pilots that will drive the investment decision in addition to the Take or Pay obligation.

LIST OF ABBREVIATIONS

AIG	American International Group
ATOQP	Annual Take or Pay Quantity
BP	British Petroleum
CCGT	Combined Circle Gas Turbine
CITI	Citicorp International Trade Indemnity
DCQ	Daily Contract Quantity

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GCSA	Government Consent and Support Agreement
GSPA	Gas Sales and Purchase Agreement
HC	Host Country
HG	Host Government
ICSID	International Centre for Settlement of Investment Disputes
IOC	International Oil Company
LPG	Liquefied Petroleum Gas
LNG	Liquefied Natural Gas
MIGA	Multilateral Investment Guarantee Agency
SPV	Special Project Vehicle
ToP	Take or Pay
TaP	Take and Pay
WAGP	West African Pipeline Gas Project
ZURICH	Steadfast Insurance Company, a Delaware Subsidiary of Zurich Financial Services Group.

1 INTRODUCTION

The upstream gas activity is very similar to upstream oil activity as both exploration and production activities are carried out in tandem. The two fuels mostly compete and are to a large extent substitutable in end use. However, there exist some fundamental differences. Gas in its natural form is about a thousand times more voluminous than oil for the same energy content. Additionally, its gaseous form implies a number of physical requirements that the transportation infrastructure cannot neglect.¹

¹ International Energy Agency. Natural Gas Transportation-Organisation and Regulation (Paris, France: IEA/OECD, 1994) p.2.

The transmission and distribution of gas include high investment costs, high degree of inflexibility and significant economies of scale all of which have created a market dynamic different from oil and a different institutional history.² Contrary to the similarity in exploration and production, the transportation costs are totally different. The costs of the gas export option whether through pipelines or liquefied natural gas (LNG) is higher by a factor of more than ten in most cases. The cost of shipping one unit of energy in the form of gas from the North Sea to the Continent is roughly equivalent to the cost of shipping an equivalent energy unit of oil twice round the globe.³

A natural gas field is exploited by developing sustained large daily gas production over twenty or more years.⁴ This underlies the capital intensive nature of Greenfield gas development projects. In the new gas prospects recently put up for tender in the great south basin of New Zealand, the exploratory drilling campaign is estimated to cost up to US\$ 100 million with production likely to cost hundreds of millions of dollars.⁵ A long distance gas pipeline with capacity of some 30 bcm from Siberia to Europe could require an investment of US\$ 8-10 billion. Similarly, an LNG export project of 6-8 billion cubic metre (bcm) a year could require up to US\$ 5b as it represents a chain of investments which includes field development, in some cases a pipeline to the coast, the liquefaction facility, tanker transportation and the regasification terminal. Each element in the LNG project chain is capital intensive and the investment is usually front-end loaded such that revenue does not begin to flow until the project is completed.⁶

The huge capital cost is therefore a critical investment driver as lenders will seek for securities to mitigate the risks of exploration, marketing, price and infrastructure expenditure. The project sponsors on the other hand will expect to have the loan repaid on time as well as a reasonable return from the project. These investment concerns by

² *Ibid.*

³ *Ibid.*

⁴ Greenwald, G, B, Liquefied Natural Gas – Developing and financing International Energy Projects (London: Kluwer Law 1998) p xxix.

⁵ www.tnz.co.nz. Last visited on December 1st 2005. (Oil and Gas News)

⁶ Jensen, J, T The Development of a Global LNG Market: Is it Likely? If So When? (London: OIES 2004) p.1.

lenders and sponsors are more prevalent in developing countries where the gas industry is at a development stage with no developed infrastructure and developed market.⁷ The typical constellation of the parties in such locations could be the lenders, an International Oil Company (IOC) as the gas producer/seller, and the buyer as a state owned company or a department of the national oil company operating under the dominant influence of the state.

To provide the necessary comfort for the lenders and sponsors, it is imperative that the volume and price risks for the sale of the gas be mitigated through long term contractual contracts under which the parties will agree the price and the volume that will be supplied over the lifetime of the project. This arrangement ensures adequate revenue flows considered essential for the project economics and the expectations of potential lenders. This has been the vehicle for sharing the large up-front investment risks that characterise the development of greenfield gas projects either for pipeline export or the LNG export option.

The long term contract is otherwise known as the Gas Sales and Purchase Agreement (GSPA). As a legal document, it represents a compromise between the interests of the parties namely the gas producers (project sponsors) as sellers for the purpose of this paper, and the gas buyers. The GSPA has various provisions which are often the subject of long negotiations by the parties. The notable provisions include the contract scope, quantity and quality, delivery points, taxes, prices, billing and payment, measurement and testing.

A fundamental provision is however the Take or Pay obligation (ToP) which requires the buyer to purchase, receive and pay for, or to pay for if not taken, gas. The rationale is to ensure a constant cash flow for the seller to realise the investment cost and pay off the project debt. The ToP obligation therefore provides the necessary comfort for lenders and sponsors as it serves as an investment pilot for project funding and implementation.

⁷ Joint UNDP/World Bank Energy Sector Management Assistance Programme (ESMAP), “*Long Term Gas Contracts: Principles and Applications*” 1993 p.122.

The above being the case, a curious issue is whether the ToP obligation is sufficient to drive investment for such capital intensive projects. Would lenders and sponsors be satisfied with just the ToP as a sole investment driver? Or will they seek other investment pilots? The evaluation of this issue is the thrust of this research. This paper seeks to analyse the role of the ToP obligations in long term gas contracts. It undertakes an evaluation of its concept and features, and examines the rationale for its justification as an investment pilot. The paper goes further to identify other investment pilots that are capable of driving such gas development projects. The paper commences with the introduction. Chapter 2 dwells on the concept and notable features of the ToP obligation. Chapter 3 provides the justification as an investment pilot. Chapter 4 highlights the other investment drivers and Chapter 5 concludes the paper.

2. CONCEPT AND FEATURES OF TAKE OR PAY

2.1 CONCEPT

The concept of ToP has long been a useful mechanism for assuring cash flow to producers and providing collateral security to lenders for capital intensive projects in the energy sector.⁸ The ToP has been a hallmark of GSPA since inception. It deals with the buyer's security of supply and the seller's security of revenue.⁹ The seller is reluctant to rely on the merchant alternative of delivering and being paid for gas only when the buyer requests gas for delivery, as it is possible for the buyer to refuse gas thereby forcing the seller not to earn revenue. It is therefore a device to overcome the price and volume risks by obliging the buyer to take and pay for a certain quantity of gas at any time or by securing a revenue stream under a take or pay commitment.¹⁰ This device operates in natural gas sales contract, throughput agreements for pipeline financing, minerals sales contracts and "hell-or-high-water" charters of oil and LNG tankers.¹¹

⁸ Greenwald, G, B "*Natural Gas Contracts Under Stress: Price, Quantity and Take or Pay*" 1987 p 1.

⁹ See Greenwald *Supra* note 4 at 176.

¹⁰ See Greenwald *Supra* note 4 at 131.

¹¹ See Greenwald *Supra* note 4 at 1.

As logical as the above sounds for the seller, a possible argument for the buyer could be that the seller has not lost anything if the quantity is not taken and that the gas remains with the seller who should be free to sell same elsewhere.¹² In real terms however, the seller would have dedicated the gas reserves to the buyer such that they cannot be freely sold elsewhere. Additionally, the seller may not have access to unutilised gas transportation capacity in order to permit a third party sale or there might not be sufficient liquidity in the market for gas to secure another buyer as the alternative sale of gas has a less ready market than oil.¹³

Thus for the seller, the ToP ensures a security of revenue while the assurance of supply security for the buyer is the delivery of the contracted quantity for its operational needs. The lack of such assurance can render it difficult for the buyer to make up the deficiency in a future period as the seller is not obligated to maintain spare capacity for any deficiency, and may in fact not have such capacity in view of production commitments to other buyers.¹⁴

The buyer therefore has the flexibility to take delivery or not to take delivery of gas as its operational needs dictate with a subsequent right to take up the quantities that have been paid for but not taken.¹⁵ The supply security implies that the long term buyer is assured of the gas when needed unlike the short term buyer who has to rely on market liquidity for gas supply. A notable reference point is the recent failure of British Petroleum (BP) to secure gas delivery for its LNG facility in the Isle of Grain due to its preference for short term supply arrangements rather than conclude its long term gas supply contract with Sonatrach of Algeria. This resulted in idle capacity for the facility and has contributed to the rise in gas price during the current winter period in the United Kingdom.¹⁶

¹² Roberts, P Gas Sales and Gas Transportation Agreements: Principles and Practice (London: S & M 2004) p 131.

¹³ See Greenwald *Supra* note 4 at 132.

¹⁴ *Ibid.*

¹⁵ See Roberts, *Supra* note 12 at 133.

¹⁶ The Independent Newspaper of 9th January 2006.

It is however instructive to note that in the case of production of associated gas, the obligation of the parties is often on *Take and Pay* (TaP) and not on ToP basis. This is to mitigate the risk of the seller having to shut in the production of the associated oil or condensate gas if the gas is not taken by the buyer and has to be flared, vented or reinjected. The ToP will also not work in terms of the make up rights of the buyer in this case, as the gas not taken would have to be flared or vented in order to facilitate associated oil and condensate production. Such disposal would lead to early depletion of the field and a subsequent inability to deliver the contract quantity for the make up gas.¹⁷ Nevertheless, the underlying principle of ensuring a constant revenue flow for the project remains the same with that of the ToP.

The commitments of both parties are firm obligations under the GSPA. For the gas pipeline export project, the quantities of gas to be delivered, taken delivery of and paid for is based on the submission by the buyer of a daily nomination for a quantity within a range of a minimum and maximum Daily Contract Quantity (DCQ) with a deemed nomination which is usually set at the minimum DCQ if the buyer fails to give a nomination.¹⁸

In financial terms, where the buyer fails to take delivery of and pay for the nominated or deemed nominated quantity of gas, then he becomes liable to compensate the seller for a monetary amount calculated upon the difference between the quantity of gas which he was obliged to take delivery of and to pay for and the quantity (if any) of gas, which the buyer actually did take delivery of and pay for, multiplied by the applicable contract price.¹⁹

How the provision is operated will depend on the agreement of the parties. A ToP can apply on annual, quarterly, monthly or daily basis. The shorter ToP period such as the daily basis may however be preferred by the seller so as to improve his cash flow and limit his exposure to a buyer's credit risk. For the LNG export project, the seller will

¹⁷ See Roberts *Supra* note 12 at 133.

¹⁸ *Ibid* at 132.

¹⁹ See Roberts *Supra* note 12 at 133.

prefer a shorter ToP period such as calendar quarters to ensure a tighter control on buyer lifting's and there is an adjustment mechanism to recalculate the ToP obligation at the end of each quarter on a cumulative basis as the year progresses.²⁰

This adjustment mechanism ensures that quantities lifted in excess of a quarterly obligation are credited against quantities previously under-lifted and paid for by buyer. In terms of price, the buyer will, depending on the agreement; be required to pay the prevailing rate at the time the quantities should have been taken or the prevailing price at the end of the year or quarter when the deficiency occurred.²¹

2.2 FEATURES

A ToP based on an annual obligation has certain features which serve as mechanisms for the parties in determining the ToP commitment under the contract. One is the Annual Take or Pay Quantity (ATOPQ) which is the specified minimum quantity that the buyer agrees to take or pay for, in each year. This is also known as the minimum bill quantity.

Another mechanism is the Adjustment mechanism which is used to determine the precise extent of the buyer's take or pay commitment. This is based on non-delivered gas, force majeure relief and carry-forward gas scenarios. A third component is the Annual deficiency mechanism which is used to determine the extent of the take or pay payment due from the buyer. This represents the difference between the buyer's annual take or pay commitment and the quality of gas (if any) which the buyer has taken delivery of and paid for in a year.²² There are other features of the ToP such as the effective ToP calculations, which are technical in nature and not relevant to the issues under reference.

²⁰ See Greenwald *Supra* note 4 at 177.

²¹ *Ibid.*

²² See Roberts *Supra* note 14 at 134.

3. JUSTIFICATION FOR INVESTMENT

How does the ToP obligation justify the investment for a gas development project? One answer could be seen from the above concept in terms of the security of revenue which the obligation creates and which is critical in facilitating the development of new gas production and transportation infrastructure. Another answer lies in the fact that the investment is fixed for a long term to create an enduring connection between the production source and the end user. Both the seller and buyer are invariably tied to the gas reservoir as long as the contract subsists with the ToP being the assurance factor for the relationship.

Another justification is in the magnitude of the investment by both parties for the delivery and off take of gas at the upstream and downstream of the delivery point. In some cases, the seller's investment to produce and deliver gas even from deep off shore waters could be the same with the buyer's investment to consume the same capacity in a newly built combined cycle gas turbine (CCGT) or in large gas grids.²³ In most cases, the buyer's investment will, more often than not, be on a limited recourse basis and the existence of the ToP serves as an essential tool for security of fuel supply will enhance the bankability of the investment.

The supply security provided by the ToP can also save the project economics by ensuring an appropriate pay-off time for the investment. If the investment is for a captive business such as a CCGT then the project economics may be in danger if the buyer (the CCGT) has to seek alternative fuels such as liquefied petroleum gas (LPG) or gas oil as a replacement for gas simply because of lack of supply.²⁴ This is also true even for utilities that do not run on alternative fuels.²⁵

²³ See Joint UNDP/World Bank Report note 7 at 27.

²⁴ The captive character of a CCGT is due to its link to gas turbine technology which requires very clean and expensive fuels with the possible exception of gas.

²⁵ See Joint UNDP/World Bank Report note 7 at 28.

A further justification is the nature of gas as a fuel when compared to oil. Gas is extremely expensive to store unlike oil, and gas markets are driven by capacity rather than by quantities. In this regard therefore, the ToP obligation allows the buyer the flexibility to take delivery based on its operational needs, whilst still entitled to his shortfall, though within a stipulated time frame. The buyer is in essence not short changed. For the seller on the other hand, the mechanism saves him from maintaining spare capacity which should otherwise be utilised for other buyers to ensure cash flow. Additionally the obligation has in-built mechanisms that allow the parties to exercise flexibility in the forms of “make up rights”, “make good rights”²⁶ or “carry forward rights”²⁷ under the contract.

If the production is for associated gas, the Take and Pay (Tap) obligation ensures that the seller is able to make physical delivery of gas especially in jurisdictions where flaring is not allowed and there is no other way of disposing the gas. This is also relevant where the technical flow characteristics of the production and treatment facilities require a minimum off take of gas.²⁸

In the light of the foregoing, there is no doubt that the ToP provision is a critical investment driver in gas development projects. The provision is however not the sole driver as there exist other investment pilots which are discussed below.

4. THE INVESTMENT CO - PILOTS

The development of natural gas projects is a potentially rewarding business for the active participants in the industry namely the Host Government, the International Oil Companies (IOC), Lenders and the Buyers. For most developing countries, the development of the gas industry is a vital engine for economic development. In such

²⁶ Make-Up Right or Make Good Right is the mechanism whereby the payment obligation for quantities taken in excess of the annual minimum pay is reduced in line with quantities or money already paid under an earlier minimum pay commitment.

²⁷ Carry-Forward Right is the mechanism whereby gas taken in excess of the minimum pay is credited against the minimum pay in later years to reduce the minimum pay obligation in those subsequent years.

²⁸ See Joint UNDP/World Bank Report note 7 at 56.

countries however, the gas industry remains at the development stage with no developed infrastructure and developed markets, possibly due to lack of funds, inability to attract investment or even their geographic and climatic characters.²⁹ . Additionally, there is a great influence by the state on the energy sector with minimal private capital investment coupled with legal systems that are not fully developed to cope with the complexities of the gas industry. This is in sharp contrast to the situation in developed countries.³⁰

This state of affairs implies the existence of certain risks which could pose as fundamental challenges, not only to the execution of the project; but also its success. They do require considerable attention from potential investors and lenders during project evaluation. The identification of these risks and how to mitigate them therefore becomes a task which must be accomplished before the investment decision. In other words, they are factors that will also influence the investment decision irrespective of the existence or assurance of the ToP obligation.

For the investors and lenders, the investment decision will be based not only on the ToP obligation, but also on the need to address all related risks that could hinder the execution of the project. Such risks include, amongst others, political, legal and regulatory, project location, investment arbitration framework and the financial credibility of the potential gas buyers which are discussed below.

4.1 POLITICAL RISK

In developing countries, political risk has unparalleled significance for international transactions than in developed countries.³¹ These risks are threats to profitability that are the result of forces external to the industry and they involve some sort of government action or inaction.³² Due to the less developed legal system, there are no transparent regulatory schemes and guidelines to assist investors in taking the investment plunge.

²⁹ See Joint UNDP/World Bank Report note 7 at 121.

³⁰ Edwin, Feo, “Project Finance: The guide to Financing International Oil and Gas Projects”(London: Euromoney Books 1996) p. 45.

³¹ Milbank et al, “The Guide to Financing International Oil and Gas Projects” 1989 p.33.

³² Moran, T, H, “Managing International Political Risk”(USA:Blackwell Publishers 1998) p 7.

The existence of these risks therefore poses a great danger not only to the project economics, but also to the security of the entire project.

The nature of these risks could be in the form of expropriation with or without compensation, war, external threats, and political instability resulting in frequent regime change, civil unrest and internal violence. It could also be repatriation restriction, new and adverse legislation, adverse contract changes, environmental activism and ethno-linguistic factionalism.³³

The possible impact of these risks on the project could be an outright expropriation of project assets by the host government (HG), or a creeping expropriation through taxation and changes in regulatory schemes, currency convertibility issues, restrictions on repatriation of royalties and dividends. It could also be changes in law, governing taxes, prices, labour, imports and export, environmental impact or retaliatory action against the investor's home state.³⁴

For the investors and lenders therefore, the political risks are critical and the need to mitigate them has to be factored into the investment decision. Hence they will ensure that all government approvals and permits necessary for the execution and operation of the project have been secured as condition precedent for the investment. They will also seek sovereign guarantees from HG against expropriation or nationalism and adequate compensation in the event of such actions.

Furthermore, they will seek guarantees for currency convertibility and transfer without restrictions and the ability of the Project Company or Special Purpose Vehicle (SPV) as the case maybe, to control and retain the project cash flows offshore. A notable international instrument offering protection in this regard is the Energy Charter Treaty.

³³ Hallmark, T, "*Political Risks in West Africa: A Comparative Analysis*" 1998, OGLTR 399, Issue 11

³⁴ See Milbank *Supra* note 29 at 33.

In addition, investors may go further to seek political insurance against these risks either with private insurers on commercial basis (for both assets and contract coverage) such as Steadfast Insurance Company (Zurich), American International Group (AIG), Citicorp International Trade Indemnity (CITI); or from export credit agencies such as Multilateral Investment Guarantee Agency (MIGA). Additional measures can be taken to arrange the financing with organisations such as Regional Development Banks, World Bank (WB) and other multilateral agencies so as to minimise the risk of interference of the HG since these lenders usually have more influence on HG than commercial lenders and they also have greater access to local and federal government officials in the host country. The failure to mitigate these risks could hinder the success of the project.

4.2 LEGAL AND REGULATORY RISKS

Legal and regulatory risks are common in developing countries with less developed legal systems. The identification and possible mitigation of these risks also serve as investment pilots due to their possible impact on the project. They will also drive the project investment decision just like the ToP obligation.

The nature of these risks include the absence or inadequate regulations on the taking and enforcement of security relating to moveable assets, lack of independent judiciary, obsolete intellectual property laws, inadequate regulations on fair trading and competition rights. They may also include a flawed dispute resolution process in which foreign parties are denied access to local courts, unenforceability of foreign judgements and a defective judicial system with restrictive rights of appeal.³⁵

The possible impact of these risks on the project is the general lack of commercial certainty as there will be no assurance to investors that the legal system is such that would ensure enforcement of security interests in times of disputes. Neither will there be an independent judiciary and expedient legal process to pursue claims when necessary. Furthermore, the absence of consistent interpretation and implementation of laws and

³⁵ Clifford Chance. "Project Finance" (London: IFR1991) p.47.

regulations by government agencies and non-independent regulatory bodies will hinder the project sponsors from planning effectively for the construction and operation of the project as well as being able to identify potential risks or problems that may result from government orders and regulations.³⁶ All these factors would also affect the investment decision.

To mitigate these risks, investors will need to procure “Legal Due Diligence Reports” from local counsels which reports should entail the review of all local legislations pertaining to the project, their impact on the project activities and business in the host state as well as compliance requirements. As an additional measure, they will seek official confirmation of such legal opinions from the HG through its legal agencies such as the Ministry of Justice and the office of the Attorney General to also confirm the legal and contractual capacities of HG and other relevant agencies as regards the project. In appropriate cases there may be need to seek necessary amendments and other palliative measures against legislations that could impact negatively on the project. The accomplishment of these tasks will greatly influence the investment decision.

4.3 PROJECT LOCATION

The status of the host country (HC) in the global community could also be an investment driver for the gas development. This issue plays a vital role in the project evaluation, as investors will be reluctant to invest in a country that is sanction prone due to acts of terrorism or human rights issues. The evidence of a viable project economics with indices such as the assurance of a ToP obligation notwithstanding, investors will not regard such countries as good investment grounds as sanctions do have a destabilising effect on investments.

A legal instrument of sanction is the International Agreement for Extraterritorial Sanctions which is an International Convention for the suppression of the financing of terrorism. The convention allows the signatories to exert jurisdiction over any financial

³⁶ See Milbank *Supra* note 29 at 31.

transaction carried out within its territory or by one of its nationals relating to the financing of terrorism amongst others.³⁷

There is also the United States Extra Territorial Jurisdiction which applies to Iran and Libya under the 1986 Iran/Libya Sanctions Act. It should be noted that Libya has now been removed from the ambit of the Act with the lifting of sanctions in 2004 thus paving the way for the return of key oil and gas players such as ConocoPhillips, Marathon Oil and Amerada Hess.³⁸ The case of Iran will however appear to have been made worse with its recent claim that Israel should be wiped off the face of the earth.³⁹ There is also the Trading with the Enemy Act (TWEA) 1917 which allows the United States President to prohibit or nullify transactions in which a country or national stipulated under the provisions of the Act has interest.⁴⁰

Such sanctions could impact negatively on financial transactions related to the project and could also affect the importation and exportation of machinery for the project, and one can only imagine the colossal loss that will result there from. The need to therefore mitigate such risks through proper due diligence and constant monitoring of the activities of the United States Congress and the HG will be an investment driver for the project.

4.4 INVESTMENT ARBITRATION FRAMEWORK

The investment arbitration framework is also a critical investment driver for the project. Investors are not only concerned with project viability through sound project economics which the ToP may offer; they will also ensure that they secure appropriate dispute resolution mechanisms in their Investment Agreements through the “Forum Shopping Method”. Such mechanisms offered by various arbitration treaties like as the New York Convention (NYC) and the International Centre for Settlement of Investment Disputes (ICSID) serve to mitigate change in law risks or restrictive regulations to the investment

³⁷ Maberry, S .John, “*Emerging Issues in Sanctions and Export Controls*”. International Energy Projects, Issues in Integration of Upstream and Downstream, 2005, p.27.

³⁸ www.iht.com. Last visited on 31st December 2005. (Oil and Gas News)

³⁹ www.bbcnews.com. Last visited on 18th November 2005.

⁴⁰ See Maberry *Supra* at 28.

as a result of dispute with HG. In this way investment treaty claims can be made against HG irrespective of its domestic laws.

In the case of ICSID, there are various provisions available to foreign investors in the event of disputes with HG such as Article 25 which curtails the sovereign immunity of the HG and Article 26 which provides that the consent of the parties to arbitration under the Convention shall unless otherwise stated be deemed consent to such arbitration to the exclusion of any other remedies. There is also the Additional Facility which allows access to parties who are signatories but are yet to ratify the instrument.

4.5 BUYERS CREDIBILITY

As the traditional gas markets experiences high build up of purchases, new markets are springing up in countries whose development creates a vast potential for energy demand.⁴¹ The potential gas buyers from such emerging economies with little industry experience unlike their traditional predecessors may be handicapped by financial constraints such as access to foreign exchange reserves, convertibility of currency, exchange rates and remittability which brings their creditworthiness into question.⁴²

These are potential risks which will need to be addressed prior to the investment decision. The investors will need to give considerable attention to these risks and how they will be mitigated as they could ultimately derail the success of the irrespective of the existence of the ToP obligations. The ToP obligation of the buyer may guarantee a cash flow but the cash flow has to be sustained for the project lifetime.

The investors will therefore require additional security to ensure that there is compliance with obligations including the purchase obligation. Such securities will include government guarantees where the buyers are state entities. This could be a Government Consent and Support Agreement (GCSA) as in the case of the West African Gas Pipeline

⁴¹ See Greenwald *Supra* note 4 at 188.

⁴² See Jensen *Supra* note 6 at 16.

Project (WAGP) which was given by the Government of Ghana to back up the obligations of the Volta River Authority (VRA), the gas buyer. In other cases the investors will require third party performance guarantees or monetary guarantees and other credit support mechanisms such as letters of credit and parent company guarantees to mitigate such risks.

It is therefore apparent from the above that there are other factors that will determine the investment decision along with the ToP obligation.

5 CONCLUSION

The final investment decision for the gas development project involves the commitment of several billions of dollars. The capital intensive nature of such projects therefore requires the confidence of the participants that the project will operate safely and reliably throughout its life. The investors will also want to be satisfied that the expected returns on the capital investment are commensurate with the technical, commercial, political and other risks that will be taken in relation to the project.

As the gas sector is now competing for investment funds with other fast growing economy sectors such as information technology,⁴³ it is imperative for investors especially the lenders to have the assurance whether the gas development project with its inherent risks, will offer returns which will at least be as good, if not preferable than those which the other investment opportunities may offer.

The magnitude of the investment and the existence of these risks therefore imply that the final “go or no go” investment decision will be driven not only by the ToP obligation, which in itself, is currently facing serious threat from the emergence of short term/spot markets due to gas industry restructuring;⁴⁴ but also by other investment pilots such as political risks, legal and regulatory risks, country risk, investment agreements and buyers

⁴³ See *International Energy Agency OECD Report 200 p.16*. www.energy-storage.org/iea. Last visited on 5th January 2006 .

⁴⁴ See *Jensen Supra* note 6 at 19.

credibility. All these factors will drive the investment decision for gas development projects in developing countries.

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