Arbitration - Ecuador

Arbitral tribunal rules against Ecuador

Contributed by **Coronel & Pérez**

November 15 2012

Author

Hernán Pérez Loose

After a long and protracted litigation an International Centre for Settlement of Investment Disputes (ICSID) tribunal found Ecuador liable under domestic and international law when it terminated unilaterally an oil contract that it had signed with Occidental Petroleum Corporation (Oxy), the US petroleum multinational, and took over its installation without compensation.(1) The majority of the arbitrators ordered Ecuador to pay $1.77 billion in damages ($2.3 billion with interest applied). It is possibly one of the largest investment awards in investment arbitration history. The tribunal found that while Oxy had violated certain domestic legal provisions, Ecuador had responded disproportionately. In doing so, Ecuador breached not only its domestic law but also international law. The arbitrators also found that Ecuador's seizure of the company's installations was tantamount to unlawful expropriation.

Background

Oxy had been operating in Ecuador since the mid 1980s under a service contract model. In response to depressing oil prices, in 1993 Ecuador passed a new legislation allowing the government to enter into production sharing agreements with oil companies. On May 21 1999, after long negotiations, Ecuador and Oxy signed a new contract under the new model. Under the contract, in return for its investments Oxy was to receive a share of the crude oil that it extracted, which it was free to dispose of. Oxy assumed the full risk of the oil price.

On October 19 2000 Oxy entered into a farm-out agreement with Encana Corporation, a Canadian oil company already operating in Ecuador. By virtue of this agreement, which is common in the oil industry, Oxy secured from Encana a flow of capital for its operation in exchange for its commitment to provide the Canadian company with 40% of its oil production. Oxy also agreed that on certain conditions, and subject to the authorisation of the Ecuadorean minister of energy, it would assign to Encana 40% of its legal rights on its participation contract with Ecuador.

In August 2001 the Ecuadorean tax authorities issued a ruling reversing a prior regulation on the application of value added tax (VAT). As a result, oil companies were ordered to make significant payments to the Ecuadorean treasury. In response to this action in November 2002, Oxy commenced an arbitral proceeding under the US-Ecuador bilateral investment treaty. On July 1 2004 the tribunal issued a $75 million VAT award in Oxy's favour, finding Ecuador's conduct unfair and discriminatory. However, this conflict affected Oxy's contractual relationship with Ecuador.

Under pressure from certain political quarters, the government offered to scrutinise Oxy's operations. On August 24 2004 the attorney general requested that the Ministry of Energy initiate a proceeding to declare the unilateral termination of the Oxy participation contract, alleging that the farm-out agreement amounted to an assignment of rights. Under the Hydrocarbon Law the assignment of rights of oil contracts to a third party requires prior ministerial authorisation. The lack of such authorisation may cause the contract to be terminated and the company to lose its installation to the government without compensation.

On May 15 2006, after months of increasing political pressure, street rallies and threats of impeachments, the minister of energy declared the termination of the Oxy contract and ordered the seizure of its installations without compensation. Two days later Oxy filed a request for arbitration with the ICSID.

Decision

In its ruling the tribunal found that the arrangement between Oxy and Encana involved an assignment of rights. Although executives of both companies had a meeting with the minister and other authorities to inform them of the agreement, the tribunal felt that they were not candid enough with regard to its scope. While the tribunal found that Oxy had violated the Hydrocarbon Law by failing to secure ministerial authorisation before signing the farm-out agreement, it also ruled that Ecuador had acted disproportionately in terminating the oil contract and taking over Oxy's installations without compensation. The tribunal held that the termination of the contract must have been the last option, not the first one.

In imposing the penalty on Oxy, the tribunal held that Ecuador should have weighted the principle of proportionality, which is recognised by its own constitution and applied by its courts. Not only was the penalty not mandatory but, as Ecuador had conceded during the proceeding, the farm-out agreement had caused no harm to the country. The tribunal went on to say that proportionality is a principle widely recognised by international law and applied by international arbitral tribunals, especially in the context of investment disputes under treaties such as the US-Ecuador one.(2)

In setting the quantum of damages, the tribunal addressed the following complex issues:

- the consequences of Oxy's actions (contributory negligence);
- the effect of Law 42 that Ecuador passed after it terminated Oxy's contract with the purpose of modifying the economics of the participation contracts in response to high oil prices; and
- the impact of the farm-out agreement on Oxy's recovery.

The tribunal was not unanimous in dealing with these issues. The majority found that Oxy's actions had contributed to the (disproportionate) penalty from Ecuador, and therefore it reduced the damages recoverable by Oxy by 25%. With regard to Law 42, the tribunal's majority found that it represented a unilateral modification of the participation contracts in its favour, a move from which Ecuador might not benefit. Thus, in calculating the damages the tribunal did not take that law into consideration.

Finally, the tribunal's majority rejected Ecuador's position that because the farm-out agreement involved the assignment of 40% of Oxy's rights to Encana, Oxy's recovery was limited to 60% of the damages. The tribunal noted that under Ecuadorean law, the assignment of rights of oil contracts without ministerial authorisation was considered non-existent, an act vitiated by radical nullity, for which there was no need for a judicial declaration. The majority found Ecuador's request that the assignment should be given full effect was unattainable. It was Oxy's contract which was, after all, terminated by Ecuador. Oxy's claim for compensation for the losses it suffered in its investment into a consortium that had built and was operating a heavy crude oil pipeline in Ecuador was rejected as speculative.

On the issue of expropriation, the tribunal did not share Ecuador's position that seizing Oxy's installations without compensation was not unlawful because the Hydrocarbon Law contemplated such action as a result of a unilateral termination decision, and therefore it was part of the contract that Oxy had agreed to. The tribunal found that it was in breach of the US-Ecuador bilateral investment treaty. With regard to interests, the tribunal opted for composite interests.

Comment

The ruling covers a wide range of issues at the centre of the ongoing debate on international investments disputes. Of particular relevance is the subject of proportionality as an element of the fair and equitable treatment that foreign investors are expected to receive from the host states under existing bilateral investment treaties. The principle has gained significant acceptance in the domestic systems of most countries during the past decade, especially in the field administrative law. It is now marking its presence in the arena of international investment litigation.

For further information on this topic please contact Hernán Pérez Loose at Coronel & Pérez by telephone (+593 4 2519 900), fax (+593 4 2320 657) or email (hperez@coronelyperez.com).

Endnotes

(1) *Occidental Petroleum Corporation, Occidental Exploration and Production Company v Republic of Ecuador* (ICSD Case No ARB/06/11).

(2) The tribunal relied on, among other cases, *MTD Equity SDN BHD v The Republic of Chile* (ICSID Case No ARB/01/07); *LG & Energy Corp v The Argentine Republic* (ICSID Case No ARB/02/1); *Tecmed SA v The United Mexican States* (ICSID Case No ARB (AF)/00/2); and *Azurix Corp v The Argentine Republic* (ICSID Case No ARB/01/12).

are subject to the disclaimer.