EMERGING OIL AND GAS ECONOMIES:
MITIGATING LEGAL, POLITICAL AND ECONOMIC
RISKS OF FOREIGN INVESTORS
IN THE RUSSIAN FEDERATION

by

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This thesis is submitted in conformity with the requirements
for the degree of Master of Laws
Graduate School of Law
Murdoch University

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Abstract

With world wide trends in oil consumption, and a growing fear of its depletion, global energy investors are forced to enter into newly emerging and high-risk energy markets. One such market is the Russian Federation. Russia looms on the horizon as an immense opportunity for domestic and foreign investors. Despite Russia’s willingness to welcome foreign investment capital into its growing economy, foreign investors appear to be reluctant to accept the Russian Federation as a reliable business partner. This thesis outlines some of the major reasons for the current investor’s concerns. It entails a survey of the various investment protection mechanisms that are available to foreign investors in Russia under contract and public international law.
To Elizaveta
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Any errors presented in this thesis are my own.
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<thead>
<tr>
<th>Abbreviation</th>
<th>Explanation</th>
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<tbody>
<tr>
<td>&amp;</td>
<td>And</td>
</tr>
<tr>
<td>AFR</td>
<td>Additional Facility Rules</td>
</tr>
<tr>
<td>BIT</td>
<td>Bilateral Investment Treaty</td>
</tr>
<tr>
<td>bmc</td>
<td>Billion cubic metres</td>
</tr>
<tr>
<td>CCPC</td>
<td>Procedural Code of the Commercial Court (2002), Russian Federation</td>
</tr>
<tr>
<td>CIS (countries)</td>
<td>Commonwealth of Independent States</td>
</tr>
<tr>
<td>ECOSOC</td>
<td>Economic and Social Council</td>
</tr>
<tr>
<td>ECT</td>
<td>Energy Charter Treaty</td>
</tr>
<tr>
<td>Ed(s).</td>
<td>Editor(s) or Edition(s)</td>
</tr>
<tr>
<td>Et al.</td>
<td>And others</td>
</tr>
<tr>
<td>EU</td>
<td>European Union</td>
</tr>
<tr>
<td>FDI</td>
<td>Foreign Direct Investment</td>
</tr>
<tr>
<td>GA</td>
<td>General Assembly</td>
</tr>
<tr>
<td>GATT</td>
<td>General Agreements on Tariffs and Trade</td>
</tr>
<tr>
<td>Ibid</td>
<td>Above</td>
</tr>
<tr>
<td>ICSID Convention</td>
<td>Washington Convention for the Settlement of International Disputes between States and Nationals of Other States, 1965</td>
</tr>
<tr>
<td>ICSID Centre</td>
<td>International Centre for Settlement of Investment Disputes</td>
</tr>
<tr>
<td>Term</td>
<td>Definition</td>
</tr>
<tr>
<td>-----------------</td>
<td>----------------------------------------------------------------------------</td>
</tr>
<tr>
<td>i.e.</td>
<td>Id est (that is)</td>
</tr>
<tr>
<td>Inter alia</td>
<td>Among others</td>
</tr>
<tr>
<td>LICA</td>
<td>The Law on International Commercial Arbitration</td>
</tr>
<tr>
<td>(1993), Russian Federation</td>
<td></td>
</tr>
<tr>
<td>mb/d</td>
<td>Million barrels per day</td>
</tr>
<tr>
<td>MFN principle</td>
<td>Most-favoured-nation principle</td>
</tr>
<tr>
<td>MIT</td>
<td>Multilateral Investment Treaty</td>
</tr>
<tr>
<td>MST</td>
<td>Minimum standard of treatment</td>
</tr>
<tr>
<td>NAFTA</td>
<td>North American Free Trade Agreement</td>
</tr>
<tr>
<td>No.</td>
<td>Number</td>
</tr>
<tr>
<td>New York Convention</td>
<td>New York Convention of the Recognition and</td>
</tr>
<tr>
<td>Enforcement of Foreign Arbitral Awards, 1958</td>
<td></td>
</tr>
<tr>
<td>OECD</td>
<td>Organisation for Economic Cooperation and</td>
</tr>
<tr>
<td>Development</td>
<td></td>
</tr>
<tr>
<td>OECD Convention</td>
<td>Convention on the Protection of Foreign Property</td>
</tr>
<tr>
<td>OIC</td>
<td>Organisation of Islamic Conference</td>
</tr>
<tr>
<td>Para.</td>
<td>Paragraph</td>
</tr>
<tr>
<td>PCIJ</td>
<td>Permanent Court of International Justice</td>
</tr>
<tr>
<td>PSA</td>
<td>Production sharing agreement</td>
</tr>
<tr>
<td>PSNR</td>
<td>Permanent sovereignty over natural resources</td>
</tr>
<tr>
<td>SCC</td>
<td>Stockholm Chamber of Commerce</td>
</tr>
<tr>
<td>tmc</td>
<td>Trillion cubic metres</td>
</tr>
<tr>
<td>TNC</td>
<td>Trans-national corporation</td>
</tr>
<tr>
<td>toe</td>
<td>Tones of oil equivalent</td>
</tr>
<tr>
<td>v.</td>
<td>Versus</td>
</tr>
<tr>
<td>Vol.</td>
<td>Volume</td>
</tr>
<tr>
<td>UN</td>
<td>United Nations</td>
</tr>
<tr>
<td>UNCITRAL</td>
<td>United Nations Commission on International Trade Law</td>
</tr>
<tr>
<td>Acronym</td>
<td>Full Form</td>
</tr>
<tr>
<td>---------</td>
<td>-----------------------------------------------</td>
</tr>
<tr>
<td>UNIDO</td>
<td>United Nations Industrial Development Organisation</td>
</tr>
<tr>
<td>U.S</td>
<td>United States</td>
</tr>
<tr>
<td>USD</td>
<td>United States’ dollars</td>
</tr>
<tr>
<td>UNCTAD</td>
<td>United Nations Conference on Trade and Development</td>
</tr>
<tr>
<td>WTO</td>
<td>World Trade Organisation</td>
</tr>
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</table>
Introduction

The former Soviet Union was one of the world's largest producers of natural gas and oil. After the collapse of the Union, the Russian Federation inherited most of its oil and gas reserves. However, struggling with its new economy, Russia was unable to exploit these resources successfully due to a lack of internal investment capital, which led Russian decision-makers to turn to foreign investors to acquire the capital, management expertise and technology needed to revitalise domestic oil and gas production.

To date, the largest barrier for the attraction of foreign investment into Russia's oil and gas industry is its allegedly unstable legal regime, and in particular, the vaguely drafted laws and seemingly endless power of the Russian politicians (including the powers to unilaterally change or amend domestic legislation and, inter alia, the ability to nationalise or expropriate foreign property without reimbursing foreign investors for their losses). Hence, the purpose of this study is to explore the investment protection options that are presently available to foreign investors who have already engaged, or who are contemplating engaging, their capital with the subsoil recourses and reserves of the Russian Federation. In particular, this thesis will offer a legal analysis of when and how a foreign investor may potentially guarantee the returns and profits of its investment, and the steps available to such an investor in cases of dispute.

2 Stoleson, M, 'Investment at an impasse: Russia's Production Sharing Agreement Law and the Continuing Barriers to Petroleum Investment in Russia' (1997) 7 Duke Journal of Comparative & International Law 671, 678
This thesis is divided into three (3) parts, with each addressing distinct but interrelated issues. Part One is entitled “Global oil demand and obstacles for foreign investors in the Russian energy sector”. This part consists of two chapters in which I have outlined the trends of the global energy demands, the role of the Russian Federation in the world energy market (chapter one), and the obstacles for foreign investors under the current legal regime in the Russian Federation (chapter two). The purpose of these chapters is not to offer solutions for the internal legal reform but to analyse the present legal regime and highlight the possible consequences of such a regime for present and potential investors. This part begins with a review of the global energy demand and the role of the Russian Federation in the international energy market. It examines energy production data, as well as the potential of the Russian oil and gas reserves. It then focuses on some of the major obstacles for foreign investors who wish to secure their investment contracts with the government of the Russian Federation or its subsidiaries. It concludes by suggesting that the peculiarities of the internal legal regime could well be remedied by the relevant provisions of the parties’ investment contracts as well as applicable provisions of public international law on investment protection.

The investment protection options are reviewed in Part Two of my thesis. This part is entitled “Investment protection mechanisms” and consists of six interdependent chapters. Chapter three represents the discussion regarding the enforcement of State contracts as the primary mechanism of investment protection. By and large, this chapter represents a review of the various contractual clauses that need to be considered and ultimately included in the investment contracts. Chapter four deals with the concept of State permanent sovereignty over natural resources, as well as discusses a second remedy of investment protection commonly known as diplomatic protection. Chapter five analyses the core investment protection mechanisms offered to foreign investors by the relevant provisions of public international law, including treaty law and customary international law. This chapter begins with an overview of the key investment protection provisions common to the treaty law and customary international law. In particular, it discusses the Host State’s obligations to provide foreign investors with non-discriminatory and fair and
equitable treatment, constant protection and security, and other obligations it has entered into on an international scale.

Chapter six deals exclusively with expropriation and discusses the conditions of its legality. It begins by introducing the meaning, nature and origin of the concept. It then focuses on various forms of expropriation, and finally discusses in some detail the conditions of legality that need to be complied with for such actions to be lawful.

Chapters seven and eight revise investment protection mechanisms and dispute settlement remedies of the 1994 Energy Charter Treaty (ECT). In essence, chapter seven analyses investment protection provisions of the ECT. It specifically focuses on “national”, “most-favoured-nation” (MFN) and “fair and equitable” treatments of investment (embodied in the various provision of Article 10 ECT), “most constant protection and security” mechanism (Article 10(1) ECT), the requirement for the parties to observe their contractual and international law obligations (Article 10(1, last sentence), expropriation and measures having equivalent effect (Article 13 ECT), and the provisions regarding the transfer of funds (Article 14 ECT).

Dispute settlement remedies of the ECT are considered in chapter eight. This chapter deals primarily with the provisions of Article 26 ECT, where three distinct resolution options are presented. These options include arbitration under the ICSID system, arbitration under the rules of the Stockholm Chamber of Commerce, and ad hoc arbitration under the UNCITRAL Arbitration Rules. The second part of this chapter reviews the mechanisms for the recognition and enforcement of the ECT awards provided for by the Washington Convention$^3$ and the New York Convention.$^4$ Finally, this chapter concludes by providing a detailed examination of how foreign arbitral awards can be recognised and enforced against the Russian Federation, as the judgement debtor.


The third and final part of my thesis is entitled “Summaries and Conclusions”, and contains one chapter. It represents a summary of my thesis in the form of concluding remarks regarding each of the above chapters. It ultimately draws upon an overall conclusion that foreign participation in the energy sector of the Russian Federation should be expanded, and that investment protection mechanisms available to investors (both privately and publicly) are sufficient to eliminate their concerns regarding the alleged inefficiencies of the Russian internal legal environment.

\textsuperscript{5} Here a reference is made to contractual investment protection mechanism as well as mechanisms provided for under the auspices of public international law.
Part I

Global Oil Demand and Obstacles for Foreign Investors in the Russian Energy Sector
Chapter One

Global energy demands and Russia’s role in the global energy market

A. Introduction

While the global energy demand continues to grow, the world’s large and medium-sized energy enterprises are raising their efforts to secure exploration and production in the newly emerging and high-risk energy markets. One such market is that of the Russian Federation. In this chapter I will provide a brief overview of the global energy trends, including the world’s oil and gas demand. Subsequently, I will discuss Russia’s role in the global energy market. Finally, I will conclude by suggesting that Russia’s role in the world energy supply and trade will continue to increase, and that Russian subsoil reserves and recourses will present potentially the most interesting area for foreign energy investment for many years to come.

B. Global energy demand

I. General

The development and evolution of the modern world largely depends on the extraction and utilisation of the world’s natural resources that are vital for human activity. These resources primarily include fossil fuels such as crude oil and natural gas. Both of these commodities, among other things, supply the vast majority of the world’s merchandise transportation equipment, and also represent the primary feedstock for many of the
chemicals that are essential to modern life. The earth's endowment of oil, however, is finite and demand for oil continues to increase with time. As projected by the 2005 Global Energy Trends report, world primary energy demand is expected to expand by more than half between 2003 and 2030, reaching 16.3 billion tonnes of oil equivalent (toe). Oil, natural gas and coal will account for 83 per cent of the increase in world primary demand between 2003-2030.

II. Oil demand

As far as global oil demand is concerned, it is stipulated that oil will remain the single largest fuel in the global primary energy mix, and its world demand is projected to grow by 1.3 per cent per year to 92 million barrels per day (mb/d) in 2010 and 115 mb/d in 2030. The statistical data presented by the International Energy Agency further demonstrates that two-thirds of the total increase in oil use will come from the transport and power generation sectors, where oil will remain the main fuel. Industrial, commercial and residential demand for oil is also projected to increase with all of the growth coming from the developing countries (Table 1.1).

Table 1.1: World oil demand (million barrels per day)

<table>
<thead>
<tr>
<th>Region</th>
<th>2004</th>
<th>2010</th>
<th>2020</th>
<th>2030</th>
<th>2004-2030*</th>
</tr>
</thead>
<tbody>
<tr>
<td>OECD</td>
<td>47.6</td>
<td>50.5</td>
<td>53.2</td>
<td>55.1</td>
<td>0.6%</td>
</tr>
<tr>
<td>OECD North America</td>
<td>24.0</td>
<td>26.9</td>
<td>29.1</td>
<td>30.6</td>
<td>0.8%</td>
</tr>
<tr>
<td>OECD Europe</td>
<td>14.5</td>
<td>15.0</td>
<td>15.4</td>
<td>15.7</td>
<td>0.3%</td>
</tr>
<tr>
<td>OECD Pacific</td>
<td>8.3</td>
<td>8.6</td>
<td>8.7</td>
<td>8.8</td>
<td>0.3%</td>
</tr>
<tr>
<td>Transitional economies</td>
<td>4.4</td>
<td>4.9</td>
<td>5.6</td>
<td>6.2</td>
<td>1.3%</td>
</tr>
<tr>
<td>Russia</td>
<td>2.6</td>
<td>2.9</td>
<td>3.3</td>
<td>3.5</td>
<td>1.2%</td>
</tr>
</tbody>
</table>

2 Ibid
4 Ibid
5 Ibid, 81
6 International Energy Agency, above n 3
### Developing countries

<table>
<thead>
<tr>
<th>Region</th>
<th>2004</th>
<th>2010</th>
<th>2020</th>
<th>2030</th>
<th>2004-2030*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Developing countries</td>
<td>27.0</td>
<td>33.9</td>
<td>42.9</td>
<td>50.9</td>
<td>2.5%</td>
</tr>
<tr>
<td>China</td>
<td>6.2</td>
<td>8.7</td>
<td>11.2</td>
<td>13.1</td>
<td>2.9%</td>
</tr>
<tr>
<td>India</td>
<td>2.6</td>
<td>3.3</td>
<td>4.3</td>
<td>5.2</td>
<td>2.8%</td>
</tr>
<tr>
<td>Other Asia</td>
<td>5.4</td>
<td>6.6</td>
<td>8.3</td>
<td>9.9</td>
<td>2.3%</td>
</tr>
<tr>
<td>Latin America</td>
<td>4.7</td>
<td>5.4</td>
<td>6.5</td>
<td>7.5</td>
<td>1.9%</td>
</tr>
<tr>
<td>Africa</td>
<td>2.6</td>
<td>3.3</td>
<td>4.5</td>
<td>5.7</td>
<td>3.0%</td>
</tr>
<tr>
<td>Middle East</td>
<td>5.4</td>
<td>6.5</td>
<td>8.1</td>
<td>9.4</td>
<td>2.2%</td>
</tr>
<tr>
<td>World</td>
<td>82.1</td>
<td>92.5</td>
<td>104.9</td>
<td>115.4</td>
<td>1.3%</td>
</tr>
</tbody>
</table>

*Average annual growth rate.


### III. Natural gas demand

The consumption of natural gas is, likewise, growing across all economic sectors worldwide. As proposed by the *Global Energy Trends* report, primary demand for natural gas will grow by 2.1 per cent, meaning that gas will overtake coal by around 2020 as the world’s second-largest primary energy source (Table 1.2). Gas consumption will increase by three-quarters between 2003 and 2030, reaching 4,789 billion cubic meters (bcm). The share of gas in world energy demand is expected to rise to 24 per cent in 2030, mostly at the expense of coal and nuclear energy. Power generation will account for most of the increase in gas demand over the projection period because, in many parts of the world, gas will be the preferred fuel in new power stations for economic and environmental reasons. In addition, a small but increasing share of gas demand will come from gas-to-liquid plants and from the production of hydrogen for fuel cells.9

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7 International Energy Agency, above n 3, 82
8 International Energy Agency, above n 3, 83
9 International Energy Agency, above n 3, 83
Table 1.2: World natural gas demand (billion cubic meters)

<table>
<thead>
<tr>
<th></th>
<th>2003</th>
<th>2010</th>
<th>2020</th>
<th>2030</th>
<th>2003-2030*</th>
</tr>
</thead>
<tbody>
<tr>
<td>OECD</td>
<td>1436</td>
<td>1617</td>
<td>1872</td>
<td>2061</td>
<td>1.3%</td>
</tr>
<tr>
<td>OECD North America</td>
<td>775</td>
<td>848</td>
<td>964</td>
<td>1039</td>
<td>1.1%</td>
</tr>
<tr>
<td>OECD Europe</td>
<td>141</td>
<td>176</td>
<td>217</td>
<td>244</td>
<td>2.1%</td>
</tr>
<tr>
<td>OECD Pacific</td>
<td>520</td>
<td>593</td>
<td>691</td>
<td>778</td>
<td>1.5%</td>
</tr>
<tr>
<td>Transitional economies</td>
<td>637</td>
<td>705</td>
<td>815</td>
<td>925</td>
<td>1.4%</td>
</tr>
<tr>
<td>Russia</td>
<td>417</td>
<td>460</td>
<td>525</td>
<td>591</td>
<td>1.3%</td>
</tr>
<tr>
<td>Developing countries</td>
<td>636</td>
<td>893</td>
<td>1374</td>
<td>1803</td>
<td>3.9%</td>
</tr>
<tr>
<td>China</td>
<td>39</td>
<td>60</td>
<td>106</td>
<td>152</td>
<td>5.1%</td>
</tr>
<tr>
<td>India</td>
<td>28</td>
<td>42</td>
<td>71</td>
<td>98</td>
<td>4.7%</td>
</tr>
<tr>
<td>Other Asia</td>
<td>162</td>
<td>215</td>
<td>305</td>
<td>387</td>
<td>3.3%</td>
</tr>
<tr>
<td>Latin America</td>
<td>107</td>
<td>145</td>
<td>220</td>
<td>318</td>
<td>4.1%</td>
</tr>
<tr>
<td>Africa</td>
<td>74</td>
<td>107</td>
<td>165</td>
<td>232</td>
<td>4.3%</td>
</tr>
<tr>
<td>Middle East</td>
<td>226</td>
<td>324</td>
<td>507</td>
<td>615</td>
<td>3.8%</td>
</tr>
<tr>
<td>World</td>
<td>2709</td>
<td>3215</td>
<td>4061</td>
<td>4789</td>
<td>2.1%</td>
</tr>
</tbody>
</table>

*Average annual growth rate.
Source: IEA (2005).10

IV. Geography of the world energy resources

As outlined above (i.e. in Table 1.1 and Table 1.2), due to the rapidly accelerating growth of their economies and population, more than two-thirds of the increase in world primary energy demand between 2003 and 2030 will come from the developing countries. Industrialisation, urbanisation and the shift in energy use from traditional non-commercial biomass to commercial fuels will also boost demand. OECD countries11 will account for almost a quarter of the global increase and the transition economies for the remaining 7 per cent.12 It is anticipated13 that nearly three-quarters, or 26 mb/d, of the 36

10 International Energy Agency, above n 3, 82
11 List of OECD member countries is available on OECD website: <http://www.oecd.org/countrieslist/0,3351,,en_33873108,33844430_1_1_1_1_1,00.html> (6 July 2007)
12 International Energy Agency, above n 3, 87
13 International Energy Agency, above n 3, 87
mb/d increase in global oil demand between 2003 and 2030 will come from developing regions in Asia. For example, oil demand in China is projected to increase almost 2.5 times over the projection period, to 13.1 mb/d in 2030. Likewise, natural gas demand will increase globally and the share in the primary fuel mix will increase in every region. The fastest rates of growth will occur, again, in China and India, where gas consumption, at present, is relatively low.

While the world’s economically exploitable energy resources are still adequate to meet the projected growth in energy demand, it is worth noting that there exists a geographical breakdown of sources of energy production. Oil is a commodity found in over 90 countries, whereas it is consumed in all countries, and traded on world markets. As shown below (Table 1.3), most of the world’s proven oil and gas reserves are located in the Middle East, South America and the blocs of the former Soviet Union. Accordingly, these countries are projected to provide the majority of the growth in world oil and gas supply in the next few decades.

Table 1.3: Greatest oil reserves (by country), 2006

<table>
<thead>
<tr>
<th>Rank and country</th>
<th>Proved reserves, billion barrels</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Saudi Arabia</td>
<td>264.3</td>
</tr>
<tr>
<td>2. Canada</td>
<td>178.8</td>
</tr>
<tr>
<td>3. Iran</td>
<td>132.5</td>
</tr>
<tr>
<td>4. Iraq</td>
<td>115.0</td>
</tr>
<tr>
<td>5. Kuwait</td>
<td>101.5</td>
</tr>
<tr>
<td>6. United Arab Emirates</td>
<td>97.8</td>
</tr>
<tr>
<td>7. Venezuela</td>
<td>79.7</td>
</tr>
<tr>
<td>8. Russia</td>
<td>60.0</td>
</tr>
<tr>
<td>9. Libya</td>
<td>39.1</td>
</tr>
<tr>
<td>10. Nigeria</td>
<td>35.9</td>
</tr>
</tbody>
</table>

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14 International Energy Agency, above n 3, 87
15 International Energy Agency, above n 3, 87
16 Hirsch, above n 1, 9
<table>
<thead>
<tr>
<th>Rank and country</th>
<th>proved reserves, billion barrels</th>
</tr>
</thead>
<tbody>
<tr>
<td>11. United States</td>
<td>21.4</td>
</tr>
<tr>
<td>12. China</td>
<td>18.3</td>
</tr>
<tr>
<td>13. Qatar</td>
<td>15.2</td>
</tr>
<tr>
<td>14. Mexico</td>
<td>12.9</td>
</tr>
<tr>
<td>15. Algeria</td>
<td>11.4</td>
</tr>
<tr>
<td>16. Brazil</td>
<td>11.2</td>
</tr>
<tr>
<td>17. Kazakhstan</td>
<td>9.0</td>
</tr>
<tr>
<td>18. Norway</td>
<td>7.7</td>
</tr>
<tr>
<td>19. Azerbaijan</td>
<td>7.0</td>
</tr>
<tr>
<td>20 India</td>
<td>5.8</td>
</tr>
<tr>
<td>Top 20 countries</td>
<td>1,224.5</td>
</tr>
<tr>
<td>Rest of world</td>
<td>68</td>
</tr>
<tr>
<td>World total</td>
<td>1,292.5</td>
</tr>
</tbody>
</table>

*Source: Oil & Gas Journal, Vol. 103, No. 47 (Dec. 19, 2005).*

### V. Anticipated energy investment patterns

The growing regional gap between demand and production of energy resources will result in the major expansion of international trade and investment in oil and gas. Such trade and investment activities will inevitably shift towards the resource-rich countries across the Middle East to the less explored fields located within the borders of the blocs of the former Soviet Union, and primarily the Russian Federation. In the remainder of this Chapter I will outline the significance of Russia’s subsoil reserves as the sites for the present and potential oil and gas developments of international scale. And in particular, I will highlight the potential importance of the Russian energy market to the world economy in general. This will be followed by the projected outline of supply and demand of Russian energy resources. Finally, this chapter will be concluded by assessing Russia’s role in the global energy market.

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17 US. U.S. Energy Information Administration
<http://www.eia.doe.gov/emeu/international/petroleu.html> (1 August 2007)
C. Russia’s role in the global energy market

I. Energy production outlook

Russia is exceptionally well-endowed with energy resources, and the energy sector now plays a central role in the Russian economy. Russia holds the world’s largest proven natural gas reserves, the second-largest coal reserves, and the seventh-largest oil reserves. It is also the world’s largest exporter of natural gas (providing close to a quarter of Europe’s total gas needs) and a major exporter of oil to Europe and, increasingly, Asia and the Pacific.

*Figure A: Oil and gas production areas*

![Map of Russia showing oil and gas production areas](image_url)

Source: IHS Inc. 2006

In particular, according to *BP Statistical Review*, at the beginning of 2004, total oil and gas concentrate reserves on Russia’s continental shelf have an estimated value of

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21 RF State Statistical Committee, above n 18, 360
approximately US$15 trillion (Figure A). With this in mind, it is worth noting that production of oil decreased in the early 1990s as a result of the economic dislocation caused by the collapse of the Soviet Union. Despite this, the production has rebounded strongly since 1999 due to high world prices (Graph X).

*Graph X: Russia's oil production outlook 2007*

![Graph X: Russia's oil production outlook 2007](image)

* During the next five years, oil production outlook is estimated to remain 11MM bo/d
Source: IHS Inc. (2006)

By and large, the share of oil and gas production in the Russian economy has grown sharply in recent years, and it now represents potentially the most appealing area for foreign investment in the energy sector (Table 1.4).

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22 The proven crude reserves of the Russian Federation (including condensate) amounted to 9.5 billion tonnes. Russia holds six per cent of total world oil reserves, ranking the country seventh in the world. At the same time, gas reserves amounted to 47 trillion cubic metres, ranking Russia first in the world in gas reserves with 26.7 per cent of global reserves. According to the 2004 Report of the Energy Charter Secretariat Russian crude oil production will reach 445 to 490 MMTA (Million tonnes per annum) by the year of 2010, with a potential increase to 520 MMTA by 2020 (Australia. Australian Trade Commission, Oil and Gas to Russia (December 2005) <http://www.austrade.gov.au/australia/layout/0,,0_S2-1,-2,-3,PWB110736758-4,-5,-6,-7,,00.html> (2 June 2007)

23 International Energy Agency, above n 19, 284

24 Ibid
**Table 1.4: Russian Energy Strategy projections to 2020**

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2020 (high and low scenarios)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Energy sector</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Primary energy demand (Mtoe)</td>
<td>619</td>
<td>794-881</td>
</tr>
<tr>
<td><strong>Oil sector</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Production (Mt)</td>
<td>383</td>
<td>450-520</td>
</tr>
<tr>
<td>Exports of crude and products (Mt)</td>
<td>248</td>
<td>305-350</td>
</tr>
<tr>
<td><strong>Gas sector</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Production (bcm)</td>
<td>584</td>
<td>680-730</td>
</tr>
<tr>
<td>Exports (bcm)</td>
<td>169*</td>
<td>275-280</td>
</tr>
<tr>
<td><strong>Power sector</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Electricity generation (TWh)</td>
<td>889</td>
<td>1 215-1 365</td>
</tr>
</tbody>
</table>

*Net exports.
Source: Government of the Russian Federation (2003)\(^{25}\)

**II. Particulars of oil supply**

1. **Resources**

According to the 2004 Report of the Energy Charter Secretariat,\(^{26}\) there are over 3,000 oil fields in the Russian Federation, which include around 34,000 oil wells, or 6 per cent of the world’s total. Crude oil reserves have been recorded in 40 administrative subdivisions of the Russian Federation, of which 35 are oil producing.\(^{27}\) Over 70 per cent of Russian reserves and a similar share of current crude oil production are located in West Siberia. The rest of the country’s reserves are in the Volga-Urals region (14 per cent), Timan-

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\(^{25}\) RF State Statistical Committee, above n 18, 360-75
\(^{27}\) The Khanty-Mansi Autonomous District is of the greatest significance with over 50 percent of explored reserves and 46 percent of preliminary estimated reserves. Large reserves are located in the Yamalo-Nenetsky Autonomous District, Nenetsky Autonomous District, and the Republic of Tatarstan. The Republics of Komi, Bashkortostan and Udmurtia, Perm, Orenburg and Tomsk Oblasts have less sizable reserves.
Pechora (7 per cent), East Siberia (4 per cent) and the Far East (3 per cent). Figure C shows the location of these basins and pipelines.

The internationally audited proven reserves of the six largest companies operating in Russia – Yukos, Lukoil, TNK-BP, Surgutneftegaz, Sibneft and Tatneft – amount to 62 billion barrels. Ultimately, however, recoverable reserves are much larger. DeGoyler and MacNaughton, a leading auditor of Russian oil reserves, estimates proven, probable and possible reserves at 150 billion barrels. A 2000 study by the US Geological Survey estimates undiscovered resources of oil and natural gas that are expected to be economically recoverable at 115 billion barrels, or 12 per cent of the total of the world’s undiscovered resources. IHS Energy put Russia’s resources potential at 140 billion barrels at the end of 2001.

2. Crude Oil Production

The last ten years have seen a dramatic turnaround in Russian oil production. Causes include higher prices, the 1998 rouble devaluation, a surge in investment and the adoption of more modern technology and management practices. Production almost halved between 1987 and 1996, reaching a low of 6.1 mb/d, largely as a result of low investment by domestic companies after the break up of the Soviet Union. Production began to recover in 1999, reaching an average of 8.5 mb/d in 2003, and over 9.3 mb/d in August 2004. Much of this growth has come from rehabilitating and stimulating existing wells to enhance the recovery of reserves. Yukos and Sibneft have relied mainly on boosting well productivity to increase output. In addition to this, drilling of development wells had also picked up. The total number of wells in operation is now

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28 International Energy Agency, above n 19, 301
29 Ibid
32 International Energy Agency, above n 19, 301
33 <http://energy.ihs.com/Solutions/Regions/CIS/> (6 August 2007)
34 International Energy Agency, above n 19, 303
close to the number in 1990, despite a number of recent well closures, whereas average well productivity has rebounded, from 51 barrels per day in 1996 to 66b/d in mid-2003.\textsuperscript{36}

\textit{Figure B: Oil export routes}

![Oil export routes diagram](image)

Source: IHS Inc. 2006\textsuperscript{37}

\textsuperscript{36} Ibid
\textsuperscript{37} Felder, above n 20
The introduction of advanced production technologies and modern management practices have helped to raise productivity and boost output. Higher prices have led to strong cash flows, which have helped finance a surge in investment and made possible partnership with international oil and oil-service companies. At US$7.7 billion, total capital expenditure in the upstream oil industry in 2003 was more than three times higher than in 1999.39 Most investment is going to West Siberia and much of it into boosting output at already operating fields (Figure B).

Production growth may slow in the next decade or so, as most low-cost opportunities to stimulate output have now been exploited. Capacity will increasingly need to come from new greenfield developments in West Siberia, including some large fields that were overlooked during the Soviet era because of poor technology. Later, attention may shift to less mature basins such as Timan-Pechora and to frontier areas such as East Siberia, the Pechora Sea, the Russian sector of the Caspian Sea and the Far East. Development and production costs for these projects are likely to be considerably higher than for existing brownfield projects in West Siberia, because of a lack of infrastructure and more difficult geological and operating conditions. The average investment needed per barrel of capacity stands at around US$13,000, which is higher than in most other parts of the world.40

3. Industry structure and the role of the State

There has been a profound shift in relations between the oil industry and the State since 2003. The former president, Vladimir Putin, and his government were reasserting State control over the sector and taming the power and influence of the oligarchs that emerged from the controversial privatisation of the 1990s. The government has indicated that private crude oil pipelines will not be permitted and that it intends to keep Transneft, the pipeline monopoly, in State hands.41

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39 International Energy Agency, above n 19, 303
41 International Energy Agency, above n 19, 307
The Yukos affair has revived fundamental concerns about property rights and the independence of the judicial system, harming the business climate and increasing investment risk. Yet, foreign interest in Russia’s private oil companies remains high. Several foreign oil companies have expressed interest in acquiring stakes in Russian companies, including Sibneft, Yukos and Lokoil (Figure D).

Figure D: Foreign investment

Source: IHS Inc. 2006

Whilst the 2003 merger of Yukos and Sibneft is now being unravelled, consolidation is still the norm in the rest of the industry. Independent upstream companies continue to be absorbed by the vertically integrated Russian majors. The share of small producers in total Russian crude oil output has fallen from around 9.5 per cent in 1998 to 6.5 per cent in 2003.

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42 Ibid
43 Felder, above n 20
44 The top ten “Russian majors” include: Yukos, LUKoil, Surgutneftegas, Sibneft, Tatneft, Rosneft, Slavneft, Bashneft and Gasprom
In summary, the Russian Federation possesses a vast number of oil reserves of international significance. And despite the reported decline in the overall oil production (attributable mainly to the collapse of the Soviet Union), the average production of oil in the territory of the Russian Federation remains higher than that in most other parts of the world.

III. Particulars of gas supply

1. Resources

Russia's gas resources are colossal. It has 47 trillion cubic metres of proven natural gas reserves, which account for 26 per cent of the world total. Gazprom holds the licences to fields holding 55 per cent of these reserves; other producers hold 28 per cent, while the rest are unallocated. Three quarters of Russian gas reserves and a similar share of current production are located in West Siberia (Figure E). European Russia accounts for 16 per cent and East Siberia and the Far East together for the remaining 9 per cent.

Some 20 giant gas fields have been discovered to date, each with more than 500 bcm in reserve. Only seven of these fields have been brought into production. As indicated in the 2004 World Energy Outlook report, Russian gas reserves are equivalent to about 81 years of production at current rates. In addition to proven reserves, there are an estimated 33 tcm of undiscovered gas resources.

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47 Gazprom is the world largest gas company. It plays a central role in the Russian economy, providing up to a quarter of federal government tax revenues. It accounts for almost 90 per cent of Russian gas production and owns and operates the national network of high-pressure inter-regional gas pipelines, which, at over 150 000km, is the longest in the world. It is also the sole owner of gas storage sites in Russia, operating 22 underground facilities. A majority of the shares in the company was sold to private investors in the 1990s. However, the state still holds 38 per cent directly and another 16.6 per cent indirectly, giving it majority control of the board
48 International Energy Agency, above n 19, 309
49 Energy Charter Secretariat, above n 26, 111
50 International Energy Agency, above n 19, 309
51 Ibid
52 The bulk of Russian gas production comes from three super giant fields that have been in production for many years. These fields are Medvezhye, Yamburg and Urengoye. There also emerges a rising output from
2. Export prospects

As it stands, Russia exports gas exclusively to other CIS countries and Europe. In 2003, Russia exported 119 bcm to OECD Europe. Gazexport, a wholly-owned subsidiary of Gazprom, is the sole exporter to Europe. Other non-Gazprom companies export Russian gas to other CIS countries (Figure F).

Rising gas demand in Europe is expected to remain the primary driver of Russian gas exports at least until 2030, although Asia will also emerge as an important new market. In particular, exports to the European Union are expected to climb to 137 bcm in 2010 and 155 bcm in 2030, whereas exports to Asia are expected to reach 30 bcm by 2030.

Increased exports to Europe will require substantial additions to the existing pipeline capacity. The existing capacity is able to meet projected export needs only through to the end of the current decade. Completion of the Yamal-Europe pipeline is expected to increase its output through Belarus and Poland to Germany; however the plans for its construction have been put on hold.

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53 International Energy Agency, above n 19, 313
54 International Energy Agency, above n 19, 313
55 International Energy Agency, above n 19, 313
56 Ibid
Figure E: Major gas reserves and supply infrastructure in the Russian Federation

Source: WEO (2004).\textsuperscript{57}

\textsuperscript{57} International Energy Agency, above n 19, 310
In addition, Gazprom is looking at the possibility of developing LNG exports based on reserves on the Yamal peninsula and in the Barents Sea. However, the costs are expected to be very high due to the extremely harsh climate conditions. For this reason, the World Energy Outlook report estimates that no LNG project other than Sakhalin-2 will proceed before 2030.

Gas exports to Asia in the form of LNG from Sakhalin-2 were expected to start in 2007. The project, owned by a foreign consortium led by Shell, involved the development of an offshore gas field and the construction of a plant with a capacity of 9.6 million tonnes per year. Gas is also known to come from an adjacent oil and associated-gas field. The total investment was estimated to reach approximately US$9 billion.

Pipeline exports to Asia are expected to begin sometime during the next decade. Russia Petroleum, owned by the TNK/BP joint venture, holds a license to develop gas reserves

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59 Felder, above n 20
59 International Energy Agency, above n 19, 313
60 Ibid
at the Kovykta field near Irkutsk in East Siberia. It plans to develop the field and build a pipeline to export the gas to China and Korea, costing the region around US$12 billion and upstream development, another US$5 billion to US$6 billion.  

In short, Russia’s colossal gas resources are expected to stimulate a continued increase in production, to meet steadily growing domestic demands and to provide increased exports to Europe and new markets in the East. It is projected that the gas production will rise from an estimated 608 bcm in 2003, to 655 bcm in 2010 and 898 bcm in 2030. Net exports are expected to rise from 169 bcm in 2002 to 182 bcm in 2030. Higher production will, however, call for considerable investment in greenfield projects to replace declining output from the old fields that have been in production for decades.

D. Conclusion

Today, Russia is the world’s largest natural gas exporter. In the coming decades, Russia is likely to play a central role in global energy supply and trade. The Russian energy sector has already undergone a dramatic transformation. This transformation has been, and remains to be, a principal driver of the country’s economic recovery since the late 1990s.

Until 2010, net exports of oil and gas are likely to increase both in absolute terms and as a share of world inter-regional trade. Much of the increase in Russian oil exports in short to medium terms will be available for export, and will go primarily to Europe, Asia and the Pacific regions.

Gas exports are also likely to increase. Russia will remain the main supplier of natural gas to Europe, and is also likely to emerge as an important supplier of gas to Asian

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61 Ibid
62 International Energy Agency, above n 19, 308
63 Id.
65 International Energy Agency, above n 19, 323
markets. Governments of importing countries in Europe and Asia may seek to improve their energy relations with Russia. Russia may also seek to strengthen its strategic and commercial ties with buyer countries in order to secure long-term outlets for its gas and extract more value from the supply chain.

In short, Russian oil and gas sectors represent potentially the most interesting area for foreign energy investment. Despite this, the Russian oil and gas industry is in great need of investment capital. Aside from the present economic slowdown, this paradox hides behind the uncertainties in the country's current legal regime. In the next Chapter, the reader will be presented with a broad overview of the relevant legislative framework covering foreign investment in the fuel and energy sectors of the Russian Federation.

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66 International Energy Agency, above n 19, 325
Chapter Two

Obstacles for investors under the current legal regime in the Russian Federation

A. Introduction

As discussed in the previous chapter, Russia looms on the horizon as an immense opportunity for investors. The paradox, however, is that Russia is still in great need of foreign investment flows. In this chapter I will examine some of the potential reasons for such a conundrum, and provide an overview of some of the major issues facing prospective investors in Russia’s oil and gas industry today. In short, these reasons (or obstacles), as identified in this chapter, include, inter alia: first, the alleged inefficiencies of Russia’s internal legal regime; second, a much feared likelihood of expropriation or nationalisation of investors’ property rights; third, the issue related to state immunity from jurisdiction of foreign courts and arbitral tribunals, and finally, the investors’ alleged obligations to resolve all present and potential disputes within the local court system of the Russian Federation. Each of these major obstacles shall now be examined.

B. Inefficiencies of Russia’s internal legal regime

I. General

Presently, foreign investment in Russian subsoil reserves is regulated by a collection of federal and regional laws, including: the Constitution of the Russian Federation of 1993,

Despite the force and historical development of these laws, it remains questionable as to whether Russia’s current legal environment is sufficiently adequate for foreign participation. Some of the issues related to these laws seem to include: overlapping and conflicting powers of federal and local authorities, exposure to double taxation and exposure to changing and supervening legislation. In the following section I will provide an overview of Russian legislation relevant to the regulation of investment activities in the energy sector, and present the reader with an outline of the historical development and current implications of Russian law in this area.

II. The Law on Foreign Investment of 1991

1. Overlapping legislative powers regulating foreign investment in subsoil

Historically, all mineral resources of the Russian Federation, including oil and gas, were assumed to fall under the jurisdiction of regional authorities. In the 1930s, the ownership of these resources shifted to the federal authorities, called the Supreme Soviet, under the theory that state government had consented to delegate their authority to the latter.\(^1\) However, with the collapse of the Soviet Union, regional authorities began to reassert ownership rights to the oil and gas in their respective territories.\(^2\) Unwilling to challenge these claims, federal superiors agreed to a system of overlapping jurisdiction.

Such agreement was subsequently incorporated, \textit{inter alia}, into the 1991 RF Law on Foreign Investment (\textit{Law on Foreign Investment}), which was aimed at regulating all foreign investment activities within the territory of the Russian Federation. The Preamble to this law states specifically that all matters regarding foreign investments shall be subjected to this federal law. In particular, it stated that:

\(^2\) Ibid
The provisions of [this law] operate on the territory of the Russian Federation with respect to all foreign investors and enterprises with foreign investments.3 (Emphasis added).

Bearing in mind the fact that the Law on Foreign Investment is the federal legislation, it may appear that this law was intended to prevail over any regional laws attempting to regulate the same subject matter. However, closer examination reveals that the drafters of the Law on Foreign Investment did not intend such a result.4 In fact, the drafters left the system of overlapping authority firmly in place, which is evident from the wording of its Article 38, where it was stated that:

[Foreign investment in land or natural resources is subject to this Law and] other legislative enactments in force on the Territory of the Russian Federation.5 (Emphasis added).

Since it can be argued that the phrase “other legislative enactments” is sufficiently broad to encompass the myriad laws, taxes, regulations and fees enacted by assertive regional or state governments,6 the investor, who is required to comply with all federal regulations, must additionally comply with all regulatory power entrusted in the regional state authorities.7

The conformation of the existence of a system of overlapping jurisdiction was also reinstated in the Constitution of the Russian Federation of 1993. Article 130(1) of the Constitution provided that the regional State governments of the subjects of the Russian Federation shall have powers to render independent decisions regarding “the ownership, use and disposal of its municipal property”.8 All mineral resources conveniently fell

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3 Law on Foreign Investment 1991 (Russian Federation), Preamble (Emphasis added)
4 Stoleson, M, ‘Investment at an impasse: Russia’s Production Sharing Agreement Law and the Continuing Barriers to Petroleum Investment in Russia’ (1997) 7 Duke Journal of Comparative & International Law 671, 678
5 Law on Foreign Investment 1991 (Russian Federation), Article 38 (Emphasis added)
6 Stoleson, M, above n 4, 678
7 Law on Foreign Investment 1991 (Russian Federation), Part IV.C.3
8 Constitution of the Russian Federation 1993, Art 130.1 (“Local self-government in the Russian Federation shall ensure independent solution by the population of local issues, the ownership, use and
under the definition of such “property”. Furthermore, according to Article 72(1)(c) of the Constitution, “possession, use and disposal of land, subsoil, water and other natural resources”, as well as management of the subsurface, are subject to the joint authority of the Federation and its regions. Therefore, the allocation of the use of the subsurface is based on joint decisions by federal and regional authorities.

Hence, a close examination of the Russian Law on Foreign Investment and the Russian Constitution shows that both federal and regional state authorities had conferred overlapping powers to regulate foreign investment within their respective territories.

2. Double taxation

Another obstacle to foreign investment in the Russian Federation is the Russian tax regime. The Law on Foreign Investment referred potential investors to the taxation laws “currently in force” in the Russian Federation. Not surprisingly, these laws allow both federal and local governments to subject foreign investors to their respective taxation regulations concurrently. This represents an obstacle for investors because bearing such a burden renders the whole investment process less profitable.

3. Exposure to supervening legislation

Yet another major inefficiency of Russia’s internal legal regime is the fact that Russian legislation is continuously subjected to new changes and updates. This means that an
investor may well be exposed to additional administrative and legislative obstacles relating to investment activities. For example, in order to get a licensing permit, the new legislation may require an investor to obtain a number of additional approvals of various agencies concerned. If this were to occur, an investor would inevitably lose valuable time in order to comply with these requirements, resulting in major inconvenience and additional financial burdens.

In addition, the practice of introducing amendments into existing legislation is also flawed, and amendments are often made to resolve short-term issues which undermine the existing principles of legislative regulations. A good illustration of such practice can be seen in the case of American Richfield Company (ARCO), which decided to invest in the Russian oil and gas market in September 1996 by expanding its partnership with AO Lukoil Holding (one of the Russia’s largest oil companies), subsequently signing a $5 billion venture to jointly develop projects in the former Soviet Union. In order to allow the transformation of ARCO (which initially was formed as a stock company) into a non-commercial organisation, an amendment was made to the Russian Civil Code envisaging the possibility of the conversion of joint stock companies into non-commercial organisations, the participants of which have completely different rights regarding participation in the management of the said legal entities. This example shows that the lack of coordination between federal and regional legislation in the Russian Federation is a destabilising factor for entrepreneurial activity.

In summary, pursuant to the provisions of the Constitution of the Russian Federation and the Russian federal Law on Foreign Investment, both federal and local governments have powers to regulate foreign investment. As a result, investors may well be exposed to taxation laws, excise fees and licensing requirements at both the federal and local levels.

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13 Basi, R, 'Foreign Investment in the Russian Oil and Gas Industry: A Time for Reckoning' (1993) 5 International Legal Perspectives, 45 (note 13)
15 Ernst & Young, Investicionni Climat v Rossii (The Investment Climate in Russia) (Moscow: Ernst & Young, 1999)
concurrently,\textsuperscript{16} meaning that an investor may be “legally” required to pay, for example, its exploration and drilling license fees, as well as the land use taxes, at least twice.

\textbf{III. The RF Law on Subsoil of 1992}

In order to overcome the inconsistencies brought about by the \textit{Law on Foreign Investment} in conjunction with other forms of pre-existing investment legislation, in 1992 the federal government introduced a new law, which became known as the \textit{RF Law on Subsoil of 1992}\textsuperscript{17} (Subsoil Law) which was drafted specifically to regulate foreign investment in natural resources.\textsuperscript{18}

Importantly, this law made one significant advance towards the establishment of a more acceptable legislative climate for foreign investors. It provided for the use of concessions and Production Sharing Agreement contracts (PSA Contracts), in conjunction with a licensing system, which were designed to stabilise the investment environment and to attract foreign capital.\textsuperscript{19} In the following section the reader will be presented with a brief overview of the advantages and peculiarities of a typical PSA Contract.

\textit{1. The nature and significance of the typical production sharing agreement}

Production Sharing Agreements (PSA) are contracts pursuant to which foreign investors transfer to the government of the Host State a share of the oil produced in lieu of taxes. Such transfers, in effect, constitute payment made by the investors to the Host State.\textsuperscript{20} The percentage of oil received by the Host State should total in value that to which the State would have received from same investors by means of taxation, including income tax, value added tax (VAT), export and other taxes.

\textsuperscript{16} Stoleson, M, above n 4, 677
\textsuperscript{17} The Subsoil Law 1992 (Russian Federation) was based on the concept of the state as owner of the resources giving an administrative-law permit (“licence”) to operators to explore and exploit mineral deposits. See Waelde, T and Friedrich, M, \textit{Introductory Note: The 1996 Russian Production-Sharing Law, The Centre for Energy, Petroleum and Mineral Law and Policy, 2000} <http://www.dundee.ac.uk/cepmlp/journal/html/vol3/article3-12.html> (16 July 2007)
\textsuperscript{18} Coine, G, above n 1, 429
\textsuperscript{19} Coine, G, above n 1, 429
\textsuperscript{20} Stoleson, M, above n 4, 681.
To regulate PSAs, the majority of the Host States introduced into their legal systems various Production sharing Laws (PSA Laws), designed to attract foreign investment specifically in the oil and gas industries.\textsuperscript{21} A typical PSA Contract protects the foreign investor by enabling him to contract out of the legal environment of the Host State.

A Production Sharing Agreement includes the following elements: the foreign investor and the government of the Host State negotiate a contract listing the rights and obligations of the parties, which are then enforceable in either international arbitration or the courts of a third country.\textsuperscript{22} When oil is produced, the foreign investor is allotted a portion of the produced oil sufficient to cover the costs of the project (known as Cost Oil) and whatever is left (known as Profit Oil) is divided between the foreign investor and the government of the Host State (known as Government Take) according to a predetermined percentage.\textsuperscript{23}

The main feature of a PSA contract is that it is entirely self-contained,\textsuperscript{24} in that it allows the foreign investor legal protection and guarantees regarding their investment. Similarly, the Host State benefits by attracting foreign investment while maintaining control over the specifics of large scale oil projects, and maintaining title over the resources in question throughout the process of exploration and extraction.\textsuperscript{25}

2. Peculiarities of the Russian law regulating Production Sharing Agreements

In Russia, the concept of Production Sharing Agreements seems to have taken on a life of its own. The provisions of the Russian Subsoil Law were somewhat different to those

\textsuperscript{21} Coine, G, above n 1, 362
\textsuperscript{24} Skelton, J, ‘Investing in Russia’s Oil and Gas Industry: The Legal and Bureaucratic Obstacles’ (1993) 8 National Resources and Environment 26
\textsuperscript{25} Ibid. This is different from other popular forms of oil contracts such as concession agreements where the state actually transfers ownership of the oil to the foreign investor. See also Smith, E, ‘From Concessions to Service Contracts’ (1992) 27 TULSA Law Journal 493, 527
provided for in the typical PSA Laws. Namely, the sharing of production was not performed with a company holding the title to the resources, but directly with the Russian government (in offshore operations), and jointly with regional authorities (when the area in question was in a regional authority jurisdiction). In other words, the mineral rights in the Russian Federation were typically held by the State (or State enterprise) whereas an investor was provided with a mere authority to exploit such rights on behalf of the State. Furthermore, subsequent to the conclusion of a PSA Contract, the investors still had to obtain the mineral licence, required under the Subsoil Law.

Hence, the Russian Subsoil Law did not offer investors the same level of security in that it still exposed investors to other relevant legislation in force on the territory of the Russian Federation. As a result, the familiar problems of overlapping authority, supervening legislation and hostile taxation environment were created.\(^{26}\) It is therefore appropriate to conclude that Russian law, with regard to the Production sharing Agreements, did not allow for the self-contained contracts anticipated by foreign investors.

In order to add clarity and consistency to the existing Subsoil Law, in 1995 the government of the Russian Federation introduced another federal law dealing particularly with Production Sharing Agreements. This law became known as the Law on Production Sharing of 1995 (Russian PSA Law).

**IV. The Law on Production Sharing of 1995**

While under the old system the mineral right was vested exclusively with the State, with the introduction of the new law, the Law on Production Sharing of 1995, the investor did not need to obtain a mineral licence subsequent to the conclusion of a PSA Contract. In particular, under Articles 2-4 of the Russian PSA Law, subsequent to the conclusion of a PSA Contract, the mineral licence was issued to the investor quasi-automatically, making

\(^{26}\) Stoleson, M, above n 4, 683
the contract seemingly self-contained. Despite this, it is still far from clear whether even under this law the recognition of contractual supremacy will, indeed, be applied to practice.

1. An attempt to deal with issues of overlapping authorities and supervening legislation

Attempting to mitigate the risks of overlapping and conflicting authorities, evolving legislation, double taxation and endless bureaucracy, the drafters of the Russian PSA Law introduced a so-called “stability” clause. Namely, Article 17 of the Russian PSA Law requires consent from both parties for changes to the agreement, thus precluding the unilateral imposition of revised terms by the government.

At the same time, the second limb of Article 17 was drafted in contemplation of the legislative changes, whereby the investors were allowed to obtain “same economic benefits” they would have obtained, in case the applicable legislation was indeed altered. In particular, the relevant provisions of Article 17.2 read as follows:

If the changes to the federal or local legislation have a negative effect on the foreign investor, the terms of the agreement between that investor and the Host State shall be modified so that the investor can obtain same economic benefits which it would have obtained in the absence on any legislative changes. (Translation).

The Russian administrative law is drafted in a manner that represents a so-called “command by the State”. Some commentators even note that this law embodies the traditions of the Communist command-control planning system: Waelde, T and Friedrich, M, Introductory Note: The 1996 Russian Production-Sharing Law, The Centre for Energy, Petroleum and Mineral Law and Policy, 2000 <http://www.dundee.ac.uk/cepmlp/journal/html/vol3/article3-12.html> (16 July 2007). On the other hand, the “civil law” approach, embodies in the Russian Civil Code of Civil Procedure (under which the new Law on Production Sharing Agreements 1995 (Russian Federation) was created), is considered to implement the notion of equality in contractual relationship between the Host State and the investor.

Original text: “Статья 17. Стабильность условий соглашения. 2. В случае, если в течение срока действия соглашения законодательством Российской Федерации, законодательством субъектов Российской Федерации и правовыми актами органов местного самоуправления будут установлены нормы, ухудшающие коммерческие результаты деятельности инвестора в рамках соглашения, в соглашение вносятся изменения, обеспечивающие инвестору коммерческие результаты, которые могли бы им быть получены при применении действовавших на момент заключения соглашения законодательства Российской Федерации, законодательства..."
Hence, while this “stability” clause, in theory, was an innovative solution to the problem of overlapping authority, its wording, as expressed in Article 17 of the Russian PSA Law, was too vague to mitigate investors’ concerns. In particular, this “stability” clause neglects to provide definitions of certain crucial terms, such as negative effect and economic benefit, leaving their interpretation to the authorities of the Host State. Even if the authorities agree with the investor that the investor was deprived of the economic benefit solely due to changing legislation, the PSA law does not describe how the agreement may be modified to protect the investor’s profit margin.29

2. An attempt to deal with the issue of aggressive taxation

Similar to the issue of changing legislation, Russian PSA Law, arguably, failed to deal adequately with the matter of aggressive taxation. Article 13.1 of the Russian PSA law (Статья 13.1) reiterates a traditional PSA structure whereby the investor pays the Host State a percentage of the oil produced in lieu of taxes.30 In other words, the investor was freed from having to pay any taxes other than income tax and certain payments for the use of subsoil. The original text of Article 13.1 reads as follows:

Статья 13. Налоги и платежи при исполнении соглашения
1. За исключением налога на прибыль и платежей за пользование недрами, инвестор в течение срока действия соглашения с учетом положений пункта 3 настоящей статьи освобождается от взимания налогов, сборов, акцизов и иных обязательных платежей (за исключением предусмотренных пунктом 6 настоящей статьи), предусмотренных законодательством Российской Федерации. Взимание указанных налогов, сборов и иных обязательных платежей заменяется разделом продукции на условиях соглашения в соответствии с настоящим Федеральным законом.31

29 Stoleson, M, above n 4, 683: “Presumably the drafters intended the investor to set off the damages incurred by challenging legislation against the government take of the produced oil. If this is the case, then the investor is only protected from local taxation and fees up to the amount of government take. In case where a local or federal authority imposes regulations which amount to more then the government take, the investor will be left without recourse”.
30 Law on Production Sharing Agreements 1995 (Russian Federation), Article 13.1
31 Article 13. Taxes and other duties payable upon entering into an agreement.
However, paragraphs two through to six of Article 13.1 compromised the law by imposing upon an investor an additional number of taxes, including income tax (as high as 32 per cent\textsuperscript{32}), value added tax\textsuperscript{33} (recoverable only if oil is found and produced\textsuperscript{34}), bonuses, royalty payments, and payments for the use of land. A closer analysis of this law, therefore, shows that the taxes payable by the investor under the Russian PSA Law are almost identical to those payable under the Russian Law on Foreign Investment. This supports the view that the Russian PSA Law offers little, if any, benefit to an investor.

Likewise, the investor who signs a PSA Contract with the Russian Federation is automatically subjected to existing legislation in the area of export duties and tariffs.\textsuperscript{35} For example, Article 9.2 of the Russian PSA Law states that investors may export oil without limitations "except those [limitations] found in the Law on Foreign Investment" (emphasis added). One of the limitations, however, gives the government power to impose "export tariffs, quotas and license fees" as it deems appropriate.\textsuperscript{36} This finding points to the fact that the Russian government may unilaterally modify any tariff or license structures, which the parties contracted for, every time it exercises its authority under the Law on Foreign Investment.

\textsuperscript{1} Except for the income tax and royalty payments, the investor ... is freed from paying its taxes and other duties otherwise imposed by the law of the Russian Federation. The payment of taxes and other relevant duties are substituted by sharing of product as prescribed by the agreement and in accordance with the current law of the Russian Federation. (Translated by the author of this thesis)


\textsuperscript{33} Under Article 13.3 of the Law on Production Sharing Agreements 1995 (Russian Federation), the investor must pay value added tax, which is essentially a tax on the incremental value the foreign investor's service add to the final product of exportable oil, including the value of goods and services the foreign investor must utilize to produce the final product. The value added tax is an especially lucrative tax for the Russian government in light of Article 7.2, which mandates that the investor gives preference to Russian products, services and technology. Under Article 7.3 the investor must not only use Russian contractors, producers and suppliers, but must also stipulate in the PSA contract to using a "minimum percentage of technological supplies that must be purchased in Russia". This means that the investor is forced to purchase goods and services in Russia under Article 7.2, which are then subject to value added tax under Article 13.3: Moss, G, above n 22, 2

\textsuperscript{34} Law on Production Sharing Agreements 1995 (Russian Federation), Article 13.3

\textsuperscript{35} Id, Article 9.2

\textsuperscript{36} Moss, G, above n 22, 2
It can thus be concluded that in the areas of tax, export duties, and dispute resolution, the Russian PSA Law is firmly attached to existing Russian legislation. What is more damaging for foreign investment, however, is the fact that this legislation is still prone to continuous changes and amendments, which could potentially destroy a profitable venture. There are currently no provisions in the Russian PSA Law to restrict the government of the Russian Federation from exercising its legislative powers under the Law on Foreign Investment and the Subsoil Law to raise income taxes or export duties. This is particularly challenging for foreign investors considering that both federal and local governments have a constitutional right to raise taxes or enact new ones (if they consider it appropriate) regardless of the “stability” provisions of Article 17 of the new Russian PSA Law.

V. The 2005 draft of the new Subsoil Law

In the year 2000, the Russian government decided to renew the country’s legislative situation and adjust it to a more market-based legislative environment. These efforts have started after adoption of the first economic program of the Russian government following the election of Vladimir Putin as the Russian President. The Program was adopted by the government headed by Michail Kasyanov, and had included a wide range of legislative initiatives, the purpose of which was the establishment of the comprehensive legislative framework for further developments of the economy. The first tier of these legislative reforms has included adoption of the Land Code, third part of the Civil Code, second part of the Tax Code, new Labour Code, etc., thus introducing the basic legal framework for normal functioning of market institutions.

The Russian Ministry of Natural Resources was put in charge of the development of the new Subsoil Law. A draft of this law was settled in early 2003. This draft law was

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37 Stoleson, M, above n 4, 685
38 Moss, G, above n 22, 2
39 Constitution of the Russian Federation 1993, Article 132.1 (local authorities can “manage municipal property” and “establish local taxes and levies”) and Article 75.3 (Federal government may establish a “system of taxes to be collected for the federal budget”)
40 Milov, V, The New Russian Subsoil Law and its Implications on Oil & Gas Upstream Business and Foreign Investment (Moscow: Institute of Energy Policy, 2005), 1
further revised by the Ministry of Economic Development and Trade of the Russian Federation, which in turn proposed another draft of the same legislation. In 2004, after the reorganisation of the Russian government connected with the re-election of Vladimir Putin, ministerial responsibilities with regard to the new law had again been changed, and the Ministry of Natural Resources, under the new head Yuri Trutnev, was put in charge of the development of the new law. The Ministry, headed by Mr Trutnev, finally, chosen to develop its own new draft, differed completely from those proposed earlier.41

This last draft was finally approved by the Russian government on March 17, 2005, and submitted to the State Duma on June 17, 2005. It should be noted that this draft did not touch upon the issue of overlapping legislative powers, nor did it discuss the matter of double taxation. However, it did attempt to resolve the issue of continuous legislative changes much feared by the investors. The drafters of this law seemed to have reached a consensus that the new law should produce minimum effect on the existing license holders in terms of reconsideration of the initial terms of license agreements (to avoid the negative impact of the new law on the business and investment climate in the subsoil sector).42 Therefore, all of the recent draft law versions had included provisions to retain previously issued rights for old investors, so new legislation would apply only to the relationships, which began after the new law became effective, or to the relationships with investors who would voluntarily choose to transfer from licenses to civil contracts.

The general weakness of this draft, however, was in the fact that the licenses already issued were not just left alone under the old license conditions, but were given a completely new regulatory framework, different from the one set by the existing subsoil legislation. This meant that while the new law seemed to have shielded investors from any issues related to the change of legislation, such a shield in reality was only illusory. This is because the old licenses would violate the new legislative requirements, unless they were either amended or reissued to ensure their compliance to the new law.43 This proposed new law, however, still has not come into force, and the primary law which

41 Id, 2  
42 Id, 3  
43 Ibid
governs the subsoil area in the Russian Federation to-date remains the 1992 federal Law on Subsoil, with its subsequent additions and amendments (particularly those incorporated in 1995).

**VI. Conclusion**

Russian law regulating the development of its subsoil (including investment) has a long history of development. Despite some progress in the area of the introduction of market-based legal mechanisms in subsoil activities and strengthening of fundamental laws and guarantees for foreign investors, current law preserves the environment of uncertainty for foreign investors. In other words, one of the largest barriers for the attraction of foreign investment into the Russian oil and gas industry is Russia's unstable legal regime and, in particular, the lack of adequate laws regulating this sector.

**C. Expropriation/ nationalisation**

**I. General**

The second major obstacle for foreign investors in the Russian energy sector is the Host State’s right to expropriate or nationalise foreign investment. This right is inherent in the sovereignty of each State. The concept of “State sovereignty”, which will be looked at in detail in chapter 4, lies at the heart of both customary international law and the Charter of the United Nations. State sovereignty denotes the competence, independence and

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44 Ernst & Young, above n 15
45 Vaughan, K, above n 32, 832
47 United Nations. UN Charter <http://www.un.org/aboutun/charter> (16 August 2007) (In accordance with Article 2(1) of the UN Charter, the world organisation is based on the principle of the sovereign equality of all member states. While they are equal in relation to one another, their status of legal equality as a mark of sovereignty is also the basis on which intergovernmental organizations are established and endowed with the capacity to act between and within states to the extent permitted by the framework of an organisation.)
legal equality enjoyed by all free States. This concept is generally used to encompass all matters in which States are permitted to make independent decisions and act without intrusion from other sovereign States. These matters include choices of political, economic, social and cultural systems, the formulation of foreign policy and, among other matters, the ownership of the State's natural resources.

The principle of State sovereignty is enshrined in the Constitution of the Russian Federation. Article 4(1) of the Constitution states:

Суверенитет Российской Федерации распространяется на всю ее территорию.
(The sovereignty of the Russian Federation shall cover the whole of its territory).

The Russian Federation, as a sovereign State and as the ultimate proprietor of its natural resources, has a right to deal with its property in a manner in which it deems fit. Collateral to such power is a statutory right to dispose of the natural resources, including the disposition by way of expropriation or nationalisation, which is precisely one of the primary concerns of foreign investors.48

II. Meaning of the concept of expropriation/ nationalisation

Expropriation is commonly understood to mean unilateral interference by the State with the property (or comparable rights) of the investor, whereby the State deprives that investor of control of the latter's property.49 A similar concept is nationalization, which denotes the transfer of an economic activity to the public sector as part of a general intergovernmental program of social and economic reform.

Traditionally, the direct physical dispossession of the property of the foreign investor by the Host State was not in itself illegal provided that such dispossession met three conditions of legality. First, it was done for a public purpose which was in the public

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48 The right to expropriate/ nationalize foreign property will be discussed in more detail in Chapter Four
interest. Second, it was not discriminatory, and was carried under due process of law. And third, it was accompanied by the payment of prompt, adequate and effective compensation.\(^50\) However, an act of the taking of foreign property has come to be clouded with difficulty as a result of the progressive expansion of the concept of taking. Today, this concept is said to include “direct taking” (or in other words – “direct expropriation”), and “indirect taking”, also known as “indirect” or “creeping” expropriation.

The problem of “indirect” taking of foreign property is reasonably straightforward. Indirect taking diminishes the rights and interests of the investor by State action without necessarily affecting the direct ownership of the foreign investment. In other words, it means that such governmental taking does not need to meet the three above-mentioned conditions of legality, resulting in the dispossession of investor’s property without any compensation. Such a broad understanding of indirect taking would potentially cover all government actions including state legislations and regulations.

Indirect expropriation is generally achieved through restrictions and infringements upon: (i) the entry of foreign wealth into the country, (ii) the use of foreign wealth, and (iii) the revenues produced from the investment of that wealth.\(^51\) Within the first category are situations in which the Host State prohibits the entry of foreign capital into certain sectors of industry. For example, in the Canadian National Energy Program, the Canadian government stated that:

Firms that are foreign-controlled will continue to be non-eligible for the Foreign Investment Review Act (FIRA) purposes.... [T]he government does not want to see the oil companies use their cash flow to expand into the non-energy part of the economy, nor does it want foreign-controlled firms to buy already-discovered oil and gas reserves.\(^52\)

\(^{50}\) Such provisions of legality can be found in, inter alia, Article 13 of the 1994 ECT
\(^{52}\) ‘Canadian National Energy Program’ (1 August 2007) <http://pages.cpsc.ucalgary.ca/~carman/courses/nep.html> (5 August 2007)
The second category involves situations in which the Host State decreases the use of foreign wealth by increasing public sector ownership in a particular industry. Increased public sector ownership is usually achieved by accelerating tax regimes and conferring rights and concessions for domestic traders and industries.\textsuperscript{53} The negative effect of this type of action is particularly acute in the Russian Federation where the taxation regime is in a state of constant evolution and federal and regional governments are able to impose separate and concurrent taxes.

Under the last category of methods for achieving indirect expropriation of foreign investment, the foreign government can use exorbitant taxation policies for already existing contractual rights. Such governmental regulations could be designed to depress the trading shares of foreign-controlled firms so that takeover bids by the public sector become more attractive. Evidently, under any of the above-mentioned mechanisms of "indirect" expropriation, the investor risks losing property (or a substantial part thereof), and is unlikely to be compensated by the Host State for the former's apparent losses.

\textit{III. The consequences of expropriation/ nationalisation on investors' interests}

While governments will typically compensate property owners for a direct expropriation, it is rare for governments to compensate property owners for reductions in property value caused by regulatory changes. In general, most States do not provide compensation for the effects of regulatory changes resulting from legislative, executive or judicial decisions, even though such changes may cause losses more severe than outright expropriation.

\textsuperscript{53} Mendes, E, above n 51, 489-501
D. State immunity from jurisdiction in legal and arbitral proceedings

The third issue posing a major concern for foreign investors is that of State immunity. State immunity is based upon the concept of sovereignty in the sense that a sovereign may not be subjected, without its approval, to the jurisdiction of another sovereign.\textsuperscript{54} State immunity may be pleaded by a Host State when a person wishes to make that State a party to legal proceedings in the court of another State.\textsuperscript{55} If successful, the plea prevents a foreign court from exercising jurisdiction over that Host State.\textsuperscript{56}

State immunity is a doctrine of customary international law. It was developed from the judgements of domestic courts (case law) whose approaches to State immunity differ from one country to another depending upon the country’s legal, political and economic systems. In most Western countries, the concept of sovereign immunity is interpreted in line with the theory of “restrictive” State immunity. Such theory is based on the distinction between commercial activities of the State (\textit{acta jure gestioinis}) and its sovereign activities (\textit{acta jure imperii}). According to this theory, a State enjoys immunity only if it acts in its capacity as a sovereign. Conversely, if a State engages in commercial activities, it would not be in a position to enjoy the privileges of immunity.\textsuperscript{57}

In some of the developing countries and countries with transitional economies, among which are the blocs of the former Soviet Union (including the Russian Federation), the concept of the immunity of the sovereign State is still seen as “absolute”. As opposed to the notion of “restrictive” State immunity, the theory of “absolute” State immunity is based on the idea that no suit may be brought against a State without its consent, regardless of the nature of the dispute. If a judgement is entered into against the State’s consent, such judgement may not be executed.

\textsuperscript{55} Aust, A, \textit{Handbook of International Law} (Cambridge: Cambridge University Press, 2005), 159
\textsuperscript{56} In this case the dispute can only be disposed of only by the court of the foreign State itself, or by an international court or tribunal, or by diplomatic settlement
\textsuperscript{57} Newman, L, et al, above n 54, 144
An example of the application of absolute State immunity is shown in the case of *Embassy of the Russian Federation v Compagnie Noga d'importation et d'exportation*. The Russian Federation, as a sovereign State, signed not only an arbitration clause providing for arbitration at the Stockholm Chamber of Commerce, but also an express waiver of “any right of immunity”. The Paris Court of Appeal came to the conclusion that the waiver of immunity did not extend to the immunity from execution guaranteed by the *1961 Vienna Convention on Diplomatic Relations* and customary international law on diplomatic immunities. Likewise, in two recent German cases the court ruled that the Russian Federation enjoys state immunity at the level of execution of the award since the attached claims arose directly out of sovereign activity. Furthermore, the court confirmed that Russia had not waived its execution immunity. And whilst the agreement in the relevant bilateral investment treaty to submit disputes to arbitration was held to be an implicit waiver of immunity from suit, such a waiver did not extend to immunity from execution proceedings.

In summary, the theory of “absolute” immunity is based on the assumption that the State and its property should always be protected and be governed by its own interests under its own laws. In exercising this right, a State does not lose its sovereignty by entering into commercial transactions with other States or foreign investors, regardless of the contractual agreement between the parties. Such a legal position clearly poses a number of issues for investors in the Russian oil and gas industry. It means investors will not be able to challenge the position of the Host State in any other jurisdiction, without the consent of the latter.

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58 Case No. 2000/14157, Paris Court of Appeal, 1st Chamber, Section A (unpublished) (decision rendered on 10 August 2000)
59 Consequently the Court of Appeal ordered the lifting of arrest orders obtained by Noga with respect to bank accounts opened in the name of Russian Federation
60 Case No. VII ZB 08/05 and VI ZB 09/05, German Federal Court (4 October 2005)
E. Enforced exposure to State courts

The final obstacle for foreign investors that will be looked at in this chapter is the issue of investors’ enforced exposure to the jurisdiction of the Host State’s courts. In order to preserve their sovereignty and also to prevent the interference with the decisions of their own domestic courts, sovereign States often appeal to the so-called doctrine of Local Remedies, which in principle, precludes any diplomatic protection, as well as international adjudication or arbitration, so long as the aggrieved party (in this case a foreign investor) has not exhausted the remedies offered by the administrative and judicial systems of the Host State.\(^{61}\) Such enforced exposure to the Host State’s domestic courts causes a great deal of concern for foreign investors due to the high level of corruption and the lack of separation of judicial and political powers in some Host States. What this means is that the foreign investor, by making an investment, is automatically submitting to the law (or the absence of it) of the Host State, which may not only prove unfavourable in terms of commercial interest, but which may potentially be applied by a non-impartial adjudicator.

The doctrine of Local Remedies is also promulgated in the so-called Calvo Doctrine, pursuant to which the jurisdiction in international investment disputes lies with the country in which the investment is located. The Calvo Doctrine operates to prohibit adjudication or arbitration, or indeed any diplomatic intervention, before the local remedies are exhausted.

Historically, both these doctrines were justified as a necessity to prevent the abuse of the jurisdiction of weak nations by more powerful ones. They have since been incorporated into many investment treaties, statutes and contracts. Nowadays, both these doctrines are used in concession contracts and clauses to give local courts final jurisdiction.

In the Russian Federation, the doctrine of Local Remedies is embodied in the Law on International Commercial Arbitration of 1993, the mandatory rules of which, provide for

cases where national courts have exclusive jurisdiction over certain types of disputes. Among these disputes are cases relating to administrative and public order issues (e.g. disputes with government bodies regarding tax, competition issues, etc); bankruptcy; incorporation and liquidation of legal entities; disputes between a company and its shareholders; and protection of goodwill. Furthermore, if one of the parties to the dispute is a foreign entity, the list for exclusive jurisdiction is extended to include disputes over state property, including issues of privatisation, disputes over real property located in Russia, disputes over registration of trade-marks and patents in Russia and disputes on invalidation of entries in the state registers (e.g. the real property register). Hence, exposure to Russian domestic courts poses another concern to foreign investors, resulting in yet another obstacle in the expansion of foreign participation in the Russian energy industry.

F. Conclusion

Russia is a vast country stretching across Europe and Asia, possessing immense wealth in the form of exploitable natural resources, technology and a large skilled workforce. It is a country whose goals are to move towards a market system based on private capital investment and enterprise and to integrate rapidly into the world economy. The opportunities for investment in the Russian Federation are immense. However, the existing level of foreign direct investment in the Russian economy remains far short of the existing need. The low levels of investment are not due to any lack of opportunities or potential. The foreign direct investment shortfall is attributable to the fact that political and legal conditions in Russia are not altogether favourable to foreign investors.

This chapter has identified some of the major obstacles for foreign investors to inject capital into the ventures situated within the territory of the Russian Federation. In

63 Öğütçü, M., Attracting Foreign Direct Investment for Russia's Modernization: Battling Against the Odds, paper presented at the OECD-Russia Investment Roundtable, 19 June 2002, 1-3
particular, this chapter presented an overview of the alleged inefficiencies of Russia’s internal legal regime, including overlapping legislative powers, aggressive taxation, supervening legislation, expropriation and nationalisation, sovereign immunity and enforced exposure to Russian domestic courts.

Some of the legislative drawbacks highlighted in this chapter are purely academic and hence are not indicative of the actual situation faced by investors in the Russian oil and gas industry. It is also noteworthy that there are views that the Russian legal environment provides adequate solutions for investment activities located within the borders of the Russian Federation.\(^{64}\) The information provided in the following chapters will be based upon the assumption (which is not necessarily correct) that Russian internal laws preserve the environment of uncertainty for foreign investors. In the next part the author will argue that a combination of contract and public international law can offset the risks and challenges discussed in this chapter.

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\(^{64}\) Rozenberg, M, 'Commercial Dispute Resolution in Russia' (October 2006) *Russian Investment Review* 44, 44-45. See also Öğütçü, M, above n 63, 3-10
Part II

Investment Protection Mechanisms
Enforcement of State contracts as a mechanism for investment protection

A. Introduction

The stability of the investment conditions responsible for economic and financial performance of the investment venture lies at the heart of investors’ concerns. Such matters are, therefore, frequently placed at the centre of contractual negotiations. This is particularly so for natural resources and energy projects, which are typically lengthy in duration, expensive and risky.¹ In this chapter it will be proposed that the parties’ contractual undertakings can provide much needed stability.

In this regard, the parties’ contractual undertakings (contractual terms) can serve as a powerful tool for the protection of the investor’s rights in that such undertakings provide investors with a real possibility of enforcing the Host State’s contractual obligations. The main objective of this Chapter is to demonstrate that where the peculiarities of the Host State’s internal legal regime for the protection of foreign investment fail to provide investors with satisfactory solutions, the provisions of the parties’ contract may fill the gap created by the existing legal commotion. This chapter will analyse various contractual terms providing for the protection of foreign investment, and will conclude by suggesting that correctly formulated and well-structured contractual clauses will

generally provide much needed assurance to the potential investors in the Russian energy industry.

B. Contract with government as a method of political risk management

Contracting with the State (or State agency) is an important component of political risk management. This strategy is informed by the intention to commit the government (including future governments) to the specific investment and fiscal regimes agreed upon during the negotiations. The compilation of the originally negotiated investment and fiscal conditions results in an agreement, which is also commonly known as a “State contract”.  

An investment agreement represents the preferred legal instrument for setting the framework for large-scale and high-risk projects. The presence of specific provisions in the agreement could potentially warrant against any subsequent government intervention. Such provisions will often include stabilisation clauses, renegotiation clauses, arbitration clauses and clauses selecting law and forum. A brief survey of the contents and nature of such contractual clauses will now be undertaken.

C. Stabilisation clauses

I. General nature and meaning of the stabilisation clause

Stabilisation clauses are used to protect investors against the detrimental effects of adverse changes to national legislation. Stabilisation (or “freezing”) clauses are aimed at restraining a Host State's government from abrogating or otherwise intervening, by

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3 Waelde, T, above n 1, 23
4 CA Settebello Ltd V Banco Totta and Acores [1985] 1 WLR 1050, 1059
exercise of State powers, in investment agreements concluded with foreign participants. In other words, a stabilisation clause prevents the Host State from changing its laws that govern the relationship between it and the investor.

A stabilisation clause usually states that the law in force on a given date – typically, the date on which the contract takes effect – is the law that will apply between the parties, regardless of future legislation, decrees, or regulations issued by the Host State. A stabilisation clause could thus be appreciated as one of the most useful methods of dealing with the political risks of foreign investment.

II. The purpose of a stabilisation clause

The purpose of a stabilisation clause is to preclude the application of subsequent legislative (statutory) or administrative (regulatory) acts made by the government that modify the legal situation of the investor. It prevents any new or changed laws from having a detrimental effect on the rights guaranteed in the investor-State contract.

For such a clause to be effective it must be contained in an agreement to which the State is directly or indirectly a party. If such an agreement exists, it is possible to argue that

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5 Waelde, T, above n 1, 1
7 Ibid
8 In this regard, it is also important to note a point of view of Professor Sornarajah, who wrote as follows: “Though the conventional wisdom is that such clauses are binding on the State party which had directly or indirectly participated in the making of the contract, there are theoretical difficulties in the way of accepting such a conclusion. The first theoretical difficulty is that a mere contractual provision cannot fetter the legislative sovereignty of the host State. Unless the State wished to exempt a particular foreign investment contract from the scope of its law, it is to be assumed that the legislative change applies to all foreign investment contracts. To overcome this problem, the argument is made that the contract containing a stabilization clause is [analogous] to a treaty and that the “treaty” is beyond the scope of national legislation. This is a far-fetched argument because treaties are made by States, whereas the foreign investor does not have the capacity to enter into relationships involving treaties or [any similar instruments]. A treaty involved a mutual surrender of sovereign rights and the foreign investor has no sovereign rights to surrender”. (See Sornarajah, M, ‘The Settlement of Foreign Investment Disputes’ in Bishop, Crawford and Reisman (eds), Foreign Investment Disputes (New York: Kluwer Law International, 2005), 290)
the State has committed itself not to extend later changes to its laws to the particular contract.\textsuperscript{10}

\textbf{III. Structure of a stabilisation clause}

A good example of a stabilisation clause can be found in the contract between the parties in \textit{LIAMCO v Libya}.\textsuperscript{11} In that case, the stabilisation clause provided as follows:

The Government of Libya, the Commission and the appropriate provincial authorities will take all steps necessary to ensure that the Company enjoys all the rights conferred by this Concession [contract]. The contractual rights expressly created by this Concession shall not be altered except by mutual consent of parties.

This Concession shall throughout the period of its validity be construed in accordance with the Petroleum Law and the Regulations in force on the date of execution of the Agreement of Amendment by which this paragraph (2) was incorporated into this Concession Agreement. Any amendments to or repeal of such Regulations shall not affect the contractual rights of the Company without its consent. (Emphasis added).

As noted by Stewart, the first paragraph makes it clear that mutual consent of the parties is needed\textsuperscript{12} to alter the contractual rights secured by the concession.\textsuperscript{13} The second paragraph establishes that the municipal law by which the concession is to be interpreted is fixed as of a certain date, so that no later government legislation or action can infringe upon the company's contractual rights.

\textsuperscript{10} Id, 290
\textsuperscript{11} \textit{LIAMCO v Libya} (1982) 20 ILM 53
\textsuperscript{12} It must be noted that the first paragraph, in requiring mutual consent to change the concession contract, is sometimes referred to as an "intangibility clause", which is distinct from the stabilization clause in a way that it was not freeze the law as of a certain date
\textsuperscript{13} Stewart, C, above n 6, 293
A stabilisation clause used by one of the former Soviet republics reads as follows:\textsuperscript{14}

Upon approval by the Parliament of the Azerbaijan Republic of this Agreement, this Agreement shall constitute a law of the Azerbaijan Republic and shall take precedence over any other current or future law, decree or administrative order (or part thereof) of the Azerbaijan Republic which is inconsistent with or conflicts with this Agreement except as specifically otherwise provided in this Agreement.

Comparable to the first example, the key element of this stabilisation clause was the removal of the government’s power to unilaterally alter the investor’s property rights by changing municipal law. It also reaffirmed that the investor’s consent is necessary before any such changes in law will affect the investor.

In summary, the main objective of the traditional form of the stabilisation clause is to “freeze” the applicable law, the fiscal regime or other essential investment conditions present at the time of entering into the contract. The incorporation of such a clause into the contract means that the government is contractually prohibited from enacting legislation inconsistent to the agreement,\textsuperscript{15} or alternatively, if such legislation was enacted, it should either be declared not applicable, or be followed by the payment of appropriate compensation.

The modern stabilisation clause is, therefore, a provision responsible for allocation of the investment risks whereby the State promises to maintain the present contractual environment, or to compensate the foreign investor should the investor’s financial burden increase as a result of legislative change. Such compensation may be an offset of the financial value of subsequent legislation against payments due by the investor to the State, or by a corresponding counter-payment by the State to the investor.\textsuperscript{16}

\textsuperscript{14}Amoco Group Agreement Dated 14 December 1996 on the Expropriation, Development and Production Sharing for Prospective Structures Ashrafi, Dan Ulduzu & Area Adjacent in the Azerbaijan Sector of the Caspian Sea, 52 Basic Oil Laws & Concession Contracts: Russia & NIS 1 (Supplement 24) (2003), Article 22.1
\textsuperscript{15}Waelde, T, above n 1, 57
\textsuperscript{16}Waelde, T, above n 1, 60
D. Renegotiation/ adaptation clauses

Other useful tools protecting the interests of foreign investors within the contract are so-called "renegotiation clauses". Renegotiation clauses demand that before resorting to arbitration or litigation before the State's courts, the parties must first attempt to reconsider the terms of their contracts.\textsuperscript{17} In other words, these clauses put the parties under an obligation to renegotiate their contractual commitments, in good faith, following the occurrence of a dispute.\textsuperscript{18} If renegotiation fails, either a specific adaptation procedure or the contract's general dispute settlement mechanism will be activated.\textsuperscript{19}

The renegotiation clause, originally designed to prevent the governments' desire for change, in effect has the same function as a standard stabilisation clause. One of the major benefits of renegotiation clauses is that they allow for easy adaptation of the agreement to changed circumstances caused by governmental disruptions, while at the same time requiring the parties to find a workable solution to their situation.

Likewise, in its request for renegotiations of the contractual terms, a party may, at times, defer to the rules of the applicable law. A number of laws recognise the right of a party to demand an adaptation or variation of the contract based upon the grounds of a fundamental change of the circumstances surrounding the contract. This right can imply the duty of the other party to cooperate in this adaptation process through the renegotiation of the contract.\textsuperscript{20} Similar to the decision of the court or an arbitral tribunal, the result of such negotiations can be a clarification of facts, a clarification of the meaning of the contract, or an adaptation of the existing contract to new circumstances. The advantage of renegotiation is that the parties can leave this classification open, and it may well be that one party may flatter itself in having obtained an adaptation of a

\textsuperscript{17} Horn, N, 'Arbitrating Foreign Investment Disputes: Procedural and Substantive Legal Aspects' (2004) 19 Studies in Transnational Economic Law, 21
contract, whilst the other is of the opinion that this was only a clarification of an unchanged contract.\textsuperscript{21}

For example, a number of BITs prescribe a 'cooling off' period followed by a certain procedure on how to initiate and conduct negotiations as a prerequisite for the commencement of arbitration. An example of such a provision can be found in Article 9(2) of the 2002 BIT between the Russian Federation and the Kingdom of Thailand, in which relevant parts it is stated that:

If the dispute cannot be settled by means of negotiations and consultations \textit{within a period of six months}, the dispute will be submitted at the choice of the investors for settlement to [a competent court or arbitration]. (Emphasis added).

A similar provision is contained in Article 8(2) of the BIT between the Russian Federation and Hungary of 1995 (prescribing a six-months cooling off period) and Article 8(2) of the BIT between the Kingdom of Great Britain and the Union of Soviet Socialist Republics of 1989 (prescribing a three-months cooling off period).

If, however, the other party clearly indicates that it is determined not to conduct such negotiations, or if its demeanour obviously obstructs negotiations, the other party may be entitled to go directly to arbitration.

In international business contracts, in particular, contracts which require long term cooperation (e.g. exploration and drilling contracts), the need for renegotiation, adaptation or variation of the contract has been long recognised. This practice is common in modern investment contracts. In particular, the duty to renegotiate the contract in the light of a change of circumstances is laid down in a number of typical legislative provisions.\textsuperscript{22} A good example is that of the Azerbaijan Union \textit{Production Sharing Agreement} (1998), which Article 22(2) states as follows:

\begin{flushright}
\begin{tabular}{l}
\textsuperscript{21} Horn, N, above n 17, 21 \\
\textsuperscript{22} Baur, Hobe (eds), \textit{Rechtsprobleme von Auslandsinvestitionen} (Baden-Baden, 2003), 65
\end{tabular}
\end{flushright}
In the event that any Governmental Authority invokes any present or future law, treaty, decree or administrative order which contravenes the provisions of this Agreement or adversely or positively affects the rights or interests of the Contractor hereunder, including, but not limiting to, any changes in tax legislation, regulations or administrative practice, or jurisdictional changes pertaining to the Contract Area, the terms of this Agreement shall be adjusted to re-establish the economic equilibrium of the Parties, and if the rights or interests of the Contractor have been adversely affected, that [the State] shall indemnify the Contractor (and its assignees) for any [disadvantage], deterioration in economic circumstances, loss or damages that ensure therefrom. (Emphasis added).

In summary, a renegotiation clause is intended to provide the parties with an opportunity to renegotiate their original bargain. The use of a renegotiation clause in a foreign investment agreement also provides an opportunity for continuity of a contact whereby investors have the chance to update and modify their contractual positions. Overall, renegotiation clauses are designed to avoid conflict, and therefore are used as one of a number of possible investment protection mechanisms. 23

E. Arbitration clauses

I. Significance of an arbitration clause

The use of an arbitration clause in contracts provides the investor with an access to international arbitration as an alternative to a national jurisdiction of the Host State. Such clauses are used to ensure that the dispute is looked at by an independent third party on an international level.

A valid arbitration clause represents a binding agreement between the parties, and is enforceable on both national and international levels. An example is that of the model ICC arbitration clause,24 which reads as follows:

23 Somarajah, M, above n 9, 307
24 'Recommended Arbitration Clauses' The London Court of International Arbi tration (LCIA) <http://www.lcia.org/ARB_folder/arb_english_main.htm#recommended> (5 July 2009)
All disputes arising out of or in connection with the present contract shall be finally settled under the Rules of Arbitration of the International Chamber of Commerce by one or more arbitrators appointed in accordance with the said Rules.

Another such example is the model clause of the London Court of International Arbitration. This clause states:

Any disputes arising out of or in connection with this contract, including any questions regarding its existence validity or termination, shall be referred to and finally resolved by arbitration under the Rules of the London Court of International Arbitration, which Rules are deemed to be incorporated by reference to this clause.

The place of arbitration shall be [insert].
The governing law of this contract shall be the substantive law of [insert country].
The number of arbitrators shall be [one/ three].
The language to be used in the arbitral proceedings shall be [insert].

If the contract does not contain an arbitration clause, an investor may still make use of such a clause if it can be found in any bilateral or multilateral investment treaty between the Host State and the investor's home State. For example, in the case of the Russian Federation, a British investor need not rely solely on the provisions of the contract with the State (regarding any potential arbitration). Instead, he or she may rely upon Articles 8(2) and 8(3) of the 1989 Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Union of Soviet Socialist Republics for the Promotion and Reciprocal Protection of Investments, allowing for the dispute between the Host State and the investor to be resolved by means of arbitration.25

Other similar examples can be found in Article 9(2) of the 1998 Russia – Ukraine BIT,

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25 In particular, Article 8 reads as follows:
(2) Any disputes which have not been amicably settled shall, after a period of three months from written notification of a claim, be submitted to international arbitration if either party to a dispute so wishes.
(3) Where the dispute is referred to international arbitration, the investor concerned in the dispute shall have the right to refer the dispute either to:
   (a) the Institute of Arbitration of the Chamber of Commerce of Stockholm, or
   (b) an international arbitration or ad hoc arbitration tribunal to be appointed by a special agreement or established under the Arbitration Rules of the United National Commission on International Trade, unless the parties to the dispute agree in writing to modify them.
Article 9(2) of the 2002 Russia – Thailand BIT, Article 8(2) of the 1995 Russia – Hungary BIT, etc. These examples show that an agreement to arbitrate can be entered into in two ways: directly (i.e. through the contract) or indirectly (i.e. by means of the relevant provisions incorporated in applicable treaties), and can be enforced by the investor regardless of the method it was entered into.

An arbitration clause agreed to between the parties and inserted into their contract is, as argued by Stewart, preferable to those provided by the treaties. This is because the contractual arbitration clause can be tailored to the particular needs of the parties, as well as address all peculiarities of the contractual undertakings. However, the arbitration clauses in both instruments can co-exist if they are drafted carefully. These clauses oblige States to honour their investment obligations. A State that refuses to submit to arbitration to which it had previously consented violates its duties under the investment contract and under international law, and as a result, may be held liable in damages on both levels.

II. Validity of contracts and severability of arbitration agreement

Validity is an important element of each and every contract. Therefore, another important issue regarding State contracts is that of legality. There have been a number of cases where a State enters into an agreement with an investor by promising, for example, certain additional subsidies or amendments to the existing set tariffs only to have these concessions cancelled later on. The conferral of such concessions may have been the result of an erroneous assessment of national law by the representatives of the Host State, or outright false representation. A far reaching legal consequence of allegations of misrepresentation would be to deny jurisdiction and arbitrability on the grounds that

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26 Stewart, C, above n 6, 225
27 Ibid
28 Horn, N, above n 17, 15
29 In the HUBCO investment dispute in Pakistan, it was alleged that certain amendments to the tariffs agreed by the foreign investor with the former government were “illegal, fraudulent, collusive, without consideration, and designed to cause wrongful loss … to the government of Pakistan”. See Cornell, H, ‘Himpurna and HUB: International Arbitration in Developing Countries’ (2000) 15/9 Mealey’s International Arbitration Report 39
parties to a contract tainted by illegal practices have forfeited any rights of the assistance of the machinery of justice in settling the dispute.\textsuperscript{30}

One of the possible solutions to the issue of validity of contracts is now offered by the doctrine of "severability" of the arbitration clause. The doctrine of "severability" (or "autonomy") of the arbitration agreement is well established in international arbitration.\textsuperscript{31} "Severability" means that the validity of an arbitration clause within the contract does not depend on the validity of the contract itself and may be enforced even if the contract is deemed void or voidable. According to this doctrine the dispute should nevertheless be submitted to arbitration, pursuant to the valid arbitration agreement. The arbitral tribunal, after affirming the jurisdiction, should rule on the merits of a dispute including the decision of whether there is an illegality of the contract. This, in fact, is today's prevailing view in literature and practice\textsuperscript{32} which has been followed in many awards.\textsuperscript{33}

\textbf{F. Choice-of-law clauses: selecting the applicable law}

The law governing the contract often plays a vital role in investor-State disputes. Sometimes the whole outcome of the dispute depends on the law chosen by the parties. State contracts generally contain an express choice of law clause. This clause is also common in international commercial contracts. By and large, this clause reads as follows:

\begin{quote}
This contract is governed by the law of [insert country/state].
\end{quote}

Where an international contract has connections with several jurisdictions, it is strongly advisable that parties indicate the law to which the contract is subject.\textsuperscript{34} All major legal

\begin{thebibliography}{9}
\bibitem{31} See Article 16(1) UNCITRAL Model Law; Section 7 of the English Arbitration Act 1996; Article 6(2), (4) of the 1998 ICC Rules
\bibitem{34} Sornarajah, M, above n 9, 257
\end{thebibliography}
systems now recognise that the parties to the contract have the autonomy to determine the law applicable to the contract. Technically, this would mean that a party anticipating a risk could ensure the application of a system of law which would favour that party’s interests, and select that system as applicable.

As noted by Professor Sornarajah, the choice by the parties is limited to the legal systems with which the contract has some connection. The parties normally choose the national law of the Host State, together with a stabilisation clause. Less common, but still in use, are clauses that select the neutral law of a third State to govern the contractual relationship. Least likely is a choice of the law of the home State of the investor.

In the absence of an express choice of law, the rules of private international law will come into play. Conflict principles will usually point to the application of the law of the contracting State party, in addition to such rules of international law as may be applicable.

Choice-of-law clauses play an invaluable role in State-investor contracts. They can serve as an additional mechanism of investment protection by providing for a law favourable to

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36 Sornarajah, M, above n 9
37 Sornarajah, M, above n 9
38 Horn, N, above n 17, 13
39 In the absence of an express choice of law, the courts or tribunals will be left to decide what the intention of the parties as to the applicable law would have been, limiting the scope of party autonomy in international investment contracts. But, despite this, the strategy that has been devised in investment protection by capital exporting country lawyers has been to lift the foreign investment contract out of the scope of national laws and subject to an international regime. In other words, the rules of private international law that determine the applicable law in such cases come into play. In this regard some commentators have submitted that State contracts, in the absence of the choice-of-law clauses, are subjected to the rules of public international law. See Bockstiegel, K, Der Staat als Vertragspartner ausländischer Privatunternehmen (The State as a Contract Party to Foreign Private Enterprise) (Frankfurt: Athenauim Verlag, 1971); Sornarajah, M, above n 9. ([The appropriateness of international law come from the fact that] “the money and assets come from overseas; they are brought in by foreign nationals; there is a situation where the foreigners or their assets are injured, [etc.”]
40 Sornarajah, M, above n 9, 257
both parties. As a result, the process of selecting the law governing State contracts should not be underestimated.

G. Forum selection clauses

The forum is the physical place of the hearing of a dispute. Choice-of-forum clauses are also important for reasons similar to those concerning choice-of-law clauses. As observed by Professors Bishop and Lee,42 “not only is it paramount that the law upholds the expectations of the parties as expressed in their agreement, but it is also important for the parties to be able to assess the risk of their venture”. The risk can be better evaluated if the forum for determining the disputes is known in advance. Professor Bishop concludes by saying that without choice-of-forum clauses, the possibility of having to litigate in a hostile forum may outweigh the benefits of the transaction. In other words, choice-of-forum clauses are designed to protect investors from the forced acceptance of a hostile forum by a State-party, which quite often has far greater bargaining power.

Choice-of-forum clauses are particularly important when drafting arbitration clauses. Such an example may be found in the model arbitration clause of the London Court of International Arbitration. The relevant part of this clause states:

The place of arbitration shall be [insert country/ city].

Hence, if a foreign investor is concerned with the internal legal regime of a particular Host State (such as, for example, the Russian Federation), it would be strongly advisable to include into the contract a carefully drafted arbitration clause, selecting a forum outside of the Russian Federation, and selecting the arbitration rules which are familiar to that investor or are more favourable to that investor’s needs.

H. Sanctity of contract versus State sovereignty

I. The nature of the issue

One of the defences that could potentially be raised by the State in omitting to comply with its obligations under the contract (including the stabilisation provisions) is the principle of State “sovereignty”. This principle will be looked at in detail in the next chapter. However, at present, it is important to note that pursuant to this principle, States can make independent decisions and act without intrusion from other States in a variety of subject matters, including ownership of the State’s subsoil resources.

In other words, if the Host State deems it necessary to alter its national subsoil legislation, or decides to expropriate or nationalise certain property rights (previously granted to foreign investors under a contract), the State will be in the position to do so legally (under the principle of State “sovereignty”) regardless of any contractual obligations to the contrary. Hence, there arises a question as to the true functional value of the contract, and whether its provisions could effectively bind a sovereign State. Underlying the debate are the concepts of sanctity of contract (“pacta sunt servanda”) and the doctrine of permanent sovereignty over natural resources (PSNR).43

II. Solutions offered by international law

Where unilateral intervention by the government results in breach of a contract, which contains a valid stabilisation clause, then this matter falls to international law.44 A careful analysis of relevant scholarly writings reveals that the question as to the precise status and effect of the stabilisation clause under international law is not settled.45 One school of

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44 Waelde, T, above n 1, 32
thought has expressed the view that any breach by the State of its contractual obligations under the agreement is unlawful under international law.\textsuperscript{46}

However, an opposing group of writers have expressed doubts as to the validity of the stabilisation clause under international law. Where its intended purpose is to "freeze" the applicable law as at the date of contracting, these writers see in such a provision an attempt to fetter the public powers of the State. If so, it is argued that such an attempt would constitute derogation from the principle of sovereignty.\textsuperscript{47} While States could exercise their sovereignty in making agreements with foreign investors, sovereignty would also constitute a lawful ground for the termination of these agreements (with compensation).\textsuperscript{48}

The doctrinal debate on this issue has divided scholarly opinion. No dominant view seems so far to have emerged. The natural tendency has thus been to look towards international arbitral practice for guidance.


\textsuperscript{48} See Paasivirta, E, 'Internationalization and Stabilization of Contracts Versus State Sovereignty' (1989) LX British Yearbook of International Law, 338. Also, according to Aréchaga ['International Law in the Past Third of a Century' (1978) 159 Recueil des Cours, 307], for example, an anticipated violation of such a clause would give rise to a "special right" to compensation. This "special right" implies that the amount of indemnity in such instances would be much higher than would otherwise be the case [See Schachter, O, 'International Law in Theory and Practice' (1982) 178 Recueil des Cours, 113-114]. It could, for instance, imply a duty to compensate which extends to prospective gains or lost profits (due to the private party) for the remainder of the period which the contract still has to run. It could also imply that the investor is entitled to compensation for any additional financial burdens imposed by subsequent unilateral amendments [See Geiger, R, 'Unilateral Change of Economic Development' (1974) 23 I.C.L.O. 73, 109-103]
III. Solutions offered by arbitral practices

A review of international arbitral practice also seems to indicate divergent views. In *AGIP v. The Popular Republic of Congo*,⁴⁹ the Tribunal ruled that the presence of a stabilisation clause in the agreement between the parties did not affect, in principle, the State’s sovereign and regulatory powers. Hence, the clause was held to be valid and enforceable under international law, having been judged not to amount to derogation from the principle of sovereignty.⁵⁰

*Texaco v. Libya*⁵¹ involved arbitral consideration of a stabilisation clause. The sole arbitrator stated that:

There is no doubt that in the exercise of its sovereignty a State has the power to make international commitments... There is no value to dwell at any great length on the exercise and value of the principle under which a State may within the framework of its sovereignty, undertake international commitments with respect to a private party. The result is that a State cannot invoke its sovereignty to disregard commitments freely undertaken through the exercise of this same sovereignty, and cannot through measures belonging to its internal orders make null and void the rights of the contracting party which has performed its various obligations under the contract.

In *Aramco v. Saudi Arabia*,⁵² another oil industry arbitration, the Tribunal came to a similar conclusion with regard to the binding force of the stabilisation clause under international law:

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⁴⁹ (1982) 21 I.L.M., 735-736
⁵⁰ Waelde, T, above n 1, 36
⁵¹ 53 I.L.R. at 471, 475. See also *RCA v China* (1936) 30 *American Journal of International Law* 535, in which the tribunal stated that the Chinese government could “certainly sign away part of its liberty of action”, and that “it can also do so as well in an implicit manner, if a reasonable construction of its undertakings under the agreement leads up to that conclusion.”
⁵² *Saudi Arabia v Aramco* (23 August 1958) 27 ILR 117, 168 (*Aramco case*). See also *Mobil Oil Iran, Inc v Iran* (1987-III) 16 Iran-U.S. C.T.R. 3 (at 64-65, where according to the tribunal, “contemporary international precedents have concluded that such contractual [stabilisation] provisions preclude a sovereign during the stated period from exercising the rights it otherwise possesses under international law to take an alien’s property for a public purpose, and without discrimination, and for a just compensation.”
By reason of its very sovereignty within its territorial domain ... nothing can prevent a State from binding itself by the provisions of a concession and from granting to the concessionaire irretractable rights, as such rights have the character of acquired rights. (Emphasis added).

These decisions seem to give recognition and validity to stabilisation clauses under international law. However, there are also decisions where the conclusions reached by the arbitral tribunal cast doubts upon the extent of the protection offered to the foreign investor by such clauses.

In the Libyan oil nationalisation case, for example, the arbitrators (in two of the three awards) reached the conclusion that stabilisation clauses cannot prevent a unilateral change of terms and conditions by a government. In Kuwait v. Aminol it was held that the sovereign rights of the State could be “contracted away”, but only for a limited period of time. A similar conclusion was reached in LETCO v. Liberia. These cases illustrate a lack of consistency in international jurisprudential practice which is indicative of the uncertainty which prevails over the status of stabilisation clauses under international law.

**IV. Solutions offered by modern State contracts**

Modern State oil and gas contracts may provide a method of circumventing the issue of State sovereignty in investor-State contractual agreements. These contracts (which include production sharing agreements), create a financial regime whereby the investor assumes risk and expenditure, and is paid out of production. Here, the mechanism for remuneration provides that “recoverable expenses” (“cost oil”) include all taxes and government levies except those expressly mentioned in the agreement. In other words,

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53 BP v Libya (1979) 53 ILR 297 (per arbitrator Lagergren). See also, arbitrator Mahmassani in Liamco v Libya (1982) 62 ILR 70
54 66 I.L.R. at 519-627, in particular para 95
56 26 I.L.M. 647 (1987)
the government may change its tax requirements, but this change would be of little (if any) relevance to the investor who will, according to the agreement, recover additional taxes and levies by incorporating them under the heading of "cost oil". The cost recovery mechanism expressed in production sharing agreements thus functions as a stabilisation clause without interfering in the State’s sovereign powers of legislation. From this perspective, the stabilisation clause has been converted from an instrument aimed at the government’s legislative powers to a risk allocation mechanism in commercial contracts with the State.

In summary, contemporary practices have moved away from the use of traditional “freezing” clauses, preferring a mechanism whereby the risk of government disruption is placed upon the shoulders of the Host State by explicit allocation or by implication in the contract’s cost recovery and cost accounting rules. Hence, stabilisation (and other similar) clauses represent a direct response to the inherent legal weakness of government contracts and as such offer a valuable mechanism for investment protection.

I. Conclusion

It is not disputed that parties must honour their contractual undertakings. Hence, the first mechanism for the protection of an investor’s rights lies within the “four corners” of the main document binding the parties – their contract. The enforcement of contractual provisions provides investors with the real possibility of enforcing the Host State’s obligations under its contract. The contract usually sets out the details of the independent investment and the obligations of the parties to support the project. In addition it typically includes or makes reference to the governmental permit or permits necessary to carry out that investment, provisions as to the tax treatment and provisions regarding the transfer of profits to the investor.

58 Waelde, T, above n 1, 61
60 Horn, N, above n 17, 12
In order to protect their capital, foreign investors should insist upon the incorporation into their contracts of certain specific provisions known to operate as safeguards against any questionable conduct by the Host State. In this chapter I have outlined examples of such clauses, and provided a brief overview of their nature and significance. It may be concluded that a carefully drafted contract may and will serve as a powerful mechanism for the protection of foreign investment in countries with yet unstable legal environments, including, among others, the Russian Federation.
A. Introduction

In the previous chapter it was argued that carefully drafted contracts may serve as a useful tool for the protection of investors' rights. Aside from the enforcement of contractual obligations, there exists numerous other mechanisms offering foreign investors significant protection. These mechanisms come from the sphere of public international law, and include diplomatic protection, customary law and treaty law protection. In this chapter I will discuss diplomatic protection of foreign investment. Prior to that, however, I will examine the concept of permanent State sovereignty over natural resources, along with the rights and obligations attached to that concept.

B. Permanent sovereignty over natural resources

I. General meaning of the concept of State sovereignty

The concept of State sovereignty lies at the heart of both customary international law and the Charter of the United Nations.\(^1\) State sovereignty denotes the competence,
independence and legal equality of all independent States with regard to their natural wealth. The concept encompasses all matters in which States are permitted, by international law, to make independent decisions and act without intrusion from other sovereign States. These matters include, but are not limited to, the choice of political, economic, social and cultural systems, the formulation of foreign policy and the ownership of the State’s natural resources.

II. The nature of the concept of permanent State sovereignty over natural resources

1. UN Resolutions

The sovereignty of States over their natural resources is an established rule of public international law. During the period from 1945 to 1962, following the epoch of the dominance of law protecting foreign investors, the United Nations adopted several resolutions in which Member States attempted to reach a mutually beneficial agreement. Consequently, the scope of “natural” resources and the activities covered by the principle of permanent sovereignty over natural resources (PSNR), were promulgated.

One of the first internationally accepted instruments recognising the right of developing countries to manage their national resources independently was the 1952 General

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3 Before the Second World War the international investment law was overly protective of the interests of the foreign investors. The Majority of these investors were from industrialized nations who were transferring their businesses to the developing countries. After the World War II, this situation compelled the developing nations and the newly de-colonized States into promoting the development of a new international principle which recognized and protected their rights over their natural resources and wealth in their own countries. The promotion of this “Permanent sovereignty over natural resources” was the natural manifestation of the fear of the developing nations that the Western world would continue exploiting their natural recourses without conceding them a just and equitable share. These countries saw foreign investment as a threat to their national sovereignty, especially since within that time there was a boom of mineral and energy resources, which naturally led to intensive involvement of many European and North American companies in the exploration and exploitation of natural resources in developing countries. See Warden-Fernandez, J, 'The Permanent Sovereignty Over Natural Resources: How It Has Been Accommodated Within the Evolving Economy' (2000) *CEPMLP Annual Review*, Article 4

Assembly (GA) Resolution 523 (VI) on Integrated Economic Development and Commercial Agreements.\(^5\) This Resolution, in its relevant parts, provided that:

> Member States of the United Nations, within the framework of their general economic policy, should ... consider the possibility of facilitating through commercial agreements ... the development of natural resources which can be utilised for the domestic needs of the under-developed countries and also for the needs of international trade.\(^6\)

This Resolution was created with the aim of realising economic growth of developing nations, and allowing these States an opportunity to use their natural recourses for the purpose of integrating such development within the general expansion of the world economy.

In the same year, the General Assembly passed another resolution, which became known as GA Resolution 626 (VII) on Right to Exploit Freely Natural Wealth and Resources. This Resolution was adopted after the argument submitted by Uruguay that the development of the under-developed countries required the recognition of their right to freely exploit their natural wealth and resources in accordance with the stipulations of the UN Charter relating to the principle of self-determination. In particular, the relevant parts of Resolution 626 (VII)\(^7\) read as follows:

> The General Assembly recommends that ... all Member States, in the exercise of their right to freely use and exploit their natural wealth and resources ...[are] to have due regard, consistently with their sovereignty, to the needs for maintaining the flow of capital in conditions of security, mutual confidence and economic co-operation among nations. The General Assembly further recommends all Member States to refrain from acts... designed to impede the exercise of the sovereignty of any State over its natural resources.

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\(^5\) General Assembly, Sixth Session, 360\(^{th}\) plenary meeting (12 January 1952)  

\(^6\) Ibid, recommendation 1(b)(ii)

\(^7\) General Assembly, Seventh Session, 411\(^{th}\) plenary meeting (21 December 1952)  
The initial draft of this Resolution was opposed by countries in both the developed and developing world, as it allowed Member States, in the exercise of their sovereign powers, to nationalise certain aspects of private property, resulting in a huge disincentive to foreign investment. Finally, it was agreed upon that the mention of nationalisation in the Resolution should be avoided and the current draft was thus adopted. Debates during the adoption of this Resolution clarified the point that all sovereign States had the right to freely manage their wealth and natural resources.

Furthermore, the 1958 General Assembly Resolution 1314 (XIII) containing Recommendations Concerning International Respect for the Rights of Peoples and Nations to Self-Determination stipulated the principle of PSNR as an element of the right to self-determination. Paragraph 1 of Resolution 1314 (XIII) specifies that, in surveying "the status of permanent sovereignty of peoples and nations over their natural wealth and resources, due regard shall be paid to the rights and duties of States under international law". This instrument carried significant importance because it established the Commission on Permanent Sovereignty over Natural Resources which undertook preliminary studies and surveys of the position of the PNRS, culminating in the adoption of the 1962 GA Resolution 1803 (XVII) on Permanent Sovereignty over Natural Resources.

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8 Warden-Fernandez, J, 'The Permanent Sovereignty Over Natural Resources: How It Has Been Accommodated Within the Evolving Economy' (2000) CEPMLP Annual Review, Article 4
9 The modified part read as follows: "[R]ecomends that all Member States in the exercise of their right freely to use and exploit their natural wealth and recourses whenever deemed desirable by them for their own progress and economic development, to have due regard, consistently with their sovereignty, to the need for the maintenance of mutual confidence and economic co-operation among nations; Recommends further all Member States to refrain from acts, direct or indirect designed to impede the exercise of the sovereignty of any State over its natural recourses." See Schrijver, N, Sovereignty Over Natural Resources (Cambridge: Cambridge University Press, 1997), 46
GA Resolution 1803 (XVII) is considered a turning point for the principle of PSNR. This is because, firstly, it declares inviolable the exercise of the right to permanent sovereignty over natural resources, and the right to nationalise or expropriate on the grounds of "public utility, security or national interest". It also establishes legal obligations for the payment of "appropriate compensation" according to international law; and in the event of conflict, contemplates the possibility of agreement between the States for settlement through arbitration or international adjudication. Specifically, the relevant paragraphs of GA Resolution 1803 stipulate:

1. The right of peoples and nations to permanent sovereignty over their natural wealth and resources must be exercised in the interest of their national development and of the well-being of the people of the State concerned.

4. Nationalisation, expropriation or requisitioning shall be based on grounds or reasons of public utility, security or national interest which are recognised as overriding purely individual or private interests, both domestic and foreign. In such cases the owner shall be paid appropriate compensation, in accordance with the rules in force in the State taking such measures in the exercise of its sovereignty and in accordance with international law. In any case where the question of compensation gives rise to a controversy, the national jurisdiction of the State taking such measures shall be exhausted. However, upon agreement by sovereign States and other parties concerned, settlement of the dispute should be made through arbitration or international adjudication.

Between 1962 and 1974, many countries were experiencing the era of nationalisation, which meant that States were regaining greater control over the exploitation of their natural resources. This development resulted in the creation of the 1966 GA Resolution 2158 (XXI) on Permanent Sovereignty over Natural Resources, which in essence highlighted the importance of the principle of PSNR as the foundation of economic development.

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development with respect to developing countries. Significantly, in paragraphs 1 and 3 respectively, it provides that:\footnote{16}{Ibid.}

1. The General Assembly reaffirms the inalienable right of all countries to exercise permanent sovereignty over their natural resources in the interests of their national development...

...  

3. The General Assembly states that such an effort should help in achieving the maximum possible development of the natural resources of the developing countries and in strengthening their ability to undertake this development themselves, so that they might effectively exercise their choice in deciding the matters in which the exploitation and marketing of their natural resources should be carried out.

2. Treaty law

As far as treaty law is concerned, the right to PSNR is most explicitly recognised in Article 1 of the 1966 Human Rights Covenants and Article 21 of the 1981 African Charter on Human and Peoples' Rights, where it is stated that, “All people may... freely dispose of their natural wealth and resources”. The 1994 Energy Charter Treaty (ECT) also recognises the principle of PSNR, providing that the Treaty shall “in no way prejudice the rules in Contracting Parties governing the system of property ownership of energy resources”\footnote{17}{Energy Charter Treaty (1 April 1994) Article 18.3 < http://www.encharter.org/index.php?id=28> (14 August 2008)} That treaty was created specifically to regulate investment activities in the energy sector. Article 18(1) ECT states:

The contracting parties recognize State sovereignty and sovereign rights over energy resources. They reaffirm that these must be exercised in accordance with and subject to the rules of international law.
Pursuant to Article 18(2) ECT, Contracting Parties also retain sovereign rights to determine the system of property ownership of natural resources. The ECT specifies that each Member State continues to hold the right to decide which geographical areas within its territory are to be made available for exploration and development of energy resources.

3. EU Directives

The principle of PSNR was also affirmed in instruments adopted within the framework of the European Union, and the European Economic Area (EEA). For example, in Directive 94/22/EC of the European Parliament and of the Council, of 30 May 1994 (the Licensing Directive), on the conditions for granting and using authorisations for the exploration and production of hydrocarbons, it is stated that: “Member States have sovereignty and sovereign rights over natural resources [within] their territories”. The Licensing Directive was integrated into the Agreement on the European Economic Area on 1 September 1995. In this context, the EEA Joint Committee adopted a joint statement containing a Declaration by the Parties to the EEA Agreement in which they declare that States have sovereign rights over their petroleum and other natural resources.

4. State legislation

In conjunction with the sources derived from international law, the principle of PSNR is often provided for in State legislation. For example, according to the Constitution of the former Soviet Union, mineral resources were the exclusive property of the State. Likewise, the domestic legislation of some of the Australian States has also provided that “all minerals in their natural state belong to the Crown”.20


19 Energy Charter Treaty, above n 16, article 18.3

20 Mining Act 1971-1976 (S.A), ss 16 and 18, provided that “all minerals in their natural state belong to the Crown and property [in these minerals] passes upon recovery to the person by whom they have have been lawfully mined. In Victoria, on the other hand, only all minerals in land not alienated before 1892 are vested in the Crown (Mines Act 1958 (Vic.), § 291(2)). All coal in New South Wales is vested in the Crown
Similarly, Article 9 of the 1993 Constitution of the Russian Federation which, in effect, repeats the provisions of Article 1(2) of the 1992 Russian Law on Subsurface, and grants the Russian Federation sovereign rights over “land and other natural resources”, establishing that the subsurface and the minerals contained in it are the property of the State.

5. Case law

The right to freely dispose of natural resources, including disposition by way of expropriation or nationalisation, is further recognised in a number of international arbitral decisions. In the Texaco Award\(^{21}\) (1977), which considered Libyan oil nationalisation measures, the Tribunal held that:

> Territorial sovereignty confers upon the State an exclusive competence to organise as it wishes the economic structure of its territory and to introduce therein any reforms which may seem to be desirable to it. It is an essential prerogative of sovereignty for the constitutionally authorized authorities of the State to choose and build freely an economic and social system. International law recognizes that a State has this prerogative just as it has the prerogative to determine freely its political regime and its constitutional institutions.

A similar view was expressed in the Liamco\(^{22}\) case, where an arbitrator observed that GA Resolution 1803 (XVII) represented compelling evidence “of the recent dominant trend of international opinion concerning the sovereign rights of States over their natural resources”.

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\(^{21}\) Texaco v Libyan Arab Republic (1978) 17 ILM 3-33, para 59

\(^{22}\) Liamco v Libya (1982) 20 ILM 53
In summary, the principle of PSNR is not only a well recognised legal concept, but also a product of political, economic and social relations. The decolonisation process marked its genesis, and the efforts of newly-independent States, to enhance their opportunities for development, had a profound impact on its evolution. The concept of PSNR imposes upon a State certain rights and obligations which that State ought to carry into effect. Therefore, the next step is a consideration of the rights and obligations attached to a sovereign State by virtue of the concept of PSNR.

III. Rights and obligations attached to the principle of permanent sovereignty over natural resources

Once the existence of the principle of PSNR is established, one must examine the myriad rights and obligations arising from it. There are a number of rights and obligations afforded to the State by this principle. These include:

1. the right to dispose of its natural resources, including by way of expropriation or nationalisation;\(^{23}\)
2. the right to explore and exploit its natural resources;\(^{24}\)
3. the right to regulate flows of foreign investment;\(^{25}\)

\(^{23}\) Texaco v Libyan Arab Republic (1978) 17 ILM 3-33, para 59

\(^{24}\) ‘GA Resolution on Permanent Sovereignty over Natural Resources 1803 (XVII)’ United Nations (14 December 1962) <http://www1.umn.edu/humanrts/instree/c2psnr.htm> (14 August 2008), GA Res. 523 (VI) and 1803 (XVII); UNCTAD I, General Principle 3 (1964); UNCTAD Res. 46 (III, 1972); TDB Res. 88 (XII, 1972) where it is stated that “Countries and its nationals have a right to freely dispose and determine the use of its natural resources”; and GA Res. 626 (VII), 3\(^{rd}\) preamble, where it was stated that “Countries and its people have a right to use and exploit their natural wealth and resources”.

\(^{25}\) GA Resolutions 1803 (XVII), 21 (XXI), and 3281 (XXIX) are the most pertinent ones as far as regulation of foreign investment is concerned. They all affirm the rights of States to regulate foreign investment according to their own objectives and development plans. By way of example, GA Resolution 1803 declares that the use of natural resources, as well as the import of foreign capital required for these purposes “should be in conformity with the rules and conditions which the peoples and nations freely consider to be necessary or desirable with regard to the authorisation, restriction or prohibition of such activities”. (‘GA Resolution on Permanent Sovereignty over Natural Resources 1803 (XVII)’ United Nations (14 December 1962) <http://www1.umn.edu/humanrts/instree/c2psnr.htm> (14 August 2008). In the same trend, GA Resolution 2158 declares that exploitation of natural resources of each country “shall always be concluded in accordance with its national laws and regulations”. (UN Doc. A/C.2/L.1386 Corr.6, 5 December 1974). Further to the above, the NIEO Declaration provides that States, on the basis of their full sovereignty, should take measures in the interest of their national economies to regulate and supervise the alternatives of Trans-National Corporations (TNC) operating within their territory. (GA Res. 3201 (S-
4. the right to manage natural resources pursuant to national environmental policies;\(^{26}\)
5. the right to use natural resources for national development;\(^{27}\)
6. the right to grant and authorise licenses for the prospection, exploration and production of minerals;\(^{28}\) and
7. the right to immunity in legal and arbitral proceedings.

The obligations imposed upon a State include:

1. an obligation to respect the rights of other States;\(^{29}\)
2. an obligation to provide minimum standards of treatment;\(^{30}\)
3. an obligation to afford full protection of its domestic laws;\(^{31}\) and
4. an obligation to pay adequate compensation in cases of expropriation or nationalisation.

\(^{26}\) Article 19(3) ECT. Other regional Conventions, such as the African Convention on the Conservation of Nature and Natural Resources (1968), the Convention on the Conservation of European Wildlife and Natural Habitats (1979) and the ASEAN Agreement on the Conservation of Nature and Natural Resources (1985), are less assertive in this respect. However it must be noted that the ECE Convention on Long-Range Transboundary Air Pollution (1979) does embody a reference to Principle 21 of the Stockholm Declaration (see preamble, para. 5).

\(^{27}\) *Kuwait v Aminoil* (1982) 21 ILM 1023, 97-99 (The relevant quote reads as follows: “This concession – in its origin a mining concession granted by a State whose institutions were still incomplete – became one of the essential instruments in the economic and social progress of a national community in full process of development. This transformation took place at first by means of successive levies going to the State, and then through the growing influence of the State in the economic and technical management of the undertaking... and the regulations of work and investment programs. The contract of Concessions thus changed its character and became one of those contracts in regards to which, in most legal systems, the State, while remaining bound to respect the contractual equilibrium, enjoys special advantages”)


A detailed analysis of all rights and obligations attached to the principle of PSNR falls outside the ambit of this thesis. For the purposes of this chapter, however, I shall discuss the Host State’s obligation to respect the rights of other States, and also the investor’s right to diplomatic protection.

**IV. The Host State’s obligation to respect the rights of other States**

UN Resolutions on PSNR have seldom referred explicitly to the obligation to respect international law and the rights of other States. Some of the clearest examples of States being compelled to respect the rights of other States can be seen in the following instruments.

In UN Resolution 837 (IX), the General Assembly requested the Commission on Human Rights to complete its Draft Article on the rights of people and nations to self-determination, including recommendations concerning their PSNR, with the phrase “having due regard to the rights and duties of States under international law”.

Similarly, in Resolution 1314 (XIII) the General Assembly instructed the Commission to require the States to have “due regard to the rights and duties of [other] States under international law”. Subsequently, the 1962 Declaration, which resulted from the Commission’s work, employed in its operative part the following formulation:

> The free and beneficial exercise of the sovereignty of people and nations over their natural resources must be furthered by the mutual respect of States based on their sovereign equality. (Emphasis added).

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34 Ibid. Paragraph 8 of this Declaration stipulated that “Foreign investment agreements freely entered into by, or between, sovereign States shall be observed in good faith”, and “Agreements entered into by States related to contracts with non-State entities, normally transnational corporations, those entered into between States are treaties. The former seems to imply that non-state entities enjoy the protection of pacta sunt servanda directly under international law.
GA Resolution 2158 (XXI, 1966) includes a reference to “mutually acceptable contractual practices”, a phrase which can be seen as an alternative reference to international law obligations. Article 2 of the Charter of Economic Rights and Duties of States (CERDS) contains no direct reference to international obligations, but is subject to the “fulfillment in good faith of international obligations”.

As far as multilateral treaties are concerned, ample support can be found for the proposition that, in regulating foreign investment, States must observe the requirements of international law. The most explicit reference to general international law obligations relating to PSNR can be found in Article 1 of the 1966 Human Rights Covenants, which provides that:

All people may, for their own ends, freely dispose of their natural resources without prejudice to any obligations arising out of international economic co-operation, based upon the principle of mutual benefit, and international law.

Similarly, the African Charter on Human and People’s Rights (1981) stipulates that:

The free disposal of wealth and natural resources shall be exercised without prejudice to the obligation of international economic co-operation based on mutual respect, equitable exchange and the principles of international law.

In summary, the State’s obligation to respect the rights of other sovereign States derives from the former State’s right to PSNR, and is well recognised in international law and practice. It follows that this obligation confers upon an investor (as a national of another State) the right to diplomatic protection. This topic is discussed below.

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C. The remedy of diplomatic protection of investment

I. General principles

The most traditional means of obtaining redress for foreign investors disadvantaged by breaches of international law is known as "diplomatic protection". While diplomatic protection existed in various forms before modern times, it was not until the time of Vattel\(^38\) that a clear attempt was made at explaining diplomatic protection. In 1758, Vattel wrote:

\[\text{[T]he sovereign of the injured citizen must avenge the deed and, if possible, force the aggressor to full satisfaction or punish him, since otherwise the citizen will not obtain the chief end of civil society, [namely] protection.}\(^39\) (Emphasis added).

Vattel's theories not only asserted the right of the States to protect their nationals, but implied that there was an obligation on States to do so. A consequence of this view was that injury incurred by the alien was regarded as being a violation of an obligation owed by the Host State to the alien's home State. This explanation was the result of the theory that the individual has no rights in international law.\(^40\)

The right and duty of States to protect their nationals abroad was also strongly asserted in some later studies of diplomatic protection, including those of Fauchille,\(^41\) Oppenheim\(^42\) and Holland.\(^43\)

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\(^38\) Emerich de Vattel was a Swiss philosopher, diplomat and legal expert whose theories laid the foundation of modern international law and political philosophy. He is most famous for his 1758 work *Droit des gens; ou, Principes de loi naturelle appliqués a la consuite et aux affaires des nations et des souverains* (The Law of Nations or the Principles of Natural Law Applied to the Conduct and to the Affairs of Nations and Sovereigns). This work is focused largely on the rights and obligations of citizens and States.


\(^40\) Martens, G F, *Précis du droit des gens moderne de l'Europe*, vol 1 (1831), 224ff. See also Amerasinghe, C F *Local Remedies in International Law*, 2nd ed (United Kingdom: Cambridge University Press, 2004), 44-45

\(^41\) Fauchille, P, 'Traité de droit international public' (1922), *The American Journal of International Law*, 884, 922


\(^43\) Holland, T E, *Lectures on International Law* (London, Sweet & Maxwell,1933), 165
The principle that the alien's home State, and not the alien himself, has the right to proceed against the Host State for its illegal actions has been recognised in several international judicial decisions. In the *Mavrommatis Palestine Concessions Case*, the PCIJ stated that:

[I]t is an elementary principle of international law that a State is entitled to protect its subjects, when injured by acts contrary to international law committed by another State, from whom they have been unable to obtain satisfaction through the ordinary channels. By taking up the case of one of its subjects and resorting to a diplomatic action or international judicial proceedings on his behalf, a State is in reality asserting its own rights – its right to ensure, in the person of its subject, respect for the rules of international law.44 (Emphases added).

In the *Mavrommatis* case, the question was whether the dispute, which stemmed from an injury to a national of the claimant's State, was a dispute involving two States or a dispute between a private individual and a State. It was held that the dispute in question was a dispute between two States, even though it arose from an injury to a private individual.

The PCIJ later confirmed the ruling in *Mavrommatis* in the *Panavezys-Saldutiskis Railway Case*. This dispute concerned the expropriation of a concession given to an Estonian company by the Lithuanian Government. The PCIJ, in this instance found that:

In the opinion of the Court, the rule of international law [...] is based on that in taking up the cases of its nationals, by resorting to diplomatic action in international judicial proceedings on his behalf, a State is in reality asserting its own right, the right to ensure in the person of its national respect for the rules of international law.45

In the *Serbian Loans Case*,46 where the dispute arose from the failure to service certain loans taken by the Serbian Government from French bond-holders, and in the *Chorzow Factory Case*,47 which concerned an expropriation of alien property, the same principle

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44 *Mavrommatis Palestine Concessions* (Greece v UK) (1924) P.C.I.J. (ser. A) No. 2, 12
45 *Panavezys-Saldutiskis Railway Case* (1938) PCIJ Series A/B No. 2, 16
46 *Serbian Loans Case* (1929) PCIJ Series A No. 20
47 *Chorzow Factory Case* (1928) PCIJ Series A No. 17 (Merits)
was held to be applicable. In *Serbian Loans*, the application of the principle resulted in the finding that the dispute before the Court was one between two States. In *Chorzow Factory* the Court applied the same principle in order to conclude that the damage suffered by the claimant (State) was identical to that suffered by its national.

In principle, when a national of State A suffers injury within the territory of State B, international law holds that the injury is as an injury to State A (instead of an injury to the national of State A) — and as a result, a remedy of diplomatic protection becomes available. Such protection may take a number of forms, including consular action on behalf of the investor, negotiation, mediation, judicial and arbitral proceedings, reprisals, severance of diplomatic relations, economic pressure and, as a final resort, the use of the force. Diplomatic protection embraces all cases of official representation by the Government on behalf of its citizens (or their property interests) within the jurisdiction of another for the purposes of preventing certain violations of international law, or obtaining redress for the injuries caused by such violation.

**II. Requirements of the “Local Remedies” rule**

It is important to note that diplomatic protection can only be sought after the investor has tried, but failed, to obtain relief through the domestic courts of the Host State, i.e. after the investor has exhausted all “local remedies”.

In accordance with the doctrine of “local remedies”, before resort may be had to an international court or arbitral tribunal, the State should have an opportunity to redress its violation by its own means and within the framework of its own domestic legal system. The foundation of the “local remedies” rule is, first and foremost, the observance of State sovereignty and a recognition that a State should be presumed competent to process a

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48 *Chorzow Factory Case* (1949) ICJ Reports 181
50 Ibid.
51 *Interhandel Case* (1959) I.C.J. 5, 27
matter through its own judicial organs. In other words, this rule allows a sovereign State independence and freedom from interference in its judicial decision-making.\textsuperscript{52}

The principle of State sovereignty may prevent an investor from utilising the remedy of diplomatic protection if the investor is unwilling to resort to the Host State's domestic Court system. There is, however, an exception to the "local remedies" rule.

\textit{III. Exception to the rule: waiver of the exhaustion of "Local Remedies" requirements}

The "local remedies" rule can be waived. An express waiver of the rule of exhaustion of "local remedies" takes place where the Host State expressly agrees that the rule will not apply to a particular dispute.\textsuperscript{53} Such a waiver may be incorporated into the parties' investment contract, in which case it will be deemed an "express" waiver. Alternatively, the waiver may be packaged in investment treaties between the States concerned. In the latter case, the waiver will be "implied" from the treaty provisions where, for example, the parties have agreed to a dispute resolution mechanism outside of the jurisdiction of the Host State courts.

For example, Articles IX(2) and IX(3) of the 1989 \textit{Russia – Canada BIT}\textsuperscript{54} states that "if the dispute cannot be settled amicably, it may be submitted by the investor to arbitration", in which case "the dispute shall be settled in accordance with the Rules of Arbitration of the United Nations Commission on Trade and Development" (UNCITRAL). Similar provisions were made in Article 9 of the 1991 \textit{Russia – Korea BIT};\textsuperscript{55} Article 8 of the BIT

\textsuperscript{52} Sorensen, M, \textit{Manual of Public International Law} (New York, St. Martin's Press, 1968) 531, 584 ("The foundation of the rule is the respect for the sovereignty and jurisdiction of the State competent to deal with the question through its judicial organs.")

\textsuperscript{53} Amerasinghe, C F, \textit{Local Remedies in International Law}, 2\textsuperscript{nd} ed (Cambridge : Cambridge Studies in International and Comparative Law, 1993) 247


between Russian and Norway,\textsuperscript{56} and many other BITs entered into by the Russian Federation. Furthermore, Article XI(1) of the \textit{Russia-Canada BIT}, for example, requires “any disputes between the contractual parties... be settled through diplomatic channels”. A provision to the same effect may be found in Article 10 of \textit{Russia – Korea BIT}. These provisions represent an implicit waiver of the requirement to exhaust the “local remedies”, which subsequently, can be implied into the investment contract between the Russian Federation, on the one hand, and a foreign investor, on the other.

The Convention for the Settlement of Investment Disputes between States and Nationals of other States (ICSID) is an example of multilateral treaties which exclude the “local remedies” rule. By virtue of Article 26 of that Convention, where a Host State and an alien (whose home State is a party to the Convention) agree to submit to international arbitration under the auspices of ICSID, there is no need for the alien to exhaust “local remedies” before seeking arbitration (unless specific provisions are otherwise made for such recourse).\textsuperscript{57} It is also worth noting that where an express waiver is given in an investment treaty, it is normally irrevocable.\textsuperscript{58}

In summary, the “local remedies” rule can be effectively waived by inserting a specific provision into the parties’ investment contract. Alternatively, an investor can draw on the provisions already incorporated into certain bilateral and multilateral investment treaties between its home State and the Host State. Such provisions are known as implicit waivers of the local remedies rule.


\textsuperscript{57} Amerasinghe, C F, \textit{Local Remedies in International Law}, 2nd ed (Cambridge : Cambridge Studies in International and Comparative Law, 1993) 247

\textsuperscript{58} UK Pleadings in the \textit{Anglo-Iranian Oil Case}, unreported; ICJ; Pleadings (1951), 118-119 \textit{Anglo-Iranian Oil Company} (Preliminary objection), unreported; ICJ; Judgment of 22 July 1952; (1952) I.C.J. Reports 109
D. Conclusion

The remedy of diplomatic protection stems from the Host State's obligation to respect the rights of other independent States, which in turn derives from the concept of PSNR. The remedy of diplomatic protection is still well-alive and to date stands as one of the most useful tools available to foreign investors seeking reparation from Host States.\(^5^9\) Diplomatic protection provides the person who goes abroad (or sends his property abroad) with the assurance that at least some attempt will be made to see that their investment enjoys the minimum of security and fair treatment. It also provides a procedure whereby many disputes are settled. In addition, it inspires a more considered treatment of aliens, which further reduces the likelihood of dispute.

One of the pre-conditions of the utilisation of this remedy, however, is the compliance with the “local remedies” rule. Pursuant to this rule, any claim against the Host State is inadmissible unless an aggrieved party has first tried to resolve its dispute in the courts of the Host State. This enforced exposure to the system of local courts places a heavy burden upon investors due to the inefficiencies of some of the Host States' internal legal systems.

There is, however, an exception to the “local remedies” rule. Under this exception the “local remedies” may not need to be exhausted if the parties elect to contract out of the rule. The parties can contract out of local remedies by either incorporating a specific provision to that effect into the contract, or by relying on the provisions of the relevant bilateral or multilateral investment treaties that provide for such a waiver.


85
A. Introduction

Public international law on investment protection is widely accepted as a useful and powerful tool for foreign investors in their battle against certain actions of the Host States. For the purposes of this chapter, I will concentrate on two major sources of public international law: treaty law and customary international law. In the course of this chapter I will discuss the nature and significance of these investment protection tools. It will be put that the investment protection offered by public international law is in itself sufficient to safeguard the interests of foreign investors on the territory of the Host States.

B. Protection of foreign investment under treaties

I. General

The number of regional, bilateral and multilateral investment agreements and treaties has grown dramatically in the last few decades. These agreements have a common general purpose – to provide for the promotion and protection of investment of one contracting party in the territory of another. This part of my thesis will provide an overview of the investment protection mechanisms offered by the existing treaty law. First, I will outline the purpose and scope of the investment treaties. Second, I will cover the major substantive interpretations of investment protection provisions such as “National treatment” protection, “Most Favoured Nations” protection, “Fair and Equitable treatment” protection and last but not least, the protection offered by the Host State’s
obligations to provide "most constant protection and security" of foreign investment. Finally, I will analyse the dispute settlement mechanisms provided for in international investment agreements, and highlight the significance of protection offered by the recognition and enforcement of international arbitral awards.

II. The purpose and scope of international investment treaties

International investment treaties, referred to in this section, are the bilateral and multilateral investment treaties, more commonly known as BITs and MITs. By and large, both BITs and MITs perform a similar function – they protect foreign investment from the acts of expropriation and governmental taking; however, there exist significant differences between the two. The BITs represent the expression of a bilateral deal between two States reflecting the interests of two contracting parties. The MITs, on the other hand, aim at reaching a much larger target group with a view of creating a system of multilateral economic integration.60

The modern type of investment treaty provides for a wide ambit of protection, including a wide definition of "investment",61 various clauses relating to treatment of foreign investment, and a broad range of dispute settlement mechanisms. Furthermore, it typically contains a wide concept of expropriation as "any measures directly or indirectly depriving investors of their investments" (emphasis added).62 At the same time it clearly defines the limits of the Host State's right to expropriate. A good illustration of this is provided in the US-Czech BIT, in which relevant parts it is stated that:

Investments shall not be expropriated or nationalized either directly or indirectly through measures tantamount to expropriation or nationalization... except for a public purpose, in

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61 Agreement on Encouragement and Reciprocal Protection of Investment between the Kingdom of the Netherlands and the Czech and Slovak Republics
<http://www.unctad.org/sections/dite/ilia/docs/bits/czech_netherlands.pdf> (1 September 2008), Article 1

62 Ibid, Article 5
accordance with due process of law, in a non-discriminatory manner, upon payment of prompt, adequate and effective compensation.63

A similar example can be found in a number of Russian BITs.64 For instance, Article 5(1) of the 1995 Russia –Hungary BIT reads as follows:

Investment of investors of one Contracting Party shall not be nationalised, expropriated or subjected to other measures having effect equivalent to nationalisation or expropriation in the territory of the other Contracting Party except for a public purpose. The expropriation shall be carried out under the process of law, on a non-discriminatory basis and shall be accompanied by the payment of prompt, adequate and effective compensation.

Overall, the main function of the investment treaties is the protection of foreign investment. Non-discrimination, including “most-favoured-nation” status and “national” treatment, as well as “fair and equitable” treatment principles are therefore illustrative of the function of modern investment treaties and show their contribution to a more secure national and international economic partnership.

III. “National” treatment protection (non-discrimination)

Under most investment treaties, the Host State is obliged to treat the foreign investor no less favourably than it treats its domestic investors in “like circumstances”. Such principle of non-discrimination generally takes two forms – “Most-Favoured-Nation” (MFN) treatment and “National” treatment.

“National” treatment concerns discrimination against investors from foreign countries in relation to national (or domestic) investors. It requires each party to a treaty to treat foreign investors no less favourably than it treats its domestic investors (once the former have crossed the border and became part of domestic commerce). In other words, if a State grants a particular right, benefit or privilege to its own citizens, it must also grant these advantages to citizens of other States.

The obligation to provide foreign investors with a similar treatment is now incorporated in most of the BITs and MITs, and operates in the following manner: if it is noted that the two compared businesses are treated differently, to the detriment of the foreign investor, then the government of the Host State has the burden of proof to show that it has an adequate reason for such preferential treatment. If this burden is not met, it will be safe to conclude that the investor has proven discrimination, which in effect means that the Host State has breached its sovereign obligations and hence may be held liable under certain provisions of public international law.

In *S.D. Myers v Canada*, 65 the tribunal took the view that:

> In assessing whether a measure is contrary to a “National” treatment norm, the following factors should be taken into account. First, whether the practical effect of the measure is to create a disproportionate benefit for nationals over non-nationals. And second, whether the measure appears to favour its nationals over non-nationals who are protected by the relevant treaty. (Emphasis added).

Interpretation of “National” treatment provisions also entails a determination of which businesses or activities ought to be compared.66 Here, the concept of “like” circumstances becomes an important premise of the application of the “National” treatment standard. However, “National” treatment provisions typically do not identify the criteria by which

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65 *S.D. Myers, Inc. v. Canada*, unreported; Partial Award on the Merits; City of Toronto, Ontario, Canada 13 November 2000, 252 <http://www.naftaclaims.com/Disputes/Canada/SDMyers/SDMyersMeritsAward.pdf> (1 September 2008)
similarity or likeness is to be determined. This issue has arisen in a number of investment disputes. In *S.D. Myers v Canada*, for example, the tribunal focused on whether the domestic and foreign businesses in question were in commercially competitive sectors. Thus, while the Myers investment was in the area of waste export, and the domestic business was dealing with waste disposal facilities, they were found to be in like circumstances as one could potentially take away the business from the other. By comparison, the tribunal in the *Methanex* case has considered the precise scope of the term “like circumstances”. It took a narrower approach to the requirement “in like circumstances” by asking whether the activities of the foreign investor were comparable to economic activities in the domestic sphere, rather than a broader approach used in the *Myers* case.

In summary, one of the main expectations arising from an investment agreement is that foreign investors will not be subject to discriminatory treatment by the Host State, whether through legal, administrative or other decision-making. In this regard the protection offered by the “National” treatment provisions in the investment treaties prohibits both direct and indirect discrimination of foreign investment as compared to the domestic investment in “similar circumstances”.

**IV. “Most-favoured-nation (MFN)” treatment protection**

1. *The concept of the treatment*

A second component of non-discrimination in investment treaties typically includes the requirement that a foreign investor be accorded the highest standard of treatment available to an investor from any other foreign country. This method of protection is known as “most-favoured-nation” (MFN) treatment.

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67 Id.
68 *S.D. Myers v Canada*, above n 6, 251
70 UNCTAD Series of International Investment Policies for Development, above n 7, 32
MFN treatment concerns discrimination among investors from foreign countries. It requires each party to a treaty to grant to every other party the same treatment that it has undertaken to grant to any other country, with respect to the same activity. Notably, this does not confer particular advantages to any particular investor. Rather, it means that that investor will be granted the same trade advantages (such as low tariffs) that are granted to any investor from any other nation. In effect, having MFN status means that one nation will not be treated worse than any other.

Traditionally, MFN treatment was applied primarily to the duties charged on imports. However, in recent decades specific provisions have extended the MFN principle to other areas of international economic contracts, such as the establishment of enterprises of one country's nationals in the territory of the other; navigation in territorial waters; real and personal property rights; intangible property rights such as patents, industrial designs, trademarks, copyrights and literary property; government purchases; foreign-exchange allocations and taxation.71

In order to stress the worldwide recognition of the international character of this principle, it is emphasised that MFN treatment was made one of the core obligations of commercial policy under the Havana Charter where Members undertook the obligation "to give due regards to the desirability of avoiding discrimination ... between foreign investors".72 Furthermore, the importance for international economic relations is shown by the fact that MFN treatment provisions of the GATT (Article I General Most Favoured Nation Treatment) and the GATS (Article II Most-Favoured-Nation Treatment) provide that this obligation shall be accorded "immediately and unconditionally".73

73 Although in the case of the GATS, a member may maintain a measure inconsistent with this obligation provided that such measure is listed in, and meets the conditions of, the Annex on Article II Exceptions. See 'Most-Favoured-Nation Treatment in International Investment Law' Organisation for Economic Co-operation and Development (OECD), Working Papers on International Investment, Number 2004/2 (September 2004) 3 <http://www.oecd.org/dataoecd/21/37/33773085.pdf> (1 September 2008)
2. Example of the MFN treatment clause in operation

Generally, MFN clauses operate in the following manner: a State (the granting state) undertakes an obligation towards another State (the beneficiary State) to accord MFN treatment in an agreed sphere of relations, and that beneficiary State accepts it. Ultimately, the extent of the benefits to which the beneficiary State may lay claim is limited by the treatment extended by the granting State to a third State. It is thus the mere fact of a more favourable treatment that sets in motion the operation of the clause. This treatment may be based upon a treaty, or another agreement or law. The beneficiary State, on the strength of the MFN clause, may also invoke the clause to demand the same benefits as were given to the third State.

A good illustration of how this principle operates can be found in the case of *Meffezini v Spain*. In this case the Argentine investor in Spain was permitted to use a more beneficial time requirement in the arbitration process found in the Chile-Spain BIT (as opposed to the Argentina-Spain BIT under which the claim was filed). The tribunal accepted this as an application of the MFN principle, subject to limitations that it did not override public policy considerations of the parties to the negotiations. On this basis, the more favourable procedural treatment was applied.

In the case of one treaty between the granting State and the beneficiary State containing the MFN clause, and the other treaty between the granting State and a third State, the

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75 Subject to the wording of the MFN clause, the mere fact that the third State has not availed itself of the benefits which were extended to it by the granting State does not release the granting State from its obligations under the MFN clause. See Report of the International Law Commission to the General Assembly on the Works of Its Thirteenth Session (1978), above n 16, article 5, commentary 5.

76 *Emilio Augustin Maffezini v The Kingdom of Spain*, unreported; ICSID Case No. ARB/97/7; Decision on Jurisdiction, 25 January 2000; unreported; ICSID; Award, 13 November 2000; unreported, ICSID; Rectification of Award, 31 January 2001 (Argentina/Spain BIT).

77 *Emilio Augustin Maffezini v The Kingdom of Spain*, unreported, ICSID Case No. ARB/97/7; Decision on Jurisdiction, 25 January 2000; unreported; ICSID; Award, 13 November 2000, paras 62-63.
treaty that contains the MFN treatment clause is considered to be the "basic" treaty.\textsuperscript{79} The majority of the Court in the landmark \textit{Anglo-Iranian Oil Company} case\textsuperscript{80} held that:

[This is the treaty which establishes the judicial link between the beneficiary State and the third party treaty and confers upon that State the rights enjoyed by the third party. A third party treaty, independent and isolated from the basic treaty, cannot produce any legal effect as between [...] the beneficiary State and [...] the granting State. The beneficiary is entitled, to the extent provided by the MFN provision under its own treaty, to claim all rights and favours extended by the granting State to the third State. This extension can be seen as "ingenious" legal shorthand to treaty process. (Emphasis added).]

This case was based on a dispute which resulted from the nationalisation by the Government of Iran of the oil industry. The United Kingdom invoked the MFN clauses of the agreements concluded with Iran in 1857 and 1903 to seek the treatment foreseen in the 1934 Treaty of Friendship between Iran and Denmark and similar agreements concluded with Switzerland and Turkey in 1934 and 1937 (that guaranteed all treatment be in accordance with international law).\textsuperscript{81}

On this same topic other commentators have also noted that:\textsuperscript{82}

\textsuperscript{79} Report of the International Law Commission to the General Assembly on the Works of Its Thirteenth Session (1978), above n 16, article 8, commentary 1
\textsuperscript{80} \textit{Anglo-Iranian Oil Company} (Preliminary objection), unreported; ICJ; Judgment of 22 July 1952; (1952) I.C.J. Reports 109
\textsuperscript{81} The Court dismissed this case on the basis that it had no jurisdiction. In contrast see also \textit{Lloyds Bank v de Ricqles and de Gaillard}, unreported, Commercial Tribunal of the Seine (1930), where the Commercial Tribunal of the Seine dismissed a claim by Lloyds Bank, which having been ordered to give security for costs. Lloyds invoked Article I of the Anglo-French Convention regulating commercial maritime relations of 28 February 1882 to benefit from the provisions of a Franco-Swiss Treaty of 15 June 1889, which gave Swiss nationals the right to sue in France without being required to give security for costs. Lloyds argued that Article I engaged the parties to give each other "immediately and unconditionally the benefits of every favour, immunity or privilege in matters of commerce and industry which have been conceded by one of the parties to any third nation whatsoever, whether within or beyond Europe." In this case the Tribunal held that a party to a convention of general character such as the Anglo-French Convention could not claim the MFN clause the benefit of a special Convention such as the Franco-Swiss Convention, which dealt with one particular subject, namely freedom of the obligation to give security for costs. In other words, the Tribunal adopted the view that MFN clauses could not be invoked to compare treatment provided under two treaties dealing with different subject matters. See also Ustor, E, 'Forth Report of the Most-Favoured-Nation Clause' (1973) \textit{Yearbook of the International Law Commission}, vol 2, 1973, 9 <http://untreaty.un.org/ilc/documentation/english/a_cn4_266.pdf> (1 September 2008)
The MFN principle contributes greatly to the rationalisation of the treaty-making process and leads to the automatic self-revision of treaties which are based on the most-favoured-nation standard. It makes unnecessary incorporation of the treaty between grantor and the beneficiary of the "most-favoured-nation" treatment of any of the relevant treaties between the grantor and the third States and their deletion whenever such treaties cease to be in force. So long as this last-mentioned aspect of the matter is kept in mind, most-favoured-nation clauses are correctly described as drafting (and deletion) by reference. (Emphasis added).

Since Meffezini v. Spain, there have been at least three other major cases dealing with the applicability of the MNF standard to dispute settlement. The case of Siemens, also favours the application of MFN status to dispute settlement. Two other cases, namely Salini and Plama, say the opposite, focusing on the intention of the parties as the decisive factor.

Although the Meffezini case's primary concern was with the applicability of the MFN provision to dispute settlement, it had also raised questions as to whether substantive protection that is greater in a BIT with another country may be relied upon by a third party investor. The trend regarding this issue is becoming more restrictive because of the view that no third-party provision should impact on the underlying "bargain" in any given BIT. As a result, recent cases have limited the possible application of such third-party treaties to situations where the additional rights do not impact upon the balance of rights in a significant way so as "to go to the core of matters that must be specifically negotiated by the contracting parties". Whilst it is difficult to determine with precision

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83 Siemens v Argentina, ICSID Case No. ARB/02/8, Decision on Jurisdiction (English), 3 August 2004 (Germany/ Argentina BIT)
85 Plama Consortium Limited v Bulgaria, ICSID Case No. ARB/03/24, Decision on Jurisdiction, 8 February 2005 (Energy Charter Treaty)
86 In this view, only where the parties to the BIT have a clear and unambiguous intention of incorporating the dispute settlement provisions from other treaties (by operation of the MFN clause) – will this be possible. See UNCTAD Series of International Investment Policies for Development, above n 7, 36
87 Ibid.
88 Tecnicas Medioambientales Timed S.A. v United Mexican States, unreported; ICSID; Case No. ARB(AF)/00/2, Award, 29 May 2003 (Spain/ Mexico BIT), para 69. Also see ADF Group Inc. v United States of America, unreported; ICSID; Case No. ARB(AF)/00/1, Final Award, 9 January 2003 (NAFTA)
when such a test has been met, it does display a greater degree of restraint than originally feared in the immediate aftermath of the Maffežini decision.

One of the recent decisions by an ICSID tribunal in the *MTD Equity Bhd. v Chile* case\textsuperscript{89} has suggested a broader notion in this regard.\textsuperscript{90} The tribunal considered that:

\begin{quote}
The [...] standard of treatment has to be interpreted in the manner most conductive to fulfil the objectives of the BIT to protect investment and create conditions favourable to investments.\textsuperscript{91}
\end{quote}

Accordingly, the tribunal felt that the inclusion of standards found in other BITs concluded by Chile with other States was “commensurate with its purpose”. The tribunal justified this reasoning by pointing to the fact that the contracting parties found it prudent to exclude, from the coverage of the MFN clause, matters relating to tax and regional cooperation. This approach can certainly broaden the coverage of a BIT. However, the tribunal required that the provision relied upon in a BIT with a third country fall within the ambit of the fair and equitable treatment standard. Thus, only those provisions specifically relevant to the clarification of obligations under BIT containing the MFN clauses may be considered.\textsuperscript{92}

Whilst it is true to say that the MFN clauses may generally be found in most international investment agreements, one ought to be mindful of the exceptions attached to them. In particular, GATT members recognised in principle that the MFN rule should be relaxed to accommodate the needs of developing countries, and the UN Conference on Trade and Development (UNCTAD) in 1964 has sought to extend preferential treatment to the exports of the developing countries. Another challenge to the MFN principle has been posed by regional trading groups such as the European Union (EU), which have lowered

\textsuperscript{89} MTD Equity Sdn. Bhd. & MTD Chile S.A.v Chile, ICSID Case No. ARB/01/7, Award, 25 May 2004 (Malaisia/ Chile BIT)
\textsuperscript{90} UNCTAD Series of International Investment Policies for Development, above n 7, 36
\textsuperscript{91} MTD Equity Sdn. Bhd. & MTD Chile S.A.v Chile, ICSID Case No. ARB/01/7, Award, 25 May 2004 (Malaisia/ Chile BIT), para 104
\textsuperscript{92} UNCTAD Series of International Investment Policies for Development, above n 7, 36
or eliminated tariffs amongst members while maintaining tariff walls between member nations and the rest of the world. Free Trade Agreements also represent an exception.

In summary, MFN treatment is essentially a method of establishing equality of trading opportunity between States by making bilateral agreements multilateral. As a principle of public international law, it establishes the sovereign equality of States with respect to trading policy. As an instrument of economic policy, it provides a treaty basis for competitive international transactions, and as a tool for investment protection, it prohibits discrimination among trading nations, and their nationals.

V. "Fair and equitable" treatment protection

The standard of *fair and equitable treatment* originated in customary international law. Subsequently there were numerous international and regional agreements and treaties, which also laid the foundation of this principle and confirmed its essence as a significant part of public international law.93 In recent years, however, with the growing number of bilateral and multilateral investment treaties, the principle of *fair and equitable* treatment turned into a standard clause of the contractual agreements between the States.94


A breach of *fair and equitable* treatment occurs “where it is shown that an investor has been treated in such an unjust or arbitrary manner that the treatment is raised to the level that is unacceptable from the international prospective”.

For example, the breach would be deemed to have occurred where the Host State’s government fails to give full notice directly to a ship-owner regarding the impending seizure of a ship, or where an investor is required to produce excessive documentation for export permits in the forestry sector, or indeed, where the government officials engage in an improper transfer of governmental funds from a private bank account into a more suitable one.

In the case of *Genin v Estonia*, the tribunal defined *fair and equitable* treatment to include:

> Acts following a wilful neglect of duty, an extreme insufficiency of action falling far below international standards, subjective bad faith, or a wilful disregard of due process.

Other arbitrations under both MITs and BITs have further considered the implications of this standard. For example, in *Pope & Talbot*, it was held that the standard applies to conduct that requires a failure of due process that “surprises the observer”. This line was applied to reach a finding against Canada for what was seen as overly aggressive use

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95 *S.D. Myers v Canada*, above n 6, 263
96 *Middle East Cement Shipping and Handling Co. S.A v Arab Republic of Egypt*, unreported; ICSID Case No. ARB/99/6, Award, 12 April 2002 (Greece/ Egypt BIT)
97 *Pope & Talbot, Inc. v The Government of Canada*, unreported; UNCITRAL, Award on Merits, 10 April 2001; unreported; Award on Damages, 31 May 2002; unreported; Award on Costs, 26 November 2002 (NAFTA)
98 *Emilio Augustin Maffezini v The Kingdom of Spain*, unreported; ICSID Case No. ARB/97/7; Decision on Jurisdiction, 25 January 2000; unreported; Award, 13 November 2000; unreported; Rectification of Award, 31 January 2001 (Argentina/ Spain BIT)
99 *Alex Genin, Eastern Credit Limited v Republic of Estonia*, unreported; ICSID Case No. ARB/99/2, Award, 25 June 2001 (United States/ Estonia BIT)
100 *Alex Genin, Eastern Credit Limited v Republic of Estonia*, unreported; ICSID Case No. ARB/99/2, Award, 25 June 2001, paragraphs 367, 371 (United States/ Estonia BIT)
101 See *Pope & Talbot, Inc. v The Government of Canada*, unreported; UNCITRAL, Award on Damages, 31 May 2002, para 57; *Mondev International Ltd v United States of America*, unreported; ICSID Case No. ARB(AF)/99/2; Award, 11 October 2002 (NAFTA), paras 114-116
102 *Pope & Talbot, Inc. v The Government of Canada*, unreported; UNCITRAL; Award on Damages, 31 May 2002, para 64
of administrative powers to gather information on the export levels of the company’s forest products, which was the subject matter of the arbitration.103

In the *Modev v United States* case,104 concerning property transactions in Boston between a Canadian developer and the city of Boston, the tribunal noted two further key elements in relation to *fair and equitable* treatment. First, the standard is needed to provide a level of real protection to investors. Second, a tribunal does not have unfettered discretion to decide when the standard is breached, but must reach its assessment on the basis of relevant sources of international law.

In the case of *Tecmed v Mexico*,105 the tribunal focused on the breach of expectations of the investors as being subject to the *fair and equitable* treatment rule. The tribunal considered the *fair and equitable* provision as a principle of good faith conduct, adding that it requires the Host States to act in a manner that is consistent, transparent and free from ambiguity.106

In *ADF Group Inc. v United States of America*, the Host State’s legislation requiring the foreign investor to use only domestically produced raw material was also held to be in violation of this principle.107 The Claimant in *ADF Group Inc. v United States of America*, a steel producer, claimed damages for alleged injuries resulting from federal legislation and implementing regulations that required federally-funded state highway projects to use only domestically produced steel. The Claimant argued, *inter alia*, that the US breached its NAFTA obligations to provide *fair and equitable* treatment. In particular, this case concerned the United States’ “Buy America Requirements”, which provided that only steel products produced and manufactured in the United States could be used in the construction of the American highways. This requirement adversely affected

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103 UNCTAD Series of International Investment Policies for Development, above n 7, 38
104 *Mondev International Ltd. v United States of America*, unreported; ICSID Case No. ARB(AF)/99/2, Award, 11 October 2002 (NAFTA), para 119
105 *Tecnicas Medioambientales Tecmed S.A. v United Mexican States*, unreported; ICSID; Case No. ARB(AF)/00/2, Award, 29 May 2003 (Spain/ Mexico BIT)
106 Ibid, para 154
107 *ADF Group Inc. v United States of America*, unreported; ICSID; Case No. ARB(AF)/00/1, Final Award, 9 January 2003 (NAFTA) Electronic <http://www.state.gov/s/l/c3754.htm> (3 September 2008)
the operations of ADF, a Canadian investor, that was awarded a sub-contract for the supply and delivery of structural steel components for nine bridges of the Springfield Interchange Project in Northern Virginia, and which sought to carry out fabrication work of US-produced steel in its facilities in Canada.

The overall result of the decisions to date is that *fair and equitable* treatment provisions may apply not only to what would be considered an abuse of government power, or disguised uses of government powers for improper purposes, but also to any open and deliberate use of government powers that fails to meet the requirements of good governance (such as transparency, protection of the investors' legitimate expectations, freedom from coercion and harassment, due process and procedural propriety and good faith).\(^{108}\)

In summary, it can be ascertained that the concept of *fair and equitable* treatment, which was founded in customary international law and over the years adopted by most of the international instruments on foreign investment (including BITs and MITs), is one of the widely recognised tools for the protection of foreign investors, in that it proclaims the principle of non-discrimination and proportionality in the treatment of foreign participants.\(^{109}\)

**VI. "Most constant protection and security" defence**

The protection offered by the principle of *most constant protection and security* for foreign investment has a particular application to periods of civil unrest and other public disturbances. It encompasses damages or losses sustained by an investor as a result of such violent episodes, whether directly due to governmental acts or to the lack of adequate protection of the investment by government officials (or police).\(^{110}\)

\(^{108}\) UNCTAD Series of International Investment Policies for Development, above n 7, 39

\(^{109}\) It must be noted that though most investment protection agreements require that investment and investors receive "fair and equitable" treatment, there is no general agreement on the precise meaning of this principle. See Salem, M, "Le Development de la Protection Conventionelle des Investissements Etrangers" (1986) *Journal du Droit International*, No. 3, 579-626

\(^{110}\) UNCTAD Series of International Investment Policies for Development, above n 7, 40
Whilst this standard has been primarily used in situations of violence, there are also examples of its application in non-violent situations in the sense of legal protection and security.\textsuperscript{111} Despite the more limited nature of this obligation, it is of considerable relevance to certain developing countries, where different forms of civil strife and interference with legal rights remains frequent, and where lack of adequate protection is an on-going issue.

With regard to investment law, at least three ICSID cases have focused on this obligation in recent years.\textsuperscript{112} In the course of these cases, the tribunals have indicated that the obligation to provide \textit{most constant protection and security} does not mean that investors are provided with a complete insurance policy against all losses due to some form of civil strife. What it means is that Host States have a duty to act in good faith and provide their best efforts to protect the foreign-owned property. Only when this duty is breached, would an investor have an actionable claim against the Host State under this heading of protection. In summary, this obligation places a clear premium on political stability and responsibility by the Host State to ensure that any instability does not have a negative effect on foreign investors.\textsuperscript{113}

\textbf{VII. Protection offered by the dispute resolution clauses in international investment agreements}

Another major investment protection mechanism, which is offered by all or at least most modern BITs and MITs is the dispute resolution clauses incorporated into these instruments. These clauses are binding and their breach amounts to a breach of


\textsuperscript{112} \textit{American Manufacturing & Trading v Zaire}, unreported; ICSID Case No. ARB/93/1; Award, 21 February 1997; (1997) 12 International Arbitration Reporter 4, A-1 & A-2; \textit{Wena Hotel Ltd. v Arab Republic of Egypt}, unreported; ICSID Case No. ARB/98/4; Decision on Jurisdiction, 29 June 1999; unreported; ICSID; Award on Merits, 8 December 2000; unreported; ICSID; Decision on Annulment, 5 February 2002 (United Kingdom of Great Brittan and Northern Ireland/ Arab Republic of Egypt BIT)

\textsuperscript{113} UNCTAD Series of International Investment Policies for Development, above n 7, 41
international law. Most of the modern investment agreements generally offer a menu of dispute resolution alternatives, including: arbitration under the ICSID Convention (if both the Host State and the investor’s home State are parties to the Convention); arbitration under ICSID Additional Facility Rules (if either the Host State or the investor’s home State are parties to the Convention); arbitration under the UNCITRAL Arbitration Rules; or arbitration under any other rules to which both the investor and the Host State agree.  

For example, under the 2002 Russia – Ukraine BIT, an investor is offered three options:

2. In the event that the dispute cannot be resolved through negotiations within six months as of the date of the written notification, then the dispute shall be passed over for consideration to:
   (a) a competent court or an arbitral court of the Contracting Party, in whose territory the investments were carried out;
   (b) the Arbitration Institute of the Chamber of Commerce in Stockholm, or
   (c) an “ad hoc” arbitration tribunal, in conformity with the Arbitration Regulations of the United National Commission for International Trade Law (UNCITRAL).

What these options mean is that investors are presented with neutral, efficient and binding mechanisms to resolve their disputes. It is therefore not surprising that clear and well-formulated arbitration agreements, contained in investment treaties, serve as an invaluable investment protection mechanism, and are often treated as prerequisites to investors entering into the contract with the Host State.

In this context, however, one should be mindful that dispute resolution mechanisms provided for in international investment treaties may differ from those provided for in the State contracts. For example, the provisions of a BIT may provide for an arbitration to be held under the rules of the International Centre for Settlement of Investment Disputes in a neutral forum, while the dispute resolution clause in the State contract may require the

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dispute to be settled in the Host-State's domestic courts and under the Host State's domestic law. This, in the first instance, raises an issue relating to the multiplicity of forums and leads to an often fruitless debate as to which forum should be given preference. Secondly, it raises the issue of the so-called *Fork-in-the-road* principle according to which an investor, once chosen (or being forced to choose) an option to litigate before State courts, loses the opportunity to bring his or her dispute to international arbitration. These issues will now be discussed.

*Conflict of jurisdictions: overstepping the "Fork-in-the-road" and "Umbrella" clauses*

One of the potential risks arising from an investment dispute settlement system (in international investment agreements) concerns the possibility of initiating the process provided for in the relevant treaty despite the existence of a "domestic forum" clause in the investment contract between the investor and the Host State. Such a clause may specify that disputes arising out of breaches of the investment contract shall be settled under domestic dispute-settlement systems.\(^{116}\) There is, therefore, a contract between the parties in which they agree that in the event of a dispute arising out of or in connection with their investment, domestic law of the Host State's shall be applied. On the other hand, there exists an international agreement between the Host State and the investor's home State whereby it is stipulated that in the event of an investment dispute, the parties will agree to submit themselves to arbitration under, for example, the ICSID Rules, and that such arbitration should be held in a neutral venue. Thus, there exists a degree of confusion not only as to which dispute resolution agreement is to apply, but also the purpose of the "domestic forum" clause if international law is to prevail and vice versa.

One of the possible solutions to these issues was proposed by a number of recent ICSID decisions,\(^{117}\) in which it was stated that where the breach of an investment contract is at

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\(^{116}\) UNCTAD Series of International Investment Policies for Development, above n 7, 18

\(^{117}\) Alex Genin, *Eastern Credit Limited v Republic of Estonia*, unreported; ICSID Case No. ARB/99/2, Award, 25 June 2001 (United States/ Estonia BIT); *Compania de Aguas del Aconquija & Compagnie Generale des Eaux v Argentice Republic*, ICSID Case No. ARB/97/3, Award, 21 November 2000 (France/ Argentina BIT); *Compania de Aguas des Aconquija & Vivendi Universal (formery Compagnie Generale*
issue, the requirement, established in the “domestic forum” clauses to pursue breach of contract claims in domestic dispute-settlement procedures, does not prevent the use of the investor-State dispute-settlement mechanism of an international investment agreement. This is so even where the alleged breach of contract is central to the establishment of a breach of the investment protection obligations in the treaty.\footnote{Compania de Aguas del Aconquija & Compagnie Generale des Eaux v Argentina Republic, ICSID Case No. ARB/97/3, Decision on Annulment, 3 July 2002 (France/Argentina BIT); Salini Construttori S.p.A. and Italstrade S.p.A. v Morocco, ICSID Case No. ARB00/4, Decision on Jurisdiction, 23 July 2001 (Italy/Morocco BIT) (Annulment Tribunal) 
Compania de Aguas del Aconquija & Compagnie Generale des Eaux v Argentina Republic, ICSID Case No. ARB/97/3, Award, 21 November 2000 (France/Argentina BIT); Compania de Aguas des Aconquija & Vivendi Universal (formerly Compagnie Generale des Eaux) v Argentina Republic, ICSID Case No. ARB/97/3, Decision on Annulment, 3 July 2002 (France/Argentina BIT); Salini Construttori S.p.A. and Italstrade S.p.A. v Morocco, ICSID Case No. ARB00/4, Decision on Jurisdiction, 23 July 2001 (Italy/Morocco BIT) \footnote{UNCTAD Series of International Investment Policies for Development, above n 7, 19} \footnote{Ibid.}}

The rationale behind these cases is that “domestic forum” clauses relate to breaches of the contract alone, while the investor-State claims relate to breaches of the treaty as a separate international law obligation. Accordingly, contractual clauses should not stand in the way of a legitimate claim, at the international level, of a breach of an international obligation as they should only be invoked in cases of contractual as opposed to international law obligations.\footnote{Ibid.} This can be viewed as a potential disadvantage to the Host State, in that it may remove what appears to be a purely contractual dispute from the domestic forum. However, it is equally plausible to argue that, should the “domestic forum” clause have the effect of prohibiting any international challenge to the Host State’s actions, the protective purpose of the international treaties would be diminished to the considerable disadvantage of the investor.\footnote{Ibid.}

One important issue in this context relates to the so-called umbrella clause. This clause establishes a treaty obligation to respect all the commitments or obligations entered into in contracts or other forms of agreements between an investor and the Host State. The effect of this clause is that breaches of investment contracts amount to a violation of the applicable international investment agreement. However, the case law on such provisions is not uniform and has given rise to some uncertainty as to the precise scope of such
clauses. In particular, in the case of *SGS v Pakistan*\textsuperscript{121} the tribunal held that the umbrella clause does not mean that breaches of contract are automatically “elevated” to the level of breaches of international treaty law. By contrast, in *SGS v Philippines*,\textsuperscript{122} the tribunal expressly disagreed with the analysis of the decision in *SGS v Pakistan*, and held that by virtue of the umbrella clause, the failure of the Host State to observe binding contractual commitments made it a breach of the BIT. To date, this issue has been the subject of some debate.\textsuperscript{123}

It is important to note that umbrella clauses arise out of a number of historical precedents that make it clear that their objective and purpose is to extend the protection of the treaty to the determination of disputes over the alleged breach of an investment contract by the Host State.\textsuperscript{124} Accordingly, such interpretation of the umbrella clause by international arbitral tribunals appears to be consistent with its main objective.

In recent decisions, tribunals have in general followed a broader approach on the application of the umbrella clauses.\textsuperscript{125} However, in the case of *Impregilo v Pakistan*,\textsuperscript{126} the tribunal limited its treaty jurisdiction over contractual claims to claims involving the State itself and not State-owned entities. In the case of *Consortium Groupement L.E.S.I – DIPENTA v Algeria*,\textsuperscript{127} the tribunal emphasised the requirement that contractual claims brought before a treaty-based tribunal must also amount to a violation of the treaty standards themselves.

\textsuperscript{121} *SGS Societe Generale de Surveillance S.A. v Islamic Republic of Pakistan*, ICSID Case No. ARB/01/13, Decision on Jurisdiction, 6 August 2003 (Swiss Confederation/ Pakistan BIT)

\textsuperscript{122} *SGS Societe Generale de Surveillance S.A. v Republic of the Philippines*, ICSID Case No. ARB/03/6, Decision on Jurisdiction, 29 January 2004 (Swiss Confederation/ Republic of the Philippines BIT)

\textsuperscript{123} For a detailed analysis of these awards in the context of the “umbrella clauses”, see further cases such as *Noble Ventures v Romania*, ICSID Case No. ARB/01/11; *Joy Mining v Egypt*, ICSID Case No. ARB/03/11, Decision on Jurisdiction, 6 August 2004; and *Sempra Energy Int. v Argentina*, ICSID Case No. ARB/02/16


\textsuperscript{125} UNCTAD Series of International Investment Policies for Development, above n 7, 20

\textsuperscript{126} *Impregilo S.p.A. v Islamic Republic of Pakistan*, ICSID Case No. ARB/02/2, Decision on Jurisdiction, 22 April 2005

\textsuperscript{127} *Consortium Groupement L.E.S.I – DIPENTA v Algeria*, ICSID Case No. ARB/03/8, Decision on Jurisdiction, 10 August 2005
Concerns may also arise in relation to the so-called *fork-in-the-road* principle. The choice-of-forum clauses generally require foreign investors to choose either a domestic or an international dispute settlement forum when a dispute arises. The purpose of such clauses is to prevent parties from resorting to multiple forums with regards to the same set of facts. However, *fork-in-the-road* provisions may not exclude the risk of having the shareholder initiate an arbitration to protect its BIT rights, while the investment (or the investor's subsidiary) initiates a domestic dispute to protect its contractual or other legal rights, including those stemming from the treaty.\(^\text{128}\)

On the face of such facts, several arbitral decisions have interpreted the *fork-in-the-road* provision as resulting in a loss of access to international arbitration only where the disputes and the parties before the domestic courts or tribunals are identical to the dispute and the parties in the international proceeding.\(^\text{129}\) In arriving at this conclusion, as noted by the UNCTAD researchers,\(^\text{130}\) the ICSID tribunal may have held the view that a foreign investor may be unable to avoid being drawn into local proceedings concerning the investment. They explained that:

> The domestic law of the [Host State] may require a defensive approach to be taken by the investor, such as the lodging of an appeal against a regulatory ruling, or the initiation of a legal challenge to an administrative decision where time limits for actions are short. In these circumstances, it may be difficult to characterize the action of the investor as a "free" choice of forum that negates the possibility of any action at the international level for breach of treaty obligation on the part of the [Host State, as] to do so, would render the protection of the relevant agreement nugatory. (Emphasis added).

Indeed, the outcome of the domestic process may itself give rise to possible further claims under the treaty. Thus, the exclusion of international proceedings under the *fork-

\(^{128}\) UNCTAD Series of International Investment Policies for Development, above n 7, 20

\(^{129}\) *Enron and Ponderosa Assets v Argentine Republic*, ICSID Case No. ARB/01/3, Decision on Jurisdiction, 14 January 2004 (United States/ Argentina BIT); see also Schreuer, C, 'Travelling the BIT route: of Waiting Periods, Umbrella Clauses and Forks in the Road' (2004) *Journal of World Investment and Trade*, Vol. 5, No. 2, 231-256

\(^{130}\) UNCTAD Series of International Investment Policies for Development, above n 7, 21
in-the-road clause appears to be consistent with the protective purpose of the treaty only in cases of full identity of issues and parties.

VIII. Direct claims by investors

It is noteworthy that the introduction and establishment of the International Centre for Settlement of Investment Disputes (ICSID) and its Rules for international commercial arbitration\(^\text{131}\) gave investors an additional and also a very significant measure of protection. It allowed investors to bring their claims, regarding violations of international law, before international tribunals directly, i.e. without having recourse to diplomatic protection.

The ICSID was established to hear "any legal dispute arising directly out of an investment, between a Contracting State ... and a national of another Contracting State, which the parties to the dispute consent in writing to submit to the Centre."\(^\text{132}\) Under the ICSID Convention, the investor's direct claim against the Host State was to be exclusive of any other remedy,\(^\text{133}\) and an investor's home State was precluded from exercising diplomatic protection with respect to disputes submitted to ICSID.\(^\text{134}\)

Under ICSID Convention, investors were generally not required to exhaust local remedies before bringing their claims to arbitration, although States were permitted,
under Article 26 of the ICSID, to require exhaustion as a condition of their consent to arbitration.135

A waiver of the local remedies rule served as a particular attraction to investors for a simple reason: "A foreign investor (justifiable in many instances) did not have confidence in the impartiality of the local courts and tribunals in settling any disputes that may arise between him or her and the Host State" (emphasis added).136 Providing investors with a more reliable remedy, such as award of an international tribunal, meant additional security and thereby "a larger flow of private international investment."137

Another great advantage of the ICSID arbitrations is that the arbitral procedure provided by ICSID offers considerable advantages to all parties concerned. As stated by Professor Schreuer:

[T]he foreign investor no longer depends on the uncertainties of diplomatic protection but obtains direct access to an international remedy. The dispute settlement process is, [thereby], depoliticized and subjected to objective legal criteria... In turn the Host State by consenting to ICSID arbitration obtains the assurance that it will not be exposed to an international claim by the investor’s home State.138 (Emphasis added).

When the ICSID Convention was drafted, it was expected that Host States would consent to ICSID jurisdiction either through direct agreements with investors or through domestic legislation.139 However such consent is found to be more commonly provided for in the investment treaties. For example, Article 26(4) of the 1994 Energy Charter Treaty

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135 ICSID Convention, above n 74, article 26 ("A Contracting State may require the exhaustion of local administrative or judicial remedies as a condition of its consent to arbitration under this Convention"). The only contracting State to have done so by notification to ICSID was Israel, which later withdrew this condition. A few other countries require exhaustion of local remedies in some of their BITs consenting to ICSID jurisdiction. See Schreuer, C, The ICSID Convention : A Commentary (London : Cambridge University Press, 2001), 392
136 See Schreuer, above n 77, 391 ("Rightly or wrongly, the national courts of one of the disputing parties are not perceived sufficiently impartial")
137 Report of Executive Directors on the Convention on the Settlement of Investment Disputes between States and National of Other States (18 March 1965) 4 I.L.M. 524, 525
138 See Schreuer, above n 77, 210-21
139 See Schreuer, above n 77, 194-210
provides for direct claims by investors with ICSID arbitration as one of the available options.

In conclusion, the possibility of investors to bring their claims directly to an international dispute resolution centre for settlement undoubtedly provided an added dimension to the development of international trade and investment. Not only did it depoliticise the settlement of investment disputes and allowed the home State to remain neutral in disputes between their nationals and other States, it also provided investors with extra security and, as a result, encouraged parties to continue international trade and increase the flows of foreign direct investment.

IX. Protection offered by the recognition and enforcement of international arbitral awards

The existence of a system where foreign arbitral awards, once rendered, can be easily recognised, enforced and executed is yet another type of remedy available to investors under international investment protection law. This system was launched by the introduction of the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards of 1958.140 Article III of this Convention reads as follows:

Each Contracting State shall recognise [international] arbitral awards as binding and enforce them in accordance with the rules of procedure of the territory where the award is relied upon, under the conditions laid down [in the Articles of this Convention]. (Emphasis added).

This system of recognition of foreign arbitral awards provides investors with additional security regarding their investments and as such facilitates their willingness to conduct business on an international scale. As noted by Professors Moens and Gillies, the New York Convention is currently the main vehicle for the recognition and enforcement of

international arbitral awards. 141 As to the effect rendered by this Convention, Professors Moens and Gillies note 142 that:

The recognition and enforcement regime provided for in the Convention aims to provide straightforward and effective procedures for the enforcement of international arbitral awards. It aims to promote uniformity in the principles and processes applying to enforcement, irrespective of the country in which enforcement is sought. [...] The Convention intends that the arbitral award be final and not subject to review by the courts in the country of recognition and enforcement. This, after all, is what the parties are taken to have intended in subscribing to an arbitral agreement. Accordingly, the Convention limits the grounds that a party resisting enforcement can plead, although it does not entirely preclude judicial review. There is no general provision in the Convention for a general review of the award on the merits, by a court in the country where enforcement is sought.

In other words, recognition of an arbitral award is the official confirmation that the award is authentic. Hence, it has two possible effects: first, confirmation of the award as final and binding, and second, recognition that it is enforceable. The recognition of an award has the effect of rendering it res judicata in the country concerned. This means that the claim on which the award was decided must not be the subject of another proceeding before a domestic court or arbitral tribunal, and that the rendered award is final and conclusive. 143

After the collapse of the Soviet Union, that signed and ratified the New York Convention, the Russian Federation declared itself its successor. Thus Russia's official declarations that it would continue to exercise rights and honour obligations arising from international treaties signed by the Soviet Union meant that it is now assumed that Russia is bound by all international acts that were signed by the Soviet Union, including the New York Convention. In other words, the courts of the Russian Federation, as the law presently stands, ought to comply with the provisions of the New York Convention.

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141 Moens, Gabriel & Gillies, Peter, International Trade & Business: Law, Policy and Ethics, 2nd ed (London: Routledge Cavendish, 2006), 591. ("The Convention has been ratified by more than 130 countries, including all of the major trading nations")

142 Id.

Russian domestic law regarding international arbitration, *The RF Arbitrazh Procedural Code* of 24 July 2002 (No. 95-F3), by and large repeats the provisions of the *New York Convention*. It states, in Article 148(5), that international arbitral awards are entitled to recognition and enforcement, subject to very few exceptions, namely where:

1. the agreement to arbitrate is not valid (Article V(1) of the New York Convention);
2. the subject matter is incapable of being settled by arbitration (Article V(2)(a) of the New York Convention); and
3. the recognition and enforcement of the award would be contrary to the public policy of the Host State (Article V(2)(b) of the New York Convention).

To be more precise, Article 148(5) reads as follows:

The Arbitrazh Court shall leave a statement of claim without consideration if, [...] it establishes that there exists an agreement between the parties [to submit their disputes to arbitration], [and none of the parties], at first available opportunity, [filed] an objection with respect to the consideration of the case in the Arbitrazh Court, with the exception of the cases where the Arbitrazh Court establishes that this agreement is invalid, inoperative or cannot be executed. (Emphasis added).

It should be noted that none of these exceptions permit local courts in Russia to review foreign arbitral awards on the merits.

In summary, one of the undisputed advantages of an arbitral award is that it is final and binding when rendered. Such an outcome allows not only for much desired stability in international trading relations but also provides an additional measure of security to investors who will, arguably, be more willing to invest their capital in a foreign jurisdiction had they been provided with an assurance that their dispute will not be subjected to constant interference by various courts and State organs and that they can gain the benefit of a system where the aggrieved party can obtain his or her rewards.
C. Protection of foreign investment under customary international law

I. An obligation to provide a minimum standard of treatment

The totality of obligations that a Host State owes a foreign investor, as it was put by Professor Salacuse, is referred to as the “treatment” which the State owes to the investor or investment.\(^{144}\) The international minimum standard of treatment (MST) is a norm of customary international law which governs the treatment of aliens by providing for a minimum set of principles which States, regardless of their domestic legislation and practices, must respect when dealing with foreign nationals and their property.\(^{145}\) The international minimum standard sets a number of basic rights established by international law that States must grant to aliens, independent of the treatment afforded to their own citizens. Violation of this norm triggers international responsibility and, potentially, opens the way for international action on behalf of the injured alien.\(^{146}\)

The MST principle was tied to the international law doctrine of State responsibility for injuries to aliens,\(^{147}\) which provides that an injury caused to an alien was an injury done to the alien’s home State, and permitted claims and protection by the home State when domestic resources were unavailable or exhausted.\(^{148}\)

During the XX\(^{th}\) century, an international custom providing for a minimum standard of treatment evolved in parallel with the conclusion of various investment treaties establishing distinct legal regimes for the protection of foreign investment.


\(^{146}\) Id


Despite the complexities of early cases in the context of customary international law, States continue to owe their investors the general minimum standard of treatment, which includes: “fair and equitable” treatment, “most-favoured-nation” treatment, and “national” (or “non-discrimination”) treatment. The nature and content of these treatment measures were explained in the beginning of this chapter.

II. Distinction between treaty protection and customary law protection

It is true to say that the minimum standard of protection under both the treaty law and customary international law is quite similar, in that the Host State generally owes a foreign investor an obligation, first, to ensure that a foreign investor is treated in the same manner as any domestic investor (i.e. the Host State must comply with the national treatment provisions). Second, to ensure that the foreign investor is not treated in a less favourable manner than any other foreign investor (i.e. the Host State must comply with the most-favoured-nation principle). And finally the Host State must ensure that the foreign investor is provided with fair and equitable treatment (in accordance with the provisions of international law, including case law).

The distinction between the two levels of protection, however, is substantial in that the protection provisions offered by treaty law can only be relied upon when, first, there is an investment treaty between the Host State and the investor’s home State, and second, this investment treaty contains the above-mentioned protection provisions. By way of example it is worth noting that there is no bilateral investment agreement between the Russian Federation and Australia. This means that unless there is any multilateral investment treaty to which both the Russian Federation and Australia are parties, an Australian investor may not be in a position to rely upon the treaty protection provision. Hence, the provisions of customary international law on the protection of foreign investment alone (i.e. MST protection provisions) may apply.
D. Conclusion

In this chapter I have highlighted the nature and significance of the two most important mechanisms for the protection of foreign investors offered by public international law. Namely, I discussed some of the international protection provisions offered by the modern treaty law and also those originated in customary law.

In the course of my discussions in this chapter I came to the conclusion that public international law is capable of safeguarding foreign investors from some of the most obvious detrimental acts of the Host States. What must be kept in mind is that every Host State, by way of its sovereign responsibilities, has an obligation to comply with its international undertakings. Such international instruments, be they bilateral or, indeed, multilateral, oblige their member-States to protect aliens entering their respective territories. The said protection extends to non-discrimination among various aliens, as well as that among aliens and the State’s own nationals, and also includes the fair and equitable treatment of investment and the obligation to provide aliens and their investment with the most constant protection and security. The same protection is also attributable to the minimum standard of treatment offered to investors under customary law.

Another significant investment protection mechanism offered by the public international law is hidden in the treaties’ dispute resolution provisions, which offer investors additional security and peace of mind in case of a contemplated dispute with the Host State. Last but not least, the membership of the Host State to the New York Convention is also considered to be a type of remedy. The New York Convention sets out a mechanism for the recognition and enforcement of foreign arbitral awards that once rendered, become binding and enforceable.
Chapter Six

Dealing with expropriation: conditions of legality & measures of protection

A. Introduction

In the previous chapters I discussed some of the most widely accepted investment protection mechanisms available to foreign investors once they or their property enter the territory of the Host State. Those investment protection mechanisms dealt specifically with the issues of constantly changing internal legislation, double taxation and last but not least, overlapping legislative powers existing in certain Host States. In this chapter I will explore another major obstacle for foreign investors in the Russian energy sector, namely, the Host State’s right to expropriate or nationalise foreign investment. In developing this argument, I shall provide the reader with an overview of the very concept of expropriation, and discuss some of the remedies and revenues available to investors following the occurrence of expropriating actions made on behalf of the Host State.

B. The meaning of the concept of expropriation

The Host State’s right to expropriate is widely recognised as a concept of public international law. Traditionally, this right has been regarded as a discretionary power inherent within the sovereignty of each State, allowing the State to develop the welfare and economic progress of the population residing within its territory.¹

¹ See GA Resolution 626 (VII) on Right to Exploit Freely Natural Wealth and Resources (General Assembly, Seventh Session, 411th plenary meeting, 21 December1952) <http://daccessdds.un.org/doc/RESOLUTION/GEN/NR0/079/69/IMG/NR007969.pdf?OpenElement>
Expropriation is commonly understood to refer to unilateral interference by the State with the property (or comparable rights) of the investor whereby the State deprives that investor of the control of his or her property by means of restrictions and infringements upon the entry of foreign wealth into the country, the use of foreign wealth, and the revenues produced from the investment of that wealth. Another similar concept is the concept of *nationalisation* which denotes the transfer of an economic activity to the public sector as part of a general program of social and economic reform. Both of these concepts will be discussed throughout this chapter under the heading of *expropriation*.

The legal evolution of the concept of *permanent sovereignty over natural resources* (PSNR) and the debate surrounding its guiding principles have been seriously affected by conflicts over the State’s right to nationalise or expropriate foreign property. As mentioned in earlier chapters, sovereign States have a right to expropriate or nationalise foreign property provided they comply with certain conditions of legality, making such conduct acceptable. These conditions include the requirement that: first, such action was performed for public purpose; second, that it was done in a non-discriminatory manner, and third, that the expropriating State provided the injured party with adequate compensation.

In this chapter, I will analyse, first, the nature and origins of the right to expropriate foreign property, and the form it generally takes. I will then go on to consider the conditions of legality for the act of expropriation, including an obligation to pay adequate compensation. Finally, I will conclude that the Host State’s obligation to pay compensation is one of the most effective means of international legal protection available to foreign investors under public international law.

December 2006) (“the right of people to [freely use and exploit] its natural resources... is inherent in their sovereignty and is in accordance with the Purpose and Principles of the Charter of the United Nations”)


C. The nature and origin of the right to expropriate or nationalise foreign investment

The right to expropriate or nationalise foreign investment, despite its controversial nature, is inherent within the sovereignty of each State and was recognised even before the United Nations Resolutions on Permanent Sovereignty over Natural Resources were adopted. This right is explicitly included in some of the Resolutions of the General Assembly (GA), UNCTAD and also in UNIDO II’s Lima Declaration. Among the more general treaties, the Havana Charter attempted to acknowledge the States’ right to nationalise. However, in its attempt, it merely provided that Member States “have the right to prescribe and give effect on just terms to requirements as to the ownership of existing and future investments”, a provision which had been interpreted to embrace the right to expropriate.

More explicit, in terms of the language used, was the 1967 Draft OECD Convention on the Protection of Foreign Property. Article 3 of that Convention stated that:

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4 Gheirghe, E, The principle of Sovereignty over Natural Resources (Leiden : Martinus Nijhoff, 1979), 1-45
7 ‘Lima Declaration II’ UNIDO, United Nations (26 March 1975) http://www.gwb.com.au/gwb/news/lima/un.html (3 August 2008) paragraph 32 (“[E]very State has the inalienable right to exercise freely its sovereignty and permanent control over its natural resources, both terrestrial and marine, and over all economic activity for the exploitation of these resources in the manner appropriate to its circumstances, including nationalisation in accordance with its laws as an expression of this right and that no State shall be subjected to any forms of economic, political or other coercion which impedes the full and free exercise of that inalienable right”)  
9 Ibid.
No party shall take any measures depriving directly or indirectly, of his property a national of another Party unless [certain] conditions are complied with (Emphasis added).

In addition to the above, most of the bilateral investment protection treaties and the investment related chapters of multilateral treaties (such as NAFTA and ECT), also recognise the right of a Host State to expropriate foreign property, subject to specific requirements of international law.\textsuperscript{11} For example, Article 5 of the 2002 Russia – Ukraine \textit{BIT}, specified that:

The investments or investors of either Contracting Party, carried out on the territory of the other Contracting Party, shall not be subject to expropriation, nationalisation or other measures, equated by its consequences to expropriation, with the exception of cases, when such measures are not of a discriminatory nature and entail prompt and adequate compensation.

Another example of such a provision may be found in Article 13 of the 1994 ECT:\textsuperscript{12}

(1) Investments of Investors of a Contracting Party in the Area of any other Contracting Party shall not be nationalized, expropriated or subjected to a measure or measures having effect equivalent to nationalization or expropriation except where such expropriation is:

(a) for a public purpose which is in the public interest;
(b) not discriminatory;
(c) carried out under due process of law; and
(d) accompanied by the payment of prompt, adequate and effective compensation.

The \textit{Chorzow Factory Case}\textsuperscript{13} is often quoted as one of the first judgements which recognised a State’s right to take foreign property.\textsuperscript{14} In another case concerning \textit{Anglo-Iranian Oil Company}, the general rights of States to nationalise foreign property was held

\textsuperscript{11} These requirements will be discussed in the next Chapter.
\textsuperscript{13} \textit{Chorzow Factory Case} (1928) PCIJ Series A No. 17 (Merits)
\textsuperscript{14} This case deals with liquidation and transfer of assets of enemy property pursuant to peace treaties. The Court recognized that there are may be certain exceptions to the principle of respect for “vested rights”, including “expropriation for reasons of public utility, judicial liquidation and similar measures”.}

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to have become commonly recognised. A further step was made in the Texaco Case where it was pointed out that the right to nationalise should be regarded as the expression of a State’s territorial sovereignty. This opinion was upheld in the Liamco Award where Mahmassani stated that the right of a State to nationalise its wealth and natural resources is a sovereign right. In the Amoco Award, the Chamber of the Iran-US Claims Tribunal recognised nationalisation as a “right fundamentally attributed to State sovereignty” and “commonly used as an important tool of economic policy by many countries”.

The recognition of the right to nationalise in general is also referred to in the ICC Guidelines, the Draft UN Code of Conduct on Trans-National Corporations (which acknowledges that “States have the right to nationalize or expropriate the assets of transnational corporations operating in their territories”), the ILA Seoul Declaration (where it is declared that “A State may, inter alia, nationalize and expropriate [... the property, or rights in property, within its territory and jurisdiction]” and the World Bank Guidelines on the Treatment of Foreign Investment. For example, in the latter in is stated that:

A State may not expropriate or otherwise take in whole or in part a foreign private investment in its territory or take measures which have similar effects, except where it is done in accordance with applicable legal procedures. (Emphasis added).

Overall, it may be stated that the State’s sovereign rights to nationalise or expropriate foreign property to-date is a well recognised concept of public international law. And despite the fact that academic opinion on the modalities of the exercise of this right is

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15 Anglo-Iranian Oil Company (Preliminary objection), unreported; ICJ; Judgment of 22 July 1952; (1952) I.C.J. Reports 109
16 Texaco v Libya (1978) 17 ILM 59
17 Liamco v Libya (1981) 20 ILM 120
divided, this right, without debate, is now considered to be one of the attributes of the State's sovereignty which it possesses in relation to all persons and things within its territorial jurisdiction.

D. Forms of expropriation: direct versus indirect

I. Direct expropriation

Generally speaking, expropriation exists in two broad forms: direct (de jure) and indirect (de facto). Direct expropriation constitutes a lawful act of the State, and as such does not give rise to international responsibility, provided that it complies with the set conditions of legality.\(^23\) Every act that falls short of the compliance with these conditions is illegal and as a result may trigger international responsibility. A good illustration of this principle is provided in \textit{Compania des Desarrollo de Santa Elena}\(^24\) case where the republic of Costa Rica issued a decree of expropriation of foreign undertakings and proposed to pay compensation in accordance with an appraisal conducted by one of its agents. The plaintiff in this case did not object to expropriation, but rather challenged the amount of the proposed compensation, claiming that he should be paid triple the sum proposed by the Costa Rican government. What had to be identified in this case is the extent to which the measures taken by the Host State had deprived the owner of the expropriated property of the normal control of his property. It was held that "[a] decree which heralds a process of administrative and judicial consideration… in a manner that effectively freezes the possibility for the owner personally to exploit the economic potential of the property can be identified as the actual act of taking"\(^25\) which in itself is illegal.

\(^{23}\) The three conditions of legality referred to in this instance are: (i) public purpose, (ii) non-discrimination, and (iii) payment of compensation.


\(^{25}\) Ibid.
Another example of so-called *direct* expropriation can be observed in the recent law passed by the government of Bolivia. In particular, on 1 May 2006, the Bolivian government passed the Supreme Decree 28701, announcing that it was taking over oil and gas resources in the country. 26 Similarily, in May 2006, the government of Ecuador has taken control of over USD 1 billion of assets owned by the US-based Occidental, the largest foreign investors in Ecuador. 27 Occidental Petroleum Corporation (Occidental) filed a request on 17 May 2006 for arbitration claiming USD 1 billion in damages under the Ecuador-U.S. bilateral investment treaty. The request came two days after Ecuador unilaterally cancelled Occidental’s contracts and assumed control of its oil and gas operations in the country. As a result, Occidental claimed that the cancellation and additional taxes recently imposed on oil revenues amount to an expropriation of its investment. 28

Overall, it can be stated that direct expropriation occurs when the government of the Host State publicly announces its intention to deprive the foreign investor of its property. Provided that such “taking” of the investors’ property was followed by prompt and adequate compensation, such activity on the part of the Host State is not illegal and as a result, it does not invoke the State’s responsibility under the auspices of public international law.

**II. Indirect (“creeping”) expropriation**

Indirect expropriation, likewise, is an activity of the government of the Host State that results in the deprivation of the wealth of an alien investor. Unlike direct expropriation, however, indirect expropriation is rarely accompanied by the payment of compensation. This is due to the fact that, arguably, it does not amount to expropriation, the taking of the

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property is not direct but is rather achieved through other means (such as trade restrictions). This type of expropriation is also commonly referred to as “disguised” or “creeping”.

By and large, indirect expropriation is generally achieved through restrictions and infringements upon: (i) the entry of foreign wealth into the country, (ii) the use of foreign wealth, and (iii) the revenues produced from the investment of that wealth. Within the first category are situations in which the Host State prohibits the entry of foreign capital into certain sectors of industry. The second category involves situations in which the Host State decreases the use of foreign wealth by increasing public sector ownership in a particular industry through accelerating taxation regimes and exclusive rights and concessions. Under the last category of methods for achieving indirect expropriation of foreign investment, the foreign government can use exorbitant taxation policies for already existing contractual rights.

In order to summarise the nature and effect of the concept of indirect expropriation it is appropriate to quote Mr Highet, an arbitrator in Waste Mgmt Inc. v United Mexican States, who stated that:

[A] creeping expropriation is comprised of a number of elements none of which can separately constitute the international wrong. These constituent elements include non-payment, non-refurbishment, cancellation, denial of judicial access, actual practice to exclude, non-conforming treatment, inconsistent legal blocks and so forth. The “measure” at issue is the expropriation itself, and not merely a sub-component part of expropriation. (Emphasis added).

In other words, to confront the State with its action of the illegal taking of the property of another, and to subsequently penalise it for such action, one needs to show that an act of

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30 Id
31 Waste Mgmt Inc. v United Mexican States (2001) 40 I.L.M. 56, 73 (ICSID Case No. ARB(AF)/98/2, Award of 2 June 2000)
"creeping" expropriation has in fact taken place. However, an act of indirect expropriation is more difficult to prove, and as a result, is more readily open to abuse by the governments of Host States.

E. The conditions of legality for the act of expropriation

Obligations relating to the right to expropriate or nationalise foreign property, as they arise from, *inter alia*, GA Resolution 1803, are concerned with the following conditions of legality: (I) public purpose, (II) non-discrimination, and (III) payment of compensation. In other words, the Host State owes a foreign investor a set of obligations that arise out of the former's right to expropriate or nationalise the latter's property in investment. Each of these pre-conditions will now be discussed separately.

I. Public purpose requirement

The public purpose requirement is derived from a number of well-recognised international sources, among which are the 1952 *Protocol to the Convention for the Protection of Human Rights and Fundamental Freedoms* which clearly stated that no one person shall be deprived of his or her possessions except in "the public interest"; the 1978 *American Convention on Human Rights*, where it is stated that "No one shall be deprived of his property except upon payment of just compensation, for reasons of public utility or social interest, and in the cases according to the forms established by law"; and the 1986 *African Charter on Human and People's Rights* which article 14 proclaims that "The right to property shall be guaranteed. It may only be encroached upon in the

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interest of public need or in the general interest of the community and in accordance with the provisions of appropriate laws”.

Likewise, the OECD Draft Convention on the Protection of Foreign Property of 1967, also states that it is legitimate and permissible to expropriate the investment in the “public interests”. Some other multilateral investment agreements that make reference to a purpose which is in the “public interest” are the 1987 ASIAN Investment Agreement, the 1994 ECT and the 1992 NAFTA, to name just a few.

With regards to the Bilateral Investment Treaties (BITs), an overwhelming majority of them also provide for “public purpose” causes. For example, Article 5 of the 1995 Russia – Hungary BIT, in its relevant parts states that foreign investments shall not be nationalised or expropriated “except for a public purpose”. Likewise, Article 4(1) of the 2002 Russia – Thailand BIT also provides that foreign investments shall not be nationalised or expropriated “except when such measures are taken for public interest in accordance with the procedures established by the law of the Contracting Party”.

The public purpose requirement was subsequently invoked in a number of well-known nationalisation cases, among which are the Chorzow Factory Case, the Aminoil Case, and the Amoco Case, in which the arbitral tribunal noted that:

[a] precise definition of the public purpose for which expropriation may be lawfully decided … is a result of the modern concept of a right to nationalize the right which can be exercised by the State at its wide discretion. (Emphasis added.)

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40 Chorzow Factory Case (1928) PCIJ (Series A, no. 17), 48
41 Kuwait v Aminoil (1982) 21 ILM, 1019-20
In conclusion it may be stated that a nationalising State has wide discretion to utilise its right to expropriate foreign property, provided that such an act serves legitimate purposes, in this instance – public interest, public utility and national security.

II. Non-discrimination requirement

The second pre-condition that a sovereign State must comply with when making a decision to expropriate foreign property is that such expropriation is conducted in a non-discriminatory manner. Some of the multilateral treaties that make reference to this condition include NAFTA and the ECT, both of which stipulate that expropriation should be "without discrimination".

Most BITs also provide explicitly for non-discriminatory treatment. The general "treatment clause" in the majority of modern BITs reads as follows:

Foreign investors shall enjoy treatment no less favourable than that accorded to nationals of the Host State.

In order to illustrate this statement, I shall cite a number of Russian BITs (as their provisions are most relevant for the purpose of this thesis). In particular, Article 3 of the 1997 Russia – Cyprus BIT relevantly states that:

41 It must be noted that the terms "public purpose", "public utility and security", and "national interests" can be interpreted widely and as a result, are subject to much stipulation, judicial interpretation and possibly abuse. The issue of the abuse of interpretation of these terms, however, falls outside of the scope of this thesis. For further information on this topic please see Higgins, R, *The Taking of Property by the State: Recent Developments in International Law* (Hague Academy Recueil des Cours, 1982-III), vol. 176, pp. 263-39; and Moinuddin, H, *The Charter of the Islamic Conference and Legal Framework of Economic Co-operation Among its Member States* (Clarendon Press: Oxford, 1987)

44 In this instance, the discrimination refers to both discrimination between foreigners and nationals, and discrimination among foreigners.


Each Contracting party shall ensure in its territory for the investment made by investors of the other Contracting Party and for the activities in connection with such investments, fair and equitable treatment which would exclude the use of discriminatory measures that might hinder management, maintenance, use, enjoyment or disposal of the investments. (Emphasis added).

Likewise, Article 3(1) of the 1991 Russia – France BIT provides that:

Chacune des Parties contractantes s'engage à assurer, sur son territoire et dans sa zone maritime, un traitement juste et équitable, conformément aux principes du Droit international, aux investissement effectués par les investisseurs de l'autre Partie contractante, excluant toute mesure injuste ou discriminatoire qui pourrait entraver la gestion, l'entretien, la jouissance ou la liquidation de ces investissements. (Emphasis added).

In effect, the language of Article 3(1) of Russia – France BIT, is mirrored in Article 3(1) of Russia – Egypt BIT of 1997, where it is also pronounced that:

Each Contracting Party shall provide on its territory a just and equitable regime for capital investment, carried out by the investor of the other Contracting Party, and for the activity involved in making such capital investment, this regime shall exclude discriminatory measures, which could have interfered with the management and disposal of the capital investment. (Emphasis added).

In fact, all 52 of the Russian BITs include conditions to the same effect.48

With regard to the case law, several well-known arbitral awards refer explicitly to the prohibition of discrimination. Among these are Amoco Award where it was stated that “[i]n the field of expropriation, discrimination is widely held as prohibited” (emphasis added);49 and the BP Case50 in which it was also found that arbitrary or discriminatory expropriation violates the norms and principles of public international law, and as such is

48 An entire list of all Russian BITs can be found online at <http://www.unctadsi.org/templates/DocSearch.aspx?id=779 >. (27 July 2007)
50 BP v Libya (1979) 53 ILR 297
absolutely unacceptable. In summary it can be asserted that the prohibition of discrimination has formed a well-established condition of legality for expropriation or nationalisation.\textsuperscript{51}

\textbf{III. Payment of compensation requirement}

The final obligation that ought to be complied with by the State is that it must pay compensation in the case of nationalisation or expropriation. This requirement originates from customary international law. It is also spelled out in most of the UN Resolutions on PSNR,\textsuperscript{52} and in particular, such an obligation can be found in the UN General Assembly Resolution 1803 on Permanent Sovereignty over Natural Resources, adopted on 14 September 1962,\textsuperscript{53} in which it was stated that:

\begin{quote}
[N]ationalisation, expropriation ... shall be based on grounds or reasons of public utility, security or the national interests, which are recognized as overriding purely individual or private interests, both domestic and foreign. In such cases [when it occurs] the owner shall be paid \textit{appropriate compensation} in accordance with the rules in force in the State taking such measures in the exercise of its sovereignty and in accordance with international law.
\end{quote}

The Treaty law also recognised the obligation to pay compensation.\textsuperscript{54} Such obligation exists in virtually all MITs and BITs that are to be found in existence to-date. For example, Article VI of the 1997 Russia – Turkey BIT expressly stipulates that:\textsuperscript{55}

\textsuperscript{51} Mouri, A, \textit{The International Law of Expropriation as Reflected in the Work of the Iran-US Claims Tribunal} (Martinus Nijhoff: Dordrecht, 1994). However, not all discrimination is prohibited. For example, in the \textit{Aminoil Case}, the Tribunal found that “nationalizing one company but not the other did not violate international law” (See \textit{Kuwait v Aminoil} (1982) 21 ILM, 1019-20)

\textsuperscript{52} For example, see ‘GA Resolution on Permanent Sovereignty over Natural Resources 1803 (XVII)’ \textit{United Nations} (14 December 1962) \textless http://www1.umn.edu/humanrts/instree/c2psnr.htm\textgreater (14 August 2008). It could also be argued that each reference in UN Resolutions to “obligations arising out of international law” implies compulsory payment of compensation.

\textsuperscript{53} ‘GA Resolution on Permanent Sovereignty over Natural Resources 1803 (XVII)’ \textit{United Nations} (14 December 1962) \textless http://www1.umn.edu/humanrts/instree/c2psnr.htm\textgreater (14 August 2008)

\textsuperscript{54} For example, see \textit{Energy Charter Treaty} (1994) \textless http://www.ena.lt/pdfia/Treaty.pdf\textgreater (20 August 2007) (1994 ECT treaty), Article 13

\textsuperscript{55} Agreement between the Government of the Russian Federation and the Government of the Republic of Turkey Regarding the Promotion and Reciprocal Protection of Investment (15 December 1997) \textless http://www.unctad.org/sections/dite/ilia/docs/bits/russia_turkey.pdf\textgreater (7 July 2009)
Investments of one Contracting Party made in the territory of the other ... shall not be expropriated... except when such measures are ... accompanied by payment of prompt, adequate and effective compensation. (Emphasis added).

The same provision can also be found, inter alia, in Article 4(1) of Russia – Thailand BIT, Article 4 of Russia – Cyprus BIT, Article 5(1) of Russia – UK BIT, Article 13(1)(d) of the 1994 ECT, etcetera.

In arbitral awards, reference to the payment of compensation can be found, inter alia, in the Chorzow Factory Case,66 the Polish Upper Silesia Case,57 the Mavrommatis Jerusalem Concessions Case,58 BP,59 Liamco60 and Aminoil61 cases where it was decided that the lack of compensation amounted to confiscatory takings.62 In the awards delivered by the Iran-US Claims Tribunal, the obligation to compensate foreign investors in cases where property was expropriated by the Host State is similarly recognised. More specifically, the Tribunal in American International Group Inc. v Iran (1983)63 clearly stated that:

[It] is a principle of public international law that even in a case of lawful nationalization, the former owner of the nationalized property is normally entitled to compensation for the value of the property taken. (Emphasis added).

Likewise, in its 1994 Award in the Ebrahimi Case,64 the Tribunal announced that international law undoubtedly sets forth an obligation to provide compensation for property taken by the State. In particular the Tribunal stated that:

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66 Chorzow Factory Case (1928) PCIJ (Series A, no. 17), 48
57 German Interests in Polish Upper Silesia Case (1926) PCIJ (Series A, no. 7), 32
58 Mavrommatis Jerusalem Concessions Case (1925) PCIJ (Series A, no. 5), 51
59 BP v Libya (1979) 53 ILR 297
60 Liamco v Libya (1982) 20 ILM 53 (Liamco case)
61 Kuwait v the American Independent Oil Company (Aminoil) (1982) 21 ILM 976 (Aminoil case)
62 In the latter case the Tribunal was particularly aware of the need to maintain trust and stability for foreign investors and pointed out that the need for a continuous flow of private capital called for nationalizing States to approach compensation issues is a manner which “should not be such as to render foreign investment useless, economically” (See Kuwait v the American Independent Oil Company (Aminoil) (1982) 21 ILM 1033)
63 American International Group Inc. v Iran (1983) 4 Iran-US CTR 105 (AIG Award)
64 Ebrahimi v. Iran, 30 Iran-U.S. CTR 170 (1994), para. 88
The Tribunal believes that, while international law undoubtedly sets forth an obligation to provide compensation for property taken, international law theory and practice do not support the conclusion that the ‘prompt, adequate and effective’ standard represents the prevailing standard of compensation [...]. Rather, customary international law favours an ‘appropriate’ compensation standard [...].

The ICC Guidelines, the Draft UN Code of Conduct on TNCs, the ILA Seoul Declaration and the World Bank Guidelines, all require payment of compensation in the event of expropriation or nationalisation. Consequently, there is no doubt that the obligation to pay compensation, as one of the main principles of public international law, is no longer challenged. What is challenged in this regard is the standard of such compensation, or in other words, what amount of compensation is appropriate and when such an amount should be made payable. These issues are discussed below.

1. **Standard of Compensation**

The issue of what standard of compensation in cases of expropriation is required, is in constant dispute between the developed and developing countries. The former, on the one hand, suggest that the compensation should be “prompt, adequate and effective”, a standard widely know as the “triple standard”.65 The latter, on the other hand, have consistently denied the existence of any strict standard in this regard, by indicating their inclinations to adhere to the doctrines of “unjust enrichment”, “excess profits” and “capacity to pay”.

Despite this continuing debate, very few multilateral treaties address the question of the compensation standard. One of these instruments is the *OECD Draft Convention on the Protection of Foreign Property*66 which maintains that payment for expropriation should be “prompt” or “without delay”. On the same topic the *ASEAN Agreement*67 referred to the payment as being “without unreasonable delay”, while the *ECT* provides for

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65 The so-called Hull formula.
expropriation to be accompanied by the payment of “prompt compensation”.68 Most of the Russian BITs provide for payable compensation to be “prompt, adequate and effective”.69 None of these instruments, however, clearly specify what is meant by “prompt”, “adequate” or “effective”, leaving the interpretation of these definitions in the hands of the judges and arbitrators.

2. Amount of compensation

As to the amount of compensation, most of the above treaties make references to “equitable” or “adequate” compensation,70 while some others lean towards “prompt, adequate and effective”.71

Most of the BITs entertain a more flexible version of this standard, namely that such compensation is “adequate” or is given “without delay” or “without undue delay”. The Russian BITs, by way of example, generally require compensation to be “without delay (or prompt), adequate and effective”.72

With regard to decisions of international courts and tribunals, reference can again be made to the frequently quoted Chorzow Factory case,73 where the tribunal came to the

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68 Article 13.1(d). It must be noted that no specification of the term “prompt” is given.
70 For example, Framework Agreement on the ASEAN Investment Area (15 December 1995) <http://www.aseansec.org/6466.htm> (20 August 2007) (ASEAN Investment Agreement) embodies the concept of “adequate compensation”
73 Chorzow Factory Case (1928) PCIJ Series A No. 17, 48
decision that the event of expropriation should be followed by "just compensation". Indeed, to be more precise, the tribunal in that case stated that:

[T]he disposition of an industrial undertaking ... involves the obligation to restore the undertaking and, if it is not possible, to pay its value at the time of indemnification, which value is designed to take the place of restitution which has become impossible. (Emphasis added).

A similar decision was made in the *Norwegian Shipowners Claims Arbitration*, where it was held that the government of the United States of America, which expropriated a certain alien property for the purposes of a war, ought to pay "just compensation ... taking into account the actual value of the expropriated property as well as circumstances surrounding the matter" (emphasis added). The concept of equitable compensation is also supported by a number of other cases including *BP, Aminoil and Liamco awards*. As to the amount of compensation, most of the above decisions leaned towards "full compensation", representing the full equivalent of the property taken. It was said that such a degree of compensation was required under both customary international law, and the 1955 *Treaty of Amity*, and that such compensation had to be equal to the "going concern" value of the property taken, including not only physical and financial assets but also intangible assets such as goodwill and future profits.

Despite the outcome of these decisions, the issue of the standard and amount of compensation is still not fully resolved, which is highlighted by the divide in both academic and scholarly opinion on this matter. Such a position is also supported by

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74 *Norwegian Shipowners Claims Arbitration* (1923) 17 AJIL 362
75 In general, in all of these cases, in determining what appropriate compensation amounted to it was decided that enquiry into all circumstances of a particular case, including a question of what would be a reasonable return from the investment and the value of the investment, were necessary. (See *Kuwait v the American Independent Oil Company (Aminoil)* (1982) 21 ILM 976 (Aminoil case); *BP v Libya* (1979) 53 ILR 297; *Libyan American Oil Company (Liamco) v Libya* (1981); 20 ILM 1-87 (Liamco case))
77 *BP v Libya* (1979) 53 ILR 297 (BP case), *Libyan American Oil Company (Liamco) v Libya* (1981) 20 ILM 1-87 (Liamco case)

79 Id.


82 The Hull formula

In conclusion, the principle that a sovereign State must pay compensation for the taking of foreign property has become fully recognised and accepted by the international community despite the difference of academic and judicial opinion with respect to the standard and mode of payment.

**F. Conclusion**

The principle that States should respect the property of citizens of other States has gained wide recognition as part of customary international law, at least to the extent that the expropriating State has a duty to compensate foreign owners in cases of expropriation. The prevailing view in this regard is that the expropriating State must pay compensation, varying from "reasonable" to the "full and just" and "adequate, effective and prompt".

An obligation to pay compensation is, no doubt, one of the most effective means of international legal protection available to investors. This obligation is owed by the Host States under both customary law and modern treaty law. It is appropriate to note, however, that UN Resolutions are not binding under international law, and as a result, they do not describe the present state of international law on state responsibility regarding
foreign investment.\textsuperscript{83} Another general problem of investment protection under customary international law is that an investor (being a private body) is not a subject of public international law. Its standing (\textit{locus standi}) in proceedings with the sovereign Host State depends upon its access to jurisdiction and arbitration provided by a treaty law or state law. Customary international law does not provide for such standing.\textsuperscript{84}

Both of these shortcomings, as noted by Professor Horn,\textsuperscript{85} have now been addressed with the existence and proliferation of international investment treaties. Investment treaties, in their unique way, have opened the door to international arbitration or adjudication. Part of the solution was a new type of multilateral investment treaty that served as the procedural protection of foreign investment and gave the investor a \textit{locus standi} in arbitration with the Host State in case of an investment dispute. The most significant of these treaties were: the 1965 International Convention for the Settlement of Investment Disputes (ICSID),\textsuperscript{86} the 1993 North American Free Trade Agreement (NAFTA),\textsuperscript{87} and the 1994 Energy Charter Treaty (ECT).\textsuperscript{88}

In summary it can be stated that State obligations to compensate foreign investors for the losses sustained by the latter as a result of the actions of expropriation or nationalisation made by (or on behalf of) the Host State, under customary international law and under the treaty law, serve as an additional warranty to investors, especially since the private investor has been granted \textit{locus standi} in public international law.

\textsuperscript{83} Horn, N, 'Arbitration and the Protection of Foreign Investment: Concepts and Means' in \textit{Arbitrating Foreign Investment Disputes: Procedural and Substantive Legal Aspects} (2004) 19 Studies in Transnational Economic Law, 9
\textsuperscript{84} Id
\textsuperscript{85} Id
\textsuperscript{86} Schreuer, C, \textit{The ICSID-Convention: A Commentary} (Cambridge : Cambridge University Press, 2001), 64
\textsuperscript{87} Eklund, 'A Primer on the Arbitration of NAFTA Chapter 11 Investor-State Disputes' (1994) 11(4) \textit{Journal of International Arbitration} 135
\textsuperscript{88} Waelde, 'Investment Arbitration under the Energy Charter Treaty – From Disputes Settlement to Treaty Implementation' (1996) 12 \textit{Arbitration International} 429
Chapter Seven

Investment protection provisions of the Energy Charter Treaty

A. Introduction

In recent years there has been increased recourse to the investment protection provisions and dispute settlement mechanisms of the 1994 Energy Charter Treaty (ECT). The reason for this is the wide recognition, between exporters and importers of oil, that multilateral rules are able to provide a more balanced and efficient framework for international cooperation than is offered by bilateral agreements alone or by non-legislative instruments. The ECT therefore plays an important role as part of an international effort to build a legal foundation for energy security, based upon the principles of open competitive markets and sustainable development.¹

The purpose of this chapter is to provide a detailed analysis of the investment protection tools presented by the ECT - the first (and only of its kind) multilateral investment treaty that deals exclusively with the investments in the energy sector. These tools include: investment protection afforded by national, fair and equitable, and most-favoured-nation treatments (Article 10(1) and 10(7) ECT); provisions related to the most constant protection and security of investment (Article 10(1) ECT); provisions relating to the observance of contractual and international law obligations, or so-called umbrella clauses (Article 10(1), last sentence); protection against expropriation (Article 13 ECT) and the freedom of transfer of funds (Article 14 ECT). The discussion on each of these key

provisions will be presented immediately after the commentary regarding the purpose and scope of the ECT.

B. Scope and purpose of the Energy Charter Treaty

The Energy Charter Treaty is a unique multilateral treaty, limited in scope to the energy sector. \(^2\) It was designed specifically to integrate the energy sector of the former Soviet Union and Eastern Europe into the broader European and world markets, and to provide comprehensive investment protection mechanisms to investors in the energy sector. The ECT establishes legal rights and obligations with respect to a broad range of issues regarding investment and trade. It is a multinational treaty in the sense that its scope covers the whole of Europe, the Members of the Commonwealth of Independent States (SIC), including the Russian Federation, plus Australia and Japan. \(^3\)

The purpose of the ECT, as stated in its Article 2, is:

\[\text{[To] establish a legal framework in order to promote long-term co-operation in the energy field, based on complementarities and mutual benefits, in accordance with the objectives and principles of the [European Energy] Charter. (Emphasis added).}^4\]

The ECT and the Energy Charter Protocol on Energy Efficiency and Related Environmental Aspects were signed in December 1994 and entered into legal force in April 1998. To date, the Treaty has been signed or acceded to by fifty-one states plus the European Communities (the total number of its Signatories is therefore fifty-two). \(^5\) It is worth noting, however, that some nations, having signed the ECT, have not yet ratified it. Among these nations is the Russian Federation. Despite this, the investment provisions of the ECT must nevertheless be studied by the present and potential investors in the


Russian energy industry. This is because the provisions of the ECT are likely to be found binding upon the Russian Federation (as a party to an investment contract) due to the fact that the Russian Federation has ratified the document upon which the ECT was drawn up, and which represents a declaration of political intent to promote energy co-operation. The document in question is the 1991 Energy Charter Declaration, a rightful and sole predecessor of the 1994 ECT.

Having outlined the fundamental significance and relevance of the ECT provisions to this thesis, I shall now continue with the discussion on the major investment protection mechanisms available to foreign investors under the auspices of this treaty.

C. National treatment: Article 10(7) ECT

As I highlighted in chapter 5, the concept of the “National treatment” (or “non-discrimination”) means that a foreign investor should be treated in a similar manner as is treated the “best” domestic investor, in “like” circumstances. In other words, pursuant to this principle the Host State cannot discriminate between investors and their activities based solely upon the investor’s nationality.

This principle was subsequently embodied in Article 10(7) ECT, and also confirmed by a number of arbitral decisions including Pope-Talbot v Canada,6 Myers v Canada,7 and Feldman Karpa v Mexico,8 to name just a few.

In order to be precise, Article 10(7)9 ECT states as follows:

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6 Pope & Talbot, Inc. v The Government of Canada, unreported; UNCITRAL; Award on Damages, 31 May 2002
7 S.D. Myers, Inc. v. Canada, unreported; Partial Award on the Merits; City of Toronto, Ontario, Canada 13 November 2000, 252 <http://www.naficlaims.com/Disputes/Canada/SDMyers/SDMyersMeritsAward.pdf> (1 September 2008)
Each Contracting Party shall accord to Investments in its Area of Investors of other Contracting Parties, and their related activities including management, maintenance, use, enjoyment or disposal, treatment no less favourable than that which it accords to Investments of its own Investors or of the Investors of any other Contracting Party or any third state and their related activities including management, maintenance, use, enjoyment or disposal, whichever is the most favourable.

Generally, "National treatment" protection applies to investments on two different levels. First, it applies to the already established investment, and second, it applies to the future investment. With regards to the already established investment, the language of Article 10(7) ECT obliges Host States to accord to foreign investors and their investments (including related activities such as management, maintenance, use, enjoyment and disposal) treatment at least as favourable as that accorded to the domestic investor. For example, an export licence may not be granted exclusively to domestic investors if foreign investors are in similar circumstances.  

There are, however, three major exceptions to this rule. In particular, the principle of so-called "Non-discrimination" does not apply, or if the principle applies, it requires further clarification with regards to the following matters. First – taxation, where the principles of the taxation in question are already covered in other international investment treaties (Article 21 ECT). Second – grants and other financial assistance for technology R&D, where these issues are already dealt with in a "Supplementary treaty" (Article 10(8) ECT). And finally – intellectual property rights, that should initially be governed by the relevant international agreements (Article 10(10) ECT).

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11 Supplementary Treaty is an international instrument (yet unfinished) which was established to supplement the ECT. The purpose of this instrument is to provide more detailed rules for issues for non-discriminatory free access to the Host State and its resources, and issues regarding privatisation. Negotiations on this Supplementary Treaty started in 1996, and have not been concluded. In autumn 2002, member states decided to put negotiations on hold pending the outcome of discussions in the WTO on a multilateral framework for foreign direct investment. The draft of the Supplementary Treaty is available on the Energy Charter website <http://www.encharter.org/index.php?id=33> (7 February 2009)

12 This limitation on the National/ MFN treatment principle was sought by the United States, and is indicated by paragraph (8) of Article 10 ECT. It notes that the "modalities of application" of paragraph (7) in relation to programs of grants, financial assistance or contract for energy technology research and
There is one other exception that applies only to cases to which the Russian Federation is a party. That is, as explained in Decision No. 2 of the ECT Secretariat concerning Article 10(7), the right of the Russian Federation to require foreign investors, or companies with foreign participation, to obtain legislative approval for the leasing of federal property, including land. However, in having this right, the Russian Federation must nevertheless comply with the requirement not to discriminate between different foreign investors (or in other words, the MFN principle ought still to be observed).

The situation regarding the duty of a Host State to afford the “National treatment” to the future foreign investment, under the ECT, appears to be somewhat different. As noted by the ECT Secretariat, a possibility to create a legally binding obligation whereby foreign investors would have been on equal legal footing with their domestic competitors in the Host State, was too ambitious to ever eventuate. As a result, the situation regarding the treatment of future foreign investment appears to be as follows. First, under Article 10(2) ECT, the Host States have a non-legally binding obligation to provide their “best effort” in making sure that prospective foreign investors are afforded similar protection to that of domestic ones. Second, under Article 10(5) ECT, the Host States should preclude themselves from introducing any new restrictions for foreign investors that could potentially affect their investments, and to endeavour to reduce progressively the existing restrictions. Third, under Article 10(6) ECT, the Host States can make legally binding voluntary commitment to grant foreign investors non-discriminatory treatment with regards to the making of an investment. And finally, under Article 10(4), the parties to a State contract can negotiate the extension of the non-discrimination principle to “potential investments”.

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development are resolved for the second phase Supplementary Treaty. Up to date reporting on such programs is required by paragraph (9) of Article 10 ECT.

Pursuant to Article 10(10) ECT the treatment to be accorded with regards to intellectual property “shall be as specified in corresponding provisions of the applicable international agreements for the protection of Intellectual Property Rights to which the respective Contracting Parties are parties”. This allows the ‘Contracting Parties’ to maintain their existing exceptions to National/ MFN treatment under the relevant intellectual property rights agreements.


For the purpose of convenience, reproduced below are the relevant provisions of Article 10 ECT.

Article 10: Promotion, protection and treatment of investment

(1) ...

(2) Each Contracting Party shall endeavour to accord to Investors of other Contracting Parties, as regards the making of Investments in its Area, the Treatment described in paragraph (3).

(3) For the purposes of this Article, “Treatment” means treatment accorded by a Contracting Party which is no less favourable than that which it accords to its own Investors or to Investors of any other Contracting Party or any thirds state, whichever is the most favourable.

(4) A supplementary treaty shall, subject to conditions to be laid down therein, oblige each party thereto to accord to Investors of other parties, as regards the Making of Investments in its Area, the Treatment described in paragraph (3). That treaty shall be open for signature by the states and Regional Economic Integration Organizations which have signed or acceded to this Treaty. Negotiations towards the supplementary treaty shall commence not later than 1 January 1995, with a view to concluding it by 1 January 1998.

(5) Each Contracting Party shall, as regards the Making of Investments in its Area, endeavour to:

(a) limit to the minimum the exceptions to the Treatment described in paragraph (3);

(b) progressively remove existing restrictions affecting Investors of other Contracting Parties.

(6)(a) A Contracting Party may, as regards the making of Investment in its Area, at any time declare voluntary to the Charter Conference, through the Secretariat, its intention not to introduce new exceptions to the Treatment described in paragraph (3).

(b) A Contracting Party may, furthermore, at any time make a voluntary commitment to accord to Investors of other Contracting Parties, as regards the Making of Investments is some or all Economic Activities in the Energy Sector in its Area, the Treatment described in paragraph (3). Such commitment shall be notified to the Secretariat and listed in Annex VC and shall be binding under this Treaty.

It is also noteworthy that there currently exists a number of challenges brought about by the ECT’s concept of “National treatment”. First, it remains unclear whether the obligation not to discriminate against foreign investors is a “negative duty” prohibiting the Host State from actual discrimination or a “positive duty” forcing the Host States to
equalise the playing field and grant foreign investors additional benefits available to domestic businesses. Second, it also remains unclear as to how far the duty to provide “National treatment” should extend where on the one hand, there is a foreign investor who exploits the resources and privileges of the Host State, and on the other, a domestic investor who potentially assumes greater social obligations of such investments relating to higher historical costs and environmental clean-up. Finally, the meaning of the ECT concept of “treatment” of investors, and how to measure discrimination, taking into account its various forms and shapes, remains a point of debate. It is hoped that these and any other uncertainties posed by the concept of “National treatment” would be resolved by the future decisions of courts and arbitral tribunals.

In summary, while the principle of “National treatment” (or “non-discrimination”) of foreign investment under the ECT provides a number of open-ended and not well tested solutions, it also provides advantages in terms of judicial and litigation measures. Under this principle, if two compared businesses are treated differently, to the detriment of the foreign investor, then the government of the Host State has the burden of proof to show that the discriminatory treatment is justified. If the government does not or cannot provide such proof, the claimant is deemed to have proven discrimination, enabling him or her to gain access to the remedies for the breach of the fundamental principles of international law.

D. Most-favoured-nation (MFN) treatment: Articles 10(1) and 10(7) ECT

There are two parts to the Host State’s most-favoured-nation (MFN) obligations under the ECT. The first part is specified in Article 10(7), stating that the Host State should treat investors or investment from one foreign country no less favourably than that of any

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other. The second part is provided in Article 10(1)(fourth sentence) which refers to the State's obligations under international law and other treaties that require the Host State to treat all investors according to the principles of international law, and in line with the standards provided by international treaties.

By and large, the obligations imposed upon a State by these two parts of Article 10 ECT are substantially similar in that they both focus on treatment accorded to investors from different countries. In other words both these parts lead to the following conclusion: if a BIT concluded by the Host State with country “A” provides a better treatment than that stipulated in a BIT between the Host State and country “B”, the provisions of the former, as suggested by Professor Waelde, can be “imported” into the ECT with regards to the latter.

This principle of law was discussed by the arbitral tribunal in the Maffezini case, where the tribunal came to the conclusion that comparable dispute resolution clauses of various BITs could be “transported” from one international instrument into another, or that their provisions may be used by implication.

This mechanism, as noted by Professor Waelde, allowed investors “to look at other investment treaties and “cut-and-paste” selective items from one treaty into another” thereby engaging in a self-selection of the most favourable (to them) investment climate. While the possibility “to pick-and-choose” the most suitable clauses provided investors with additional security regarding their investment, it also, arguably, placed an extra burden upon the Host State requiring the State to honour the obligations which it did not consent to, or could not have consented to for various policy reasons.

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17 ECT, Article 10(7)
18 ECT, Article 10(1)
20 Emilio Augustin Maffezini v The Kingdom of Spain, unreported; ICSID Case No. ARB/97/7; Decision on Jurisdiction, 25 January 2000; unreported; ICSID; Award, 13 November 2000; unreported, ICSID; Rectification of Award, 31 January 2001 (Argentina/ Spain BIT)
21 Waelde, T, above n 19, 221
A possible solution to this problem was proposed by Professor Waelde who argued that an option to "pick-and-choose" does not impose any extra burden upon the Host State, in addition to its existing obligations under international law. In support of this argument Professor Waelde wrote that:

"[O]ne needs not to look at individual items in the other [investment] treaty, but at the overall package. "Treatment" does not mean a particular component of the treatment, but it means the overall treatment provided in a particular treaty, constituted and assessed on the basis of material equivalency." (Emphasis added).

In summary, the MFN treatment under the ECT operates in the following manner: if one treaty provides an overall better treatment than that provided in another, then such an overall treatment package should be made easily importable into the latter and any other similar instruments. If, however, an overall treatment provided by the treaties is substantially equal, despite the differences of certain provisions, an investor should not be allowed to "cut-and-paste" more favourable clauses, fundamentally changing the overall effect of the State’s obligations under these treaties. This conclusion supports the main effect of the MFN clause – to provide for a more secure and stable investment climate and encourage and facilitate the growth of international investment and trade.

E. Fair and Equitable treatment: Article 10(1) ECT

"Fair and equitable" treatment is becoming one of the most important, if not the most important, of the substantive obligations owed by the Host State to foreign investors. Nearly every investor-State arbitration these days includes a "fair and equitable" claim. Recent years have witnessed a string of major awards for investors premised in whole or in part on a breach of this standard.

"Fair and equitable" treatment, as discussed in chapter 5, is an absolute standard of treatment to which foreign investors are entitled regardless of how a State treats its own

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22 Waelde, T, above n 19, 222
nationals. In some sense, it is a “gap-filling” provision that is designed to guarantee foreign investors an internationally-required level of protection, even when other more-specific standards are not implicated.

In the past, tribunals have been reluctant to reduce “fair and equitable” treatment to a single legal standard or formula. To date, opinion seems to be that “this standard is to some extent a flexible one which must be adapted to the circumstances of each case.” This opinion was presented in, *inter alia*, the *Waste Management* case, where the tribunal attempted to summarise the “fair and equitable” concept as follows:

[T]he minimum standard of fair and equitable treatment is infringed by conduct attributable to the State and harmful to the claimant if the conduct:

(a) is arbitrary, grossly unfair, unjust or idiosyncratic;
(b) is discriminatory and exposes the claimant to [various] prejudice; or
(c) involves a lack of due process leading to an outcome which offends judicial propriety—as might be the case with a manifest failure of natural justice in judicial proceedings or a complete lack of transparency ... in an administrative process. (Emphasis added).

The decision makers in *Waste Management* have taken the position that the “fair and equitable” standard is implied by customary international law. Some tribunals, however, have disagreed with this view. Most recently, for example, in *Saluka Investments BV v. The Czech Republic*, the tribunal held that “the fair and equitable treatment standard ... is an autonomous Treaty standard,” and as such it “must be interpreted in light of the object and purpose of the Treaty.” Construing the Netherlands-Czech Republic BIT, the tribunal in *Saluka* offered its own interpretation of what “fair and equitable” treatment means. Thus it had decided that:

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23 *Waste Management, Inc. v United Mexican States*, unreported; ICSID; Final Award, Case No. ARB (AF)/00/3; 30 Apr 2004, para 99
24 Ibid.
25 *Saluka Investments BV (The Netherlands) v The Czech Republic*, unreported, UNCITRAL, Partial Award, 17 March 2006, 309
[W]ithout undermining its legitimate right to take measures for the protection of the public interest, [the Contracting State has] assumed an obligation to treat a foreign investor's investment in a way that does not frustrate the investor's underlying legitimate and reasonable expectations. A foreign investor whose interests are protected under the Treaty is entitled to expect that the [Contracting State] will not act in a way that is:

(a) manifestly inconsistent with the applicable law;
(b) non-transparent;
(c) unreasonable (i.e. unrelated to some rational policy); or
(d) discriminatory (i.e. based on unjustifiable distinctions). (Emphasis added).

The content of the “fair and equitable” standard is too complex, and it would be inappropriate at this stage to establish its definitive interpretation. The cases which discuss this principle are relatively recent and are not uniform, and therefore, they do not allow for a firm and conclusive meaning. Despite this, recent developments offer three important lessons for investors and corporate counsel.

First, the “fair and equitable” treatment analysis may point out different elements in different circumstances, depending upon the nature of the dispute. In a challenge to a judicial measure, for example, the central question may be due process. When an administrative proceeding is at issue, the key factor may be transparency. In other situations, the issue may be whether government officials acted in a fundamentally arbitrary fashion. The absence of a single uniform standard can make it difficult for investors and corporate counsel to determine whether they have a viable claim. On the other hand, the “fair and equitable” treatment standard provides enormous flexibility in ensuring protection for investors in a wide variety of circumstances.

Second, the “fair and equitable” treatment obligation may provide a remedy even where no expropriation has occurred. For example, in the CMS case, the tribunal rejected the expropriation claim because the impugned measures did not result in a “substantial deprivation of the fundamental rights of ownership nor have these rights been rendered
useless. As the tribunal explained further, however, the absence of a “substantial deprivation” is no obstacle to finding a violation of “fair and equitable” treatment. A central element of that obligation, the tribunal held, is the duty to maintain a stable and predictable legal and business framework upon which foreign investors can rely. In finding a breach of that duty, it noted that the government had “entirely transform[ed] and alter[ed] the legal and business environment under which [CMS’] investment was decided and made” (emphasis added). Notably, the tribunal reached this conclusion without regard as to whether there was “any deliberate intention and bad faith in adopting the measures in question,” explaining that “such intention and bad faith ... are not essential elements of the standard.”

Third, as illustrated by the existing case law, one of the most significant principles emerging from recent case law is the increased focus on the investor’s “legitimate and reasonable expectations” at the time of the investment, and whether those expectations have been frustrated unreasonably by actions attributable to the State. As explained by the tribunal in the Tecmed case, for example, “fair and equitable” treatment includes the obligation not to “affect the basic expectations that were taken into account by the foreign investor to make the investment.” In light of this trend in the case law investors may be well advised to document any government representations upon which they reasonably rely in making their investment decision.

With regards to the ECT, the situation is by no means clearer. The ECT provides that the parties to an investment agreement should, “at all times”, provide each other with “fair and equitable” treatment. One of the key ECT Articles, namely Article 10(1) begins with

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26 CMS Gas Transmission Co. v The Argentine Republic, unreported; ICSID; Award, Case No. ARB/01/08, 12 May 2005, para 259
27 Id. at para. 275
28 Id. at para. 280
29 Saluka Investments BV (The Netherlands) v The Czech Republic, unreported; UNCITRAL; Partial Award, 17 March 2006; CMS Gas Transmission Co. v The Argentine Republic, unreported; ICSID; Award, Case No. ARB/01/08, 12 May 2005
30 Saluka Investments BV (The Netherlands) v The Czech Republic, unreported; UNCITRAL; Partial Award, 17 March 2006, para. 302
31 Tecnicas Medioambientales Tecmed S.A. v United Mexican States, unreported; ICSID; Case No. ARB(AF)/00/2, Award, 29 May 2003 (Spain/ Mexico BIT), para 154
32 Ibid.
general statements concerning the favourable conditions that Contracting Parties must maintain for investments by investors of other Contracting Parties. These provisions are intended to assure an absolute minimum standard of treatment such as that which has been established in BIT practices, based to a considerable extent upon developments in international law. Article 10(1) consists of five sentences, the first two of which explicitly refer to the making of investments. The first sentence obliges each Contracting Party “to encourage and create stable, favourable and transparent conditions for the making of investments” in accordance with the provisions of this Treaty. The second sentence adds that such conditions “shall include a commitment to accord at all times to Investments of Investors … fair and equitable treatment.”

In order to be accurate, Article 10(1) ECT reads as follows:

Each Contracting Party shall, in accordance with the provisions of this Treaty, encourage and create stable, equitable, favourable and transparent conditions for Investors of other Contracting Parties to make Investments in its Area. Such conditions shall include a commitment to accord at all time to Investments of other Contracting Parties fair and equitable treatment. Such Investments shall also enjoy the most constant protection and security and no Contracting Party shall in any way impair by unreasonable or discriminatory measures their management, maintenance, use, enjoyment or disposal. In no case shall such Investments be accorded treatment less favourable than that required by international law, including treaty obligations. Each Contracting Party shall observe any obligations it has entered into with an Investor or an Investment of an Investor of any other Contracting Party.

It is however, important to appreciate that the application of the “fair and equitable” standard of treatment requires a balancing process. Investment treaties, as international law disciplines, often interfere with domestic regulatory and administrative sovereignty. While they are meant to do so in order to upgrade the quality of governance, Professor

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Waelde argues that they must not be operated as the instruments of intervention.\textsuperscript{35} In other words, a simple breach of a rule is not enough to constitute a violation of the "fair and equitable" treatment. This standard will only be deemed to have been breached if the aggrieved party shows that there was an accumulation of breaches of relevant standards of sufficient severity, weight and impact to justify the intervention of the treaty in domestic governance.\textsuperscript{36}

In summary, an obligation to provide investors with "fair and equitable" treatment, as stipulated by the provisions of Article 10(1) ECT, requires Host States to treat foreign investors in accordance with the standards and practice established by the norms of public international law, regardless of whether the Host States treat their domestic investors in a similar fashion.\textsuperscript{37} Despite this, however, the ECT (as well as any other investment treaty) does not provide a precise definition of "fair and equitable", leaving its interpretation to the discretion of the decision makers. Hence, the protection afforded to the foreign investor by this principle is generally determined on a case-by-case basis,\textsuperscript{38} and despite the above-mentioned uncertainties it represents a powerful tool for investors in their actions against the Host States.

**F. Most constant protection and security: Article 10(1) ECT**

As discussed in chapter 5, this protection mechanism generally comes into effect during the times of military and economic unrest whereby the Host State is obliged to provide foreigners with police protection.\textsuperscript{39} In light of the ECT, however, this mechanism has not yet been well-explored and as an outcome could result in various inconsistent

\textsuperscript{35} Waelde, T, above n 19, 210
\textsuperscript{36} Waelde, T, above n 19, 211
\textsuperscript{39} *Wena Hotel Ltd. v Arab Republic of Egypt*, unreported; ICSID Case No. ARB/98/4; Decision on Jurisdiction, 29 June 1999; unreported; ICSID; Award on Merits, 8 December 2000; unreported; ICSID; Decision on Annulment, 5 February 2002 (United Kingdom of Great Brittan and Northern Ireland/ Arab Republic of Egypt BIT)
interpretations. Within the ECT, this protection provision is incorporated in Article 10(1) (third sentence), in which relevant parts it is stated that:

[Foreign] Investments shall also enjoy the most constant protection and security and no Contracting Party shall in any way impair by unreasonable or discriminatory measures their management, maintenance, use, enjoyment or disposal. (Emphasis added).

One of the substantive interpretations of this provision in existence to-date, is that proposed by Professor Waelde. He argues that the “powers of police”, for the purposes of the ECT interpretation, should be read to include “economic police”.40 In other words, “the obligation of the Host State to provide investors with “constant protection and security” could be read to stand for an obligation of the State to use its police and economic regulatory powers in a wider sense to ensure that the foreign investor can operate its business in a context free not only from direct physical harassment, but also from harassment by administrative powers and abusively used dominant economic powers derived from control over natural monopolies, essential facilities and other sources of dominant economic power”.41 This view may be inconclusive; however, it is as yet the only view regarding the interpretation of this protection standard. It is hoped that the development of the ECT law in the next few years will shed more light on this issue.

In summary, under the ECT, an obligation of a State to provide investors with “constant protection and security” would be breached if at least one of the following occurs. First, the Host State fails to provide an investor with the protection of its police powers in times of military unrest. Second, the Host State exercises its powers towards an investor in an active and abusive manner. And finally, the Host State fails to intervene where it had the power and duty to intervene to protect the normal ability of the investor’s business to function generally. Following the breach, the Host State will be held liable (under the auspices of public international law) in damages, which the investor would be entitled to recover.

40 Waelde, T, above n 19, 213
41 Ibid.
G. Observance of contractual and international law obligations: umbrella clauses

Multilateral and Bilateral investment protection treaties commonly contain a so-called "umbrella clause" whereby the State signatories (to the treaty) make a promise to honour their obligations or commitments towards investments made by investors from the other signatory State.\(^{42}\) An example of such a clause can be found, *inter alia*, in Article XI of the Australia – China BIT,\(^ {43}\) which provides that:

> A Contracting Party shall, subject to its law, adhere to *any written undertaking* given by a competent authority to a national of the other Contracting Party with regard to an investment in accordance with its law and the provisions of this Agreement. (Emphasis added).

Another similar example can be found in Article 11 of the Australia – PNG BIT,\(^ {44}\) which includes a provision almost identical to that in the Australia – China BIT. Similar umbrella clauses are also found in the majority of European BITs,\(^ {45}\) which generally provide that each Contracting State shall observe *any other obligations* it has assumed with regard to investments in its territory by investors or the other Contracting State.

The interpretation debate over the meaning of this potentially powerful clause is intense because it involves a determination of the applicable law as well as the forum of the dispute (national versus international). On an extensive reading, such clauses open up the possibility for contracting parties to sue under international law whenever a contractual commitment has been breached. In that interpretation, the clause subsumes all contractual

\(^{42}\) Foster, D, 'Umbrella Clauses – A Retreat from the Philippines?' (2006) *Int’l A.L.R.* 100


\(^{45}\) For example, see BIT between United Kingdom and St. Lucia, which article 2(2)(last paragraph) states that: "Each Contracting Party shall observe any other obligations it may have entered into with regard to investments of nationals or companies of the other Contracting Party" (emphasis added)
breaches under the umbrella of the treaty. Nevertheless, tribunals have openly clashed over the meaning to be ascribed to such treaty clauses, and the extent to which they may permit foreign investors to dispense with the dispute settlement provisions spelled out in contracts in favour of pursuing international arbitration under a treaty.

Umbrella clauses are frequently the basis for a substantive claim in any legal dispute between an investor and a State founded on the terms of a BIT. Yet until relatively recently there were no published decisions dealing directly with the interpretation and application of such clauses in the context of an international treaty dispute.

The first time these issues were expressly addressed was in the ICSID arbitration *SGS v Pakistan*, in a decision on jurisdiction dated 6 August 2003. However, shortly after that decision was published, the position was made more uncertain as a result of a conflicting decision issued by another ICSID tribunal in *SGS v The Philippines*. Since the publication of these two decisions there has been considerable debate over which approach should be preferred. Not surprisingly, parties involved in investor-State arbitrations have argued in favour of the case which most supported their own position: i.e. investors relying on *SGS v The Philippines*; with States preferring *SGS v Pakistan*.

In each case, the central question was whether, through the umbrella clause in the applicable BIT, the investors' contractual claims against the Host State could be resolved under the arbitration provisions of the BIT, rather than under the dispute resolution provisions of the contract in dispute.

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47 For example, see *El Paso Energy International Company v The Argentine Republic*, ICSID Case No. ARB/03/15 (US/Argentina BIT)
49 *SGS Société Generale de Surveillance S.A. v Republic of the Philippines*, ICSID, Case No. ARB/02/6, 29 January 2004
50 Foster, D, above n 41
The arbitral tribunal in *SGS v Pakistan* had to interpret Article 11 of the 1995 BIT between Switzerland and Pakistan, which read as follows:

Either Contracting Party shall constantly guarantee the observance of the commitments it has entered into with respect to the investments of the investors of the other Contracting Party.

The tribunal held that, unless expressly stated, an umbrella clause does not derogate from the widely accepted international law principle that a contractual breach is not by itself an infringement of international law, particularly if such a contract had a valid forum selection clause. The tribunal added that the umbrella clause was not a paramount obligation; rather, it provided a general pledge on the part of the Host State to ensure the effectiveness of State contracts.\(^5\) The tribunal noted that:\(^5\)

There would be no real need to demonstrate a violation of those substantive treaty standards if a simple breach of contract, or of municipal statute or regulation, by itself, would suffice to constitute a treaty violation on the part of the Contracting Party and engage the international responsibility of the Party.

Moreover, the structure of the relevant treaty and the place in which the umbrella provision appeared within that treaty also led the tribunal to conclude that the umbrella provision did not elevate the contract into the protection regime of the treaty.\(^5\) The precise interpretation which must be given to such an umbrella clause was, however, left unclear.

The arbitral tribunal in *SGS v The Philippines* returned to the question of the effect of an umbrella clause. While the contract between the parties in this case provided that the courts of the Philippines would have exclusive jurisdiction over disputes under the contract, SGS commenced an ICSID arbitration proceeding on the ground that its


\(^{53}\) Id. para 168

\(^{54}\) UNCTAD, above n 50, 21-22
contract claim would be elevated to a treaty claim under the umbrella clause in the BIT between the Philippines and Switzerland.

In this case, the tribunal interpreted the umbrella clause in a way which is totally opposite to that of the tribunal in *SGS v Pakistan*. It held that the umbrella clause did, in practice, have the effect of conferring jurisdiction on an arbitral tribunal constituted under the BIT to determine purely contractual claims between an investor and the Host State. The tribunal disagreed that the umbrella clause was merely a “second order” protection, instead adopting the view that the clause “meant what it said”.

From the prospective of an investor, the approach taken by the *Philippines* tribunal would offer greater protection, as it makes it clear that a breach of a State contract amounts to a breach of a primary obligation in the BIT to observe contractual commitments. The interpretation taken in the *Pakistan* case, on the other hand, is more favourable to the position generally taken by the Host States — that breaches of contractual obligations do not amount to a violation of any relevant treaty provisions (as the treaty requirements have a more difficult standard of proof). Hence, the protection offered to foreign investors by the treaty applies only where an investor meets that standard. Therefore, the required standard of proof will not be met by reference to the breach of the State contract alone.

Arguably, this approach could be seen as depriving the umbrella clause of any independent meaning, in that it would annul any possibility of viewing a breach of an obligation entered into by the Host State under a State contract as amounting to a breach of the BIT by reason of an infringement of the umbrella clause.

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56 A decision by the ICSID tribunal in *El Paso Energy International Co Ltd v The Argentine Republic* has revisited some of the issues raised by umbrella clauses, and may have helped to clarify the position by decisively rejecting the approach taken in *SGS v The Philippines*
57 Schreuer, above n 55
With regard to the interpretation of the "umbrella clause" provisions within the ambit of the ECT, it is argued that Article 10(1)(last sentence), as opposed to, for instance, the language in the SGS Awards, makes it clear that the Host State must "observe any obligations it has entered into with an Investor or an Investment of an Investor of any other Contracting Party". This is, as suggested by Professor Waelde, not to say that the provision of customary international law or those specified in various investment treaties are not applicable, or are redundant to the extent of inconsistency. The general consensus in relation to this matter is that States have to respect contracts that they freely enter into with a foreign party, under the condition, namely, that it is proven that such contracts are of governmental (or sovereign) character.

Generally speaking, for a breach of contract to amount to a breach of international law, the following elements must be established. First, the Host State government must enter into a State contract (or any other similar instrument) with a foreign investor. Second, the State contract has to be breached. Finally, the government's commitment specified in the State contract has to have more than merely commercial character.

The text of Article 10(1)(last sentence) ECT, however, has no such limitations. According to this Article, each party to a State contract shall observe "any obligations it has entered into with an Investor or Investment of any other Contracting Party" (emphasis added). The plain interpretation of the words "any obligations", as argued by

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58 Waelde, T, above n 19, 214
59 Waelde, T, above n 19, 215
60 Such consensus emerged from the interpretation of the historical Calvo doctrine (legal principle, applicable in international disputes, that aliens have no more rights than the citizens of a sovereign state. Therefore, such disputes lie within the purview of the domestic laws and only the courts in the host country have the jurisdiction to hear the case. Named after the Argentine diplomat and historian Carlos Calvo (1824-1906) who propounded it in his 1868 book Derecho Internacional teórico y práctico de Europa y América)
61 Schwebel, S, Essays in Honour of Roberto Ago (Milano Guiffre, 1987), 401 "Breach of State contract with an alien is a breach of international law, [unless the special powers of government are at least somewhere significantly at play]"
62 This provision covers any contract that a Host State has concluded with a subsidiary of the foreign investor in the Host State, or a contract between the Host State and the parent company of the subsidiary
Schwebel,\textsuperscript{63} suggests that such obligations may be of both governmental and non-governmental (i.e. commercial) character.

Notably, there exists an argument to the contrary. In particular, in \textit{Azinian v Mexico}\textsuperscript{64} it was argued that merely commercial contracts are not covered by the treaty law and as a result, breaches of investment contracts where States exercise a purely commercial function, were not considered to amount to the breaches of their international obligations. This case is often cited as authority for the proposition that commercial contracts do not fall under the ambit of Article 10(1) ECT. However, one should note that the \textit{Azinian} case, unlike the ECT, does not have any mention of the \textit{breadth} of obligations which are meant to be covered by the applicable investment treaty (which in that case was NAFTA). Moreover, the main idea behind the \textit{Azinian} case was to make it clear that foreign contractors, who have chosen to go to domestic tribunals, can no longer start litigation or arbitration before an international tribunal.\textsuperscript{65} As a result, the findings in \textit{Azinian} should not be applicable with reference to the scope of the ECT, and even less so, it should be allowed to determine the breadth of obligations that the ECT imposes on the contracting parties.

Another argument in favour of the distinction between "commercial" and "governmental" (or sovereign) acts of the contracting States can be built on the assumption that the purpose of investment treaties is to regulate a possible misuse of governmental powers and balance the bargaining powers of the States with those of private investors. Thus, purely commercial undertakings entered into by the governments of Host States fall, arguably, beyond the scope and function of international investment treaties, including the ECT. The only possible solution to this issue to date appears to be hidden in the interpretation of the last sentence of Article 10(1) ECT. In this regard, in one of his studies Professor Waelde purports that:\textsuperscript{66}

\textsuperscript{63} Schwebel, above n 61
\textsuperscript{64} \textit{Azinian and ors v United Mexican States}, unreported; ICSID Case No. ARB(AF)/97/2, 1 November 2000; (2000) 39 ILM 537
\textsuperscript{65} Waelde, T, above n 19, 216-217
\textsuperscript{66} Waelde, T, above n 19, 217
To solve the dilemma between the "plain meaning" and the purpose and target of the ECT, it is appropriate to imply into Article 10(1, last sentence), a qualification that the contractual relationship must have at least in one significant aspect something that involves governmental powers and prerogatives; such a qualification would then have to be read widely to satisfy the explicitly wide and unqualified "plain meaning" of Article 10(1). (Emphasis added).

In other words, the governmental conduct of a purely commercial nature does not fall under the umbrella of the international treaty law unless such conduct can be qualified as involving the usage of governmental powers. For example, if at the time of entering into the State contract, the State uses special State-derived privileges, such as exclusive licenses, or if the State retains a duty to regulate and intervene, then such conduct is more likely to be considered as that where governmental (sovereign) powers were used. Another example where the governmental entity may be seen as engaging in not only commercial activity, is one where the government elects to exercise, exercises or has an option to exercise its right to sovereign immunity (or any other privileges associated with its sovereign nature).

The author of this thesis suggests that in terms of the investment contracts in the energy and resources sector, the States, in effect, had already exercised their sovereign privilege by declaring their "sovereignty over natural resources". As a result, any type of contract that States enter into with the private investor (within the energy sector) cannot be seen as purely commercial from the outset. Moreover, most Host States, by means of their domestic legislation, regulate the activities of foreign investors. These regulations (i.e. issuing of exclusive exploration licenses, mining permits etc.) can also, arguably, fall under the umbrella of State-derived special privileges as acts limiting the activities of foreign investors. Hence, the breach of any type of State contract, irrespective of the alleged nature, will (in the opinion of the author) result in a violation of the State's international obligations under the treaty law, thus invoking international remedies. This approach is also consistent with the express language of Article 10(1)(last sentence) ECT.
In summary, Article 10(1)(last sentence) ECT has the important effect that a breach of an individual investment contract by the Host State becomes a violation of the ECT. As a result, the foreign investor can invoke the entire investment protection provision of the ECT, as well as make a good use of the dispute settlement mechanism provided by the Treaty.

H. Expropriation and measures having an equivalent effect to expropriation: Article 13 ECT

Protection of foreign investment in cases of expropriation is a core element of investment agreements. The ECT is not an exception. The provisions relating to the protection of investors against expropriation within the ECT are discussed in Article 13. According to that Article, foreign investment may only be expropriated if at least one of the following conditions is fulfilled:

(a) the expropriation was in the public interest;
(b) the expropriation was not discriminatory;
(c) the expropriation was carried out under due process of law; and
(d) the expropriation was accompanied by payment of prompt, adequate and effective compensation (which shall amount to the fair market value of the investment at the time immediately before the expropriation, or impending the expropriation).

The availability of protection afforded to investors under the ECT in cases of indirect expropriation is less clear. It is now recognised that governmental actions, which limit the ability of investors to manage their property (or their proprietary rights), undermining the

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67 It must be noted, however, that Article 26(3)(c) ECT grants States (Members of the ECT) the right to exclude international arbitration in such cases. Four countries, namely Australia, Canada, Hungary and Norway have opted for this solution (see ECT, Annex IA).
68 This mechanism and its operations are discussed in the next Chapter.
69 ‘The Energy Charter Treaty: The Readers Guide’ Secretariat of the ECT <http://www.encharter.org/upload/9/2038809502208314677780487897316925863021421737824f886v1.pdf> (5 September 2006). Furthermore, the investor has the right to prompt review of the valuation of the investment and the amount of compensation under the law of the Host State by a judicial or other competent and independent authority of the Host State: Article 13(2) ECT.
business’ ability to function in the expected manner,\textsuperscript{70} constitute a compensable expropriation. This view is confirmed by the US-Iran claims tribunal cases that reiterate the fact that “a formal taking is not necessary [for] the government’s interference in the ability of the owner to manage their property, or its omission to protect the property against disruption, [to amount] to expropriation”.\textsuperscript{71}

The issue arises as to when the otherwise legal governmental activity will indeed amount to an act of indirect expropriation. In this respect, the findings in the case of Pope \& Talbot suggest that “a mere reduction in value [of the investment] due to the government regulation is not [sufficient to establish expropriation]”. What seems to be required is that the deprivation of the investor’s rights is “significant and intensive”.\textsuperscript{72}

The list of factors that should be taken into account in determining whether or not the act of expropriation took place is conveniently presented in, for example, the Chile-US FTA.\textsuperscript{73} These factors include:

(a) the character of the government action;
(b) the intensity of the deprivation of ownership rights;
(c) the economic impact of governmental action;
(d) discrimination;
(e) the extent to which the government action interferes with distinct and reasonable investment expectations;
(f) excessive taxation; and
(g) serious underpayment by, for example, an energy monopoly to an energy producer who is dependent on the uptake of electricity.

\textsuperscript{70} Waelde, T, Koko, A, ‘Environmental Regulations, Investment Protection and Regulatory Taking in International Law’ (2001) 50 ICLQ 811, 848
\textsuperscript{71} Waelde, above n 19, 223
\textsuperscript{72} Pope \& Talbot, Inc. v The Government of Canada, unreported; UNCITRAL; Award on Damages, 31 May 2002
\textsuperscript{73} Chile Free Trade Agreement (1 January 2004), Annex 10-D, Article 10.9(1) <http://tcc.export.gov/Trade_Agreements/All_Trade_Agreements/exp_060984.asp> (11 February 2009)
This list is not inclusive. However, it appears to be capable of serving the purpose of preventing investors from bringing forward far-fetched expropriation claims thereby causing great inconvenience, unwanted delays and accelerated costs to the transition.

The next issue with regard to expropriation under Article 13 is the calculation of compensation payable to the investor by the expropriating State. Traditionally, such compensation was calculated according to the following formula: the payable compensation equals to investment expenditure plus lost profit.\(^{74}\) This formula, however, fails to address the issue of a possible double recovery if applied to calculate lost profits of a medium to long term investment project as such future incomes may be too speculative to be taken into account.\(^{75}\)

One of the possible solutions to this issue was discussed in the case of *Santa Elena v. Costa Rica* where another formula for the calculation of compensation was proposed. According to this new formula, the amount of compensation payable to investors should be equal to “the likely market value of the investment at the time of expropriation, [taking into account] the investment expenditures, on the one hand, and the discounted net future cash flow on the other, as well as additional factors such as indications of market based valuations and other equitable considerations” (emphasis added).\(^{76}\)

In summary, the language and context of Article 13 ECT very much resembles that specified in similar provisions of most modern BITs, and constitutes yet another confirmation of the principle of full compensation following expropriation or measures with an equivalent effect.


\(^{75}\) Stauffer, T, ‘Valuation of Assets in International Takings’ (1996) 17 *ELJ* 459-288

\(^{76}\) *Compania del Desarrollo de Santa Elena, S.A. v. Republic of Costa Rica*, ICSID, Case No. ARB/96/1
I. Transfer of funds: Article 14 ECT

One of the major disincentives for foreign investors is the risk of not being able to transfer capital connected to their investment to another country. These risks exist, in particular, in countries with high inflation, long delays in transfer systems, widely fluctuating exchange rates or poor foreign exchange services. Pursuant to Article 14 of the ECT, each contracting party is obliged to guarantee the free transfer of funds with respect to investments, both in and out of the area in question, without delay and in freely convertible currency. Article 14 provides a non-exclusive list of transactions which fall within the "freedom to transfer" provisions. They include payments under contract, unspent earnings and other forms of remuneration of personnel, proceeds from sale or liquidation, compensation for expropriation and other losses.

Article 14, however, contains three exceptions. First, a contracting party may protect creditors' rights, ensure compliance with securities laws and ensure the satisfaction of judgements. Second, any of the former Soviet republics may opt-out of the requirements of Article 14 when dealing with another former Soviet republic. Third, the Host State may restrict the "returns-in-kind" in circumstances where the GATT allows export restrictions.

In addition to this, Article 14 also provides for two extra exceptions for Russian investors. According to these exceptions, the Host State is allowed to impose restrictions upon movement of capital by its own investors (subject to several conditions aimed at protecting the rights of investors). In particular, the purpose of allowing such exceptions was to exclude the right of domestic investors to request certain transfers without foreclosing the right of the foreign investor himself to make the same request.

78 E.g. export of crude oil pursuant to a production sharing agreement (PSA).
79 Except that such returns must be allowed in accordance with the provisions of any written agreement that the foreign investor or its domestic subsidiary had with the Host State.
J. Conclusion

The main investment obligations of the ECT Member States are set forth in Part III of the ECT - “Investment Promotion and Protection”. This Part represents a cornerstone of the Treaty. The provisions in Part III aim to promote and protect foreign investment in member countries. Hence, the Treaty grants a number of fundamental rights to foreign investors with regard to their investment in the Host State. Under the ECT, foreign investors are protected against the most important political risks, such as discrimination, expropriation, nationalisation, breaches of individual investment contracts and, inter alia, unjust restrictions on the transfer of funds.\footnote{The Energy Charter Treaty: The Readers Guide, Secretariat of the ECT}
Chapter Eight

Dispute settlement remedies of the Energy Charter Treaty

A. Introduction

The 1994 Energy Charter Treaty (ECT) creates a number of enforceable rights for foreign investors who invest their capital in any of the ECT Member States.1 These rights carry great significance to investors in the energy industry because such investments tend to require large amounts of capital (which may take many years to recover),2 and are often made in politically, economically and legally unstable environments.

Due to investors' uncertainties about the neutrality or competence of some of the ECT Member States' local courts, a significant number of energy disputes are now referred to international arbitration. International arbitration is a powerful tool for investors to encourage States to abide by their treaty obligations and, if they do not, to resolve disputes in a neutral forum. A binding commitment to arbitrate disputes is particularly significant in the energy sector where, under national laws, it is sometimes the case that disputes can not be referred to arbitration or that States are reluctant to submit an energy related dispute to an independent third party.

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2 Professor Waelde argues that "[w]hile there is undoubtedly a convergence of international trade and investment law, there remains still a significant distinction. Trading is mainly a much more short-term interaction between a foreign trader and a national economy; whereas investment implies a much more long-term exposure of capital and efforts to on-going risks of government regulation and political, regulatory and administrative volatility". See Waelde, T, above n 1
In this Chapter I will discuss the dispute resolution mechanisms under the ECT, and also the mechanisms of recognition and enforcement of the ECT awards. First, I will outline the dispute resolution options provided by the Treaty. Second, I shall discuss general mechanisms of the recognition and enforcement of the ECT awards. Finally I will highlight some of the methods of recognition and enforcement of foreign arbitral awards rendered against the Russian Federation, which will tighten my discussion to the nature and purpose of this thesis.

B. Dispute resolution options of the Energy Charter Treaty

The dispute resolution options of the ECT are specified in Article 26, which in its relevant parts states: 3

(4) In the event that an Investor chooses to submit the dispute for resolution [...], the Investor shall further provide its consent in writing for the dispute to be submitted to:

(a)(i) The International Centre for Settlement of Investment Disputes, established pursuant to the Convention of the Settlement of Investment Disputes between States and Nationals of other States [...] if the Contracting Party of the Investor and the Contracting Party to the dispute are both parties to the ICSID Convention; or

(a)(ii) The International Centre for Settlement of Investment Disputes, [...], under the rules governing the Additional Facility for the Administration of Proceedings by the Secretariat of the Centre, [...], if the Contracting Party of the Investor or the Contracting Party to the dispute, but not both, is a party to ICSID Convention.

(b) a sole arbitrator or ad hoc arbitration tribunal established under the Arbitration Rules of the United National Commission on International Trade Law (“UNCITRAL”); or

(c) an arbitral proceedings under the Arbitration Institute of the Stockholm Chamber of Commerce. (Emphasis added).

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In other words, Article 26(4) of the ECT offers the parties 3 options. First, an investor can initiate institutional arbitration under the Arbitration Rules of the International Centre for the Settlement of Investment Disputes (ICSID). This option is available if both parties have consented to this option, and if both the home State of the investor and the Host State are parties to the 1965 ICSID Convention (also known as the Washington Convention). If both parties have consented to ICSID Arbitration, but either the home State of the investor or the Host State, but not both, is a party to the ICSID Convention, the ICSID Additional Facility Rules for the Administration of Proceedings will apply instead.

The second option permits the investor to initiate institutional arbitration under the Arbitration Rules of the Arbitration Institute of the Stockholm Chamber of Commerce (SCC). The last option, provides the investor with the opportunity to commence an ad hoc arbitration under the Arbitration Rules of the United Nations Commission on International Trade Law (UNCITRAL).

Each of these options will now be discussed.

I. Option one: arbitration under the ICSID system

The ICSID system of dispute resolution is presented in three parts: ICSID Arbitration, ICSID Conciliation and ICSID arbitration under the Additional Facility Rules. There are substantial differences between these three instruments and thus it is important to consider each of them separately.
1. ICSID Arbitration

In 1965 the Washington Convention established the International Centre for Settlement of Investment Disputes (ICSID or Centre). The purpose of establishing this institution was to provide facilities for dispute settlements of investment disputes.

The membership of the Washington Convention does not result in the ICSID arbitration being a compulsory means of solving investor-State investment disputes. ICSID Arbitration becomes binding only upon the written consent of the parties contained either in an investment agreement or in any of the relevant investment treaties. This is evident from the last paragraph of the Preamble to the ICSID Convention, where it is stated that:

[Declaring that] no Contracting State shall by the mere fact of its ratification, acceptance of approval of this Convention and without its consent, be deemed to be under any obligation to submit any particular dispute to conciliation or arbitration. (Emphasis added).

Once the Contracting Parties have provided a written consent to the ICSID Arbitration, the following consequences take immediate effect: the Contracting Parties may not, unilaterally, withdraw their consent to arbitrate, and the arbitral tribunal (appointed by the parties) is then able to decide on its own jurisdiction. Furthermore, once an ICSID

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5 These “facilities” include: keeping lists of possible arbitrators (Article 12 ICSID), screening and registering arbitration requests (Article 36(para 3) ICSID), assisting in the constitution of arbitral tribunals and the conduct of proceedings (Article 38 ICSID), adopting rules and regulations (Article 6, para 1, ICSID), and drafting model clauses for investment agreements.


8 'Convention of Settlement of Investment Disputes between States and Nationals of Other States 1965' World Bank <http://www.worldbank.org/icsid/basicdoc-archive/9.htm> (20 August 2007) (Washington Convention or ICSID Convention) (entered into force on 14 October 1966), Article 41, para 1. See also Attorney-General v Mobil Oil NZ Ltd., unreported; High Court, Wellington; 1 July 1987; (1987) 4 ICSID Reports 117. In this case the New Zealand government instituted parallel proceedings before its own domestic court in order to obtain an interim injunction seeking to restrain Mobil Oil from continuing the proceedings before ICSID. Basing its decision, inter alia, on Article 26 of the ICSID Convention, the New Zealand High Court, however, stayed the proceedings until the ICSID tribunal had determined its jurisdiction in this case.
Award is rendered, pursuant to Articles 53 and 54 ICSID, it becomes binding and enforceable. As such, these awards may not be challenged in any other way except as provided by the annulment procedure specified in Article 52 of the ICSID Convention.

Not all investment disputes, however, may be brought before ICSID arbitration panels. Rather, access to ICSID arbitration depends upon the fulfilment of jurisdictional requirements provided for in Article 25 of the Convention. These requirements are confined to the nature of the dispute and to the status of the parties to the dispute. According to Article 25 ICSID the nature of the disputes is limited to "legal disputes" arising "directly" out of an "investment". The jurisdiction regarding the status of the parties to the dispute extends over "Contracting States" on the one hand, and "nationals of another Contracting State", on the other. In other words, even if parties to an investment agreement expressly gave their consent to ICSID arbitration, any tribunal would have to satisfy itself of the fact that the dispute arose directly from an investment, was of a legal nature and that both the Host State and the investor's home State both party to the ICSID Convention.

In the interests of clarity, the provisions of Article 25 ICSID are reproduced below:

**Article 25**

(1) The jurisdiction of the Centre shall extend to any legal dispute arising directly out of an investment, between a Contracting State (or any constituent subdivision or agency of a Contracting State designated to the Centre by that State) and a national of another Contracting State, which the parties to the dispute consent in writing to submit to the Centre. When the parties have given their consent, no party may withdraw its consent unilaterally.

(2) "National of another Contracting State" means:

(a) any natural person who had the nationality of a Contracting State other than the State party to the dispute on the date on which the parties consented to submit such a dispute to conciliation or arbitration as well as on the date on which the request was registered pursuant to paragraph (3) of Article 28 or paragraph (3) of Article 36, but does not include
any person who on either date also had the nationality of the Contracting State party to the dispute; and

(b) any juridical person which had the nationality of a Contracting State other than the State party to the dispute on the date on which the parties consented to submit such dispute to conciliation or arbitration and any juridical person which had the nationality of the Contracting State party to the dispute on that date and which, because of foreign control, the parties have agreed should be treated as a national of another Contracting State for the purposes of this Convention.

(3) Consent by a constituent subdivision or agency of a Contracting State shall require the approval of that State unless that State notifies the Centre that no such approval is required.

(4) Any Contracting State may, at the time of ratification, acceptance or approval of this Convention or at any time thereafter, notify the Centre of the class or classes of disputes which it would or would not consider submitting to the jurisdiction of the Centre. The Secretary-General shall forthwith transmit such notification to all Contracting States. Such notification shall not constitute the consent required by paragraph (1).

Another special feature of ICSID arbitration is that it allows for only minimal (if any) interference with its arbitral process by way of review. According to Article 54 (first paragraph) of the Convention, the ICSID awards are final and binding and have to be recognised in all Contracting States, parties to the Convention, in a similar manner as the Host States recognise the judgments of their own domestic courts. By virtue of Article 54, the parties are prevented from failing to recognise the rendered arbitral award and to exercise the supervisory powers of their national courts under the provisions of the New York Convention.9 Instead, the ICSID Convention offers its own awards-annulment procedure. The details of this procedure are specified in Article 52 of the Convention, and are as follows:10

10 The rather broad scope of review exercised by the first two ad hoc committees (in Klockner v Kameroon, ICSID Case No. ARB/81/2, Ad hoc Committee decision, 3 May 1985, 3 ICSID Reports 95 and Amco Asia v Indonesia, ICSID Case No. ARB/81/1, Ad hoc committee decision, 16 May 1986, 1 ICSID Reports 509; 25 ILM 1441 (1986)) provoked substantial criticism. See Reisman, The Breakdown of the Control Mechanism in ICSID Arbitrations, 4 Duke Law Journal 739 (1989); Caron, Reputation and Reality in the
Article 52

(1) Either party may request annulment of the award by an application in writing addressed to the Secretary-General on one or more of the following grounds:

(a) that the Tribunal was not properly constituted;
(b) that the Tribunal has manifestly exceeded its powers;
(c) that there was corruption on the part of a member of the Tribunal;
(d) that there has been a serious departure from a fundamental rule of procedure; or
(e) that the award has failed to state the reasons on which it is based.

In summary, ICSID arbitration offers a number of advantages to both parties of an investment agreement. On the one hand, it provides investors with direct access to a form of settlement of a dispute; it offers an opportunity to extend the possibility of a dispute settlement beyond the realm of the Host State’s national courts, and provides an assurance of fully effective and enforceable awards. On the other hand, it benefits the Host States by promoting that State as favourable for investment climate, and by releasing it from the burden of diplomatic negotiations (often politically and commercially sensitive). However, once this method of dispute resolution is chosen (i.e. it is duly consented to by the Contracting Parties), the parties lose their rights to avail themselves of any other dispute settlement instruments available both nationally and internationally.

2. ICSID Conciliation

The second method of dispute settlement provided for under the ICSID auspices is ICSID Conciliation. ICSID Conciliation is known as a highly flexible and informal method of dispute settlement involving a third party that assists the Contracting Parties in reaching an agreed settlement. As opposed to arbitration, ICSID conciliation does not lead to a
binding decision, but rather to a recommended "suggestion" allowing the parties "[to] bring about agreement between them upon mutually acceptable terms". Such informality is twofold. First, it renders the proceedings less expensive. Second, it requires a higher degree of cooperation between the parties, who theoretically, could reject a proposed solution at any given moment.

One other point that ought to be noted in this regard is that the "jurisdiction of the Centre", as specified in Article 25 ICSID, does not differentiate between arbitration and conciliation as separate dispute settlement techniques. This could potentially lead to a serious problem since an unspecified submission regarding the Centre's jurisdiction may result in differences between the parties as to the appropriate method of dispute settlement and lead, at the very least, to inevitable procedural delays. One of the possible solutions to this problem was proposed by the ICSID Tribunal in *SPP v Egypt*, where it was held that:

> Once consent has been given to the jurisdiction of the Centre, the Convention and its implementing regulations afford the means for making the choice between the two methods of dispute settlement. The Convention leaves that choice to the party instituting the proceedings.

It is hoped that future practice will not prove contentious in this respect, and it is advisable for the parties to specify in advance whether their consent refers to arbitration or conciliation. Finally, it should be noted that while this method of dispute resolution is significant, it is not expressly included in the list of options available to investors under Article 26 ECT. Instead, the reference is made exclusively to ICSID Arbitration or ICSID Additional Facility Rules, which I shall proceed to discuss.

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13 *SPP v Egypt* (14 April 1988) 3 ICSID Reports 156 (Decision on jurisdiction II)
3. ICSID Additional Facility Rules

As mentioned above, the jurisdiction of the ICSID Centre rests on two pillars. First, it requires that both the Host State and the home State of an investor are Members of the ICSID (Washington) Convention. Second, it entails both Contracting Parties to have consented to ICSID arbitration in writing. Generally, if one of these pillars is missing, the Centre would be held to have no jurisdiction. This legal position is acceptable where the parties did not consent to the applicability of the ICSID rules to the potential dispute. However, the situation is somewhat different where both parties are willing to submit their dispute to ICSID arbitration, but one of these parties is not a Member to the ICSID Convention.

This situation was remedied in 1978, by the Centre’s adoption of the ICSID Additional Facility Rules.\(^{14}\) By virtue of Article 2, Additional Facility Rules extended the Centre’s jurisdiction to the following three situations: first, where at least one side to a dispute (either the Host State or the home State of an investor) is a party to the ICSID Convention; second, where the legal dispute does not directly arise out of an investment\(^{15}\) and finally, where arbitration or conciliation involves fact-finding between a State and a national of another State.

An illustration of how the Additional Facility Rules operate is best described with the reference to the relevant provisions of the North America Free Trade Agreement (NAFTA). Pursuant to Article 1120\(^ {16}\) NAFTA, an investor may submit his claim to

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\(^{14}\) 'ICSID Additional Facility Rules 1978' World Bank
<http://www.worldbank.org/icsid/facility/facility.htm> (20 February 2009)

\(^{15}\) Article 2(b) of the Additional Facility Rules extends the ICSID Convention’s jurisdiction over investment disputes to “disputes not directly arising out of an investment”. This provision must be read in conjunction with Article 4(3) of Additional Facility Rules which makes Additional Facility dispute settlement conditional on the fact that “the underlying transaction has features which distinguish it from an ordinary commercial transaction”. If one reads Article 2(b) as requiring the disputes to, at least, “indirectly” arise out of an investment, then this implies that a certain “investment nexus” remains a precondition for Additional Facility dispute settlement mechanism.

\(^{16}\) Article 1120 NAFTA provides:
1. Except as provided in Annex 1120.1, […], a disputing investor may submit the claim to arbitration under:
ICSID arbitration only if his home State or the Host State (or both) are party to the ICSID Convention. The three parties to NAFTA are: the United States, Canada and Mexico. Out of these three parties, only the United States is a party to the ICSID Convention. It therefore follows that as long as Canada and Mexico are not party to the ICSID Convention, the NAFTA will not operate to confer jurisdiction under the Convention except where either the United States or its national (as investor) is involved. Since the US is a party to the Convention, ICSID Additional Facility arbitration is available between the US investors and Canada and Mexico and between Canadian and Mexican investors and the US (though it is also possible to opt for UNCITRAL arbitration). Consequently, for the disputes between Canadian investors versus Mexico and Mexican investors versus Canada – only UNCITRAL arbitration (as another option of dispute resolution provided by NAFTA) is available.

In must be noted that since dispute settlement under the Additional Facility is neither ICSID arbitration nor ICSID conciliation, it falls by definition outside the jurisdiction of the Centre. This means that although such proceedings may be administered by the Secretariat of the Centre and thus benefit from the institutional support and expertise provided by the Centre, the ICSID Convention does not apply to proceedings, recommendations, awards or reports under the Additional Facility. This means, inter alia, that the ICSID Convention's rules on recognition and enforcement of arbitral awards are not applicable to awards rendered under the Additional Facility. In order to secure the effectiveness of such awards, Article 20 of the Additional Facility Rules

(a) the ICSID Convention, provided that both the disputing Party and the Party of the investor are parties to the Convention;
(b) the Additional Facility Rules of ICSID, provided that either the disputing Party or the Party fo the investor, but not both, is a party to the ICSID Convention, or
(c) the UNCITRAL Arbitration Rules.


ICSID Additional Facility Rules, above n 13, Article 3
provides that arbitral proceedings must be held only in States that are party to the 1958 New York Convention on Recognition and Enforcement of Foreign Arbitral Awards.19

II. Option two: institutional arbitration under the rules of the Stockholm Chamber of Commerce

The second dispute resolution option offered by Article 26 ECT is arbitration pursuant to the Rules of International Arbitration of the Stockholm Chamber of Commerce (SCC).20 The SCC focuses on international commercial arbitration, and in particular, the settlement of business disputes between private parties and private parties and sovereign States, with an interest in the Russian Federation.

Similarly to ICSID and other institutional arbitration, the personnel of the SCC do not arbitrate the disputes itself, but supervise and monitor the arbitral procedures conducted within the facilities of an Institution. In practice, this is done through the rendering of various administrative services, such as providing a list of arbitrators or participating in the process of their appointment, calculating fees and offering other administrative services. The advantages of choosing this mechanism of dispute resolution are similar to those of any other institutional arbitration. In particular, the SCC offers:

(a) (automatic incorporation of a book of rules (i.e. Rules of the Arbitral Institute of the Stockholm Chambers of Commerce),21
(b) trained staff to administer arbitrators;22 and
(c) various administrative services (i.e. providing a list of arbitrators, well-equipped arbitral facilities, calculating fees, etcetera).

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19 In *Metalclad Corporation v The United Mexican States* (30 August 2000, Case No. ARB(AF)/97/1, 16 ICSID Review 1 (2001); 40 ILM 36 (2001)) the Additional Facility arbitral tribunal determined the place of arbitration to be Vancouver, Canada, which is a member of the New York Convention.
22 These personnel are normally responsible for monitoring the appointment of the arbitral tribunal, controlling time frames allocated for each arbitration and, *inter alia*, collecting the advanced payments and fees.
In the opinion of the author, the only significance of the SCC over any other arbitral Institution is, perhaps, the locality of the Centre and hence its physical proximity to the former blocs of the former Soviet Union and Eastern Europe. Another important factor is the familiarity of the SCC’s personnel with the Russian language and the Russian legal system – bearing in mind that one of the initial objectives of the ECT was to create cooperation within the energy sector with the countries of Eastern Europe including, primarily, the blocs of the former Soviet Union including the Russian Federation.

III. Option three: ad hoc arbitration under the UNCITRAL Arbitration Rules

The final dispute resolution option stipulated in Article 26 ECT is an ad hoc arbitration pursuant to the rules of United Nations Commission on International Trade Law (UNCITRAL). For the purposes of Article 26 ECT, ad hoc arbitration represents a potential plan “B” option if ICSID or Additional Facility dispute settlement is not available. Generally, however, ad hoc arbitration is desirable when claimants do not wish to resort to institutional arbitration and apply a fixed set of rules, but prefer to adopt procedural rules tailored to their specific needs.

Ad hoc arbitration has the advantage of offering a certain procedural flexibility – the parties may adopt the existing rules (i.e. the UNCITRAL Arbitration Rules) or, they may

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23 Ad hoc is a Latin phrase which means “for this [purpose].” It generally signifies a solution that has been tailored to a specific purpose. It can also refer to an improvised and often impromptu event or solution “on an ad-hoc basis”, as opposed to well-prepared ones. It comes from the Latin phrase meaning “to the thing”. With regard to arbitration, ad hoc arbitration generally refers to a non-institutional arbitration where the process can be tailored to the needs of the parties (via amending the proposed “Model Clauses” of, for example, UNCITRAL Model Law on international arbitration).

24 The United Nations Commission on International Trade Law (UNCITRAL) was established by the General Assembly in 1966 (Resolution 2205(XXI) of 17 December 1966). In establishing the Commission, the General Assembly recognised that disparities in national laws governing international trade created obstacles to the flow of trade, and it regarded the Commission as the vehicle by which the United Nations could play a more active role in reducing or removing these obstacles. Electronic <http://www.uncitral.org/> (16 August 2007)

25 See, for example, Azinian and ors v United Mexican States, unreported; ICSID Case No. ARB(AF)/97/2, 1 November 2000, (2000) 39 ILM 537; Mondev International Ltd. v United States of America, unreported; ICSID Case No. ARB(AF)/99/2, Award, 11 October 2002 (NAFTA), (2003) 42 ILM 85; Waste Management, Inc. v United Mexican States, 2 Jun 2000, Case No. ARB(AF)/98/2, 15 ICSID Review 214 (2000); 40 ILM 56 (2001)
agree to develop their own tailor-made set of rules,\textsuperscript{26} or indeed, such rules may be
established by the arbitral tribunal in consultation with the parties, as was the case in the
\textit{Aminoil} arbitration.\textsuperscript{27} In \textit{Aminoil} the arbitral tribunal adopted its own set of rules of
procedure “on the basis of natural justice and of such principles of trans-national
arbitration procedure as it found applicable”.\textsuperscript{28} A further advantage of the UNCITRAL
Arbitration Rules is that, since they have been drafted by the United Nations
Commission, they arguably provide better protection against any possible unconscionable
bias of the drafters in favour of a given continent or industry.\textsuperscript{29} However, this point may
well be disputed.

Since the parties under the UNCITRAL Arbitration Rules are able to choose the rules that
would govern their potential dispute, they may choose the arbitration rules of any
institution or centre including, for example, those of the ICSID. Although in such
situations where the Convention and, in particular, its provisions governing enforcement
of arbitral awards do not apply, the actual arbitral process would largely resemble ICSID
arbitration.\textsuperscript{30}

In contrast to institutional arbitration, \textit{ad hoc} arbitration lacks the support of an
administrative organisation and is equally deprived of a strong enforcement mechanism
(generally offered by the Rules of an arbitral Institution). Nevertheless, enforcement of
arbitral awards rendered by \textit{ad hoc} arbitration tribunals will be facilitated by the

\textsuperscript{26} See \textit{CME Czech Republic B.V. v The Czech Republic}, unreported; UNCITRAL; Partial Award, 13
and Arbitration Materials 35

\textsuperscript{27} \textit{Kuwait v the American Independent Oil Company (Aminoil)} (1982) 21 ILM 976 (Aminoil case)

\textsuperscript{28} Ibid.

\textsuperscript{29} Rubino-Sammartano, M, \textit{International Arbitration: Law and Practice}, 2\textsuperscript{nd} ed (The Hague: Kluwer Law
International, 2001), 823

25, para 140
application of the *New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards*.\(^{31}\)

A number of major investment disputes were settled through *ad hoc* arbitration in the past, amongst which are the Libyan expropriation cases such as *BP v Libya*,\(^{32}\) *Liamco*\(^{33}\) and *Texaco/Calasiatic*.\(^{34}\) Also, some of the older mixed arbitrations were conducted according to arbitral rules set up *ad hoc*. To illustrate, one may cite cases such as the *Lena Goldfields*\(^{35}\) arbitration, *Saudi Arabia v Aramco*,\(^{36}\) and the *Sapphire* case.\(^{37}\)

In summary, arbitration under the UNCITRAL Arbitration Rules represents the last (in the chronological order) of the three dispute resolution options provided for in Article 26 ECT. If the parties select this option, by way of incorporating it into their arbitration agreement (or otherwise putting it in writing), they automatically waive their right to select any other of the two available options, namely, arbitration pursuant to ICSID Convention or arbitration in accordance with the Rules of the Stockholm Chamber of Commerce. The choice of the UNCITRAL Rules of Arbitration allows the parties to tailor the applicable procedural rules to their unique commercial and legal needs. However, it ought to be noted that these Rules do not provide an internal award-enforcement mechanism.\(^{38}\) These and many other peculiarities of *ad hoc* arbitrations ought to be taken into account by the Contracting Parties before they make their selection of a dispute resolution mechanism, pursuant to Article 26 ECT.

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\(^{32}\) *British Petroleum v Libya* (1979) 53 ILR 297-388

\(^{33}\) *Libyan American Oil Company (Liamco) v Libya* (1981) 20 ILM 1-87 (*Liamco* case)

\(^{34}\) *Texaco Overseas Petroleum Company/ California Asiatic (Calasiatic) Oil Company v Libya* (1978) 17 ILM 1-37

\(^{35}\) *Lena Goldfields Company Ltd. v Soviet Union* (1930) 5 Ann. Dig. 1/426; (1959) 36 CornellLQ 42

\(^{36}\) *Saudi Arabia v Aramco* (1958) 27 ILR 117 (*Aramco* case)

\(^{37}\) *Sapphire International Petroleum Ltd. v National Iranian Oil Company* (1963) 35 ILR 136

\(^{38}\) The enforcement of UNCITRAL awards can only be done through the application of the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards 1958
IV. Exceptions to arbitration under the Energy Charter Treaty

The ECT Member States (or their nationals) are automatically entitled to utilise one of the three arbitration options specified in Article 26(4) ECT. As a result, no further arbitration agreement, such as a dispute resolution clause within the parties’ investment agreement, is necessary. The States’ consent to arbitrate is contained within the provisions of the ECT, and is unconditional and irrevocable. In other words, the ECT Member States are deemed to have given their unconditional and irrevocable consent to submit to arbitral proceedings in accordance with the procedure set out in Article 26(3)(a) ECT. Member States are only able to withdraw from their investment obligations in limited circumstances, none of which allow them to escape from existing liability for breaches of the treaty that took place before their withdrawal, or for a period of 20 years thereafter (Article 47(3) ECT). There are some limited exceptions to this general principle.

Article 26(3)(b) ECT provides that the States listed in Annex ID have not unconditionally consented to international arbitration when the investor has previously submitted the dispute in question to the Host State’s courts or administrative tribunals or to a previously agreed dispute settlement procedure. Twenty four (24) Member States (almost half the signatories to the ECT) are listed in Annex ID, including the Russian Federation, Japan and the European Union.

Furthermore, Article 26(3)(c) ECT provides that the States listed in Annex IA have not unconditionally consented to international arbitration when the dispute involves an alleged breach of the contractual obligations referred to in the last sentence of Article 10(1). This is a far-reaching exception. However it will have a limited effect in practice as only Australia, Canada, Hungary and Norway have chosen this option. Hence, while the ECT offers foreign investors a wide spectrum of dispute resolution mechanisms, one should remain mindful of its exceptions.

39 It must be noted that State’s consent to arbitrate does not extend to the commercial activities of the State, but only the alleged breaches of specific standards referred to in part III of the ECT.
C. Recognition and enforcement of the ECT awards

I. Introduction

Depending upon the parties’ choice of the dispute resolution mechanism, and consequently the applicable Arbitration Rules, there exists at least two possible procedures for the recognition and enforcement of the arbitral awards rendered pursuant to Article 26 ECT. Assuming that the parties had (successfully) submitted their dispute to ICSID Centre, the recognition and enforcement of an award would be subjected to the procedures specified in the Washington (ICSID) Convention 1965. For all other awards, i.e. those rendered under the Rules of SCC, UNCITRAL Arbitration Rules or ICSID Additional Facility Rules, the appropriate recognition and enforcement procedure is that specified in the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards 1958. I shall now discuss each of these mechanisms separately.

II. Recognition and enforcement of arbitral awards under the Washington Convention

1. General

The general obligation to recognise and enforce ICSID awards is specified in Article 54(1) ICSID Convention. Article 54(1) reads as follows:

Each Contracting State shall recognise an award rendered pursuant to this Convention as binding, and enforce the pecuniary obligations imposed by that award within its territories as if it were a final judgment of a court in that State. A Contracting State with a federal constitution may enforce such an award in or through its federal courts and may provide that such courts treat the award as if it were a final judgment of the courts of the constituent State. (Emphasis added).
In other words, under Article 54 all States, party to the ICSID Convention, shall recognise and enforce an ICSID award as if it were a final judgement of their own domestic courts.\(^{40}\)

Recognition and enforcement of an award may be sought in any State that is a party to the ICSID Convention, and not just in the States of the parties to the arbitral proceedings in question. Therefore, the party, seeking recognition and enforcement of an award has the possibility to select the forum most favourable for its purpose.\(^{41}\) Failure of a State, party to the Convention, to recognise and enforce an award would amount to a breach of a treaty obligation and would carry the usual consequences of State responsibility, including diplomatic protection.

The obligation to recognise and enforce ICSID awards only applies to final awards. Decisions preliminary to awards, such as decisions on jurisdiction (Article 41 ICSID) or decisions regarding procedural orders (Articles 43 and 44 ICSID) or, indeed, decisions regarding interim protection measures (Article 47 ICSID), are not, therefore, subject to recognition and enforcement pursuant to the rules specified under the Convention.\(^{42}\)

Under Article 53(2) ICSID, “award” (for purposes of Article 54 ICSID) includes decisions under Articles 50, 51 and 52 ICSID, on interpretation, revision and annulment respectively. This means that the ICSID awards are to be recognised and enforced subject to any interpretation, revision or annulment. Subsequently, a decision annulling the award, for example, removes the obligation to recognise or enforce it.\(^{43}\)

\(^{40}\) It should, however, be noted that Article 54 ICSID does not distinguish between the recognition and enforcement of awards against investors on one side, and against Host States, on the other.

\(^{41}\) This selection is determined primarily by the availability of suitable assets.

\(^{42}\) It is, however, possible to make these interim awards enforceable. This can be done by way of incorporation them into the final award.

\(^{43}\) In case of a partial annulment, the obligation to recognise and enforce the award is limited to the portion of the award that has not been annulled.
Furthermore, recognition and enforcement are subject to the condition that there is no "stay" of enforcement. In other words, the duty to recognise and enforce an ICSID award is suspended while a stay of enforcement is in force. A stay of enforcement may be granted under Articles 50(2), 51(4) and 52(5) ICSID, while proceedings for interpretation, annulment or revision are pending.

ICSID awards may not be made subject to conditions for their recognition and enforcement which are not provided for by the ICSID Convention. In the process of recognition and enforcement, the authority of domestic courts is confined to verifying the authenticity of the ICSID award. In one of the reports prepared by the UNCTAD in 2003 it is stated that:

[The domestic courts] may not re-examine the ICSID tribunal's jurisdiction. [They] may not re-examine the award on the merits. Nor may [the courts] examine the fairness and propriety of the proceedings before the ICSID tribunal. Not even the public order of the State, where recognition and enforcement is sought, is a valid ground for a refusal to recognise and enforce. (Emphasis added).

Such a stringent recognition and enforcement mechanism is unique to the ICSID awards alone. In contrast, the non-ICSID awards, including Additional Facility awards, may be reviewed by the domestic courts in accordance with the domestic law and applicable treaties on the occasion of their recognition and enforcement.

In summary, if the ICSID award is final and is not subject to interpretation, revision or annulment procedures, the court in which the recognition is sought must recognise this award as authentic. Once recognised as authentic, an award becomes final and binding. In addition to this, recognition of an award is also a preliminary step leading to its enforcement or execution.

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44 "Stay" is an order made by a court suspending all or part of an action either before or after a determination by a court in respect of the action (Butterworths Concise Australian Legal Dictionary, 3rd ed (LexisNexis Butterworths, 2004), 411).
45 Enforcement under ICSID Convention is independent of the New York Convention and other international and domestic rules dealing with the enforcement of foreign arbitral awards.
46 'Series on Dispute Settlement' UNCTAD, United Nations (2003)
2. *ICSID procedure for recognition and enforcement of awards*

The procedure for recognition and enforcement of ICSID awards is covered by Articles 54(2) and 54(3) ICSID in the following terms:

54(2) A party seeking recognition of enforcement in the territories of the Contracting State shall furnish to a competent court or other authority, which such a State has designated for this purpose, a copy of the award certified by the Secretary-General. Each Contracting State shall notify the Secretary-General of the designation of the competent court or other authority for this purpose and of any subsequent change in such designation.

54(3) Execution of the award shall be governed by the laws concerning the execution of judgments in force in the State in whose territories such execution is sought.

In other words, a party must provide a copy of the award certified by the Secretary-General of the Centre in order to obtain recognition or enforcement by the competent court or authority. Under Article 11 ICSID, the Secretary-General authenticates arbitral awards and certified copies thereof, which are generally promptly dispatched to the parties.

A proceeding for the recognition and enforcement of the award may only be initiated by the party to the original ICSID arbitration. An interested third party is not entitled to do so. This would exclude action by a State acting on behalf of its constituent that was a party to the ICSID proceedings. A State exercising diplomatic protection is also barred from acting under Article 54(2) of the ICSID Convention.

It should be noted that the Convention provides no provisions prohibiting a party seeking the recognition and enforcement of an arbitral award to initiate such proceedings in several States simultaneously. The obvious drawback of this option is that the courts, in which enforcement is sought, need to bear an extra burden by having to ensure that the sought payment is not made more than once.\(^\text{47}\) The question as to what procedures the

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\(^{47}\) This is necessary to prevent double recovery.
courts should undertake to comply with its “obligations to ensure” that there is no double recovery remains unclear.

The execution of the ICSID award is subject to the law of the country where the execution takes place. Therefore, only procedures and remedies that are available under the local law will be applied to ICSID awards. Obstacles to the enforcement of the ICSID award under the law where execution is sought in no way affect the obligation of the party to the ICSID arbitration to abide by and comply with the award in accordance with Article 53(1). A State that successfully relies upon the law concerning State immunity from execution will still be deemed to have breached its obligation under the ICSID Convention. The logical consequence of this appears to be the investor’s revival of his right to diplomatic protection under Article 27(1) of the Convention.

**III. Recognition and enforcement of arbitral awards under the New York Convention**

1. General

Arbitral awards issued pursuant to Article 26 ECT (other than those that fall under the ICSID enforcement procedure) should be enforceable in all countries which are signatories to the 1958 *New York Convention on Recognition and Enforcement of Foreign Arbitral Awards* (the New York Convention). The *New York Convention* requires States which are a party to it to enforce foreign arbitral awards in their domestic courts, in the same manner that it enforces its domestic awards or judgements of its domestic courts. Under Article 26(5)(b) ECT, the parties to the arbitration may request that the arbitration takes place in a State which is a party to the New York Convention, thereby ensuring the enforceability of the future award. The parties’ enforcement rights are further protected by the last sentence of Article 26(5)(b) ECT which confirms that
disputes submitted to arbitration under Article 26 fall within the scope of transactions set out in Article I New York Convention.\textsuperscript{48} Namely, Article 26(5)(b) ECT states that:

Any arbitration under this Article shall at the request of any party to the dispute be held in a state that is a party to the New York Convention. Claims submitted to arbitration hereunder shall be considered to arise out of a commercial relationship or transaction for the purposes of article I of that Convention. (Emphasis added).

Article I of the New York Convention specifies that the Convention applies "to the recognition and enforcement of arbitral awards made on the territory of a State other than a State where the recognition and enforcement of such awards are sought",\textsuperscript{49} and that the Convention "shall also apply to arbitral awards not considered [as] domestic awards in the State where their recognition and enforcement are sought".\textsuperscript{50}

Hence, the recognition and enforcement of arbitral awards under the ECT is performed in accordance with the relevant provisions of the New York Convention.

Generally speaking, the obligation to recognise and enforce international arbitration award is incumbent upon all States party to the New York Convention.\textsuperscript{51}


(1) This Convention shall apply to the recognition and enforcement of arbitral awards made in the territory of a State other than the State where the recognition and enforcement of such awards are sought, and arising out of differences between persons, whether physical or legal. It shall also apply to arbitral awards not considered as domestic awards in the State where their recognition and enforcement are sought.

(2) […]

(3) When signing, ratifying or acceding to this Convention, or notifying extension under article X hereof, any State may on the basis of reciprocity declare that it will apply the Convention to the recognition and enforcement of awards made only in the territory of another Contracting State. It may also declare that it will apply the Convention only to differences arising out of legal relationships, whether contractual or not, which are considered as commercial under the national law of the State making such declaration.

\textsuperscript{49} Ibid.

\textsuperscript{50} Ibid.

Convention contains the rules on validity of arbitration clauses and rules on recognition and enforceability (as opposed to actual enforcement) of arbitral awards. The issues regarding the validity of arbitral agreements will not be discussed within this thesis. The discussion on the recognition and enforceability of foreign arbitral awards is provided below.

2. General rules of the New York Convention

The system of recognition and enforcement of arbitral awards under the New York Convention is laid down in Articles III to V of the Convention. According to Article III:

Each Contracting State shall recognise arbitral awards as binding and enforce them in accordance with the rules of procedure laid down in the following articles.

Article IV then determines the formal requirements that have to be fulfilled by an application for the enforcement of foreign arbitral awards. Those requirements (the submission of the arbitral award and of the arbitral agreement in the original or in certified copies as well as a certified translation of those documents into the official language of the country where enforcement is sought) usually do not constitute an obstacle for the enforcement of the award. Of greater practical importance, therefore, are the grounds of refusal of recognition and enforcement of an arbitral award, which are exclusively enumerated in Article V of the New York Convention. In particular, the provisions of Article V read as follows:

1. Recognition and enforcement of the award may be refused, at the request of the party against whom it is invoked, only if that party furnishes to the competent authority where the recognition and enforcement is sought, proof that:
   (a) The parties to the agreement referred to in article II were, under the law applicable to them, under some incapacity, or the said agreement is not valid under the law to which the

\[\text{Convention on the Recognition and Enforcement of Foreign Arbitral Awards, 1958,}\]
\[<\text{http://www.uncitral.org/pdf/english/texts/arbitration/NY-conv/XXII_1_e.pdf> (20 August 2007)}\] (New York Convention), Article II

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parties have subjected it or, failing any indication thereon, under the law of the country where the award was made; or
(b) The party against whom the award is invoked was not given proper notice of the appointment of the arbitrator or of the arbitration proceedings or was otherwise unable to present his case; or
(c) The award deals with a difference not contemplated by or not falling within the terms of the submission to arbitration, or it contains decisions on matters beyond the scope of the submission to arbitration, provided that, if the decisions on matters submitted to arbitration can be separated from those not so submitted, that part of the award which contains decisions on matters submitted to arbitration may be recognized and enforced; or
(d) The composition of the arbitral authority or the arbitral procedure was not in accordance with the agreement of the parties, or, failing such agreement, was not in accordance with the law of the country where the arbitration took place; or
(e) The award has not yet become binding on the parties, or has been set aside or suspended by a competent authority of the country in which, or under the law of which, that award was made.

2. Recognition and enforcement of an arbitral award may also be refused if the competent authority in the country where recognition and enforcement is sought finds that:
(a) The subject matter of the difference is not capable of settlement by arbitration under the law of that country; or
(b) The recognition or enforcement of the award would be contrary to the public policy of that country.

These grounds deal, however, with exceptional circumstances only. As a result, the provisions on recognition and enforcement of the *New York Convention* can be summarised in the rule that foreign arbitral awards are generally recognised and enforceable in a Member State of the *New York Convention*, unless exceptional circumstances occur.

In order to evaluate whether a creditor can seek enforcement of an arbitral award under the principles of the *New York Convention*, it is important to ascertain whether that creditor could rely on this Convention. The discussion on this point is provided in the next paragraph.
3. **Scope of the application of the New York Convention**

An investor can generally rely on the provisions of the *New York Convention* when the arbitral award was rendered and is being enforced in one of the Member States. The *New York Convention* has been ratified by more than 130 countries, including all of the major trading nations.\(^{53}\) The list of Member States covers all major economic centres of the world and is constantly increasing.\(^{54}\) Additionally, the person or entity in whose favour an award is rendered can, pursuant to the *New York Convention*, seek enforcement of such an award almost anywhere in the world. Having said that, it is important to note, however, that a considerable number of Member States\(^{55}\) made use of the first reservation under Article I(3)\(^{56}\) of the *New York Convention* and declared that they will not apply the Convention to awards of non-Member States on the basis of reciprocity only.

Due to the constantly decreasing number of non-Member States, however, the reservations provided in Article I(3) lost most of its practical importance. What is more notable is that even if a Member State refuses to apply the *New York Convention* to arbitral awards of non-Member States, the Member State is still free to grant recognition of such awards on the basis of its local laws. The *New York Convention* does not exclude the application of local laws if those laws are more favourable to enforcement of a


\(^{54}\) Countries that have not (yet) ratified the New York Convention are located mostly in Africa and Pacific Islands. The most notable non-Member States include Afghanistan, Andorra, Bahamas, Iraq, Liechtenstein, Pakistan, Tajikistan, Taiwan and Turkmenistan.

\(^{55}\) According to the list published on the website of UNCITRAL, 68 out of 133 Member States of the New York Convention have filed a reservation not to recognise awards made in a non-Member State. Some of these countries include Argentina, China, France, USA, United Kingdom and others.


(3) When signing, ratifying or acceding to this Convention, or notifying extension under article X hereof, any State may, on the basis of reciprocity declare that it will apply the Convention to the recognition and enforcement of awards made only in the territory of another Contracting State.[…].
foreign arbitral award, which is also supported by the provisions of Article VII(1) of the 
New York Convention.57

4. Recognition of an arbitral award rendered in a non-Member State to the New 
York Convention

In cases where an award is rendered in a non-Member State to the New York Convention, 
such an award may nevertheless be enforceable. According to one of the judgements of 
the French Cour de Cassation,58 even if the assets of the debtor are located in a State, 
which is non-party to the New York Convention, the creditor may nevertheless have 
access to these assets. This is due to the following set of circumstances. First, an arbitral 
award might be enforceable on the basis of the local laws of the non-Member State. More 
specifically, the fact that a country has not become a Member of the New York 
Convention does not mean that that country will not grant enforcement of foreign arbitral 
awards.

Second, there are situations when enforcement against assets located in a non-Member 
State might be carried out from a Member State. This situation was discussed in the Cour 
de Cassation case,59 where it was argued that if a judgement creditor knows that his 
debtor has assets in another State, he can apply for a garnishment order by which all 
claims of the judgement debtor against the third party debtor are seized in favour of the 
creditor. The exact process of how the garnishment orders operate is provided at the end 
of this chapter.

57 Convention on the Recognition and Enforcement of Foreign Arbitral Awards, 1958, 
<http://www.uncitral.org/pdf/english/texts/arbitration/NY-eng-conv/XXII_1_e.pdf> (20 August 2007) (New 
York Convention), Article VII:

(1) The provisions of the present Convention shall not affect the validity of multilateral or bilateral 
agreements concerning the recognition and enforcement of arbitral awards entered into by the 
Contracting States nor deprive any interested party of any right he may have to avail himself of an 
arbitrary award in the manner and to the extent allowed by the law or the treaties of the country 
where such award is sought to be relied upon.

Critique 329
59 Ibid.
5. Subject matter of the New York Convention: restrictions on the application

While the geographical scope of the New York Convention is practically unlimited, its restrictions with regards to its subject matter are of greater relevance.

First, the New York Convention applies to “foreign” as opposed to “domestic” arbitral awards. If, for example, an Australian investor seeks to enforce an Australian arbitral award against certain assets of the Russian Federation that are located in Australia (i.e., mining equipment), the Australian investor is unable to rely upon the provisions of the New York Convention, but has to rely purely on the relevant provisions of the domestic law.

Second, some Member States[^60] made use of the second reservation under Article I(3)[^61] of the New York Convention and declared that they will only apply the Convention to “commercial” disputes. As a result, these States may refuse enforcement of arbitral awards in matters like matrimonial and other domestic relations or in disputes on the exercise of sovereign or State powers (*acta iure imperii*).

The most important restriction on the application of the New York Convention, however, lies in the fact that it only deals with the conditions for enforceability of an arbitral award. This means that the rules of procedure on how an award becomes an enforceable title in a Member State are subject to the local laws of that State where enforcement is sought.[^62] The New York Convention does not specify that a court has to issue a so-called judgement of enforcement in order to render a foreign arbitral award enforceable, nor does the New York Convention contain provisions on which court has jurisdiction to

[^60]: According to the list published on the website of UNCITRAL, 43 out of 133 Member States of the New York Convention have filed that reservation. Some of these countries include Argentina, China, India, USA, Poland, Turkey and others.


(3) […] It may also declare that it will apply the Convention only to differences arising out of legal relationships, whether contractual or not, which are considered as commercial under the national law of the State making such declaration.

[^62]: Except for the formalities of the application laid down in Article IV of the New York Convention.
decide on the enforceability of a foreign award. The local laws of the country where enforcement is sought can thus set up additional requirements for jurisdiction of the local courts in such cases. A good example of such “additional requirements” may be found in the case of Transatlantic Bulk Shipping Ltd. v Saudi Chartering\(^{63}\) where the US District court for the Southern District of New York dismissed the claimant’s petition for confirmation of the London’s arbitral award for lack of personal jurisdiction over the respondent. The court ruled that personal jurisdiction would have required “some basis […], whether arising from the respondent’s residence, his conduct, his consent, the location of his property or otherwise” (emphasis added).

Despite the ruling in the Transatlantic Bulk Shipping case, a sufficient connection between the debtor and the State where enforcement is sought can usually be established. This is because the enforcement of an arbitral award is normally only pursued in a State if the debtor has assets in that State and there certainly exists a clear and direct connection between an entity and its assets.

There exists, however, one other issue where the restrictions of the New York Convention as to its subject matter are of significant practical relevance. That is, since the New York Convention only deals with the enforceability of foreign arbitral awards, it fails to provide for uniform law in the subsequent enforcement proceedings. As a result, among the New York Convention’s Member States there are at least 130 different legal systems on how to execute an enforceable award against the debtor’s assets. For example, a judgement creditor who wants to know whether he can seek enforcement of an arbitral award against certain assets of his debtor in foreign State ‘X’ should not only be satisfied with the answer that ‘X’ is a Member of the New York Convention, but must also investigate whether and under what conditions he can actually seize certain assets located in country ‘X’ (which will depend upon the local laws of ‘X’).

\(^{63}\) Transatlantic Bulk Shipping Ltd. v Saudi Chartering (1985) 622 F. Supp. 25 (S.D.N.Y.). This was an action for confirmation of a London arbitral award rendered between a Liberian claimant and a Panamanian respondent with its principal place of business in Greece.
Following the objectives of this thesis, it is now convenient to discuss the issues of recognition and enforcement of foreign arbitral awards rendered against Russian energy entities or the State of the Russian Federation.

D. **Recognition and enforcement of foreign arbitral awards against the Russian Federation**

I. **General**

Generally speaking, an arbitral award to which the Russian Federation is a party may be dealt with in two different ways. First, a foreign investor may take an arbitral award for the purposes of recognition and enforcement to one of the Russian domestic courts. Second, an investor may take an award to a court of any other State if his debtor (i.e., the State or a private company) holds sufficient assets in that State. I shall now discuss each of these options in turn.

II. **Recognition and enforcement of foreign arbitral awards in Russian courts**

The obligation to recognise and enforce international arbitration awards is incumbent upon all States parties to the 1958 *New York Convention on Recognition and Enforcement of Foreign Arbitral Awards*. The Soviet Union acceded to the *New York Convention* in 1960. After the collapse of the Soviet Union, the Russian Federation declared itself its successor. Thus Russia's official declarations that it would continue to exercise rights and honour obligations arising from international treaties signed by the Soviet Union mean that Russia is now bound by all international acts that were signed by the Soviet Union, including the *New York Convention*.65

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65 In addition to that, on 16 June 1992, Russia signed the *ICSID Convention*, but has not yet ratified it.
The New York Convention, as mentioned above, does not provide any procedure for the execution of foreign arbitral awards. Thus far, when a foreign arbitral award against a Russian party is brought before one of the Russian domestic courts, the court must follow the execution procedure of its own domestic laws.

Presently, there are two Russian laws which serve as the basis of enforcement of foreign arbitral awards. These are the Law on International Commercial Arbitration of 1993 (LICA) and the Procedural Code of the Commercial Court of 2002 (CCPC). The LICA is broadly based upon the UNCITRAL Model Law (Model Law). The preamble to LICA declares that the Law is based upon the recognition of the usefulness of arbitration as a widely applied method of settling disputes emerging in the area of international trade.

Article 5 LICA, which mirrors Article 5 of the Mode Law, provides that: "[i]n matters governed by [this] Law, no court shall intervene except where so provided in [this] Law,"\(^{66}\) (emphasis added). The court’s intervention, as further provided by Article 6 LICA, is authorised in limited circumstances, among which is the procedure for setting aside the arbitral awards (the grounds for which are listed in Article 34 LICA and Article 34 Model Law, respectively).

The issues regarding the recognition and enforcement of foreign arbitral awards in Russian courts are addressed in Chapter 8 LICA, in which Article 35(1) it is provided that:

> Arbitral awards, regardless of where they were granted, are recognised as binding and by submission of application to a competent court, shall be enforced by taking into consideration the rules of the present provision and of Article 36.

Article 36 LICA sets out the grounds for the refusal of recognition and enforcement of foreign arbitral awards. Paragraph one of Article 36 is almost identical to the provisions

of Article V of the New York Convention, i.e. it lists the grounds for refusal of arbitral awards by the Russian courts. Accordingly, the recognition and enforcement of an arbitral award, irrespective of the country in which it was made, may be refused only when:

(a) the arbitration agreement is void;
(b) one of the parties to arbitration did not have the capacity to act;
(c) the subject matter of an award was not covered in the arbitration agreement;
(d) the party to arbitration was not duly informed of the appointment of arbitrators, or of arbitral proceedings, or was unable to present his case;
(e) the arbitral procedure or the composition of an arbitral agreement did not coincide with the agreement or law;
(f) the award is not final, was revoked or its enforcement was suspended under other grounds;
(g) the subject matter of the arbitration cannot be dealt with by an arbitration according to Russian law; and
(h) the recognition and enforcement of an award would be against the public policy of the Russian Federation.

The second law which is relevant in this respect is the 2002 Procedural Code of the Commercial Court (CCPC). Article 32 CCPC provides for the exclusive jurisdiction of commercial courts in the enforcement of foreign judgements and arbitral awards.

The CCPC covers the procedural aspects of enforcement. Section 31 CCPC accommodates provisions on the enforcement of foreign judgements and arbitral awards. Article 241 CCPC allows for recognition and enforcement of foreign arbitral awards on the basis of either an international treaty or a federal law. The New York Convention is one of those treaties. The procedure for the application for enforcement is set out in a detailed manner.
Article 244 CCPC lists the grounds upon which enforcement and recognition may be refused. This provision covers both foreign judgements and arbitral awards. A commentary to the CCPC\textsuperscript{67} points out that these grounds correspond to the grounds as provided in the LICA, and as such also mirrors the provisions of the UNCITRAL Model Law and New York Convention.

A novel approach introduced by the 2002 CCPC concerns jurisdiction over the application for enforcement of foreign arbitral awards. Before the introduction of the Commercial Courts (\textit{Treteiskie Sudi}) in the Russian Federation, the jurisdiction over international awards was assumed by the ordinary courts. Commercial courts were established in 1992. However, there were no explicit provisions in any laws or regulations regarding their jurisdiction. LICA, a predecessor of CCPC, merely referred to a \textit{competent court}, avoiding this issue. While there was no explicit provision which denied the jurisdiction of commercial courts, a majority of foreign cases went to the ordinary courts, most prominent of which were the Russian Supreme Court and the Supreme Commercial Court.\textsuperscript{68}

The struggle for jurisdiction between the ordinary courts and commercial courts was resolved by the introduction of the 2002 CCPC, in which Article 32 “the jurisdiction over the recognition and enforcement of foreign judgements and arbitral awards” was finally and permanently granted to the commercial courts.

This had a significant impact upon the enforcement of arbitral awards. On the one hand, it successfully eliminated any confusion over which Russian court held jurisdiction over the matter. Conversely, the newly appointed commercial court judges appeared to be hostile to commercial arbitration. One of the commentators observed that “while the

\textsuperscript{67} Zhilin, G A, \textit{'Kommentarii k arbitraznomu processualnomu kodeksu RF'} (Commentary on the Russian Commercial Procedural Code) (Unpublished paper, Moscow, 2003) 598 (translated by the author of this thesis)

\textsuperscript{68} The Supreme Commercial Court should not be mixed with “Treteiskii” Court. The Supreme Commercial Court of the Russian Federation is the court of ordinary jurisdiction and deals with various disputes of general commercial character; whereas the “Treteiskii” Court only came into existence in 1992 and is now known to deal with the matters concerning international judgments and awards.
[commercial court judges] were ready to enforce foreign judgments, there was some general reluctance to enforce arbitral awards” (emphasis added). 69

Such hostility, which is evident from the outcome of some of the recent cases,70 appears to be the primary reason as to why foreign investors hesitate to seek enforcement and execution of arbitral awards in Russia. Therefore, the second option, namely to take an award to a court of any other State where the Russian party holds sufficient assets and, subsequently, enforce that award there, presents as the more attractive option. This option is discussed below.

III. Recognition and enforcement of foreign arbitral awards (involving a Russian party) outside of Russia

1. General

Due to the fact that enforcement proceedings are generally ruled by local laws of the country where such enforcement is sought, a full evaluation of the chances and risks in seeking enforcement abroad ought to be performed (by way of due diligence). There are at least three common components that feature in the States’ enforcement laws. First, prohibition of further argument on the merits of the case; second, the rule of territoriality, and third, enforcement against debtor rule. 71

With regard to the prohibition of re-arguing the merits of the case, proceedings for the enforcement of an arbitral award are supplementary and are based upon the arbitration proceedings that have resulted in the award.72 The debtor, against whom an arbitral award

70 Decision of the Federal Commercial Court of the Moscow District, Russia, 18 November, 2002; Decision of the Federal Commercial Court of the North-West District, Russia, 20 March 2003; Decision of the Federal Commercial Court of the Moscow District, Russia, 19 February 2004; Decision of the Presidium of the VAS (‘Visshii Arbitrazhnyi Sud’), Russia, 26 October 2004
71 Stankewitsch, P, ‘Enforcement of Arbitral Awards against Russian Companies outside Russia’ (June 2005) volume 2 issue 3 TDM, 1
72 Ibid.
was rendered, is deemed to have utilised his chance at raising defences in terms of the merits of the case in the arbitral proceedings.\textsuperscript{73} This is because most arbitral agreements stipulate that the award, once rendered, is final and binding. Hence, any re-opening of the case would breach the parties’ contractual obligations and potentially, the State’s obligations under the treaty law.\textsuperscript{74}

With regard to the rule of territoriality, it can be stated that it is a recognised principle of international law that States are only able to grant enforcement against assets that are located within their territorial borders.\textsuperscript{75} For example, an Australian investor cannot obtain an enforcement of an arbitral award in Australia if the party against whom an award is rendered does not have any assets in Australia, or if such assets are insufficient.

Finally, pursuant to the enforcement against the debtor rule, enforcement may only be validly carried out against the assets of the award debtor, and not any other third party. The issue as to whether certain assets belong to the award debtor is determined in accordance with the relevant property law.

These three common features of local enforcement laws may considerably influence the success of enforcement proceedings abroad. This shall be illustrated in the remainder of this chapter.

2. Attachment of assets located outside of jurisdiction

General

Based upon the rule of territoriality a State in which an enforcement of an award is sought cannot make any decisions regarding the assets of the judgement debtor where such assets are located outside of that State’s territorial borders. In other words, the domestic

\textsuperscript{73} If, for example, the debtor was not given the possibility to defend its case during the arbitral proceedings, under Article V(1)(b) of the New York Convention, an award would not be enforceable.

\textsuperscript{74} Stankewitsch, P, ‘Enforcement of Arbitral Awards against Russian Companies outside Russia’ (June 2005) volume 2 issue 3 TDM, 1

\textsuperscript{75} Geimer, Reinhold, \textit{Internationales Zivilprozessrecht}, 4\textsuperscript{th} ed (Cologne, 2001) note 3200
court of the State of enforcement cannot attach the assets of the award debtor (located in another country) to its decision pursuant to its own domestic law on enforcement.

*Tangible property*

The location of tangible property may generally be determined with little difficulty. Relevant information can usually be obtained by way of due diligence. Once it is established that the judgement debtor holds sufficient assets within the jurisdiction of the State of enforcement, the local courts of that State are generally empowered to attach the assets of the judgement debtor to his decision.

*Property in shares*

The determination of the location of shares is more difficult to ascertain than the location of tangible property. In this regard, it is appropriate to evaluate whether the company shares can be classified as tangible assets (the location of which would then be associated with the location of share certificates), or whether shares should be classified as intangible property (the location of which is then associated with the domicile of the company). There is no general answer to this question and therefore, the location of shares often depends upon the applicable law of the State of enforcement.

Foreign shareholders (and potential foreign shareholders) of Russian entities should be aware that the shares of a company which are transferred by way of share certificates are generally considered to be located at the location of their certificates. By contrast, the shares not presented by certificates, are usually assigned by way of intangible accounts receivable, meaning that the judgement creditor is required to obtain a garnishment order before he can seize the shares.

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76 Stankewitsch, P, 'Enforcement of Arbitral Awards against Russian Companies outside Russia' (June 2005) volume 2 issue 3 TDM, 1
77 The term "garnishment" describes the attachment of a claim that a judgment debtor has against its debtor (the so-called garnishee). In order to attach such claim of the judgment debtor, the creditor usually has to obtain, according to the local laws, a so-called "garnishment order" from the competent court (or other State authority). By that order, which has to be served upon the garnishee, the garnishee is notified of the
Foreign investors should also note that whilst the shares of the debtor’s subsidiaries are also considered to be the debtor’s property, an arbitral award cannot be executed against the subsidiary (provided that it is a separate legal entity) because a subsidiary is not identical to the judgement debtor, and hence is generally treated as a third party.\(^79\)

The final important consideration is the issue of the retention of title. Judgement creditors should always bear in mind that if the goods of the Russian judgement debtor have left the jurisdiction on the basis that they were sold to third parties, the property in these goods may nevertheless be returned to the judgement creditor if the buyer has not acquired a good title in those goods (i.e. has not paid full purchase price etc.), and thus has not yet acquired property in the goods.

3. Attachment of securities

Similar to the situation of the enforcement against shares, there is no generally accepted rule on how the location of securities should be determined.\(^80\) According to the law of one State, securities might be located at the place where the security certificate is located, whereas according to the law of another State, securities might be located at the registered office of the issuer of these securities. In addition, different enforcement laws may provide for different rules depending on the nature of the security and on the conditions for the transfer of title.

As a result, if a judgement creditor wants to enforce the arbitral award against certain foreign securities held by a Russian debtor, the judgement creditor has to find out attachment by the judgment creditor. After service of the garnishment order, the garnishee can usually no longer validly fulfil the garnished claims towards the judgment debtor, but has to disclose the details of the garnished claim to the court and can only validly fulfil garnished claim as the court shall direct.\(^78\) Stöber, Kurt, Forderungspfändung, 12th ed (Verlag : Gieseking, 1999) notes 1605 and 1612

\(^79\) There are a number of exceptions to this rule. First exception can be derived from the doctrine of “piercing the corporate veil”. Another exception would be the situation that the judgment debtor transferred property to its subsidiary, thus impairing the chances of the judgment creditor to obtain enforceable property of the debtor. In such a case, the judgment creditor might, according to the applicable local laws, be entitled to challenge that property transfer.

\(^80\) In this contents the “securities” are referred to as instruments evidencing an obligation of the issuer towards the security holder.
whether the local enforcement laws provide for different rules depending upon the nature of the security pursuant to the chosen law.\textsuperscript{81} If, for example, according to the chosen law the foreign securities can be traded by simple transfer of certificates, the creditor may attempt to obtain such securities from within the territory of another State. This is because another State’s law on enforcement may allow the seizure of such securities by a simple attachment of the certificates by a bailiff.\textsuperscript{82}

4. Attachment of accounts receivable

The most obvious example of a situation where the rule of territoriality cannot be properly applied is the attachment on accounts receivable. The location of accounts receivable is, due to their intangible nature, a question of law and not of fact. Local enforcement laws can thus provide different kinds of solutions to locate accounts receivable. Among these are: the creditor’s domicile, the debtor’s domicile, or the place where payment must be carried out. To date, there is no accepted general rule in this regard.

Moreover, the local rules on jurisdiction differ broadly with regard to garnishment of accounts receivable in international cases. A local court may assume jurisdiction to issue a garnishment order, by which accounts receivable are attached. It is thus not unusual that a creditor has the choice to apply for a garnishment order with different courts, i.e. the courts where the debtor is located and the courts where the garnishee (the debtor’s debtor) is located. For example, an Australian investor who obtained an arbitral award against the Russian Federation may apply for a garnishment order in one of the Russian courts (assuming that the judgment debtor also had debtors in that country), or alternatively, he may apply for such an order in, for instance France, where a French company, that owes a debt to a Russian company in question, is located.

\textsuperscript{81} Stankewitsch, P, ‘Enforcement of Arbitral Awards against Russian Companies outside Russia’ (June 2005) volume 2 issue 3 TDM, 1

\textsuperscript{82} Stöber, above n 73, notes 2092 and 2096
Generally speaking, the creditor is said to be in a better position if he applies for a garnishment order directly with the court that has a jurisdiction over a garnishee, i.e. in the garnishee’s country of domicile. If the creditor chooses the court of the garnishee’s domicile, the creditor might be entitled to seek an enforcement of the garnishee’s assets directly (provided that the garnishee does not bring forward a defence against the garnishment claim).

5. **Parent companies’ liabilities against the subsidiaries’ debts**

According to the enforcement against the debtor rule, an arbitral award obtained against a subsidiary, generally, cannot be enforced against the assets of the parent company since the parent company was not a party to the arbitral proceedings and could not defend its case. However, there are situations when, under local laws, a parent company can be held liable for its subsidiary’s debts, e.g. if the parent company unduly interferes with the subsidiary’s business or if the two companies’ assets are combined in a way that they can no longer be attributed to one company or the other. In such a situation, some local laws allow for the so-called *piercing of the corporate veil*, with the result that the parent company can no longer raise the defence that it is a separate legal entity, not responsible for the debts of its subsidiary.

It is doubtful, however, whether this concept can also be applied to enforcement proceedings. A parent company’s liability for its subsidiaries’ debts allows the creditors

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83 Stankewitsch, P, ‘Enforcement of Arbitral Awards against Russian Companies outside Russia’ (June 2005) volume 2 issue 3 *TDM*, 1
84 The garnishment of accounts receivable by court order is the country of the garnishee’s domicile can, however, result in a serious dilemma for the garnishee. Namely, if the debtor is entitled to pursue the garnished claims before the courts of another country, the garnishee cannot be sure whether those courts will recognise the foreign garnishment order. Since there exists no international convention on the recognition of foreign garnishment orders, the courts of another State might well refuse to recognise garnishment order and might confirm the garnishee’s obligation towards the debtor. As a result, the garnishee could be faced to carry out his obligations twice - once towards the creditor pursuant to the garnishment order, and second time towards the debtor who turned to a court not recognizing the garnishment order. See Stankewitsch, P, ‘Enforcement of Arbitral Awards against Russian Companies outside Russia’ (June 2005) volume 2 issue 3 *TDM*, 1
85 Stankewitsch, P, ‘Enforcement of Arbitral Awards against Russian Companies outside Russia’ (June 2005) volume 2 issue 3 *TDM*, 1
of a subsidiary to sue both the parent and the subsidiary. However, it does not necessarily imply that the creditor can enforce a judgement against the parent company without having sued the parent company before. In *Flip Side Productions*,87 however, a decision of the Illinois District Court, the judges allowed an affiliate company of the judgement debtor to be subjected to enforcement proceedings. Notably, this decision has not been followed since.

In summary, due to the almost worldwide application of the *New York Convention*, foreign arbitral awards are generally recognised and enforceable throughout the world, unless exceptional circumstances occur. However, since the *New York Convention* deals only with the enforceability of a foreign arbitral award, the subsequent enforcement proceedings are subject to the local laws on enforcement. Despite the diversity of these laws, enforcement laws in general have at least three common features: the judgement debtor is strictly prevented from re-arguing the merits of the case; a State can only grant enforcement against assets that are located within its territorial borders in accordance with its property and corporation laws.

**E. Conclusion**

The ECT, as it has been shown throughout this chapter, is one of the most significant international instruments for the promotion and cooperation in the energy sector. It is also said to be one of the most significant multilateral treaties providing for the promotion and protection of investments. By the large, the ECT provides protection that is similar to most bilateral investment treaties. It provides for binding international dispute settlement, with particular respect to investment disputes. In short, under Article 26 ECT, disputes

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87 In *Flip Side Productions, Inc. v. Jam Productions, Ltd.*, unreported, U.S. Dist. LEXIS 15411 N.D. Ill, 8 November 1990, the US District Court for the Northern District of Illinois, Eastern Division, held that an affiliate company of the judgment debtor can be subject to enforcement proceedings under the doctrine of piercing the corporate veil. Since the affiliate company had treated the debtor's assets as though they were its own, the District Court considered the affiliate company as alter ego of the debtor and therefore did not grant it the right to a full new trial on the merits of the case. However, the judgment of the District Court has not been confirmed by Illinois State Courts later, and since the legal issues at stake are subject to State law, Illinois case law does not give clear guidance so far. Cf. the judgment of the US District Court for the Northern District of Illinois, Eastern Division, in *Harris Custom Builders, Inc. v. Richard Hoffmeyer*, unreported; U.S. Dist. LEXIS 10032 N.D. Ill, 17 July 2001
relating to the investment of an investor can be referred to international arbitration if they are not settled amicably between the disputing parties. 88 Under the provisions of the same article, the investor is given an option to choose between ICSID arbitration, the arbitration under the auspices of the Stockholm Chamber of Commerce, or the ad hoc arbitration pursuant to the Arbitration Rules of the United Nations Commission on International Trade Law (UNCITRAL).

With regard to the recognition and enforcement of the ECT awards, there are primarily two mechanisms that can be relied upon by the aggrieved party. First, an aggrieved party (usually the private investor) can rely upon the relevant provisions of the Washington Convention, which stipulate that awards rendered under the auspices of this Convention are final and binding, and are not subject to interpretation, revision or annulment. Furthermore, the Washington Convention also provides for a procedure for the recognition and enforcement of awards. Second, an aggrieved party can rely upon the relevant provisions of the New York Convention that also provide certain procedures for the recognition and enforcement of foreign arbitral awards. The provisions of this Convention may be relied upon when the arbitral award is rendered and is being enforced in one of its Member States. 89

Finally, the issue of recognition and enforcement of foreign arbitral awards against the Russian Federation has also been discussed in this chapter. The conclusions that may be drawn from this discussion can be summarised as follows: an aggrieved investor has, in essence, two options of enforcing foreign awards against the Russian Federation. First, an investor can take an award (for the purposes of enforcement) to one of the Russia’s domestic courts. Second, an investor can take an award to a court of any other State (that is a Member of the New York Convention), provided that such a State holds sufficient assets belonging to either the debtor of the judgement award or the garnishee (debtor of

the debtor). In each case an award should be recognised and enforced in a manner such that it reflects the judgement of that State’s own domestic court.
Part III

Summaries and Conclusions
In the new era of doing business in Russia, a foreign investor needs to be mindful of certain peculiarities of the Russian culture and more so of certain specificities of the Russian legal system. In this thesis I have outlined a number of crucial areas that ought to be studied by the potential investor in the Russian oil and gas industry. In particular, in chapter one of this thesis I highlighted some of the issues relating to global energy demand, and also discussed the role that the Russian Federation, as a State and the ultimate owner of its immense subsoil resources, plays in the global energy market. Having outlined certain statistical data about the distribution and demand of oil and gas resources I came to the conclusion that the Russian oil and gas sector represents potentially one of the core investment opportunities for energy investors, and that Russian subsoil resources cannot and should not be overlooked by global energy traders.

In the second chapter, I indicated some of the major obstacles for foreign investors in securing their contracts with the government of the Russian Federation or its subsidiaries. In short, these obstacles comprised some of the alleged inefficiencies of the Russian internal legal system, the prospect of expropriation or nationalisation of foreign property, the issue of State sovereign immunity and lastly, the problem of enforced exposure of foreign investors to the Russian domestic courts. In this chapter I have brought to the reader’s attention some of the potential inefficiencies of Russia’s internal legal regime much feared by investors. I have also indicated, however, that the legislative drawbacks highlighted in this chapter are largely academic. Hence, it is still arguable as to whether
these inefficiencies leave any impact on the investor who engaged himself in the investment activities connected to the Russian territorial borders and its subsoil wealth.

The remainder of my thesis provides a detailed discussion regarding various investment protection mechanisms available to foreign investors in cases where the internal legislative environment of the Host State lacks efficiency. Thus, in chapter three I have acknowledged the importance of carefully drafted contracts as the first and most important mechanism for the protection of investment. In chapter three the reader is presented with a discussion concerning various contractual clauses that could effectively shield a more vulnerable party to the contract from certain risks associated with that contract. In particular, I have identified a number of contractual clauses that ought not to be overlooked by the corporate counsel and their clients-investors. These clauses include stabilisation, renegotiation and arbitration, as well as choice-of-law and choice-of-forum clauses. In the same chapter I have addressed issues relating to the sanctity of contract, on the one hand, and State sovereignty, on the other. I have concluded this chapter by drawing upon the often underestimated importance of drafting the key contractual promises, suggesting that carefully drafted contracts may assist investors in overcoming certain fundamental issues associated with their investments located within the territory of another State.

In chapter four I have highlighted another major mechanism of investment protection available to foreign participants within the territory of the Russian Federation. This second investment protection tool is known as the remedy of diplomatic protection. This type of investment protection originates in customary international law and is generally available to every investor as a remedy of last resort. This remedy involves the negotiations between the Host State and the member of the diplomatic mission of the investor's home State regarding the poor treatment of the said investor in alien territory. If such negotiations prove to be pointless, the power of this remedy may potentially extend to the initiation of judicial and arbitral proceedings, severance of diplomatic relations (including trade relations), and as a last resort – the use of force. Nowadays, the
remedy of diplomatic protection is rarely relied upon, and if ever it is, it rarely extends to the use of force.

Before introducing the remedy of diplomatic protection, however, I have raised the argument regarding the Host States’ permanent sovereignty over its natural resources. The reason for this was to outline the scope and nature of this concept, but most importantly – to indicate the implications attached to it. In particular, I have stressed that the concept of State sovereignty, which also originates in customary international law, brings with it certain rights and obligations towards the State. Notably, among these rights, is the Host State’s authority and power to expropriate or nationalise alien property under certain conditions (of legality). Among the Host State’s obligations is the duty to respect the right of other States and to adhere to its international undertakings spelled out in relevant international treaties and conventions.

The discussion of the State’s obligations to honour its international undertakings resulted in the debate regarding Russia’s obligations under public international law. Hence, in chapter five I have identified another international protection mechanism offered to foreign investors under the auspices of public international law. I have suggested that the investment protection tools offered by these instruments are in themselves (i.e. regardless of the collateral contractual undertakings) sufficient to safeguard the interests of foreign investors with respect to their financial engagements with the government of the Host State. In this chapter I have discussed a number of key investment protection provisions common to both the treaty law and the customary international law. These provisions include the Host State’s obligations to provide foreign investors with non-discriminatory\(^1\) and fair and equitable treatment. I have also stressed the importance placed upon the Host State’s obligation to provide foreign investment with most constant protection and security, and lastly, I have discussed the possibility for investors to initiate international arbitral proceedings directly (or without recourse to the diplomatic protection).

\(^{1}\) In this context, non-discriminatory treatment includes “National” treatment and “Most-favoured-nation” treatment.
Chapter six deals exclusively with expropriation and nationalisation of foreign investment by the government of the Host State. In this chapter I have outlined the meaning and the origin of the concept of expropriation. Furthermore I have highlighted the various forms of expropriation, and finally presented a discussion regarding the conditions of legality associated with the aforementioned rights concerning the Host State. One such condition, is an obligation to remedy the aggrieved investor by compensating him for his loss. I concluded this chapter by suggesting that the State’s obligation to pay compensation is one of the most effective means of international legal protection available to investors, and that a failure to comply with such an obligation may result in severe damages imposed upon the State by the relevant provisions of public international law.

In chapters seven and eight I have discussed the investment protection provisions and the dispute settlement remedies of the 1994 Energy Charter Treaty (ECT) – the only multilateral investment treaty that deals exclusively with investment in the energy sector. My decision to include this discussion was based upon the finding that the ECT is specifically relevant to the energy sector, and also because this Treaty was created specifically to integrate the countries of the former Soviet Union (including the Russian Federation) into the broader European and world market. Among other things I have brought to the reader’s attention the fact that while the ECT has not yet been formally ratified by the Russian Federation, its provisions are nevertheless semi-binding upon the State due to the fact that the Russian Federation has ratified the document upon which the ECT was based.

I have highlighted the fact that the ECT commits its Member States to provide, at least, minimum guarantees to investors, to increase confidence and minimise the risk of making substantial investments in their territories. The most important guarantees, as discussed in previous chapters, can be summarised as follows. First, Member States must provide protection for foreign investors against the expropriation of their investment. Any act of expropriation conducted by the State must be lawful, non-discriminatory and in the public interest. It must then be followed by the payment of prompt and effective
compensation, in convertible currency, at a level equivalent to the fair market value of the investment immediately before the expropriation. Second, Member States must provide protection from discrimination. Under Article 10(7) ECT, the treatment accorded to an investor by a Member State must be as favourable as that to which they give their own investors or investors from other States (subject to a limited number of exceptions). Third, and most importantly, Member States undertake to abide by the terms of investment contracts that they enter into with foreign investors. The investor is therefore given the right to sue a Member State under the ECT in respect of any breach of the investment contract. This mechanism can be used by the investor even if the investment contract specifies other methods of dispute resolution.

Subsequently, I have noted that the ECT also provides investors with a powerful selection of dispute resolution remedies providing a choice of methods as to how, or rather in which manner, the dispute should be resolved. Hence, I made reference to the provision of Article 26 ECT, which stipulates that the parties are obliged to submit to international arbitration under either the ICSID Rules of Arbitration, the SCC Rules or the UNCITRAL Rules.

Finally, I have highlighted the two mechanisms provided by the ECT for the recognition and enforcement of international arbitral awards, namely those provided for by the Washington Convention (also referred to as the ICSID Convention), and the New York Convention respectively. I have concluded my thesis by pointing, in particular, to the peculiarities of the recognition and enforcement of foreign arbitral awards against the Russian Federation.

An overall conclusion that is hinted at throughout this thesis may be summarised as follows: despite the alleged inefficiencies of the Russian internal legal environment, foreign investors can and should expand their participation in the Russian energy sector. This is largely due to the fact that investors’ uncertainties and concerns associated with

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2 This protection is only afforded to investors after they have made an investment and not during the pre-investment stage (such as during a tender).
the development of the newly emerging oil and gas markets are reasonably well remedied by the provision of public international law, and in addition to that, any such uncertainties can be discretely disposed of by the thorough preparation of the contractual documents and careful drafting of the contractual clauses.