CLIFFORD CHANCE

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Middle East legal trends in a sustained low oil price world

When we first started talking about the crude oil price crash at the turn of 2014/2015, it was clear that this downturn was different from the last crash in late 2008.

While we cannot know how long this pricing environment will last, it is clearly having a significant impact on a range of issues in the legal field which reflect the difficult dynamics our clients face both in their day-to-day operations and from a broader strategic perspective.

We share some of our observations below.

Key observations

- Increase in disputes and arbitration
- Descoping and project deferment
- Tax risk becomes key
- Withdrawal from challenging frontiers
- Regional M&A activity still quiet
- Macro impact flow through

Fundamental pricing shift

The 2008 pricing downturn lasted only a few months before prices recovered to US$100+/barrel. After a period of around five years during which Brent Crude traded consistently around or above US$100/barrel – and nearly 10 years at pricing consistently above $50/barrel – we are now in a period where Brent Crude has traded in a range of US$25-US$65 per barrel since the start of 2015. With sustained supply from OPEC into a market oversupplied by new production, new technology, large inventories and an uncertain demand picture, some commentators have suggested parallels to the impact of new North Sea supply in the 1980s, with oil trading in the US$10-US$30 range for most of that decade. The industry's mantra seems to have become "much lower, for much longer".

Increase in disputes and arbitration

Similar to previous market shifts, we have seen an increase in requests for contentious advice from our clients, particularly in the construction sector. There are predictable disputes relating to non-payment and non-completion of works. Whether legitimate or not, we have seen some developers claiming inadequate performance as a method of deferring payments to manage restricted cash flows.

We have also seen much more scrutiny of cost overruns, variations and extensions of time, with perhaps a longer period between claim and resolution. Some of this has been pushed by private developers unwilling or unable to tolerate additional cost or deferment of revenues, and some has been passed on from government oversight committees and auditors more conscious than ever of preserving government "take" by limiting developer/contractor costs. In either case, while contractors are often geared up for a multitude of claims on any project as a matter of course, we are seeing some developers preparing to take harder lines by adding in-house dispute capabilities or partnering with external counsel such as ourselves to access on-call contentious advice.

For both sides, appropriate deployment of dispute tactics can be used to achieve successful outcomes.

As an aside, we see time and time again that poorly drafted contracts are much more difficult to manage in this environment. Despite ever-increasing pressure to reduce legal spend in the current market, in our recent experience those that invest at the front end to create robust contracts (taking into account high risk areas such as those discussed above) generally end up in a better position. Legal fees for creating a co-ordinated suite of up-to-date, best-practice transaction documents or precedents can be a fraction of the fees on a single dispute, let alone the cost implications of a dispute loss.

Descoping and project deferment

The current market has been approached very differently by various governments and developers. With some notable exceptions, many in the region have avoided announcing project cancellation for the time being. However, where projects are still proceeding, we are seeing an overall trend towards discussing project deferment or de-scaling. This creates a number of specific concerns and considerations for all involved.

At the initial stages, we are seeing a greater emphasis by developers on creating flexibility in contractual arrangements. Of course, invitations to tender need to be structured to allow cancellation or delay without claims. However, as an example, more detailed mechanisms such as limited notices to proceed, extendable notices to proceed and phasing options can be structured to allow more time flexibility while managing some level of pricing certainty past typical tender validity periods. Similarly, more attention is being paid to suspension clauses, with added nuance being given to allocation of standby, demobilisation and remobilisation costs in differing circumstances.

Specific consideration has also been given to potential descoping or de-scaling, as recent case law has highlighted various pitfalls in removing scope of work from a contract.[1] These include the difficulties of pricing such omissions, which can lead to bitter payment disputes and arbitration proceedings that adversely impact continuing work.

Tax risk becomes key

In GCC countries with low tax/no tax regimes, deficits in oil-funded budgets have created a much greater chance that new taxes (eg VAT) will be implemented in the near future. In February this year the UAE Government announced the implementation of a 5% value added tax from 1 January 2018. Similarly, in various jurisdictions (eg the UAE and Oman) government subsidies are being scaled back or removed from utilities and other inputs. The result is an increased risk of cost volatility over the near term, and a question over which party is best placed to bear such risk.

This has renewed a focus on tax provisions in regional contracts that were once relegated to second order importance. Furthermore, careful consideration is being given to change in law provisions as one of the primary mechanisms to allocate the residual risk. Developers often push for change in law relief to be limited to changes that are unforeseeable, and the question has been raised as to whether any of the current trends has taken some of these changes out of that category.

Withdrawal from challenging frontiers

This downturn has hit exploration and production (E&P) companies operating in the Middle East at a time when many are already facing political and security issues in several parts of the region. Producing assets in Libya have been severely affected by conflict and instability in that country, with force majeure declared in relation to a number of producing onshore fields and attacks on key installations and infrastructure. Promising assets in Iraq and Yemen have been clouded by such concerns, with the appetite to hunker down and "wait it out" severely diminished by the impact of decreased cash reserves, especially for junior E&P companies. Producers in northern Iraq have engaged in arbitration with the Kurdish Regional Government. In other cases, we have seen companies taking a view on the long-term economic prospects of marginal or exploratory blocks – weighing, of course, the terms of the minimum exploration and work commitments and any contractual relief available to them under the terms of their concessions.

In this context, we have been advising a number of entities with respect to the suspension and ultimate withdrawal from some regional blocks and concessions. In some cases, governing agreements allow a clear path towards such

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1 Please see for instance *MT Hojgaard a/s v E.ON Climate and Renewables* TCC [2013] EWHC 967 and [2014] EWHC Civ 710, *Abbey Developments Ltd v PP Brickwork Ltd* [2003] CILL 2033, *Amec Building Ltd v Cadmus Investments Co Ltd* (1996) 51 Con LR 105, and *Multiplex Construction (UK) Limited v Cleveland Bridge UK Limited and Cleveland Bridge Dorman Long Engineering Limited* [2008] EWHC 2220 (TCC).

ends. In others, a favourable resolution requires some creativity and negotiation. We have also worked with several clients seeking successful negotiated outcomes on force majeure, commitment extensions and payment issues.

Notwithstanding this trend, we have noted the number of entities who have discussed with us entering new and uncertain markets (including Iran) in this environment in a determined search for high quality, low-cost production. Others are seeing opportunities unique to a low price context, such as fee-per-barrel arrangements which have suddenly become more attractive (to the chagrin of host governments who had originally driven a hard bargain).

M&A activity remains quiet

At the start of the pricing downturn, many were predicting that low prices would precipitate an increase in M&A activity across the oil and gas industry. The expectation was that under-capitalised companies would seek to sell themselves or non-core assets to salvage shareholder value and that well-capitalised companies would take advantage of bargain pricing to make strategic acquisitions. Several commentators forecast that 2015 would be a record year for oil & gas M&A. Following announcements of the proposed Shell/BG and Halliburton/Baker Hughes mergers, there was expectation of more market consolidation in line with a historic trend of mega-mergers during periods of low oil prices.

We have seen some of this come to fruition. Globally, the Shell/BG, Energy Transfer Equity/William Cos., Halliburton/Baker Hughes and Schlumberger/Cameron mega-deals have attracted significant attention. Occidental Petroleum is one of the more recent to offer its non-core MENA assets for sale, and we are aware of a number of others who are quietly searching out deals on both the buy and sell side.

However, the predicted "wave" of M&A activity has not yet occurred, and in general the market in the Middle East has remained relatively quiet. This is somewhat in line with the global trend; Merrill Corporation has pointed out that while there are a number of factors which are forcing companies in the sector globally to explore all their options, beyond the mega-deals, overall, deal value has declined in the sector and deal volume in 2015 was softer than that in 2014.[2]

We are told that some are waiting for signs of a market bottom, while others are assessing and re-assessing tactics and long-term strategy in a period where the future of the industry (or at least the value of certain plays and assets) has been greatly questioned. Government-related entities with strategic mandates to increase reserves and production have discussed with us their interest in taking advantage of a low-price environment but, like many others in the industry, they have displayed a cautious approach to date. Also, they are not in a position to use scrip as an acquisition currency. As in any other market, pricing uncertainty and volatility is a key issue which holds back dealmaking: buyers concerned about further downside risk do not want to "catch a falling knife" and sellers are tempted to hold out in the hope of an improvement in the pricing environment.

Macro impact flow through

Of course, a re-pricing of oil raises a number of macro issues which impact Middle-Eastern financial markets more broadly and, of course, flow through to the legal market. Given the importance of the government sector in many GCC economies, oil pricing becomes a fundamental macro point across whole economics, even leaving aside the impact on those businesses linked to the oil & gas sector, including the broad range of service providers and consultants to the hydrocarbon/petrochemical industry. These include:

- debt finance market liquidity issues;
- corporate and government funding options and costs;
- government spending priorities and reform and economic diversification agendas;
- asset valuation issues in the broader regional M&A market;
- valuation and risk appetite in the region's equity capital markets; and
- balance sheet impairment and potential solvency and restructuring issues,

- but to name a few!

These issues are outside the scope of this article but they are at the forefront of our clients' thinking. We are closely engaged with our clients on how we can help them position around these issues in the new environment and assist them with addressing the challenges and opportunities they create.

[2] "*M&A in the Energy Sector in the Face of Long-Term Oil Prices*", Merrill Datasite White Paper, February 2016.

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