INTERNATIONAL CENTRE FOR THE SETTLEMENT OF INVESTMENT DISPUTES

IN THE PROCEEDING BETWEEN

OCCIDENTAL PETROLEUM CORPORATION
OCCIDENTAL EXPLORATION AND PRODUCTION COMPANY
(CLAIMANTS)

- AND -

THE REPUBLIC OF ECUADOR
(RESPONDENT)

(ICSID Case No. ARB/06/11)

AWARD

Members of the Tribunal
Mr. L. Yves Fortier, C.C., Q.C., President
Mr. David A.R. Williams, Q.C., Arbitrator
Professor Brigitte Stern, Arbitrator

Secretary of the Tribunal
Gonzalo Flores

Assistant to the Tribunal (Through 16 December 2011)
Renée Thériault

Representing the Claimants
David W. Rivkin
Marjorie J. Menza
Debevoise & Plimpton LLP

Gaëtan J. Verhoosel
Carmen Martínez López
Covington & Burling LLP

Donald P. de Brier
Laura C. Abrahamson
Occidental Petroleum Corporation

Representing the Respondent
Dr. Diego García Carrión
Procurador General del Estado

George von Mehren
Stephen P. Anway
Squire, Sanders (US) LLP

Eduardo Silva Romero
Pierre Mayer
José Manuel García Represa
Dechert LLP

Date of dispatch to the parties: 5 October 2012

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GLOSSARY

Abbreviation	**Definition**
"AEC"	Alberta Energy Corporation
"BIT" or "Treaty"	Treaty Between the United States of America and the Republic of Ecuador Concerning the Encouragement and Reciprocal Protection of Investment
"DCF"	Discounted Cash Flow
"DNH"	National Hydrocarbons Directorate
"FMV"	Fair Market Value
"HCL"	Hydrocarbons Law
"OCP"	*Oleoducto de Crudos Pesados*
"OEPC"	Occidental Exploration and Production Company
"OPC"	Occidental Petroleum Corporation
"PetroEcuador"	The Republic of Ecuador's national oil company and successor to *Corporación Estatal Petrolera Ecuatoriana* ("CEPE"). Today, *Empresa Pública de Hidrocarburos del Ecuador*.
"RAFs"	Reserve Adjustment Factors
"SOTE"	*Sistema de Oleoducto Trans-ecuatoriano*
"VAT"	Value Added Taxes

THE TRIBUNAL

Composed as above,

After deliberation,

Makes the following Award:

I. PROCEDURE

A. Registration of the Request for Arbitration

1. On 17 May 2006, Occidental Petroleum Corporation ("OPC") and Occidental Exploration and Production Company ("OEPC"), two U.S. companies, (together the "Claimants") incorporated in the States of Delaware and California, respectively, filed with the International Centre for Settlement of Investment Disputes ("ICSID" or the "Centre") a Request for Arbitration under the Convention on the Settlement of Investment Disputes between States and Nationals of Other States ("ICSID Convention') against the Republic of Ecuador ("Ecuador" or the "Respondent") and Empresa Estatal Petróleos del Ecuador ("PetroEcuador").[1]

2. The parties' dispute concerns the termination [*caducidad*] of a 1999 Participation Contract between OEPC and PetroEcuador for the exploration and exploitation of hydrocarbons in Block 15 of the Ecuadorian Amazon region (the "Participation Contract").

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[1] *PetroEcuador* was Ecuador's national oil company and the successor to *Corporación Estatal Petrolera Ecuatoriana* ("CEPE"). By letter to the Centre of 29 September 2006, the Claimants withdrew their claims against PetroEcuador.

3. The Request for Arbitration invoked Ecuador's consent to ICSID arbitration contained in the 1993 Treaty Between the United States of America and the Republic of Ecuador Concerning the Encouragement and Protection of Investments (the "BIT"), and PetroEcuador's consent to ICSID arbitration in the Participation Contract.

4. On 22 May 2006, ICSID acknowledged receipt of the Request for Arbitration and, in accordance with Article 36(1) of the ICSID Convention, transmitted copies of the Request for Arbitration and accompanying documentation to the Republic of Ecuador and PetroEcuador.

5. By letters of 7, 16 and 29 June 2006, ICSID requested additional information from the Claimants. By letters of 13, 23 and 29 June 2006, the Claimants provided information supplementing their Request for Arbitration. Further information was provided by the Claimants by letter of 6 July 2006.

6. On 13 July 2006, the Acting Secretary-General of ICSID, in accordance with Article 36(3) of the ICSID Convention, registered the Request for Arbitration, and notified the parties of the registration under ICSID Case Number ARB/06/11.

7. The Request for Arbitration included (in paragraphs 76 and 77) a Request for Provisional Measures. In accordance with a schedule fixed by ICSID pursuant to Rule 39(5) of ICSID's Rules of Procedure for Arbitration Proceedings (the "ICSID Arbitration Rules"), and later amended with the agreement of the parties, the Claimants filed a particularized Application for Provisional Measures on 18 October 2006. Ecuador then

filed a response to the Claimants' Application on 1 December 2006, followed by the Claimants' Reply of 15 December 2006 and Ecuador's Rejoinder of 30 December 2006.

B. Constitution of the Tribunal and Commencement of the Proceeding

8. By letter dated 29 September 2006, the Claimants informed the Centre that they had selected the method envisaged in Article 37(2)(b) of the ICSID Convention for the constitution of the Tribunal (*i.e.* the Tribunal would consist of three arbitrators, one arbitrator appointed by each party and the third, who would be the president of the Tribunal, to be appointed by agreement of the parties). By same letter, the Claimants informed the Centre of their appointment of Mr. David A.R. Williams, QC, of New Zealand, as an arbitrator. Mr. Williams accepted his appointment on 18 October 2006.

9. On 13 October 2006, the Claimants requested ICSID to appoint the arbitrators not yet appointed and to designate an arbitrator to be the president for of the Tribunal in this case, pursuant to Article 38 of the ICSID Convention and ICSID Arbitration Rule 4(1).

10. By letters of 25 October, 21 November, 1, 12, 13 and 27 December 2006 and 5 January 2007, the Centre consulted with the parties in connection with the appointment of the arbitrators not yet appointed, as envisaged in Article 38 of the ICSID Convention and ICSID Arbitration Rule 4.

11. By letter of 25 January 2007, the Centre informed the parties that, pursuant to Article 38 of the ICSID Convention and ICSID Arbitration Rule 4, the Acting Chairman of ICSID's Administrative Council had appointed Professor Brigitte Stern, a national of France, as a co-arbitrator and Mr. L. Yves Fortier, QC, of Canada, as the third arbitrator

and President of the Tribunal. Professor Stern accepted her appointment on 31 January 2007. Mr. Fortier accepted his appointment on 5 February 2007. At the time of their respective appointments, Professor Stern was a member of the ICSID Panel of Arbitrators appointed by France and Mr. Fortier was a member of the ICSID Panel of Arbitrators appointed by the Chairman of the ICSID Administrative Council.

12. By letter of 6 February 2007, the Secretary-General of ICSID notified the parties that, all three arbitrators having accepted their appointments, the Tribunal was deemed to be constituted and the proceeding deemed to have begun on that date. By the same letter, the Secretary-General provided copies of the declarations of independence and impartiality signed by each member of the Tribunal in accordance with ICSID Arbitration Rule 6 and informed the parties that Ms. Gabriela Álvarez-Ávila, Senior Counsel, ICSID, would serve as Secretary of the Tribunal.

C. Written and Oral Phases of the Proceeding

13. The Tribunal and the parties held a preliminary telephone conference on 16 February 2007, during which it was agreed that the First Session of the Tribunal would be held on 2 May 2007 at the seat of the Centre in Washington, D.C. It was also agreed that a hearing on the Claimants' Application for Provisional Measures would be held on 3 May 2007. The telephone conference was recorded and copies of the audio recordings were provided to the parties and the members of the Tribunal.

14. By letter of 19 February 2007, the parties were invited to simultaneously submit any further documents and/or testimony related to the Claimants' Application for

Provisional Measures that they may wish to rely upon by 20 April 2007. Both parties submitted additional documentation on 18 April 2007.

15. With the agreement of the parties and the members of the Tribunal, the President of the Tribunal held an organizational pre-hearing telephone conference with the parties on 26 April 2007. The conference was attended by Messrs. David W. Rivkin, Mark W. Friedman and Gaëtan Verhoosel from Debevoise & Plimpton LLP and by Ms. Laura C. Abrahamson, Assistant General Counsel of OPC, on behalf of the Claimants; Mr. Paul Reichler and Ms. Janis Brennan, from Foley Hoag LLP, Mr. Alberto Wray, at the time with the law firm of Cabezas & Wray Abogados in Quito, and Ms. Claudia Salgado from Ecuador's *Procuraduría General del Estado* [Ecuador's Attorney General's Office], participated on behalf of the Respondent; Ms. Gabriela Álvarez-Ávila and Messrs. Gonzalo Flores and Emilio Rodriguez-Larraín, from the ICSID Secretariat, and Ms. Renée Thériault, then from the law firm of Ogilvy Renault LLP in Ottawa, Mr. Fortier's law firm, also participated in the conference call. During the conference call, a number of agreements were reached in connection with the organization of the forthcoming First Session and the hearing on the Claimants' Application for Provisional Measures. Among these, the parties agreed to the appointment of Ms. Thériault as Assistant to the Tribunal. The telephone conference was recorded and copies of the audio recordings were provided to the parties and the members of the Tribunal.

16. The First Session of the Tribunal and the hearing on the Claimants' Application for Provisional Measures were held, as scheduled, on 2-3 May 2007 at the seat of the Centre in Washington, D.C. In attendance were the three members of the Tribunal,

Mr. L. Yves Fortier, Professor Brigitte Stern and Mr. David A.R. Williams. In the absence of Ms. Álvarez-Ávila, Mr. Gonzalo Flores, Senior Counsel, ICSID, was in attendance for the ICSID Secretariat. Ms. Renée Thériault, Assistant to the Tribunal, was also present. The Claimants were represented by Messrs. David W. Rivkin, Mark W. Friedman, Shane Spelliscy, Claudio D. Salas and Gaëtan Verhoosel, from Debevoise & Plimpton LLP, and by Ms. Laura Abrahamson and Messrs. Gerald Ellis and Terry Lindquist of OPC. The Respondent was represented by Dr. José Xavier Garaicoa Ortíz, Ecuador's *Procurador General del Estado* [Attorney General], Mr. Alberto Wray of Cabezas & Wray Abogados in Quito, Mr. Paul Reichler, Ms. Janis Brennan and Ms. Clara Brillembourg of Foley Hoag, LLP in Washington, D.C., Ms. Claudia Salgado, of the Office of Ecuador's Attorney General, Ms. María Augusta Carrera from PetroEcuador and Mr. Peter Phaneuf from TrialTek Consulting.

17. During the First Session, the parties confirmed that the Tribunal had been properly constituted in accordance with the ICSID Convention and the ICSID Arbitration Rules and that they had no objection to the appointment of any of the members of the Tribunal. The parties also confirmed their agreement to the appointment of Ms. Renée Thériault, an associate in Mr. Fortier's law firm of Ogilvy Renault, as Assistant to the Tribunal. Finally, the parties agreed to a number of procedural matters which were reflected in summary minutes prepared by the Secretariat and circulated to the parties and the Tribunal. During this session, the parties agreed that the jurisdiction/liability phase and quantum phase (if required) should be separated, but the Claimants requested that the timetable for the quantum phase be fixed at the same time as the liability phase so as avoid unnecessary delay. [A copy of the Minutes is attached to this Award as Annex1].

18. Upon conclusion of the First Session, the parties addressed the Tribunal on the Claimants' Application for Provisional Measures. Messrs. Rivkin and Friedman addressed the Tribunal on behalf of the Claimants and Mr. Reichler addressed the Tribunal on behalf of the Respondent. During the hearing, and following consultations between the parties, the Claimants' Application was significantly amended.

19. In accordance with the schedule fixed during the First Session (slightly amended by the Tribunal, following delays in the parties' production of documents), the Claimants filed a Memorial on Liability, with accompanying documentation, on 23 July 2007. The accompanying documentation included, *inter alia*, the witness statements of Messrs. Andrew Patterson, Casey Olson, Fernando Albuja, Gerald Ellis, John L. Keplinger, Paul MacInnes, and Steven Bell; and the Expert Report of Dr. Hernán Pérez Loose.

20. On 17 August 2007, the Tribunal issued its unanimous Decision on Provisional Measures.[2] In its Decision, the Tribunal, after careful consideration of the parties' positions, concluded that the Claimants had failed to demonstrate that an order for provisional measures was justified in the circumstances and thus dismissed their Application.

21. By letter of 24 August 2007, the parties were informed that Mr. Gonzalo Flores, Senior Counsel, ICSID, would replace Ms. Álvarez-Ávila as Secretary of the Tribunal, following her departure from ICSID.

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[2] Available online at icsid.worldbank.org and attached to the Award as Annex 2.

22. On 17 September 2007, the Claimants filed a Memorial on Damages with accompanying documentation. The accompanying documentation included, *inter alia*, the Second Witness Statements of Messrs. Fernando Albuja, Gerald Ellis, and Andrew Patterson; the Witness Statement of Dr. Surendra Pal (S.P.) Sing; the Expert Reports of Prof. Joseph P. Kalt and Netherland, Sewell & Associates, Inc., and a Second Expert Report of Dr. Hernán Pérez Loose.

23. Successive changes in the Republic of Ecuador's representation led the Respondent to request, on 17 September 2007, a modification to the schedule for written pleadings agreed during the First Session. The Claimants opposed the Respondent's request by letter of 24 September 2007. The Respondent replied by letter of 15 October 2007.

24. On 31 October 2007, with the agreement of his co-arbitrators, the President of the Tribunal held a telephone conference with the parties to address: (a) the Respondent's request for a new procedural calendar and (b) the Respondent's representation in this case. During the call, it was concluded that the procedural timetable established by the Tribunal during the First Session would have to be amended. It was further decided that the parties would confer and try to agree on an amended calendar and that a further telephone conference would be held on 31 January 2008 in order to consider revisions to the procedural calendar. The telephone conference was recorded and copies of the audio recordings were provided to the parties and the members of the Tribunal.

25. By letter of 20 December 2007, the Republic of Ecuador informed the Tribunal that it had selected the law firm of Squire, Sanders & Dempsey LLP as its new counsel of record. The firm is now known as Squire, Sanders (US) LLP.

26. On 23 January 2008, the parties wrote separately to the Tribunal to inform it that they had failed to reach agreement on a revised procedural calendar and, in their respective letters, each party proposed a procedural calendar to the Tribunal.

27. As agreed, a telephone conference call was held between the President of the Tribunal and the parties on 31 January 2008. Ms. Laura Abrahamson from OPC, as well as Mr. David W. Rivkin and Ms. Carmen Martinez López from Debevoise & Plimpton LLP, participated in the teleconference on behalf of the Claimants. The Respondent was represented in the telephone conference by Mr. Carlos Venegas, Ms. Claudia Salgado and Ms. Christel Gaibor, from Ecuador's *Procuraduría General del Estado* and by Messrs. George von Mehren and Stephen P. Anway, from Squire, Sanders (US) LLP. During the telephone conference both parties were given full and equal opportunity to elaborate on their respective submissions of 23 January 2008. The telephone conference was recorded and copies of the audio recordings were provided to the parties and the members of the Tribunal.

28. On 11 February 2008, the Tribunal issued Procedural Order No.1 directing a revised procedural calendar, including a timetable for the jurisdictional phase of the arbitration with separate timetables for each of the liability and quantum phases (as required).

29. Pursuant to Procedural Order No. 1, the Respondent, on 7 March 2008, filed a Memorial on its Objections to Jurisdiction, with accompanying documentation. The accompanying documentation included, *inter alia*, an Expert Report by Dr. Juan Pablo Aguilar Andrade. The Claimants filed a Counter-Memorial on Jurisdiction, with accompanying documentation, on 4 April 2008. The accompanying documentation included, *inter alia*, a Third Expert Report by Dr. Hernán Pérez Loose.

30. By letter of 14 April 2008, the Republic of Ecuador informed the Tribunal that, in addition to Squire, Sanders (US) LLP, the law firm of Dechert LLP would represent the Respondent in this proceeding.

31. Pursuant to Procedural Order No. 1, the Respondent filed a Reply on Jurisdiction, with accompanying documentation, on 23 April 2008. The accompanying documentation included, *inter alia*, a Second Expert Report by Dr. Juan Pablo Aguilar Andrade.

32. By letter dated 28 April 2008, the Republic of Ecuador informed the Tribunal of the appointment of Dr. Diego García Carrión as the new *Procurador General del Estado* [Attorney General], following the resignation of Dr. Xavier Garaicoa Ortíz. In the same letter, the Republic of Ecuador requested amendments to the procedural calendar established in Procedural Order No. 1. The Claimants opposed this request by letter dated 29 April 2008.

33. On 6 May 2008, the Tribunal issued Procedural Order No. 2, amending the calendar established in Procedural Order No. 1.

34. The Claimants filed a Rejoinder on Jurisdiction, with accompanying documentation, on 12 May 2008. The accompanying documentation included, *inter alia*, a Fourth Expert Report by Dr. Hernán Pérez Loose.

35. As directed by Procedural Order No. 1, a two-day hearing on jurisdiction was held at the World Bank's offices in Paris, on 22-23 May 2008. The three members of the Tribunal, Mr. L. Yves Fortier, Professor Brigitte Stern and Mr. David A.R. Williams, attended the hearing. Mr. Gonzalo Flores, Secretary of the Tribunal, and Ms. Renée Thériault, Assistant to the Tribunal, were also present at the hearing. During the hearing, the Claimants were represented by Messrs. Rivkin and Verhoosel and Ms. Martinez López of Debevoise & Plimpton LLP and by Ms. Laura Abrahamson and Mr. Gerald Ellis of OPC. The Republic of Ecuador was represented by Dr. Diego García Carrión, *Procurador General del Estado;* Messrs. Carlos Venegas and Francisco Paredes and Ms. Claudia Salgado, from the Attorney General's office; Messrs. George von Mehren, Stephen P. Anway, Hernando Díaz and Rostislav Pekar of Squire, Sanders (US) LLP; Messrs. Eduardo Silva Romero, Pierre Mayer, George Foster and Edward Kling of Dechert LLP; Dr. Galo Chiriboga, Ecuador's Minister of Energy and Mines; and Dr. María Angélica Martinez, from PetroEcuador.

36. During the hearing, the parties' respective counsel made extensive opening and closing submissions on the various issues raised by the Respondent's jurisdictional challenge. Dr. Juan Pablo Aguilar Andrade and Dr. Hernán Pérez Loose also appeared as expert witnesses at the hearing and were examined by counsel under the control of the Tribunal.

37. On 16 June 2008, in accordance with the procedural calendar amended by the Tribunal in Procedural Order No. 2, the Respondent filed its Counter-Memorial on Liability, with accompanying documentation. The accompanying documentation included, *inter alia*, witness statements of Ministers Pablo Terán and Iván Rodríguez and of Mr. Felipe Sánchez. It also included an Expert Report by Mr. Timothy Martin and a Third Expert report by Dr. Juan Pablo Aguilar Andrade. In accordance with ICSID Arbitration Rule 40, the Respondent's Counter-Memorial also included a Counterclaim.

38. On 11 August 2008, the Claimants filed a Reply on Liability, with accompanying documentation. The accompanying documentation included, *inter alia*, a Fifth Expert Report from Dr. Hernán Pérez Loose; Expert Reports from Messrs. Andrew B. Derman and Norman E. Maryan Jr.; First Witness Statements from Messrs. Derek Aylesworth, Ian Davis and Gary Guidry; Second Witness Statements from Messrs. Steven Bell, John L. Keplinger, Paul MacInnes and Casey Olson; and Third Witness Statements from Messrs. Fernando Albuja, Gerald Ellis and Andrew Patterson. The Claimants' Reply included a Response to the Respondent's Counterclaim.

39. On 9 September 2008, the Tribunal issued its Decision on Jurisdiction. In its Decision, which forms an integral part of the present Award and is attached to it as Annex 3, the Tribunal addressed the two jurisdictional challenges raised by the Republic of Ecuador, namely: (a) that the adjudication of the parties' dispute was governed by the Participation Contract, which excluded *caducidad* from arbitration; and (b) that the Claimants failed to comply with the 6-month cooling-off period required under the BIT. In its conclusions, the Tribunal, unanimously, ruled that (a) "based on elementary

principles of contract interpretation, any exception to the availability of ICSID arbitration for the resolution of disputes arising under the Participation Contract, in this case *caducidad*-related disputes, requires clear language to this effect. Had the parties wished to exclude such disputes from ICSID jurisdiction and confer exclusive jurisdiction to the Ecuadorian administrative courts in this regard, they could have done so. They did not and the Tribunal will not imply such wording in the clause;" and (b) that "the *caducidad* procedure at issue in this arbitration was in fact initiated in 2004. As noted earlier, for some 18 months or so prior to the issuance of the actual *Caducidad* Decree on 15 May 2006, OEPC made a number of submissions seeking to rebut the allegations on the basis of which the *caducidad* procedure was initiated, but to no avail. Furthermore, the Tribunal accepts, albeit without prejudging the merits, that attempts at reaching a negotiated solution were indeed futile in the circumstances."

40. The Tribunal accordingly declared that it had jurisdiction over OEPC's and OPC's claims in this arbitration and that the arbitral proceedings would continue to the merits phase in accordance with the calendar established in the Tribunal's Procedural Order No. 1 as modified by Procedural Order No. 2.

41. On 19 September 2008, the Respondent filed a Rejoinder on Liability, with accompanying documentation, which included, *inter alia*, a Witness Statement from Mr. Ángel Basantes; Second Witness Statements from Ministers Iván Rodríguez and Pablo Terán; a Third Witness Statement from Mr. Wilson Pastor Morris; an Expert Report from Dr. Marcelo Merlo Jaramillo; a Second Expert Report from Mr. Timothy

Martin; and a Fourth Expert Report by Dr. Juan Pablo Aguilar Andrade. The Respondent's Rejoinder included a Reply on its Counterclaim.

42. On 23 September, 10 October and 20 October 2008, the Tribunal issued Procedural Orders No. 3, 4 and 5 concerning production of documents.

43. By letter of 27 October 2008, the Tribunal fixed the venue and dates for a hearing on liability. The hearing would be held at the seat of the Centre in Washington, D.C., from 13 to 20 December 2008.

44. On 14 November 2008, the Claimants filed a Rejoinder to the Respondent's Counterclaim, with accompanying documentation. The accompanying documentation included, *inter alia*, a Sixth Expert Report from Dr. Hernán Pérez Loose; a Second Expert Report from Mr. Andrew B. Derman; a Second Expert Report from Mr. Norman E. Maryan Jr.; and a Fourth Witness Statement from Mr. Gerald Ellis.

45. On 2 December 2008, the Tribunal issued Procedural Order No. 6 concerning the hearing on liability and objections raised by the Respondent to certain sections of the Claimants' Rejoinder to Respondent's Counterclaim.

46. As scheduled, a hearing on liability was held at the seat of the Centre in Washington D.C. from 13 through 20 December 2008. The three members of the Tribunal, Mr. L. Yves Fortier, Professor Brigitte Stern and Mr. David A.R. Williams, attended the hearing. Mr. Gonzalo Flores, Secretary of the Tribunal, and Ms. Renée Thériault, Assistant to the Tribunal, were also present during the hearing.

47. During the hearing, the Claimants were represented by Mr. Donald P. de Brier, Executive Vice-President and General Counsel of Occidental Petroleum Corporation, Ms. Laura Abrahamson, OPC's Assistant General Counsel, Mr. Jaime Alarcón from OPC and Messrs. David W. Rivkin, Gaëtan Verhoosel, Claudio D. Salas, Marco Serrano, Max Drawe and Marshall Weber and Ms. Carmen Martinez López from Debevoise & Plimpton LLP.

48. During the hearing, the Republic of Ecuador was represented by Dr. Diego García Carrión, Ecuador's *Procurador General del Estado*; Messrs. Álvaro Galindo, Francisco Paredes and Luis Alberto Cabezas-Klaere from the office of the Attorney General, Messrs. Eduardo Silva Romero, Pierre Mayer, José Manuel García Represa, George Foster and Bernard Powell, from Dechert LLP, Messrs. George von Mehren, Stephen P. Anway, David Alexander, Pedro Martinez-Fraga and Ms. Ann Catherine Kettlewell, Ms. Karen van Horn and Ms. Danielle Sundberg from Squire, Sanders (US) LLP, Mr. Ronald E. Goodman, from Foley Hoag LLP; Messrs. Andrés Donoso, Francisco Ricaurte and Ms. Triana Vásquez, Ms. Titha Moreno and Dr. María Angélica Martinez, from PetroEcuador.

49. During the hearing, Messrs. Rivkin and Verhoosel addressed the Tribunal on behalf of the Claimants. Messrs. García Carrión, von Mehren, Silva Romero and Mayer addressed the Tribunal on behalf of the Respondent. During the eight-day hearing, the following twenty-one witnesses and experts were examined by counsel, under the control of the Tribunal: Paul McInness, Casey Olson, Steven Bell, Andrew Patterson, Fernando Albuja, John Keplinger, Gary Guidry, Ian Davis, Gerald Ellis, Derek Aylesworth, Pablo

Terán, Luis Felipe Sánchez, Ángel Basantes, Iván Rodriguez, Wilson Pastor Morris, Hernán Pérez Loose, Marcelo Merlo, Juan Pablo Aguilar Andrade, Andrew Derman, Norman Maryan Jr., and Timothy Martin.

50. By letter of the Respondent dated 9 January 2009, the parties informed the Tribunal of their agreement on a briefing schedule for the quantum phase of the proceeding. Pursuant to this agreement, which was confirmed by the Claimants' email of 15 January 2009, the Respondent would file a Counter-Memorial on Quantum on 9 March 2009; the Claimants would file a Reply on Quantum on 12 June 2009; the Respondent would file a Rejoinder on Quantum on 8 September 2009; and the Claimants would file a Rejoinder on Counterclaim Damages on 15 October 2009. Finally, in accordance with the parties' agreement, a hearing on quantum would be held in November 2009. The parties were informed of the Tribunal's approval of the agreed timetable by email from the Secretary of the Tribunal on 16 January 2009.

51. In accordance with the Tribunal's instructions at the closing of the hearing on liability, both parties filed post-hearing briefs, with accompanying documentation, on 13 February 2009. Also in accordance with the Tribunal's instructions, on 26 February 2009, the parties' filed a Joint Chronology of Relevant Events.

52. In accordance with the agreed timetable, on 9 March 2009, the Respondent filed a Counter-Memorial on Quantum and a Memorial on Counterclaim Damages, with accompanying documentation. The accompanying documentation included, *inter alia*, a Witness Statement from Mr. Alberto Panchi; a Fourth Witness Statement from

Mr. Wilson Pastor Morris; and Expert Reports of from Mr. Daniel Johnston, RPS Scotia, Mr. Alfredo Corral Borrero and Mr. Hernán Salgado Pesantes.

53. On 20 and 21 March 2009, the Tribunal held a hearing with the parties at the offices of the World Bank in Paris. The hearing was a continuation of the hearing on liability held in Washington, D.C. in December 2008. The three members of the Tribunal, Mr. L. Yves Fortier, Professor Brigitte Stern and Mr. David A.R. Williams, attended the hearing. Mr. Gonzalo Flores, Secretary of the Tribunal, and Ms. Renée Thériault, Assistant to the Tribunal, were also present at the hearing.

54. During the hearing, the Claimants were represented by Mr. Donald P. de Brier and Ms. Laura Abrahamson from OPC, Messrs. David W. Rivkin, Gaëtan Verhoosel, Marco Serrano and Claudio D. Salas (by video-conference) and Ms. Carmen Martinez López, Ms. Ruth Miller and Ms. Marjorie Menza (by video-conference) from Debevoise & Plimpton LLP. Also present during the hearing was Dr. Hernán Peréz Loose, the Claimants' legal expert.

55. During the hearing, the Republic of Ecuador was represented by Dr. Diego García Carrión, Ecuador's *Procurador General del Estado*; Messrs. Álvaro Galindo and Francisco Paredes and Ms. Claudia Salgado from the Office of Ecuador's Attorney General, Messrs. Eduardo Silva Romero, Pierre Mayer, José Manuel García Represa, George Foster and Ms. Natalia Belomestnova, from Dechert LLP; Messrs. George von Mehren and Stephen P. Anway, from Squire, Sanders (US) LLP; and Dr. Wilson Narvaez and Ms. Triana Vasquez from PetroEcuador.

56. During the hearing, Messrs. Rivkin and Verhoosel addressed the Tribunal on behalf of the Claimants. Messrs. García Carrión, von Mehren, Silva Romero and Mayer addressed the Tribunal on behalf of the Respondent. At the end of the hearing, the President of the Tribunal informed the parties that, while the Tribunal would attempt to issue a decision on liability before the scheduled quantum hearing in November 2009, there were many sizable and important issues to be considered. Therefore, the parties should continue to prepare for the quantum hearing, regardless of whether or not it may be necessary as a result of the decision on liability.

57. By letter dated 4 May 2009, counsel for the Claimants informed the Tribunal that Mr. Gaëtan Verhoosel and Ms. Carmen Martinez López had joined the law firm of Covington and Burling LLP, but that they would continue to form part of the Claimants' representation.

58. On 12 June 2009, the Claimants filed a Reply on Damages and Counter-Memorial on Counterclaim Damages, with accompanying documentation. The accompanying documentation included, *inter alia*, a Fourth Witness Statement from Mr. Fernando Albuja, a Second Witness Statement from Mr. Ian Davis, a Fifth Witness Statement from Mr. Gerald Ellis, a Third Witness Statement from Mr. Paul MacInnes, a Witness Statement from Mr. John W. Morgan, a Fourth Witness Statement from Mr. Andrew Patterson, a Second Witness Statement from Dr. Surendra Singh, a Seventh Expert Report from Dr. Hernán Pérez Loose, a Supplemental Expert Report from Netherland, Sewell & Associates, and a Rebuttal Expert Report from Prof. Joseph P. Kalt.

59. By letter of 11 August 2009, the Respondent objected to the admissibility of some of the Claimants' claims. By letter of 20 August 2009, the Claimants filed observations to the Respondent's objections. On 27 August 2009, the Respondent replied to the Claimants' response. On 28 August 2009, the Claimants filed a rebuttal.

60. On 31 August 2009, the Tribunal issued Procedural Order No. 7 concerning the Respondent's challenge to the admissibility of some of the Claimants' claims.

61. On 8 September 2009, the Respondent filed a Rejoinder on Quantum and Reply on Counterclaim Damages, with accompanying documentation, which included, *inter alia*, a Fifth Witness Statement of Mr. Wilson Pastor Morris; a Second Witness Statement from Mr. Alberto Panchi; a Fifth Expert Report from Dr. Juan Pablo Aguilar Andrade; a Second Expert Report from Mr. Alfredo Corral Borrero; a Rebuttal Expert Report from Mr. Daniel Johnston; a Second Expert Report from Mr. Hernán Salgado Pesantes; and a Rebuttal Expert Report from RPS Scotia.

62. On 21 September 2009, the Tribunal informed the parties by letter that it would not be in a position to issue its findings on liability prior to the hearing on quantum in November 2009. On 2 October 2009, the Tribunal held a pre-hearing telephone conference with the parties. The conference was recorded and copies of the audio recordings were provided to the parties and the members of the Tribunal.

63. On 5 October 2009, the Tribunal issued Procedural Order No. 8 concerning production of documents.

64. On 15 October 2009, the Claimants filed their Rejoinder on Counterclaim Damages, with accompanying documentation.

65. By email of 16 October 2009, the Claimants informed the Tribunal that, as requested during the 2 October 2009 telephone conference, the parties had reached an agreement as to the manner in which to conduct the hearing on quantum.

66. On 29 October 2009, the parties, as requested by the Tribunal, simultaneously filed Pre-Hearing Skeleton Briefs. On 30 and 31 October 2009, both parties filed additional exhibits in respect of the hearing on quantum.

67. On 3-7 November 2009, the Tribunal held a hearing on quantum with the parties at the offices of the World Bank in Paris. The three members of the Tribunal, Mr. L. Yves Fortier, Professor Brigitte Stern and Mr. David A.R. Williams, attended the hearing. Mr. Gonzalo Flores, Secretary of the Tribunal, and Ms. Renée Thériault, Assistant to the Tribunal, were also present at the hearing. At the beginning of the hearing, the Tribunal confirmed that (as the parties had previously been informed), despite sustained deliberations it had not proved possible for the Tribunal to issue its decision on liability prior to the commencement of the quantum hearing. This possibility was foreshadowed at the liability hearing and, as the dates for the quantum hearing had been set for a considerable time, they had decided nevertheless to proceed with the hearing.

68. During the hearing, the Claimants were represented by Mr. Donald P. de Brier, Ms. Laura Abrahamson, Ms. Melissa Schoeb and Mr. Diego Cattani from OPC;

Messrs. David W. Rivkin, Marco Serrano, William Castledine and Claudio D. Salas and Ms. Marjorie Menza and Ms. Ruth Miller from Debevoise & Plimpton LLP; and by Mr. Gaëtan Verhoosel and Ms. Carmen Martinez López of Covington & Burling LLP.

69. During the hearing, the Republic of Ecuador was represented by Dr. Diego García Carrión, Ecuador's *Procurador General del Estado*; Messrs. Álvaro Galindo and Francisco Paredes from the Office of Ecuador's Attorney General; Messrs. Pierre Mayer, Eduardo Silva Romero, José Manuel García Represa, Philip Dunham, José Caicedo Demoulin, Juan Felipe Merizalde Urdaneta, Octavio Fragata Martins de Barros and Mr. Erik Johnston, from Dechert LLP; Messrs. George von Mehren, Howard Nicols, Dave Alexander and Ms. Sarah Rathke and Ms. Karen van Horn from Squire, Sanders (US) LLP; Cptn. Jorge Abarca from PetroEcuador; and Dr. Andrés Donoso from Petroamazonas.

70. During the hearing, Messrs. Rivkin and Verhoosel addressed the Tribunal on behalf of the Claimants. Messrs. García Carrión, von Mehren, Silva Romero, Mayer and Nicols and Ms. Rathke addressed the Tribunal on behalf of the Respondent.

71. During the six-day hearing, the following seventeen witnesses and experts were examined by counsel under the control of the Tribunal: Fernando Albuja, S.P. Singh, John W. Morgan, Paul McInness, Ian Davis (by video-conference), Andrew Patterson, Gerald Ellis, Alberto Panchi, Wilson Pastor Morris, Hernán Pérez Loose, Hernán Salgado Pesantes, Juan Pablo Aguilar Andrade, Alfredo Corral Borrero, Lee George, Gene B. Wiggins, Joseph P. Kalt and Daniel Johnston.

72. On 18 December 2009, in accordance with the Tribunal's instructions, the parties simultaneously filed (a) Post-Hearing Briefs on Quantum and (b) Post-Hearing Briefs on the Impact of Law 42 (HCL Amendment) and the VAT Interpretative Law on Quantum, with accompanying documentation. The Respondent's accompanying documentation included, *inter alia*, a Third Expert Report from Mr. Daniel Johnston.

73. On 22 January 2010, the parties simultaneously filed (a) Reply Post-Hearing Briefs on Quantum and Counterclaim Damages, and (b) Reply Post-Hearing Briefs on the Impact of Law 42 (HCL Amendment) and the VAT Interpretative Law on Quantum, with accompanying documentation.

74. On 4 February 2010, the Tribunal held a second hearing on quantum (closing arguments) at the seat of the Centre in Washington, D.C. The three members of the Tribunal, Mr. L. Yves Fortier, Professor Brigitte Stern and Mr. David A.R. Williams, attended the hearing. Mr. Gonzalo Flores, Secretary of the Tribunal, and Ms. Renée Thériault, Assistant to the Tribunal, were also present at the hearing.

75. During the hearing, the Claimants were represented by Mr. Donald P. de Brier, Ms. Laura Abrahamson and Mr. Gerald Ellis from OPC; Messrs. David W. Rivkin, Marco Serrano and Claudio D. Salas and Ms. Marjorie Menza and Ms. Kimberley Dettman of Debevoise & Plimpton LLP; and by Mr. Gaëtan Verhoosel and Ms. Carmen Martinez López of Covington & Burling LLP.

76. During the hearing, the Republic of Ecuador was represented by Dr. Diego García Carrión, Ecuador's *Procurador General del Estado*, Messrs. Álvaro

Galindo, Francisco Paredes and Felipe Aguilar from the Office of Ecuador's Attorney General, Messrs. Pierre Mayer, Eduardo Silva Romero, José Manuel García Represa, Philip Dunham and José Caicedo Demoulin from Dechert LLP; Messrs. George von Mehren, Howard Nicols and Christopher Panek and Ms. Sarah Rathke and Ms. Rachel Harris from Squire, Sanders (US) LLP, and Messrs. José Murillo and Geovanny Nuñez from PetroEcuador.

77. During the hearing, Messrs. Rivkin and Verhoosel addressed the Tribunal on behalf of the Claimants. Messrs. García Carrión, von Mehren, Silva Romero, Mayer, Nicols and García Represa addressed the Tribunal on behalf of the Respondent.

78. On 15 February 2011, the President of Tribunal wrote to the parties as follows:

> … The Tribunal has reached the point in its deliberations where it requires the assistance of both parties' experts, Mr. Joseph Kalt and Mr. Daniel Johnston, in order to help the Tribunal assess the proper calculation of damages.
>
> Therefore, in accordance with Rule 34 (2) of the ICSID Arbitration Rules, the Tribunal calls upon the parties to produce Messrs. Kalt and Johnston for consultation with the Tribunal at the ICSID's headquarters in Washington at 10.30 a.m. on Wednesday, 27 April 2011. If the parties agree, the Tribunal would wish to consult with the parties' experts alone without the presence of counsel.

79. On 23 February 2011, the President of the Tribunal, in response to the parties' reply to his letter of 15 February 2011, wrote to the parties as follows:

> On behalf of the Tribunal, I acknowledge receipt of the parties' replies the contents of which have been noted.
>
> To be clear, the Tribunal reiterates that its deliberations are continuing. The Tribunal requests the parties to protect the date of 27 April 2011 for consultation with Messrs. Kalt and Johnston. Again, to be clear, this consultation will not take place without the presence of counsel unless both parties agree.

> Finally, the Tribunal notes that both parties request that they be informed of the issues it wishes to discuss with their experts. The Tribunal agrees. This information will be communicated to the parties after the consultation of 27 April 2011 has been definitely confirmed. The parties are invited to confirm by Monday, 7 March 2011, their and the experts' availability on the proposed date…

80. On 11 March 2011, the Tribunal issued Procedural Order No. 9, concerning the production of further expert evidence. In its Order, the Tribunal noted that "[i]n the event the Tribunal, after it concludes the first phase of its deliberations, makes a positive finding of liability, it will be required to determine the fair market value of Block 15 as of 16 May 2006 … [T]o assist the Tribunal in its continuing deliberations, the Tribunal deems it necessary to require the assistance of the parties' experts with respect to certain issues regarding the determination of the fair market value of Block 15 as of 16 May 2006." Accordingly, the Tribunal invited the parties' experts, Professor Kalt and Mr. Johnston, "to confer and produce jointly a report estimating the fair market value of Block 15 as of 16 May 2006, using the discounted cash flow method." The Tribunal further established a procedure for the parties to comment on the experts' joint report and declared the consultation date of 27 April 2011 vacated.

81. As requested by the Tribunal, on 11 April 2011, the parties' experts, Professor Joseph P. Kalt and Mr. Daniel Johnston, issued a Joint Expert Report, which was circulated to the parties and the members of the Tribunal.

82. In accordance with the Tribunal's instructions in Procedural Order No. 9, both parties submitted observations on the Experts' Joint Report on 18 April 2011.

83. On 1 May 2011, the Tribunal informed the parties of its decision to hold a hearing at the seat of the Centre in Washington D.C. with the parties and their experts Professor Kalt and Mr. Johnston.

84. On 13 May 2011, the Tribunal issued Procedural Order No. 10, providing the parties' instructions with respect to the organization of a one-day hearing to be held on 30 June 2011 at the seat of the Centre in Washington D.C. In this Order, the Tribunal requested that Professor Kalt and Mr. Johnston confer again and produce jointly to the Tribunal, by 10 June 2011, a supplemental report addressing the parties' comments. The two experts were asked by the Tribunal to be present at the 30 June hearing to assist the Tribunal and answer questions which may be put to them by the Tribunal.

85. On 10 June 2011, Professor Kalt and Mr. Johnston submitted to the parties and the Tribunal their Supplemental Joint Expert Report. On 17 June 2011, both parties filed observations on the Experts' Supplemental Joint Report, as directed in Procedural Order No. 10.

86. On 20 June 2011, the Tribunal issued Procedural Order No. 11, with further directions to the parties' experts.

87. On 24 June 2011, Professor Kalt and Mr. Johnston, pursuant to the terms of Procedural Order No. 11, submitted to the parties and the Tribunal a Second Supplemental Joint Expert Report.

88. As scheduled, the Tribunal held a one-day hearing at the seat of the Centre in Washington D.C. on 30 June 2011. The three members of the Tribunal, Mr. L. Yves

Fortier, Professor Brigitte Stern and Mr. David A.R. Williams, attended the hearing. Mr. Gonzalo Flores, Secretary of the Tribunal, and Ms. Renée Thériault, Assistant to the Tribunal, were also present at the hearing.

89. During the hearing, the Claimants were represented by Ms. Laura Abrahamson and Messrs. Paul MacInnes and Gerald Ellis from OPC; David W. Rivkin, Greg Senn, Julian S. Manu-Sarbeng, Vonn Ricks and Kirk Monroe and Ms. Marjorie Menza and Ms. Bethany A. Davis Noll of Debevoise & Plimpton LLP. The Claimants' expert, Professor Joseph P. Kalt, Mr. Stephen Makowka and Ms. Nandana Thomas, from Compass Lexecon, were also present during the hearing.

90. During the hearing, the Republic of Ecuador was represented by Dr. Diego García Carrión, Ecuador's *Procurador General del Estado*, Mr. Francisco Grijalva, Ms. Christel Gaibor and Ms. Gianina Osejo from the Office of Ecuador's Attorney General; Messrs. George von Mehren, Howard Nicols and Ms. Rachel Harris from Squire, Sanders (US) LLP; Messrs. Eduardo Silva Romero, Philip Dunham and Álvaro Galindo from Dechert LLP. The Respondent's expert, Mr. Daniel Johnston, as well as Messrs. Erick Johnston and René Daigre were also present during the hearing.

91. At the beginning of the hearing, the President of the Tribunal made the following statement:[3]

> As the parties will recall, on 15 February 2011, the tribunal informed the parties that it had reached the point in its deliberations both as to liability and

[3] Hearing Transcript (30 June 2011) at pages 11-12.

> quantum where it required the assistance of both parties' respective quantum experts, Professor Joseph Kalt and Mr. Daniel Johnston. More specifically, the tribunal stated that, in the event, after it concludes the first phase of its deliberations, it should make a positive finding of liability, it will be required to determine the fair market value of Block 15 as of 16 May 2006. If it decided -- if it decided to use the discounted cash flow method in order to estimate this value, the tribunal formed the view that Professor Kalt and Mr. Johnston, who had given evidence earlier on the use of that method, could answer certain specific questions and help it with certain calculations.

During the hearing, the members of the Tribunal posed questions to the parties' experts and counsel.

92. On 6 October 2011, the President of the Tribunal wrote, on behalf of the Tribunal, to the parties as follows:

> Members of the Tribunal continue their intense deliberations. The Tribunal regrets that its decision has taken longer to finalize than it would have wished. However, the parties have submitted to the Tribunal, in their extensive written and oral submissions, a myriad of factual and legal issues which all need to be analyzed and determined. The Tribunal is confident that its deliberations will end soon and a decision issued shortly thereafter.
>
> In recent days, the Tribunal has been addressing an issue which, in its view, neither party has dealt with comprehensively in its prior submissions. The issue concerns the interpretation of the Farmout Agreement and the Joint Operating Agreement.
>
> The Respondent submits […] that the calculation of damages (if any) to be awarded to the Claimants in the circumstances must be limited to a 60% interest in Block 15 because of the transfer by the Claimants to AEC under the terms of the Farmout Agreement of 40% of their interest under the Participation Contract. The Claimants do not accept the Respondent's contention […]
>
> The governing law clause of the Farmout Agreement provides:
>
>> This Agreement shall be governed by and construed, interpreted and applied in accordance with the laws of the State of New York, United States of America, excluding any choice of law rules or conflict of law principles which would refer the matter to the laws of another jurisdiction, except to the extent that the laws of Ecuador require application of the laws of Ecuador to the Participating Agreements and Block 15 or other property situated in or operations or activities conducted in Ecuador.

> The Tribunal notes that the Claimants argued that the transfer of the "economic interest" to AEC would not be considered an assignment under New York law and that, as a result, the non-assignment clause in Article 16(1) of the Participation Contract was not breached […] . Accordingly, the Claimants did not analyze the effect and validity of an assignment, (assuming an assignment had indeed occurred as a result of the Farmout Agreement and the Joint Operating Agreement), in breach of Article 16(1) of the Participation Contract and Article 79 of the Hydrocarbons Law. In addition, the Claimants did not analyze Ecuadorian and New York law in this regard. The Tribunal further notes that the Respondent argued that New York law is irrelevant to the issue of whether an assignment under the Farmout Agreement and the Joint Operating Agreement (if any) is in breach of Ecuadorian law (Counter-Memorial on Liability, para 185).
>
> In sum, neither party, in their quantum submissions, referred to the effect of Article 79 of the Hydrocarbons Law or Article 16(1) of the Participation Contract on the assumption that an assignment of rights occurred as a result of the Farmout Agreement and the Joint Operating Agreement.
>
> The Tribunal now invites the parties to assume that an assignment of rights did occur as a result of the Farmout Agreement and the Joint Operating Agreement. On the basis of this assumption, the parties are requested to undertake a detailed analysis of the effect of an assignment of rights made under a contract governed by New York law (i.e. the Farmout Agreement and the Joint Operating Agreement) in violation of a non-assignment clause set forth in a contract governed by Ecuadorian law (i.e. Article 16(1) of the Participation Contract) and in violation of Article 79 of the Hydrocarbons Law. The parties are further requested to address both New York law and Ecuadorian law and to make submissions accordingly, even if one or both parties may consider that, for any reason, New York law and/or Ecuadorian law may not be relevant to the determination of the effect of the Farmout Agreement and the Joint Operating Agreement.
>
> The parties' submissions will be exchanged simultaneously and submitted to the Tribunal within 28 days from this date. The Tribunal will then decide whether reply briefs are necessary.
>
> While the parties may refer to new legal authorities with their respective submissions, they may not file any document which is not already in the record.

93. On 3 November 2011, the parties simultaneously filed briefs in response to the Tribunal's directions of 6 October 2011. As directed by the Tribunal, the parties filed simultaneously reply briefs on 22 November 2011.

94. On 16 December 2011, Ms. Thériault, the assistant to the Tribunal, left the successor law firm to Ogilvy Renault, Norton Rose OR, and thus ceased her functions.

95. On 23 February 2012, the President of the Tribunal wrote, on behalf of the Tribunal, to the parties as follows:

> …Members of the Tribunal have now conferred on whether to schedule a hearing in person, as requested by the Respondent, in order to address orally the issues raised by the Tribunal in its communication of 6 October 2011 to the parties and then briefed extensively by them in the submissions of 3 and 22 November 2011.
>
> While the Tribunal remains of the view that a hearing is not necessary, it notes that the Claimants, in their communication of 20 February, stated that they had no objection to a hearing. In the circumstances, the Tribunal has decided to accede to the Respondent's request and schedule peremptorily a hearing in London on Thursday 12 April 2012. The Hearing will commence at 10 a.m. and end at 5 p.m.
>
> The parties are invited to confer and agree a timetable for the hearing which they will communicate to the Tribunal by 23 March 2012.
>
> The parties are put on notice now that, immediately after the hearing of 12 April, the Tribunal will declare the proceeding closed in accordance with ICSID Arbitration Rule 38.

96. In accordance with the Tribunal's directions, a hearing with the parties was held in London, United Kingdom on 12 April 2012. The three members of the Tribunal, Mr. L. Yves Fortier, Professor Brigitte Stern and Mr. David A.R. Williams, attended the hearing. Mr. Gonzalo Flores, Secretary of the Tribunal was also present at the hearing.

97. During the hearing, the Claimants were represented by Mr. Donald P. de Brier, Ms. Laura Abrahamson, Mr. Michael L. Preston and Mr. Gerald Ellis from OPC; Messrs. David W. Rivkin and Ms. Marjorie Menza of Debevoise & Plimpton LLP; Messrs. Gaëtan Verhoosel and James O'Shea and Ms. Carmen Martinez López of Covington & Burling, LLP.

98. During the hearing, the Republic of Ecuador was represented by Dr. Diego García Carrión, Ecuador's *Procurador General del Estado*, Ms. Christel Gaibor and Ms. Gianina Osejo from the Office of Ecuador's Attorney General; Messrs. George von Mehren, and Stephen P. Anway from Squire, Sanders (US) LLP.; Messrs. Eduardo Silva Romero and Pierre Mayer and Ms. Audrey Caminades from Dechert LLP; and H.E. Ambassador Ana Albán, Ecuador's Ambassador to the United Kingdom.

99. During the hearing, Messrs. Rivkin and Verhoosel addressed the Tribunal on behalf of the Claimants. Dr. García Carrión and Messrs. von Mehren, Anway, Silva Romero and Mayer addressed the Tribunal on behalf of the Respondent.

100. At the end of the hearing, the President of the Tribunal, in accordance with ICSID Arbitration Rule 38(1), declared the proceedings closed and invited the parties to submit statements of the costs incurred by them in the conduct of these proceedings.

101. In accordance with the Tribunal's instructions, the parties simultaneously filed their Statements of Costs and Fees on 30 April 2012 (revised by Respondent on July 9, 2012 and by Claimants on July 16, 2012).

102. As the procedural history of this case makes abundantly clear, this proceeding has been very lengthy. In fact, the procedural history of this arbitration set out above is not meant to be exhaustive. From the outset, the parties have raised a myriad of legal and factual issues pertaining to provisional measures, jurisdiction, merits and liability. In addition, the Tribunal, throughout this arbitral proceeding, has been required to address numerous procedural requests and applications, all of which were extensively and

diligently briefed by the parties, resulting in literally thousands of pages of submissions and exhibits. The Tribunal considers it unnecessary to describe these submissions beyond the account set forth above.

103. As has been seen, the Tribunal has issued a 47 page Decision on the Claimants' Application for Provisional Measures, a 44 page Decision on Jurisdiction and 11 important Procedural Orders. The Claimants have submitted 32 statements by 14 witnesses and 15 reports by 5 experts. For its part, the Respondent has submitted 18 statements by 11 witnesses and 17 reports by 7 experts. The Claimants have filed 662 exhibits and 667 legal authorities and the Respondent has filed 379 exhibits and 368 legal authorities. In all, there have been 9 hearings, comprising 22 days, since the First Session of the Tribunal on 2 May 2007. The many written submissions of the Claimants consist of 2,226 pages and the written submissions of the Respondent 1,964 pages. The transcripts of all proceedings consist of 5,291 pages.

104. The Tribunal wishes to acknowledge the dedication and professionalism of counsel for both the Claimants and the Respondent who have assisted the Tribunal throughout this arbitration.

II. FACTUAL BACKGROUND

A. Introduction

105. This proceeding concerns various alleged breaches by Ecuador under both domestic and international law, especially under the Treaty Between the United States of America and the Republic of Ecuador Concerning the Encouragement and Reciprocal

Protection of Investment (the "Treaty" or "BIT"). In addition, the Claimants rely on an agreement referred to as the "Participation Contract" dated 21 May 1999 between OEPC, Ecuador and Petroecuador in connection with the exploration and exploitation of hydrocarbons in what has been identified as "Block 15" of the Ecuadorian Amazon. The *caducidad* of the Participation Contract was declared by decree of the Ecuadorian Minister of Energy and Mines on 15 May 2006, resulting in termination of the Participation Contract.

106. By way of introduction, the Tribunal recalls that the relief sought by the Claimants in their Request for Arbitration is set forth as follows:

> Claimants respectfully request an award in their favor,
>
> (a) Declaring that Respondents have breached their obligations under the Participation Contract and the Operating Agreements, the Treaty, and Ecuadorian and international law;
>
> (b) Ordering Respondents to declare null and void the *Caducidad* Decree and to reinstate fully OEPC's rights under the Participation Contract and the Operating Agreements;
>
> (c) Directing Respondents to indemnify Claimants for all damages caused as a result of their breaches, including costs and expenses of this proceeding, in amounts to be determined at the hearing, which Claimants believe will exceed US$1 billion;
>
> (d) Directing Respondents to pay Claimants interest on all sums awarded, in amounts to be determined at the hearing, and to order any such further relief as may be available and appropriate in the circumstances.

107. The Tribunal further recalls that, in response, the Respondent has denied the Claimants' allegations of breach and formulated a counterclaim as follows:

> Ecuador respectfully requests that the Tribunal:

1. Declare that Ecuador has complied with its obligations under the Participation Contract, Ecuadorian law, and the Treaty, and dismiss all of the Claimants' claims without prejudice.

2. Declare that OEPC breached the Participation Contract by using diplomatic channels and making recourse to the U.S. Government in connection with disputes arising out of or relating to the performance of the Participation Contract in contravention of Clause 22.2.1.

3. Declare that OEPC's claims in this arbitration were not made in good faith, and to the contrary, were asserted either negligently or with the intent to cause harm to Ecuador, and did in fact cause such harm.

4. Declare that Ecuador suffered damages from OEPC's breaches of contract, malicious prosecution/abuse of rights, destruction of Block 15's operation, and failure to pay assignment fees, and order OEPC to pay such damages in an amount subject to proof;

5. Order the Claimants to pay interest on such amount at the legal rate;

6. Order the Claimants to pay the costs of this arbitration, including all costs paid to ICSID and to the Tribunal, plus Ecuador's attorneys' fees and disbursements, as well as interest on the foregoing.

108. In order to fully understand the Tribunal's analysis and findings on liability, it is necessary to set out at some length the factual matrix disclosed by the written and oral evidence presented by the parties during this arbitration. The Tribunal will now proceed to do so.

B. OEPC's Development and Operation of Ecuador's Block 15

109. The area of land in Ecuador known as Block 15 covers approximately 200,000 hectares and is located several hundred kilometres east of Quito in Ecuador's most prolific oil-producing region, known as the Oriente Basin, deep in the Ecuadorian Amazon rainforest.

110. Block 15 includes, in the western part, the producing fields of Limoncocha, Yanaquincha, and the Indillana Complex, and in the eastern part, the Edén Yuturi field.

The Limoncocha and Edén Yuturi fields are located partially within, and partially outside Block 15. They straddle the border between Block 15 and properties managed by Petroproducción, the operating subsidiary of Petroecuador. Under Ecuador's Hydrocarbons Law (the "HCL"), fields such as these, once declared to be common to both a contractor and Petroecuador by the Minister of Energy and Mines, must be "unitized" and run jointly by the contractor and Petroproducción pursuant to unitized field agreements.

111. OEPC's presence in Ecuador began on 25 January 1985, when it entered into a services contract with the *Corporación Estatal Petrolera Ecuatoriana* (now Petroecuador).[4] Pursuant to that contract, OEPC provided services related to the exploration and production of oil in Block 15 (the "Services Contract").

112. Under the terms of the Services Contract, OEPC provided 100% of the services required to produce oil in Block 15, ranging from identifying possible deposits through exploration to producing the oil out of the ground. If OEPC discovered oil, it was reimbursed for its costs and investments pursuant to various conditions and formulas in the contract. However, 100% of the crude oil produced belonged to Petroecuador.

113. At the time the Services Contract was signed, Block 15 remained relatively unexplored. Hence, OEPC's initial focus in the block was on identifying possible reserves for exploitation. After eight years of exploration, OEPC began production from Block 15 in 1993. In May 1993, OEPC and Petroecuador also signed a unitized field

[4] Today, *Empresa Pública de Hidrocarburos del Ecuador*.

agreement for the joint operation of the Limoncocha field. That unitized field agreement was set to expire as soon as the Services Contract expired.

C. The Participation Contract

114. In 1993, Ecuador amended its HCL to allow the negotiation of "participation contracts." At its core, a participation contract is essentially a type of production sharing agreement: the State and contractors share in the production of crude oil, with all expenditures borne by the contractor. This contractual model gave producers a stake in the production that made exploration risks more palatable. Further, it guaranteed Ecuador a profit from its production share, since it no longer had any expenses associated with oil production.

115. OEPC and Ecuador began the negotiation of their participation contract in January 1997. The negotiations took nearly two years, and the Participation Contract was finally signed on 21 May 1999 (the previously-defined "Participation Contract"). According to Clause 1, the contracting parties were the "Republic of Ecuador, through [...] Petroecuador [...] [and] Occidental Exploration and Production Company, Ecuador Branch." Pursuant to Clause 6.1 of the Participation Contract, OEPC had the right to develop and to exploit the Indillana Complex, known as the Base Area in the Contract, until 2012, and other fields from which production began after the signing of the Participation Contract, such as the Edén Yuturi and Yanaquincha fields and potentially the Paka Sur and Paka Norte fields, until 2019.

116. The Participation Contract, which expressly stated that it was to be "governed exclusively by Ecuadorian law," transformed the conditions under which OEPC operated

in Ecuador. Pursuant to Clause 4.2 of the Participation Contract, OEPC would no longer be reimbursed for its expenditures in exploring and producing Block 15. In return for accepting the obligation to explore, develop and exploit Block 15, and being responsible for all the associated expenditures, OEPC received a share of the oil produced from Block 15, referred to as OEPC's "participation". Clause 4.3 provided that "Contractor shall invest capital and use the personnel, equipment, machinery and technology needed for the faithful performance of such activities in consideration of which Contractor shall receive, as participation, the percentage of Fiscalized Production provided for in Clause 8.1." OEPC also had various other obligations under the Participation Contract, including payment of all Ecuadorian taxes and duties; periodic reporting of certain information to Ecuador; the establishment of good relations with the community; and the protection of the environment.

117. The amount of OEPC's participation was determined on the basis of the equation described in the above-referred Clause 8.1. That equation took into account several factors, including the field, the rate of production, and certain agreed-upon percentages. At the end of 2005, OEPC's participation was approximately 70% of the oil produced from Block 15. After payment of expenses, taxes and other assessments, however, between 1999 and 2006, OEPC allegedly received approximately 30% of total net profits.

118. Clause 8.5 established Ecuador's participation in the oil produced from Block 15. That participation was calculated as the balance of the oil produced from Block 15 over and above OEPC's participation. Pursuant to Clause 5.1.2, OEPC was obligated to

"[t]ransfer to Petroecuador the State Participation at the Fiscalization and Delivery Center."

119. The Tribunal notes, since this provision will be referred to later in the present Award, that OEPC was allowed to dispose freely of its share of the production from Block 15 as it wished. Under Clause 5.3.2, OEPC had the right to "[r]eceive and freely dispose of Contractor participation as established in Clause 8.1 of this Participation Contract." While OEPC could freely dispose of its participation, its ability to transfer or assign its rights and obligations under the Participation Contract was subject to stringent conditions. Chapter 16 of the Participation Contract, entitled "Transfer and Assignment", sets forth these conditions in provisions which are at the heart of the parties' dispute in this arbitration. These provisions, which are considered in greater detail later in this Award, include the following:

> **16.1** Transfer of this Participation Contract or assignment to third parties of the rights under the Participation Contract, must have the authorization of the Corresponding Ministry, in accordance with existing laws and regulations, especially the provisions contained in Art. 79 of the Hydrocarbons Law and Executive Decrees No. 809, 2713 and 1179.
>
> **16.2** The prohibition to transfer or assign rights under this Participation Contract without the approval of the Corresponding Ministry, as determined in Art. 79 of the Hydrocarbons Law, is not an obstacle to freely trade Contractor's stock, without need of said authorization, provided that the trading of said stock does not change, modify or extinguish the legal existence of Contractor, nor constitute a decrease in its administrative, financial and technical capacities with reference to this Participation Contract.
>
> […]
>
> **16.4** If Contractor deems it advisable to create consortia or associations for one or several exploration and exploitation activities covered by this Participation Contract, Contractor may do so with the prior acceptance of PETROECUADOR and authorization from the Corresponding Ministry. Contractor's obligations shall continue to exist in their parts, and the companies forming the consortium or

> association shall be jointly and severally liable for performance of same; and for such purpose shall furnish the corresponding guarantees. A joint and several commitment shall constitute an indispensable requirement for PETROECUADOR to accept the creation of the aforementioned consortia or associations. PETROECUADOR shall continue to maintain its direct legal relations with Contractor, to demand compliance with all obligations, and to pay the agreed participation percentages.
>
> **16.5** The integration of such consortia or associations, or the withdrawal of Contractor from same, without the authorization of the Corresponding Ministry, shall constitute legal grounds for declaring the termination of this Participation Contract.
>
> […]

120. The Tribunal also notes that these provisions were mirrored in the "Termination and Forfeiture [*Caducidad*]" provisions of the Participation Contract, which stated that "[t]his Participation Contract shall terminate," *inter alia*, as follows:

> **21.1.1** By a declaration of forfeiture [*caducidad*] issued by the Corresponding Ministry for the causes and following the procedure established in Articles seventy four (74), seventy five (75) and seventy six (76) of the Hydrocarbons Law, insofar as applicable.
>
> **21.1.2** Due to a transfer of rights and obligations of the Participation Contract without prior authorization from the Corresponding Ministry.
>
> […]
>
> **21.3** For the purposes of forfeiture and penalties, the provisions of Chapter IX of the Hydrocarbons Law shall be applicable.

121. At this juncture, the Tribunal also observes that these provisions of the Participation Contract refer to many of the provisions of Ecuador's HCL[5], in particular the following:

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[5] As per the parties' agreed translation of the HCL in effect on 15 May 2006.

CHAPTER IX
Caducidad, Sanctions and Transfers

Art. 74. The Ministry of Energy and Mines may declare the *caducidad* of contracts, if the contractor:

[…]

11. Transfers rights or enters into a private contract or agreement for the assignment of one or more of its rights, without the Ministry's authorization;

12. Forms consortia or associations for exploration and exploitation operations, or withdraws from them, without the Ministry's authorization; and,

13. Commits repeat violations of the Law and the regulations thereto.

Art. 75. The declaration of *caducidad* of a contract implies the immediate return to the State of the contracted areas, and the delivery of all equipment, machinery and other exploration or production items, industrial or transportation installations, at no cost to PETROECUADOR and, also in addition, the automatic loss of bonds and securities provided under the Law and the contract, which shall remain to the benefit of the State.

Art. 76. Before *caducidad* of a contract is declared, the Ministry of Energy and Mines shall notify the contractor, providing it not less than thirty and not more than sixty days from the date of the notification, to perform its unmet obligations or dismiss the charges.

Art. 77. A breach of contract that does not cause *caducidad* effects or a violation of the Law or Regulations shall be punished with a fine imposed by the National Hydrocarbons Director, of two hundred to three thousand United States Dollars, depending on the seriousness of the violation, in addition to compensation for the damages caused.

[…]

Art. 79. The transfer of a contract or the assignment to third parties of rights derived from a contract shall be null and void and shall have no validity whatsoever if there is no prior authorization from the Ministry of Energy and Mines, without prejudice to the declaration of *caducidad* as provided for in this Law.

The State shall receive a premium for the transfer and the beneficiary company shall enter into a new contract under more favourable economic conditions for the State and for PETROECUADOR than the ones contained in the original contract.

As will become apparent, the provisions of Article 74(11) and Article 79 are of central importance in this case.

D. The Unitized Fields Joint Operating Agreements

122. During the negotiation of the Participation Contract, OEPC sought to conclude an overall agreement that would allow it to receive the full benefits of operating Block 15. Thus, on the same day that the Participation Contract was signed, OEPC and Petroproducción also signed joint operating agreements for the unitized exploitation of the common reservoirs in both the Edén Yuturi and Limoncocha fields (the "Unitized Fields Joint Operating Agreements").

123. Pursuant to Clause 3.3 of the Unitized Fields Joint Operating Agreements, OEPC and Petroproducción agreed that "[t]o obtain greater efficiency and economy in the operation, [...] the management of the Unitized Field shall be treated as part of the management of Block 15. Therefore, the same rights and obligations of the Parties under the Participation Contract, in whatever is pertinent, shall be applicable to this Operational Agreement."

124. There was one significant change to the terms of the Participation Contract with respect to these unitized fields. For the Limoncocha and Edén Yuturi fields, OEPC was not deemed the sole operator. Rather, unlike Clause 4.2 of the Participation Contract, which gave OEPC the "exclusive right" to develop and to produce from Block 15, Clause 5.1 of the Unitized Fields Joint Operating Agreements provided that "[u]nder the scheme of Joint Management, Contractor and PETROPRODUCCION constitute the Operator for the Unitized Field[s], starting on the Effective Date of this Operational Agreement."

125. This joint operatorship was achieved through the establishment of a joint operating committee (the "Unitized Fields Committee"), which was the executive body charged with managing the joint operation of the Limoncocha and Edén Yuturi fields. Among other things, the Unitized Fields Committee approved the budgets and development plans, and was informed of the daily operations in the unitized fields.

126. The Tribunal observes that when the Participation Contract and the Unitized Fields Joint Operating Agreements were signed in 1999, OEPC was producing approximately 28,000 barrels per day from Block 15. After the signature of these agreements, OEPC began a significant capital expenditure program in Block 15 and allegedly increased daily production from Block 15 from approximately 28,000 barrels per day to over 100,000 barrels per day, a level of production it maintained through 2006. Production from the Edén Yuturi field allegedly accounted for the majority of this increase. During this period, the field was thus brought from being entirely undeveloped to producing 70% of the oil produced from Block 15.

E. The Farmout with AEC

127. In order to finance the expansion of its operations in Ecuador, OEPC sought an arrangement that could provide the necessary funds, as well as diversify and reduce its exposure. At the same time, Alberta Energy Corporation Ltd. ("AEC"), through the related entity AEC International ("AECI" or "AEC"), was looking to expand its investments in Ecuador. AEC had originally considered purchasing outright Block 15 from OEPC in 1999, together with two unrelated companies, City Investing and City Oriente, which operated blocks to the north of Block 15. However, while it did purchase

the City companies that year, it did not approach OEPC about a purchase of Block 15 until 2000. On 15 May 2000, AEC made a formal proposal to OEPC to acquire OEPC's entire interest in Block 15. OEPC rejected AEC's proposal.

128. AEC then proposed to "farmin" to Block 15. OEPC stated to the Tribunal that a farmout agreement with AEC was an attractive alternative because it allowed OEPC to continue to invest in Block 15 but with less of its own capital and to diversify its in-country risk. The negotiations led to the signing on 9 August 2000 of a Letter of Intent which described in some detail (at paragraph 1) the proposed farmout as a two-stage transaction as follows:

> 1. **PROPOSED FARMIN TRANSACTION**
>
> AEC International a Business Unit of Alberta Energy Company Ltd., or its designated direct or indirect wholly owned subsidiary (collectively hereinafter referred to as "AECI"), would acquire a 40% economic interest in Block 15 by farming it to OEPC's interest as follows (the "Farmin Transaction").
>
> (a) AECI would farmin to Block 15 to acquire a 40% economic interest in Block 15 from OEPC. The economic interest would be a "working interest" or "participating interest" except that it would not include nominal legal title to Block 15 or interest as a party to the Participation Contract. While OEPC would continue to own 100% of the legal title of the participating interest in Block 15 under the Participation Contract, OEPC would hold AECI's 40% economic interest as a "nominee" or "bare trustee" with the obligation to convey legal title, subject to government approvals, at a mutually agreeable time following AECI's payment of all amounts required to earn its interest. Prior to such conveyance, while OEPC holds AECI's interest in trust, OEPC shall be obligated to represent the interest of AECI, as if AECI were a participant with a 40% interest under the terms of a standard joint operating agreement to be mutually agreed. After such acquisition, the economic interests associated with Block 15 would be shared as follows (subject to paragraph (b) below):
>
> | | |
> |---|---|
> | OEPC | 60% |
> | AECI | 40% |

(b) AECI would earn its 40% economic interest by paying a total of U.S. $180 million (subject to increase as described below) towards OEPC's share of Block 15 exploration and development expenditures. This U.S. $180 million shall be paid as U.S. $70 million as described in Clause 1(c) below, plus 90% of OEPC's 60% share (the "OEPC Carry") of: (A) the total capital expenditures to be incurred in connection with the development of Block 15, including, without limitation, costs associated with the construction of ancillary pipelines or facilities related to Block 15 crude oil production and (B) costs otherwise properly incurred under the Participation Contract for drilling, exploration or exploitation (collectively, "Block 15 Capex"), for the calendar years as set forth below (each, an "Annual Carry Amount"), pursuant to the following schedule:

Calendar Year	Annual Carry Amount
2001	US$50 million
2002	US$25 million
2003	US$20 million
2004	US$15 million

For each calendar year set forth above (each, a "Year") AECI shall pay its 40% share of Block 15 Capex plus the Annual Carry Amount to satisfy the OEPC Carry, and the Annual Carry Amount shall constitute a cap on AECI's obligation to pay the OEPC Carry; provided that:

(i) if AECI satisfies the OEPC Carry for any Year, then additional Block 15 Capex for such Year, shall be shared among OEPC and AECI as set forth in paragraph (a) above;

(ii) if the amount of the OEPC Carry for any Year except 2004 is less than the Annual Carry Amount for such Year, then AECI shall add 110% of the shortfall amount (the "Carry Over Amount") to the Annual Carry Amount for the following Year, thereby increasing the Annual Carry Amount for the following Year; and

(iii) if the amount of the OEPC Carry for 2004 is less than the Annual Carry Amount for such Year, then AECI shall pay to OEPC, on or before January 31, 2005, an amount equal to the shortfall amount as an advance by AECI to OEPC of OEPC's 60% share of Block 15 Capex to be incurred thereafter. AECI and OEPC shall each act in good faith and use reasonable efforts to conduct development, drilling, exploration and exploitation operations on Block 15 so as to minimize the shortfall amount for 2004.

(c) AECI shall pay to OEPC, on the Closing Date, as hereinafter defined, the sum of U.S. $70 million as an advance by AECI to OEPC of OEPC's 60% share of Block 15 Capex incurred after the Effective Date, as hereinafter defined, in excess of the OEPC Carry. Notwithstanding OEPC's obligation ultimately to use this U.S. $70 million and any shortfall amount payable to OEPC pursuant to Clause 1(b)(iii) above for its 60% share of Block 15 Capex, nothing herein shall prohibit, limit, or otherwise restrict OEPC, in the meanwhile, from loaning all or any portion of such U.S. $70 million and/or such shortfall amount to one or more of its affiliates, at a reasonable fair market interest, with such interest to be for OEPC's account and used to pay OEPC's Block 15 Capex incurred after the Effective Date in excess of OEPC Carry.

(d) The effective date of the proposed Farmin Transaction shall be August 1, 2000 (the "Effective Date"), and the closing date shall be at a time and date mutually agreed by the Parties and as soon thereafter as practicable (the "Closing Date"), subject to satisfaction or waiver of the conditions set forth in Section 5 of this letter. On the Closing Date AECI shall acquire, effective as of the Effective Date, a 40% economic interest in Block 15 and 40% of OEPC's (or its affiliate's, as the case may be) interest, if any, in the OCP Pipeline Project.

(e) Each of Alberta Energy Company Ltd. and Occidental Oil and Gas Corporations will cause their respective subsidiaries to perform their obligations under the Transaction Documents (as defined below).

(f) OEPC will be the Operator under the Joint Operating Agreement.

129. Negotiations continued through the late summer and early fall. On 19 October 2000, the parties signed the Farmout Agreement (the "Farmout" or "Farmout Agreement"), which contained the terms originally outlined in the Letter of Intent. The parties also signed an operating agreement for the purpose of implementing the Farmout (the "Joint Operating Agreement" or "JOA" and, together with the Farmout Agreement, the "Farmout Agreements"). The parties did not, however, close the deal until 31 October 2000. The contract was made retroactive to 1 October 2000, *i.e.* the beginning of the fourth quarter.

130. The Farmout, an agreement governed by the laws of New York, provided for two phases. In the first phase of the transaction AEC purchased a 40% so-called "economic interest" in Block 15. Essentially, through contributions to OEPC's Block 15 investments, AEC purchased the right to 40% of OEPC's share of Block 15's production. This stage of the Farmout was described in Article II, titled "Farmout of Interest in Farmout Property". The central provisions of Article II of the Farmout provided as follows:

> Art. 2.01 Effective as of the Effective Time, and subject to obtaining required governmental approvals, if any, OEPC agrees at Closing (as defined in Section 2.06) to farm out and transfer to AECI, and AECI agrees at Closing to assume all obligations that originate, accrue or arise after the Effective Time with respect to, a 40% economic interest (the "Farmout Interest") in the Farmout Property, subject, however, to payment by AECI of the amounts required to earn such interest as hereinafter provided and subject to the terms and provisions set out hereinafter. The Farmout Interest to be transferred to AECI as of the Effective Time includes a "working interest" or "participating interest" in the Participating Agreements and Block 15 except that it does not include nominal legal title to an interest in Block 15 or an interest as a party to the Participating Agreements. OEPC shall continue to own 100% of the legal title to the Participating Agreements and to the interests in Block 15 granted or provided for in the Participating Agreements; provided that from and after the Effective Time OEPC shall hold legal title to the interest in the Farmout Property represented by the Farmout Interest of AECI in the Participating Agreements and Block 15 as a "nominee" with the obligation to convey legal title to such interest to AECI, subject to obtaining required governmental approvals, promptly following AECI's payment of all amounts required to earn the interest in the Farmout Property represented by the Farmout Interest as hereafter provided and the expenditure of such amounts by OEPC as Operator under the JOA for Block 15 Capex (as hereinafter defined). Prior to such conveyance, while OEPC holds legal title to AECI's interest in the Farmout Property on behalf of AECI, OEPC shall be obligated, at the sole risk, cost and expense of AECI, to act with respect to the Farmout Interest of AECI as AECI shall direct from time to time as if AECI were a party to the Participating Agreements owning legal title to a 40% interest in the Participating Agreements and the interests therein granted in Block 15, subject to and in accordance with the terms and provisions of the JOA provided for in Section 2.02.
>
> […]
>
> Art. 2.03 For such period of time that under Ecuadorian law OEPC holds legal title to the Farmout Interest on behalf of AECI pursuant to this Agreement, OEPC and

> AECI recognize and agree that taxable items attributable to the Farmout Interest will be required to be included on the Ecuadorian tax returns of OEPC's branch registered in Ecuador and that OEPC will pay AECI's Farmout Interest share of Ecuadorian Tax on behalf of AECI. If Closing occurs, AECI agrees to reimburse OEPC for any Ecuadorian Taxes payable by OEPC, or its Ecuador branch, that are attributable to the Farmout Interest. […]
>
> […]
>
> Art. 2.07 If all required governmental approvals, if any, for the transfer to AECI of the Farmout Interest pursuant to Section 2.01 (being the transfer of an economic interest in the Farmout Property as provided therein as opposed to the transfer of a legal title interest as provided for in Section 4.01) have not been obtained on or before March 31, 2001 then any party hereto may elect, at its option, to terminate this Agreement by written notice of termination delivered to the other parties, whereupon this Agreement shall terminate without any further liability or obligation on the part of any party hereto. […]

131. The second stage of the Farmout was described in Article IV of the Farmout Agreement, titled "Assignment of Legal Title." Article 4.01 provided that this phase could not occur until and unless two conditions were met: AEC had made the required payments, and the Government had given its prior authorization:

> Art. 4.01 Promptly after AECI has made all payments of the OEPC Carry provided for in Sections 3.03, 3.04 and 3.05 and OEPC as Operator under the JOA has expended such amounts for Block 15 Capex, OEPC and AECI shall execute and deliver such documents as are required to convey legal title to AECI in and to a 40% economic interest in the Participating Agreements and Block 15 and to make AECI a party to the Participating Agreements as owner of such 40% economic interest (subject to obtaining required governmental approvals). Any transfer fees or administrative charges imposed by any government agency or department with respect to such transactions shall be paid by AECI.

132. In exchange for its economic interest in the production from Block 15, AEC agreed to pay 40% of all the capital and operating expenses in developing Block 15. Article 2.02 of the Farmout provided:

> As between OEPC and [AEC], [AEC] upon Closing shall be obligated and agrees to perform all obligations and to bear and pay all costs, charges, expenses and

> liabilities attributable to the Farmout Interest in the Participating Agreements and Block 15 [...].

133. AEC also agreed to pay approximately $180 million towards OEPC's historical development costs. Under Article 3.02, approximately $70 million was to be paid upon Closing. Pursuant to Article 3.03, AEC's payment of the remaining amount was spread over four years according to the following schedule: $50 million in 2001, $25 million in 2002, $20 million in 2003 and $15 million in 2004.

134. The Joint Operating Agreement refers to the Farmout at Article 3.2.1 as follows:

> Pursuant to the provisions of the Farmout Agreement, AECI has on the Effective Date a forty percent (40%) interest in the Participating Agreements that until the Transfer Date shall be equivalent economically to, but shall not include, nominal legal title and, thereafter, shall include legal title. As between OEPC and AECI, AECI shall be obligated and agrees to perform all obligations and to bear and pay all costs, charges, expenses and liabilities attributable to the Farmout Interest in the Participating Agreements and Block 15, and shall be entitled to the rights and benefits attributable to such Farmout Interest, accruing from and after and attributable to periods of time after 4:00 a.m. local time in Ecuador on the Effective Date under and subject to the terms and provisions of this Agreement, in the same manner and to the same extent as if AECI held legal title to a 40% economic interest as a participant in the Participating Agreements and Block 15 as a Non-Operator under this Agreement, both prior to and after legal title to the 40% interest comprising the Farmout Interest in the Participating Agreements and Block 15 is conveyed from OEPC and AECI pursuant to Section 4.01 of the Farmout Agreement. Likewise, as between OEPC and AECI, subject to the provisions of Article III of the Farmout Agreement, OEPC shall be obligated to perform all obligations and to bear and pay all costs, charges, expenses and liabilities attributable to the remaining 60% interest in the Participating Agreements and Block 15 owned and held by OEPC for its own account, and shall be entitled to the rights and benefits attributable to such remaining 60% interest, accruing from and after and attributable to periods of time after the Effective Time under and subject to the terms and provisions of this Agreement applicable to OEPC as Operator and owner of such remaining 60% interest. This results in the following effective Participating Interests, for purposes of this Agreement.

OEPC	60%
AECI	40%

135. Pursuant to Article 4.2.1 of the Joint Operating Agreement, OEPC, as sole operator, had "all of the rights, functions and duties of [the] Operator under the Participating Agreements [*i.e.* the Participation Contract and Unitized Fields Joint Agreements] and [...]shall conduct all Joint Operations." As defined in Article 1.40 of the Joint Operating Agreement, a Joint Operation is an "operation[ ] or activit[y] carried out by [the] Operator pursuant to this Agreement for Block 15 [...], the costs of which are chargeable to all Parties."

136. Under the Joint Operating Agreement, a two-member management committee was established, with OEPC and AEC each electing one member (the "Management Committee"). Pursuant to Article 5.2 of the Joint Operating Agreement, the Management Committee had the "power and duty to authorize and supervise Joint Operations that are necessary or desirable to fulfill the Participating Agreements and properly explore and exploit the Agreement Area in accordance with this Agreement and in a manner appropriate in the circumstances." That responsibility was to be exercised "[w]ithout prejudice to the rights and duties of Operator under this Agreement."

137. Furthermore, Article 4.2.2 provided that "[i]n the conduct of Joint Operations Operator shall [...] [p]erform Joint Operations in accordance with the provisions of the Participating Agreements, this Agreement, and the approvals and instructions of the Management Committee not in conflict with this Agreement [...]."

138. Finally, Article 5.13.5 provided that "[n]o decision of the Management Committee shall be binding if it conflicts with a decision by any Integrated Management Committee with Petroecuador for the Eden-Yuturi Unit or the Limoncocha Unit or any

other unit in which all or any portion of Block 15 is hereafter unitized." AEC had no representation on the Unitized Fields Committee.

F. The OCP Pipeline

139. At the time the Participation Contract was signed, the only way of bringing oil from the Oriente Basin to the coast for export was through the aging state-owned pipeline, known as the SOTE. By that time, however, the SOTE was already operating at its maximum capacity, and was not capable of transporting the heavier variety of crude that OEPC found in the Edén Yuturi field.

140. The idea for a new pipeline running from the Oriente Basin to the coast at Esmeraldas was first considered by a consortium of foreign producers in 1998, but Ecuador eventually decided to place the contract to build the pipeline out for bid. To this end, Occidental and other foreign oil companies operating in Ecuador formed two companies, Oleoducto de Crudos Pesados (OCP) Ltd. ("OCP Ltd.") and its wholly owned operating subsidiary, Oleoducto de Crudos Pesados (OCP) Ecuador S.A. ("OCP S.A.").

141. In August 2000, OCP Ltd. submitted its bid to construct the pipeline. Ecuador selected OCP Ltd.'s bid over the bids of two other groups in the final quarter of 2000, and the deal was finalized between November 2000 and February 2001. The OCP project was of such importance to Ecuador that the then Minister of Energy and Mines, Pablo Terán, personally conducted the negotiations.

142. Occidental originally took a 24% equity interest in OCP Ltd. However, Occidental subsequently transferred 40% of that interest to AEC, which reduced

Occidental's interest to 14.3%. Because of several further minor and unrelated revisions to OCP Ltd.'s ownership structure, Occidental's interest in OCP Ltd. was subsequently reduced to 14.15%.

143. On 15 February 2001, OCP Ltd. and Ecuador signed the "Contract to Construct and Operate the Heavy Crude Oil Pipeline and Provision of Public Services for Transportation of Hydrocarbons" (the "OCP Contract"). Subsequently, on 3 July 2001, OCP Ltd. signed an approximately $700 million contract with Techint International Construction Corporation to build the OCP pipeline. Construction was completed in August 2003. The total cost of the OCP project was approximately $1.5 billion. The pipeline runs 500 kilometres from Lago Agrio in the Oriente Basin to Balao in the province of Esmeraldas on the Pacific coast, and ascends and descends nearly 3,000 meters in elevation during that span. It has a capacity of 450,000 barrels per day, though it has never reached that capacity. The first oil was shipped through the OCP pipeline in the fall of 2003.

144. The OCP pipeline was financed through a combination of equity contributions by the owners of OCP Ltd., guaranteed debt, and financing from lenders. As of 2004, Occidental had made equity contributions of $78 million to the $1.5 billion project and guaranteed debt worth $118 million.

145. OCP Ltd. secured the majority of the financing through the ship-or-pay commitments from the pipeline's users. These commitments were contained in agreements between the users and OCP S.A. called Initial Shipper Transportation

Agreements ("ISTAs"). OEPC entered into such an ISTA with OCP S.A. on 30 January 2001, as subsequently amended on 29 May 2001 and 31 July 2001.

146. Pursuant to the ship-or-pay commitments, each sponsor purchased a certain amount of pipeline capacity, and agreed to pay for that capacity, even if the sponsor did not use it. OEPC had originally planned on purchasing 70,000 barrels per day of such guaranteed capacity. Following the Farmout, however, OEPC committed in its ISTA to 42,000 barrels per day. The difference, 40% or 28,000 barrels per day, was purchased by AEC in performance of the Farmout.

G. The Farmout and Ecuador

147. On 24 October 2000, senior executives of both OEPC and AEC flew to Quito from the United States and Canada in order to meet with the Minister of Energy and Mines, Pablo Terán, in the Minister's office. The purpose of the meeting was to inform the Minister about the Farmout and discuss the commitment to the OCP pipeline and new projects in Ecuador. Casey Olson, then Executive Vice President for Business Development of Occidental, and Paul MacInnes, then President and General Manager of OEPC, attended this meeting on behalf of OEPC. Steven Bell, then Vice President International of AEC, and Stephen Newton, then President and General Manager of AEC Ecuador, attended on behalf of AEC. Minister Terán was the only representative of Ecuador present at the meeting.

148. There were two distinct subject matters which were addressed during the meeting and the meeting itself had two distinct phases. The purpose of the first session, which lasted about 45 minutes, was to present the Farmout to Minister Terán and was attended

by both the OEPC and AEC officials. In the second session, attended only by the OEPC officials and Minister Terán, the parties discussed new projects in Ecuador that OEPC was interested in pursuing.

149. There is much controversy in this proceeding about what was said, or not said, during the first session of this meeting. The Tribunal will analyze in a later Section of the present Award[6] the meeting of 24 October and subsequent events. In this Section, the Tribunal will only set out the facts which inform the background of the arbitration.

150. Both parties acknowledge that no copy of the Farmout Agreement or the Joint Operating Agreement were handed to Minister Terán during the meeting.

151. The next day, on 25 October 2000, Mr. MacInnes wrote to Minister Terán regarding the previous day's meeting. Mr. MacInnes wrote that the Farmout was an "imminent transaction pursuant to which [OEPC] intends to transfer to [AEC] 40% of its economic interest in the Participation Contract." Mr. MacInnes also wrote that, following that first stage of the transaction, "OEPC will continue being the only 'Contractor' entity under the Contract for Block 15;" and that "once [AEC] has complied with its obligations contemplated in the transfer agreement, OEPC shall transfer to [AEC] the legal title corresponding to 40% of its interests [...] subject to the approvals that the Government of Ecuador may require at that time." The letter ended with a request to the Minister to "confirm […] [the] consent with respect to the aforementioned transfer of economic interests in favor of [AEC]."

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[6] <u>See</u> *infra*, Part V.B.1.

152. As explained later in this Award, one of the central issues in this proceeding is whether, during the meeting of 24 October 2000, Minister Terán in fact indicated that government approval was (or was not) required for the transfer of the economic interest to AEC under the Farmout. In this regard, the Tribunal notes that upon closing the Farmout on 31 October 2000, OEPC and AEC entered into a letter agreement mutually waiving satisfaction of any required government approvals for the first stage of the Farmout. That letter also expressly envisaged the requirement of government approval for the contemplated future transfer of legal title to AEC.

153. Immediately after the Farmout's closing, on 1 November 2000, OEPC's ultimate parent, OPC, issued a press release announcing the Farmout. The press release confirmed that OEPC would remain the operator of Block 15 and that AEC would receive a 40% economic interest in the operations.

154. Between late October and late November 2000, there were some meetings between Mr. MacInnes and Petroecuador's then Executive President, Mr. Rodolfo Barniol, during which the Farmout was mentioned.

155. On 8 November 2000, a memorandum was sent by the Director, Operations Control to the Director of Hydrocarbons Economy in the Ministry of Energy and Mines. It read as follows:

> SUBJECT: TRANSFER OF 40% OF THE ECONOMIC INTERESTS OF THE BLOCK 15 PARTICIPATION CONTRACT BY OCCIDENTAL EXPLORATION TO CITY INVESTING COMPANY
>
> With regard to letter No. GG-014-00 dated October 25, 2000, in which Occidental reports the transfer of 40% of the economic interests in the Participation Contract for Hydrocarbons Production and Additional Exploration

> for Block 15, including the OEPC rights in the Unified Production Operating Agreements for the Unified Edén Yuturi and Limoncocha Fields to City Investing Company, I would like to inform you of the following:
>
> City Investing currently has a Participation Contract with the Government in the Tarapoa Block and Fanny-18B and Mariann-4A Unified Fields and is the current operator of the aforementioned Fields. Therefore, it has proven that it has technical solvency, and for this reason, there would be no impediment for that assignment of rights.

156. In a letter dated 22 November 2000, the Director of the National Hydrocarbons Directorate ("DNH"), Dr. Raúl Salgado, wrote to OEPC requesting information regarding the technical and financial capabilities of AEC. This letter states:

> BACKGROUND:
>
> In communication GG-014-00 dated October 25, 2000, the company you represent requests authorization to transfer 40% of the rights it has in Block 15, including the Operational Agreements for Unified Exploitation of the Unified Fields Edén Yuturi and Limoncocha, in favor of City Investing Company.
>
> ANALYSIS:
>
> According to stipulations in Art. 3 of Executive Decree No. 2713, published in Official Register No. 694 of May 12, 1995, in which the Regulations to Art. 79 of the Hydrocarbons Law were issued, the total or partial transfer of rights and obligations derived from a contract cannot for any reason originate the deterioration of the financial solvency or operational capacity of the contractor, nor can it negatively affect the work and investment chronogram contemplated in the original contract or the economic participation of the State and PETROECUADOR.
>
> In view of this, the Minister of Energy and Mines, previous to the authorization to transfer said rights and obligations, must make a technical - economic analysis with the purpose of guaranteeing the work and operation of this current contract.
>
> CONCLUSION:
>
> The National Direction of Hydrocarbons, as a technical organism of the Ministry of Energy and Mines, requires information to guarantee the economic solvency of the company City Investing Company Limited, regarding:
>
> Income Tax Declarations for the last two years.

Balances audited and duly notarized, for the last two years.

157. Dr. Salgado then met with OEPC's Vice President of Government Relations, Mr. Fernando Albuja, and two other OEPC representatives on 14 December 2000 in his office to discuss OEPC's October 25 letter to Minister Terán.

158. On 12 January 2001, Dr. Salgado sent a memorandum to Minister Terán which reads, in full, as follows:

> BACKGROUND:
>
> Through letter GG-014-00 dated October 25, 2000, Occidental Exploration and Production Company informed the Ministry of Energy and Mines of its intent to assign 40% of the rights and obligations for Block 15 to City Investing Company in the future, including the Unified Production Operating Agreements for the Unified Edén Yuturi and Limoncocha Fields.
>
> ANALYSIS:
>
> At a meeting held on December 14 of this year at the Department of Hydrocarbons Economy of this National Office, executives from Occidental stated that the company is negotiating with City Investing Company to transfer 40% of the rights and obligations it has in Block 15. They will report the decision when they reach a final agreement.
>
> The representatives of this National Office explained to the company that when they decide to assign the rights, they must request authorization from the Ministry of Energy and Mines; otherwise, any participation of City Investing Company in the current contract would be null and void, as stipulated by Executive Decree No. 809 that issued the Regulations for Article 79 of the Hydrocarbons Act, published in Official Gazette No. 197 of May 31, 1985.
>
> CONCLUSIONS:
>
> From the explanation given by executives from Occidental Exploration and Production Company, we can conclude that the Company is not requesting authorization to transfer rights, but only reporting on a possible transaction to be made in the immediate future.
>
> When the company decides to make that transfer, it will request the corresponding approval from the Ministry of Energy and Mines, which will be

> legalized after payment of the premiums for transfer and improvement of the economic conditions of the contract.
>
> The only company that will continue to participate in the current contract with the Ecuadorian Government will be Occidental Exploration and Production Company, owner of 100% of the shares.

159. Finally, on 17 January 2001, Minister Terán responded to OEPC's letter of 25 October 2000, noting the company's "intention to transfer in the future 40% of the rights and obligations of block 15," and indicating that such a future transfer would require prior government approval. Minister Terán also stated that OEPC "shall be the sole company that will continue participating in the current contract with the Ecuadorian State since it is the owner of 100% of the rights and obligations." This letter, which tracks language from the 12 January 2001 memorandum quoted above, reads in full as follows:

> I acknowledge receipt of your letter GG-014-00, dated October 25, 2000, in which the company that you represent made know to this Minister its intention to transfer in the future 40% of the rights and obligations of block 15, including the Operating Agreements for the Unified Exploitation of the Eden-Yuturi and Limoncocha Fields in favor of City Investing Company, and further to the meeting with officers of Occidental, please be advised of the following:
>
> Executive Decree No. 809, which contains the Regulation to Art. 79 of the Hydrocarbons Law, published in the Official Register No. 197, dated May 31, 1985, in its Article I stipulates that the total or partial transfer of rights and obligations derived from a contract may be assigned in favor of third parties with the prior authorization of the Corresponding Ministry, otherwise such transfer will be invalid and may give rise to the contract's termination.
>
> In the meeting held at the National Directorate of Hydrocarbons, officers from Occidental said that the 40% transfer of rights and obligations previously mentioned would not be implemented at the moment, therefore once the company you represent decides to perform said transfer, you must request to this State Ministry the corresponding authorization and the issuance of the Ministerial Decree through which such transfer will be legalized, with the prior payment of the transfer fees and enhancement of the economic conditions of the contract, as it is stipulated in Art. 1 of the Executive Decree 2731, published in the Official Register No. 694, dated May 12, 1995.

> It is important to point out that Occidental Exploration and Production Company shall be the sole company that will continue participating in the current contract with the Ecuadorian State since it is the owner of 100% of the rights and obligations.

160. The record does not disclose any response on the part of OEPC to Minister Terán's letter of 17 January 2001.

H. The Moores Rowland Audit

161. The issue of transfer of rights by OEPC to AEC surfaced again when, in 2003, the audit firm Moores Rowland Ecuador ("Moores Rowland") was retained by the DNH to conduct the audit of OEPC. During their audit, Moores Rowland analyzed invoices from OEPC to AEC for the sale of crude oil during the calendar year 2002 and, in this connection, asked OEPC on 29 January 2004 to examine the contract between OEPC and AEC in virtue of which these sales took place.

162. Shortly thereafter, on 9 February 2004, Moores Rowland wrote to the DNH regarding the "current situation and decision of the Ministry of Energy and Mines" in connection with OEPC's "transfer in the future [of] 40% of the rights and obligations of Block 15" to AEC.

163. Moores Rowland was then provided with unsigned but true copies of both the Farmout Agreement and the Joint Operating Agreement by Mr. Fabian Revelo of OEPC. These copies were later given by Moores Rowland to Dr. Patricia Zurita, the DNH audits coordinator.

164. Moores Rowland requested from OEPC an executed copy of its agreements with AEC. OEPC decided not to accede to this request. The Tribunal notes the following internal OEPC email of 8 March 2004:

> We are not going to provide a copy of the agreement with Encana to the DNH auditors. Informally, the DNH auditors have told us that not providing them with a copy will determine the inclusion of a paragraph called "limitación al alcance" (limitation to the audit scope). I consider we shall do nothing until the auditors issue they [*sic*] report and/or DNH request us information on the deal with AEC.

165. On 15 March 2004, Mr. MacInnes wrote to Moores Rowland as follows:

> In the year 2000, OEPC and AEC Ecuador signed an agreement by means of which, subject to satisfying certain conditions and subject to approvals required by the Ecuadorian Government, they committed themselves to transfer in the future the legal title corresponding to 40% interest in the Contract for Block 15 and the Operation Agreements for Unified Exploitation. OEPC informed this to the Ministry of Energy and Mines in letter GG-014-00 of October 25, 2000. In said communication, we also stated that the Company I represent will continue being the only one responsible for total obligations under the Participation Contract for Block 15 until the indicated conditions are fulfilled and receive the required approvals.
>
> Consistent with the above, OEPC is the only entity that maintains signed with the Ecuadorian State the Participation Contract for Block 15, including the year 2002, period that corresponds to the Cost Auditing that the Firm Moores Rowland Ecuador Cia. Ltda. is performing in representation of the National Direction of Hydrocarbons ("DNH"). Therefore, OEPC exercised and assumed, in the year 2002, 100% of the rights and obligations derived from the Participation Contract for Block 15.
>
> […]
>
> During the 2004 exercise, the conditions agreed upon between OEPC and AEC Ecuador will have been fulfilled for transfer of the legal title corresponding to 40% of the rights and obligations in the Contract for Block 15 and in the Operational Agreements for Unified Exploitation. Therefore, in accordance with letter GG-014-00 from OEPC and Official Letter No. 003-DNH-EH-CE-P1, 01-0079, issued in response by the Minister of Energy and Mines, OEPC will ask for the authorizations that may be required to make the transfer according to applicable legal, regulatory, and contractual provisions, after the referred conditions have been satisfied.

166. As part of the audit process, Moores Rowland then requested from OEPC that they sign a representation letter. OEPC did so on 12 July 2004, and included a representation to the effect that it had provided Moores Rowland with a copy of the "Agreement with Alberta Energy Corp.":

> 2. We have placed at your disposal:
>
> […]
>
> d) The Agreement with Alberta Energy Corp – AEC, formally City Investing, which, once the conditions set forth in such agreement have been met, and subject to the authorizations from Petroecuador and the Ministry of Energy and Mines, would culminate in the assignment of 40% of the rights and obligations of the Participation Contract for the Exploration and Exploitation of Hydrocarbons in Block 15 of the Ecuador Amazon Region and the unified fields of Edén Yuturi and Limoncocha; […]

167. Moores Rowland issued its audit report on 14 July 2004, noting therein that the assignment of rights and obligations contemplated in the Farmout was made contingent on future events and that the assignment "might or might not happen" at the end of the four years during which the conditions were to be satisfied. The audit report recommended to the DNH that OEPC seek government authorization for the assignment during that year, assuming the assignment conditions were satisfied, and that the required ministerial approval be granted to OEPC in order to properly register the assignment.

168. The evidence discloses that, by February 2004, AEC had made all payments due to OEPC under the Farmout. The day after Moores Rowland issued its audit report, on 15 July 2004, OEPC wrote to the new Minister of Energy and Mines, Mr. Eduardo López Robayo, "request[ing] the Ministry to approve the transfer by OEPC to AEC Ecuador of legal title to a 40% interest" in Block 15, as contemplated under the Farmout. In making

this request, OEPC referred to its letter of 25 October 2000, as well as Minister Terán's response of 17 January 2001.

169. The approval sought by OEPC was not granted. Rather, on 24 August 2004, as set forth in more detail later in this Award, the Attorney General of Ecuador ordered the Ministry of Mines and Energy to terminate the Participation Contract and the Unitized Fields Joint Operating Agreements through a declaration of *caducidad*.

I. The VAT Dispute

170. In August 2001, Ecuador's tax authority, the SRI, contrary to its established practice of refunding value added taxes ("VAT") to oil companies, refused to grant such refunds in the future and, retroactively, claimed refunds of the taxes already paid. OEPC interpreted this decision to be a violation of Ecuadorian tax laws and the Treaty and, in November 2002, filed an international arbitration claim against Ecuador to recover the VAT refunds.

171. On 1 July 2004, the VAT Tribunal issued a $75 million VAT Award in OEPC's favor, finding that Ecuador's conduct had been unfair and discriminatory. The VAT Award was sent to the parties on 12 July 2004, and was immediately made public.

172. Ecuador challenged the award in the English courts. Its annulment application was rejected by the High Court on 2 March 2006 and that decision was confirmed by the Court of Appeal on 4 July 2007.

J. The *Caducidad* Proceedings and Related Events

173. On 20 July 2004, Gerald Ellis and Fernando Albuja met with Minister López for the purpose of introducing Mr. Ellis as the new President and General Manager of OEPC. There is evidence in the record that, during this meeting, the Minister referred to the VAT Award as well as OEPC's alleged failure to comply with Ecuadorian laws and regulations.

174. At around the same time, the Attorney General of Ecuador went to London to consult with Ecuador's attorneys with respect to a possible application before courts in London for the annulment of the VAT Award. In the course of an interview where the validity of the VAT Award was referred to, the Attorney General responded that "[w]e do not recognize it, and so much so that we will propose its nullity. Now, I am also studying the contract linking Occidental with the country. I want to check whether the contractual norms have been strictly complied with."

175. Upon his return from London, in the course of a radio interview, the Attorney General stated:

> In August 2004, once I came back from London, I went to the Energy Ministry and asked the Hydrocarbons Directorate to present me all the documentation that proved whether or not the Occidental Company was fulfilling the contract. Once the information was checked, after twelve hours of work, we concluded that this company had been in breach of contract.

176. On 3 August 2004, following receipt of OEPC's request for approval of the transfer to AEC of legal title to a 40% interest in Block 15, Dr. Zurita, the DNH audits coordinator, submitted a memorandum to the National Director of Hydrocarbons. After

reviewing the terms of the 25 October 2000 letter from OEPC and the 17 January 2001 reply from Minister Terán, Dr. Zurita concluded as follows:

> According to the abovementioned, it is determined that Occidental exploration and Production Company on year 2000 carried out a transfer of the 40% of its rights and obligations in Block 15, including the Operational Agreements de Unified Exploitation of the Unified Fields Eden Yuturi and Limoncocha, in favor of City Investing Company, currently Alberta Energy Company based on a private agreement executed between the parties, which effective date was October 1, 2000, transfer that was carried out without authorization of the corresponding Ministry.

177. A few weeks later, on 24 August 2004, the Attorney General wrote to the Minister of Energy and Mines, Mr. López, and requested that he terminate the Participation Contract. The Attorney General asserted that, in 2000:

> [OEPC] transferred 40% interests and obligations from the Participation Contract for Exploration and Exploitation of Hydrocarbons in Block 15 in favor of [AEC], **without having received the authorization of the Ministry of Energy and Mines,** as provided by Article 79 of the Hydrocarbons Law and the same Participation Contract. (Emphasis in original)

178. The Attorney General also alleged that OEPC had committed a number of technical infractions, which, he claimed, constituted a cause for termination under Articles 74.13 and 77 of the HCL. Finally, in that letter, the Attorney General stated that OEPC had not fulfilled its investment obligations with respect to Block 15, which, he claimed, constituted a cause for termination of the Participation Contract under Article 74.6 of the HCL.

179. On the same day, the Attorney General sent a letter to the Executive President of PetroEcuador requesting that PetroEcuador follow the process set out in Clause 21.2 of the Participation Contract. The Tribunal recalls that Clause 21.2 provides that, in cases where there may be cause for forfeiture (*i.e. caducidad*) of the contract, PetroEcuador

must serve OEPC with a notice of non-compliance and provide OEPC ten days to deny or accept the allegation. If OEPC admitted the allegation of non-compliance, it had thirty days to cure its breach.

180. In a letter to the Executive President of PetroEcuador dated 8 September 2004, Minister López, acting upon the Attorney General's request of 24 August 2004, instructed PetroEcuador to initiate the termination procedure. The Minister's letter attached OEPC's request of 15 July 2004 for the transfer to AEC of 40% of the legal title to Block 15, the Farmout Agreement and the Joint Operating Agreement, as well as a report from the DNH listing various technical infractions committed by OEPC. Acting on Minister López's letter, on 15 September 2004, PetroEcuador notified OEPC of its alleged non-compliance with the Participation Contract. This notification gave OEPC ten business days to respond to the allegations. On 24 September 2004, OEPC sent a detailed 28-page letter to PetroEcuador denying the Attorney General's allegations.

181. Nothing further happened until the first few months of 2005 when anti-American and anti-foreign investor groups of demonstrators protested in the streets of Quito, in particular in front of OEPC's offices. The demonstrators voiced their concern that OEPC's contract had not yet been terminated.

182. In February 2005, Minister López and PetroEcuador Executive President Hugo Bonilla were called before the Ecuadorian Congress and questioned with respect to their perceived procrastination over the termination of OEPC's contract.

183. On 14 March 2005, Attorney General Borja wrote to PetroEcuador Executive President Bonilla. He reminded Mr. Bonilla of the causes for termination of the Participation Contract and insisted that the termination process be accelerated. In his letter, the Attorney General also requested to be informed within ten days of all steps taken in the process.

184. The Attorney General emphasized that the termination process should already have been completed and warned that "the delay in the prosecution of the termination process constitutes a lamentable injury to the Ecuadorian State," and that "[t]here will not be dignitary, authority, functionary nor public servant exempt from responsibility for acts realized in carrying out his duties or for his omissions." The Attorney General also delivered the same message in a letter to the President of the Republic.

185. The record discloses that, during March and April 2005, Occidental had meetings with PetroEcuador Executive President Bonilla, the President's Chief of Staff, Mr. Carlos Pólit, and the Minister of Labor, Mr. Raúl Izurieta, in an attempt to find a negotiated solution to the situation.

186. In April 2005, after days of violent street protests in Quito, the Ecuadorian Congress ousted President Gutierrez from power. Minister López and Executive President Bonilla resigned. President Gutiérrez was replaced by then Vice President Alfredo Palacio.

187. On 18 June 2005, during a major strike, a number of government officials, including the new Minister of Energy and Mines, Mr. Iván Rodríguez, signed resolutions

making certain commitments to the Ecuadorian Orellana and Sucumbios provinces. The first of these resolutions stated: "The Minister of Energy and Mines and the President of PetroEcuador, as the competent authorities, commit to undertaking all of the necessary steps for the departure from Ecuador of the companies Occidental and EnCana AEC for having violated the juridical norms of the country."

188. On 1 July 2005, the Attorney General issued a press release in which he stated that he would insist again that the Minister of Energy and Mines conclude the termination process and issue the "corresponding response". He also affirmed in the press release that the transfer to AEC on 1 November 2000 had been done "without authorization from the Ministry of Energy and Mines, as provided by Article 79 of the Hydrocarbons Law and the same Participation Contract."

189. In addition, a report from a committee of PetroEcuador concluded that OEPC had not discharged its burden of proof with respect to its denial of the Attorney General's allegations and recommended that the process of *caducidad* be initiated immediately. The committee referred specifically to Articles 74, 75, 76 and 79 of the HCL as well as Clause 21.2.2 of the Participation Contract.

190. On 2 August 2005, the new Executive President of PetroEcuador, Mr. Carlos Pareja, responded to the Attorney General's request and issued his recommendation to the Minister to declare termination of the Participation Contract. The Tribunal notes that Mr. Pareja resigned the day after issuing his recommendation to the Minister.

K. The *Caducidad* Decree

191. In early November 2005, as the record discloses, Minister Rodríguez was facing several petitions for censure in Congress because of his failure to act on PetroEcuador's recommendation. On 10 November 2005, 27 members of Congress wrote to the President of the Congress calling for the impeachment of Minister Rodríguez if he failed to conclude the termination process.

192. Minister Rodríguez was notified of this letter on 14 November 2005. The next day, November 15, the Minister officially notified OEPC of PetroEcuador's findings that there were causes for termination of the Participation Contract. He gave OEPC 60 business days either to cure the alleged violations or to disprove them.

193. On 7 February 2006, OEPC responded to the Minister's notification in a 45-page letter to which were attached numerous documents. OEPC contended that there was no basis at all for termination of the Participation Contract. With this letter, OEPC submitted several requests to the Government of Ecuador for the production of certain documents.

194. On 16 February 2006, PetroEcuador's Executive President Román resigned. Mr. Fernando González was appointed as his successor, the sixth Executive President of PetroEcuador since May 2004.

195. On 10 March 2006, Minister Rodríguez commissioned two experts to examine and report on the documentary evidence submitted by the Attorney General, PetroEcuador, and OEPC. Minister Rodríguez also received a report on the legal effects

of the Farmout from Andrew Derman who subsequently became the Claimants' oil and gas expert in the present proceeding. Mr. Derman concluded that the transfer of an economic interest was not an assignment under the laws of New York, the governing law of the Farmout.

196. On 15 March 2006, President Palacio's press secretary stated that the administration feared a *coup d'État* as a result of strikes and demonstrations which had closed the highways in the north and center of the country. On 22 March 2006, the strike's leader issued a statement, promising that: "If caducity of the Occidental contract is declared, we will lift the strike."

197. In late April 2006, Minister Rodríguez sent the Attorney General a letter asking him to confirm whether or not the law permitted a settlement with OEPC. On 2 May 2006, following a second request from the Minister, the Attorney General responded to the Minister's letter that the law did allow a settlement. He gave the same information to PetroEcuador. The Attorney General's opinion sparked a public outcry in the country.

198. On 9 May 2006, the then candidate for President, Dr. Rafael Correa, led a demonstration outside OEPC's offices in which he and other demonstrators called for a symbolic "closure forever" of OEPC. The same day, various social organizations in Ecuador declared that they would demand the impeachment of both President Palacio for considering a settlement agreement with OEPC, and Attorney General Borja for opining that such an agreement was legally possible.

199. On 15 May 2006, Minister Rodríguez issued the *Caducidad* Decree. The Decree terminated, with immediate effect, OEPC's Participation Contract and ordered OEPC to turn over to PetroEcuador all its assets relating to Block 15. The thirty-three page Decree included: (i) a summary of the termination process; (ii) block quotes from the letters of the Attorney General, PetroEcuador and OEPC; (iii) additional description of these letters and the positions articulated therein, as well as descriptions of other documents in the record; (iv) a description of norms considered; and (v) approximately four pages of reasoning. The Decree cited as a legal basis for *caducidad* Articles 74.11, 74.12 and 74.13 of the HCL.

200. On 16 May 2006, State officials arrived at OEPC's offices in Quito and seized all of its property, including computers, files and other equipment, which were now said to be the property of the State. The next day, 17 May, other State officials, accompanied by the National Police, seized OEPC's oil fields in Block 15, including wells, drills, storage facilities and other oil exploration and production assets.

III. THE CLAIMANTS' CLAIMS

A. The Claimants' Position

1. Overview of the Claimants' Position

201. The Claimants' principal contention in this arbitration is that the termination of the Participation Contract was made without legitimate cause, *i.e.* in the absence of legal grounds for termination under both the Participation Contract itself (otherwise referred to by the Claimants as a "Termination Event") and Ecuadorian law (namely the Hydrocarbons Law). The *Caducidad* Decree was not, according to the Claimants, a

"good-faith response to a breach of Ecuador's contractual interests." Pointing to the Respondent's alleged "after-the-fact shifts in position", the Claimants assert that "[t]he evidence demonstrates that the Termination Decree was the product of a desire to find an excuse for the predetermined conclusion to expel OEPC from Ecuador, which was inspired by a desire for revenge for OEPC's success in the prior BIT arbitration of the VAT dispute and by the demands of political rivals and organized pressure groups."

202. The Claimants contend that, due to its political significance, the *caducidad* administrative proceedings were tainted from start to finish by a complete lack of due process. In particular, the Claimants submit that the *caducidad* proceedings failed to yield a result based on evidence or law, that the Ecuadorian authorities prejudged OEPC's alleged wrongdoing before the *caducidad* proceedings even began and that OEPC was not given any meaningful opportunity to develop testimony during the proceedings at issue.

203. Furthermore, the Claimants argue that it matters little whether an actual "Termination Event" in fact occurred in the circumstances because "both international and Ecuadorian law proscribe the unilateral termination of a government contract where, as here, the alleged breach was always known and never objected to by the State, and such termination was manifestly unfair, arbitrary, discriminatory and disproportionate."

204. The Claimants accordingly present their case on liability on the basis of the two following main arguments.

205. First, the Claimants maintain that by terminating the Participation Contract without cause (*i.e.* in the absence of a Termination Event), the Respondent has breached its obligations under both the Participation Contract and the Treaty. In advancing this argument, the Claimants essentially allege that (i) the Farmout Agreement did not operate an assignment of contractual rights and obligations in violation of Article 74.11 of the HCL, and (ii) the Farmout Agreement and the Joint Operating Agreement did not create a consortium in violation of Article 74.12 of the HCL.

206. Second, assuming a Termination Event is found to have occurred, the Claimants contend that the *Caducidad* Decree would still be in breach of the Respondent's obligations under the Treaty and Ecuadorian law because it was unfair, arbitrary, discriminatory and disproportionate.[7]

207. Each of the Claimants' two main arguments on liability will now be developed in more detail.

2. The Claimants' First Main Argument: Breach Due to Absence of Termination Event

208. As noted above, the Claimants argue that by terminating the Participation Contract without legitimate cause, the Respondent breached its obligations under the Treaty and international law. According to the Claimants, "[t]he Treaty proscribes

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[7] The Tribunal notes that the proportionality or otherwise of the *Caducidad* decree pervaded the submissions of both parties (see paragraph 425 below). This was understandable since the Ecuadorian Constitution firmly establishes as a matter of Ecuadorian law the principle of proportionality: see the discussion at paragraphs 390 and 396 - 401 below. Moreover, as discussed in paragraphs 402- 409 below numerous investment treaty tribunals have found that the principle of proportionality is part and parcel of the overarching duty to accord fair and equitable treatment to investors.

(i) *any failure to comply* by the State with any contractual obligation into which it has entered with regard to an investment; and (ii) the *unjustified repudiation* by the State of any contract into which it has entered with an investor." (Emphasis in original)

209. On this basis, the Claimants contend that the Respondent breached its duties under Article II.3(c) of the Treaty which requires Ecuador "to observe any obligation it may have entered into with regard to investments", as well as its duties under Article II.3(a) prohibiting unfair treatment, Article II.3(b) prohibiting arbitrary impairment, and Article III prohibiting expropriation.

210. In making their first main argument, the Claimants submit that the Respondent has failed to demonstrate the occurrence of "Termination Events" under the HCL:

> Ecuador claims that it was entitled under Article 74 of the HCL to terminate for cause. However, the Termination Decree provides remarkably little by way of explanation or argument and nothing by way of proof for that claim. Neither did the papers of the Attorney General and Petroecuador from which the Minister copied and pasted in his Termination Decree. This manifest lack of proof and reasoning reflected Ecuador's lack of evidence and arguments. As Claimants will show below, none of the alleged Termination Events has in fact occurred. For that failure alone, the Termination Decree was wrongful as a matter of both Ecuadorian and international law.

211. Recalling that the *Caducidad* Decree and the proceedings that preceded it were based principally on the Respondent's view that the transfer of an economic interest to AEC pursuant to the Farmout Agreements purportedly constituted an assignment of rights and obligations in violation of Article 74.11 of the HCL, and that OEPC purportedly committed various technical violations of Ecuadorian hydrocarbons legislation contrary to Article 74.13 of the HCL, the Claimants deny that the Participation Contract can be properly terminated on such grounds.

212. The Claimants also deny what they refer to as the Respondent's "new grounds" for termination, namely that the Farmout arrangement allegedly created a "consortium" in violation of Article 74.12 of the HCL and that, in parallel, diplomatic pressures were made against the Respondent in violation of Clause 22.2.1 of the Participation Contract.

(a) Alleged Violations of Articles 74.11 and 74.12 of the HCL

213. The Tribunal observes from the outset that although the Claimants' wrongful termination submissions (as well as those of the Respondent) regarding Articles 74.11 and 74.12 of the HCL significantly overlap, they predominantly address the former (unauthorized transfer or assignment) rather than the latter (unauthorized consortium). Thus, by reference to the two-stage transaction envisaged by the Farmout, the Claimants reject the Respondent's allegation that the Farmout violated the HCL because it was tantamount to a wrongful assignment or transfer:

> In *the first stage*, OEPC transferred a 40% economic interest in Block 15 to AEC, in exchange for certain capital contributions by AEC. AEC's economic interest consisted essentially of 40% of OEPC's share in the crude produced from Block 15. AEC's capital contribution required payments from AEC to OEPC over the course of four years and was known in the industry as the "earning obligation."
>
> Article 2.01 of the Farmout, which described this phase, specifically stated that the Farmout of the economic interest:
>
>> *does not include nominal legal title* to an interest in Block 15 or an interest as a party to the Participating Agreements. *OEPC shall continue to own 100% of the legal title* to the Participating Agreements and to the interest in Block 15 granted or provided for in the Participating Agreements. CE-9 (OC00347). (Emphasis added)
>
> Thus, the operative provision of the Farmout directly contradicts Ecuador's claim that an assignment or transfer occurred.
>
> The *second stage,* which never came to pass, contemplated a future assignment by OEPC of legal title to the 40% economic interest. As described in Article 4.01, that assignment was subject to: (i) AEC's meeting its earning obligation; and (ii) OEPC's obtaining prior government approval:

> *[A]fter AEC has made all payments* . . . OEPC and AEC shall execute and deliver such documents as are required to convey *legal title* to AEC in and to a 40% economic interest in the Participating Agreements and Block 15 and to make AEC a party to the Participating Agreements as owner of such 40% economic interest ***(subject to obtaining required governmental approvals)***. CE-9 (OC00353). (Emphasis added)

> When AEC met its earning obligation in July 2004, OEPC proceeded to request government approval for the transfer of legal title to AEC. It sent a letter to this effect to the then-Minister of Energy and Mines, Eduardo López Robayo on July 15, 2004. The government never responded to the request, and OEPC therefore did not proceed with the transfer. (Emphasis in original)

214. The Claimants further emphasize that the Farmout Agreement is governed by the laws of New York, under which the transfer of an economic interest, they argue, does not effectuate an assignment:

> Under New York law, as presented in the opinion submitted by Andrew Derman, the expert appointed by the Minister of Energy and Mines, an assignment does not exist unless "the assignor's right to performance by the obligor is extinguished in whole or in part and the assignee acquires a right to such performance." CA-236, *Restatement Second* ¶ 317; CA-235, *American Jurisprudence* ¶ 1; CA-237, *Williston* ¶ 74:1. Put otherwise, an assignment requires that "an assignee step[] into the assignor's shoes and acquire[] whatever rights the latter had." CA-234, *Furlong* ¶ 382. Under New York law, a mere promise to assign rights and obligations in the future subject to conditions precedent is not an assignment. CA-236, *Restatement Second* ¶ 330; CE-127. (OC02737; OC02741)

> It is plain that as a matter of New York law, the transfer of a 40% economic interest did not effectuate an assignment. The mere transfer of an economic interest did not in any way create privity under the Participation Contract between Ecuador and Petroecuador, on the one hand, and AEC, on the other. That transfer of economic interest did not create any rights of AEC against Ecuador or Petroecuador; nor did it create any obligations for AEC to them.

215. Regarding Ecuadorian law on assignment, the Claimants add:

> Thus, under Ecuadorian law, for the transfer of economic interest under the Farmout to constitute an assignment, it should have resulted in AEC exercising rights and assuming obligations under the Participation Contract vis-à-vis Ecuador and Petroecuador, and OEPC ceasing to exercise such rights and to perform such obligations. HPL ER ¶ 49. Additionally, under Ecuadorian law, the assignment of a contract or personal rights occurs only when the assignor

> turns over to the assignee a deed that describes the rights being assigned. HPL ER V ¶¶ 18-27. In other words, there is no assignment without the physical transfer from assignor to assignee of such deed. HPL ER V ¶ 21. As explained below, neither of these conditions for an assignment has been met.

216. Based on the above, the Claimants aver that until legal title was transferred, only OEPC remained liable *vis-à-vis* the Respondent and PetroEcuador for the performance of the Participation Contract and, furthermore, that only OEPC could enforce its rights under the Participation Contract. In other words, according to the Claimants, an assignment or transfer of contractual rights required privity between AEC and the Respondent and the transfer of a 40% economic interest did not create such privity. Along the same lines, the Claimants also argue that a mere promise to assign rights and obligations in the future subject to conditions precedent is not an assignment, and that a contractual agreement to reimburse for taxes or other costs does not create an assignment either.

217. Regarding the Respondent's allegation that OEPC deliberately concealed the Farmout Agreement, the Claimants answer that OEPC had neither the motive nor the opportunity to do so. They further submit that OEPC fully knew that authorization by the Respondent of the agreements at issue would ultimately be necessary:

> In the Counter-Memorial on Liability, Ecuador surmises without support that "OEPC presumably hoped that the true nature of the [Farmout Agreement and the Operating Agreement] would never be known to Ecuador. …" In fact, the evidence proves that at all times prior to the eventual transfer of legal title, OEPC recognized that authorization by Ecuador and full disclosure of all agreements would occur. The agreement itself required full disclosure and governmental consent. OEPC not only disclosed its relationship with AEC to Ecuador in a series of meetings in 2000, but it would have provided copies of the underlying agreements in 2000 if the Minister of Energy and Mines had advised that approval was necessary at that stage – or if the Minister had simply requested them.

218. This brings the Claimants to the underlying premise of their case, *i.e.* that the Claimants did not ask for approval in 2000 because all OEPC was transferring at the time was an economic interest, not a legal one. Arguing that it would have been "irrational" for OEPC and AEC to conceal the nature of the Farmout, the Claimants contend that the Respondent's "concealment theory" requires, at a minimum, the following findings on the part of the Tribunal:

- The agreements constituted a transfer of rights and obligations under the Participation Contract.
- OEPC and AEC believed that the nature of the Farmout Agreement and the Joint Operating Agreement constituted such a transfer that required immediate government approval.
- Nevertheless, in order to obtain certain short-term benefits, OEPC and AEC chose to risk their substantial investments and their long-term profits in Block 15 by concealing the "true nature" of the Farmout Agreement and the Joint Operating Agreement.

219. The Claimants maintain that "Minister Terán, the Director of the DNH, and other Ecuadorian government officials confirmed OEPC's and AEC's belief that no government approval was necessary for the first stage of the transaction, the transfer of a 40% economic interest." They further submit that OEPC had no reason to doubt that it would have received approval for either stage of its transaction with AEC, based *inter alia* on its "excellent relations with Ecuador in the fall of 2000." The Claimants also emphasize that OEPC never had any financial incentive to hide its relationship with AEC.

220. In addition, the Claimants argue that the Respondent's "concealment theory" flies in the face of the parties' dealings at the relevant time, *i.e.* in late 2000. They contend that the Respondent was informed of the Farmout at all relevant levels of government and

refer, in particular, to the 24 October 2000 meeting with Minister Terán, the November 2000 meetings with PetroEcuador, the 14 December 2000 meeting with the Director of the DNH and the further communications with Minister Terán in January 2001.

221. Regarding Minister Terán's testimony in particular, the Claimants state:

> Minister Terán complains that OEPC and AEC never informed him of the details of the Operating Agreement, but concedes that OEPC did inform him that a transfer of legal title was subject to a future negotiation. Ecuador apparently hopes that the Tribunal will read these two statements by Minister Terán together to imply that no discussion of either AEC's proposed involvement in Block 15 or of the agreement between AEC and OEPC ever occurred, although Minister Terán does not actually say as much. Contrary to what Ecuador seeks to imply, OEPC and AEC informed Minister Terán that AEC would be offering its expertise to OEPC, and that OEPC and AEC were in the midst of closing the deal to transfer an economic interest in Block 15. It is not plausible that OEPC and AEC would schedule a meeting with Minister Terán in 2000 only to limit the conversation, for all intents and purposes, to a hypothetical transfer of legal title tentatively planned for 2004. In fact, OEPC informed Minister Terán of the immediate transfer of economic interest and everything that the transfer entailed.

222. The Claimants further add:

> Ecuador concedes that OEPC communicated on several different occasions that AEC had acquired an economic interest in Block 15. Ecuador seeks to diminish these presentations by arguing that OEPC's description of the Farmout Agreement as a transfer of economic interest was insufficient. However, as Claimants have shown, that description was entirely accurate for the earn-in period of the transaction. In light of considerable effort spent by OEPC to inform Ecuador of the transfer of economic interest and its public disclosure of the transaction, it is implausible to suppose that OEPC's efforts were part of a campaign actually to withhold information. OEPC had no reason to conceal any aspect of its relationship with AEC, but instead chose to communicate repeatedly that AEC was acquiring an economic interest in Block 15.

223. As for the Respondent's allegation that it inadvertently discovered the true nature of the Farmout Agreements as a result of the 2003/2004 Moores Rowland audit, the Claimants refute this suggestion in the following words:

> DNH was continuously involved in exchanges or discussions about the Farmout and Operating Agreements, between February and early May 2004. Not once during that period – or thereafter until the VAT Award was issued – did the DNH suggest that it learned anything from Moores Rowland about the Farmout that it did not already know. Not once did the DNH suggest that OEPC would face *caducidad* because of the Farmout. On the contrary, on May 10, 2004, having discussed the matter with Moores Rowland and OEPC, the DNH specifically subscribed to the conclusion that it would be "prudent" for OEPC to "define and expedite the process of assignment of obligations and rights to AEC," so that the Ministry of Energy and Mines could authorize the transfer of legal title and "thereby avoid any observation by the regulatory authorities." Thus, it is not at all surprising that, as noted above, Ecuador never alleged concealment through the *caducidad* proceedings or in the Termination Decree.

224. In addition to rebutting the Respondent's "concealment theory," the Claimants also reject the Respondent's claim that the *Caducidad* Decree was a *bona fide* implementation of a legitimate regulatory policy. In this regard, the Claimants submit that the policy concerns raised by the Respondent are in fact reflected in Clause 16.2 of the Participation Contract, which states:

> The prohibition to transfer or assign rights […] is not an obstacle to freely trade Contractor's stock, without need of said authorization, provided that the trading of said stock does not change, modify or extinguish the legal existence of the Contractor, nor constitute a decrease in its administrative, financial and technical capacities.

225. The Claimants submit that, pursuant to that provision, "OPC could have sold its entire 100% share of OEPC to AEC. As long as OEPC maintained 'its administrative, financial and technical capacities,' the transaction would not have violated the HCL's underlying policy or warranted any sanction."

226. The Claimants maintain that the Agreements with AEC did not reduce OEPC's ability to execute the Participation Contract and that even if AEC had operated Block 15 (which they deny), the Respondent does not dispute that it had already fully vetted and was prepared to approve AEC as an operator of Block 15. They also argue that Minister

Terán admitted that a financial relationship between OEPC and AEC was beneficial to the Respondent. The Claimants accordingly conclude that the Farmout caused no harm to the Respondent but provided, rather, significant benefit.

227. In terms of AEC's rights under the Farmout Agreement and Joint Operating Agreement, the Claimants deny the allegation of "operational control" put forward by the Respondent as follows:

> Ecuador's case that an assignment occurred within the meaning of Article 74.11 rests on the assertion that "it is enough if the contractor agrees to share [participation contract] rights with a third party, or otherwise gives the third party the ability to influence the contractor's performance of the contract." Its case that a consortium was formed within the meaning of Article 74.12 similarly rests on the assertion that OEPC and AEC "enter[ed] into a binding agreement in which they commit[ted] themselves to work together for exploration or production operations."
>
> Both assertions are factually wrong. Under the terms of the Operating Agreement, AEC *could not* direct either the day to day management or long term development strategy of Block 15; and AEC *never did* direct either the day to day management or long term development strategy of Block 15. (Emphasis in original)

228. Specifically, the Claimants refute the Respondent's argument that the funding and voting provisions of the Joint Operating Agreement conferred upon AEC any control over Block 15 operations. These provisions, according to the Claimants, only allowed AEC to make financial decisions, not operational ones. The Claimants submit:

> It was envisaged under the Operating Agreement that OEPC and AEC would jointly *fund* operations in Block 15 as "joint operations," and its voting procedures gave both parties a vote on whether any particular proposed joint operation should receive such funding. Clause 5.13. Ecuador cites these voting procedures to claim that "all significant operational decisions … required AEC's approval." That is simply not true. The only right that AEC had under these voting provisions was the right to refuse to *fund* a certain operation by not approving certain items of a work plan and budget – not a right to preclude OEPC from *carrying out* the operation altogether.

> […]
>
> Even with full access to the voluminous files OEPC left in Ecuador, the only evidence Ecuador can produce to support this claim are a few documents showing nothing more than AEC's frustration at its lack of involvement in Block 15 operations and a few letters recommending or "approving" specific operational issues. As explained above, AEC's "approval" only affected the financing of operations, not the operations themselves. Ecuador has failed to offer any evidence demonstrating that AEC possessed any control over the operations at Block 15. Indeed, the frustration shown in the few letters cited by Ecuador proves the absence of control by AEC rather than any ability in fact to control these operations.
>
> […]
>
> OEPC alone established the key strategic Development Plans and the Work Plans and Budget, and OEPC alone retained final decision-making authority over day to day operations. AEC provided views and advice on specific operations based on its independent assessment and its experience operating other blocks. AEC never withdrew funding and knew it could not sole-risk OEPC. As evidenced by AEC's complaints about its lack of involvement in Block 15 operations, OEPC never hesitated to exercise its final decision-making authority. AEC was a watchful investor, but it never exercised rights or assumed obligations under the Participation Contract, nor did it cause OEPC to depart from its operational plans and objectives. (Emphasis in original)

229. In the words of the Claimants, "OEPC was always prepared to listen to AEC's opinions but was ultimately sovereign when making operational decisions." It is the Claimants' position that AEC neither acquired in theory nor exercised in practice any rights under the Farmout Agreement or the Joint Operating Agreement to direct either the day-to-day management or long-term development strategy of Block 15. In this regard, they add that "taking free advice from time to time does not equate with granting operational control rights."

230. Finally, the Claimants deny that AEC and OEPC in any way agreed to form a consortium or association. This charge, according to the Claimants, is in fact a "new" ground invoked by the Respondent to justify the *Caducidad* Decree. The Claimants refute this allegation in the following words:

> [N]o Article 74.12 Termination Event has occurred because *(i)* a consortium must have separate legal personality and AEC and OEPC did not create any entity with separate legal personality; and *(ii)* even if no separate legal personality were required, members of a consortium must undertake joint and several liability; OEPC remained at all times the only party to the Participation Contract with Petroecuador and Ecuador, and because AEC never assumed any liability under the Participation Contract, OEPC never undertook joint and several liability with AEC vis-à-vis Petroecuador and Ecuador. In any event, general principles of Ecuadorian and international law preclude punishment on the basis of concepts as ill-defined as "consortium" is under Ecuadorian law.

231. The Claimants thus object to the Respondent's definition of a "consortium," and conclude as follows:

> Unable to show that OEPC and AEC formed a consortium, Ecuador attempts to employ untenably broad definitions and argues that a consortium within the meaning of Article 74.12 is created whenever parties "enter into a binding agreement in which they commit themselves to work together for exploration or production operations."
>
> As shown above, this nebulous definition is baseless; but the Farmout and the Operating Agreement do not meet even Ecuador's untenably broad definition. As shown above, AEC neither acquired nor exercised any rights under the Farmout Agreement or the Operating Agreement to direct either the day to day management or long term development strategy of Block 15. Therefore, even under Ecuador's erroneous definition, OEPC and AEC did not form a consortium.

(b) Alleged Violations of Hydrocarbons Regulations

232. Regarding the Respondent's allegations of technical infractions, the Claimants characterize them as baseless, trivial and inconsequential. They write:

> The 62 alleged technical infractions referenced by the Termination Decree's [*sic*] occurred over a period of five years, 2001-2006, and can be grouped as follows: (i) 12 claims of drilling of individual wells either without prior authorization or without proper notification; (ii) 14 claims of production from individual wells above, or without, the authorized rates; (iii) 22 claims of reporting violations, such as late filing of final drilling reports; and (iv) 11 claims of miscellaneous violations. Due to the lack of substantiating documents in the administrative file for almost half of the 62 alleged infractions, Claimants have been unable to determine in any way the nature of three of these infractions.

233. The Claimants further refute the Respondent's charge in this regard by arguing that "no Article 74.13 Termination Event has occurred because Ecuador has failed to *(i)* document nearly half of the technical infractions on which it purported to base the Termination Decree; and *(ii)* disprove that the documented infraction allegations were misapplications of the HCL regulation, took place in the unitized fields with PetroEcuador's knowledge and approval, and/or were of a clerical or otherwise inconsequential nature."

234. In addition, the Claimants aver that "the only alleged infractions Ecuador spends any effort attempting to describe as serious and substantive are those alleging that OEPC overproduced from certain individual wells," *i.e.* 4 of the 62 alleged infractions. They further emphasize that OEPC, like other oil companies operating in Ecuador, paid its overproductions fines (at most $3,000 each). Finally, they expressly refer to an opinion on the part of PetroEcuador regarding Petrobras to the effect that technical infractions for which a fine has already been paid cannot give rise to *caducidad*.

(c) Alleged Diplomatic Pressures

235. The Claimants address the Respondent's allegation that they sought the assistance of the U.S. Government in violation of the Participation Contract by noting from the outset that this consists of another entirely "new" ground put forward by the Respondent and raised for the first time in this arbitration. More particularly, the Claimants submit as follows:

> Ecuador's new theory should be dismissed because (i) under international law the Tribunal should assess the lawfulness of Ecuador's conduct solely on the basis of the reasons stated in the Termination Decree; (ii) Clause 22.2.1 is unenforceable

> as a matter of international law; (iii) Ecuador is estopped from invoking Clause 22.2.1 because it had knowledge of the relevant facts long before it began its *caducidad* proceedings in 2002; and (iv) Ecuador failed to prove that Occidental engaged in any proscribed conduct after the caducity proceedings began (and indeed after 2002). To the contrary, once Ecuador began those proceedings in 2004, OEPC consistently informed the U.S. Government that it did not seek diplomatic assistance.

236. The Claimants thus maintain that the Respondent was well aware of OEPC's frequent contact with the U.S. Government about the VAT dispute from 2001-2002, but that OEPC did not seek any assistance from the U.S. Government after 2002, *i.e.* in connection with the *caducidad* dispute.

3. The Claimants' Second Main Argument: Breach Notwithstanding Termination Event

237. As an alternative argument, the Claimants contend that even if a Termination Event is found to have occurred in the circumstances, the termination of the Participation Contract was unlawful under both the Treaty and Ecuadorian law on the grounds that it was grossly unfair, arbitrary, discriminatory and disproportionate. In the words of the Claimants:

> Both the Treaty and Ecuadorian law guaranteed Claimants and their investments fair, non-arbitrary, and non-discriminatory treatment. In passing the Termination Decree, Ecuador blatantly disregarded these standards. Having openly premeditated the termination, Ecuador imposed manifestly disproportionate punishment on Claimants on grounds that it never substantiated in the face of OEPC's vigorous defenses and that were not found sufficient to warrant contract termination in the case of other oil companies.

238. The discretionary nature of the ministerial decision which led to the Termination Decree is central to the Claimants' second main argument. Citing Article 79 of the HCL regarding nullity of an unauthorized transfer or assignment, the Claimants contend that "the nullity of the transfer itself, such as the Farmout Agreement if it were illegal, is

mandatory; but the possibility of terminating the underlying contract, the Participation Contract, is entirely discretionary." On this basis, the Claimants submit that the Minister exercised his discretion in a manner inconsistent with the Treaty and Ecuadorian law for the following reasons:

(i) the Termination Decree was manifestly disproportionate;

(ii) the Termination Decree frustrated the Claimants' legitimate expectations;

(iii) the Termination Decree was unfair and arbitrary;

(iv) the Termination Decree was discriminatory;

(v) the Termination Decree denied the Claimants' full protection and security;

(vi) the Termination Decree expropriated the Claimants' investments without compensation; and

(vii) the Respondent allowed PetroEcuador and Petroproducción to aid and abet the Termination Decree.

239. In connection with their submission that the termination of the Participation Contract was grossly unfair, arbitrary, discriminatory and disproportionate, the Claimants reiterate their contention that the Respondent terminated the Participation Contract for reasons of political expediency, rather than on the basis of evidence or law. The Claimants also emphasize that the Respondent has not terminated the contracts of other oil and gas operators in Ecuador (namely, Tripetrol and Petrobras), even though these operators have assigned rights and obligations subject to government approval, and others (such as Petrobell, Perenco, Tecpecuador and Canada Grande) have allegedly committed as many or more technical infractions as OEPC in relation to production.

240. In addition, the Claimants rely on the prohibition against disproportionate measures under the Treaty and do not accept the Respondent's contention that any and all Article 74 violations justify termination of the Participation Contract:

> Accepting Ecuador's simplistic proposition, for which it cites no authority, that imposing "the very sanction that the law calls for in a specified context" is *per se* proportionate would deny the very essence of the proportionality principle. A finding that prohibited conduct has occurred is *not* enough to justify the administration in imposing the harshest of sanctions in the administrative arsenal. The administration must also carefully examine the particular circumstances of the alleged prohibited conduct, including the consequences flowing from it. As the cases cited above show, the Minister had to find that the contract was no longer viable, or at least that serious damage had occurred, as well as determining that the underlying policy of the contractual norm had been violated, before it could terminate OEPC's contract. No such finding was made here, and as shown above, none could have been made. (Emphasis in original)

241. Referring to the circumstances in which the *Caducidad* Decree was issued, the Claimants allege that it bore no relation to the requirements of general interest, and reiterate that the Respondent had already vetted AEC and was prepared to approve it as a participant in Block 15. In this regard, the Claimants add that neither the Farmout nor the alleged technical infractions rendered continued performance of the Participation Contract impossible or caused any damage to the Respondent.

242. In terms of their legitimate expectations, the Claimants refute the Respondent's suggestion that they were not entitled to place reliance on the government's alleged acquiescence of the Farmout. In particular, they take issue with the Respondent's interpretation of the *Temple of Preah Vihear* case on estoppel by conduct. They write:

> […] Contrary to Ecuador's assertion, however, this standard is nowhere found in the text of *Temple of Preah Vihear*, nor is it a settled rule of international law. On the contrary, the doctrine of estoppel in international law has traditionally included two elements: *(i)* clear, voluntary and authorized statements *or conduct* from a party and *(ii)* reliance by the other party triggering either detriment to the

> relying party or advantage to the party making the statement or engaging in conduct. ("What appears to be the common denominator of the various aspects of estoppel which have been discussed, is the requirement that a State ought to maintain towards a given factual or legal situation *an attitude consistent with that which it was known to have adopted* with regard to the same circumstances on previous occasions.") (emphasis added); ("Estoppel operates on the assumption that one party has been induced to act in reliance on the assurances or *other conduct* of another party in such a way that it would be prejudiced were the other party later to change its position."). (Emphasis in original)

243. Finally, the Claimants maintain that the Respondent's "one-size-fits-all" argument that OEPC should have exhausted local remedies was specious as a jurisdictional theory and remains so in its "reincarnation" as a merits theory, because the Treaty itself required the Claimants to make an irrevocable choice between pursuing remedies before the Ecuadorian courts or this Tribunal.

B. The Respondent's Position

1. Overview of the Respondent's Position

244. At the outset of its pleadings, the Respondent characterizes the Claimants' case, to the extent that it is based on an alleged "purely innocuous arrangement that the Government had known about all along," as pure fiction. The Respondent summarizes its own view of the facts of the case as follows:

> OEPC's transaction with AEC was *not* of the innocuous nature the Claimants suggest, *did* require the approval of the Ministry of Energy and Mines (the "Ministry"), and was *not* properly disclosed to Ecuador. In fact, the Claimants repeatedly represented to the Government that the "first phase" of the transaction involved only the transfer of what it called a passive "economic interest" having no effect on any aspect of the Participation Contract. That was false. Far from assigning a mere "economic interest," the so-called "Farmout Agreement" transferred to AEC a "'working interest' or 'participation interest'" in Block 15. As a result, OEPC was obliged, from the outset of the relationship, "to act with regard to the Farmout Interest of [AEC] as [AEC] shall direct from time to time *as if [AEC] were a party to the Participation Agreement owning legal title to a 40% interest in the Participation Agreements.*" This fundamental aspect of the OEPC/AEC arrangement was never disclosed to Ecuador.

On the same day they signed the Farmout Agreement, OEPC and AEC also executed an undisclosed "Joint Operating Agreement." Under that agreement, AEC was given the right to appoint a representative to the Block 15 Management Committee that "supervised and directed" the Block 15 operations. It also had the power to veto the most important decisions relating to Block 15's operations, such as the adoption of its development plan, work program, and budget. Moreover, AEC could, at its election, conduct "exclusive operations" in Block 15 without the participation or approval of OEPC. In sum, OEPC was required to obtain AEC's approval for all major operating actions, including, but not limited to:

- submitting development plans;
- submitting work programs or budgets;
- making financial decisions;
- designating oil discoveries as commercial;
- amending or extending the Participation Contract; and
- assigning, selling, licensing or transferring any Participation Contract rights.

It is undisputed that OEPC failed to disclose the foregoing terms to Ecuador. And in its numerous meetings with the Government in 2000 and 2001, OEPC *never* provided the Government with copies of the Farmout Agreement or the Joint Operating Agreement. To the contrary, OEPC misrepresented to the Government that it was still in negotiations with AEC over any possible future transfer of rights. In reality, the Farmout Agreement and Joint Operating Agreement had been executed on October 19, 2000 – five days *before* OEPC's first meeting with the Government on the matter.

Once these simple facts are understood, the real story emerges. As told by Pablo Terán, then-Minister of Energy and Mines, in his witness statement, the Government was never told of a "farmout" or that there had been (or would be in the immediate future) an effective transfer of meaningful rights and obligations under and in relation to the Participation Contract. Moreover, Minister Terán made clear to OEPC that approval *would* be necessary if and when OEPC and AEC reached an agreement on the transfer of rights and obligations concerning the Participation Contract.

Thus, Minister Terán sent a letter to OEPC dated January 17, 2001, stating that he would wait until OEPC and AEC had reached an agreement on the transfer of rights and obligations under the Participation Contract and would expect OEPC to seek prior approval at that time. He also warned that such a transfer without authorization "would give rise to the contract's *caducidad.*" Unbeknownst to the Government, the transfer agreements between OEPC and AEC had already been executed three months earlier. (Emphasis in original)

245. The Respondent refutes the Claimants' interpretation of the Farmout Agreement and the Joint Operating Agreement in the following words:

> [T]he Claimants contended that anything short of a formal conveyance of a legal interest was permissible without consent. That position is artificial, disingenuous, and unsustainable under both Ecuadorian law and common sense. The Farmout Agreement and the Joint Operating Agreement created immediately-effective rights for AEC to exert influence over the Participation Contract area. They also created a means by which premiums arising from Block 15 interests could be earned by others to the exclusion of Ecuador. Both are objectionable unless fully informed consent is given in advance.

246. In addition, the Respondent takes issue with the Claimants' alleged attempt to circumvent the language of the agreements at issue:

> Thus, the Claimants' case has now been reduced to an argument that, although the *actual language* of the Farmout Documents provided for AEC to receive operational and managerial rights in Block 15 in 2000, OEPC and AEC had some unwritten "understanding" that these rights could not be exercised until the "second phase" of their transaction. The Claimants do not – and cannot – point to a single contemporaneous document that reflects this understanding.
>
> More fundamentally, this argument is flatly contradicted by two undeniable facts. ***First***, the argument is contradicted by what the Farmout Documents actually *say*. Those agreements make unmistakably clear that operational rights vested *immediately*. Indeed, the precise timing of the transfer of these operational rights is clearly set forth by the Farmout Agreement itself:
>
>> The Farmout Interest is to be transferred to AECI *as of the Effective Time* includes a "working interest" or "participation interest" in the Participation Agreements and Block 15 except that it does not include nominal legal title to an interest in Block 15 ….
>
> […]
>
> ***Second***, the Claimants' argument that the operational rights assigned to AEC were "illusory" is disproved by how the parties *acted.* As discussed in Paragraphs 43 to 47 of Ecuador's Counter-Memorial, AEC frequently exercised its operational rights with respect to Block 15. These rights were hardly "illusory," and AEC's conduct conclusively shows that it did not believe they were. (Emphasis in original)

247. In terms of its overall position in this arbitration, the Respondent contends that OEPC acted in bad faith *vis-à-vis* Ecuadorian officials by not disclosing the true nature of its contractual relationship with AEC. In particular, the Respondent refers to the circumstances in which the Farmout Agreements were inadvertently "discovered" by Moores Rowland in 2003/2004, alleging that OEPC in fact then resisted disclosure of the agreements.

248. More substantively, the Respondent maintains that OEPC's conduct constituted valid grounds for termination of the Participation Contract pursuant to Articles 74.11 and 74.12 of the HCL, *i.e.* where the contractor, it is recalled, "transfers rights or enters into a private contract for the assignment of one or more of its rights" or "forms consortiums or associations for the exploration or production operations, or withdraws from them," without authorization from the Ministry. As argued by the Respondent, "[i]t follows necessarily that the issuance of the *Caducidad* Decree could not have been a breach of the Participation Contract, because the Participation Contract is governed by Ecuadorian law." The Respondent adds:

> [T]he issuance of the *Caducidad* Decree was explicitly contemplated in the Participation Contract. As previously noted, the Participation Contract provides at Clause 21.1.1 that the Contract shall terminate by *caducidad* if OEPC commits any of the causes specified in Article 74 of the Hydrocarbons Law. Accordingly, although the issuance of the Decree was not itself a contractual act, the Contract clearly put OEPC on notice that it would be terminated under the precise circumstances that ultimately arose, and OEPC accepted this when it signed the Contract. The *Caducidad* Decree thus could in no event be considered a breach of contract. Indeed, it is hard to imagine *any* legal regime that would consider it to be a breach of contract for a party to a contract to take an action to which its counterparty has explicitly consented, in response to that counterparty's own violations of the law and breaches of contract. (Emphasis in original)

249. As for the Respondent's defense to the Claimants' allegation that the *Caducidad* Decree was issued in violation of both the Treaty and international law (*i.e.* the Claimants' second main argument of breach notwithstanding a Termination Event), it argues that "the relevant aspects of Ecuadorian law comported fully with international standards and were applied by the Minister in an even-handed and rational manner. Under these circumstances, Ecuador cannot be deemed to have violated any of its obligations under the Treaty or international law in connection with the Claimants' investment." The Respondent accordingly considers the Claimants' "attempts to cast doubt on the thoroughness and integrity of the two-year *caducidad* investigation" as entirely unfounded and irrelevant.

250. The Respondent's defenses to the Claimants' two main submissions will now be reviewed in more detail.

2. The Respondent's Defense to the Claimants' First Main Argument: The Caducidad Decree Complied Fully with Ecuadorian Law

251. The Respondent states that the *Caducidad* Decree complied fully with Ecuadorian law because OEPC's conduct constituted valid grounds for termination of the Participation Contract, an agreement governed by the laws of Ecuador. The Respondent describes the causes for *caducidad* under Articles 74.11 and 74.12 of the HCL as encompassing situations where "a third party has acquired control or influence over operational activities in the relevant fields, without the Ministry having been afforded the opportunity to assess the suitability of that third party for this role, or even to monitor the identity of the entities investing in the hydrocarbon sector in Ecuador." The requirement

for authorization in such situations (and, conversely, the prohibition against unauthorized transactions) is, according to the Respondent, based on sound policy reasons.

252. As part of its argument to the effect that the *Caducidad* Decree complied fully with Ecuadorian law, the Respondent further submits that (i) the sanction of *caducidad* was *per se* appropriate and proportionate in this case; (ii) the Ministry was not precluded from declaring *caducidad* by the doctrines of *actos propios, confianza legítima, buena fe,* or any other doctrine recognized by Ecuadorian law; (iii) the Respondent observed OEPC's due process rights during the *caducidad* investigation, and afforded OEPC a full opportunity for challenging the Decree; and (iv) the requirement that OEPC turn over all of its equipment and installations upon declaration of *caducidad* was agreed to by OEPC, and was in no way unconstitutional.

(a) Alleged Violations of Articles 74.11 and 74.12 of the HCL

253. The Respondent argues first that OEPC concealed the fact that it had concluded a Farmout with AEC without prior authorization by the Minister. In the words of the Respondent:

> It is undisputed that OEPC entered into the Farmout Agreement and Joint Operating Agreement without prior authorization, and that no subsequent authorization was ever granted. While the Claimants have alleged that OEPC was led to believe that no authorization was *required* for their agreements with AEC, they do not contend that OEPC *obtained* authorization. The only question, therefore, is whether those agreements gave rise to a consortium or association for the exploration or production operations, or whether they constituted a transfer of rights or private agreement for the assignment of one or more rights under the Participation Contract. (Emphasis in original)

254. From the Respondent's perspective, the parties' dispute is quite straightforward. The Respondent maintains that certain core facts are agreed by the parties, including the

following which it deems “fatal” to the Claimants’ case, *i.e.* that (i) OEPC consistently told the Government that it planned to transfer only an “economic interest” to AEC; (ii) OEPC never informed the Government that AEC had been given operational and managerial rights relating to Block 15; (iii) OEPC never provided copies of the Farmout documents to the Government; and (iv) OEPC never described the transaction as a “farmout” in any communication with the Government.

255. The Respondent is of the view that the Claimants are guilty of “a lengthy pattern of deception” and that they “deserved to lose their contract”. The Claimants are also accused of seeking to “distract from the evidence of their deceit by calling into question the fairness of the *caducidad* process itself.”

256. Regarding the Claimants’ contention that the Respondent allegedly gave OEPC the impression that authorization was not required in the circumstances, the Respondent argues:

> The Claimants contend that OEPC was justified in going forward with its agreements with AEC without Ministry authorization, because Ecuadorian officials led them to believe that authorization was not necessary. This contention fails for two simple reasons. ***First***, the officials in question could not possibly have offered a meaningful appraisal as to whether or not authorization was required without knowing the true nature of OEPC’s agreements with AEC, and OEPC knew this. ***Second***, those officials repeatedly emphasized to OEPC that it would need to seek authorization from the Ministry before making any transfer of rights. (Emphasis in original)

257. As previously noted, the Respondent further argues that the Farmout resulted in more than the transfer of a mere “economic interest” and that the use of this term “was clearly calculated to mislead.” The reality, according to the Respondent, is that “[f]ar from being a mere transfer of a passive ‘economic interest,’ the Farmout Agreement and

its attendant Joint Operating Agreement immediately made AEC a full partner in the Block 15 operations and transferred to it significant managerial rights and responsibilities."

258. Referring *inter alia* to Article 5.9 of the Joint Operating Agreement entitled "Voting Procedure," the Respondent emphasizes that "all significant operational decisions regarding Block 15 required AEC's approval" The Respondent quotes this provision:

> **5.9 Voting Procedure**
>
> […]
>
> 5.92 The following acts shall require affirmative vote of one (1) or more Parties then having collectively at least sixty-six and two-thirds percent (66-2/3%) of the Participating Interests [which would necessarily include AEC]:
>
> 5.9.2.1 Approval of a Development Plan;
>
> 5.9.2.2 Approval of a Work Program and Budget or any amendment or modification thereof;
>
> 5.9.2.3 Overexpenditures on any line item of an approved Work Program and Budget by more than twenty percent (20%) or U.S. $1,000,000, whichever is less, of the authorized amount for such line item, or overexpenditures for a Calendar Year of a total Work Program and Budget by more than ten percent (10%) or U.S. $5,000,000, whichever is less; and
>
> 5.9.2.4 Decisions on financing Joint Operations (including any decisions to repay indebtedness on any such financing) prior to the Transfer Date.
>
> […]

259. The Respondent adds:

> [F]rom the outset OEPC was "obligated, at the sole risk, cost and expense of [AEC], to act with respect to the Farmout Interest of AECI ***as AECI shall direct from time to time as if AECI were a party to the Participating Agreements***

> ***owning legal title*** to a 40% interest in the Participating Agreements and the interests therein granting in Block 15."
>
> The Farmout Agreement added, moreover, that AEC would be entitled to all "rights and benefits … in the same manner and to the same extent as if AECI held legal title to a 40% economic interest as a participant in the Farmout Property as a Non-Operator under the Joint Operating Agreement, both prior to and after legal title to the participating interest … is conveyed from OEPC to AECI." In substance, therefore, AEC was to be treated *exactly* as if it were an actual party to the Participation Contract as between AEC and OEPC from the moment the Farmout Agreement closed. Indeed, the fact that the Farmout Agreement granted AEC *identical* interests and powers before and after OEPC made the contemplated transfer of "legal title" to AEC shows that the transfer of formal "legal title" was inconsequential to AEC's control over the interests in question. (Emphasis in original)

260. Emphasizing that the Joint Operating Agreement, at Article 7.2.1, provides that AEC may, on its own initiative, conduct "exclusive operations" in Block 15 (defined as operations chargeable to the account of less than all parties to the Agreement), the Respondent interprets the rights of AEC thereunder as follows:

> These were not just paper rights. As shown by correspondence and meeting minutes between AEC and OEPC produced by the Claimants in this arbitration, AEC in fact frequently exercised its managerial and operational rights with respect to Block 15 and regarded the arrangement as a "joint venture" between the two companies. AEC was given, and exercised, voting rights with respect to well locations, contributed to planning and budgeting decisions, and participated in Block 15 operations in respect of which it demonstrated its willingness to exercise its rights on important development decisions.
>
> […]
>
> As previously noted, one of the grounds for the Government's declaration of *caducidad* was that OEPC and AEC entered into an unauthorized consortium, in violation of the Hydrocarbons Law. And this is precisely what OEPC and AEC formed. Indeed, in their ordinary business communications, these companies *themselves* referred to their arrangement as a "consortium." In April 2004, for example, representatives from AEC and OEPC discussed the possibility of asking the Ministry for authorization for the transfer of "legal title" to OEPC's rights to AEC, and AEC's representatives indicated that AEC would prefer to delay seeking Government authorization for the time being: "For your info, my current preference is to do nothing this calendar year, and next year approach the government with the proposal to pay the transfer tax, *but continue to leave the 'consortium' outside the country*" – in other words, continue to hide it from the Government.

> Their use of this terminology is not surprising, as the arrangement established between OEPC and AEC was of a nature that is commonly called a consortium in the international oil and gas industry. As Mr. Martin explains, the term "consortium" is typically used in the industry to encompass, among other things, "[a] group of companies operating jointly, usually in a partnership with one company as operator in a given permit, license, contract area, block, etc." Mr. Martin observes further that this concept "describe[s] exactly what international O&G companies undertake to do in farmout agreements and JOAs, including the Farmout Agreement and Operating Agreement that OEPC and AEC signed and used to carry out their activities on Block 15. (Emphasis in original)

261. According to the Respondent, an Article 74 violation does not require proof of "control" *per se*:

> [T]he Claimants' experts assert that AEC's Management Committee rights may have been insufficient to give it "control" of operations in Block 15. This is another red herring, because a third party need not have "control" over operations in order for an Article 74 violation to occur. To the contrary, as explained by Dr. Merlo, a "transfer of rights" occurs when the contractor conveys to the transferee the right to participate in strategic and operational decisions relating to petroleum exploration or extraction, thereby giving it influence over operations. Similarly, a "consortium" is formed within the meaning of Article 74.12 if a contractor and a third party "enter into a binding agreement in which they commit themselves to work together for exploration or production operations." Hence, neither type of violation is contingent on the third party obtaining "effective operational control."

262. In any event, it is the Respondent's position that AEC actually exercised managerial and operational rights from the outset of its relationship with OEPC. The Respondent accordingly submits that OEPC and AEC formed an unauthorized consortium for the exploration and production of oil in violation of Article 74.12 of the HCL. Furthermore, the Respondent rejects the Claimants' contention that a "consortium" requires the formation of a separate legal entity to carry out the joint operations. Referring to Ecuadorian case law in this regard, the Respondent contends:

> Thus, whereas the Claimants contend that the formation of a consortium requires the creation of a distinct legal person, the decision clearly states that the mere agreement between the parties to enter into a consortium (as defined by the

> Court) is sufficient to create a consortium and that, as a consequence of the parties' agreement, a new legal entity exists, without the need to accomplish any special formality.
>
> It cannot be disputed that OEPC and AEC both (*i*) "contributed something in common" (with AEC's contribution consisting of, *inter alia*, providing funding and expertise for the development of Block 15), and (*ii*) "divided among them[selves] the benefits derived from the common activity," in the proportion of 60%-40%, less the operating costs born in the same proportion. It follows that OEPC and AEC *did* form a consortium, according to the definition given by the Court. It also follows, although this is not relevant to the present case, that this consortium had legal standing as a separate legal person. (Emphasis in original)

263. In addition, the Respondent maintains that the formation of a consortium under Ecuadorian law does not require that the third party assume joint and several liability for the performance of the Participation Contract.

264. The Respondent also contends that the Farmout constituted a transfer of rights and an agreement to assign rights to AEC in violation of Article 74.11 of the HCL. It argues that, for purposes of this provision, "it is not necessary for the contractor to divest itself completely of the rights in question; it is enough if the contractor agrees to share those rights with a third party, or otherwise gives the third party the ability to influence the contractor's performance of the contract." *In fine*, the Respondent characterizes the Claimants' contention that an actual "assignment" has not been effected in the circumstances as a "red herring".

265. Turning to the Claimants' contention that OEPC in fact revealed the farmout transaction with AEC to Ecuadorian officials, the Respondent denies that any such disclosure was made and refers in particular to the meeting among OEPC, AEC and Minister Terán in the latter's office in Quito on 24 October 2000:

> At the meeting, OEPC and AEC brought up their contemplated transaction relating to Block 15. They spoke in generalities from a prepared "script," without referring to their transaction as a "farmout," and without ever providing Minister Terán with the Farmout Agreement or the Joint Operating Agreement. Nevertheless, that script (now disclosed by the Claimants in this arbitration) *confirms* that OEPC and AEC concealed the true nature of the transaction from Minister Terán.
>
> The script begins by asserting that "Oxy and AEC have agreed that AEC will assume a 40% economic interest" and that there will be "no change in the operations" and "no initial change in the contractual rights and obligations or legal title for [Block 15]." What Minister Terán did not know, of course, was that significantly more was being transferred to AEC. OEPC's script also suggests that OEPC stated that at a later date it "would seek to transfer 40% of our legal title subject to the Government's approval," although, as Minister Terán has testified, OEPC assured Minister Terán that this was a matter to be left for future negotiation and would be subject to Ministry approval, if it happened at all. (Emphasis in original)

266. In this regard, the Respondent further recalls the follow-up letter of 25 October 2000 sent to Minister Terán by Paul MacInnes. In this letter, OEPC expressly requests "that the Ministry of Energy and Mines confirm as soon as possible, its consent with respect to the aforementioned transfer of economic interest in favour of [AEC]." The Respondent argues that this letter fails to disclose that OEPC had in fact already concluded a binding agreement with AEC, and alleges that OEPC continued to conceal this fact when it made a presentation to the Joint Management Committee of the Limoncocha and Edén-Yuturi Fields on 22 November 2000.

267. Furthermore, the Respondent recalls the meeting between OEPC and the DNH on 14 December 2000. According to the Respondent, OEPC's representatives present at this meeting "falsely represented to the Government that [OEPC] was still in negotiations with AEC over a possible future transaction". This meeting led to the letter by Minister Terán to OEPC dated 17 January 2001, which the Respondent characterizes as follows:

> For avoidance of doubt, Minister Terán made sure that OEPC knew the consequences of making a transfer without authorization. In his January 17, 2001 letter, Minister Terán stated in no uncertain terms:
>
> > Executive Decree No. 809, which contains the Regulation to Art. 79 of the Hydrocarbons Law, published in the Official Register No. 197, dated May 31, 1985, in its Article I stipulates that the total or partial transfer of rights and obligations derived from a contract may be assigned in favour of third parties with the prior authorization of the Corresponding Ministry, otherwise such transfer will be invalid and ***will give rise to the contract's termination***.
>
> Thus, Minister Terán specifically warned OEPC, as early as January 2001, that a transfer of rights without approval would result in *caducidad*. Unbeknownst to the Government, however, the deed had already been done – back in October 2000. (Emphasis in original)

268. The Respondent then addresses its discovery of what it refers to as the "true nature" of OEPC's relationship with AEC and the investigation that led to the *caducidad* proceedings and, ultimately, the *Caducidad* Decree. This discovery is alleged to have been made in the context of the 2003/2004 Moores Rowland's audit of OEPC. The Respondent disputes the Claimants' suggestion that the *caducidad* proceedings were initiated in retaliation to the VAT arbitration. Rather, according to the Respondent, "the proximity of those events was of the Claimants' own making." The Respondent particularizes its position as follows:

> Specifically, it was the Claimants' decision to make their request for transfer of "legal title" to AEC immediately after the VAT Award was dispatched to the parties that led to the discovery of the details of the relationship between OEPC and AEC by the Minister of Energy and Mines and the Attorney General. The timing of that request – following as it did on the heels of the VAT Award – could not have been coincidental.
>
> As the witness statement from OEPC witness Paul MacInnes reveals, AEC had completed its required payments under the Farmout Agreement by the spring of 2004. Under the terms of the Farmout Agreement, OEPC should have immediately sought authorization from the Government for the "second stage" of the transaction, *i.e.,* the transfer of "legal title" to AEC. But OEPC did not make any such request at that time. Instead, it delayed for several months,

> failing to make the request until July 15, 2004, immediately after the award in the VAT Arbitration was dispatched to the parties.
>
> OEPC must also have known that any request for the transfer of "legal title" to AEC would prompt scrutiny from the Ministry, given that the Ministry was bound to conduct an investigation whenever a request for the transfer of rights was made. OEPC must also have known that this could lead to the discovery of the offending agreements by Government officials who would be able to appreciate their significance. This may explain why OEPC did not make an immediate request for the transfer of "legal title" to AEC when AEC's payments were completed in Spring 2004, and, instead, delayed until the VAT Arbitration had concluded. Indeed, correspondence between OEPC and AEC in April 2004 confirms the parties' intent, for the time being anyway, to "continue to leave the 'consortium' outside the country." OEPC would have known that if it prevailed in the VAT Arbitration, then made its request for transfer of legal title to AEC, any adverse response by the Government could be made to appear retaliatory in nature. OEPC has certainly not hesitated to characterize the Government's response in precisely that manner in this arbitration.

269. The Respondent then refutes the Claimants' denial of motive to conceal the Farmout Agreements in the following words:

> The objective reality, however, is that the Claimants most certainly *did* have at least two motives to conceal the Farmout: (*i*) the desire to avoid the payment of a transfer fee and the enhancement to the economic terms of the contract, and (*ii*) the desire to avoid any potential delay or complications that could have been associated with the Ministry's evaluation of the Claimants' transfer request. Further, AEC, in the context of deciding not to seek approval for the second phase transfer, noted that it would have to "approach the government with the proposal to pay the transfer tax," and OEPC said that AEC might be concerned about "anti-trust provisions." (Emphasis in original)

270. The Respondent concludes that, in any event, the Claimants' motive is irrelevant in the circumstances.

271. Finally, the Respondent argues that the *caducidad* proceedings at all times afforded the Claimants due process since OEPC was afforded the opportunity to respond at each stage of the process.

(b) Alleged Violations of Hydrocarbons Regulations

272. As part of a parallel line of argument in support of its position that the *Caducidad* Decree complied fully with Ecuadorian law, the Respondent contends that OEPC not only sought to conceal the Farmout Agreements, but that its behaviour "was also a repeat violation of the laws governing oil exploitation" thus forming "a secondary, but entirely independent reason for *caducidad.*" These violations, however, are not said to have been "essential" to the Minister's decision to declare *caducidad*.

(c) Alleged Diplomatic Pressures

273. The Respondent asserts that it has discovered a third "separate" and "independent" justification for termination of the Participation Contract in the circumstances based on the Claimants' repeated use of diplomatic channels to put improper pressure on Ecuadorian authorities in violation of Clause 22.2.1 of the Participation Contract. In this regard, the Respondent does not accept the Claimants' explanations:

> In any event, the point that the Claimants are now attempting to make – *i.e.*, that the Claimants lobbied the U.S. Government with regard to the VAT arbitration but did not with regard to this dispute – is a distinction without a difference. *Both* are prohibited under the plain terms of the Participation Contract, and *both* give Ecuador grounds to declare *caducidad*. The Participation Contract prohibits the use of "diplomatic or consular channels" with regard to any "controversies that may arise as a result of this Participation Contract." Article 22.2.1 of the Contract provides:
>
> > "In the event of controversies that may arise as the result of the performance of this Participation Contract, in accordance with Ecuadorian law, Contractor expressly waives its right to use diplomatic or consular channels, or to have recourse to any national or foreign jurisdictional body not provided for in this Participation Contract. Lack of compliance with this provision shall constitute grounds for the *caducidad* of this Participation Contract."

> […]
>
> More to the point, Ecuador certainly *has* presented evidence of post-2002 lobbying pressure with its Counter-Memorial. Among the evidence already identified by Ecuador as showing post-2002 lobbying pressure is a telling e-mail exchange between the Claimants and the U.S. State Department on August 23-26, 2004. An examination of this document shows that it is a communication *initiated by the Claimants*, inviting U.S. Government assistance in this very dispute. (Emphasis in original)

3. The Respondent's Defense to the Claimants' Second Main Argument: The Caducidad Decree Complied Fully with the Treaty and International Law

274. By way of a preliminary observation regarding the Respondent's defense to the allegation that the *Caducidad* Decree was issued in violation of both the Treaty and international law, the Tribunal notes that the Respondent's first written submissions on this point were filed prior to the Tribunal's Decision on Jurisdiction referred to earlier in this Award. The Respondent contends that the Claimants' Treaty claims are necessarily defective in light of the Claimants' failure to challenge the *Caducidad* Decree before the Ecuadorian courts. In the words of the Respondent:

> In its Decision on Jurisdiction, the Tribunal denied Ecuador's request for a stay of the arbitration pending OEPC's pursuit of claims before Ecuadorian courts, but the denial of the request was in no way dispositive of Ecuadorian courts. The Tribunal based its decision to deny the stay on its conclusion that the Claimants were not *contractually required* to pursue their claims before Ecuadorian courts. Decision on Jurisdiction ¶96. The reasoning of the Tribunal seems to have been that since the Claimants were not contractually required to bring their claims in Ecuador, there was not basis to direct them to pursue claims in that forum before their present claims could be addressed on the merits. That conclusion does not dispose of the present argument because Ecuador's position is that the Claimants' Treaty claims are substantively defective *even if the Tribunal has jurisdiction over those claims and the Claimants were not contractually required to bring their claims in Ecuador*. This is true for the simple reason that (as developed more fully below) the act of the Minister in issuing the *Caducidad* Decree cannot attach responsibility to the State as a substantive matter when there was a mechanism available for the review of that act, which the investor simply failed to invoke. (Emphasis in original)

275. Because termination of the Participation Contract by way of *caducidad* was, according to the Respondent, proper under Ecuadorian law, "this leads to the inevitable conclusion that it was not an expropriation". The Respondent contends that it is not open to this Tribunal to conclude otherwise in the absence of a contrary ruling by the Ecuadorian courts:

> When considering the propriety of the termination under the Participation Contract and its governing law, it is important to keep in mind that the *Caducidad* Decree carries with it a presumption of validity, which may be overcome only through a determination in an Ecuadorian administrative court. Because the Claimants have not sought such a determination, they could not possibly establish that the termination was wrongful under the Participation Contract or under Ecuadorian law generally. It bears noting in this regard that several BIT tribunals have acknowledged that an investor cannot state a valid treaty claim if the viability of the claim under international law turns on whether or not a contract governed by municipal law has been violated, and the investor has not sought a ruling on that issue from a domestic court – provided, of course, that the investor had the opportunity to pursue such a claim.

276. The Respondent adds that the Claimants' Treaty and international law claims are unsustainable even if redress had been sought before the Ecuadorian courts. The Respondent argues:

> The Claimants can hardly maintain that an expropriation occurred, or that their legitimate expectations were violated, given that Ecuador issued the *Caducidad* Decree in response to OEPC's own violations of the Hydrocarbons Law, particularly where the Participation Contract itself explicitly provided for that result in such a situation. Nor can the Claimants credibly claim to have been subjected to any arbitrary or discriminatory treatment, given that the Minister's decision was grounded in Ecuadorian law and was open to review by competent Ecuadorian courts, and there were valid reasons for him to terminate the OEPC's contract, while leaving in place those of other investors. The simple truth is that the Claimants have no one but themselves to blame for the forfeiture of their investment.

277. The Respondent's submissions to the effect that it did not violate the Treaty or international law are articulated as follows:

(i) the Respondent did not expropriate the Claimants' investment because the termination of a contract in accordance with its terms and governing law is not an expropriation, and the *Caducidad* Decree was a *bona fide* administrative sanction in furtherance of a legitimate regulatory policy;

(ii) the Respondent did not violate the obligation to provide treatment "no less favourable;"

(iii) the Respondent did not arbitrarily or discriminatorily impair OEPC's investment;

(iv) the Respondent did not deny the Claimants fair and equitable treatment because, *inter alia*, the Claimants' "legitimate expectations" theories (estoppel, disproportionate sanction and absence of due process) are unwarranted and, additionally, it cannot be unfair and inequitable for the State to exercise a right explicitly granted to it in a contract with the investor, in the absence of any showing that the contract was obtained by fraud or duress, or was otherwise unenforceable;

(v) the Respondent did not deny the Claimants full protection and security;

(vi) the Respondent did not violate the umbrella clause; and

(vii) the Respondent did not violate the Treaty based on conduct of PetroEcuador.

278. The Respondent emphasizes that it acted in good faith in relation to OEPC's investment, that the *Caducidad* Decree was consistent with OEPC's legitimate expectations because it was specifically provided for under Ecuadorian law and the Participation Contract and that the *caducidad* proceedings comported with due process and were not motivated by political considerations. Specifically, regarding the Claimants' allegation that the Respondent favored other contractors (such as Canada Grande, Petrobras and Petrocol), it argues that these instances are readily distinguishable from the present case.

279. The Respondent is also of the view that the Claimants' submissions on the proportionality of the *caducidad* sanction are without merit and that the Claimants' assertion that it should have refrained from imposing *caducidad* in the absence of specific harm or damage should be rejected.

280. Additionally, the Respondent argues that, contrary to the Claimants' suggestion, it was not estopped in the circumstances from declaring *caducidad*. The Respondent maintains:

> The Claimants do not come close to meeting the *Temple of Preah Vihear* [estoppel] standard. To begin with, neither the Ministry, nor any other Ecuadorian official, ever made a "clear statement of fact" that authorization was not required for an agreement of the nature that was actually signed between OEPC and AEC, let alone one that was "voluntary, unconditional, and authorized." Indeed, no indication from an official to the effect that authorization did not seem to be necessary could have been "voluntary," because the Claimants withheld key details of OEPC's contractual arrangements with AEC in their discussions with officials, and never gave them a copy of the actual agreements. Moreover, there was no "reliance in good faith" by OEPC, let alone detrimental reliance. OEPC could not have relied on any statements of Ecuadorian officials in good faith because it had concealed key details from them, and was aware that they had no way of knowing the true nature of OEPC's agreements with AEC. And there was certainly no detrimental reliance by the Claimants, because – far from suffering any detriment – OEPC made profits from its investments in Ecuador that were made after the Farmout was signed.

281. In conclusion, the Respondent reiterates its position as to the Claimants' expectations in the circumstances of the present case:

> In the instant case, the Claimants' expectations at the time OEPC made its investment were necessarily shaped by the terms of the Participation Contract and the Hydrocarbons Law, both of which explicitly prohibited transactions of the nature that OEPC surreptitiously entered into with AEC, and provided that *caducidad* would be the sanction for any such unauthorized agreements. The Claimants' expectations were further confirmed by the letters from the Ministry and DNH, which both stated that prior authorization would be required before any such agreement could be concluded. Despite knowing full well about that prohibition, and the sanction that would result if their violations came to light,

> the Claimants went ahead and entered into the Farmout Agreement and the Joint Operating Agreement with AEC, without prior authorization from the Ministry, and concealed the true nature of both agreements from Ecuadorian authorities. In this context, the Claimants cannot credibly claim that they had a legitimate expectation that *caducidad* would not be declared when their violations were discovered, and they have no equitable basis to seek relief from this Tribunal.

282. The Respondent's counterclaim and the Claimants' response thereto, are summarized next.

IV. THE RESPONDENT'S COUNTERCLAIM

A. The Respondent's Position

283. The Respondent filed a counterclaim against the Claimants on the basis of four distinct grounds:

(i) malicious prosecution (*abuso del derecho)* in relation to these ICSID proceedings;

(ii) breach of Clause 22.2.1 of the Participation Contract regarding waiver of the right to use diplomatic or consular channels;

(iii) the Claimants' allegedly destructive and unlawful conduct following the *Caducidad* Decree, including alleged damage to data and software as well as unavailability of drilling rigs; and

(iv) the Claimants' alleged failure to pay the required assignment fee and negotiate a new participation contract more favourable to the Respondent in accordance with Article 79 of the HCL.

284. The Respondent's submissions regarding the first two heads of its counterclaim are based principally on allegations of bad faith and coercion on the part of the Claimants, as reflected by the following:

> The Claimants have launched these proceedings knowing that their claims in relation to *caducidad* are objectively baseless and cannot succeed. They have done so to apply further severe pressure on Ecuador – both in itself and in combination with procuring the U.S. Government pressure noted herein – in

> order to coerce settlement and other concessions by making it extremely difficult for Ecuador to maintain its defense in this action, and also to avoid the financial consequences of creating a means by which synthetic interests in Block 15 could be traded and profits thereby earned and concealed.
>
> In a growing number of cases, claimants who have asserted baseless claims purportedly founded in international law before ICSID or other tribunals have been ordered to pay the fees and costs of the Respondent State, in order to compensate the Respondent State for the burden and expense of defending the claims. In this case, however, recovery of fees and costs alone could by no means compensate Ecuador for all of the harm it has suffered from OEPC's wrongful conduct, which includes not only the expense associated with defending these unworthy claims, but also the loss of profits arising on the improper trading of Block 15 interests, and the substantial damage to Ecuador's reputation and economic prejudice in the market for foreign investment and world opinion.

285. With respect to the amount of the damages which it says it has suffered as a result of the Claimants' fault, the Respondent maintains that they are not readily quantifiable in economic or material terms. The Respondent accordingly argues that, under both international law and Ecuadorian law, it is entitled to moral damages to redress the consequences of the Claimants' alleged malfeasance and prevent their unjust enrichment.

286. In connection with the third ground of its counterclaim, the Respondent seeks economic damages to compensate it for losses allegedly suffered as a result of the Claimants' "destructive actions" regarding Block 15 following the issuance of the *Caducidad* Decree. The alleged "destructive actions" principally consist of the Claimants' (a) release of two drilling rigs required to maintain production levels at Block 15 and (b) deactivation of Block 15's operational software. These actions, the Respondent contends, resulted in lost production damages of over $80 million.

287. The fourth and final head of the Respondent's counterclaim, based on the allegation that the Claimants failed to pay the assignment fee and negotiate a new

participation contract more favourable to the Respondent in accordance with Article 79 of the HCL, is no longer pursued by the Respondent. It has made no attempt to quantify this claim during the quantum phase of this proceeding.

B. The Claimants' Position

288. The Claimants characterize the first two heads of the Respondent's counterclaim as "ludicrous", and submit that they fail for the following reasons:

> *First*, Ecuador's counterclaim for abuse of process is legally misconceived. The doctrine of abuse of process is seldom invoked in international practice, and Ecuador is unable to cite a single international-law case in which a tribunal has actually determined that an abuse of process occurred. The consensus that emerges from the cases that deal with the issue is that, as long as the tribunal has jurisdiction and the claims have been properly submitted, no abuse of process can have occurred. Indeed, the cases question whether the doctrine of abuse of process has any application at all in international arbitral practice.
>
> […]
>
> *Second*, even if Ecuador's expansive notion of abuse of process has any merit, it would still fail because OEPC's claims are fully justified by the facts and the law, and Ecuador's allegation of bad faith is completely baseless. (Emphasis in original)

289. Noting that the Respondent's counterclaim is based in part on the premise that the Claimants have put forward their own claims in order to obtain "leverage", the Claimants rebut this allegation of bad faith by reasserting their submissions on liability.

290. As for the Respondent's allegations of "destructive actions" on the part of the Claimants, and in particular the release of two drilling rigs required to maintain production levels at Block 15, the Claimants maintain that nothing in the Participation Contract or the HCL required OEPC to maintain at the site equipment such as oil rigs that were no longer in use. The Claimants further argue that PetroEcuador could have

assumed OEPC's oil rig contracts had it wished to recall the rigs itself. The Claimants otherwise contend that OEPC took all steps necessary to ensure the smooth transition of Block 15 from OEPC to PetroEcuador, and that any ensuing difficulties, including software-related issues, were the result of PetroEcuador's own failure to plan adequately for the Block 15 transition.

V. ANALYSIS

A. The Tribunal's Jurisdiction over the Claimants' Claims

291. The Respondent at the outset maintains that the Claimants' Treaty claims are "substantially defective" even if the Tribunal has jurisdiction over these claims because "the act of the Minister in issuing the *Caducidad* Decree cannot attach responsibility to the State as a substantive matter when there was a mechanism available for the review of that act, which the investor simply failed to invoke." The Claimants were legally obliged, says the Respondent, to pursue a local challenge to the *Caducidad* Decree before the courts in Ecuador.

292. In brief, the Claimants answer that this is a "recycled" version of the jurisdictional argument advanced by the Respondent in its jurisdictional challenge which has been dismissed by the Tribunal in its Decision on Jurisdiction[8] and which is now being "reincarnated" as a merits defense.

293. The Tribunal agrees with the Claimants. The matter is "*res judicata.*"

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[8] <u>See</u> Decision on Jurisdiction dated 9 September 2008

294. In its Decision on Jurisdiction, the Tribunal, after having referred to Article VI of the Treaty and Clause 2.2.2.1 of the Participation Contract, stated very clearly that it "does not accept that […] the parties agreed that *caducidad*-related disputes under the Participation Contract would solely be resolved by submission to the Ecuadorian administrative courts […]."[9]

295. The Tribunal then concluded that it "has jurisdiction over the Claimants' claims under both the Participation contract and the Treaty".[10]

296. This disposes of the Respondent's preliminary objection which is dismissed.

B. The Tribunal's Findings in Connection with the Claimants' Claims

1. OEPC's Breach of the Participation Contract

(a) Preliminary Observations

297. At the heart of the Claimants' case in this arbitration lies the issue of whether the Respondent, by issuing the *Caducidad* Decree on 15 May 2006, validly terminated the Participation Contract in accordance with both the Participation Contract itself and its governing law, namely Ecuadorian law and, in particular, the Hydrocarbons Law. In addressing this issue, the Tribunal must first answer the specific question of whether OEPC, upon entering into the Farmout Agreement and the Joint Operating Agreement with AEC, (i) transferred or assigned rights under the Participation Contract contrary to

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[9] *Ibid.* at paragraph 70.

[10] *Ibid*. at paragraph 89.

Clause 16.1 of the Participation Contract and in violation of Article 74.11 of the HCL, and/or (ii) created a consortium contrary to Clause 16.4 of the Participation Contract and in violation of Article 74.12 of the HCL. In the event the Tribunal answers this question in the affirmative, it will then have to determine whether or not authorization was obtained in the circumstances – it is undisputed that in either instance, authorization on the part of the Ecuadorian authorities was indeed required. And in the event that the Tribunal finds that such authorization was not obtained, it will thereafter need to address the question of whether or not the termination of the Participation Contract and the Unitized Fields Joint Operating Agreements by the Respondent through the declaration of *caducidad* was consistent with both the Treaty and customary international law as well as Ecuadorian law, and in particular whether or not it was a proportionate sanction in the circumstances.

298. As noted earlier in this Award, whilst the Claimants' wrongful termination submissions (as well as those of the Respondent) regarding the above significantly overlap, they predominantly address the Respondent's allegations of an unauthorized transfer or assignment as opposed to the Respondent's allegations of an unauthorized consortium. The Tribunal will thus consider first the central issue of whether the Farmout Agreement and the Joint Operating Agreement operated a transfer or assignment of rights under the Participation Contract contrary to Clause 16.1 thereof and in violation of Article 74.11 of the HCL.

299. Crucial to this issue of the alleged prohibition to transfer or assign rights under the Participation Contract are Clauses 16.1 and 16.2, which will be quoted again for ease of reference. They read as follows:

> **SIXTEEN: TRANSFER AND ASSIGNMENT.-**
>
> **16.1** Transfer of this Participation Contract or assignment to third parties of the rights under the Participation Contract, must have the authorization of the Corresponding Ministry, in accordance with existing laws and regulations, especially the provisions contained in Art. 79 of the Hydrocarbons Law and Executive Decrees No. 809, 2713 and 1179.
>
> **16.2** The prohibition to transfer or assign rights under this Participation Contract without the approval of the Corresponding Ministry, as determined in Art. 79 of the Hydrocarbons Law, is not an obstacle to freely trade Contractor's stock, without need of said authorization, provided that the trading of said stock does not change, modify or extinguish the legal existence of Contractor, nor constitute a decrease in its administrative, financial and technical capacities with reference to this Participation Contract.
>
> […]

300. The Respondent argues that it was entitled to terminate the Participation Contract in accordance with Clause 21.1.2 thereof, which expressly provided that the Participation Contract shall terminate "[d]ue to a transfer of rights and obligations of the Participation Contract without prior authorization of the Corresponding Ministry". The Claimants, the Tribunal recalls, deny that the Farmout Agreement and the Joint Operating Agreement operated a transfer or assignment of contractual rights and obligations under the Participation Contract. They accordingly contend that prior authorization in connection with these Agreements, when entered into in 2000, was not required.

(b) Evidence of a Transfer of Rights under the Participation Contract

301. As explained in more detail below, based on its review of the entirety of the record, the Tribunal considers that there is ample evidence to conclude that the purpose of the Farmout Agreement and the Joint Operating Agreement was to transfer from OEPC as Contractor to AEC certain of the Contractor's exclusive rights to carry out the oil exploitation activities under the Participation Contract, as set forth under Clause 4.2 of the Participation Contract, along with related rights and obligations.

302. The evidence of the intention to transfer OEPC's exclusive right to carry out the oil exploitation activities under the Participation Contract to AEC is found principally in the Joint Operating Agreement which the parties entered into as envisaged in the Farmout. Indeed, the very terms of the Joint Operating Agreement define its scope by reference to an apportionment of rights under the Participation Contract as between OEPC and AEC. Clause 3.1.1 of the Joint Operating Agreement – under the heading entitled "Scope" – stated that "[t]he purpose of this Agreement is to establish the respective rights and obligations of the Parties with regard to operations under the Participation Agreements [which include the Participation Contract], including without limitation the joint exploration, appraisal, development and production of Petroleum from the Agreement Area […]." (Emphasis added) This, in the Tribunal's view, explicitly evidences that the Joint Operating Agreement was intended to effectuate a transfer of rights and obligations held under the Participation Contract to the benefit of AEC.

303. Similarly, the terms of Clause 3.3.1 of the Joint Operating Agreement – under the heading entitled "Ownership, Obligations and Liabilities" – stated that "[u]nless

otherwise provided in this Agreement, <u>all the rights and interests in and under the Participating Agreements</u>, all Joint Property and any Petroleum and any Petroleum produced from the Agreement Area <u>shall, subject to the terms of the Participating Agreements, be owned by the Parties in accordance with their respective Participating Interests</u>." (Emphasis added) Again, this language explicitly evidences that the Joint Operating Agreement served to operate a transfer of rights and obligations held under the Participation Contract, resulting in AEC's purported "ownership" over these rights to the extent of its Participating Interest.

304. The Tribunal concludes that by virtue of having "ownership" over "all the rights and interests in and under the Participating Agreements", albeit to the extent of its 40% respective Participating Interest, the parties intended that AEC acquire such ownership as a result of a transfer of such rights and interests effected by the Joint Operating Agreement.

305. The Tribunal observes that the prohibition to transfer or assign rights and obligations under the Participation Contract is not expressed as being limited to total transfers or assignments. This prohibition must be interpreted as encompassing partial transfers or assignments such as the one effected by the Joint Operating Agreement. In the event of a transfer or assignment of rights and obligations under the Participation Contract, authorization was required regardless of whether (i) only a percentage of such rights and obligations was being transferred or assigned, (ii) only some and not all of such rights and obligations were being transferred or assigned, or (iii) only some aspect and not all aspects (for instance legal title) of such rights and obligations were being

transferred or assigned. As set out in paragraphs 612-659 below, without this authorization, any purported transfer (including a partial transfer) was invalid under the HCL. The Tribunal's finding in this regard is also confirmed by HCL-related legislation, such as Executive Decree No. 809[11], which expressly contemplates that both partial and total transfers of rights and obligations must be authorized.

306. Although the Farmout was sometimes characterized by the Claimants as "merely" transferring to AEC, in 2000, a 40% economic interest in Block 15, as opposed to legal title to an interest in Block 15, the Tribunal does not accept that the transaction, whatever may have been the parties' intention, did not serve to effectuate a transfer of rights and obligations requiring authorization on the part of the Ecuadorian authorities. As noted above, neither the Participation Contract nor the HCL allow a narrow reading of the concepts of transfer or assignment. They must be read as including all forms of such transfers or assignments, be they total or partial in nature. The fact that OEPC may have retained legal title in order to prevent any privity as between AEC and Ecuador in relation to the Participation Contract – an issue which is addressed in more detail later in this Chapter – does not, *per se*, mean that a transfer of rights and obligations was not intended by the Joint Operating Agreement. Indeed, the Tribunal has already found that the Joint Operating Agreement, by its very scope, contemplates such a transfer.

307. In addition, the Tribunal is not persuaded by the Claimants' contention that, irrespective of the Joint Operating Agreement, OEPC remained at all times the "sole

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[11] See Exhibit CA-570. See also CB-23.

guarantor" of the rights and obligations under the Participation Contract *vis-à-vis* Ecuador and that, consequently, these rights and obligations could not have been transferred to AEC. The reality is that by entering into the Joint Operating Agreement, OEPC agreed to share with AEC some of the rights and obligations it had under the Participation Contract and, in so doing, it agreed to a transfer of these rights and obligations. As such, prior authorization on the part of the Ecuadorian authorities was required.

(c) Nature of the Rights to be Transferred: The Joint Operating Agreement

308. As previously mentioned, the parties disagree as to the true nature of the rights and obligations conferred by OEPC to AEC by virtue of the Farmout Agreement and, in particular, the Joint Operating Agreement. The Claimants, on the one hand, contend that, pursuant to the Farmout Agreements, AEC had no real power or influence in connection with Block 15 operations, whereas the Respondent, on the other hand, submits that the Farmout Agreements provided AEC with "operational" influence and control over OEPC's performance as a Contractor under the Participation Agreement.

309. In support of its allegation of "operational" influence and control, the Respondent relies in particular on the funding and voting provisions of the Joint Operating Agreement as evidence that AEC had the ability to direct the day-to-day management or long-term strategy of Block 15 during the "earn-in" phase. The Claimants refute this contention, arguing that, during the "earn-in" phase, AEC had no right *per se* under the Joint Operating Agreement to force OEPC to operate Block 15 in one way or another. According to the Claimants, the only right that AEC obtained under the Joint Operating

Agreement during the "earn-in" phase was the right to sit on the Management Committee. Most of the decisions by the Management Committee, they argue, did not require AEC's concurrence – only those in connection with development and work plans, budgets and joint operations. And the only consequence of a refusal by AEC to approve a work plan or budget or operation, they conclude, was that AEC would not be required to fund that particular operation.

310. The Tribunal notes that paragraph 2(a)(ii) of the Letter of Intent expressly stated that the "Farmin Transaction is subject to the negotiation […] of […] a Joint Operating Agreement […] providing the Parties joint control (in accordance with normal Joint Operating Agreement provisions) over programs and expenditures on Block 15." (Emphasis added) Thus, "joint control […] over programs and expenditures on Block 15" was clearly part of the Joint Operating Agreement's *raison d'être*.

311. The Farmout Agreement itself refers to the Joint Operating Agreement as "govern[ing] exploration, exploitation, development, maintenance, operation and production of Block 15" (at Article 2.02). The Farmout Agreement also stated that OEPC was to "serve as Operator under the JOA" (*ibid.*).

312. In this context, the Tribunal considers it apposite to highlight certain provisions of the Joint Operating Agreement:

(i) Article 4.2 of the Joint Operating Agreement under the heading "Rights and Duties of Operator" of Article 4 entitled "Operator":

> 4.2.1 Subject to the terms and conditions of this Agreement, Operator shall have all of the rights, functions and duties of Operator under the

Participating Agreements and shall have exclusive charge of and shall conduct all Joint Operations. Operator may employ independent contractors and/or agents (which may include any Non-Operator, Affiliates of Operator and Affiliates of any Non-Operator) in such Joint Operations.

4.2.2 In the conduct of Joint Operations Operator shall:

[…]

4.2.2.4 Perform the duties for the Management Committee set out in Article 5, and prepare and submit to the Management Committee the proposed Work Programs, Budgets and AFEs as provided in Article 6. Operator shall perform all Joint Operations in accordance with approved Work Programs and Budgets;

[…]

(ii) Article 4.10.3 of the Joint Operating Agreement under the heading entitled "Removal of Operator" of Article 4 entitled "Operator":

4.10.1 Subject to Article 4.11, Operator shall be removed upon receipt of notice from any Non-Operator if:

[…]

4.10.3 Notwithstanding any provisions of this Article 4.10 to the contrary, in no event may Operator resign or be removed prior to the Transfer Date unless another Person legally entitled under the Participation Agreements to become a successor Operator may be appointed as successor Operator.

(iii) Article 5.2 of the Joint Operating Agreement entitled "Powers and Duties of Management Committee" of Article 5 entitled "Management Committee":

Without prejudice to the rights and duties of Operator under this Agreement, the Management Committee shall have power and duty to authorize and supervise Joint Operations that are necessary or desirable to fulfill the Participating Agreements and properly explore and exploit the Agreement Area in accordance with this Agreement and in a manner appropriate in the circumstances. […]

(iv) Article 5.9.2 of the Joint Operating Agreement entitled "Voting Procedure" of Article 5 entitled "Management Committee":

> 5.9.2 The following acts shall require affirmative vote of one (1) or more Parties then having collectively at least sixty-six and two-thirds percent (66-2/3%) of the Participating Interests [which would necessarily include AEC]:
>
> 5.9.2.1 Approval of a Development Plan;
>
> 5.9.2.2 Approval of a Work Program and Budget or any amendment or modification thereof;
>
> 5.9.2.3 Overexpenditures on any line item of an approved Work Program and Budget by more than twenty percent (20%) or U.S. $1,000,000, whichever is less, of the authorized amount for such line item, or overexpenditures for a Calendar Year of a total Work Program and Budget by more than ten percent (10%) or U.S. $5,000,000, whichever is less; and
>
> 5.9.2.4 Decisions on financing Joint Operations (including any decisions to repay indebtedness on any such financing) prior to the Transfer Date.
>
> […]

(v) Article 5.13.5 of the Joint Operating Agreement under the heading entitled "Effect of Vote" of Article 5 entitled "Management Committee":

> 5.13.5 No decision of the Management Committee shall be binding if it conflicts with a decision by any Integrated Management Committee with Petroecuador for the Eden-Yuturi Unit or the Limoncocha Unit or any other unit in which all or any portion of Block 15 is hereafter utilized.

(vi) Article 6.3 of the Joint Operating Agreement under the heading entitled "Production" of Article 6 entitled "Work Programs and Budgets":

> On or before the 1st Day of October of each Calendar Year, Operator shall deliver to the Parties a proposed production Work Program and Budget detailing the Joint Operations to be performed in the Development Area and the projected production of schedule for the following Calendar Year. Within Thirty (30) Days of such delivery, the

> Management Committee shall agree upon a production Work Program and Budget.

(vii) Article 7.1.1 of the Joint Operating Agreement under the heading entitled "Limitation on Applicability" of Article 7 entitled "Operations By Less Than All Parties":

> 7.1.1 No operations may be conducted in furtherance of the Participating Agreements except as Joint Operations under Article 5 or as Exclusive Operations under Article 7. No Exclusive Operation shall be conducted which conflicts with a Joint Operation or which conflicts with any of the Participating Agreements.

(viii) Article 14.1 of the Joint Operating Agreement under the heading entitled "Relationship of Parties" of Article 14 entitled "Relationship of Parties and Tax":

> The rights, duties, obligations and liabilities of the Parties under this Agreement shall be individual, not joint or collective. It is not the intention of the Parties to create, nor shall this Agreement be deemed or construed to create a mining or other partnership, joint venture or association or (except as explicitly provided in this Agreement) a trust. This Agreement shall not be deemed or construed to authorize any Party to act as an agent, servant or employee for any other Party for any purpose whatsoever except as explicitly set forth in this Agreement. It is understood that each Party is entering into this Agreement for the purpose of protecting and developing its Participating Interest. In their relations with each other under this Agreement, the Parties shall not be considered fiduciaries except as expressly provided in this Agreement.

313. The Tribunal further recalls that the parties, during the Hearing, pointed extensively to Management Committee minutes for purposes of analyzing AEC's actual involvement with Block 15. The Claimants refer to such minutes as evidence that AEC was only consulted as a mere financial backer with no actual veto power regarding development plans, work plans and budgets, whereas the Respondent refers to such minutes as evidence that AEC's approval was required in connection with Block 15 expenditures and operations.

314. The Tribunal has already found that, subject to paragraphs 612-659 below, by virtue of the Joint Operating Agreement, AEC was to acquire rights and interests in and under the Participating Agreements, to the extent of its 40% Participating Interest. But as can be gleaned from these provisions, the Joint Operation Agreement did not only seek to operate as a general transfer of certain rights and interests in and under the Participating Agreements. To the contrary, the Joint Operating Agreement resulted in the exercise of <u>specific</u> managerial and voting rights by AEC in connection with Block 15.

315. In particular, the Tribunal notes that AEC was granted the right to veto all "acts" of significance under the Joint Operating Agreement as a member – on an equal footing with OEPC – of the Management Committee. Article 5.1 of the Joint Operating Agreement stated that "[t]o provide for the overall supervision and direction of Joint Operations, there is established a Management Committee composed of representatives of each Party holding a Participating Interest." The "Joint Operations", the Tribunal further recalls, are defined as "those operations and activities carried out by the Operator pursuant to this Agreement for Block 15" (Article 1.40 of the Joint Operating Agreement). As a member of the Management Committee, AEC thus acquired the "<u>power</u> and duty to authorize and supervise Joint Operations that are necessary or desirable to fulfill the Participating Agreements and properly explore and exploit the Agreement Area in accordance with this Agreement and in a manner appropriate in the circumstances" (Article 5.2). (Emphasis added)

316. The Management Committee's "Voting Procedure" under Article 5.9.2 sheds further light on AEC's real and well defined rights in its capacity as a full member of the

Committee. This provision identifies a number of "acts" which required a majority vote, (thus the vote of both AEC and OEPC), including *inter alia* "Approval of a Development Plan" (Article 5.9.2.1); "Approval of a Work Program and Budget or any amendment or modification thereof" (Article 5.9.2.2); "Overexpenditures on any line item of an approved Work Program and Budget by more than twenty percent (20%) or U.S. $1,000,000, whichever is less, of the authorized amount for such line item, or over expenditures for a Calendar Year of a total Work Program and Budget by more than ten percent (10%) or U.S. $5,000,000, whichever is less" (Article 5.9.2.3); and "Decisions on financing Joint Operations (including any decisions to repay indebtedness on any such financing) prior to the Transfer Date" (Article 5.9.2.4).

317. In the Tribunal's view, these provisions demonstrate incontrovertibly that the Joint Operating Agreement conferred to AEC real and specific managerial and voting rights in connection with Block 15, and thereby sought to confer rights under the Participation Contract, and the Tribunal so finds.

318. The fact that OEPC, as Operator, retained exclusive charge of all Joint Operations pursuant to Article 4.2.1 of the Joint Operating Agreement does not modify the Tribunal's finding. In this connection, the Tribunal notes that when, on 15 July 2004, OEPC made its formal request to PetroEcuador for the transfer to AEC of legal title to its 40% economic interest in Block 15, it confirmed explicitly that it would retain the operation of Block 15 both before and after the "earn-in" phase. In other words, OEPC remained sole Operator under the Participation Agreements both before and after AEC was to acquire legal title. Consequently, the fact that OEPC, after execution of the

Farmout Agreement retained exclusive charge of all Joint Operations is not a relevant factor in the determination by the Tribunal of whether or not a transfer of rights to AEC was to occur prior to the vesting of legal title to those rights.

319. A related issue – which the Tribunal need not determine in view of its earlier finding – concerns the question of whether AEC, prior to the vesting of legal title, was entitled to impose an "Exclusive Operation" in the event the Management Committee failed to reach agreement on a "Joint Operation." Article 7.1.1 of the Joint Operating Agreement provided as follows:

> No operations may be conducted in furtherance of the Participating Agreements except as Joint Operations under Article 5 or as Exclusive Operations under Article 7. No Exclusive Operation shall be conducted which conflicts with a Joint Operation or which conflicts with any of the Participating Agreements.

320. In the Tribunal's view, the issue of whether or not AEC could impose an Exclusive Operation under the Joint Operating Agreement prior to obtaining legal title is immaterial to the question of whether AEC acquired rights under the Participation Contract. AEC's rights in connection with Block 15 Exclusive Operations do not change the fact that the Joint Operating Agreement conferred to AEC specific managerial and voting rights in connection with such Block 15 Joint Operations, and thereby sough to confer rights under the Participation Contract, as found earlier by the Tribunal.

321. Another argument by the Claimants is that AEC's specific managerial and voting rights cannot result in a transfer of rights under the Participation Contract because the Joint Operating Agreement did not allow for decisions on the part of the Management Committee that conflicted with the Participation Agreements. In support of this

argument, the Claimants point to the above-quoted Article 7.1.1 of the Joint Operating Agreement, as well as Article 5.13.5 of the Joint Operating Agreement, which the Tribunal reproduces again for ease of reference:

> 5.13.5 No decision of the Management Committee shall be binding if it conflicts with a decision by any Integrated Management Committee with Petroecuador for the Eden-Yuturi Unit or the Limoncocha Unit or any other unit in which all or any portion of Block 15 is hereafter utilized.

322. The fact that rights under the Joint Operating Agreement were to be exercised in accordance with the Participating Agreements (which would have been the case both before and after AEC had acquired legal title) does not imply that such rights were not being transferred to AEC or that they did not otherwise exist. It simply means, and the Tribunal so finds, that OEPC could not transfer other rights than those it held under the Participation Agreements: *nemo dat quod non habet*.

323. The distinction which must be made is between rights that may (or not) have been immediately "exercisable" by AEC, as opposed to rights that were immediately "transferable" to AEC. Hence, the Claimants contend that even if the Joint Operating Agreement may appear on its face to transfer specific rights to AEC in connection with the day-to-day management and operation of Block 15, these rights, they aver, could only be exercised in the future, *i.e.* once legal title had been acquired by AEC.

324. In other words, according to the Claimants, the Joint Operating Agreement did not operate an immediate transfer of rights, but rather a conditional transfer which would only vest upon transfer of legal title to AEC.

325. The Claimants' expert on this point, Mr. Norman E. Maryan Jr., opined as follows: "I believe that the Parties intended the JOA in this case to be broadly drafted to enable its use both before and after legal title vested. I do not believe that such broadly drafted Joint Operating Agreements, such as the JOA in this case, can support the conclusion that AECI was vested with full rights of a non-operator from the inception of the JOA."[12]

326. The Tribunal notes however that Mr. Maryan nuanced his opinion and admitted that the rights were indeed granted, albeit "apparently". He stated as follows: "I believe that <u>many of the rights apparently granted</u> AEC under the JOA <u>could, in fact, not be fully exercised</u> until after legal title vested."[13] (Emphasis added)

327. The Respondent's expert, Mr. A. Timothy Martin, when questioned at the Hearing on Mr. Maryan's views in this regard, opined as follows: "I disagree with this conclusion. It is my opinion that most of the rights that you would normally see in an industry JOA are, in fact, existent in this Operating Agreement, and <u>they are fully exercised both before and after legal title vested</u>."[14] (Emphasis added)

328. Thus, the parties' experts are in agreement that, on its face, the Joint Operating Agreement operated, at a minimum, an apparent transfer of rights, but they disagree as to whether such rights could be exercised by AEC prior to the transfer of legal title. In the

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[12] Expert Report of Norman E. Maryan Jr. dated 10 August 2008 at page 13.

[13] *Ibid.* at page 5.

[14] Hearing Transcript (20 December 2008) at page 1789.

Tribunal's view, the fact that the debate between the experts focussed on whether certain rights could be exercised, as opposed to whether such rights were to be transferred, is irrelevant for purposes of the findings the Tribunal has made in respect of its interpretation of the Joint Operating Agreement. The true issue is whether a transfer of rights was to occur between OEPC and AEC upon execution of the Farmout Agreement and the Joint Operating Agreement, *i.e.* whether a purported transfer of rights has been established, and the Tribunal has conclusively found this to be the case. The issue of whether such rights, once transferred, could or could not be immediately exercised is not relevant to the Tribunal's analysis.

(d) The Farmout Agreement

329. The Tribunal has found in the previous Section that, by its terms, the Joint Operating Agreement purported to transfer rights to AEC which OEPC held under the Participation Agreements. In the present Section, the Tribunal finds that the Farmout Agreement by its terms, also purported to transfer rights to AEC, which OEPC held under the Participation Agreements.

330. One of the central provisions of the Farmout Agreement, Section 2.01, provided that, during the "earn-in" phase, OEPC would "hold[] legal title to AECI's interest in the Farmout Property on behalf of AECI". The "Farmout Property" was defined in Section 1.01 as including "the Participation Agreements and the rights and interest therein granted to OEPC in and with respect to Block 15." Section 2.01 of the Farmout Agreement (quoted earlier) further provided, in relevant part, as follows:

> Art. 2.01 […]The Farmout Interest to be transferred to AECI as of the Effective Time includes a "working interest" or "participating interest" in the Participating Agreements and Block 15 <u>except that it does not include nominal legal title to an interest in Block 15</u> or an interest as a party to the Participating Agreements. <u>OEPC shall continue to own 100% of the legal title to the Participating Agreements</u> and to the interests in Block 15 granted or provided for in the Participating Agreements; provided that from and after the Effective Time <u>OEPC shall hold legal title to the interest in the Farmout Property represented by the Farmout Interest of AECI in the Participating Agreements and Block 15 as a "nominee" with the obligation to convey legal title to such interest to AECI, subject to obtaining required governmental approvals, promptly following AECI's payment of all amounts required to earn the interest in the Farmout Property</u> represented by the Farmout Interest as hereafter provided and the expenditure of such amounts by OEPC as Operator under the JOA for Block 15 Capex (as hereinafter defined). <u>Prior to such conveyance, while OEPC holds legal title to AECI's interest in the Farmout Property on behalf of AECI, OEPC shall be obligated, at the sole risk, cost and expense of AECI, to act with respect to the Farmout Interest of AECI as AECI shall direct from time to time as if AECI were a party to the Participating Agreements owning legal title to a 40% interest in the Participating Agreements and the interests therein granted in Block 15</u>, subject to and in accordance with the terms and provisions of the JOA provided for in Section 2.02. (Emphasis added)

331. It is clear to the Tribunal that this crucial Section 2.01 of the Farmout Agreement confirms that AEC was to have *de facto* legal title to its interest in the "Farmout Property," but that this title was to be "held" by OEPC on its behalf until the required governmental approvals were obtained. This provision further confirms that OEPC had undertaken to act as the Contractor under the Participation Contract – a right it had acquired on an exclusive basis – "as if" AEC was a party to this Participation Contract. In reality, as between OEPC and AEC, the situation was identical both before and after conveyance of legal title in so far as the Participation Contract was concerned; they were operating *de facto* pursuant to the Joint Operating Agreement "as if" legal title had already been conveyed, and the ministerial authorization for the conveyance of legal title was a mere formality. More fundamentally, in the view of the Tribunal, this meant that OEPC was sharing with AEC its exclusive right to carry out Block 15 operations and was obligated "to act with respect to the Farmout Interest of AECI as AECI shall direct from

time to time." This Section 2.01 of the Farmout Agreement, coupled with those provisions of the Joint Operating Agreement which the Tribunal reviewed previously, comfort the Tribunal in its conclusion that OEPC did indeed seek to transfer to AEC under these agreements rights it acquired from Ecuador under the Participation Contract.

(e) Privity of Contract

332. One of the Claimants' main argument in support of its contention that OEPC did not transfer or assign rights under the Participation Contract to AEC contrary to Clause 16.1 of the Participation Contract and in violation of Article 74.11 of the HCL is that, until legal title was transferred to AEC, only OEPC remained liable *vis-à-vis* the Respondent and PetroEcuador for the performance of the Participation Contract and that only OEPC could enforce its rights under the Participation Contract. In other words, according to the Claimants, an assignment or transfer of contractual rights required privity between AEC and the Respondent and since the transfer of a 40% economic interest did not create such privity, AEC did not acquire rights in the Participation Contract that could be enforced against Ecuador.

333. The Tribunal is not persuaded by the Claimants' submission. The fact that OEPC may have retained legal title and that no privity as between AEC and Ecuador existed in relation to the Participation Contract does not necessarily lead to the conclusion, in the circumstances of this case, that the Farmout Agreement and/or the Joint Operating Agreement did not purport to transfer rights from OEPC to AEC, as the Tribunal has found.

334. The Tribunal observes that, if it adopted the Claimants' argument, an unauthorized transfer or assignment of rights in a case such as the present one, could never be found. Privity necessarily implies authorization on the part of the Ecuadorian authorities since it requires that AEC be made a party to the Participation Contract, which cannot happen without such authorization. The Claimants appeared to recognize that their argument was illogical since they acknowledged that "neither the transfer of economic interest nor the unauthorized transfer of legal title would have created privity."

335. The Tribunal also observes that Article 4.01 of the Farmout Agreement confirms the Tribunal's conclusion. Under this Article, the conveyance of legal title and the creation of privity between AEC and PetroEcuador under the Participation Contract are clearly identified as two separate and distinct legal transactions. This Article, which is found in Part IV of the Farmout Agreement, titled "Assignment of Legal Title", reads as follows:

> Art. 4.01 Promptly after AECI has made all payments of the OEPC Carry provided for in Sections 3.03, 3.04 and 3.05 and OEPC as Operator under the JOA has expended such amounts for Block 15 Capex, OEPC and AECI shall execute and deliver such documents as are required to convey legal title to AECI in and to a 40% economic interest in the Participating Agreements and Block 15 and to make AECI a party to the Participating Agreements as owner of such 40% economic interest (subject to obtaining required governmental approvals). Any transfer fees or administrative charges imposed by any government agency or department with respect to such transactions shall be paid by AECI. (Emphasis added)

336. In sum, the absence of privity in the circumstances of this case is of no consequence in view of the Tribunal's earlier findings that OEPC sought to transfer to AEC rights it held under the Participation Contract. The Farmout Agreement itself confirms the Tribunal's conclusion.

(f) The Remaining Allegations of Breach of the Participation Contract and HCL Violations

337. Having found that the Farmout Agreement and the Joint Operating Agreement purported to effect a transfer of rights under the Participation Contract from OEPC to AEC, the Tribunal need not address the question of whether it also created a consortium contrary to Clause 16.4 of the Participation Contract and in violation of Article 74.12 of the HCL. For the same reason, the Tribunal need not address the Respondent's allegations of technical infractions on the part of OEPC in violation of Article 74.13 of the HCL.

338. Even if the Tribunal were to find in favor of the Respondent with respect to these allegations, these findings would not affect the conclusion of the Tribunal that the *Caducidad* Decree was not a proportionate response by Ecuador in the particular circumstances of this case.[15] In addition, the Tribunal notes that whether it finds one, two or three violations by the Claimants of the HCL, the sanction remains the same: *Caducidad*. The sanction is not cumulative.

339. The Tribunal will now turn to the issue of OEPC's obligation to obtain authorization from the "Corresponding Ministry" for this transfer and whether OEPC did seek such authorization.

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[15] <u>See</u> *Infra*, paragraph 442.

2. OEPC's Duty to Obtain Authorization for the Transfer of Rights under the Participation Contract

340. As noted earlier, it is undisputed that in order to proceed with a transfer of rights under the Participation Contract, OEPC was required to obtain prior authorization on the part of the Ecuadorian authorities. The previously-quoted Clause 16.1 of the Participation Contract clearly stated:

> **SIXTEEN: TRANSFER AND ASSIGNMENT.-**
>
> **16.1** Transfer of this Participation Contract or assignment to third parties of the rights under the Participation Contract, <u>must have the authorization of the Corresponding Ministry</u>, in accordance with existing laws and regulations, especially the provisions contained in Art. 79 of the Hydrocarbons Law and Executive Decrees No. 809, 2713 and 1179. (Emphasis added)

341. Just as clearly, Clause 21.1.2 of the Contract expressly provided that the Participation Contract shall terminate "[d]ue to a transfer of rights and obligations of the Participation Contract <u>without prior authorization of the Corresponding Ministry</u>." (Emphasis added) The Tribunal recalls that the Participation Contract tracks the requirements of Ecuador's HCL, in particular the following:

> **CHAPTER IX**
> ***Caducidad,* Sanctions and Transfers**
>
> Art. 74. The Ministry of Energy and Mines may declare the *caducidad* of contracts, if the contractor:
>
> […]
>
> 11. Transfers rights or enters into a private contractor agreement for the assignment of one or more of its rights, <u>without the Ministry's authorization</u>;
>
> […]

> Art. 79. The transfer of a contract or the assignment to third parties of rights derived from a contract shall be null and void and shall have no validity whatsoever <u>if there is no prior authorization</u> from the Ministry of Energy and Mines, without prejudice to the declaration of *caducidad* as provided for in this Law.
>
> […] (Emphasis added)

342. In its review of the evidence on this crucial issue, the Tribunal notes, firstly, that the Letter of Intent dated 9 August 2000[16], signed prior to entering into of the Farmout Agreement and Joint Operating Agreement, stated at paragraph 5 that the "Farmin Transaction would be expressly conditioned upon the approval by the respective Boards of Directors of AECI and Occidental Petroleum Corporation and necessary governmental approvals, <u>if any</u>, including without limitation, the approval of Ministry of Energy and Mines in Ecuador." (Emphasis added) There was thus no consensus between AEC and OEPC that ministerial authorization was necessary.

343. The evidence before the Tribunal discloses that the debate within the ranks of OEPC as to whether or not ministerial authorization was necessary with respect to the first phase of the Farmout continued after the execution of the Letter of Intent. Two separate draft letters to the Ecuadorian Minister of Energy and Mines, both dated 23 October 2000, constitute proof eloquent that there were indeed two schools of thought in this regard. These draft letters prepared by OEPC officials set forth different courses of action and, in the Tribunal's opinion, assist in understanding the events that followed. The first draft letter, "Version A," is worded as follows:

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[16] <u>See</u> *supra* at paragraph 128.

I. BACKGROUND

1. As you are aware, OEPC and PETROECUADOR entered into a Participation Contract for upstream activities in Block 15 of the Amazon Region, in the terms and conditions contained in the corresponding Public Deed, recorded with the National Hydrocarbons Registry on June 2, 1999.

2. In order to reinforce the additional exploration work, development and production of Block 15, OEPC and AOEPC [AEC] are in the process of studying the possibility of executing an agreement based on which AOEPC [AEC] would contribute funds to finance part of the investments required for such purpose, in exchange of a share in the proceeds derived from such investment. AOEPC [AEC] would not acquire the rights and obligations derived from said Participation Contract, and OEPC will continue to comply with said Contract and will continue to be the sole liable party towards PETROECUADOR. Consequently, this negotiation only implies the acquisition by AOEPC [AEC] of an economic interest in the results produced by such additional exploration work, development and production of the Block 15 Participation Contract, without AOEPC [AEC] acquiring legal tile in said Contract. OEPC will continue to be the only entity with legal rights and obligations under the Block 15 Participation Contract.

3. Based on this negotiation, OEPC would recognize to AOEPC [AEC] the right to acquire legal title and an effective share in the Block 15 Participation Contract, once the several conditions that would be stipulated in the agreement, prior clearance from the Ministry of Energy and Mines, and other requirements of Ecuadorian laws and the Block 15 Participation Contract between OEPC and PETROECUADOR are met.

I. REQUEST:

In view of the above and based on the provisions contained in Article 74(1) and Article 79 of the Law on Hydrocarbons, as well as the regulatory rules issued for the application of said law, we request the following:

1. <u>Please confirm whether, as is our understanding, the transaction described in the background to this request does not require the prior approval referred to in Article 74(11) and 79 of the Law on Hydrocarbons.</u> As indicated above, this transaction does not imply an assignment of legal title or rights in the Block 15 Contract, but rather it is a simple recognition in favor of AOEPC [AEC] of an economic interest in the results derived from said contract. If, however, AOEPC [AEC] will acquire legal title and rights in the Block 15 Participation Contract once the conditions to be stipulated in said agreement are fulfilled, then prior clearance from the Ministry of Energy and Mines and compliance of other procedures and requirements contemplated by Ecuadorian laws would be required;

2. <u>On a subsidiary basis,</u> in the unlikely event that your answer to the preceding point is negative, <u>we request you authorize OEPC to assign to AOEPC [AEC] an economic interest in the results produced by the additional exploration work, development and production of the Block 15 Participation Contract.</u> In this case, we request you also authorize the agreement by virtue of which both companies would agree that once several conditions to be stipulated in the contract to be executed between them have been fulfilled, OEPC would transfer to AOEPC [AEC] legal title and rights in the Block 15 Participation Contract, prior compliance of other procedures and requirements contemplated by applicable Ecuadorian laws and regulations and the Block 15 Participation Contract. It should be noted that the transaction described in the background to this request would not, in any way, affect the rights and obligations assumed by the Contractor – OEPC – under the Participation Contract with PETROECUADOR; and that the transfer of rights in Block 15, which would be made once the several conditions to be stipulated in said agreement are fulfilled, would in no way diminish the capacity of the Block 15 Contractor. Not only would OEPC continue to be jointly liable for contract compliance, but AOEPC [AEC] would also be liable for the compliance of said obligations. It should also be noted that the financial, technical and operative capacity of AOEPC [AEC] to enter into upstream contracts has already been qualified by the Ecuadorian Government since the time Petroecuador executed several upstream contracts with said company.

3. Lastly, in the event the answer to the first point is negative, we would also appreciate your indicating whether the payments contemplated in Article 2.b of Presidential Decree 809 (Official Gazette 197, May 31, 1985) that regulates the application of Article 79 of the Law on Hydrocarbons must be made as a result of the authorization referred to in point 2 above; or, otherwise whether such sums must be paid only when the transfer of rights and obligations in the Block 15 Participation Contract, by OEPC in favor of AOEPC [AEC], becomes effective. As repeatedly stated above, the transfer would be made only when several conditions to be agreed in the agreement that would be negotiated are fulfilled, and after other formalities and requirements contemplated by Ecuadorian Law and the conditions stipulated in the Participation Contract have been met. (Emphasis added)

344. Version B, on the other hand, is formulated as follows:

I. BACKGROUND

1. As you are aware, OEPC and PETROECUADOR entered into a Participation Contract for upstream activities in Block 15 of the Amazon Region, in the terms and conditions contained in the corresponding Public Deed, recorded with the National Hydrocarbons Registry on June 2, 1999.

2. In order to reinforce the additional exploration work, development and production of Block 15, upon receipt of all required government approvals, OEPC and AOEPC [AEC] will complete an agreement based on which AOEPC [AEC] would contribute funds to finance part of the investments required for such purpose, in exchange for a forty percent (40%) share in the proceeds derived from the Block including its unitized operations. AOEPC [AEC] would only acquire the rights and obligations derived from said Participation Contract at a future time and only after the Ministry of Energy and Mines granted its express approval, prior to the time that such rights are transferred. Until such future transfer is separately approved by the Ministry of Energy and Mines and finalized with OAEPC [*sic*] [AEC], OEPC will continue to comply with said Participation Contract and will continue to be the sole party liable to PETROECUADOR. Consequently, the agreement to be completed, for the present only implies the acquisition by AOEPC [AEC] of an economic interest in the results produced from the Block 15 Participation Contract, without AOEPC [AEC] acquiring any legal title in said Participation Contract. OEPC will continue to be the only entity with legal rights and obligations under the Block 15 Participation Contract.

3. In addition to the economic interest presently being acquired by AOEPC [AEC], as described above, and based on the negotiated agreement to be completed between OEPC and AOEPC [AEC], OEPC will commit to assign to AOEPC [AEC], sometime during or after January, 2005, legal title and an effective share in the Block 15 Participation Contract and its unitized operations, but only once the several conditions stipulated in the agreement, the requirement for prior clearance from the Ministry of Energy and Mines, and other requirements of Ecuadorian laws and the Block 15 Participation Contract between OEPC and PETROECUADOR are satisfied. Separate approval of this transfer of interest in the Block 15 Participation Contract and unitized areas will be sought from the Ministry of Energy and Mines at future time.

I. REQUEST:

In view of the above and based on the provisions contained in Article 74 (11) (12) and Article 79 of the Law on Hydrocarbons, as well as the regulatory rules issued for the application of said law, we request the following:

1. <u>Please grant for this transaction the prior approval referenced in Articles 74 (11) (12) and 79 of the Law on Hydrocarbons or else indicate that no such approval is required for such transaction</u>. As indicated above, this transaction does not imply a present assignment of legal title or rights in the Block 15 Participation Contract, but rather is a simple recognition in favor of AOEPC [AEC] of an economic interest in the results derived from said contract.

> 2. Under the negotiated agreement between OEPC and AOEPC [AEC], AOEPC [AEC] may acquire legal title and rights in the Block 15 Participation Contract and unitized areas, provided that approval from the Ministry of Energy and Mines is obtained prior to the time of the transfer, and further, provided that the conditions to be stipulated in said agreement are satisfied, and finally, provided that compliance of other procedures and requirement contemplated by Ecuadorian laws is achieved.
>
> 3. Lastly, we would also appreciate your indicating whether the payments contemplated in Article 2.b of Presidential Decree 809 (Official Gazette 197, May 31, 1985) that regulates the application of Article 79 of the Law on Hydrocarbons must be made as a result of the authorization referred to in point 1 above; or, otherwise whether such sums must be paid only when the transfer of rights and obligations in the Block 15 Participation Contract, by OEPC in favour of AOEPC [AEC], becomes effective as described in point 2 above. As repeatedly stated above, the transfer would be made only when several conditions to be agreed in the agreement that would be negotiated are fulfilled, and after the other formalities and requirements contemplated by Ecuadorian Law, including the requirement for formal approval by the Ministry of Mines and Energy, and all other conditions stipulated in the Participation Contract have been met. (Emphasis added)

345. In the Tribunal's view, the two camps within OEPC had sound and valid reasons for advocating their respective positions. The proponents of Version A saw the Farmout for what it truly was for oilmen, *i.e.* an "oil for money" deal which allowed OEPC to finance and leverage its continued exploration of Block 15. In effect, AEC would serve as a bank for OEPC. During the "earn-in" phase, OEPC would continue to be solely responsible *vis-à-vis* PetroEcuador for the performance of all its obligations under the Participation Contract. The future event which mattered and which would require ministerial authorization was the eventual transfer of legal title to AEC of 40% of Block 15 sometime later when AEC, the farmee, had fulfilled its "earn-in" obligations under the Farmout.

346. The proponents of Version A within OEPC (and AEC) were in good company which included the Claimants' expert on this issue, Mr. Andrew Derman. In his report

submitted as part of this proceeding, Mr. Derman concluded, very categorically, that "[t]here was no transfer of legal title or rights and obligations under the Participation Contract by OEPC to AEC under either the Farmout Agreement or the Operating Agreement."[17] As he explained later in his report:

> Under the Farmout Agreement, if AEC satisfied its payment obligations, AEC had a right to receive from OEPC a portion of OEPC's oil produced under the Participation Contract. While OEPC could not guarantee that AEC would receive legal title, as legal title required approval by the Government of Ecuador, OEPC had a right to dispose of its oil freely, under the Participation Contract, and it could give AEC a portion of such produced oil. AEC essentially financed a portion of OEPC's financial exposure and, <u>like a bank</u>, AEC was repaid and compensated under the pre-agreed terms of the Farmout Agreement. If the Government of Ecuador did not approve the assignment of legal title, AEC would be repaid and compensated for its financing, but it would never secure its position and it would never obtain legal title. <u>Like a bank</u>, AEC's financing would remain uncollateralized.[18] (Emphasis added)

347. On the other hand, the proponents of Version B, probably the lawyers, advocated that it was prudent to ask for "prior approval" for the "earn-in" phase. They had obviously carried out a cursory examination of the agreements at issue. But tellingly, the proponents of Version B were not dogmatic about the requirement of ministerial authorization. As noted earlier, the key paragraph of their draft concluded "… or else indicate that no such approval is required for such transaction."

348. Members of the Version A clan prevailed. They did not heed the sound advice of the lawyers and, in doing so, may have acted unwisely and been imprudent. Their proposed course of action may have been risky, as later events confirmed, but, for the

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[17] Expert Report of Andrew B. Derman dated 10 August 2008 at paragraph 15.

[18] *Ibid.* at paragraph 37.

reasons set forth in more detail below, the Tribunal fails to see any evidence that their views were driven by bad faith. They were business people, seasoned oilmen, for whom legal niceties were not as important as the business realities of the deal. Their behaviour, unfortunately for the Claimants, was to have dire consequences.

349. That behaviour, as the record after 23 October 2000 illustrates, led to other instances where OEPC's silence and, in particular, one confusing written message, resulted in serious misunderstandings and understandable confusion within the Ecuadorian Ministry of Energy and Mines.

350. The saga which has culminated in the present dispute commenced on 24 October 2000. As noted earlier, on that date, senior executives of both OEPC and AEC flew to Quito from the United States and Canada for the purpose of informing Minister Terán of the transaction. The reason for the meeting was not conveyed to the Minister when the appointment was scheduled.

351. The "script" prepared for that important meeting demonstrates, without the shadow of a doubt, that the proponents of Version A had carried the day and that no authorization would be sought for the "earn-in" phase. The first three numbered paragraphs of this "script" tell the whole story in a nutshell by highlighting that:

> 1) Oxy and AEC <u>have agreed</u> that AEC will assume a 40% economic interest in Block 15 effective 01 Oct 00.
>
> 2) AEC will assume a role as <u>full partner</u> effective 2005, <u>subject to GoE approval</u>.
>
> 3) No initial change in the contractual rights and obligations or legal title for Bl15. No change in operational methodology for Petroecuador or the GoE. (Emphasis added)

352. The first paragraph of the "script" thus, very succinctly, describes the "earn-in" phase, for which no authorization is sought, nor confirmation that authorization is not required. The second paragraph of the "script", again succinctly, describes the subsequent phase by which AEC would become a "full partner" by virtue of acquiring legal title and for which "GoE approval" is required. The third paragraph sets forth the Claimants' view of the world during the "earn-in" phase.

353. During the meeting of 24 October 2000, Minister Terán was not provided with a copy of the Farmout Agreement which OEPC and AEC had signed five days earlier. While there is no evidence that the Minister asked for a copy of the Agreement, the Tribunal has formed the view that the better course would have been to have handed a copy to the Minister. After all, OEPC and the Government of Ecuador were partners under the Participation Contract. If only on the basis of that contractual relationship, OEPC should have concluded that the better course was to provide a copy of the Farmout Agreement to their partner during that meeting.

354. On 25 October 2000, Paul MacInnes, President of OEPC, who had lead the OEPC team during the meeting on the previous day wrote to Minister Terán. Due to the importance of this letter, which has already been referred to[19], the Tribunal will quote it in full:

> In our meeting held on October 24 of this year, we had the opportunity to notify you about the imminent transaction pursuant to which Occidental Exploration and Production Company ("OEPC") intends to transfer to City Investing Company

[19] See *supra* at paragraph 151.

> Limited ("CITY") 40% of its economic interests in the Participation Contract for the Exploitation and Additional Exploration of Hydrocarbons in Block 15 (the "Block 15 Contract"). This transfer shall also include the rights of OEPC in the Operating Agreements for Unified Exploitation of the Eden Yuturi and Limoncocha Unified Fields.
>
> After the consummation of this transaction, OEPC shall continue being the only "Contractor" entity under the Block 15 Contract. Once CITY has complied with its obligations contemplated in the transfer agreement, OEPC shall transfer to CITY the legal title corresponding to 40% of its interests in the Block 15 Contract and in the Operating Agreements for Unified Exploitation, subject to the approvals that the Government of Ecuador may require at that time.
>
> This transaction will not negatively affect any of the operations contemplated in the Block 15 Contract or in the Operating Agreements for Unified Exploitation.
>
> We are sure that this transaction will bring significant benefits to the Government of Ecuador and the companies. Therefore, we respectfully request that the Ministry of Energy and Mines confirm as soon as possible, your consent with respect to the aforementioned transfer of economic interests in favor of CITY.

355. That letter is very confusing and at the source of conflicting evidence both as to events prior to and subsequent to that date.

356. The Tribunal notes that the letter was written in Spanish but there is no dispute between the parties as to the accuracy of the English translation. The introductory paragraph, which refers to "the imminent transaction", is clearly a reference to the "earn-in" phase. The Tribunal recalls that, whilst the Farmout Agreement was executed on 19 October 2000 to be effective 1 October 2000, the Joint Operating Agreement was dated 31 October 2000 to "have effect from the 1st day of October 2000". In other words, while it may have been strictly correct for OEPC to refer to an "imminent transaction", it would have been more accurate to refer to a transaction (and thus a "transfer") which had taken place 6 days earlier, on 19 October 2000, and which was in effect since 1 October

2000. Indeed, the Tribunal notes that paragraph 1) of the "script" correctly stated that "Oxy and AEC <u>have agreed</u> …." (Emphasis added)

357. The Tribunal further observes that in the second paragraph of the letter of 25 October 2000, OEPC is clearly referring to the subsequent phase of the Farmout which, it states, is "subject to the approval that the Government of Ecuador may require at that time."

358. As for the third paragraph of this letter, in the Tribunal's view, it can only be interpreted as referring to the "earn-in" phase. "This transaction" clearly refers to the "imminent transaction" described in the introductory paragraph.

359. Thus, the first three paragraphs of the follow-up letter of 25 October 2000 are in fact a reiteration, albeit more detailed, of the first three paragraphs of the "script."

360. By contrast, the very last paragraph of the letter does not fit either the script or the Version A approach. What is perplexing is that, after a few weeks of confusion, as the Tribunal will demonstrate later, as far as OEPC is concerned, it acted *vis-à-vis* Ecuador as if this last paragraph referred to the subsequent phase of the Farmout, not the "earn-in" phase. In the Tribunal's view, this clearly was not the case. That paragraph is misleading. The Tribunal does not believe that OEPC intended to mislead Minister Terán but that was nevertheless the result of the imprecise wording.

361. The paragraph at issue, the Tribunal recalls again, reads as follows:

> We are sure that this transaction will bring significant benefits to the Government of Ecuador and the companies. Therefore, we respectfully request that the Minister

> of Energy and Mines confirm as soon as possible, your consent with respect to the aforementioned transfer of economic interests in favour of CITY.

362. In the second sentence of that fourth paragraph, OEPC can only be seeking from Minister Terán confirmation of his consent to the transfer ("*transferencia*") described in the introductory paragraph, to wit the "earn-in" phase. This interpretation, the Tribunal notes, contradicts the evidence of the Claimants' witnesses who maintain that, at the 24 October meeting, Minister Terán, explicitly or implicitly, had agreed with them that no ministerial authorization was required for the "earn-in" phase.

363. On the other hand, the mutual waiver executed by OEPC and AEC on 31 October 2000 also confirms the prevailing OEPC and AEC view that no government approval was required for the transfer of the 40% economic interest. This waiver is consistent with Version A, the script, and the first three paragraphs of the 25 October letter but not with the fourth paragraph of that letter. It reads as follows: "Of even date herewith, [OEPC] and [AECI] are consummating that certain Farmout Agreement […] pursuant to which OEPC is farming out and transferring to AECI a 40% economic interest in certain properties [etc.]….". Then, in numbered paragraph 1, the mutual waiver of 31 October 2000 further confirms that the parties agree that:

> 1. Notwithstanding anything to the contrary contained in the Farmout Agreement or in any related document, OEPC and AECI <u>hereby expressly waive satisfaction of any and all requirements for governmental approvals applicable to the transfer by OEPC to AECI of said 40% economic interest in the Farmout Property</u>. The foregoing mutual waiver is not intended, however, and shall not be construed to constitute a waiver by either party hereto of any requirements for governmental approvals applicable to (a) the assignment, transfer or assignments, transfers or conveyances by OEPC and Occidental del Ecuador, Inc. to AECI provided for in that certain letter agreement or even date herewith, by and among OEPC, Occidental del Ecuador, Inc., AECI and AEC OCP Holdings Ltd., relating to the Oleoducto de Crudos Pesados (OCP) Project referred to therein. (Emphasis added)

364. On 1 November 2000, OPC issued a press release. That news release is wholly inconsistent with the theory of the Respondent that the Claimants wanted to conceal their transaction with AEC. For the oil savvy operators in the Ministry of Energy and Mines and the experienced oil engineers in PetroEcuador familiar with the intricacies of oil exploration and operation by international companies such as OPC, that press release contains the information which they needed to become cognizant of the Farmout, not the minute detail of the actual transaction which would only have been revealed if they could have read the Farmout Agreement and the Joint Operating Agreement, but certainly the general structure of the farmout transaction.[20] It read in relevant part as follows:

> Occidental Petroleum Corporation (NYSE:OXY) said today that it has agreed to farm out an interest in its operations in Block 15 in Ecuador to Alberta Energy Company Ltd., of Calgary, Canada.
>
> AEC will earn a 40-percent interest in the block and will assume certain capital costs through 2004. Occidental will remain the operator.

365. An internal memorandum of 8 November 2000 within the Ministry will be considered later in this Award when the Tribunal addresses the issue of whether the sanction of *caducidad* was proportionate in the circumstances. At this juncture, the

[20] In this context, the Tribunal notes the description provided by Mr. Derman of a farmout agreement. He states (see Expert Report of Andrew B. Derman dated 10 August 2008 at paragraph 27): "Provisions like Sections 2.01, 2.02, and 4.01 are common to farmout agreements under which a farmee party like AEC acquires an interest in an oil and gas project by "earning-in" (paying money or performing services). Typically, a farmee (AEC) earning into an oil and gas project negotiates to have some influence regarding the management and operation of the farmout interest until title transfers, which like the Farmout Agreement is subject to host government approval (where such approval is required) and satisfaction of the farmee's earn-in obligations. However, until title transfers and the farmee becomes a party to the host government contract (in this case the Participation Contract), the farmor (OEPC) remains solely responsible to fulfill the obligations under the contract vis-à-vis the host government. Thus, the degree of participation allowed to a farmee, who has no right or obligation vis-à-vis the host government, is the subject of much negotiation."

Tribunal notes that, in this memorandum, officials of the Ministry – acting on the misleading request set out in the last paragraph of the 25 October 2000 letter – conclude plainly that AEC "has proven that it has technical solvency" and that "there would be no impediment for that assignment of rights" (*i.e.* the "earn-in" phase). It reads as follows:

> SUBJECT: TRANSFER OF 40% OF THE ECONOMIC INTERESTS OF THE BLOCK 15 PARTICIPATION CONTRACT BY OCCIDENTAL EXPLORATION TO CITY INVESTING COMPANY
>
> With regard to letter No. GG-014-00 dated October 25, 2000, in which Occidental reports the transfer of 40% of the economic interests in the Participation Contract for Hydrocarbons Production and Additional Exploration for Block 15, including the OEPC rights in the Unified Production Operating Agreements for the Unified Edén Yuturi and Limoncocha Fields to City Investing Company, I would like to inform you of the following:
>
> City Investing currently has a Participation Contract with the Government in the Tarapoa Block and Fanny-18B and Mariann-4A Unified Fields and is the current operator of the aforementioned Fields. Therefore, it has proven that it has technical solvency, and for this reason, there would be no impediment for that assignment of rights.

366. The Tribunal notes three important facets in this memorandum: (i) it refers clearly to a "transfer" that has taken place, not a future transfer; (ii) AEC is well known in Ecuador and is considered to have technical solvency ("*solvencia técnica*"); and (iii) in characterizing the transfer, it speaks of an "assignment of rights" ("*cesión de derechos*"), the very words used in Clause 16.1 of the Participation Contract.

367. It is plainly obvious that, within the Ministry, there reigns at that time much confusion and that this confusion is due solely to the careless drafting by OEPC of the last paragraph of the 25 October 2000 letter.

368. There was a meeting of the Joint Management Committee on 22 November 2000 attended by representatives of Petroproducción and Occidental. Paul MacInnes reported to the meeting on the "Agreement with AECI." The relevant item in the minutes reads as follows:

> 2. REPORT ON THE AGREEMENT WITH AECI
>
> Paul MacInnes reports to the Joint Management Committee on the negotiations carried out between OEPC and Alberta Energy Corporation International (AECI), by virtue of which OEPC would sell to AECI 40% of the shares in Block 15, long term. He indicates that a letter was sent to the Ministry of Energy and Mines reporting on these negotiations. This change does not mean a change in OEPC operations, as it is only a stake by AECI in part [of] the capital and OEPC could invest in other projects.
>
> The contractual obligations that OEPC has with the Government would remain unchanged.

369. The minutes appear to suggest that the Farmout Agreement was in the process of being negotiated ("*venderá*"). However, the evidence before the Tribunal does not disclose who drafted the minutes which are signed by the participants but not by Paul MacInnes. In any event, in the Tribunal's view, it demonstrates again that, for the Claimants, their transaction with AEC was in the public domain in Ecuador. The transaction was definitely not a secret.

370. Also on 22 November 2000, Dr. Salgado, the Director of the DNH in the Ministry, wrote a letter to Paul MacInnes, in effect acknowledging receipt of Paul MacInnes' confusing letter of 25 October 2000. Dr. Salgado can be excused for misinterpreting OEPC's request to transfer to AEC 40% of its economic interests and referring instead to a request for "authorization to transfer 40% of the rights it has in

Block 15" (*i.e.* the second phase). Quite naturally, Dr. Salgado then proceeds to ask for "information to guarantee the economic solvency of [AEC]".

371. On 14 December, Dr. Salgado received a visit from Fernando Albuja of OEPC. It is clear to the Tribunal that OEPC has now realized that its carelessness has caused much confusion within the Ministry. Thus, Fernando Albuja's mission was to put Version A back on the rails.

372. As the Tribunal notes from the contemporaneous report of Fernando Albuja to Paul MacInnes following that meeting, the last paragraph of the 25 October letter 2000 is now stated to be "a notice of the future transaction". As the Tribunal has already found, this is clearly not what was written in the 25 October 2000 letter. But, the views of clan A, as expressed in the script that no authorization is required for the "earn-in" phase transfer, prevail again. Only the subsequent phase will require ministerial authorization and there is no outstanding request for approval of the "earn-in" phase. In other words, it was as if the last paragraph of the 25 October 2000 letter was never written.

373. The Tribunal considers it important to quote in full Fernando Albuja's account of this meeting:

> We had a meeting with the DNH regarding the notice of the Minister about the AECI deal. Their initial position was to understand the deal as a current transfer of rights. <u>They explained that they were ready to issue a Ministerial Decree authorizing the transfer</u>. After reviewing with them the terms of our letter they realized that the letter basically contains a notice of the future transaction. The answer from the DNH to our letter will be as an acknowledgement of the notice given to them stating that the corresponding Ministerial Decree will be issued once OEPC request the government to authorize the transfer. Meanwhile OEPC will remain 100% liable for the performance of Block 15 contract. (Emphasis added)

374. The confusion created by the wording of the last paragraph of the 25 October 2000 letter has thus been cleared up by the Version A proponents and, rightly or wrongly, the conclusion of OEPC that the "earn-in" phase did not require ministerial authorization remains the company mantra, with OEPC and Ecuador, as of this point, now on the same page. For OEPC, it has cleared the air and the Ministry has been informed.

375. Fully in accordance with the message that he received from Mr. Albuja on 14 December 2000, Dr. Salgado reported to Minister Terán on 12 January 2001 that OEPC intended to assign "in the future" 40% of the rights and obligations for Block 15 and, "when they decide", they "will require the corresponding approval."

376. And thus, on 17 January 2001, Minister Terán wrote to Paul MacInnes an official letter which brought the exchange between OEPC and the Ministry to an end for the time being. Minister Terán acknowledged that "(i)n the meeting held at the National Directorate of Hydrocarbons, officers from Occidental said that the 40% transfer of rights and obligations previously mentioned would not be implemented at the moment". When the "previously mentioned transfer," was to be "implemented," wrote the Minister, you "must request to this State Ministry the corresponding authorization and the issuance of the Ministerial Decree through which such transfer will be legalized, with the prior payment of the transfer fees and enhancement of the economic conditions of the contract, as it is stipulated in Art. 1 of the Executive Decree 2731, published in the Official Register No. 694, dated May 12, 1995".

377. The Tribunal notes that the OEPC 2000 mantra was still maintained three years later when the Claimants described the 2000 Farmout Agreement to Moores Rowland. In his letter of 15 March 2004, Paul MacInnes wrote:

> In the year 2000, OEPC and AEC Ecuador signed an agreement by means of which, subject to satisfying certain conditions and subject to approvals required by the Ecuadorian Government, they committed themselves to transfer in the future the legal title corresponding to 40% interest in the Contract for Block 15 and the Operational Agreements for Unified Exploitation.

378. Although there is no specific reference in that letter to the transfer to AEC of a 40% economic interest in 2000, the letter is consistent with the conclusion reached by OEPC and AEC in October 2000 when they visited Minister Terán that this was a two-phase transaction and that the first phase did not require ministerial authorization.

379. The Tribunal finds in the record another statement by OEPC with the same mantra in the letter sent to PetroEcuador in July 2004 in which it requested approval of the transfer of legal title to AEC "… in accordance with Article 79 of the Hydrocarbons Law and Article 46 of the Regulation for the Application of Law 44, and as contemplated by Clause 16.1 of the Participation Contract." The first phase is not mentioned explicitly because, in October 2000, OEPC and AEC had reached the conclusion that it did not require ministerial authorization:

> In the year 2000, Occidental Exploration and Production Company ("OEPC") and AEC Ecuador LDT (formerly known as City Investing Company Limited) ("AEC" Ecuador) entered into an agreement pursuant to which, subject to satisfying certain conditions and subject to obtaining required government approvals, the parties agreed to convey to AEC Ecuador in the future legal title to a 40% interest in the Block 15 Participation Contract […].

380. The Tribunal reiterates its conclusion. As the Tribunal's analysis of the Farmout Agreements earlier in this Award has demonstrated, the Claimants' interpretation of the

Farmout Agreement was wrong. However, the Tribunal does not consider, as the Respondent has argued, that it was made in bad faith. The Claimants' failure to seek ministerial authorization was a mistake, a serious mistake, but it was not done in bad faith. Should Paul MacInnes and his colleagues, during their visit with Minister Terán on 24 October 2000, have given him a copy of the Farmout Agreement and the Joint Operating Agreement so that his advisors could have formed their own opinion about the true nature of the transaction? As stated earlier, the Tribunal has no hesitation in answering its own question in the affirmative. OEPC and AEC were negligent in not doing so. But again, the Tribunal does not find that failure to do so amounted to bad faith. They may have been negligent but there was no intention on their part to mislead. They were simply convinced that they were right and acted accordingly without seeking to mislead the Ecuadorian government. In a number of instances, in the fall of 2000, they revealed publicly in Ecuador that they had entered into a farmout transaction with AEC. When they realized that their behaviour, and in particular the last paragraph of their 25 October letter, created confusion within the Ministry, they tried to dissipate that confusion. Unfortunately, the confusion persisted until the spring of 2004 when officials of the Respondent sighted and analysed the Farmout Agreements.

381. In conclusion, the Tribunal finds, based on the above, that OEPC, by failing to secure the required ministerial authorization, breached Clause 16.1 of the Participation Contract and was guilty of an actionable violation of Article 74.11 of the HCL.

382. The Tribunal will now address the Claimants' allegation that the sanction imposed by the Respondent for the failure to secure the required authorization for the

transfer of rights under the Participation Contract, namely the *Caducidad* Decree, was inconsistent with the Treaty (Article II.3(a) and Article III.1) and Ecuadorian law because it was, in the circumstances, manifestly disproportionate.

383. However, before turning to the proportionality of the *Caducidad* Decree, the Tribunal recalls that the Claimants have also alleged that the *Caducidad* Decree was inconsistent with the Treaty and Ecuadorian law because, *inter alia*, it frustrated their legitimate expectations in the circumstances. Having concluded above that OEPC's failure to secure the required authorization on the part of the Ecuadorian authorities in October 2000, while not amounting to bad faith, was negligent, the Tribunal considers that the Claimants cannot be found to have had a legitimate expectation that the Minister would not exercise his discretion and impose *caducidad*. The failure to secure the required authorization meant that OEPC breached Clause 16.1 of the Participation Contract and was guilty of an actionable violation of Article 74.11 of the HCL which, as one option, expressly allowed the Minister to declare the *caducidad* of the Participation Contract and the Joint Operating Agreements. For this reason, the Claimants' allegation that the *Caducidad* Decree frustrated their legitimate expectations is rejected.

3. The Proportionality of the Sanction for the Unauthorized Transfer of Rights under the Participation Contract

(a) Preliminary Observations

384. The Tribunal has found that the Farmout Agreement and the Joint Operating Agreement operated to effect a transfer of rights under the Participation Contract from OEPC to AEC. The Tribunal has also found that this transfer required authorization on

the part of the Ecuadorian authorities, that this authorization was not sought, but that OEPC's failure to secure such authorization in October 2000, while imprudent and ill advised, did not amount to bad faith.

385. The Tribunal recalls that the issue of the transfer of rights under the Participation Contract by OEPC to AEC resurfaced in 2004 in the context of what has been referred to as the Moores Rowland audit, described in some detail earlier in this Award. Ultimately, Moores Rowland issued its audit report on 14 July 2004, noting therein that the assignment of rights and obligations contemplated in the Farmout was made contingent on future events and that the assignment "might or might not happen" at the end of the four years during which the conditions were to be satisfied. The audit report recommended to the DNH that OEPC seek government authorization for the assignment during that year, assuming the assignment conditions were satisfied, and that the required ministerial approval be granted to OEPC in order to properly register the assignment.

386. As also recalled earlier in this Award, AEC had in fact made all payments due under the Farmout a few months earlier in February 2004. The day after Moores Rowland issued its audit report, on 15 July 2004, OEPC wrote to the then-Minister of Energy and Mines, Eduardo López Robayo, "request[ing] the Ministry to approve the transfer by OEPC to AEC Ecuador of legal title to a 40% interest" in Block 15, as contemplated under the Farmout. In making this request, OEPC referred to its letter of 25 October 2000, as well as Minister Terán's response of 17 January 2001.

387. The approval sought by OEPC was never granted and ultimately, following *caducidad* proceedings, the Attorney General of Ecuador issued orders to the Ministry of

Mines and Energy to terminate the Participation Contract and the Unitized Fields Joint Operating Agreements through a declaration of *caducidad*. On 15 May 2006, the *Caducidad* Decree officially terminated, with immediate effect, OEPC's Participation Contract and ordered OEPC to turn over all its assets relating to Block 15. The purpose of the following Section is to examine the proportionality of this sanction imposed by the Respondent.

(b) The Parties' Competing Cases[21]

388. The Claimants have submitted that even if any of the alleged Termination Events had occurred, the Respondent would still have breached its obligations under the Treaty and the Participation Contract by imposing a sanction which in the circumstances was manifestly disproportionate. As to the Treaty, reliance was placed on Article II.3(a) which obliges Ecuador *inter alia* to accord investments fair and equitable treatment. There are several aspects to this argument as set out below.

389. The Claimants have contended that it was of critical importance that the Minister's authority to declare *caducidad* was discretionary in nature. The Claimants have further contended that in exercising such discretion the Minister must adopt a proportionate approach, as a matter of Ecuadorian law and under the Treaty.

390. The Claimants emphasized that the *Caducidad* Decree was expressly based on contravention of the HCL (specifically Article 74) and not on breach of the Participation

[21] Although reviewed earlier in this Award, the Tribunal considers it necessary, in this section, to summarize the key arguments of the parties with respect to the proportionality issue.

Contract. Accordingly, it was an administrative act based on legislative powers, rather than a private act grounded in private contractual rights. Under Ecuadorian law, a Minister exercising such powers is bound to act in a proportionate manner.

391. The Claimants further submitted that the *Caducidad* Decree was not justified by any or any sufficient interest in public welfare. The Decree did not specify any public welfare factors that it was seeking to protect. To the contrary, it was the Claimants' contention that the Respondent was intent on expelling OEPC from the country in retaliation for the VAT Award and/or for other reasons of political expediency.

392. The alleged absence of any justifying policy reasons associated with public welfare was reflected in the contention that the Farmout Agreement caused no harm or damage to the Respondent. It was further supported by the contention that the Farmout Agreement did not violate the policy rationale of the HCL's prohibition on the unauthorized assignment of rights (Article 74). Insofar as that latter point was concerned, the Claimants relied on the fact that the Respondent had already scrutinized AEC in relation to other blocks in Ecuador, and found it to be a suitable and solvent contractor.

393. Countering the proportionality argument, the Respondent argued that the question of proportionality does not arise in circumstances where the sanction imposed was one specifically agreed upon by the parties in their contract. OEPC having agreed that *caducidad* could be ordered in certain identified circumstances, there could be no objection when *caducidad* was in fact ordered in precisely such circumstances.

394. On the question of discretion, the Respondent disputed that there was a true discretion in this case. Such choice as existed, it said, was either a choice to order *caducidad* or to do nothing. The latter, from the point of view of a State in the Respondent's position, was not a realistic or appropriate option.

395. Further, the Respondent argued that in any event the sanction of *caducidad* was indeed a proportionate response to the Farmout Agreement and the breaches of the Participation Contract which it says were committed by OEPC. The Respondent emphasized the national importance of the oil fields in question, and the right of the Ecuadorian Government to strictly control and administer the activities of all parties operating in those fields.

(c) Proportionality in Ecuadorian law

396. Clause 22.1 of the Participation Contract provides that the contract is to be governed exclusively by Ecuadorian law.

397. The expert evidence for the Claimants (and on this general point there was no challenge from the Respondent) was that the principle of proportionality applies generally in Ecuadorian law. In Ecuador, the principle originates in the Constitution, Article 24 of which provides:

> Art. 24. In order to ensure due process, the following basic guarantees must be observed, without prejudice to any others established by the Constitution, international instruments, laws, or precedent:
>
> […]
>
> > 3. Laws shall establish due proportionality between offences and penalties. The law shall also determine penalties other than those

> involving the deprivation of liberty, depending on the nature of each case, the character of the offender, and the convict's reintegration into society.

398. At first blush, that provision would appear to be directed toward criminal rather than commercial or administrative matters, but the evidence is that Article 24 of the Ecuadorian Constitution is of wide application. In his original brief, the Claimants' expert on Ecuadorian law, Dr. Pérez Loose[22], explained that the Government is under a duty to apply the principle whenever there is conflict between the Constitution and an inferior law, such as the HCL.[23] It was Dr. Pérez Loose's evidence that the Government must weigh the content and purpose of any sanctioning measure with the conduct which has been impugned, and with the loss of rights which the individual will suffer by reason of the intended sanction.[24]

399. Dr. Pérez Loose cited the following statement of principle from a decision of Ecuador's Supreme Court of Justice, which specifically addresses clause 3 of Article 24 of the Constitution:

> With [the] principle of proportionality of the penalties as a basis, all democratic legal orders state that the measures or sanctions adopted within <u>any legal or administrative proceeding</u> must be proportional with the facts or acts established as violations. In this way, administrative responsibility is graduated in accordance

[22] The Tribunal recalls that, late in these proceedings (on 10 November 2011), the Respondent submitted "that the Tribunal should not give any credibility to the written reports submitted or the oral evidence given by Mr. Pérez Loose" because he was acting as counsel with Mr. David Rivkin, the lead counsel for the Claimants in the present case, in a new case against Ecuador. The parties were invited to brief the Tribunal in respect of this matter. Having reviewed these submissions, the Tribunal then formed the view that the credibility of Mr. Pérez Loose who gave evidence more than a year earlier as an expert witness on behalf of the Claimants in the liability and quantum phases of this arbitration is in no way impacted on account of his acting as counsel with Mr. Rivkin in 2011 in a family related dispute against Ecuador.

[23] Expert Report of Hernán Pérez Loose dated 18 July 2006 at paragraph 107.

[24] *Ibid.*

> with the fault committed and is not only a punitive action, through the coercion of the sanction, but also preventive, because knowing the consequence of the probable deviation, it reduces the possibility of other officials committing breaches. In this sense, the mentioned principle of proportionality constitutes a requirement for the Government, since to establish a sanction between the two limits, minimum and maximum, it must consider the factual situation beforehand and attend to the end sought by the rule […].[25] (Emphasis added)

400. Dr. Pérez Loose explained that the wider application of the constitutional principle of proportionality is further confirmed in the Regulation for the Control of Discretion in Acts of Public Administration (Decree No. 3179 dated 19 October 2002).[26] The relevant provisions of that Regulation, of which Article 11 is the most important for present purposes, are as follows:

> Art. 2 – ON DISCRETIONARY ACTS. The discretion envisaged by law, implies choosing one among many equally valid options […]
>
> […]
>
> Art. 4 – RATIONALE. Under the terms of the Constitution and these regulations, the government is required to provide the rationale for its decision regarding these administrative actions.
>
> […]
>
> Art 6. – PROHIBITION OF ARBITRARY NATURE. The monitoring to be done must be carried out based on the principle of prohibition of arbitrary nature. This includes the most generic features, which are those that appear to be the most suitable for the task to be carried out. It is not sufficient for the rationale to be based on premises, but rather that the premises must be true.
>
> […]
>
> Art. 11 – PROPORTIONALITY. The measures involved in the discretionary action must be proportionally suitable to the goal.

[25] As quoted in the Expert Report of Hernán Pérez Loose dated 18 July 2006 at paragraph 108.

[26] Expert Report of Hernán Pérez Loose dated 18 July 2006 at paragraph 107.

401. For the Respondent, Dr. Aguilar accepted that the principle of proportionality was an established feature of Ecuadorian law.[27] During cross-examination, Dr. Aguilar also accepted the applicability of the principle of proportionality in fact situations such as the present one, where an administrative sanction is imposed following a violation of relevant domestic law:

> Q. To be clear, if a violation has caused no economic damage, then [the] administration would have to take that into account in its proportionality determination; is that right?
>
> A. This, yes, but also how the violation has affected the integrity of the legal system.[28]

(d) Proportionality in the Context of International Investment Disputes

402. The application of the principle of proportionality may be observed in a variety of international law settings, including cases in which the proportionality of countermeasures taken in trade disputes is challenged before a WTO Panel under the General Agreement on Tariffs and Trade ("GATT").

403. On the application of proportionality generally in the context of administrative action, the most developed body of jurisprudence is in Europe. It is very well-established law in a number of European countries that there is a principle of proportionality which requires that administrative measures must not be any more drastic than is necessary for achieving the desired end. The principle has been adopted and applied countless times by

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[27] Expert Report of Juan Pablo Aguilar Andrade dated 19 September 2008 at paragraphs 77-78.

[28] Hearing Transcript (19 December 2008) at page 1582.

the European Court of Justice in Luxembourg, and by the European Court of Human Rights in Strasbourg.

404. Against that background, the Tribunal observes that there is a growing body of arbitral law, particularly in the context of ICSID arbitrations, which holds that the principle of proportionality is applicable to potential breaches of bilateral investment treaty obligations. In the present case, the Treaty provides at Article II.3(a) that investments shall at all times be accorded fair and equitable treatment, shall enjoy full protection and security and shall in no case be accorded treatment less than that required by international law. The obligation for fair and equitable treatment has on several occasions been interpreted to import an obligation of proportionality. Cases cited by the Claimants include:

- *MTD Equity SDN.BHD. and other v. The Republic of Chile*, ICSID Case No. ARB/01/7 (25 May 2004);
- *LG&E Energy Corp. and others v. The Argentine Republic*, ICSID Case No. ARB/02/1 (3 October 2006);
- *Tecmed S.A. v. The United Mexican States*, ICSID Case No. ARB (AF)/00/2 (29 May 2003); and
- *Azurix Corp. v. The Argentine Republic*, ICSID Case No. ARB/01/12 (14 July 2006).

405. In *MTD Equity*, discussing the meaning of "fair and equitable treatment", the tribunal noted (at paragraph 109):

> The parties agree that there is an obligation to treat investments fairly and equitably. The parties also agree with the statement of Judge Schwebel[29] that "the

[29] Called as an expert witness by the Claimants in that proceeding.

> meaning of what is fair and equitable is defined when that standard is applied to a set of specific facts." As defined by Judge Schwebel, "fair and equitable treatment" is "a broad and widely-accepted standard encompassing such fundamental standards as good faith, due process, non-discrimination, and proportionality."

406. The earlier *Tecmed* case involved such a proportionality approach, and was particularly relied upon by the Claimants. In *Tecmed*, the claimant had committed some licensing infringements in operating a landfill in Mexico. Certain community groups became opposed to the operation and existence of the landfill, which dealt with hazardous waste, and when Tecmed applied for renewal of its licence in 1998, the relevant government body refused to renew the licence, citing the infringements. The tribunal stated as follows (at paragraph 122):

> After establishing that regulatory actions and measures will not be initially excluded from the definition of expropriatory acts, in addition to the negative financial impact of such actions or measures, the Arbitral Tribunal will consider, in order to determine if they are to be characterised as expropriatory, whether such actions or measures are proportional to the public interest presumably protected thereby and to the protection legally granted to investments, taking into account that the significance of such impact has a key role upon deciding the proportionality.
>
> […]
>
> There must be a reasonable relationship of proportionality between the charge or weight imposed to the foreign investor and the aim sought to be realized by any expropriatory measure.[30]

407. The *Tecmed* tribunal concluded that the responsible regulatory agency was predominantly influenced and/or motivated by socio-political factors beyond the licence violations (concerning storage of impermissible types of waste, or storage of excess

[30] In support of the various propositions set forth in paragraph 122 of the *Tecmed* award, the tribunal cited several decisions of the European Court of Human Rights.

waste) which had been alleged against Tecmed. The tribunal held that the manner of operation of the landfill never compromised the ecological balance, the protection of the environment or the health of local people (as alleged by certain pressure groups), and that all the infringements committed were either remediable or remediated or subject to minor penalties. Although the licence and applicable regulations *prima facie* permitted a refusal to renew the license in the case of such violations, the tribunal held (at paragraph 149):

> [I]t would be excessively formalistic, in light of the above considerations, the [BIT] and international law, to understand that the Resolution is proportional to such violations when such infringements do not pose a present or imminent risk to the ecological balance or to people's health, and the Resolution, without providing for the payment of compensation […] leads to the neutralization of the investment's economic and business value and the Claimant's return on investment and profitability expectations upon making the investment.

408. In discussing the European jurisprudence concerning review of decisions affecting human rights, the *Tecmed* tribunal noted that such statements of the Strasbourg Court also apply to the actions of the State in its capacity as administrator, and not only in its capacity as legislator. The application of proportionality to an act of administration (as opposed to the promulgation of legislation or regulations) was what was at issue in *Tecmed*, and it is similarly at issue in the present case.

409. Following *Tecmed*, a subsequent ICSID tribunal in *Azurix* considered the issue of proportionality in the context of measures taken supposedly for a public purpose. The *Azurix* tribunal endorsed the reliance in *Tecmed* on case law from the European Court of Human Rights – in particular the case of *James and Others*[31] – and placed particular

[31] *In the Case of James and Others*, Judgment of 21 February 1986 (http://hudoc.echr.coe.int).

emphasis on the need for proportionality between the means employed and the aim sought to be realized. It is worth noting that this is the same principle which finds expression in Article 11 of the Ecuadorian Regulation for the Control of Discretion in the Acts of Public Administration.

(e) Detailed Arguments regarding Proportionality

410. The essence of the Respondent's position was that *caducidad* was *per se* appropriate and proportionate, mainly for the reason that it is specifically identified in the Participation Contract and in the HCL as the appropriate sanction in the case of an unauthorized transfer of rights.

411. While acknowledging that Article 74 of the HCL provides that the Minister "may" declare *caducidad*, the Respondent drew attention to a subsequent regulation being Decree No. 1363 dated 27 March 2001 (entitled "Regulation for the Transfer or Assignment of Rights and Obligations of Hydrocarbon Agreements"), Article 14 of which provides that "[t]he execution of private contracts or agreements that breach the provisions of the [HCL] and of these regulations <u>shall</u> give rise to the declaration of *caducidad* in the manner established by the Hydrocarbons Law." (Emphasis added) This is an unconvincing point – the regulation is subsidiary legislation and still only refers to a process to be followed in accordance with the main legislation. The purpose of the provision appears to be to provide that breach of the regulation is also to qualify as an act which triggers Article 74 of the HCL (perhaps to distinguish it from other regulations, which would require repeated breach to fall within the scope of Article 74.13). However, there is nothing in this regulation tending to support a conclusion that the introductory

words of Article 74 in the main legislation ("may declare") have been rewritten to remove all discretion of the Minister.

412. The Respondent submitted in its Counter-Memorial on Liability that even if the declaration of *caducidad* is discretionary, it could not offend the principle of proportionality to impose a sanction which was expressly authorized and called for in both the Participation Contract and the relevant legislation.

413. The principle of proportionality received more developed argument later in the proceedings. Focus shifted to the question of whether the declaration was made pursuant to the Participation Contract or the legislation, whether the Minister did or did not have a discretion in the matter, and whether (considered objectively) the sanction was a proportionate response to the breaches by OEPC.

414. In its Rejoinder on Liability, the Respondent challenged the Claimants' proportionality argument on three grounds as follows:

(i) The various ICSID authorities cited by the Claimants were distinguishable from the present case because none of those other disputes involved a contract which expressly provided for the sanction in question. In circumstances where the Claimants had freely agreed that the Participation Contract "shall terminate" in the event of an unauthorized transfer of rights and obligations, the Respondent argued that the sanction of *caducidad* could not be challenged as disproportionate or otherwise unreasonable;

(ii) Second, the Respondent also argued that as a matter of fact, the sanction was not disproportionate. Although accepting that AEC had previously been authorized to carry out similar operations in a different block, the Respondent criticized OEPC's actions as having nonetheless deprived the Respondent of the opportunity to exercise its regulatory prerogative. That was a serious violation which warranted and required a serious response by way of punishment and deterrent; and

(iii) Third, the Respondent argued that even if the Minister had discretion to impose a lesser sanction, as a practical matter he could not because it would have created a precedent making it impossible ever to apply the full sanction in the future. Any subsequent declaration of *caducidad* against a different contractor in similar circumstances would, it was said, by met with claims of discrimination.

415. As a separate point, the Respondent rejected the Claimants' position that it was relevant to the issue of proportionality to inquire into whether or not the Respondent had suffered harm or damage from OEPC's conduct. Apart from asserting that Ecuador did indeed suffer damage, the Respondent's main response on this point was to submit that "no State is ever obliged to demonstrate harm to itself as a precondition to enforcing its own laws".

416. As to this latter point, the Tribunal considers that the Respondent failed to properly appreciate the Claimants' argument. The argument is not that the State must prove harm, but that any penalty the State chooses to impose must bear a proportionate relationship to the violation which is being addressed and its consequences. This is neither more nor less than what is encapsulated in the Respondent's own constitutional rules about proportionality. In cases where the administration wishes to impose a severe penalty, then it appears to the Tribunal that the State must be able to demonstrate (i) that sufficiently serious harm was caused by the offender; and/or (ii) that there had been a flagrant or persistent breach of the relevant contract/law, sufficient to warrant the sanction imposed; and/or (iii) that for reasons of deterrence and good governance it is appropriate that a significant penalty be imposed, even though the harm suffered in the particular instance may not have been serious. The potential justification predicated on deterrence explains why, for example, it may be proportionate to give a heavy fine for speeding[32] even where no accident occurred and where, plainly, the State suffered no direct "harm" from the driver's breach of the law. The potential for harm, and the need to deter others from acting in the same way, justifies the imposition of a penalty even though no identifiable harm was caused in the particular instance.

417. The test at the end of the day will remain one of overall judgment, balancing the interests of the State against those of the individual, to assess whether the particular sanction is a proportionate response in the particular circumstances. Accordingly, while

[32] To use the example selected by the Respondent.

it is possible to envisage many instances where punishment is imposed for violations which have not directly caused harm, it is immediately apparent that such punishments tend to be at the lower end of the scale – they are intended to educate and deter both the offender and the general populace. But more serious punishments are still usually reserved for instances where true harm has been suffered. And typically, the more serious the harm then the more serious the punishment. This is a familiar principle in all legal systems and, in this particular case, one need only look to Article 77 of the HCL which expressly refers to the "seriousness of the violation" as follows: "A breach of contract that does not cause *caducidad* effects or violation of the Law or Regulations shall be punished with a fine […] <u>depending on the seriousness of the violation</u>, in addition to compensation for the damages caused." (Emphasis added)

418. To return to the Respondent's three arguments identified above, the Tribunal does not accept the submission that the ICSID authorities relied upon by the Claimants can be distinguished because of the absence of a contractual provision comparable to that found in Clause 21 of the Participation Contract. As noted earlier, the *Caducidad* Decree was not predicated upon breach of contract, but was instead issued pursuant to, and in reliance upon, alleged breaches of Article 74 of the HCL. This is a point of general importance given that the Respondent consistently advanced the plea that *caducidad* could not be a breach of the Treaty when it was a penalty freely agreed to by OEPC. Accordingly, it is an issue which deserves careful analysis.

419. There is no dispute that the *Caducidad* Decree refers only to Article 74 of the HCL. That in itself might not be the end of the matter if the termination provisions of the

Participation Contract were identical as in the HCL, but they are not. Article 74.11 of the HCL empowers the Minister to declare *caducidad* if the contractor "transfers rights or enters into a private contract or agreement for the assignment of one or more of its rights, without the Ministry's authorization." The Tribunal notes that the reference is to transfer of rights only. By contrast, Clause 21.1.2 of the Participation Contract refers to an unauthorized transfer of "rights and obligations."

420. There was no suggestion by the Respondent that the "earn-in" stage of the Farmout Agreement somehow effected a transfer to AEC of OEPC's <u>obligations</u> under the Participation Contract. The fact is that the only party who ever owed obligations to PetroEcuador, and the only party against whom PetroEcuador might plausibly have sought to enforce obligations owed under the Participation Contract, was OEPC. It is presumably for that that reason that the Respondent sought to proceed under the HCL rather than the Participation Contract.[33]

421. Nor is the position changed by reason of the fact that OEPC agreed that the contract "shall terminate" in the event of "a declaration of forfeiture issued by the Corresponding Ministry for the causes and following the procedure established in Article 74 … of the [HCL] …"[34] The reference to a declaration of *caducidad* under the HCL can only mean a declaration properly made – the contractor cannot be taken to have agreed to

[33] The *Caducidad* Decree specifically refers (in relation to Article 74.11) only to the transfer of rights, and the execution of a contract or private agreement for the assignment of one or more rights.

[34] Clauses 21.1. and 21.1.1 of the Participation Contract.

accept termination in circumstances where the decree is issued contrary to the requirement of proportionality in Ecuadorian law.

422. The fact that a contractor agrees that *caducidad* may be a remedy in certain situations does not mean that the contractor has waived its right to have such a remedy imposed proportionately, or otherwise imposed in accordance with all relevant laws. That is particularly so when, as in the present case, the parties agree that the contract is to be governed by a system of law (Ecuadorian law) which expressly requires the principle of proportionality to be observed. There is nothing in the Participation Contract to indicate an intention to "contract out" of proportionality or any other legal principles of general application.[35]

423. In any event, whatever OEPC agreed in the Participation Contract is only relevant to actions taken under or pursuant to the contract – it cannot be relevant to action which is taken independently of the contract and which does not proceed in reliance upon it. It is a matter of central importance in this case that the *Caducidad* Decree was issued pursuant to the provisions of the HCL. In those circumstances, there cannot be any doubt that OEPC remained entitled to the full protection of Ecuadorian law, both procedural and substantive, which would ordinarily apply to such actions regardless of what may or may not have been agreed in the underlying contract.

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[35] In any event, it must be doubtful whether parties could actually contract out of a principle of such central importance that it is included in the Ecuadorian Constitution.

(f) Common Ground between the Parties

424. During the Hearing on Liability, it was eventually a matter of common ground between the parties that in issuing the *Caducidad* Decree, the Minister was exercising discretion. That is to say, the Minister was not obliged to terminate the Participation Contract. In particular, this was accepted by Minister Terán in cross-examination when he acknowledged that the power to declare *caducidad* was "optional, absolutely".[36] Similarly, the Respondent's expert, Dr. Aguilar, acknowledged during cross-examination that "[the Minister] would have the discretion over the decision as to whether to declare Caducidad."[37]

425. It was also common ground between the parties that, where the Minister has a discretion, the principle of proportionality is relevant.[38] The Respondent's arguments were ultimately directed to persuading the Tribunal that proportionality was satisfied in this case – either because proportionality was to be effectively "presumed" as a result of the sanction itself being included in the Participation Contract as just discussed above, or because of the actions of OEPC upon which the *Caducidad* Decree was predicated.

(g) Outstanding Issues

426. Accordingly, the issues that eventually emerged by the time of the parties' post-hearing submissions as being central to the question of proportionality were: (i) whether

[36] Hearing Transcript (17 December 2008) at page 1582.

[37] Hearing Transcript (19 December 2008) at pages 1553-1554.

[38] Hearing Transcript (21 March 2009) at page 76, lines 16-21 and Claimants' Post-Hearing Brief on Liability, paragraphs 155-158.

the Minister in fact had available to him some meaningful alternative short of declaring *caducidad*; and/or (ii) whether in any event the sanction of *caducidad* was in this instance a proportionate response to the violation of Article 74 of the HCL committed by OEPC.

427. Issue (ii) arises even if the answer to (i) is in the negative. To conclude otherwise would be tantamount to finding that the HCL operates indifferently and would not give due effect and recognition to the principle of proportionality. The Tribunal understands that such a principle, established in the Constitution and reiterated in subsequent legislation, would take precedence over the HCL.[39] Even if the Tribunal is wrong on that question of domestic Ecuadorian law, the Tribunal has no doubt that the principle of proportionality is applicable as a matter of general international law, and has been applied in many ICSID arbitrations in the past.

(h) ***Alternatives to Caducidad***

428. The Respondent submits that notwithstanding the acknowledgement of the Minister's discretion, there really was no option except to terminate. At the very most, the only other option which could be said to exist was simply to do nothing.

429. The first difficulty with this argument for the Respondent is evident from its own counterclaim. One of the heads of counterclaim is a claim for damages arising from the failure of OEPC to pay the required transfer fee in or around October 2000, and to

[39] Expert Report of Hernán Pérez Loose dated 18 July 2006 at paragraph 107.

negotiate a new participation contract on terms more favourable to the Respondent. The basis for this claim is Article 79 of the HCL which provides in its second paragraph that:

> The State shall receive a premium for the transfer and the beneficiary company shall enter into a new contract under more favourable economic conditions for the State and for PETROECUADOR that the ones contained in the original contract.

430. The Respondent (through Minister Terán) acknowledged that there have been instances where, in addition to the transfer fee, the Government sought improvements to the economic terms of the contract[40]. As for the transfer fee, which in accordance with Decree No. 2713 is based on the previous year's profits resulting from the underlying contract, the evidence was that if OEPC had sought consent to transfer in October 2000, and if consent had been granted, the transfer fee would have been in the order of $1.1 million based on OEPC's net income of $21.7 million in 1999. Furthermore, the evidence was that by 2006, with extraction having increased in the intervening six years, the transfer fee would have been tenfold, *i.e.* in the order of $11.8 million, based on OEPC's net income of $289.2 million in 2003.[41]

431. If the Respondent considers it is entitled not only to terminate the Participation Contract but also to claim by way of damages the fees which were potentially payable as at the date the Farmout Agreement was made, then the Respondent could have likewise pursued those fees at the same time as choosing <u>not</u> to terminate the Participation

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[40] Second Witness Statement of Pablo Terán, paragraph 6. <u>See also</u> Hearing Transcript (17 December 2008) at page 1154, lines 10-20.

[41] <u>See also</u> Regulation 1363, although this only sets a minimum figure for the transfer.

Contract. Indeed, the logic for the latter approach would seem stronger given that OEPC would presumably receive the benefit of the Farmout Agreement continuing.[42]

432. A second difficulty with the argument that there was no option except to terminate is that there was a further option available to the Respondent, short of declaring *caducidad*, namely a variation on the provision (Article 79) requiring the contractor to enter into a new contract with more favourable terms for the Respondent. That option would have involved a negotiated settlement, which had the potential to reflect and address all concerns which the Respondent may have as a result of the breach of contract which occurred. Such a settlement might include any one or more of the following features: (i) a transfer fee; (ii) a sum by way of compensation for any damage suffered; (iii) varied terms for the Participation Contract, presumably aimed at improving the contract for the Respondent by addressing the impact of the VAT Interpretative Law and Law 42; and/or (iv) penalty sums payable by OEPC whether based on Article 79 of the HCL or by agreement at some higher level (if so agreed).

433. In the present case the Attorney General has acknowledged that it was legal to settle the case.[43] Paragraph 15 of the *Caducidad* Decree records that OEPC's efforts to

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[42] The Tribunal notes that if, in 2006, the Respondent had decided not to declare *caducidad*, then under Article 79 of the HCL, the purported assignment of rights by the Farmout Agreement would still have been null and void under Ecuadorian law. It would have been null and void *ab initio*, but that would be a problem for OEPC and AEC, and not a matter of concern for the Respondent. The first paragraph of Article 79 provides: "The transfer of a contract or the assignment to third parties of rights from a contract shall be null and void and shall have no validity whatsoever if there is no prior authorization from the Ministry of Energy and Mines, without prejudice to the declaration of *caducidad* as provided for in this Law."

[43] Letter from the Attorney General to PetroEcuador dated 4 May 2006, advising that "a compromise and settlement is proper because it is so permitted by law".

settle with the Respondent were finally rejected only on 15 May 2006. The fact that settlement was being considered shows the Minister had a discretion not to declare *caducidad*, and further a discretion to negotiate what the appropriate sanction (the "settlement") might be.

434. In summary, the Tribunal considers that the foregoing options existed as an alternative to *caducidad*[44], namely:

i) insistence on payment of a transfer fee in the order of USD 11.8 million; and/or

ii) improvements to the economic terms of the original contract; and/or

iii) a negotiated settlement which could of course have covered any areas that the parties so desired, including payment of the transfer fee which had been avoided, renegotiation of the contract and additional compensation.

435. The final option was to have done nothing except perhaps issue a statement making it plain to all foreign oil companies that all transfers of economic interests must be authorized and that if not so authorized *caducidad* proceedings would be inevitable. No doubt this option was viewed by the Respondent as unpalatable and unrealistic, but as

[44] Such an alternative does not arise from Article 77 of the HCL which provides as follows: "A breach of contract that does not cause *caducidad* effects or a violation of the Law or Regulations shall be punished with a fine imposed by the National Hydrocarbons Director, of two hundred to three thousand United States Dollars, depending on the seriousness of the violation, in addition to compensation for the damages caused." This provision is not relevant to the Tribunal's analysis regarding alternatives to *caducidad* since its operation is confined to instances of breach of the Participation Contract which do not cause *caducidad* effects nor a violation of the Law or Regulations.

a matter of logic such an option did exist. Article 74 of the HCL is empowering only, and not directive.

436. For these reasons, the Tribunal finds that the Respondent's argument that there was really no option but to terminate is unsound and it is not accepted.

(i) The Background to the Caducidad Decree

437. As indicated earlier, the Tribunal has found that Article 74 of the HCL was violated. Specifically, the Tribunal has concluded that the better interpretation of the Farmout Agreement and the Joint Operating Agreement is that they constituted an unauthorized transfer of certain of OEPC's rights under the Participation Contract. Because of the absence of authorization, such transfer was a breach of the Participation Contract and a violation of Article 74 of the HCL.

438. The background to the *Caducidad* Decree has been referred to at length previously in this Award and need not be repeated *in extenso* here. It suffices to note that:

(a) OEPC publicly announced the Farmout Agreement on 1 November 2000;

(b) By inter-departmental memorandum within the Ministry of Energy, it was noted on 8 November 2000 that AEC was already party to a participation contract for other fields and was the operator of those fields, that it had demonstrated technical solvency, and that there would be "no impediment for [the] assignment of rights [in OEPC's Participation Contract];"

(c) Nearly four years passed, until early 2004 (the Moores Rowland audit) during which time the Participation Contract proceeded without any major incident, and all payments due under it to PetroEcuador were made by OEPC;

(d) During those four years, the Claimants also committed substantial further investment to the OCP pipeline, and purchased a certain amount of capacity on the pipeline through a long-term ship-or-pay commitment;

(e) On 12 July 2004, the VAT Award was sent to the parties;

(f) On 14 July 2004, Moores Rowland issued its audit report, noting that the assignment of rights and obligations contemplated in the Farmout was made contingent on future events and that the assignment "might or might not happen;"

(g) On 15 July 2004, OEPC sought approval for the 40% transfer to AEC;

(h) On 24 August 2004, the Attorney General of Ecuador wrote to the Minister of Energy and Mines and requested that he terminate the Participation Contract;

(i) On 18 June 2005, during a major strike and following civil unrest which had persisted for several months, the new Minister of Energy and Mines, Minister Rodríguez, signed a resolution stating: "The Minister of Energy and Mines and the President of PetroEcuador, as the competent authorities, commit to undertaking all of the necessary steps for the departure from Ecuador of the companies Occidental and EnCana AEC for having violated the judicial norms of the country";

(j) By letter dated 2 August 2005, the President of PetroEcuador wrote to the Minister asking him to "declare the caducity of the Participation Contract […] according to the provisions set forth in Articles 74, 75, 76 and 79 of the [HCL]." Responding to the argument of proportionality which had been raised in correspondence by OEPC, the President of PetroEcuador said: "Although from the year 2000, operations have been executed by OEPC without any quantifiable economic damage resulting from the transfer of its economic interests, nevertheless, their arguments have not disproved the cause for caducity contemplated in numeral 11 of Article 74 of the [HCL]."

(k) On 10 November 2005, 100 members of Congress petitioned the President of Congress calling for an impeachment trial of Minister Rodríguez if he did not advance the *caducidad* process;

(l) On 26 March 2006, the leader of strikes which had been blocking highways in the north and centre of Ecuador stated that "if *caducity* of the Occidental contract is declared, we will lift the strike";

(m) In late April and early May 2006, Minister Rodríguez and PetroEcuador respectively asked the Attorney General whether the law permitted a negotiated settlement with OEPC, and he advised them both that it did;

(n) On 9 May 2006, various social organisations declared that they would demand the impeachment of the President for considering a settlement agreement with OEPC, and of the Attorney General for opining that a settlement was legally permitted;

(o) On 15 May 2006, the *Caducidad* Decree was issued.

439. The foregoing recitation of events shows that the question of whether a *caducidad* decree should be issued had become a national political issue, especially after the issuance of the Moores Rowland audit report and the publication of the VAT Award.

(j) The Influence of the VAT Award

440. As to the influence of the VAT Award and its connection with the eventual declaration of *caducidad*, the Tribunal refers to the following matters in particular:

(a) By March 2004, the Respondent was in possession of (unsigned) true copies of both the Farmout Agreement and the Joint Operating Agreement. However, no action was taken until July 2004, after the VAT Award was published, and after the Respondent received signed copies of the Farmout Agreement and Joint Operating Agreement.

(b) On 15 July 2004, three days after the VAT Award was published and one day after the Moores Rowland audit report was issued, OEPC informed PetroEcuador that the conditions in the Farmout Agreement of October 2000 had been met, and that OEPC was now requesting PetroEcuador to approve the transfer of the 40% interest to AEC. At the same time, OEPC submitted a formal request to the Ministry of Energy and Mines for approval of the transfer in accordance with Article 79 of the HCL.

(c) After meeting with Mr. Ellis of OEPC, Minister López wrote to him on 17 August saying as follows: "In order to have all the components to form a decision on your request for authorization, kindly send to the Office as soon as possible a certified copy of the Agreement executed with AEC Ecuador Ltd in the year 2000 and the relevant operating agreement that allowed OXY to continue as operator of Block 15 within the framework of the said transfer agreement."

(d) Accordingly, although the possibility of *caducidad* for violation of Article 74.11 of the HCL had been raised in an internal memorandum within the Ministry,[45] the Minister appeared to be proceeding with an open mind and wished to review the relevant documentation to address the request for authorization.

(e) However, during August 2004, the Attorney General of Ecuador, Dr. Borja, reacted strongly and publicly to the VAT Award which had ordered Ecuador to pay $75 million to OEPC. Dr. Borja told the media that he was examining OEPC's contract with Ecuador to "check whether the contractual norms have been strictly complied with." The

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[45] Dr. Zurita, DNH Audits Coordinator, memorandum dated 3 August 2004. The Claimants noted that Dr. Zurita was not called by the Respondent to give evidence.

contemporaneous press clippings which were produced in evidence leave no doubt as to the link between the VAT Award and Dr. Borja's sudden interest in reviewing OEPC's performance of its contract, despite many years of apparent satisfaction (on the part of the Respondent) with OEPC's operations within Ecuador.

(f) On 24 August 2004, Dr. Borja wrote to his colleague, Minister López, an official letter which was released to the press. It referred to the transfer by OEPC to AEC of "40% interests and obligations from the Participation Contract […] without having received authorization from the Ministry of Energy and Mines" and requesting him to "apply the provisions in the [HCL] and the referred contract, with regards to the causes of caducity of same." In making such a request, and in particular in making it public, Dr. Borja on behalf of the Respondent was clearly intending to create a situation whereby the only acceptable political outcome was to find (i) that there had been a relevant violation of the HCL or the Participation Contract, and that (ii) the only appropriate sanction (being a sanction specifically requested by the Attorney General) was to declare *caducidad*.

(g) As well as releasing the letter, a press release of the same date (24 August 2004) announced further that "in the case of non-compliances by Occidental with the State" the Attorney General had requested that

Minister López apply the provision of the HCL and the contract regarding *caducidad.*

(h) On 8 September 2004, Minister López complied with the Attorney General's request and wrote to the CEO of PetroEcuador asking him to commence the process under Clause 21.2 *et seq.* of the Participation Contract.

(i) PetroEcuador in turn wrote to OEPC on 15 September 2004 giving notification of breach of the Participation Contract and inviting OEPC to respond within 10 days, disproving or accepting the breaches alleged. OEPC responded in great detail (a 28-page letter) on 24 September 2004 denying all allegations in PetroEcuador's notice of 15 September 2004. OEPC's letter specifically invoked the principles of "*actos propios,*" estoppel, legitimate expectations, and proportionality – and also referred to the four year administrative silence following October 2000 – and concluded by stating that *caducidad* would be unlawful and in breach of the Treaty.

(j) The matter seems to have rested there for nearly six months until the Attorney General became involved once again. On 14 March 2005, he wrote to PetroEcuador in forceful terms requesting that they initiate *caducidad* proceedings. Furthermore, the letter was copied to the President of Ecuador together with the following message: "I insist that said public official [PetroEcuador's Executive President] should apply the clauses contemplated in the [HCL], its regulations and the contractual clauses, in order to declare caducity of the Participation Contract […].”

(k) The remaining steps in the process have been summarized above. The Tribunal refers again to the resolution (comprising part of some meeting minutes) which was signed on 18 June 2005 by the new Minister of Energy and Mines, Minister Rodríguez, and the Minister of Government, committing to undertaking “all of the necessary steps for the departure from Ecuador of the [OEPC and AEC] for having violated the judicial norms of the country”. There was also reference in the same set of minutes to the VAT issue in general, the resolution stating that there should be “a better control of the collection of the Value Added Tax.”

(l) As noted earlier, there were attempts at settlement and in May 2006 the Attorney General wrote to PetroEcuador advising that a “compromise and settlement was proper because it is so permitted by law.”

441. That is the relevant background to the matter, and the context in which *caducidad* was ultimately declared.

(k) Was the Caducidad Decree a Proportionate Response?

442. Based on the above, it is apparent that the VAT Award had created anger and disappointment in Ecuadorian political circles. It is not appropriate in this Award to discuss the merits or demerits of the VAT Award. It is sufficient to note that it seems to

have led to a good deal of ill-feeling against OEPC, as did the discovery that OEPC had transferred rights under the Participation Contract in violation of the laws of Ecuador.

443. To the Tribunal, it appears that there were different camps in the Government's decision-making. One camp was proposing to take a hard line and insist upon *caducidad.* Another camp appeared to be seeking an amicable resolution of the dispute. In the end the former succeeded.

444. Turning then to the question of harm, as noted earlier, it is significant that farmout agreements are very common in the oil and gas industry. In providing his evidence for the Respondent, Minister Terán acknowledged that the Farmout was (or was likely to have been) beneficial to the State: "[T]he obtainment of additional resources by OEPC to increase its investments in Ecuador seemed to me to be a good idea since it was beneficial to the country."[46]

445. The fact that AEC was already an approved operator in Ecuador, and continued to receive further approvals in relation to other projects/fields after signing the Farmout Agreement, means that it is overwhelmingly likely that approval would have been given if authorization had been sought in October 2000. Even if authorization could have been reasonably withheld, it does not follow that the Respondent has suffered a loss. Indeed, as recorded in PetroEcuador's letter of 2 August 2005, the evidence shows that the Respondent did not suffer any quantifiable loss as a direct result of AEC taking an

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[46] Witness Statement of Pablo Terán dated 16 June 2006 at paragraph 23 and Hearing Transcript (17 December 2008) at pages 1144-1145.

economic interest in Block 15. Furthermore, it is likely that the involvement of AEC with Block 15 actually resulted in increased investment in that Block, and thus increased the return for PetroEcuador under the Participation Contract.

446. The rationale for the "approval" requirement in Articles 74.11 and 74.12 of the HCL is readily apparent: the Respondent wishes to protect Ecuador's natural resources, and the income it can generate from them, by carefully assessing the technological capability, financial soundness and overall suitability of any party who will have access to and/or a measure of control over those resources. It goes without saying that such is not an unusual or unreasonable precaution to adopt.

447. But, having been deprived of the opportunity on this occasion to "vet" a potential third party, the question then shifts to whether the loss of that opportunity has actually occasioned any harm. Has the Respondent, without its knowledge, been faced with the fact that the operation of one of its oilfields was entrusted to an unsuitable third party, and if so has there been any harm suffered? The answer to both questions, on the evidence presented to this Tribunal, is clearly no.

448. The Claimants submitted that the Farmout Agreement did not offend the rationale for the approval requirement in Article 74 of the HCL. To the extent that the Respondent was deprived of the opportunity at the relevant time to consider the suitability of AEC, then it must be that the Farmout Agreement did offend the rationale for the approval requirement. OEPC circumvented the requirement for approval altogether. Acknowledging that fact, the Tribunal accepts the Respondent's submission that it is not

competent for OEPC or any other private party to arrogate to itself the right to oversee and regulate the identity of contractors to be involved with Ecuador's oilfields.

449. But that is a different matter from assessing whether the loss of the approval prerogative in a particular instance has caused harm. Certainly it did not cause economic harm in this case. The Respondent answers that point by asserting that OEPC's breach in this case "threatened the very integrity of Ecuador's hydrocarbons regulatory regime – and it required decisive action from the Ministry sufficient to pose an effective deterrent to future violations."

450. It can be accepted that some punishment or other step may well have been justified, or at the very least defensible. The options available to the Respondent have been explored above. The Tribunal does not necessarily disagree with the reasoning that the Respondent could justifiably have wished to re-emphasize the importance of adherence to its regulatory regime. But the overriding principle of proportionality requires that any such administrative goal must be balanced against the Claimants' own interests and against the true nature and effect of the conduct being censured. The Tribunal finds that the price paid by the Claimants – total loss of an investment worth many hundreds of millions of dollars – was out of proportion to the wrongdoing alleged against OEPC, and similarly out of proportion to the importance and effectiveness of the "deterrence message" which the Respondent might have wished to send to the wider oil and gas community.

451. Regarding the submission that as a practical matter the Minister could not choose anything but forfeiture, lest future declarations of *caducidad* be met with claims of

discrimination, the simple answer to this is that every case turns on its own facts. Despite differences between the parties on the question of the precise circumstances in which other contractors have faced potential proceedings for *caducidad*[47], the evidence was that the Ministry of Energy and Mines has on several other occasions chosen not to declare *caducidad* notwithstanding that violations of Article 74 had been alleged. As Lord Steyn has famously noted, when giving his imprimatur to the importation into English law of the principle of proportionality: "In law, context is everything."[48]

452. It follows that even if OEPC, as the Tribunal found earlier, breached Clause 16.1 of the Participation Contract and was guilty of an actionable violation of Article 74.11 (or Articles 74.12 or 74.13), the *Caducidad* Decree was not a proportionate response in the particular circumstances, and the Tribunal so finds. The *Caducidad* Decree was accordingly issued in breach of Ecuadorian law, in breach of customary international law, and in violation of the Treaty. As to the latter, the Tribunal expressly finds that the *Caducidad* Decree constituted a failure by the Respondent to honour its Article II.3(a) obligation to accord fair and equitable treatment to the Claimants' investment, and to accord them treatment no less than that required by international law.

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[47] A fact which only serves to emphasize the central importance of the specific facts in any given case.

[48] *R. v. Secretary of State for the Home Department*, ex parte *Daly* [2001] 3 All ER 433 at 447.

(l) Expropriation in Breach of Article III of the Treaty

453. The Claimants have also contended that the *Caducidad* Decree was an unlawful expropriation of the Claimants' investment in violation of Article III.1 of the Treaty, which states:

> ARTICLE III
>
> 1. Investments shall not be expropriated or nationalized either directly or indirectly through measures tantamount to expropriation or nationalization ("expropriation") except: for a public purpose; in a non-discriminatory manner; upon payment of prompt, adequate and effective compensation; and in accordance with due process of law and the general principles of treatment provided for in Article II(3). Compensation shall be equivalent to the fair market value of the expropriated investment immediately before the expropriatory action was taken or became known, whichever is earlier; calculated in a freely usable currency on the basis of the prevailing market rate of exchange at that time; be paid without delay; include interest at a commercially reasonable rate from the date of expropriation; be fully realizable; and be freely transferable.
>
> […]

454. In response, the Respondent maintains that it did not expropriate the Claimants' investment because the termination of a contract in accordance with its terms and governing law is not an expropriation, and that the *Caducidad* Decree was a *bone fide* administrative sanction in furtherance of a legitimate regulatory policy.

455. The Tribunal agrees with the Claimants. Having found in the previous Section of the present Award that the *Caducidad* Decree was issued in breach of Ecuadorian law, in breach of customary international law and in violation of the Respondent's Article II.3(a) obligation to accord fair and equitable treatment to the Claimants' investment, the Tribunal now has no hesitation in finding that, in the particular circumstances of this case which it has traversed earlier, the taking by the Respondent of the Claimants' investment by means of this administrative sanction was a measure "tantamount to expropriation"

and thus in breach of Article III.1 of the Treaty. This phrase is found in NAFTA Article 1110 which provides that "[n]o party shall directly or indirectly … expropriate an investment … or take a measure tantamount to … expropriation…" In the well-known case of *Metalclad v Mexico*[49], in relation to the definition of "tantamount to expropriation", the Tribunal said:

> "Thus, expropriation under NAFTA includes not only open, deliberate and acknowledged takings of property, such as outright seizure or formal or obligatory transfer of title in favour of the host State, but also covert or incidental interference with the use of property which has the effect of depriving the owner, in whole or in significant part, of the use or reasonably-to-be-expected economic benefit of property even if not necessarily to the obvious benefit of the host State."[50]

(m) The Remaining Allegations of Breach under the Treaty and Ecuadorian Law

456. Having found that the *Caducidad* Decree was not a proportionate response in the particular circumstances and as such was issued in breach of Ecuadorian law, in breach of customary international law, and in violation of Articles II.3(a) and III.1 of the Treaty, the Tribunal need not address the remaining allegations of breach under the Treaty and Ecuadorian law raised by the Claimants, including the allegations that the *Caducidad* Decree was imposed in a discriminatory manner or that it otherwise denied the Claimants

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[49] *Metalclad Corporation v. The United Mexican States* (ICSID Case No. ARB(AF)/97/1), Award, 30 August 2000.

[50] *Ibid.* paragraph 103 (emphasis added). See also *e.g. S.D. Myers v. The Government of Canada*, Partial Award of 13 November 2000 (NAFTA) at paragraphs 280 and 285: "In general, the term 'expropriation' carries with it the connotation of a 'taking' by a governmental-type authority of a person's 'property' with a view to transferring ownership of that property to another person, usually the authority that exercised its *de jure* or *de facto* power to do the 'taking.'" […] "The primary meaning of the word 'tantamount' given by the Oxford English Dictionary is 'equivalent.' Both words require a tribunal to look at the substance of what has occurred and not only at form. A tribunal should not be deterred by technical or facial (*sic*) considerations from reaching a conclusion that an expropriation or conduct tantamount to an expropriation has occurred. It must look at the real interests involved and the purpose and effect of the government measure."

full protection and security. Indeed, even if the Tribunal were to make positive findings in this regard, this would have no impact on the determination of the resulting damages. For the same reason, the Tribunal need not address the Claimants' allegation that the Respondent allowed PetroEcuador and Petroproducción to aid and abet the *Caducidad* Decree in a manner inconsistent with the Treaty or Ecuadorian law.

VI. QUANTUM

A. Introduction

457. In view of its findings on liability, the Tribunal now turns to the determination of the quantum of the Claimants' damages. In this regard, the Tribunal observes that in addition to the applicable standard for valuing the Claimants' losses and other related quantum issues, there are four "core" threshold quantum issues that it must first resolve. These issues concern the impact (if any) on the Tribunal's determination of quantum of:

1) The Ecuadorian Law 42;

2) The Ecuadorian VAT Interpretative Law;

3) The Farmout Agreement; and

4) The fault of the Claimants prior to the *Caducidad* Decree.

458. All four of these "core" quantum issues have been raised by the Respondent in response to the Claimants' contention that compensation for their losses should be equal to the full fair market value of the Participation Contract as of the date of the *Caducidad* Decree, *i.e.* 15 May 2006. As will be seen, the Respondent argues that the quantification

of the Claimants' losses must be reduced on account of each one of these four factors, whereas the Claimants reject any suggestion that the damages they seek should be anything less than the full market value of their investment.

459. The parties briefed the Tribunal, in writing and orally, at great length about these four issues. The Tribunal will thus, before analyzing each issue, summarize the parties' respective arguments, all of which have been taken into consideration by the Tribunal.

B. The Respondent's Procedural Objections in connection with Law 42 and the VAT Interpretative Law

460. The Respondent contends, as a preliminary matter and in the form of procedural objections that, since the Claimants did not assert any claims based on Law 42 or the VAT Interpretative Law during the liability phase of the arbitration, they are precluded from challenging their lawfulness as a basis for their inapplicability during the quantum phase.

461. The Claimants reply that, because the lawfulness of Law 42 or the VAT Interpretative Law only became relevant in the event the Tribunal found the Respondent liable to the Claimants, the time to raise those issues was in the quantum phase, more specifically in their Memorial on Damages, which is precisely what they did.

462. The Tribunal agrees with the Claimants. It stands to reason that the Claimants' argument that these two Ecuadorian laws should not be taken into account by the Tribunal for purposes of quantifying their losses becomes pertinent to the Claimants' damages claim only after and in the event the Respondent has been found liable.

463. The Tribunal notes, in addition, that the Claimants, in their Memorial on Liability, stated very clearly that these issues would be addressed in their submissions on damages.

464. Accordingly, these procedural objections on the part of the Respondent are dismissed.

C. The Ecuadorian Law 42

1. Introduction

465. Law 42, also referred to as the HCL Amendment, was passed by the Ecuadorian Congress on 19 April 2006 and published in the Official Gazette on 25 April 2006. Law 42 added a provision to the HCL titled "State's Participation in surplus from oil sales prices not agreed upon or not foreseen". This provision, which became Article 55 of the HCL, states, in relevant part, as follows:

> Contractor companies that hold participation contracts for the exploration and exploitation of hydrocarbons in effect with the Ecuadorian State in accordance with this Law, without prejudice to the volume of participation crude oil that corresponds to them, when the average actual monthly FOB sales price of Ecuadorian crude oil exceeds the average monthly sales price in effect on the date on which the contract was executed […] shall recognize a participation in favor of the Ecuadorian State of at least 50% of the extraordinary revenues generated by the difference in prices. For purposes of this article, extraordinary revenues shall be understood to mean the difference in price described above, multiplied by the number of barrels produced.
>
> The price of crude oil as of the date of contract execution, used as reference to calculate of the difference, shall be adjusted based on the United States' Consumer Price Index published by the Central Bank of Ecuador.[51]

[51] The Claimants observe that PetroEcuador determined the monthly average price in effect at the time of the execution of the Participation Contract at $13.66 per barrel, which adjusted for inflation and quality of oil was $16.43 as of June 2006.

466. On 13 July 2006, Ecuador issued Decree 1672 implementing Law 42 at the 50% rate.[52]

2. The Impact of Law 42

(a) The Respondent's Position

467. The Respondent maintains that any valuation of the Claimants' damages should take into account the impact of Law 42 since any valuation of the Claimants' interest in Block 15 would have to reflect the actual situation that a hypothetical purchaser of that interest would have faced in Ecuador on 15 May 2006 after the enactment of Law 42.

468. In brief, it is the Respondent's position that Law 42 did not violate the Treaty. More particularly, the Respondent submits that Law 42 is nothing more than a generally-applicable fiscal measure. The Respondent rejects the Claimants' contention that Law 42 improperly modified the legal framework that existed at the time their investment was made. Law 42, says the Respondent, cannot be found to violate the Claimants' legitimate expectations or otherwise deny them fair and equitable treatment and full protection and security. The Respondent further denies that Law 42 imposed a unilateral modification of the Participation Contract in breach thereof and in violation of the Treaty's "umbrella" clause, or that it otherwise operated an expropriation of the Claimants' investment.

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[52] The Tribunal notes that on 4 October 2007, Ecuador issued Decree 662 increasing the State's participation to 99%.

469. Clause 8.6 of the Participation Contract is central to the Respondent's argument that Law 42 does not modify the Participation Contract. The Tribunal will now cite this clause and other related clauses of the Contract for ease of reference:

> **EIGHT: PARTICIPATION AND DELIVERY PROCEDURES.-**
>
> […]
>
> **8.6 Economic Stability:** In the event that, due to actions taken by the State of Ecuador or PETROECUADOR, any of the events described below occur and have an impact on the economy of this Participation Contract:
>
> **a.** Modification of the tax regime as described in clause 11.11.
>
> **b.** Modification of the regime for remittances abroad or exchange rates, as described in clause 12.1 and 12.3 respectively.
>
> **c.** Reduction of the production rate, as determined in clause 6.8.3.
>
> **d.** Modification of the value of the transport rate described in clause 7.3.1 in accordance with the procedure established in Annex XIV.
>
> **e.** Collection of the Value Added Tax, VAT, as set forth in Official Letter No. 01044 of October 5, 1998, which appears as annex number XVI, pursuant to which the Directorate of Internal Revenue Service states that the imports made by the contractor for the operations of block 15 under the structure of the participation contract, are subject to said tax.
>
> In the cases indicated in letters a) and b), the Parties shall enter into amending contracts as indicated in clause 15.2, in order to re-establish the economy of this Participation Contract. When the events indicated in letters c), d) and e) occur, a correction factor shall be included in the participation percentages, to absorb the increase or decrease of the economic burden, in accordance with Annex No. XIV. (Emphasis added)
>
> **11.9 Exemptions:** According to Art. 54 of the Hydrocarbons Law, Contractor is exempt from payment of entry rates, surface rights, royalties and contributions to compensation works, as well as the contribution to technical research set forth in first section of the above mentioned provisions of the Hydrocarbons Law.
>
> […]

> **11.11 Tax Regime Modification:** In the event that: a) there is a modification of the tax or labor participation regimes in effect as of the signing date of this Participation Contract, as these are described in this Clause; and/or (b) of their legal interpretation; and/or (c) the creation of new taxes or levies not foreseen in this Participation Contract, which have an impact upon the economy of same, a correction factor shall be included in the participation percentages that shall absorb the increase or decrease of the aforementioned tax burden or labor participation. This correction factor shall be calculated between the Parties, following the procedure outlined in Art. Thirty-one (31) of the Regulations for the Application of the Reformatory Laws to the Hydrocarbons Law. The modification of this Participation Contract will take into account the date on which the corresponding modification or legal interpretation of the indicated tax or labor regimes went into effect, or the date on which the new taxes not covered in this Clause were created.
>
> […]
>
> **15.2 Modifying Contracts.-** After prior agreement between the Parties, there shall be an opportunity to negotiate and enter into modifying contracts in those cases determined in Art. 30 of the Regulations for the Application of Law 44, especially in the following cases:
>
> […]
>
> **c)** When the regime for taxes, foreign currency, remittance of funds abroad or labor participation applicable to this type of contract in the country have been modified, in order to re-establish the economy of this Participation Contract, in accordance with sub-clauses 8.6 and 11.10.
>
> […]

470. It is the Respondent's position that Law 42 cannot have "an impact on the economy of this Participation Contract" as contemplated by Clause 8.6. Law 42 was enacted in 2006, says the Respondent, merely for the purpose of capturing a portion of the windfall profits that were by then flowing to oil companies in Ecuador as a result of an "astounding and unforeseeable" increase in the price of oil. In so doing, the Respondent claims to have done "nothing more than exercise its indisputable sovereign authority to raise revenue for its governmental operations and the public welfare." The Respondent argues that the Claimants were not entitled to expect windfall profits generated by prices for oil unimaginable at the time the Participation Contract was

signed. By reference to Clause 8.6 of the Participation Contract, the Respondent seeks to refute the Claimants' contention to the contrary as follows:

> […][T]here is no provision in the Participation Contract which could possibly evidence Claimants' supposed expectation. On the contrary, the provisions of clause 8.6 make it clear that Claimants (*i*) knew and expected that OEPC's revenues may be adversely affected by changes in Ecuadorian law and (*ii*) agreed that it would only be indemnified against such changes (*a*) if the measure at issue fell within a certain class and (*b*) only to the extent necessary to re-establish the economic value of the contract.
>
> With oil prices at unimaginable highs, the value to OEPC of its Participation Contract remained far greater than it could ever have imagined at the time it negotiated it and certainly well above the agreed point of equilibrium. Claimants' bare assertion that they had an expectation that OEPC would be entitled to the full value of its windfall profits unaffected by a law such as the HCL Amendment is baseless. OEPC knew and expected at the time that it executed the contract that State measures may impact its revenue stream from the sale of its participation, and tried to deal with that situation in clause 8.6 of the Participation Contract. Its problem is clause 8.6 is triggered only if some measure fell within its ambit *and* reduced the net present value of the contract below the agreed equilibrium point. The HCL Amendment did neither. In the absence of a stabilization clause, Claimants could have had no legitimate expectation that a measure such as the HCL Amendment would not be enacted or, if it was, that they would be immune from its application. (Emphasis in original)

471. The Respondent adds that even if Law 42 fell within the ambit of Clause 8.6, the obligation imposed on the parties by Clause 8.6 would merely be to "reestablish the economy of this Participation Contract." According to the Respondent, Clause 8.6 is thus a classic re-negotiation clause and not a stabilization clause.

472. Furthermore, the Respondent contends that even if Clause 8.6 required the parties to negotiate amendments to the Participation Contract that would re-establish the agreed economic value of the contract to OEPC in the event that the Respondent took some measure which adversely affected it, the underlying premise was that the economic value of the Participation Contract to OEPC was less than that which had been forecasted at the

time the contract was negotiated. In other words, says the Respondent, as long as the price of Block 15 crude exceeds the $15 per barrel price agreed by the parties in determining their respective participation percentages, the economic value of the contract to OEPC will be above the value expected to be yielded at any given point in time. That is so even if Law 42 is applied, since OEPC will still always enjoy 50% of the upside of every cent above $15 per barrel.

473. Finally, the Respondent avers that even if an obligation to re-establish the economic value of the Participation Contract did arise, the obligation on the parties was to negotiate a modifying contract in accordance with Clause 15.2. According to the Respondent, the mere enactment of Law 42 could never have amounted to a breach of the Participation Contract and, in the circumstances, there could be no breach of contract absent a failure on the part of the parties to agree a revised contract.

474. Echoing its submissions regarding the *Caducidad* Decree, the Respondent also denies that Law 42 was a direct or indirect expropriation, that Law 42 discriminated against the Claimants in favour of Ecuadorian companies, or that Law 42 caused arbitrary and discriminatory impairment of the Claimants' investment. The Respondent, in addition, reasserts the constitutionality of Law 42 as declared by the Ecuadorian Constitutional Court.

(b) The Claimants' Position

475. As previously noted, the Claimants contend that Law 42 – which they refer to as a "value-depressing measure" – should not be taken into account for purposes of

quantifying their losses. Law 42, contend the Claimants, violates both the Treaty and Ecuador's Constitution.

476. More particularly, it is the Claimants' position that, by enacting Law 42 in 2006, the Respondent unilaterally introduced by law a contractual term that it had rejected in 1999 when it negotiated the Participation Contract, and subsequently failed to obtain in 2005 when the parties sought to renegotiate that contract on a mutually agreed basis. According to the Claimants, Law 42 violates the express terms of the formula set out in Clause 8.1 of the Participation Contract[53]:

> […] Ecuador, by taking 50% (which increased in 2007 to 99%, see ¶ 246 above) of OEPC's revenues from Block 15 production above an arbitrary reference price, radically modified the participation formula of Clause 8.1 of the Participation Contract. That clause provides unequivocally that OEPC's participation will vary with volume and quantity, but *not* with price. CE-2, Clause 8.1. In fact, as Mr. Albuja has explained and Ecuador has not denied, the parties specifically considered tying OEPC's participation to price fluctuations during the negotiation of the Participation Contract but decided not to do so. *See* CMD ¶¶ 104-1078; FA WS II ¶ 4. It is therefore clear that the HCL Amendment struck at the very heart of OEPC's acquired rights under the Participation Contract by changing the agreed upon participation formula of Clause 8.1 to reduce OEPC's agreed-upon share in production. (Emphasis in original)

477. The Claimants emphasize that, when the parties converted their Services Agreement to a Participation Contract, they specifically agreed to tie their participations exclusively to production volume, and not to oil prices, thereby giving the Claimants a legitimate basis to expect that the Respondent would not subsequently retract that essential part of the bargain. In the words of the Claimants:

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[53] Clause 8.1 and 8.5 are set out *infra*, at paragraphs 512 and 513.

> Most fundamentally, when an investor enters into a long-term contract with a clear and unambiguous revenue-distribution formula, it can reasonably expect that the agreed upon formula will allocate the risks and rewards of the parties throughout the life of the contract. That is all the more true where, as here, the investor assumed all of the risk of the required capital investment. An investor cannot be fairly required in those circumstances to bear all of the risk of a low price environment without the commensurate reward of a high price environment.

478. The Claimants accordingly contend that the Respondent breached its obligation under Article II.3(c) of the Treaty to observe any obligation it might have entered into with regard to investments because Law 42 writes two essential terms out of the Participation Contract, namely the production-sharing formula under Clause 8.1, as well as OEPC's right under Clause 5.3.2 of the Participation Contract freely to dispose of its participation. According to the Claimants, the Clause 5.3.2 right is meaningless unless it includes the right freely to enjoy the revenues from such disposal and Law 42, they add, removed that right from the Participation Contract with respect to half of all pre-tax revenues accruing from sales at a price in excess of the price of crude oil as of the date of the Participation Contract.

479. In addition, the Claimants contend that, by enacting Law 42, the Respondent breached its obligation under Article II.1 of the Treaty, pursuant to which the Respondent is required to "treat investment, and activities associated therewith, on a basis no less favourable than that accorded in like situations to investment or associated activities of its own nationals or companies, or of nationals or companies of any third party." According to the Claimants, the impact of Law 42 was such that U.S. investments were inevitably going to suffer losses that simply bear no comparison to any losses suffered by Ecuadorian investments.

480. The Claimants also submit that Law 42 is in breach of the fair and equitable treatment (Article II.3(a)) and full protection and security (Article II.3(b)) provisions of the Treaty, reiterating that they had a legitimate expectation that the Respondent would not impair the long-term contractual bargain on which they had premised their investment. The Claimants stress that it is on the basis of that bargain that they decided to put enormous capital at risk in Ecuador, and that they did so in the expectation that the Respondent would not take away the reward of the investment once they had successfully managed the risk of that investment.

481. Specifically, the Claimants refute the Respondent's assertion that they could not have expected to be insulated from any kind of generally applicable modification to Ecuador's tax or legal framework. Law 42 was not, say the Claimants, a "generally-applicable modification to Ecuador's tax or legal framework." In this regard, the Claimants submit that even with respect to companies with a participation contract, Law 42 was applied selectively (*e.g.* the Tarapoa contract was exempted from the application of Law 42).

482. The Claimants also aver that, by enacting Law 42, the Respondent has breached the Article III expropriation provision of the Treaty, arguing that the Respondent has thereby deprived OEPC of (i) the participation in Block 15 production to which the Participation Contract entitled it and that, it was specifically agreed, would not vary with oil price fluctuations; and (ii) its right to freely dispose of its entire participation in Block 15 production and to receive the revenues from such free disposal. The Claimants add

that those rights are both a “claim to money” and a “right conferred by contract,” both of which are expressly included in the Treaty’s definition of investment.

483. Finally, the Claimants assert that Law 42 violates the Ecuadorian Constitution because (i) it violates the principles of legal security and non-retroactivity, (ii) the principle of freedom of contract, (iii) it constitutes an unlawful confiscation, and (iv) it violates the principle of equality of treatment.

(c) The Tribunal’s Analysis and Conclusion

(i) Preliminary Observations

484. At the outset of its analysis of Law 42, the Tribunal recalls the title of the HCL Amendment: “State’s Participation in surplus from oil sales prices not agreed upon or not foreseen.”

485. The Tribunal notes that Decree 1672 fixed the “State’s Participation” at the level of 50% of what Law 42 refers to as the “extraordinary revenues” earned by “Contractor companies” such as the Claimants as a result of any increase in price above the monthly average price in effect at the time of the execution of the Participation Contract.

486. The Tribunal further notes that the words “extraordinary revenues” are found nowhere in the Participation Contract.

(ii) Characterization of Law 42 and the Respondent’s Jurisdictional Objection

487. Against this background, the Tribunal has determined that its analysis regarding the impact of Law 42 requires that it first characterize this legislation. Is it a tax, a

royalty, a levy or, more generally, a "matter of taxation" under the Treaty, or is it something else?

488. There is also a compelling procedural reason why the Tribunal must characterize Law 42. At the Hearing on Quantum, the Respondent, for the first time in these proceedings, claimed that "the question of Law 42 is excluded from the Arbitral Tribunal's jurisdiction in accordance with Article 10 of [the] Treaty".[54] In effect, as will be seen, the Respondent was now adopting the position that Law 42 was a "matter of taxation."

489. The Tribunal recalls that the Respondent, throughout the Hearing on Quantum, was loath to characterize Law 42. In its Post-Hearing Brief, the Respondent stated categorically that Law 42 was not a royalty.

490. The Tribunal also recalls that at the Hearing on Quantum, the Respondent submitted categorically that Law 42 "is not a tax". In the words of counsel for Ecuador: "[I]n Ecuador […] for a tax to be created and imposed on the citizens, you need to follow some special procedures in the constitution. Here, this Law 42 was issued pursuant to a different procedure. <u>So it couldn't be a tax</u>."[55] (Emphasis added)

491. The Claimants have argued, albeit in the alternative, that Law 42 is either a royalty within the meaning and in breach of Clause 11.9 of the Participation Contract, or

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[54] Hearing Transcript (6 November 2009) at page 161.

[55] Hearing Transcript (4 November 2009) at page 175.

otherwise a tax or a levy within the meaning of Clause 11.11 of the Participation Contract which requires an adjustment in the form of a correction factor pursuant to Clauses 8.6 and 11.11 of the Contract.

492. The Tribunal agrees with the Respondent that Law 42 is not a royalty. Such a characterization is contrary to the plain text of Clause 11.9 of the Participation Contract as well as the plain text of the operative provision of Law 42 referred to above.

493. By its express terms, Clause 11.9 incorporates into the Participation Contract Article 54 of the HCL which it repeats word for word:

> **11.9 Exemptions:** According to Art. 54 of the Hydrocarbons Law, Contractor is exempt from payment of entry rates, surface rights, royalties and contributions to compensation works, as well as the contribution to technical research set forth in first section of the above mentioned provisions of the Hydrocarbons Law. (Emphasis added)

494. In addition, as also noted by the Respondent, a royalty is generally defined as a payment made in exchange for access to a natural resource.[56] This is clearly not what Law 42 contemplates. The Tribunal thus concludes that Law 42 is not a royalty.

495. The Tribunal also agrees with the Respondent that Law 42 is not a tax. Again, such a characterization is contrary to the plain text of Law 42 and, in any event, as stressed by the Respondent, it was not "created" in accordance with the Ecuadorian Constitution.

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[56] See Black's Law Dictionary, 7th edition (1999).

496. In this regard, the Tribunal notes that the Claimants' contention that Law 42 is a tax was not pressed with much vigour in either their written or oral submissions. Even their legal expert, Dr. Pérez Loose, could not bring himself to opine clearly that Law 42 was a tax.

497. In any event, even if Law 42 were a tax, it would not, in the opinion of the Tribunal, create a jurisdictional barrier to the Claimants' Law 42 claim under the Treaty for the following reasons.

498. Article X of the Treaty provides that:

> 1. With respect to its tax policies, each Party should strive to accord fairness and equity in the treatment of investment of nationals and companies of the other Party.
>
> 2. Nevertheless, the provisions of this Treaty, and in particular Article VI and VII, shall apply <u>to matters of taxation</u> only with respect to the following:
>
>> (a) expropriation, pursuant to Article III;
>>
>> (b) transfers, pursuant to Article IV; or
>>
>> (c) the observance and enforcement of terms of an investment agreement or authorization as referred to in Article VI (1) (a) or (b), to the extent they are not subject to the dispute settlement provisions of a Convention for the avoidance of double taxation between the two Parties, or have been raised under such settlement provisions and are not resolved within a reasonable period of time. (Emphasis added)

499. The Tribunal is of the view that Law 42, even if it was characterized as a "matter of taxation", would be captured by the "exception to the exception" of Article X.2(c) of the Treaty. The dispute between the parties, in the present arbitration, relates directly to the observance and enforcement of the terms of the Participation Contract which, in the opinion of the Tribunal, is an investment agreement under Article VI(1)(a) of the Treaty.

500. The Respondent's jurisdictional objection regarding Law 42 is thus dismissed.

501. Having found that Law 42 is neither a royalty nor a tax, it remains for the Tribunal to determine whether Law 42 can be characterized as a levy.

502. The Tribunal notes that in its Post-Hearing Brief on Law 42, the Respondent wrote that "[i]f the Arbitral tribunal requires that Ecuador characterize Law 42 under Ecuadorian Law, Ecuador would submit that Law 42 is a levy."

503. The word "levy" is not a defined term in the Participation Contract. In fact, the word is only used once in the Participation Contract, in Clause 11.11, in the context of "the creation of new taxes or levies not foreseen in this Participation Contract, which have an impact upon the economy of same […]." (Emphasis added)

504. The Tribunal notes Clause 3.4.4 of the Participation Contract which reads as follows:

> **3.4.4.** For those definitions not included in this Participation Contract or in the provisions that comprise the legal framework hereof, the Parties will refer to the definitions included in the Hydrocarbons Law and its regulations, as well as those generally accepted by the international oil industry.

505. There is no definition of "levy" in the Hydrocarbons Law or its regulations.

506. Neither party has represented to the Tribunal that a "levy" was a word "generally accepted by the international oil industry".

507. In the circumstances, the Tribunal refers again to Black's Law Dictionary where levy is defined as "the imposition of a fine or tax; the fine or tax so imposed".

508. The participation of "50% of the extraordinary revenues" decreed by Law 42 in favour of the Ecuadorian State cannot, in the view of the Tribunal, be considered as a fine

or tax. Rather, as evidenced by both its title and its express terms, Law 42 decrees an increased participation “in favour of the Ecuadorian State” from “companies [such as OEPC] that hold participation contracts”.

509. For purposes of characterizing Law 42, it is sufficient for the Tribunal to conclude, as it now does, that the participation of Ecuador under Law 42 “in surplus from oil sales prices not agreed upon or not foreseen,” is neither a royalty, a tax, a levy or any other measure of taxation under the Participation Contract.

510. It is, as its title makes explicit, a unilateral decision of the Ecuadorian Congress to allocate to the Ecuadorian State a defined percentage of the revenues earned by contractor companies such as OEPC that hold participation contract.

511. The Tribunal will now turn to its analysis of Law 42.

(iii) Analysis of Law 42

512. In the Tribunal’s view, the analysis of Law 42 must commence with the determination of the basis on which OEPC’s participation in the exploration and exploitation of hydrocarbons in Block 15 was to be calculated. Clauses 8.1 and 8.5 of the Participation Contract are very clear in that respect: PetroEcuador and OEPC agreed that, as of May 1999, OEPC would receive a participation in the production of crude oil and that such participation would be calculated as follows:

EIGHT: PARTICIPATION AND DELIVERY PROCEDURES.-

8.1 Calculating Contractor Participation.- Contractor Participation shall be calculated according to the following formula:

$$PC \quad \frac{X.Q}{100}$$

Where:

PC	=	Contractor Participation
Q	=	Fiscalized Production
X		Average factor, in percentage, rounded out to the third decimal, corresponding to Contractor Participation, calculated according to the following formula:

$$x = \frac{X1.q1 + X2.q2 + X3.q3}{q} + Y$$

Where:

q = is average daily Fiscalized Production for the corresponding Fiscal Year.

q1 = is the part of q lower than L1

q2 = is the part of q between L1 and L2.

q3 = is the part of q greater than L2.

513. As for the Respondent, its participation was to be calculated as follows:

8.5 State Participation in Production. – Once production has started, State Participation shall be calculated as follows:

$$PE = \frac{(100 - X)\ Q}{100}$$

Where:

PE = State Participation

X and Q are defined in Clause 8.1

514. Under the Participation Contract, the parties' respective participations were thus dependent exclusively on production volume.

515. The Tribunal recalls that the Participation Contract replaced a Services Contract between the parties. As explained by Mr. Fernando Albuja,[57] under the Services Contract model the Respondent remained the sole owner of the oil produced and thus captured the higher revenues flowing from any increase in the price of oil. According to Mr. Albuja, during the negotiations of the Participation Contract, OEPC proposed that the parties' participations remain dependent on production volume but also vary with crude oil price fluctuations. This proposal was rejected by PetroEcuador. In the words of Mr. Albuja, "they insisted that under a participation contract […] the parties' participations could only vary with production volume and not with price."[58]

516. As a result, observes Mr. Albuja, "Occidental accepted the risk that crude oil market prices would remain below the hypothetical $15 per barrel price, and PetroEcuador accepted that each party would benefit from future price increases in proportion to its volume-defined participations and that it would not receive more oil if the price of oil increased."[59]

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[57] Mr. Albuja submitted four witness statements on behalf of the Claimants. From 1992 to 15 May 2006, he worked for OEPC in Ecuador. See, in particular, his Second Witness Statement dated 17 September 2007. The Tribunal notes that Mr. Albuja's evidence was not challenged or contradicted by the Respondent.

[58] Second Witness Statement of Fernando Albuja dated 17 September 2007 at paragraph 8.

[59] *Ibid.* at paragraph 9.

517. Mr. Albuja adds: "Based on what PetroEcuador's negotiators told me at the time[60], the parties therefore fully shared the understanding that Occidental would bear all of the risk of low prices but would also take no less than what its participation entitles it to in the case of high prices."[61]

518. In addition, the Tribunal notes that both before and after the conclusion of the Participation Contract, the Respondent did agree, in other oil exploration and exportation contracts, to tie the participation percentages to oil price fluctuations.

519. It is against that background that, in the fall of 2005, in a higher oil price environment, the Respondent sought to revisit the bargain that it had struck with OEPC (and other oil companies) seven years earlier and asked for a renegotiation of the Participation Contract. While the evidence is not clear as to why these negotiations did not lead to an agreement between the parties, it is a fact that they were not successful.

520. In April 2006, shortly before *caducidad* was declared, Law 42 was passed which, as noted earlier, now made the Respondent's participation in the revenues from oil directly dependent on crude oil prices, in stark contradiction with Clauses 8.1 and 8.5 of

[60] Mr. Albuja refers specifically, in this connection, to an affidavit submitted in the VAT arbitration by Patricio Larrea, whom he describes as PetroEcuador's lead negotiator (see Second Witness Statement of Fernando Albuja dated 17 September 2007 at paragraph 9).

[61] Second Witness Statement of Fernando Albuja dated 17 September 2007 at paragraph 9.

the Participation Contract which sets the participation of the parties in the oil produced without any reference to the price of oil.[62]

521. While it is true, as argued by the Respondent (and indeed admitted by the Claimants), that Clause 8.1 does not contain any guaranteed revenue term and that Law 42 has not changed the percentage in the volumes, in the opinion of the Tribunal this is not a complete answer to the question posed by the Respondent as to whether or not Law 42 should be taken into account for purposes of quantifying the Claimants' losses.

522. It is clear to the Tribunal that, in the Participation Contract, the Claimants knowingly accepted the risk of losses on its investment in case of a low price scenario and the Respondent knowingly forewent the opportunity to increase its participation in case of a high price scenario. This was the bargain which was struck by the parties and which was reflected in the Participation Contract.

523. Law 42, by taking 50% of OEPC's revenues from Block 15 production above the agreed reference price, modified radically the participation of the parties agreed in Clause 8.1. The Tribunal agrees with the Claimants' submission that "the HCL Amendment struck at the very heart of OEPC's acquired rights under the Participation Contract by changing the agreed upon participation formula of Clause 8.1 to reduce OEPC's agreed upon share in production."

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[62] Mr. Albuja affirmed that "[s]ince under the participation contract we would make all required investments at our own risk and our participation in production would be our only source of revenue, this determination was an essential part of the [negotiation] process" (see Second Witness Statement of Fernando Albuja dated 17 September 2007 at paragraph 5). (Emphasis added)

524. In addition, the Tribunal notes that the Respondent, with Law 42, wrote out of the Participation Contract another right enjoyed by OEPC under the Participation Contract. Under Clause 5.3.2, OEPC had the right to "freely dispose" of its participation. Obviously, that right becomes meaningless unless it includes the right "freely" to enjoy the revenues from such disposal. Law 42 extinguished that right with respect to half of all revenues accruing from sales by OEPC at a price in excess of the reference price.

525. Thus, the Tribunal finds that with the introduction of Law 42, the Respondent modified unilaterally and in a substantial way the contractual and legal framework that existed at the time the Claimants negotiated and agreed the Participation Contract and thereby violated Clauses 5.3.2 and 8.1 of the Participation Contract.

526. The considerable investments made by OEPC in Ecuador after the execution of the Participation Contract were based upon the explicit representations made by the Respondent during the negotiation of the Participation Contract which were then crystallized in the participation agreed by the parties in Clauses 8.1 and 8.5. The investor, OEPC, was justified in expecting that this contractual framework would be respected and certainly not modified unilaterally by the Respondent.

527. In conclusion, Law 42 is in breach of the Participation Contract and flouts the Claimants' legitimate expectations. It is, as a result, in breach of the Respondent's Article II.3(a) Treaty obligation to accord fair and equitable treatment to the Claimants' investment and the Tribunal so finds. In the circumstances, the Tribunal need not rule on whether Law 42 is in breach of other provisions of the Treaty.

528. There remain three additional arguments of the Respondent which the Tribunal needs to address. First, the Respondent claims that, by enacting Law 42 in the light of the "astounding and unforeseeable" increase in the price of oil, it has done "nothing more than exercise its indisputable sovereign authority to raise revenue for its governmental operations and the public welfare."

529. There cannot be any doubt that a sovereign State has the undisputable sovereign authority to enact laws in order to raise revenue for the public welfare but, as is equally well established, "the exercise of such right is not unlimited and must have its boundaries."[63]

530. As the tribunal stated in the *ADC* award, "the rule of law, which includes treaty obligations, provides such boundaries."[64] The *ADC* tribunal continued with a statement which the present Tribunal finds apposite and adopts:

> Therefore, when a State enters into a bilateral investment treaty like the one in this case, it becomes bound by it and the investment-protection obligations it undertook therein must be honoured rather than be ignored by a later argument of the State's right to regulate.[65]

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[63] *ADC Affiliate Ltd. and ADC & ADMC Management Ltd. v. Republic of Hungary* (ICSID Case No. ARB/03/16), Award of 2 October 2006 at paragraph 423.

[64] *Ibid.*

[65] *Ibid.* The Tribunal is of course mindful of the well-known international law principle summarized very clearly by the *Saluka* tribunal *(Saluka Investments BV v. Czech Republic,* Partial Award of 17 March 2006 at paragraph 255): "It is now established in international law that States are not liable to pay compensation to a foreign investor when, in the normal exercise of their regulatory powers, they adopt in a non-discriminatory manner *bona fide* regulations that are aimed at the general welfare." However, the situation is different where, as in the present case, the State is bound by the terms of a contract which it has entered into with the investor. That contract fetters the State's exercise of its regulatory powers.

531. The Respondent submits, in addition, that Clause 8.6 makes it clear that the Claimants knew that their revenues could be adversely affected by changes in Ecuadorian law and agreed that they could only be indemnified against such changes in certain defined circumstances.

532. The Tribunal has already found that Law 42 did not create a royalty, a tax nor a levy. Since, as the Respondent itself submitted, "Clause 8.6 is triggered only if some measure fell within its ambit", there is accordingly no need for the Tribunal to enter into the debate between the parties with respect to the meaning of the "economy" of the Participation Contract as referred to in Clause 11.11 regarding a "tax regime modification."

533. The Respondent also contends that a proportionate sanction for the Claimants' breach of its obligation not to transfer rights under the Participation Contract without authorization would have been re-negotiation of the Participation Contract so as to lead to a result equivalent to that imposed by Law 42, and that, prior to *caducidad*, the Claimants were prepared to recognize the principle of a "price sharing mechanism substantially similar to the price sharing mechanism contained in the […] Tarapoa Block Participation Contract […]" in a re-negotiated Participation Contract, as shown by the 22 February 2006 letter agreement between OEPC and Andes Petroleum Ecuador Ltd.[66]

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[66] Exhibit C-425 and Respondent's Post-Hearing Brief on Law 42 of 18 December 2009 at paragraphs 44 and following.

534. In the view of the Tribunal, both of these contentions are wrong because they overlook the simple fact that a re-negotiation of the Participation Contract did not occur. The basic question to be answered in a valuation exercise such as the present one, discussed below, is "what was the value of that which the Claimants actually lost?" The question is not "what was the value of that which the Claimants might have lost had history been different?" To answer this latter question, which is effectively what the Respondent invites this Tribunal to do, would be to engage in impermissible speculation as to the terms of any possible re-negotiation. The Tribunal cannot know what the terms would have been, and in particular what the Claimants would have bargained for in exchange for the arrangement in question. Thus, these factors cannot be taken into account by the Tribunal in its determination of the fair market value of the Claimants' investment.

535. This is why, in the view of the Tribunal, this letter agreement does not, as the Respondent contends, show clearly that "a split of the extraordinary revenues very close to the one encompassed in Article 2 of Law 42 would have been accepted by Claimants as part of a renegotiation of the Participation Contract."[67] At its highest, it is an agreement by Andes that OEPC will have the "right to negotiate with the Ecuadorian Government […] to resolve the Caducity Proceedings" with the inclusion of terms nearly

[67] *Ibid*.

equivalent to Law 42.[68] But, as noted in the previous paragraph, a re-negotiation of the Participation Contract never did take place.

536. Consequently, as advocated by the Claimants, the Tribunal will not take into account Law 42 for the purpose of its valuation of the quantum of the Claimants' damages.

(iv) Final observations

537. Notwithstanding this conclusion, the Tribunal is compelled to address the Respondent's submission that the Tribunal must consider Law 42 because in valuing the fair market value of the Participation Contract, and using the analogy of a willing buyer and seller, "any willing buyer would have used the existence of Law 42 to obtain a reduction of the price to be paid for Block 15 on May 15, 2006."

538. In substance, the Respondent is saying that, either generally as part of commercial behaviour or specifically given the requirements of authorization, Law 42 should feature in assessing what Block 15 would realize in a hypothetical sale.

539. The Tribunal concludes that this argument suffers from a fundamental flaw. It is obvious that a hypothetical third party would not pay more than would be justified by the prospective returns on an investment, and that Law 42 would have to figure in an assessment of these returns (either because of the risk of its continued application or because Ecuador would insist on this as a pre-condition to authorization). But asking

[68] Exhibit C-425 at paragraphs 2(b), (c) and (e).

what a hypothetical investor would pay under Law 42 which the Tribunal has found to be in breach of the Participation Contract is irrelevant to assessing what OEPC, whose contract protected it against things like Law 42, has actually lost. To reiterate, the test is not "what would a hypothetical buyer pay in the circumstances as they are now"; the test is "what have the Claimants lost." The fair market value is a guide to answering this question, but what must be calculated is the discounted cash flow value of the Participation Contract (*i.e.* Block 15) excluding breaches of it (*i.e*. Law 42) by the Respondent.

540. In essence, what this argument says is that the answer to the question "what have the Claimants lost" is "the value (as assessed by discounted cash flow analysis) of the Participation Contract, conformed to by the Respondent"; the answer to that question is not "an opportunity to sell the Participation Contract to a third party." It is in focussing on the latter that Ecuador is mistaken.

541. This reasoning is persuasively presented by the Claimants when they observe that "a State cannot reduce its liability for a wrongful act [here, expropriation/disproportionate sanction via *caducidad*] on the basis of another wrongful act [applying Law 42 to OEPC in breach of the Participation Contract]. […] *A valuation tool like the willing buyer analogy cannot override that principle*." The emphasized statement effectively refutes the Respondent's arguments based on the fair market value and the willing buyer/seller standard. In particular, it renders its contention that "[i]nternational tribunals have noted that petroleum companies can expect to be required to make economic concessions when oil prices go up significantly and that such risk should be factored in the value that a

willing buyer would be willing to pay" irrelevant: regardless of how common it is in general, OEPC specifically (and any purchaser of its investment) did not have to expect to make such concessions and hence comply with Law 42, because the Participation Contract shielded it against precisely such things. A similar logic refutes the suggestion that the Respondent's ability not to approve a transfer means Law 42 must be taken into account: *vis-à-vis* OEPC and any potential buyer of the Participation Contract rights, Law 42 simply does not enter into the equation.

542. The above conclusions are supported in international law. The starting point is the *American International* case. The relevant passage is worth citing at length:

> In ascertaining the going concern value of an enterprise at a previous point in time for purposes of establishing the appropriate quantum of compensation for nationalization, it is – as already stated – necessary to exclude the effects of actions taken by the nationalizing State in relation to the enterprise which actions may have depressed its value.[69]

543. On the other hand, prior changes in the general political, social and economic conditions which might have affected the enterprise's business prospects as of the date the enterprise was taken should be considered.

544. The force of this passage must be even greater when "actions taken by the nationalizing State in relation to the enterprise" are actions that themselves constitute a breach of a contract between the State and the investor. The fact that Law 42 is in violation of the Participation Contract means that it cannot be relegated to the status of

[69] See *American International Group, Inc. and American Life Insurance Company v. The Islamic Republic of Iran*, Award of 19 December 1983, reprinted in 4 Iran-US C.T.R. 96 at page 107.

"changes in the general political, social and economic conditions." While, without the inconsistency with the Participation Contract, Law 42 could possibly have been categorized as such a "background" change, in the specific context of the Participation Contract it cannot be.

545. This is made even more plain by Marboe's comment on the *American International* principle:

> It is, according to this view, necessary to distinguish the negative consequences on the value which were caused by the actions of the State from those negative consequences on the value caused by changes of the general political, social, and economic conditions. *The former must be excluded from the valuation because otherwise the State would benefit from its own acts. The latter, however, fall under the business risk*.[70] (Emphasis added)

546. The emphasized passage makes it clear that to relegate a wrongful act (*i.e.* breach of the Participation Contract by application of Law 42 to OEPC or its purchaser) to the category of "background" change or "business risk" would be to allow the Respondent to profit from its own wrongdoing, contrary to the general principles of international law explicitly proscribing this. The necessary implication from this is that if a measure is not lawful (even if not lawful only *vis-à-vis* OEPC because of its protection from things such as Law 42 in the Participation Contract), then it must be discounted for valuation purposes.

547. For all the foregoing reasons, the Tribunal will disregard Law 42 for the purpose of its valuation of the quantum of the Claimants' damages.

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[70] Irmgard Marboe, *Calculation of Compensation and Damages in International Investment Law* (Oxford University Press, 2009) at paragraph 3.258.

D. The Ecuadorian VAT Interpretative Law

1. Introduction

548. The VAT Law, also referred to as the VAT Interpretative Law, was passed by the Ecuadorian Congress on 3 August 2004 very shortly after the VAT Award's release on 2 August 2004. Its sole article provides as follows:

> Article 69-A of the Internal Tax Regime Law […] is hereby interpreted in the sense that reimbursement of Value Added Taxes, VAT, is not applicable to petroleum activities when referring to extraction, transportation and commercialization of oil, since petroleum is not produced, but is extracted from the respective reservoirs.

2. The Respondent's Procedural Objections

549. The Tribunal recalls that it has already dismissed the Respondent's initial procedural objections pursuant to which the Respondent argued that the Claimants did not assert any claims based on the VAT Interpretative Law during the liability phase of the arbitration and that they were precluded from challenging its lawfulness as the basis for its inapplicability during the quantum phase.

3. The Impact of the VAT Interpretative Law

(a) The Respondent's Position

550. The Respondent, echoing its position regarding Law 42, submits that the VAT Interpretative Law must be taken into account in the determination by the Tribunal of the value of the Claimants' investment because a "hypothetical buyer would have acquired its interest after the enactment of the VAT Interpretative Law" and would therefore have had no legitimate expectation to the VAT refunds.

551. With reference to the VAT Award, the Respondent asserts that the VAT Interpretative Law seeks to clarify any ambiguities that may have existed prior to the VAT Award. The Respondent adds that the VAT Award did not – and could not – prevent Ecuador from promulgating an official and definitive interpretation of its own domestic legislation.

(b) The Claimants' Position

552. The Claimants do not accept that the VAT Interpretative Law, which they refer to as another "value-depressing measure," should be taken into account for purposes of quantifying their losses. The Claimants contend that the VAT Interpretative Law violates the terms of the VAT Award, the Treaty as well as directly applicable norms of Andean Community Law. Their argument follows:

> *First*, the VAT Tribunal found that the SRI's decrees refusing VAT refunds to OEPC were unfair, arbitrary, and discriminatory, in breach of Articles II.1 and II.3(a) of the Treaty. CE-180. By turning an executive decree into statute, Ecuador changed the form of its wrongful conduct, but not its substance.
>
> The VAT Interpretative Law is not any less discriminatory than the SRI's practice. Both the intent and effect of the law were plainly to single out one specific group of foreign-owned companies. It does not matter in the eyes of international law whether Ecuador discriminates by law, regulation, or decree. CA-268, *Articles on State Responsibility*, Art. 4.1 ("The conduct of any State organ shall be considered an act of that State under international law, whether the organ exercises legislative, executive, judicial or any other functions…"). The effect is exactly the same, and so is the resulting breach of Article II.1 of the Treaty.
>
> In addition, the VAT Interpretative Law unfairly and arbitrarily frustrated the legitimate expectations of OEPC just as the SRI's unlawful practice that it purported to codify had done. As the VAT Tribunal found, when the parties negotiated the Participation Contract, it was mutually acknowledged and understood that OEPC would recover all VAT paid on the acquisition or importation of goods and services used for the production of oil for export. CA-18 *Occidental* ¶ 136. It does not matter for purposes of international law whether Ecuador frustrated that legitimate expectation by law, regulation, or decree. The

> effect is exactly the same, and so is the resulting breach of Article II.3(a) of the Treaty.
>
> *Second*, as the VAT Tribunal held, Article 4 of Andean Community Decision No. 388 expressly entitled OEPC to a refund of the "total amount" of VAT paid "in connection with the acquisition of domestic or imported raw materials, intermediate inputs, services, and capital goods consumed or used in the process of production, manufacture, transport, or marketing of" oil for export. CA-348, *Decision No. 388*, Art. 4.
>
> Decision No. 388 is binding upon Ecuador. CA-350, *Treaty establishing the Andean Court of Justice*, Art. 2 ("Decisions become binding for Member Countries as of the date they are approved by the Andean Council of Foreign Ministers or the Commission of the Andean Community."). Ecuador could therefore not derogate from Decision No. 388, whether it was by law, regulation, decree, or otherwise. CA-350, *Treaty establishing the Andean Court of Justice*, Art. 4 (Member States must "refrain from adopting or employing any such measure as may be contrary to those provisions or that may in any way restrict their application."). A wealth of jurisprudence by the Andean Court of Justice has reaffirmed these principles of direct applicability and supremacy of Andean Community Law time and again. CA-353, *Case 51-AI-202* 15; CA-349, *Case 07-AI-98* 15; CA-352, *Case 25-Ai-2001* 17. (Emphasis in original)

(a) The Tribunal's Analysis and Conclusion

553. On 1 July 2004, the VAT Tribunal issued its Final Award (the previously-defined "VAT Award"). Its main findings and conclusions are very pertinent to the Tribunal's analysis.

554. The VAT Tribunal found that Ecuador was obliged, under the Treaty, to reimburse OEPC for the VATs and that, furthermore, OEPC had a legitimate expectation that Ecuador would reimburse those taxes because Ecuadorian law had provided such reimbursement at the time OEPC made its investment. Paragraph 196 of the VAT Award, in particular, is very clear. It reads, in relevant part, as follow:

> The Tribunal concludes on this matter that, as stated above, OEPC undertook its investments, including its participation in the pipeline arrangements, in a legal and business environment that was certain and predictable. This environment was changed as a matter of policy and legal interpretation, thus resulting in the breach of fair and equitable treatment. <u>This breach relates to the effects of</u> both

> revoking the Granting Resolutions and <u>denying further VAT refunds</u>. […] (Emphasis added)

555. The VAT Tribunal also decided that OEPC was entitled to the refund of all VATs paid, that such refund was not included in Factor X of the Participation Contract and that the SRI Decrees refusing VAT refunds were "without legal effect" because Ecuador had breached its obligations under Articles II.1 (discrimination), II.3(a) (fair and equitable treatment) and II.3(b) (arbitrariness) of the Treaty.

556. Exactly one month after the VAT Award, on 2 August 2004, the Ecuadorian Congress adopted the VAT Interpretative Law. The Tribunal recalls that its sole article provides as follows:

> Article 69-A of the Internal Tax Regime Law […] is hereby interpreted in the sense that <u>reimbursement of Value Added Taxes, VAT, is not applicable to petroleum activities</u> when referring to extraction, transportation and commercialization of oil, since petroleum is not produced, but is extracted from the respective reservoirs. (Emphasis added)

557. Since the VAT Interpretative Law was adopted 31 days after the VAT Award, it is obvious to the Tribunal that the VAT Interpretative Law was a direct response to the VAT Award with which, the Respondent admits, it disagreed "strongly".

558. While the VAT Interpretative Law was presented as an attempt to clarify the confusion identified by the VAT Tribunal, the fact of the matter is that the VAT Interpretative Law accomplishes the very same effect as the SRI Decrees which the VAT Tribunal had found to be in breach of certain provisions of the Treaty.

559. Under international law, a State can be found to have discriminated either by law, regulation or decree. Article 4.1 of the Articles on Responsibility of States for

Internationally Wrongful Acts, as adopted by the International Law Commission, is controlling. It provides that:

> *Article 4. Conduct of organs of a State*
>
> 1. The conduct of any State organ shall be considered an act of that State under international law, whether the organ exercises legislative, executive, judicial or any other functions […]
>
> […]

560. In the view of the Tribunal, the VAT Interpretative Law, unfairly and arbitrarily, frustrated the legitimate expectations of the Claimants in precisely the same way as the SRI's Decrees and is thus also in breach of the Treaty. As such, as between the Claimants and the Respondent, the VAT Interpretative Law is without legal effect and should not be taken into account as a factor which impacts the fair market value of the Claimants' investment.

561. The Respondent also argues that the VAT Award "is in any event immaterial for present purposes" since:

> [t]he question at hand is not whether *OEPC* would have had an entitlement to VAT reimbursements had it continued operating in Ecuador, but whether *a hypothetical purchaser of OEPC's interest in Block 15* would have had such an entitlement. And the answer to that question is no. Any such purchaser would have acquired its interest *after* the enactment of the VAT Interpretative Law and, therefore, would not be able to claim any "legitimate expectation" that such reimbursements would be made. (Emphasis in original)

562. The Tribunal does not agree with the Respondent's reasoning. As it demonstrated in the previous Section of this Award[71], the appropriate question to be answered in a

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[71] See *supra* at paragraph 539.

valuation exercise such as the present one is "what have the Claimants lost"; the answer to the question "what have the Claimants lost" is "the value (as assessed by discounted cash flow analysis) of the Participation Contract, conformed to by the Respondent;" the answer to that question is not "an opportunity to sell the Participation Contract to a third party."

563. In addition, the Tribunal observes that when a willing buyer establishes the fair market value of the assets, he steps into the shoes of OEPC and he must be entitled to claim, invoke and weigh all the provisions of the Participation Contract which OEPC negotiated and bargained for with PetroEcuador. The hypothetical willing buyer is not buying a hypothetical asset but rather an existing asset, to wit the Claimants' investment in Ecuador which, in virtue of the Participation Contract, included rights in favor of the Claimants which were protected under the Treaty.

564. As the Tribunal emphasized earlier, *nullus commodum capere de sua injuria propria*: a State cannot be allowed to take advantage of its own wrongful act.[72] The result of the implementation of that well-known principle of international law is that "the effects of actions taken by the nationalizing State in relation to the enterprise which actions may have depressed its value" must be disregarded in the determination of that value.[73] The Tribunal, applying that principle to the facts of the present case, concludes

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[72] See Bin Cheng, General Principles of Law as Applied by International Courts and Tribunals (Cambridge: Grotius Publications Limited, 1987) at page 149; see also *Tippetts, Abbett, McCarthy, Stratton v. TAMS-AFFA* et al., Award of 22 June 1984, reprinted in 6 Iran-U.S. C.T.R. 219 at pages 227-228.

[73] See *American International Group, Inc. and American Life Insurance Company v. The Islamic Republic of Iran*, Award of 19 December 1983, reprinted in 4 Iran-US C.T.R. 96 at page 107.

that it must disregard the VAT Interpretative Law in determining the fair market value of the Claimants' investment.

565. There is one more facet of the VAT Interpretative Law which has been addressed by the parties and which the Tribunal will now analyze: whether or not Clause 8.6(e) of the Contract is triggered into effect in the circumstances of the present case.

566. The Tribunal recalls again that the relevant provisions of Clause 8.6 of the Participation Contract read as follows:

> **EIGHT: PARTICIPATION AND DELIVERY PROCEDURES.-**
>
> […]
>
> **8.6 Economic Stability:** In the event that, due to actions taken by the State of Ecuador or PETROECUADOR, any of the events described below occur and have an impact on the economy of this Participation Contract:
>
> […]
>
> **e.** Collection of the Value Added Tax, VAT, as set forth in Official Letter No. 01044 of October 5, 1998, which appears as annex number XVI, pursuant to which the Directorate of Internal Revenue Service states that the imports made by the contractor for the operations of block 15 under the structure of the participation contract, are subject to said tax.
>
> […]
>
> In the cases indicated in letters a) and b), the Parties shall enter into amending contracts as indicated in clause 15.2, in order to re-establish the economy of this Participation Contract. <u>When the events indicated in letters c), d) and e) occur, a correction factor shall be included in the participation percentages, to absorb the increase or decrease of the economic burden, in accordance with Annex No. XIV</u>. (Emphasis added)

567. It is clear that, for the correction factor to be triggered automatically into effect, the VAT Interpretative Law must be found to have an impact on the economy of the

Participation Contract. The Tribunal notes that the parties to the Participation Contract did not in any way specify how that impact was to be measured. It is thus left to the Tribunal, in the exercise of its discretion, to do so.

568. The Tribunal recalls that the VAT Award held that OEPC has "a right to reimbursement (of the VAT) under the law" and that "this reimbursement was not included in OEPC's contract". The right of the Claimants to be reimbursed the Value Added Tax has now been legislated out of existence. There is no doubt, in the view of the Tribunal, that the VAT Interpretative Law has thereby increased the economic burden of the Claimants and thus impacted the economy of the Participation Contract.

569. Consequently, any hypothetical willing buyer of OEPC's rights under the Participation Contract, relying on the findings and conclusions of the VAT Tribunal,[74] would be entitled to apply for a correction factor in the participation percentages to absorb the increase in its economic burden in accordance with Clause 8.6 and Annex No. XIV of the Participation Contract.

570. In summary, in the opinion of the Tribunal, the VAT Interpretative Law should not be taken into consideration in its determination of the fair market value of the assets acquired by Ecuador as a result of the *Caducidad* Decree. Alternatively, if it is taken into consideration, the Tribunal can assume the application of a correction factor in accordance with Clause 8.6 of the Participation Contract and its Annex No. XIV which would neutralize the effect of the VAT Interpretative Law and the Tribunal so finds.

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[74] <u>See</u>, in particular, VAT Award at paragraphs 111-114.

E. The Farmout Agreement

1. The Parties' Initial submissions

(a) The Respondent's Position

571. The Respondent submitted that any calculation of damages to be awarded to the Claimants must be limited to a 60% interest in Block 15 because of the Claimants' transfer of 40% of their interest under the Participation Contract to AEC.

572. According to the Respondent, the Claimants do not have standing to request damages beyond their "remaining" 60% interest in Block 15.

573. The Respondent also maintains that by virtue of the Farmout Agreement, the Claimants are the beneficial owners of only 60% of the Participation Contract and that, as a result, they were entitled to only 60% of the total profits derived from their investment. In the circumstances, argues the Respondent, an award granting the Claimants damages on the basis of a 100% interest in Block 15 triggers a risk of double-jeopardy:

> [I]f Claimants were to collect from Ecuador for losses attributable to the interest of AEC or Andes in Block 15, Ecuador would be exposed to a potential double jeopardy for the same purported losses, which would violate the principle of *ne bis in idem* ("not twice for the same"). The possibility cannot be eliminated that AEC and/or Andes will at some point assert claims against Ecuador for the loss of their investment in a separate proceeding, under one theory or another – as unjustified as any such claims would be. Because AEC and Andes are not parties to the present arbitration, they could potentially argue that they are not bound by its result and that any recovery made by OEPC should not be attributed to them. The only way to eliminate this risk of double damages is for this Tribunal to deny Claimants recovery for amounts attributable to the interest of AEC or Andes.[75]

[75] See Respondent's Counter-Memorial on Quantum and Memorial on Counterclaim Damages, paragraph 49.

574. According to the Respondent, the Claimants' argument that OEPC was the sole owner of 100% of the rights under the Participation Contract thus "misses the point". The Respondent emphasizes that AEC paid due consideration to OEPC for the former's acquisition of a 40% economic interest in Block 15, and that OEPC would be unjustly enriched if it now received, in addition, damages representing 100% of the fair market value of the Participation Contract.

(b) The Claimants' Position

575. The Claimants do not accept the Respondent's contention that they are only entitled to claim 60% of the value of the Participation Contract. According to the Claimants, as the sole owner of the Participation Contract rights, OEPC has the necessary standing to claim 100% of its damages. The Claimants characterize the Respondent's argument regarding standing as a belated objection to the Tribunal's jurisdiction which should have been raised at the very latest when the Respondent filed its Counter-Memorial on Liability.

576. The Claimants maintain that, in any event, OEPC has always been the sole owner of the Participation Contract rights and that both Claimants are entitled to 100% of the value of those rights.

577. The Claimants emphasize that the basis for their claims is OEPC's sole ownership of the rights conferred by the Participation Contract. Thus, according to the Claimants, while OEPC has to meet its contractual liabilities *vis-à-vis* AEC (now Andes), that does not confer to AEC any ownership of the Participation Contract rights.

578. As for the Respondent's allegations of unjust enrichment and double-jeopardy, they are refuted by the Claimants as follows:

> *First*, there is no risk of unjust enrichment. OEPC has always been the sole owner of the Participation Contract rights, and it continues to have a contractual liability vis-à-vis Andes requiring OEPC to pay Andes an amount equal to 40% of any compensation awarded in this arbitration. As in *Enron*, therefore, OEPC holds 100% of both the equity and the related liabilities, and there is no risk of an improper windfall. If Claimants are awarded 100% of the value of the Participation Contract, they will be left with only 60% after honouring their contractual obligations vis-à-vis Andes.
>
> *Second*, there is no risk of double jeopardy. Upon the rendering of an award, Andes will be able to enforce its contractual right to payment against OEPC. However, Andes has no rights under the Participation Contract and would not be able to make any claims against Ecuador. In any event a clear recording by the Tribunal in its award that compensation is awarded for 100% of the Participation Contract rights would indisputably preclude any future claims by Andes.

579. The Claimants assert that the issue of the 40% "Farmout liability," as the Claimants put it, basically raises two fundamental questions: (i) whether the "Farmout liability" is in the nature of a contractual obligation of OEPC *vis-à-vis* AEC as opposed to a right of ownership of AEC in the Participation Contract with Ecuador or the Block 15 oil; and (ii) whether OEPC continued to have the "Farmout liability" after *caducidad* and through the present.

580. The Claimants answer their own questions as follows: As a result of the Farmout, AEC did not acquire any ownership right in the Participation Contract or the Block 15 oil, let alone a "perpetual" one. The Claimants also emphasize that their "Farmout liability" "did not disappear with *caducidad*."

581. The Tribunal notes the Claimants' final prayer in this regard: "[T]he Tribunal could fully safeguard Ecuador's interest in this respect by recording in the award that Claimants' damages correspond to 100% of the value of the Participation Contract rights.

As soon as Claimants pay AEC its 40% of any award, its claims against OEPC under the Farmout Agreement would have been fully satisfied, so that AEC could not have any further claims."

2. The Dictum of the Permanent Court of International Justice in the Chorzów Factory Case

(a) Introduction: The Chorzów Factory Dictum

582. The Tribunal notes that both parties have relied, for purposes of their diametrically opposed conclusions, on the often-quoted dictum of the Permanent Court of International Justice in the *Chorzów Factory* case.

583. Before it sets out the parties' Additional Submissions and its conclusions on what should or should not be excluded from the Claimants' damages on account of the Farmout Agreement, the Tribunal considers it useful to quote this dictum and then summarize the parties' different interpretations of it.

584. The *dictum* reads as follows:

> On approaching this question, it should first be observed that, in estimating the damage caused by an unlawful act, only the value of property, rights and interests which have been affected and the owner of which is the person on whose behalf compensation is claimed, or the damage done to whom is to serve as a means of gauging the reparation claimed, must be taken into account. This principle, which is accepted in the jurisprudence of arbitral tribunals, has the effect, on the one hand, of excluding from the damage to be estimated, injury resulting for third parties from the unlawful act and, on the other hand, of not excluding from the damage the amount of debts and other obligations for which the injured party is responsible. The damage suffered by the Oberschlesische in respect of the Chorzów undertaking is therefore equivalent to the total value – but to that total only – of the

> property, rights and interests of this Company in that undertaking, without deducting liabilities.[76] (Emphasis added)

(b) The Respondent's Interpretation

585. The Respondent starts by reiterating the *Chorzów* principle and contends that it should be applied in the present case:

> The *Chorzów* principle is fully applicable in the present case. Claimants' damage is restricted to the *personal and actual loss* of revenue arising from the loss of their investment. Since Claimants, following the Farmout Agreement, only benefited from 60% profits from Block 15, their damage is restricted to that loss corresponding to their economic interest in Block 15. (Emphasis in original)

586. The Respondent insists on the fact that, as explicitly provided by Article 2.02 of the Farmout Agreement, OEPC was only "entitled to the rights and benefits attributable to such remaining 60% interest" upon closing. Moreover, OEPC could not, even before *caducidad*, have sold 100% of the rights to a willing buyer, as 40% had already been paid and acquired by AEC. It follows, says the Respondent, that "[b]ecause […] AEC paid due consideration to OEPC for the former's acquisition of a 40% economic interest in Block 15, OEPC would be unjustly enriched if it now received, in addition, damages representing 100% the fair market value of the Participation Contract."

587. The Respondent adds that even if the Tribunal were to follow the Claimants' contention that "AEC acquired no more than a contractual right against OEPC to receive from OEPC 40% of Block 15 production," this would be characterized as an investment since under Article 1c) of the Ecuador-China BIT, an "investment" includes money

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[76] *Case concerning the Factory at Chorzów* (Claim for Indemnity) (Merits), P.C.I.J. Series A, No. 17 (Judgement of 13 September 1928) at page 31.

claims and any entitlement of economic value. On this point, the Respondent accordingly submits:

> […] As a result, AEC/Andes' 40% economic interest is an investment different from Claimants' investment. Such investment is not protected by the Treaty because it does not belong to United States companies or nationals. As to OEPC, it can only claim, on its own behalf, the value of its reduced investment.
>
> Consequently, as Ecuador explained in its last submission, *caducidad* affected two investments from two separate investors. Would *caducidad* to be found to be in breach of Ecuador's international obligations, the investors could claim compensation, separately, for their own personal damage.

588. In the Respondent's view, the concept of a "Farmout Liability" was entirely invented by the Claimants for the sake of advancing their position:

> Claimants, in order to benefit from the principle set forth by the *Chorzów* case (providing that liabilities should not be deducted from the injured party's damages), have simply invented the concept of a "Farmout Liability" which would continue to be due to AEC/Andes after *caducidad*. Claimants have failed to point to a single clause of the Farmout Agreement establishing such a liability.

589. In sum, the Respondent considers that OEPC, having transferred 40% of its rights to AEC pursuant to the Farmout Agreement, can only claim for the 60% remaining rights it held at the moment of *caducidad*.

(c) The Claimants' Interpretation

590. The Claimants summarized their position in the following manner, consistent, according to them, with the Permanent Court of International Justice's dictum:

> It is settled international law that contractual obligations and liabilities for which the injured party remains responsible must not be excluded from its compensable damages. Only when a third party has a right of ownership in the investment, the compensable damage must be reduced to the extent of that third party's ownership right.

591. Based on this theoretical framework, the Claimants added that there are only two salient questions for the Tribunal, *i.e.*:

> (a) Whether the Farmout Liability is in the nature of a contractual obligation of OEPC vis-à-vis AEC (as opposed to a right of ownership of AEC in the Participation Contract with Ecuador or the Block 15 oil);
>
> and
>
> (b) Whether OEPC continued to have the Farmout Liability after *caducidad* and through the present.

592. In response to these questions, the Claimants argue that AEC did not, as a result of the Farmout Agreement, acquire actual legal title or actual ownership in the Participation Contract. Rather, it only acquired "a contractual right to claim a certain share of production from OEPC." And they add that this contractual liability of OEPC towards AEC remained with OEPC after *caducidad*.

593. Moreover, the Claimants submit that even if the Tribunal were to conclude that AEC is the beneficial owner of 40% of the rights and interests in the Participation Contract, this would be of no consequence given that there is no principle of international law, say the Claimants, that limits standing to "beneficial owners." They maintain that the Respondent's claim that only the beneficial owner of an investment can claim damages under international law is irrelevant given that OEPC is the owner of 100% of the rights under the Participation Contract.

594. The Claimants accordingly conclude that they are entitled to the entire fair market value of the Participation Contract.

3. The Parties' Additional Submissions

595. On 6 October 2011, during the Tribunal's deliberations, the President, on behalf of the Tribunal, wrote to the parties as follows:

> Members of the Tribunal continue their intense deliberations. The Tribunal regrets that its decision has taken longer to finalize than it would have wished. However, the parties have submitted to the Tribunal, in their extensive written and oral submissions, a myriad of factual and legal issues which all need to be analyzed and determined. The Tribunal is confident that its deliberations will end soon and a decision issued shortly thereafter.
>
> In recent days, the Tribunal has been addressing an issue which, in its view, neither party has dealt with comprehensively in its prior submissions. The issue concerns the interpretation of the Farmout Agreement and the Joint Operating Agreement.
>
> The Respondent submits (Counter-Memorial on Quantum, para 43; Post-Hearing Brief on Damages, para 127) that the calculation of damages (if any) to be awarded to the Claimants in the circumstances must be limited to a 60% interest in Block 15 because of the transfer by the Claimants to AEC under the terms of the Farmout Agreement of 40% of their interest under the Participation Contract. The Claimants do not accept the Respondent's contention (Reply on Damages, paras 207-208; Post-Hearing Brief on Damages, para 15).
>
> The governing law clause of the Farmout Agreement provides:
>
>> "This Agreement shall be governed by and construed, interpreted and applied in accordance with the laws of the State of New York, United States of America, excluding any choice of law rules or conflict of law principles which would refer the matter to the laws of another jurisdiction, except to the extent that the laws of Ecuador require application of the laws of Ecuador to the Participating Agreements and Block 15 or other property situated in or operations or activities conducted in Ecuador."
>
> The Tribunal notes that the Claimants argued that the transfer of the "economic interest" to AEC would not be considered an assignment under New York law and that, as a result, the non-assignment clause in Article 16(1) of the Participation Contract was not breached (Memorial on Liability, para 244). Accordingly, the Claimants did not analyze the effect and validity of an assignment, (assuming an assignment had indeed occurred as a result of the Farmout Agreement and the Joint Operating Agreement), in breach of Article 16(1) of the Participation Contract and Article 79 of the Hydrocarbons Law. In addition, the Claimants did not analyze Ecuadorian and New York law in this regard.

> The Tribunal further notes that the Respondent argued that New York law is irrelevant to the issue of whether an assignment under the Farmout Agreement and the Joint Operating Agreement (if any) is in breach of Ecuadorian law (Counter-Memorial on Liability, para 185).
>
> In sum, neither party, in their quantum submissions, referred to the effect of Article 79 of the Hydrocarbons Law or Article 16(1) of the Participation Contract on the assumption that an assignment of rights occurred as a result of the Farmout Agreement and the Joint Operating Agreement.
>
> The Tribunal now invites the parties to assume that an assignment of rights did occur as a result of the Farmout Agreement and the Joint Operating Agreement. On the basis of this assumption, the parties are requested to undertake a detailed analysis of the effect of an assignment of rights made under a contract governed by New York law (i.e. the Farmout Agreement and the Joint Operating Agreement) in violation of a non-assignment clause set forth in a contract governed by Ecuadorian law (i.e. Article 16(1) of the Participation Contract) and in violation of Article 79 of the Hydrocarbons Law. The parties are further requested to address both New York law and Ecuadorian law and to make submissions accordingly, even if one or both parties may consider that, for any reason, New York law and/or Ecuadorian law may not be relevant to the determination of the effect of the Farmout Agreement and the Joint Operating Agreement.

596. Pursuant to the Tribunal's directions, the parties, on 3 November and 22 November 2011, provided the Tribunal with their respective simultaneous written submissions to the above. These submissions are now summarized.

(a) The Respondent's Additional Submissions

597. In its Additional Submissions, the Respondent expressed the view that, under both Ecuadorian and New York law, its contention that the Claimants would only be entitled to 60% of the claimed damages remains valid. The Respondent contends that the nullity provided for in Article 79 of the HCL does not apply *de pleno derecho* (automatically). Instead, Article 1699 of the Ecuadorian Civil Code requires a judicial declaration to effect that absolute nullity. The Respondent submits that no one has requested that the nullity provided for in Article 79 be declared and no judge has made such a declaration.

It provided the following translations of Articles 1698 and 1699, as well as citing a number of cases which, in its view, confirm the principles contended:

> 1698: "… the nullity produced by the omission of any requirement or formality which the law demands for certain acts and contract to be valid, in consideration to their nature, and not to the quality or status of the persons who execute or agree to them, are absolute nullities"
>
> 1699: "The absolute nullity can and shall be declared by the judge, even if nor party so requests, when it manifestly arises from the act or contract; it may be claimed by anyone having an interest to do so, excepting those who have performed the act or contract knowing or under the duty to know the vice invalidating it; it may also be claimed by the Public Ministry, for the benefit of morals or of the law; and it cannot be cured by ratification of the parties, nor by the passing of a period of time of less than fifteen years."

598. The Respondent's position is that the nullity provided for in Article 79 is merely a defence that could be raised should Andes or AEC pursue claims against it. However, if declared, it would operate retroactively to void the transfer *ex tunc*. The Respondent notes that the Claimants, as the party who has performed the act or contract knowing, or being under a duty to know, the vice invalidating it, cannot request that the nullity be declared.

599. While addressing New York and Ecuadorian law, the Respondent states that neither law is relevant to calculating the amount of damages (if any) due to the Claimants which can only be determined under international law. The Respondent therefore reiterated its submissions on the application of international law to the question of damages. In particular, the Respondent stresses that no willing buyer would have paid a price based on 100% of the fair market value of Block 15. Therefore, the Claimants' interests in Block 15 amounted to 60% of its fair market value, and any losses thus also

only amount to 60% of the value. The Claimants' cannot claim any losses suffered by Andes or AEC.

600. The Respondent also reiterates its argument that compensating the Claimants on the basis of 100% of fair market value would result in unjust enrichment, as the Claimants had already been paid for a 40% interest in Block 15 and would consequently be paid twice. In addition, the Respondent points to the international law principle that would not allow the Claimants to take advantage of their own wrongdoing.

601. Turning to New York law, the Respondent maintains that there is no requirement that would oblige a New York court to render the Claimants' illegal assignment void. The Respondent asserts that the New York courts would not ignore the governing law clause and would therefore acknowledge that Ecuadorian law governs the Participation Contract, Block 15 and operations in Ecuador. However, it also contends that under New York law (i) an illegal assignment or contract is not automatically void, (ii) the Claimants would be prevented from benefitting from their own wrongdoing (citing *Southwestern Shipping Corp. v. National City Bank* 6 NY.2d 454), and (iii) contract invalidation is not self-executing and therefore requires a judicial pronouncement which has not been obtained. In addition, the Respondent considers that New York courts are reluctant to invalidate contracts that reflect the free will of the parties on the basis of illegality under foreign law and cites *Peregrine Myanmar Ltd. v. Segal* 89 F.3d 41 in support.

602. In response to the Claimants' submissions on New York law, the Respondent suggests that New York courts have interpreted "void" to mean "voidable," citing

Lynbrook v. Cadoo 252 NY 308 and *St. George Seaport Assoc. v. CSX Realty Inc.* 1991 US Dist LEXIS 15463.

603. Finally, the Respondent notes that Article 79 of the HCL and Clause 16 of the Participation Contract cannot be viewed in isolation and the *Caducidad* provisions must be taken into account when considering the overall position. In relation to this, the Respondent rejects the Claimants' set-off proposal, stating that the options available to it following an unauthorized assignment are to declare *Caducidad* or do nothing.

(b) The Claimants' Additional Submissions

604. In their Additional Submissions, the Claimants assert that under both Ecuadorian and New York law, an unauthorized assignment would be null and void or without effect and, consequently, the Claimants continue to own 100% of the value of Block 15.

605. This assertion is based on the application of Article 79 of the HCL. The Claimants draw on the expert evidence and the parties' submissions to demonstrate agreement that the consequence of Article 79 is that the transfer "does not exist" and has no legal effect. The Claimants also point out that the *Caducidad* Decree itself states that, under Articles 9 and 10 of Ecuador's Civil Code, acts prohibited by law are null.

606. The Claimants contend that the nullity imposed by Article 79 is automatic and mandatory. They reject the Respondent's contention that a judicial declaration is required to effect the nullity. The Claimants consider that Article 79 imposes an "essential element" of the solemn formality of a public deed that is required to give "life"

to the agreement and that, without Ministerial authorization, the transfer would be considered automatically "inexistent".

607. In relation to New York law, the Claimants' position is that a New York court would apply Ecuadorian law under the governing law clause of the Farmout Agreement and consequently find that no assignment had occurred. The Claimants also note that a New York court would invalidate an assignment if it purports to assign rights that are subject to a non-assignment clause (citing *Allhusen v. Caristo Const. Corp.* 303 NY 446 and a number of other cases as authority). As Clause 16.1 contained a non-assignment provision, the Claimants assert that New York law would not recognize an assignment in breach of this clause.

608. The Claimants point out that while any assignment may be invalid under New York and Ecuadorian law, any other provisions in the Farmout and Operating Agreements remain in effect between OEPC and AEC, citing both New York law authorities and Article 8.05 of the Farmout Agreement in support of this position.

609. The Claimants also maintain that, regardless of the effectiveness of any assignment, there is no contractual privity between AEC and Ecuador, meaning that AEC could never recover its losses from Ecuador. All AEC has ever owned are contractual rights against OEPC, and any action for the recovery of loss can only be brought against OEPC. As such, the Claimants insist that they remained at all times the 100% owner of the Participation Contract and responsible for all obligations thereunder. Consequently, under international law, the Claimants consider that they are entitled to receive as damages 100% of the contract value The Claimants also reiterate earlier submissions

regarding the effect of the *Chorzow* case on the effect of private contractual rights held by third parties and rejected the Respondent's position on the application of international law.

610. Finally, the Claimants emphasize that awarding 100% of the damages claimed would not result in a windfall for the Claimants, as they remain liable to account for 40% of any compensation to Andes under the February 2006 Andes Letter Agreement. In response to the Respondent's argument that they had already been paid for a 40% interest, the Claimants state that they have only received payment for oil delivered and not for future oil. Rather, according to the Claimants, an award of less than 100% would unjustly enrich the Respondent who seized 100% of the operations and would leave the Claimants "woefully short" as they would still have to account to Andes.

611. The Claimants suggest that Article 79(2) means that Ecuador is entitled to set-off an amount equal to a transfer fee, a second fee in lieu of renegotiation of the contract, and a fine for non-compliance with a contractual and statutory requirement. The Claimants contend that this amount would be between US$1,071,000 and US$11,771,000.

4. The Tribunal's Analysis and Conclusion

(a) Introduction

612. The Tribunal has considered very carefully the extensive learned written and oral submissions of both parties on this issue, including the Additional Submissions provided in November 2011 and the representations made to the Tribunal at the hearing in London on 12 April 2012.

613. The Tribunal will now deal with the central issue which, in its view, after the parties' arguments have been stripped of their complex legal ramifications, comes down to the following: does the execution by OEPC of the Farmout Agreement with AEC on 1 October 2000 (together with the Joint Operating Agreement) allow Ecuador, following *caducidad*, to compensate OEPC for 60% only of its interest in Block 15 or is it legally obliged to compensate OEPC for 100% of its interest in Block 15, being precisely what it has acquired upon the issuance of the *Caducidad* Decree?

614. In other words, the key issue to be addressed in this section is whether any assignment to AEC of the 40% beneficial interest in Block 15 was actually effected by the Farmout Agreements (i.e., the Farmout Agreement and the Joint Operating Agreement) or whether any such purported assignment was void and therefore without legal effect. If the former, OEPC would be entitled to recover 100% of the established value of Block 15 under the relevant principles of international law; if the latter, it could recover 60% only.[77]

615. Before considering this issue, it is apposite to repeat the governing law clause (clause 7.02) of the Farmout Agreement:

> This Agreement shall be governed by and construed, interpreted and applied in accordance with the laws of the State of New York, United States of America, excluding any choice of law rules or conflict of law principles which would refer the matter to the laws of another jurisdiction, except to the extent that the laws of Ecuador require application of the laws of Ecuador to the Participating

[77] Under International law, the owner of a beneficial interest in contractual rights is able to bring its own claim for compensation. Where the beneficial interest has been transferred, the nationality of the Claimant will be tested by reference to the beneficial owner, rather than the nominal owner of the legal title (see *Saghi v. The Islamic Republic of Iran* Case No. 298, 29-Iran.U.S.CT.R. §§18-26).

> Agreements and Block 15 or other property situated in or operations or activities conducted in Ecuador.

616. Consequently, in determining this issue, the Tribunal must consider whether a valid assignment of an equitable interest took place under the Farmout Agreement by reference to both New York law and the Ecuadorian law applicable to the Participation Contract. Both parties acknowledge that this was the correct approach.[78] In this light, the Tribunal must then consider the relevant contractual provisions, including the non-assignment clause in Clause 16.1 of the Participation Contract. The Tribunal notes that, as mentioned by the Respondent in its Additional Submissions, while the application of New York and Ecuadorian law is relevant to whether the assignment was valid, domestic law is not relevant to the subsequent determination of compensation which is governed by international law, as set out below.

(b) Ecuadorian Law

617. The Tribunal first considers whether the assignment was valid under Ecuadorian law. In this connection, the Tribunal recalls the terms of Clause 16.1 of the Participation Contract. It reads as follows:

> "Transfer of this Participation Contract or assignment to third parties of the rights under the Participation Contract, must have the authorization of the Corresponding Ministry, in accordance with existing laws and regulations, especially the provisions contained in Art. 79 of the Hydrocarbons Law and Executive Decrees No. 809, 2713 and 1179." (Emphasis added)

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[78] See Claimants' Brief, 3 November 2011, paras 15-17 and Respondent's Brief, 3 November 2011, paragraphs 55-57.

618. The laws of Ecuador require the application of the HCL to the Participation Contract, including the application of Article 79 to any assignment of rights under that Contract. Article 79 states:

> Art. 79. The transfer of a contract or the assignment to third parties of rights derived from a contract <u>shall be null and void and shall have no validity whatsoever</u> if there is no prior authorization from the Ministry of Energy and Mines, without prejudice to the declaration of *caducidad* as provided for in this Law …. (Emphasis added)

619. As clause 7.02 of the Farmout Agreement expressly includes the laws of Ecuador to the extent that they require application "to the Participating Agreements and Block 15," it is evident that Article 79 of the HCL must be taken into account when determining whether a valid assignment occurred under the Farmout Agreement. The HCL categorically states that any assignment of rights under the Participation Contract is null and void and shall have no validity whatsoever unless authorized by the Ministry of Energy and Mines. On its face, therefore, the assignment that purportedly occurred under the Farmout Agreement was invalid. The assignment therefore had no legal effect and OEPC retained 100% of both the legal and beneficial ownership of all rights in the Participation Contract. As noted further below, Article 79 of the HCL serves to invalidate the assignment, not the Farmout Agreement itself which remains a valid contract as between OEPC and AEC.

619(bis). There are two further points to stress with regard to the application of Article 79. The first is that the invalidity of any purported assignment does not affect the right of the State to declare *caducidad*. In other words, the breach identified in paragraphs 301 to 339 above still occurred, even if the assignment itself is deemed invalid. The second point is that Article 79 of the HCL is concerned with the legal effect of the assignment itself; it does not purport to invalidate either the Farmout Agreement under which OEPC had an obligation to obtain any necessary government approvals for the assignment or the Joint Operating Agreement.

620. In its Additional Submission of 3 November 2011, the Respondent stated that under Articles 1698 and 1699 of the Ecuadorian Civil Code, the lack of ministerial authorization for the assignment created an "absolute nullity" which requires a judicial declaration in order to have effect. In other words, the assignment is not null and void until an Ecuadorian judge has declared it so. At the hearing of 12 April 2012, the Respondent reiterated this submission with much emphasis.[79]

621. The Claimants, in their Reply Submission of 22 November 2011, stated that the assignment lacked an essential element required for "life" and was therefore "inexistent" under the doctrine of "ineffectiveness" articulated by the Ecuadorian Supreme Court. As such, no judicial declaration was required. At the hearing of 12 April 2012, the Claimants reiterated their submission with no less emphasis.[80]

622. Although not expressly stated in the Ecuadorian Civil Code, the Ecuadorian Supreme Court has confirmed on a number of occasions that Ecuadorian law recognizes automatic nullity or "inexistence". It is common ground between the parties that when the Ecuadorian Supreme Court has issued three consistent decisions on a precise point,

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[79] Hearing Transcript (12 April 2012) in particular at pages 25-51.

[80] Hearing Transcript (12 April 2012) in particular at pages 134-175.

the law on that point is considered settled and becomes binding on lower courts. It becomes what, in some jurisdictions, is referred to as a "jurisprudence constante."

623. The Tribunal, in the present case, has been referred to more than three decisions of the Ecuadorian Supreme Court where the concept of automatic nullity or inexistence was judicially recognized.[81] Although the Respondent averred that the "inexistence" category applied only to a limited body of real estate transactions requiring the execution of a public deed, as discussed below, there is nothing in the general definitions set out in the case law to support such a narrow application of "inexistence".

624. Of the four cases presented to the Tribunal on this issue, the most extensive – and in the Tribunal's view, the most useful – discussion of the categories of ineffectiveness is contained in the Supreme Court decision of 16 May 2001.[82] This was the first and seminal discussion of this doctrine in the cases provided to the Tribunal. This case is particularly important as the Supreme Court sets out in its own words the difference between the categories of inexistence, absolute nullity and relative nullity, and summarises Ecuadorian doctrine on the matter. In this decision the Court states:

> "This Chamber has examined on several occasions the question relating to the ineffectiveness of a juridical act. The doctrine distinguishes three types of ineffectiveness: 1. Maximum ineffectiveness or inexistence, when the act does

[81] In fact, the Tribunal was referred to four decisions. The Tribunal notes that it was supplied by the parties with English translations of these four decisions. There was never any dispute between the parties as to the accuracy of these translations. See CA-662 (Drs. Galo Galarza Paz, Santiago Andrado Ubidia, and Ernesto Albán Gómez), CA-660 (Drs. Galo Galarza Paz, Santiago Andrado Ubidia, and Ernesto Albán Gómez), CA-658 (Drs. Bolivar Guerrero Armijos, Olmedo Bermeo Idrovo and Bolivar Vergara Acosta), CA-659 (Drs. Galo Galarza Paz, Santiago Andrado Ubidia, and Ernesto Albán Gómez).

[82] CA-662.

> not have the essential requirements for it to have a life. The inexistent act cannot be cured and does not need to be invalidated; 2. absolute nullity, when the act is capable of producing some effects in certain special conditions. There is an appearance of act until its nullity is declared. Absolute nullity cannot be cured but must be invalidated, i.e., declared; 3. relative nullity, which implies that the act is said to be valid and is only invalidated as of the day on which it is voided. The relatively void act can be validated."[83]

625. The question before this Tribunal is whether the assignment falls within the first category (inexistence) or the second category (absolute nullity). As Article 79 of the HCL is clear that there is no possibility of retrospective cure, the third category of "relative nullity" cannot apply, nor did either party suggest otherwise.

626. It is the Tribunal's view that the intended assignment that occurred under the Farmout Agreement and the Joint Operating Agreement undoubtedly meets the criteria expressed in the above quotations for "inexistence". Article 79 of the HCL is key - it stipulates that ministerial authorization is an essential element to give life to any assignment of rights in the Participation Contract – without this authorization, an assignment has "no validity whatsoever". Indeed, counsel for the Respondent admitted that this authorization was an "essential requirement" during the 12 April 2012 hearing, although in the Respondent's submission, it was not one that constituted inexistence.[84] Where the law itself stipulates that an act has "no validity whatsoever" there is no need on its face for the assignment to be declared invalid by a judge, because it could never be valid in the first place – it lacked an essential element required for life. Therefore, both

[83] Supreme Court of Ecuador, 16 May 2001 at page 1528. CA-662 (Claimants' translation of RLA-348). (Emphasis added.)

[84] Hearing Transcript (12 April 2012), page 32 line 22 to page 33 line 2.

elements of "ineffectiveness" identified by the Supreme Court have been satisfied: the attempted assignment (1) lacked an essential element required to give it life; and (2) as noted above, this defect cannot be cured.

627. In the same 16 May 2001 decision, the Supreme Court held that inexistence applied because the contract was not executed using the required form (a public deed). In supporting its decision the Court quoted Columbian scholars who have stated that required elements for life in the context of contracts are "expressed will, the consent, an object, and the solemn form."[85] Although the Respondent attempted to argue that the Farmout Agreements did not fall within any of these criteria, it failed to appreciate that it is not the contracts – the Farmout Agreements or the Joint Operating Agreement – that are at issue here. The issue is the validity of the assignment sought to be accomplished by these Agreements. Therefore applying a contractual analysis is inappropriate. Instead, this Tribunal must consider the essential elements for the assignment to have life in the present circumstances.

628. As noted above, Article 79 of the HCL is categorical in expressing, not only the illegal act, but also the consequence of the illegality. Significantly, a similar provision (Article 1745 of the Civil Code) was being applied by the Supreme Court in the above case (and in others discussed below). Article 1745 provides that, where the law requires a public deed, contracts signed in another form "will be deemed as non-executed or signed". Thus, the consequence of the illegality is specified. The result of the Court's

[85] Supreme Court of Ecuador, 16 May 2001 at page 1529. CA-662 (Claimants' translation of RLA-348).

decision that such contracts are "inexistent" is that Article 1745 is given effect without the need for a judicial declaration. In other words, where the law itself clearly states that the contract is deemed to be unexecuted, and therefore has no life, there is no requirement for judicial confirmation. Similarly, under Article 79, the law itself has deemed that an unauthorised assignment has no validity whatsoever, and therefore has no life. The logical consequence of this provision is that no further action is required to invalidate an unauthorised assignment.

629. This should be the end of the analysis. However, for completeness, the Tribunal notes that it also does not accept the Respondent's characterisation of "absolute nullity" as meaning that the assignment is essentially effective (or valid) until declared invalid by a judge. Not only would such a finding leave this Tribunal in direct contravention of Article 79 of the HCL, it is clear from the case law presented to the Tribunal that an action subject to absolute nullity cannot produce a "valid" act. As noted above, the 16 May 2001 decision states that "there is an <u>appearance of act</u> until nullity is declared."[86] In other words, no actual act has occurred – only the appearance of an act. This is consistent with the notion that an absolute nullity cannot be cured and the requirement in Art 1699 of the Civil Code that a judge "shall" declare the nullity (i.e., there is no discretion).

[86] Supreme Court of Ecuador, 16 May 2001 at page 1528. CA-662 (Claimants' Translation RLA-348).

630. In a further decision of the Ecuadorian Supreme Court dated 29 August 2001,[87] the Court (being comprised of the same three judges that decided the 16 May 2001 case) endorsed its definition of inexistence provided in the above decision, noting (as it did in the 16 May 2001 decision) that inexistence occurs where "the act lacks the essential requirements in order for it to have life and, therefore, cannot be validated, nor does it need to be invalidated."[88] The language used is identical to the 16 May 2001 decision.

631. In the 29 August 2001 case, the parties had agreed to terminate a "promise to purchase" agreement, but the Court held that the promise to purchase agreement had not been properly executed as was therefore "inexistent." As such, the parties were unable to terminate it. In relation to absolute nullity, the Court quoted one of its earlier decisions, stating that:

> "In the same way, <u>if a Judge accepts the validity of a mutual dissent … pertaining to a null contract, he would be providing effectiveness to that contract</u>, since that is why parties could avail themselves of the rights produced by it if it were valid, <u>but by acting in this way the judge would have violated section 10 of the Civil Code, which says: "In no case may the Judge declare valid an act that the law decrees to be null and void</u>." It should be noted, in order to avoid confusion, that this is different from the situation of contracts that are possibly and relatively null … Likewise, <u>if a legal act suffers from absolute nullity, even though it enjoys the semblance of validity with regard to third parties while there is no enforceable judgment declaring its nullity, however the act lacks its structural elements, thereby the legal effects it was intended to produce had it been signed in a valid manner, are not produced</u>".[89]

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[87] CA-660.

[88] Supreme Court of Ecuador, 29 August 2001 at page 22. CA-660. (Emphasis added)

[89] Supreme Court of Ecuador, 29 August 2001 at page 23. CA-660. (Emphasis added)

The last underlined passage is dispositive of the issue in this case if absolute nullity were to apply.

632. This decision makes it clear that a null act produces no legal effects, even before a judicial declaration is obtained. As such, an agreement to assign without authorisation produces no actual assignment and a judicial declaration does not reverse the assignment – a valid assignment never occurred. There is only an "appearance of an act" until a judicial declaration is issued. This may lead to a "semblance of validity with regard to third parties". These statements reinforce the conclusion that no actual assignment occurred and that OEPC remained the owner of 100% of all rights in the Participation Contract, regardless of its agreement to assign a 40% beneficial interested to AEC. Hence, pursuant to Article 79 of the HCL, an unauthorised assignment had "no validity whatsoever", even under the absolute nullity doctrine.

633. Article 10 of the Civil Code quoted in the above passage from the 29 August 2001 case is notable: "In no case may the Judge declare valid an act that the law decrees to be null and void." If this Tribunal were to award only 60% compensation as requested by the Respondent, it would be acting in direct contravention of this Article by treating as valid an act that the law decrees to be null and void. The very wording of Article 10 demonstrates that the Ecuadorian authorities specifically contemplated situations like the present case – where the law itself (not a judge) decrees something to be null and void.

634. In summary, it is clear from the case law that, regardless of whether the assignment falls into the category of "inexistent" or whether it falls into the category of "absolute nullity", no valid assignment occurred and OEPC remained the 100% owner of

all rights in the Participation Contract. This conclusion is consistent with the application of the HCL.

635. The parties also provided the Tribunal with the Supreme Court decisions of 7 June 2001 and 20 February 2002,[90] both of which affirm but discuss only briefly the categories of "inexistence" and "absolute nullity", doubtless because the Court had firmly established the principles relating to inexistence in its decision of 16 May 2001. Both cases relate to real estate contracts and therefore focus on the formal requirements for executing such contracts. For the avoidance of doubt, as noted above, the Tribunal reiterates that in the present case it is the validity of the assignment that is under scrutiny, and not the validity of the Farmout Agreement or the Joint Operating Agreement. The Tribunal's findings on the validity of the assignment do not affect other obligations that might arise between the parties to the Farmout Agreement and the Joint Operating Agreement (such parties being different to those in the present arbitration), nor does it affect the ability of AEC to seek damages from OEPC for a failure to comply with the terms of those Agreements, such as obtaining necessary government consent for the assignment.[91]

636. It is important to stress that the Tribunal's analysis of the position under Ecuadorian law is consistent with the position of both parties prior to the Additional Submissions. It is clear to the Tribunal that, prior to the Additional Submissions, not

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[90] CA-658 and CA-659.

[91] As events have unfolded, AEC has no need to pursue this option in virtue of the agreement it reached with OEPC which is referred to in paragraph 655 below.

only the Claimants[92] but also the Respondent and all of its legal experts on Ecuadorian law considered that any unauthorized assignment would have no legal effect whatsoever (i.e., would be automatically void). Indeed, in its closing oral submissions at the March 2009 hearing, counsel for the Respondent contended that "[Article 79] *says that… the assignment to third parties of rights derived from a contract shall be null and void, and shall have no validity whatsoever if there is no prior authorisation from the Ministry. If this … unauthorized transfer is null and void, that means that it does not exist. It does not produce legal effects*."[93]

637. On the following day, the Respondent again repeated that " … *if there is no authorization, then there is no transfer* …"[94] confirming precisely what it had affirmed in its Reply Memorial on Liability that " … *such a transfer <u>will simply be deemed</u> null and void <u>as a matter of Ecuadorian law</u>*."[95] (Emphasis added) Attempts during the 12 April 2012 hearing by the Respondent's counsel to explain these statements as referring to retrospective nullity (that is, the transfer would be null retrospectively if so declared by a judge) were wholly unpersuasive.[96]

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[92] <u>See</u>, *inter alia*, Professor Hernán Pérez Loose, Fifth Expert Report, at page 18, paragraph 34.

[93] Hearing Transcript (20 March 2009) at pages 200 and 201. <u>See also</u> at pages 204 and 205.

[94] Hearing Transcript (21 March 2009) at page 37.

[95] Respondent's Counter-Memorial on Liability and Counterclaim (16 June 2008) at page 66, footnote 260.

[96] Hearing Transcript (12 April 2012) at pages 140-145 and 203.

638. Moreover, the Respondent's main legal experts on Ecuadorian law, at the earlier stages of this arbitration, also opined that any unauthorized assignment would be automatically void and have no legal effect whatsoever.

639. Professor Aguilar, in one of his reports, stated categorically that "for the assignment to have legal effect, the Hydrocarbon law establishes an additional requirement to those set forth in the civil legislation: the ministerial authorization."[97] In the same report, he also stated that "the Hydrocarbon Law establishes that absent the ministerial authorization, the rights assignment contract lacks value, regardless of whether the title has been delivered or not" and that the "contract … does not produce effects due to a lack of authorization from the relevant Ministry."[98] During his oral evidence, he testified that the "transfer of rights is null, undoubtedly."[99]

640. Professor Merlo, another one of the Respondent's expert on Ecuadorian law, was no less categorical on this issue when he gave evidence before the Tribunal. Answering in Spanish, his native tongue, he stated "*Y **más aún** el **artículo** 79 dice que no tiene ningún valor, se declara nulo, <u>de pleno derecho</u>*."[100] (Emphasis added)

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[97] Fourth Aguilar Expert Report (English translation) (19 September 2008) at page 10, paragraph 31.

[98] *Ibid*, at p. 10, paragraphs 32 and 33.

[99] Hearing Transcript (19 December 2008) at page 1586.

[100] *Ibid* (Spanish) at page 1586 (Translation: "Particularly Article 79 says that it has no value. It is declared null and void as a matter of law," at page 1513 of the English Hearing Transcript (19 December 2008)).

641. The Tribunal further notes that, in its Submission of 3 November 2011, the Respondent translates "automatic" as "*de pleno derecho*".[101]

642. The Tribunal also notes, as stressed by the Claimants at the 12 April 2012 hearing, that most of these opinions of the Respondent and its experts "*were not taken in the heat of argument, extemporaneously or by way of improvisation …*" [102] While this in no way rises to the level of an estoppel, it does, to a certain extent, undermine the credibility of the position which Ecuador later adopted on this crucial issue when the matter was the subject of further attention by the Tribunal. That final position of the Respondent was summarized succinctly in its written submissions of 3 November 2011 as follows: "*Ecuadorian law has not adopted the notion of "inexistence" of acts or contracts*."[103]

643. It is clear to the Tribunal that the Respondent's position prior to November 2011 is flatly inconsistent with the Respondent's later argument that a judicial declaration is required to nullify the unauthorized assignment. The Tribunal does not consider that this later argument is correct. Its earlier position – that the assignment is automatically invalid as a matter of Ecuadorian law – is consistent with the both the statutory evidence and the case law presented to the Tribunal. Article 79 of the HCL is clear that any unauthorized assignment is null and void and shall have no validity whatsoever.

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[101] Respondent's 3 November 2011 Submission, at page 22, paragraph 5.2

[102] Hearing Transcript (12 April 2012) at page 141.

[103] Respondent's Brief of 3 November 2011 at page 24, paragraph 79.

644. Moreover, at a general level, it seems that Ecuadorian law would not in any case recognise that an assignment has occurred unless relevant conditions precedent (such as required consents) had been fulfilled. In this regard, the Tribunal recalls the evidence of the Claimants' expert on Ecuadorian law, Dr Hernán Pérez Loose, who opined:

> The transfer or assignment of legal title was necessarily and inexorably subject to fulfilment of a condition precedent [i.e. authorisation from the Ministry] … Under Ecuadorian law, while the condition precedent is pending, the right affected by said type is not even given legal effect, since the obligee only has a legitimate expectation of acquiring it, obviously if the condition is confirmed.[104]

(c) New York Law

645. As noted above, by virtue of the governing law clause of the Farmout Agreement, and as acknowledged by the parties, New York law is also relevant to the interpretation of the Farmout Agreement and therefore as to whether a valid assignment took place. The Tribunal considers that the application of New York law results in exactly the same conclusion as the application of Ecuadorian law. First, it is clear that New York law does not recognize an assignment in breach of a valid non-assignment clause.[105] As Clause 16.1 of the Participation Contract contains a non-assignment clause clearly stating that any unauthorized assignment is null and void, New York law would not recognize any purported assignment where such consent had not been obtained.

646. Secondly, where the governing law of the assignment is a foreign law, New York courts (like other Anglo-American jurisdictions) apply the governing law of the contract

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[104] Prof. Hernán Pérez Loose, Fifth Expert Report, at page 18, paragraph 34.

[105] *Allhusen v. Caristo Const. Corp.* 303 NY 446, 103 N.E. 2d 891 (N.Y. Ct. App. 1952)

containing the non-assignment clause when interpreting that clause. As Clause 7.02 of the Farmout Agreement states that mandatory Ecuadorian laws governing the Participation Contract apply, the New York courts would give effect to such laws, including the HCL, when considering the validity of the assignment. The Tribunal does not accept the Respondent's argument that the New York courts are reluctant to invalidate contracts on the basis of illegality under foreign law. The only case cited by the Respondent in support of this argument[106] concerned a share transfer (not an assignment of rights) and the Court simply stated that the relevant government entity was entitled to bring a case in the courts of Myanmar or any other court around the world, if it considered that the said share transfer had infringed the Joint Venture Agreement to which it was a party. The New York Court in that case did not consider that any such dispute needed to be decided as part of the case before it. This case provides no support for the sweeping generalization of the Respondent.

647. New York courts commonly apply foreign laws where the relevant contractual provision so provides,[107] and there is no reason to suggest that they would fail to do so in relation to the assignment sought to be effected by the Farmout Agreement which requires the application of Article 79 of the HCL.

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[106] *Peregrine Myanmar Ltd. v. Segal* 89 F.3d 41 (2d. Cir. 1996).

[107] As noted by the Claimants at footnote 8 of their Reply Brief, 22 November 2011, *Korea Life Ins. Co. v. Morgan Guar. Trust Co. of N.Y.*, 269 F.Supp.2d 424, 441 (S.D. N.Y. 2003) (RLA-338) and *JPMorgan Chase Bank, N.A. v. Controladora Comercial Mexicana S.A.B. DE C.V.*, 920 N.Y.S.2d 241 (N.Y. Sup. Ct. 2010) (RLA-340) are examples of the New York courts applying foreign law.

648. The Tribunal also rejects the Respondent's contention that the New York courts have interpreted the phrase "null and void" as meaning "voidable at the direction of the protected party."[108] In *Lynbrook v. Cadoo*, cited by the Respondent in support of its contention, the Court held that "[t]he word 'void' is *sometimes* used in statutes in the sense of 'voidable'"[109] It by no means held that "void" is *always* to be interpreted as "voidable." Moreover, this case concerned the application of "village law" in determining the validity of a vote on a town planning matter, and had absolutely nothing to do with an assignment of rights. Similarly, *St. George Seaport Assoc. v. CSX Realty Inc.*[110] (also cited by the Respondent) did not establish that void is interpreted by the New York courts to mean voidable with respect to the legality of assignments. The Court's decision in that case concerned the interpretation of a particular statutory provision as it related to a property transaction and must be considered specific to that set of circumstances.

(d) Findings

649. As the Tribunal found earlier in this Award, the purported assignment on 1 October 2000 by OEPC to AEC by operation of the Farmout Agreement and the Joint Operating Agreement of rights derived under the Participation Contract was never

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[108] Ecuador's Reply to Claimants' Brief in Response to Tribunal's Request of 6 October 2011, 22 November 2011, paragraph 19.

[109] 252 NY 308, 312 (NY 1929). (Emphasis added)

[110] 1991 US Dist LEXIS 15463.

authorized by the Ecuadorian Ministry of Energy and Mines and was thus in breach of Article 74.11 of the HCL.

650. It follows that, pursuant to New York and Ecuadorian law, the purported assignment by OEPC to AEC of rights under the Participation Contract pursuant to the Farmout Agreement and the Joint Operating Agreement is null and void and has no validity whatsoever[111] and the Tribunal so finds. Under the doctrine of inexistence and under New York law, there is no requirement that the Court must first declare the assignment to be invalid. Indeed, even under the doctrine of absolute nullity, any purported assignment is not considered "valid" prior to a declaration of nullity – there is only the "appearance" of an act. As such, the purported assignment of rights under the Farmout Agreement and the Joint Operating Agreement was not valid and produced no legal effect. It must therefore be disregarded by the Tribunal for purposes of determining the compensation to which the Claimants are entitled.[112] Consequently, the Tribunal finds that OEPC continued to own, as of the date of the *Caducidad* Decree, 100% of the rights under the Participation Contract.

651. The Tribunal accordingly concludes that the Respondent is obliged to compensate the Claimants for 100% of their interest in Block 15 which it acquired upon the issuance of the *Caducidad* Decree.

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[111] See Article 79 of the HCL.

[112] There can be no doubt that the purported assignment of rights by OEPC to AEC is also in breach of Article 74.11 of the HCL.

652. For the avoidance of doubt, there is no inconsistency between the Tribunal's earlier conclusion that OEPC acted in breach of the HCL and Clause 16.1 of the Participation Contract in purporting to assign rights in Block 15 without authorization and its conclusion here that the assignment was invalid. Article 79 of the HCL itself makes it clear that the fact that an unauthorized assignment has no validity does not negate the breach caused by a purported assignment: "… <u>shall have no validity whatsoever</u> … without prejudice to the declaration of *caducidad* as provided for in this Law." Moreover, the fact that AEC and OEPC acted as though the assignment had taken place prior to the declaration of *caducidad* does not somehow cause an invalid assignment to become valid.

653. The conclusions of the Tribunal in this section are sound under the principles of public international law to be applied when determining damages. Both parties referred, in particular, to unjust enrichment and to those principles contained in the *Chorzow Factory* case.

654. In relation to unjust enrichment, there was produced to the Tribunal the letter agreement of February 22, 2006 between OEPC and Andes whereby OEPC is obliged to compensate Andes to the level of 40% of any compensation it receives from action taken against Ecuador regarding the termination of the Participation Contract.[113] Even without

[113] C-425. Clause 2(g) of the Agreement states:

> "If Occidental receives any monetary award from the Government of Ecuador as a result of the Government's actions to enforce caducity and terminate Occidental's contract with respect to Block 15, Occidental agrees that the Company is entitled to a 40% share in the net

this letter agreement, the Tribunal notes that the invalidity of the assignment under New York and Ecuadorian law does not mean that AEC (or Andes) may not have recourse against OEPC under the Farmout Agreement. As mentioned earlier, the unauthorised assignment does not invalidate the Farmout Agreement as between the assignor, OEPC and the assignee, AEC nor is the legal position affected by the fact that the assignor and the assignee actually implemented *inter se* parts of the legally invalid and unauthorised assignment. OEPC promised to deliver certain rights to AEC under the Farmout Agreement, but due to its failure to secure authorisation from the Ministry it was in breach of that promise. This breach of contract may form the basis of a claim by AEC (or Andes) against OEPC. These factors weigh heavily against any unjust enrichment arguments raised in respect to OEPC's entitlement to receive compensation for 100% of the interests in the Participation Contract.

655. In this respect, by far the greater risk of unjust enrichment lies at the door of Ecuador. Ecuador would be unjustly enriched if only obliged to compensate for 60% of a 100% unlawful taking. Ecuador stated in its Additional Submissions that a declaration of nullity could be sought by it if AEC or Andes attempted to bring an action against Ecuador in relation to its purported 40% beneficial interest,[114] effectively ensuring that Ecuador would only ever pay a maximum of 60% compensation for a 100% unlawful taking.

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amount received, after all costs and expenses of the Caducity Proceedings have been reimbursed or paid (in calculating such amount there shall be no double counting)."

[114] Respondent's Brief, 3 November 2011, paragraph 27.

656. As a matter of international law, any liability that OEPC might have to AEC or Andes under various other agreements (including the Farmout Agreement) does not affect the Claimants' right to receive compensation from Ecuador. Ecuador cannot discount OEPC's claim by reference to liabilities that may be owed to third parties such as AEC. This principle is clearly recognised in the *Chorzow Factory* dictum at page 26 to which both parties referred and which the Tribunal will quote again:[115]

> This principle … has the effect, on the one hand, of excluding from the damage to be estimated, injury resulting for third parties from the unlawful act *and, on the other hand, of not excluding from the damage the amount of debts and other obligations for which the injured party is responsible*. The damage suffered by the Oberschlesische in respect of the Chorzow undertaking is therefore equivalent to the total value—but to that total only—of the property, rights and interests of this Company in that undertaking, *without deducting liabilities*." (Emphasis added)

657. Similarly, the Tribunal does not accept the Respondent's suggestion that the principle *nemo auditor propriam turpitudinem allegans* (preventing a party from taking advantage of its own wrongdoing) is applicable to this issue.[116] The *nemo auditur* principle cannot turn an invalid assignment into a valid one. The question addressed in this section is whether AEC actually acquired ownership of any rights in the Participation Contract as a matter of law (both Ecuadorian and New York) and the *nemo auditor* principle is not relevant to this issue. The separate question of the quantification of damages and, in particular, any consideration of the Claimants' contribution to the

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[115] This principle was confirmed in *Enron Corporation and Ponderosa Assets, L.P. v. The Argentine Republic* (ICSID Case No. ARB/01/3), Award of May 22, 2007 (CA-8).

[116] See Ecuador's Brief on the effect of Claimants' unauthorized, illegal assignment of rights arising out of the Participation Contract, 3 November 2011, paragraphs 51–55.

damages it suffered as a result of the Respondent's breach are examined elsewhere in this Award.

658. Before closing its conclusions on this issue, the Tribunal notes that the Respondent has objected that the Claimants did not have the standing to claim damages beyond their "remaining" 60% interest in Block 15, that the Claimants' interest amounts to 60% of the value of Block 15 and that no willing buyer would pay a price based on 100% of the value for Block 15. In view of the Tribunal's conclusion in relation to the invalidity of the assignment as set out above, this objection of the Respondent has become moot. Also moot is the Respondent's contention that there is a risk of double jeopardy as AEC has no standing to sue Ecuador directly for compensation given that it holds no rights – beneficial or otherwise – in the Participation Contract.

F. The Fault of the Claimants Prior to the *Caducidad* Decree

1. The Respondent's Position

659. The Respondent posits that any recovery by the Claimants should be reduced in order to reflect the Claimants' reckless conduct which violated the laws of Ecuador and which, it maintains, provoked the Respondent's decision to declare *caducidad*, thus terminating the Participation Contract and resulting in the Claimants' alleged losses.

660. The Respondent submits that any damages awarded to the Claimants should be "substantially reduced" on account of the Claimants' contributory fault.

2. The Claimants' Position

661. Assuming a finding that they were negligent in failing to obtain prior ministerial authorization, the Claimants argue that the damages they seek should not be reduced because any such negligence did not cause their losses. This, they aver, is an issue of causality. The Claimants reiterate that the Respondent's totally disproportionate action (*i.e. caducidad*) was in breach of the Treaty and international law and must be considered as the sole and exclusive cause of their resulting losses.

3. The Tribunal's Analysis

662. As the Tribunal commences its analysis of this last threshold question, it is important to recall that, earlier in the present Award, the Tribunal has already found the following:

- by virtue of the Farmout Agreement, executed on 1 October 2000, OEPC purported to transfer rights under the Participation Contract to AEC;
- this transfer of rights required prior ministerial authorization which was neither requested nor obtained by OEPC;
- the Claimants failed to give a copy of the Farmout Agreement to the Respondent in the fall of 2000;
- it was only in the spring of 2004 that the true nature of the Farmout Agreement became known to Ecuador when unsigned but true copies of the Farmout Agreement and of the Joint Operating Agreement, also executed on 1 October 2000, were provided to the audit firm of Moores Rowland who had been retained by the

DNH to conduct an audit of OEPC; these two Agreements were provided by Moores Rowland to the Respondent in July 2004;

- failure by OEPC to disclose the true nature of the Farmout Agreement to Ecuador and to obtain ministerial authorization in 2000 was a "grave mistake"; OEPC, while not acting in bad faith, was negligent;
- OEPC thus breached Clause 16.1 of the Participation Contract and was guilty of an actionable violation of Article 74.11 of the HCL which, as one option, allowed the Minister to declare the *caducidad* of the Participation Contract;
- the *Caducidad* Decree, issued, according to its terms, because of the breach of Clause 16.1 of the Participation Contract and the violation by OEPC of Article 74 of the HCL, was a disproportionate sanction by the Respondent in the particular circumstances of this case; and
- the *Caducidad* Decree was issued in breach of Ecuadorian law, and in violation of the Treaty and customary international law.

663. The Tribunal now has to determine whether the damages caused to the Claimants by the wrongful act of the Respondent should be reduced because, as the Respondent argues, "the Claimants' own wrongful conduct directly contributed to *caducidad*."

664. In support of its submission, the Respondent invokes the legal principle of "contributory negligence" on the part of the Claimants.

665. The Tribunal's analysis commences with a reference to Article 39 of the International Law Commission's Articles on Responsibility of States for Internationally Wrongful Acts which is invoked by both parties. It provides:

> *Article 39. Contribution to the injury*
>
> In the determination of reparation, account shall be taken of the contribution to the injury by willful or <u>negligent</u> action or omission of the injured State or any person or entity in relation to whom reparation is sought. (Emphasis added)

666. Extracts in the International Law Commission's Commentary to Article 39 are pertinent, including the following:

> Article 39 deals with the situation where damage has been caused by an internationally wrongful act of a State, which is accordingly responsible for the damage in accordance with Articles 1 and 28, but where the injured State, or the individual victim of the breach, has <u>materially contributed</u> to the damage by some willful or <u>negligent</u> act or omission. (Emphasis added)

667. The Tribunal also refers to Article 31 of the International Law Commission's Articles on Responsibility of States for Internationally Wrongful Acts, which states:

> *Article 31. Reparation*
>
> 1. The responsible State is under an obligation to make full reparation for the injury caused by the internationally wrongful act.
>
> 2. Injury includes any damage, whether material or moral, caused by the internationally wrongful act of a State.

668. The following extract from the International Law Commission's Commentary to Article 31 is also noted:

> It is true that cases can occur where an identifiable element of injury can properly be allocated to one of several concurrently operating causes alone. But unless some part of the injury can be shown to be severable <u>in causal terms</u> from that attributed to the responsible State, the latter is held responsible for all the consequences, not being too remote, of its wrongful conduct. (Emphasis added)

669. The Tribunal must therefore decide, on the basis of the totality of the evidence before it, whether there is a causal link between the negligent failure of OEPC in October 2000 to disclose the true nature of the Farmout Agreement to Ecuador and to request and obtain prior ministerial authorization from the Minister for the transfer of certain rights in the Participation Contract to AEC and the declaration of *caducidad* by the Respondent on 15 May 2006 and, through the latter, with the damages resulting from *caducidad*.

670. The Tribunal notes that it is not any contribution by the injured party to the damage which it has suffered which will trigger a finding of contributory negligence. The contribution must be material and significant.[117] In this regard, the Tribunal has a wide margin of discretion in apportioning fault.[118]

671. The Tribunal recalls the terms of Clauses 21.1.1 and 21.1.2 of the Participation Contract, which state that "this Participation Contract shall terminate", *inter alia*:

> **21.1.1** By a declaration of forfeiture [*caducidad*] issued by the Corresponding Ministry for the causes and following the procedure established in Articles seventy four (74), seventy five (75) and seventy six (76) of the Hydrocarbons Law, insofar as applicable.
>
> […]
>
> **21.1.2** Due to a transfer of rights and obligations of the Participation Contract without prior authorization from the Corresponding Ministry.

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[117] *MTD Equity Sdn. Bhd. and MTD Chile S.A. v. Republic of Chile* (ICSID Case No. ARB/01/7), Decision on Annulment of 21 March 2007 at paragraph 101.

[118] *Ibid.*

672. OEPC thus agreed to a contractual framework with Ecuador that explicitly authorized *caducidad* upon a violation of Article 74.11 of the HCL. By agreeing to Clauses 21.1.1 and 21.1.2 in the Participation Contract and then failing imprudently and negligently to obtain ministerial authorization as required, OEPC exposed itself to a serious risk that *caducidad* could be declared.

673. Paraphrasing the words of Article 39 of the International Law Commission's Articles on Responsibility of States for Internationally Wrongful Acts and its commentary, the Tribunal must determine whether this unlawful act of OEPC contributed to its injury in a material and significant way, or was it a minor contributory factor which, based on subsequent events such as the VAT Award, cannot be considered, legally, as a link in the causative chain.

674. Both parties, in support of their respective positions, have quoted extensively to extracts of the 1974 seminal thesis of Professor Brigitte Stern, a member of this Tribunal, entitled "*Le préjudice dans la théorie de la responsabilité internationale.*" The Tribunal agrees that Professor Stern's thesis, particularly Chapter II entitled "*Application nuancée des règles normales de la causalité,*" is very instructive to and informs its decision on this issue.

675. In a section of this chapter of her thesis entitled "*Acte de la victime justifiant partiellement l'acte de l'État*," Professor Stern refers to the cases of *Delagoa Bay Railway*[119] and *Lillie Kling v. Mexico*[120] as authorities for the following proposition:

> Il y a enfin un certain nombre de circonstances dans lesquelles l'acte de la victime ne justifie que partiellement l'acte de l'État et où il faut donc considérer qu'aussi bien l'un que l'autre sont intervenus de façon complémentaire dans la production du dommage.
>
> [Translation: Finally, there are a certain number of circumstances in which the act of the victim only partially justifies the State action, and in which as a result it must be concluded that both the former and the latter operated in a complementary fashion to produce the damage.]

676. The words of the Tribunal in *Delagoa Bay Railway* are particularly pertinent to the present case:

> Toutes ces circonstances qui peuvent être alléguées à la charge de la compagnie concessionnaire et à la décharge du gouvernement portugais atténuent la responsabilité de ce dernier et justifient […] une réduction de la réparation à allouer.[121]
>
> [Translation: All these circumstances that can be put forward against the concessionaire and to the credit of the Portuguese government lessen the responsibility of the latter and justify […] a reduction in the damages to be granted.] (Emphasis added)

677. In *Lillie Kling*, the presiding commissioner opined that "*it is impossible not to consider that the action of the [Mexican] soldiers [the shooting and killing of an*

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[119] *Delagoa Bay Railway Arbitration* (Award of 29 March 1900), reprinted in H. Lafontaine, *Pasicrisie Internationale* (1902) 397.

[120] *Lillie S. Kling (U.S.A.) v. The United Mexican States* (Award of 8 October 1930), reprinted in Reports on International Arbitral Awards (2006), Volume IV, 575.

[121] *Delagoa Bay Railway Arbitration* (Award of 29 March 1900), H. Lafontaine, *Pasicrisie Internationale* (1902) at page 402.

American] was caused by the shots fired in the air […] in a very imprudent manner" by some of the victim's companions.[122] This "imprudence" was thus taken into consideration by the Commission to reduce the amount of the indemnity.

678. The Tribunal agrees that an award of damages may be reduced if the claiming party also committed a fault which contributed to the prejudice it suffered and for which the trier of facts, in the exercise of its discretion, considers the claiming party should bear some responsibility.[123]

679. In the present case, as noted earlier, OEPC had agreed in the Participation Contract that, if it failed to obtain prior ministerial authorization to transfer rights under the Participation Contract to AEC, it ran the risk that the Respondent would declare the caducity of the Participation Contract. Since it did not seek nor obtain the required authorization, the Tribunal has found that it acted negligently and committed an unlawful act. The Claimants' fault prevented the Respondent from exercising, in a formal way, its sovereign right to vet and approve AEC as the transferee of those rights and, even more importantly on the facts of the present case, to vet any other unknown investor to which AEC could eventually transfer its rights.

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[122] *Lillie S. Kling (U.S.A.) v. The United Mexican States* (Award of 8 October 1930), reprinted in Reports on International Arbitral Awards (2006), Volume IV, at page 575.

[123] This is also the basis of the tribunal's ruling in *MTD Equity Sdn Bhd. v. The Republic of Chile*, Award of 25 May 2004 at paragraphs 242 and 243 that "the Claimants should bear part of the damages suffered." In that case, that "part" was quantified as 50% of the damages.

680. In the view of the Tribunal, the Claimants should pay a price for having committed an unlawful act which contributed in a material way to the prejudice which they subsequently suffered when the *Caducidad* Decree was issued.

681. In considering the extent of the contribution of the Claimants' negligence to their injury, the Tribunal notes that the issuance of the *Caducidad* Decree which ensued, as the Tribunal has found, was a disproportionate sanction and a measure tantamount to expropriation of the Claimants' substantial investment in Ecuador. The totality of the Claimants' damages were caused by *Caducidad*. The Tribunal must now determine to what extent and in what proportion the Claimants' unlawful act in 2000 contributed to lessen the responsibility of the Respondent.

682. The Tribunal recalls that, in the fall of 2000, AEC was an entity already present and active in Ecuador and thus well known to the Respondent and, in particular, to PetroEcuador.

683. If OEPC had sought the Minister's consent in October 2000, in all likelihood it would have obtained it and it is probable that the Respondent would not have declared "Caducidad" in 2006. In other words, without the violation of the law by OEPC, C*aducidad* may not have happened. In this connection, the Tribunal recalls that the violation of the law by OEPC was invoked by Ecuador as the principal legal basis for the Decree.

684. On the other hand, as noted earlier in the present Award, the publication of the VAT Award in favour of the Claimants and the social unrest directed against OEPC

which ensued were also causes which, in the view of the Tribunal, contributed in a material and significant way to the declaration of *Caducidad*.

685. In other words, it is a conjunction of different factors which, taken together, in a complementary manner, were the causes of the decision of the Respondent to declare *Caducidad*. The difficult task of the Tribunal in this case is to weight the relative causal link of this series of causes on the *Caducidad Decree* and, as a consequence, on the damages caused to the Claimants.

4. The Tribunal's Conclusion

686. The Tribunal agrees with the ICSID Annulment Committee in the *MTD Equity* case that "the role of the two parties contributing to the loss [is] […] only with difficulty commensurable and the Tribunal [has] a corresponding margin of estimation." [124] However, the Tribunal must reach a decision and it has.

687. Having considered and weighed all the arguments which the parties have presented to the Tribunal in respect of this issue, in particular the evidence and the authorities traversed in the present chapter, the Tribunal, in the exercise of its wide discretion, finds that, as a result of their material and significant wrongful act, the Claimants have contributed to the extent of 25% to the prejudice which they suffered when the Respondent issued the *Caducidad* Decree. The resulting apportionment of

[124] *MTD Equity Sdn Bhd. v. The Republic of Chile*, Decision on Annulment of 21 March 2007 (ICSID) at paragraph 101.

responsibility as between the Claimants and the Respondent, to wit 25% and 75%, is fair and reasonable in the circumstances of the present case.

G. Remaining Quantum Issues

1. Introduction

688. Now informed by its conclusions in respect of the four threshold issues which it has analyzed in the previous Sections of this Award, the Tribunal will determine the quantum of the damages which the Respondent owes to the Claimants.

689. There are several remaining fundamental issues associated with the determination of quantum in the present case. As will be seen, these issues include, first and foremost, both the appropriate standard of reparation as well as the appropriate method of valuation.

690. Both parties agree that one method of valuation is the discounted cash flow ("DCF") method[125] which involves the application of a number of variables including (i) the exact production profile, (ii) reserve adjustment factors, (iii) oil price projections, (iv) the appropriate discount rate, and (v) capital expenditures and operating expenses. The Claimants also present a claim for consequential damages which they allegedly suffered following the *Caducidad* Decree on account of their "ship or pay" contract with OCP, a claim for employee termination costs and a claim for a stranded cargo.

[125] The Claimants assert that, in this particular case, the DCF method is the only method that should be used, whereas, as noted later in this chapter of the Award, the Respondent submits that the Tribunal should also examine comparable sales.

691. At the outset of its analysis, the Tribunal wishes to acknowledge the assistance which has been provided to it in the determination of the quantum of the Claimants' damages by counsel for both parties as well as the reports and testimony of the parties' quantum experts, Professor Joseph P. Kalt on behalf of the Claimants, and Mr. Daniel Johnston on behalf of the Respondent.

692. More particularly, the Tribunal recalls that, during its deliberations, it sought the assistance of the parties' experts. In this connection, as mentioned earlier, on 11 March 2011, it issued Procedural Order No. 9 which reads, in relevant parts, as follows:

> **2 EXPERT ASSISTANCE**
>
> 2.1 The Tribunal invites the experts, Professor Kalt and Mr. Johnston, to confer and produce jointly a report estimating the fair market value of Block 15 as of 16 May 2006, using the discounted cash flow method.
>
> 2.2 In estimating this value, the experts shall make the following assumptions:
>
> (a) That the risked reserves of Block 15 as of 15 May 2006 consisted of approximately 240 million barrels of oil (the "production profile").
>
> (b) That approximately 33.4 million barrels of oil should be deducted from this production profile, representing reserves in the Edén-Yuturi, Paka Sur and Paka North fields, classified as "probable" rather than "proved".
>
> (c) That a further [to be determined by the experts] million barrels of oil should be deducted from this production profile, representing the value of the proved reserves that a willing buyer could not have developed due to the absence of the two rigs withdrawn by OEPC prior to 15 May 2006.
>
> (d) With respect to items (b) and (c) above, the experts will determine the impact of these deductions on the operating expenditures (<u>see</u> item (h) below).
>
> (e) That the following reserve adjustment factors should be used:
>
> - 100% for proved reserves

- 50% for probable reserves
- 25% for possible reserves

(f) That the future NYMEX based-WTI prices should be used as the basis for the forecast of crude oil prices from May 2006.

(g) That a discount rate of 12% should be used.

(h) That the twelve months of operating costs incurred directly prior to 15 May 2006 (*i.e.* May 2005 to May 2006) should be used to forecast operating expenditures.

(i) That an amount of $243 million should be used as capital expenditures.

(j) That no examination of comparable sales should be undertaken.

693. The President of the Tribunal, on 21 March 2011, clarified assumption 2.2(a) in an email to the parties which reads, in relevant parts, as follows:

> With respect to the specific issue raised by the parties in connection with paragraph 2.2(a) of the Procedural Order, the Tribunal is of the view that a clarification is required. The Tribunal confirms that the experts shall assume that the risked reserves of Block 15 as of 15 May 2006 consisted of approximately 240mmbo before deducting from that figure the actual production between 1 January and 15 May 2006 as well as any adjustment already acknowledged by the Claimants.

694. The experts, on 11 April 2011, submitted a joint report to the Tribunal in which, in accordance with the instructions of the Tribunal set forth in Procedural Order No. 9, they opined and agreed as to the fair market value of Block 15 as of 16 May 2006 (the "Joint Expert Report"). The Tribunal will refer later in this chapter, as necessary, to the Joint Expert Report.

695. As provided for in Procedural Order No. 9, the parties, on 18 April 2011, submitted comments to the Tribunal on the Joint Expert Report.

696. The President of the Tribunal, on 29 April 2011, informed the parties that the Tribunal had decided that a one-day hearing was necessary in order "to examine the experts on their Joint Report and hear the parties' representations".

697. On 13 May 2011, the Tribunal issued Procedural Order No. 10 which provided, in relevant parts, as follows:

> 7. The purpose of the present Order is to provide the parties with the Tribunal's instructions with respect to the organization of the hearing to be held in Washington, D.C. on 30 June 2011 (the "Hearing").
>
> 8. The Hearing is a continuation of the Tribunal's consultation with the parties' quantum Experts, whose assistance, as noted earlier, has been required.
>
> 9. The Tribunal recalls the following passages from the Experts' Joint Report :
>
>> 6. […] [W]e agreed, based on our joint review of each other's damage models, that it was possible to identify and harmonize otherwise minor methodological and modeling differences. As a result, we are here able to employ a common model and present its results to the Tribunal.
>>
>> 7. […] [W]e also reached agreement on the most reasonable approaches and methodology for calculating fair market value consistent with the Tribunal's instructions. […]
>>
>> […]
>>
>> 26. […] We are certainly willing to make our model available and/or to perform any additional calculations with that model that the Tribunal may request.
>
> 10. Against this background, the Tribunal requests that the Experts confer again and produce jointly to the Tribunal, by 10 June 2011, a supplemental report addressing (i) the Respondent's comments of 18 April 2011 and its letter of 27 April 2011, and (ii) the Claimants' comments of 18 April 2011 and their letters of 25 and 28 April 2011.
>
> 11. The parties may submit comments to the Tribunal on the Experts' supplemental joint report by no later than 17 June 2011.
>
> 12. The Tribunal requests that Professor Kalt and Mr. Johnston be present at the Hearing in order to assist the Tribunal and answer questions which may be put to them by members of the Tribunal.

698. The experts, on 10 June 2011, submitted a supplemental joint report to the Tribunal in accordance with the instructions of the Tribunal set forth in Procedural Order No. 10 (the "Supplemental Joint Expert Report"). Again, the Tribunal will refer later in this chapter, as necessary, to the Supplemental Joint Expert Report.

699. On 17 June 2011, the parties submitted their comments regarding the Supplemental Joint Expert Report.

700. On 20 June 2011, the Tribunal issued Procedural Order No. 11 which provided, in relevant part, as follows:

> The experts, Prof. Kalt and Mr. Johnson, to the extent that they consider that either party, in its last comments, has raised issues which were not addressed earlier, are required to confer again and produce jointly to the Tribunal, by 24 June 2011, another report addressing such new issues.
>
> In addition, in order to further assist the Tribunal in its continuing deliberations, recalling again the following passage from the Experts' Joint Report of 11 April 2011:
>
>> 26. […] <u>We are certainly willing to make our model available and/or to perform any additional calculations with that model that the Tribunal may request.</u> (Emphasis added)
>
> reiterated in para 7 of the Experts' Joint Report of 10 June 2011, the Tribunal requests the experts to present to the Tribunal and to the parties alternative calculations of the fair market value of Block 15 as of 16 May 2006 (see Table 3, at para 30 of the Experts' Joint report of 10 June 2011) reflecting, in turn, all of the following, separately and cumulatively:
>
> i. the full effect of the rig delay case based on the NSA Delay Case (See Respondent's Comments of 17 June 2011 at pp 6-12);
>
> ii. the addition of $20 million to the twelve months of OEPC's operating costs prior to 15 May 2006 in order to forecast operating expenditure (See Respondent's Comments of 17 June 2011 at pp 12-15); and

> iii. the deduction of an additional .38 million barrels of oil from the OEPC production profile representing reserves in the Limoncocha well LC-103 which should have been classified as "probable" rather than proved."
>
> These alternative calculations are required by the Tribunal as its members continue their preparation for the hearing of 30 June.

701. The experts, on 24 June 2011, submitted a second supplemental joint report to the Tribunal in accordance with the instructions of the Tribunal set forth in Procedural Order No. 11 (the "Second Supplemental Joint Expert Report"). The Tribunal will refer later in this chapter, as necessary, to the Second Supplemental Joint Expert Report.

702. Finally, as contemplated by Procedural Order No. 10, the Tribunal held a one-day hearing in Washington, D.C. on 30 June 2011. The experts were then examined by the Tribunal which also heard the parties' representations.

703. After this hearing, the Tribunal continued its deliberations both as to the liability and quantum issues.

2. Fair Market Value ("FMV")

(a) The Claimants' Position

704. The Claimants submit that international law governs the proper remedy for the Respondent's Treaty breaches, and that the appropriate standard of reparation under international law is compensation for the losses suffered by the victim. Under international law, the Claimants add, FMV is the appropriate measure of damages.

705. Regarding FMV *per se*, the Claimants contend that the standard for valuing the net present worth of Block 15 as of the date of expropriation is "the price that a willing

buyer would pay to a willing seller in circumstances in which each had good information, each desired to maximize his financial gain, and neither was under duress or threat."

(b) The Respondent's Position

706. The Respondent does not disagree with the Claimants that, in the event of a finding by the Tribunal that there has been an expropriation of the Claimants' investment (which the Tribunal has found), Article III of the Treaty is controlling, *i.e.* "[c]ompensation shall be equivalent to the fair market value of the expropriated investment immediately before the expropriatory action was taken or became known, whichever is earlier".

(c) The Tribunal's Conclusion

707. The Tribunal agrees with the parties. Having found earlier in this Award that the Claimants' investment in Ecuador has not been accorded fair and equitable treatment by the Respondent and has been expropriated by the issuance of the *Caducidad* Decree, the Tribunal will now determine, as mandated by Article III of the Treaty, the fair market value of this investment. The Tribunal agrees with and adopts the definition of FMV which Professor Kalt has explained as follows:

> Measurement of fair market value in a context such as at hand here properly entails consideration of *market* outcomes. Specifically, the fair market value today of a stream of net revenues (i.e., gross revenues minus attendant costs) that can be earned from operation of a multi-year project such as OEPC's development of Block 15 entails assessment of the amount that a willing buyer would reasonably be expected to have to pay a willing seller to induce the seller to give up its rights to those net revenues. Here, Occidental is in the position of a seller in the sense that we seek measurement of the amount Occidental would reasonably have been

> willing to accept to be voluntarily bought out of the instant contract and associated income-generating opportunities, as opposed to having had that contract and those opportunities involuntarily terminated by Ecuador.[126] (Emphasis in original)

3. The Discounted Cash Flow ("DCF") Method

708. The Tribunal is of the view that, in this case, the standard economic approach to measuring the fair market value today of a stream of net revenues (*i.e.*, gross revenues minus attendant costs) that can be earned from the operation of a multi-year project such as OEPC's development of Block 15 is the calculation of the present value, as of 16 May 2006, of the net benefits, or "discounted cash flows". These net cash flows are appropriately determined by calculating the flow of benefits ("cash flows") that the Claimants would have reasonably been expected to earn in the "but for" state of the world in which the termination of the Participation Contract hypothetically did not occur relative to the actual cash flow that the Claimants will derive subsequent to the termination. The difference between these two cash flow streams (the "but for" state of the world with no termination less the actual state of the world with contract termination), discounted to the date of the actual contract termination, is the economically appropriate and reliable measure of the cumulative economic harm suffered by the Claimants as a consequence of the contract termination.

709. Using a DCF model as the starting point for measuring FMV, the Tribunal further observes that the analytical framework for determining FMV in the present circumstances

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[126] Expert Report of Joseph P. Kalt dated 17 September 2007 at paragraph 14. See also the Tribunal's Comments *supra* at paragraphs 540, 541and 563.

requires several steps. These steps are clearly summarized by the Respondent. The Claimants agree. They are:

(a) Determination of the size of the reservoir (project the number of barrels that are in the field);

(b) Creation of a production profile (establish the number of barrels that can be produced each year economically);

(c) Assignment of risk adjustment factors ("RAFs") to the reserves (to reflect the risk that certain reserves categories will not produce the amount of oil projected);

(d) Application of a price forecast (multiplication the number of barrels in the production profile by a projected price of oil, subtraction of the costs to produce those barrels); and

(e) Application of a discount rate (to reflect, among other things, the time-value of money and business and country risks).

4. Volume and Production Profile of Block 15

710. The most important component of the DCF model in the present case is the determination of the volume and production profile of Block 15. The evidence proffered by the parties on this item is voluminous. The Tribunal will endeavour to summarize and analyze this evidence.

(a) The Parties' Expert Reports

(i) NSAI Expert Report dated 17 September 2007

711. For the Claimants, Netherland, Sewell & Associates Inc. ("NSAI") provided its first expert report by way of a full independent estimate of all the gross Block 15 reserves <u>as of 30 April 2006</u>. The Tribunal notes that this study was carried out using the 1997 definitions for oil and gas reserves adopted by the Society of Petroleum Engineers and

the World Petroleum Council, which represent the industry accepted standards for reserves classification.

712. In this report, NSAI estimated the gross Block 15 reserves as of 30 April 2006 at 320 million barrels.[127] The Claimants then subjected this estimate of reserves to standard OEPC risk analysis and their expert, Professor Kalt, determined that NSAI's reserve estimate equalled approximately 240 million barrels of oil as of 1 January 2006.[128]

(ii) RPS Scotia's Expert Report dated March 2009

713. In this report submitted on behalf of the Respondent, RPS Scotia averred that NSAI's non-producing and undeveloped reserves utilised in Professor Kalt's economic model were overstated. It concluded that the Block 15 gross risked reserves were, as of 30 April 2006, 132.8 million barrels for the RPS Scotia Base Case[129] and 134.0 million barrels for the RPS Scotia Acceleration Case[130]. Unrisked reserves were 199.2 million barrels for the Base Case and 202.2 for the Acceleration Case. This compared with the NSAI/OEPC gross risked and unrisked reserves of 228.6 million barrels and 320.7 million barrels, respectively, for Block 15 as of 30 April 2006.

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[127] See NSAI Expert Report dated 17 September 2007 at paragraph 183.

[128] Expert Report of Joseph P. Kalt dated 17 September 2007, Exhibit 1 at page 14.

[129] Defined by RPS Scotia as a "forecast which follows as closely as possible the capital schedule used in the Kalt model. […] RPS eliminated certain cases in the NSA project set which it believes a prudent operator would not execute. In order to match the Kalt capital schedule, eight additional projects were eliminated." See RPS Scotia's Expert Report dated March 2009 at page 27.

[130] Defined by RPS Scotia as a forecast which "used all of the projects that 'made the cut' in RPS Scotia's opinion, including the eight projects discussed above": see RPS Scotia's Expert Report dated March 2009 at page 27.

(iii) RPS Scotia June 2009 Report Entitled "Ecuador Block 15 Reserves Certification and Plan of Development Study as of January 1, 2009"

714. The Tribunal notes that this report (the "RPS Scotia June 2009 Reserves Certification") was obtained by the Claimants on discovery. It was made for Petroamazonas' business and reporting purposes and not for this arbitration. Petroamazonas, an Ecuadorian entity, is required under Ecuadorian law to report to the DNH annually on reserves and other matters, and to certify that its estimates are correct. The Claimants maintain, that this report confirms NSAI's reserve estimates. According to the Claimants, if adjusted to <u>1 May 2006</u>, the RPS Scotia June 2009 Reserves Certification yields an estimate of 227.1 million barrels using the Claimants' reserve adjustment factors, which the Claimants maintain, is "remarkably similar" to NSAI's risked estimate of 228.6 million barrels <u>as of 30 April 2006</u>.

(iv) RPS Scotia's Rebuttal Expert Report dated September 2009

715. In this report, submitted on behalf of the Respondent, RPS Scotia opined that a substantial number of wells had to be eliminated from its June 2009 Reserves Certification and from NSAI's estimate. The reserves from these wells, argued RPS Scotia, is greater than would have been actually recoverable in Block 15 because, for example, the Claimants double-counted barrels and included projects that did not meet the minimum economic threshold. In addition, RPS Scotia maintained that the Claimants' damages model rests on production plans that were not approved by Ecuadorian authorities as well as a drilling schedule that no reasonable buyer would have considered since the drilling rigs required to accomplish that schedule simply did not exist.

(v) NSAI Supplemental Expert Report dated 12 June 2009

716. This supplemental report by NSAI on behalf of the Claimants was carried out for the purpose of:

- evaluating the sufficiency and reliability of the RPS Scotia Report of March 2009 which estimated significantly lower reserves for Block 15 than did the initial NSAI Report;
- assessing the merits of RPS Scotia's numerous criticisms of NSAI's methodology and reserves estimates; and
- confirming the accuracy of NSAI Report's gross (100 percent) reserves estimates based on production and operational data provided by Ecuador for Block 15 for the time period May 2006 through March 2009.

717. In this supplemental report, NSAI affirmed that RPS Scotia did not estimate Block 15 reserves using commonly accepted oil industry practices. In particular, RPS Scotia did not conduct its own independent analysis of Block 15 data but rather relied upon the work of NSAI, Petroamazonas and Occidental. Thus, this represented an audit, not a separate free-standing analysis. NSAI also considered that RPS Scotia's well-by-well reductions to NSAI's reserves estimates were not technically justified. It opined that production data since May 2006 confirmed the accuracy of NSAI's initial production forecast of 17 September 2007, to wit risked reserves of 240 million barrels of oil <u>as of 1 January 2006</u>.

(b) The Tribunal's Conclusion

718. The Tribunal has considered carefully the written reports of the parties' experts as well as their oral evidence. The Tribunal has also considered the parties' submissions regarding the risked reserves of Block 15. As noted earlier, this is the most significant

component in the application of the DCF model in the present case. In reaching its conclusion on the volume and production profile of Block 15, the Tribunal has made the following findings.

719. From the outset, the Tribunal observes that NSAI's estimate of reserves in its 17 September 2007 Report in the form of a production forecast is standard in the industry. The Claimants, in order to create a risked production profile, applied the standard risking percentages used by the company and its affiliates in their ordinary course of business around the world.

720. The Tribunal is well aware that the Respondent, relying on the two reports of its expert, RPS Scotia, has represented that there were "numerous deficiencies in the production profile advanced by Claimants"[131] and that their production profile was "simply not achievable."[132]

721. However, the Tribunal recalls that RPS Scotia's Rebuttal Expert Report of September 2009 was seriously challenged by the Claimants. In the view of the Tribunal, the strongest point made by the Claimants' expert, NSAI, in its Supplemental Report is that the Petroamazonas' reserve estimates of June 2009 carried out by RPS Scotia very much confirm the NSAI estimates initially put forward by the Claimants.

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[131] See footnote 1, item (1), in the Respondent's Annotated Damages Tables of 20 February 2010.

[132] *Ibid.*

722. The Tribunal agrees with the Claimants. However, as will be seen later, these reserve estimates, in the opinion of the Tribunal, must be adjusted because the Claimants' damages model rests on some production plans which were not approved and assumptions which were not realistic.

723. In criticising Mr. Johnston's use of the RPS Scotia production profile, Professor Kalt stated:

> **Johnston Approach**: As shown in Table 2, Mr. Johnston's use of the RPS Scotia production profile is the largest source of difference between his and my NPV determinations. This highlights the importance of assuring that the underlying reserve estimates used for the purposes of a DCF analysis are reasonable and supported by available data.
>
> The RPS Scotia estimate of gross risked reserves, relied upon by Mr. Johnston, however, is only 131 mmbbl. This 131 mmbbl figure is dwarfed by the aforementioned risked reserves figure of 294.3 mmbbl (as of December 31, 2006) which Ecuador reported itself as operator of Block 15 in PetroEcuador's 2007-2011 Five Year Plan. <u>Thus, Ecuador's own reserves estimates are approximately two and a quarter times the level proffered by RPS Scotia and used by Mr. Johnston in his testimony here on behalf of Ecuador.</u> This disconnect in the estimates of underlying reserves undermines the reliability of the RPS Scotia/Johnston results.
>
> The low risked-reserve estimates used by Mr. Johnston are the product of RPS Scotia's reserves estimation methodology and its application to those reserves of reserve adjustment factors ("RAFs") taken directly from the aforementioned SPEE survey. These survey results represent, at best, general rules of thumb. They differ substantially from the risk factors actually used by Block 15 operators.[133] (Emphasis added; footnotes omitted)

724. The RPS Scotia June 2009 Reserves Certification obtained by the Claimants during the discovery phase of the arbitration obviously presented the Respondent with a

[133] Rebuttal Expert Report of Joseph P. Kalt dated 12 June 2009 at paragraphs 62-64. The Tribunal finds Professor Kalt's criticism very sound.

dilemma. The Respondent chose not to challenge the accuracy of these estimates. Rather, it took the legal position that it is impermissible for a party to refer to post-valuation evidence.

725. In this connection, the Tribunal notes that RPS Scotia, in its September 2009 Rebuttal Expert Report submitted on behalf of the Respondent, referred to and relied upon its June 2009 Reserves Certification Report to Petroamazonas. It said:

> Finally, as developed in Section 5 of this report, RPS Scotia was retained by Petroamazonas in December 2008 to conduct a six-month detailed reserves certification study of Block 15, separate and apart from RPS Scotia's involvement in this arbitration proceeding. The cost of the study was $1.3 million and a final report was provided to Petroamazonas in July 2009. The results of that study have been incorporated into this report and are presented in Section 5.0 of this report. […][134]

726. The Claimants submit that it is permissible, as the Respondent's expert has done, to utilize post-valuation date data to verify or otherwise check assumptions made in the DCF model. The Tribunal agrees. The tribunal in the *Starrett Housing* award opined that the tribunal appointed-expert could rely on events subsequent to the date of expropriation to test his assumptions as long as those assumptions were reasonably foreseeable on the date of valuation.[135] This is precisely what the Claimants' expert did in the present case.

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[134] Rebuttal Expert Report of RPS Scotia dated September 2009 at paragraph 50.

[135] *Starrett Housing Corporation* et al*. v. The Islamic Republic of Iran*, Award of 14 August 1987, reprinted in 4 Iran-US C.T.R. 112 at pages 123-124.

727. In the circumstances, the Tribunal accepts, subject to the two adjustments hereinafter explained, that the risked reserve estimates of the Claimants, as of 1 January 2006, were approximately 240 million barrels of oil. The risked reserve estimates of the Claimants, when adjusted for production that occurred from 1 January to 15 May 2006, yield total risked reserves of 227 million barrels of oil as of 16 May 2006.[136]

728. As foreshadowed earlier, there remain two important areas of dispute between the parties which, in the opinion of the Tribunal, are pertinent to its determination of the Claimants' reserve estimates as of the date of the *Caducidad* Decree.

729. Firstly, the Respondent contends that some reserves in the fields of Edén-Yuturi, Paka Sur, Paka Norte and Limoncocha should be eliminated because, although they were submitted by OEPC to the DNH for approval on 1 December 2005 in its Second Amended Development Plan, approval had not yet been granted on the date of the *Caducidad* Decree. These reserves, says the Respondent, total 33.7 million barrels that should have been classified as "probable," and not as "proved."

730. The Claimants acknowledge that the development of these fields had not been approved by the DNH as of the date of the *Caducidad* Decree,[137] but they maintain that this was due to the fact that in the months prior to *caducidad*, the DNH approval process slowed down considerably. They also submit that the Edén-Yuturi Development Plan

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[136] See, in this regard, the Joint Expert Report at paragraphs 9-10. See also the Supplemental Joint Expert Report at paragraph 12.

[137] See NSAI Expert Report dated 17 September 2007 at page 3, note (1).

was actually approved by the DNH in March 2007 when it was presented by Petroamazonas on the basis of OEPC's own operator studies.

731. In order to decide this issue, the Tribunal recalls that "proved" reserves are those which, by analysis of geologic and engineering data, can be estimated with reasonable certainty to be commercially recoverable from known reserves. The development of the wells at issue in Ecuador was undisputedly subject to approval by the DNH. The fact is that this plan was not approved by the time the *Caducidad* Decree was issued. Thus, a willing buyer could not have started drilling these wells the day after the *Caducidad* Decree.

732. The Tribunal is not satisfied, on the basis of the record, that the failure of the DNH to approve the work programmes and budgets related to the plan at issue was influenced by the strained relationship between OEPC and Ecuador at that time.

733. In the circumstances, the Claimants' production profile will accordingly be reduced to account for the barrels of the oil reserves in the Edén-Yuturi, Paka Sur, Paka Norte and Limoncocha fields which should have been classified as "probable" rather than "proved."[138] As a corollary of this adjustment, the Tribunal will be required to consider the impact of this reduction in connection with the Claimants' forecast of operating expenses.[139]

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[138] See, in this regard, the Joint Expert Report at paragraphs 11-12. See also the Supplemental Joint Expert Report at paragraphs 8-10 and the Second Supplemental Joint Expert Report at paragraphs 11-13.

[139] See, in this regard, the Joint Expert Report at paragraphs 17 and following.

734. Lastly, the Respondent contends that the Claimants' production profile should also be adjusted to reflect the release by OEPC of two rigs prior to the *Caducidad* Decree.[140]

735. The Claimants reply that "[they] are entitled to assume that Block 15 drilling would have taken place <u>as if</u> there had been two rigs on the block on May 16, 2006." (Emphasis added)

736. The decision by the Claimants to release two drilling rigs and withdraw their Development Plan in April 2006 because of the enactment of Law 42 may have been driven by valid economic considerations, but a reliable DCF calculation cannot rest on "as if" assumptions. In the words of the Claimants' expert himself, Professor Kalt, the inputs used as the basis for a DCF analysis cannot be based on speculation or wishful thinking.[141]

737. In the circumstances, the Claimants' production profile will be further reduced to account for the "impact of delaying" caused by the lack of drill rig availability that a willing buyer would have encountered the day after the *Caducidad* Decree due to the absence of two drilling rigs.[142] Again, the Tribunal will also be required to consider the

[140] The Tribunal notes that NSAI's estimate of the number of wells for drilling from May to December 2006 was based on OEPC's drilling schedule during the previous two years.

[141] Rebuttal Expert Report of Joseph P. Kalt dated 12 June 2009 at paragraph 53.

[142] <u>See</u>, in this regard, the Joint Expert Report at paragraphs 13-15, in particular footnote 2. <u>See also</u> the Supplemental Joint Expert Report at paragraphs 22-29 and the Second Supplemental Joint Expert Report at paragraphs 5-6.

impact of this reduction in connection with the Claimants' forecast of operating expenses.[143]

738. In summary, and after factoring into the DCF model the two adjustments set out above, the Tribunal concludes that the Claimants have otherwise met their burden of proof with respect to their production profile as of the date of the *Caducidad* Decree. The Block 15 risked reserves on 16 May 2006 total 208.9 million barrels of oil as calculated by the parties' experts, Professor Kalt and Mr. Johnston, following instructions from the Tribunal.[144]

5. Reserve Adjustment Factors ("RAFs")

739. When reserves are estimated, it is standard practice in the oil industry business to adjust them according to their category in order to estimate future productions. Such estimates are used in the actual planning and operation of oil extraction, as well as for financial reporting purposes including future profit forecasts.

740. The Claimants point out that the Respondent's expert witness on this issue, Mr. Wiggins, agreed with Professor Kalt that, in a fair market valuation, the hypothetical willing seller's ordinary course of business assessment of its reserve adjustment factors and other parameters should be used.

[143] See, in this regard, the Joint Expert Report at paragraphs 17 and following.

[144] See, in this regard, the Joint Expert Report at paragraphs 9 and 16 and the Supplemental Joint Expert Report at paragraph 12.

741. In the words of Professor Kalt:

> I note, however, that it is appropriate to use RAFs developed in the normal course of business of operating and evaluating particular assets. In this case, I have adopted the risking factors of 100% for proved, 50% for probable, and 25% for possible reserves, as developed in the course of business by OEPC.[145]

742. Mr. Wiggins gave evidence to the same effect:

> Q: […] So now looking at the willing buyer side of the equation, a willing buyer would look at the operating history of the fields. Isn't that right? The willing buyer would look at the production history of the fields, the reserves, that it is buying. Isn't that right.
>
> A: Yes.[146]

743. The Tribunal notes Professor Kalt's conclusion:

> […] In this case I have adopted the risking factors of 100% for proved, 50% for probable, and 25% for possible reserves, as developed in the course of business by OEPC. I note that these RAFs are conservative from the perspective of the risking factors used by Ecuador itself as operator of Block 15 in the post-termination period. For example in the 2007-2011 Five Year Plan, Ecuador adopts risking factors of 100%, 75% and 50%, respectively. I summarize these factors in Table 4 below:

Table 4

Reserve Adjustment Factors

Category	**OEPC**	**Ecuador**	**RPS Scotia**
Proved	100%	100%	56-100%
Probable	50%	75%	0-38%
Possible	25%	50%	0-25%

[145] Rebuttal Expert Report of Joseph P. Kalt dated 12 June 2009 at paragraph 65.

[146] Hearing Transcript (7 November 2009) at page 142.

744. The question for the Tribunal is whether to adopt the RAFs of Professor Kalt, which, as he notes, are more conservative than those actually used by Ecuador, or take the RPS Scotia's RAFs, which are based on a composite of figures taken from surveys conducted by the Society of Petroleum Evaluation Engineers ("SPEE") and selected industry overviews by the investment banks Donaldson, Lufkin, and Jenrette ("DLJ") and Credit Suisse First Boston ("Credit Suisse"). It appears to the Tribunal that RPS Scotia's resulting RAFs are inconsistent with the normal course of business RAFs employed in relation to Block 15 by OEPC and Ecuador as shown in Professor Kalt's Table 4.

745. The Tribunal is of the view that the Claimants have established that their consistent operational approach to RAFs is reasonable.

746. The RPS Scotia approach was compiled from a number of sources including RAFs taken from the SPEE survey, the results of which, as Professor Kalt pointed out, "represent, at best, general rules of thumb [and] differ substantially from the risk factors actually used by Block 15 operators".[147]

747. Professor Kalt pointed out in his criticism of the RPS Scotia RAFs that the DLJ and Credit Suisse estimates were dated from 1999 and 2001 respectively, and that the

[147] Rebuttal Expert Report of Joseph P. Kalt dated 12 June 2009 at paragraph 64.

lack of information regarding the sources of the DLJ and CSFB data as well as their vintage made it difficult to evaluate their applicability in the present context.[148]

748. The Tribunal agrees with Professor Kalt. It makes eminent good business and legal sense to use OEPC's RAFs. The Tribunal will therefore use the following reserve adjustment factors in its calculation of the fair market value of Block 15:

- 100% for proved reserves
- 50% for probable reserves
- 25% for possible reserves

749. The Tribunal recalls that, pursuant to its Procedural Order No. 9, the parties' experts were instructed to use these reserve adjustment factors for the purpose of estimating the fair market value of Block 15.

6. Oil Price Projections

750. If the DCF analysis is to serve its purpose, the other parameters used in the model, such as the projected price of oil, must be based on objective and reliable data.

751. Once the revenue generated by OEPC's share of Block 15 production has been calculated, the DCF method requires that the forecasted production stream be multiplied by the realized price of the oil produced. In the present case, this means using a forecast

[148] Rebuttal Expert Report of Joseph P. Kalt dated 12 June 2009 at paragraph 67.

of Block 15 crude oil prices based on market conditions existing at the time of the termination of the Participation Contract, *i.e.* 15 May 2006.

752. The Tribunal notes that the Claimants' expert, Professor Kalt, has used, to effect his calculation, the NYMEX-based WTI (West Texas Intermediate) prices. This approach, he says, is "common, reliable and conservative" and is recognized "as the most reliable basis for projecting prices of crude oil."[149]

753. The Tribunal notes that the Respondent's expert, Mr. Johnston, on the other hand, also uses NYMEX futures pricing which he combines with an average of price forecasts published by SPEE. Mr. Johnston gives NYMEX a 60% weight and the SPEE figures a 40% weight.[150]

754. Having considered the experts' and the parties' written and oral submissions, the Tribunal, for the reasons which follow, has reached the conclusion that Professor Kalt's NYMEX futures price "strip" method offers the proper and methodologically sound assessment of actual market expectations and is to be preferred over Mr. Johnston's weighted NYMEX and SPEE approach.

755. The Tribunal considers that Mr. Johnston's approach provides an unreliable basis for determining value, principally because it evidently entails a form of double-counting. As Professor Kalt says:

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[149] Expert Report of Joseph P. Kalt dated 17 September 2007 at paragraph 63.

[150] Expert Report of Daniel Johnston dated 9 March 2009 at paragraph 52.

> The double-counting effect arises because, if futures marketplace participants rely on SPEE figures in forming their expectations regarding future oil prices, those expectations have already been factored into the actual prices yielded in NYMEX trading.[151]

756. The Tribunal further notes that, SPEE itself, in its 2006 Survey, explicitly warns against use of its data for the very purpose for which Mr. Johnston uses it. It writes:

> The SPEE does not endorse the use of the Survey results, either in whole or in part, as a valuation guideline. Neither the Survey nor its contents are intended to dictate Fair Market Value parameters.[152]

757. Finally, the Respondent's assertion that NYMEX prices are not used for actual transactions does not seem well-founded. The U.S. Federal Department of the Interior, for instance, observes that the use of NYMEX in its royalty contracts has several advantages, including the fact that the volume of transactions and the number of participants is so large that, in theory, no one entity could manipulate the resultant price.

758. The Tribunal will therefore use the future NYMEX based-WTI prices as the basis for its forecast of crude oil prices from May 2006 in the calculation of the fair market value of Block 15.[153] The Tribunal recalls that, pursuant to its Procedural Order No. 9, the parties' experts were instructed to use these prices for the purpose of estimating the fair market value of Block 15.

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[151] Rebuttal Expert Report of Joseph P. Kalt dated 12 June 2009 at paragraph 79.

[152] See SPEE 2006 Survey at page 3, as quoted in Rebuttal Expert Report of Joseph P. Kalt dated 12 June 2009 at paragraph 82.

[153] See Expert Report of Joseph P. Kalt dated 17 September 2007 at paragraph 62, as well as Exhibit 1 at page 10.

7. Discount Rate

759. The DCF analysis requires that future cash flows be converted to current dollar cash flows using an appropriate discount rate.

760. The Tribunal notes that the parties' experts, Professor Kalt and Mr. Johnston, disagreed initially on the proper discount rate to be applied in the instant case given the risk characteristics and the time profile of the Block 15 project. Professor Kalt, in his initial expert report, used a rate of 9.18%, which represents the WACC of OEPC's parent, OPC, in its worldwide operations. Mr. Johnston adopted a 15% discount rate.

761. At the end of the day, after having exchanged briefs and rebuttal expert reports, the Claimants, in their Skeleton Submission, wrote that they were prepared to accept "that the Tribunal may reasonably use either the 10% discount rate that Petroecuador has used or the 12% rate that both parties have used".

762. In fact, the Tribunal notes that Petroamazonas, in both its 2007-2011 and 2008-2012 Five Year Plans filed with the Ecuadorian *Ministerio de Minas y Petróleos*, used a discount rate of 12% which, it stated, reflected the financial, country and industry risks.[154]

763. The Tribunal sees no point in debating the matter further since, in its view, it also considers that a 12% discount rate is appropriate in the circumstances.

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[154] RPS Scotia also used a 12% discount rate when it calculated the value of reserves cash flows in its estimate of reserves for Petroamazonas.

764. Therefore, the Tribunal will use a discount rate of 12% in its determination of the fair market value of Block 15. The Tribunal recalls that, pursuant to its Procedural Order No. 9, the parties' experts were instructed to use a discount rate of 12% for the purpose of estimating the fair market value of Block 15.

8. Operating (OPEX) and Capital (CAPEX) Expenditure Forecasts

765. The differences between the parties regarding operational and capital expenditures are summarized below.

766. As to OPEX, the Claimants have based their forecasts through 2019 on their actual 2005 expenditures.

767. The Respondent, on the other hand, has used the first four and a half months of OPEX in 2006 to forecast operational expenditures through the life of the Participation Contract.

768. The Claimants maintain that the Respondent's approach creates "a forecast in which costs are significantly and unwarrantedly high year after year" since "[t]hat portion was, on a monthly basis, higher than the remainder of expenses which were scheduled to be incurred between May 16, 2006 and year-end".

769. The Respondent criticizes the Claimants' approach since, it says, "OEPC's 2005 costs […] are lower and inflate Claimants' DCF valuation".

770. Neither approach of the parties finds favour with the Tribunal. While the Tribunal agrees with the Respondent that OEPC's most recent operating costs are the best

evidence of its likely costs going forward, it is of the view that a period of 4½ months is too short to provide a reliable forecast. Twelve months of operations would be more reliable.[155]

771. The Tribunal will therefore use the twelve months of OEPC's operating costs incurred directly prior to the *Caducidad* Decree, *i.e*. May 2005 to May 2006, as a reference period to forecast operational expenditures. As noted above[156], it will be necessary to adjust the calculation of these expenditures on account of expenses directly related to those reserves which have been subtracted from the Claimants' production profile.

772. The parties' experts, at the request of the Tribunal pursuant to its Procedural Order No. 9, considered this reference period and opined jointly that, on that basis, the operating costs used in the DCF analysis to forecast the Claimants' operational expenditures should be approximately $151 million.[157]

773. As to CAPEX, the parties disagree only as to whether they should be risked.

774. The Claimants maintain that capital expenditures are properly risked in a DCF analysis, whereas the Respondent argues that all projects should be accounted for on a "fully funded" basis.

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[155] See D.I. Heather and G.B. Wiggins, "How to Bid Successfully in a Changed Marketplace" in Oil & Gas Journal (2001), reprinted by LexisNexis at page 3.

[156] See *supra* at paragraphs 733 and 737.

[157] See paragraph 21 and Table 1 on page 6 of the Supplemental Joint Expert Report; see also paragraphs 8-10 of the Second Supplemental Joint Expert Report.

775. The Claimants maintain that, like other oil and gas companies, they risk their capital in the course of their business planning and evaluation. Referring to their many years of experience in developing Block 15, the Claimants only included a portion of the CAPEX ($243 million) in their DCF model.[158]

776. The Respondent, while it recognizes that an oil field operator "might risk capital expenses in the ordinary course of business," says "[this] is not true in a DCF analysis, which by necessity is frozen in time." The Respondent concludes: "Having claimed credit for [this] production, the parties must also accept all of the capital costs required to fund it."

777. Having reviewed the evidence on this issue, the Tribunal has decided to give more weight to the Claimants' approach based as it is on their many years of Block 15 operations. The Tribunal agrees with the Claimants that, in a dynamic business such as oil exploration, all projects cannot be accounted for on a fully-funded basis. Some of their capital costs must be risked and the Tribunal finds that the use of a portion of the CAPEX in the DCF model is appropriate.

778. As to the appropriate figure of capital costs which should be used by the Tribunal in its DCF analysis, the Tribunal accepts the joint conclusion of the parties' experts that, in addition to the costs of $243 million[159] which represent drilling-related capital costs

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[158] According to the experts, these capital costs represent drilling-related capital costs only (see Joint Expert Report at paragraph 22).

[159] Adjusted by the experts to take account of certain delays in drilling and reclassification of reserves (see Joint Expert Report at paragraph 21).

only, the facilities-related capital costs associated with the base production profile of 240 million barrels, to wit $203 million, should also be incorporated in its cash flow analysis.[160]

9. Use of Comparable Sales

779. The Tribunal recalls that it has formed the view that the discounted cash flow method is the most widely used and generally accepted method in the oil and gas industry for valuing sales or acquisitions.

780. The Respondent submits that the examination of comparable sales is also critical "because it allows the evaluator to test the reasonableness of the DCF assumptions against market conditions."

781. The Claimants maintain that it is inappropriate to use a comparable sales analysis in this case. They write: "Each oil and gas property presents a unique set of value parameters: size, quality of oil, type of contractual relationship, environmental or remedial obligations." There is also the difference in oil prices which, the Claimants submit, can make the comparable unreliable.

[160] See Joint Expert Report at paragraph 22. The Tribunal has noted that Mr. Daniel Johnston, in an Appendix to the Second Supplemental Joint Expert Report, questions OEPC's risking methodology which, he concludes, "understates drilling costs, potentially overstates reserves and certainly overstates fair market value" (at page 13). The Tribunal notes however that at the Hearing on 30 June 2011, Mr. Johnston acknowledged that had an alternative approach been adopted in this regard, it would not have yielded anything beyond a "fairly modest" difference (see Hearing Transcript of 30 June 2011at pages 54-55)

782. The Tribunal notes that the Respondent's expert, Mr. Daniel Johnston, in his own publication, acknowledges the difficulty in finding truly comparable situations.[161] SPEE also recommends caution with the use of alternate methods of valuation.[162]

783. The Tribunal has reviewed the parties' competing submissions in respect of this issue. The Tribunal finds very convincing Professor Kalt's demonstration that the comparable sales approach of the Respondent's expert, RPS Scotia, is unreliable in this case.[163]

784. The Respondent submits that the EnCana sale "as of 30 August 2005" to Andes of its shares in AEC which, as the Tribunal recalls, held a 40% economic interest in the Participation Contract, "presents a unique situation." The Tribunal agrees that this "comparable" needs to be addressed separately.

785. The Claimants disagree with the Respondent. They argue that the Supplemental Indemnity Agreement ("SIA") was a negotiated figure arrived at under the threat of *caducidad*. The Claimants also rely on Professor Kalt's Rebuttal Expert Report to buttress their submission that the EnCana sale is "an inapt choice for a comparable analysis".[164]

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[161] David Johnston and Daniel Johnston, *Introduction to Oil Company Financial Analysis* (2006, PennWell) at page 24.

[162] SPEE, *Perspectives on the Fair Market Value of Oil and Gas Interests* (2002) at page 43.

[163] Rebuttal Expert Report of Joseph P. Kalt dated 12 June 2009 at paragraphs 120-145, as well as Rebuttal Figures 5-9.

[164] Rebuttal Expert Report of Joseph P. Kalt dated 12 June 2009 at paragraphs 146-154.

786. There is no doubt that the EnCana sales contract and its Appendix 1, the SIA, was executed at a time when *caducidad* was very much under consideration by the Ecuadorian authorities, to wit 30 August 2005. In fact, the Tribunal notes the obvious reference to "*caducidad*" in the SIA as well as the following provision in the preamble to the SIA:

> Whereas, Seller and EnCana agree to indemnify Purchaser or its permitted assignee as provided for in this Agreement in the event the relevant Governmental Authorities take certain actions with respect to the Block 15 Contract.

787. Having considered the parties' arguments and the evidence of their respective witnesses and experts, the Tribunal agrees with the Claimants that "each oil and gas property presents a unique set of value parameters". Therefore, the Tribunal concludes that it can derive no assistance from an analysis of the seven transactions which the Respondent has submitted as comparable sales.

788. As for the EnCana sale, the Tribunal has decided that it is not a useful comparable and thus should not be taken into consideration in the determination of the fair market value of the Participation Contract, mainly for the following reasons: (i) the important difference in oil prices between 30 August 2005 and 15 May 2006; and (ii) the inclusion of non-Block 15 assets (Tarapoa, Block 14, Block 17 and the Sherepino Block) in the August 2005 transaction.

10. Consequential Damages

789. The Claimants allege that they have also suffered consequential damages as a result of the *Caducidad* Decree. They claim:

(i) OEPC's ship-or-pay commitments of $194 million owed to OCP S.A. under the Initial Shipper Transportation Agreement (the previously-defined "ISTA");

(ii) employee severance costs for early termination of $7 million; and

(iii) a stranded cargo, valued at $1 million, which the Claimants were forced to abandon at the time of the *Caducidad* Decree.

(a) Preliminary Issues

790. There are two preliminary issues with respect to the Claimants' claims for consequential damages. The Respondent maintains that such claims are not recoverable under international law or Ecuadorian law. The Claimants disagree. They argue firstly that the remedies for any violation of the Treaty is "by necessity" governed by international law because every treaty breach is a breach of international law.

791. The Tribunal agrees with the Claimants. Numerous tribunals have so held.[165]

792. The availability of consequential loss in international law is uncontroversial. The starting point is the principle of "full reparation", expressed by the Permanent Court of International Justice in the *Chorzów Factory* case as follows:

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[165] See, *e.g.*, *Siemens A.G. v. The Argentine Republic* (ICSID Case No. ARB/02/8), Award of 6 February 2007 at paragraph 352; *Watkins-Johnson v. The Islamic Republic of Iran*, Award of 27 July 1989, reprinted in Iran-U.S. C.T.R., volume 22 (1990) 218 at paragraphs 114-117; *Uiterwyk v. The Islamic Republic of Iran*, Partial Award of 6 July 1988, reprinted in 19 Iran-U.S. C.T.R. 107 at paragraph 117.

> [R]eparation must, so far as possible, wipe out all the consequences of the illegal act and reestablish the situation which would, in all probability, have existed if that act had not been committed.[166]

793. This principle is now also embodied in Article 31 of the International Law Commission's Articles on Responsibility of States for Internationally Wrongful Acts which, as previously observed, states:

> *Article 31. Reparation*
>
> 1. The responsible State is under an obligation to make full reparation for the injury caused by the internationally wrongful act.
>
> 2. Injury includes any damage, whether material or moral, caused by the internationally wrongful act of a State.

794. Marboe states simply:

> According to the principle of full reparation […] consequential damage must […] be taken into account.[167]

795. As to the standard of causation, Marboe concludes that the "direct/indirect" dichotomy is now seen as unhelpful in international law, and instead "[i]nternational practice seems so far to have relied on two main criteria: 'causality' and 'provability'".[168]

796. Marboe categorizes "liability to subcontractors," for instance, as an "accepted" head of consequential loss in international law, subject to the caveat that the quantum of

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[166] *Case concerning the Factory at Chorzów* (Claim for Indemnity) (Merits), P.C.I.J. Series A, No. 17 (Judgement of 13 September 1928) at page 47.

[167] Irmgard Marboe, *Calculation of Compensation and Damages in International Investment Law* (Oxford University Press, 2009) at paragraph 5.394; see also *ibid.* at paragraph 7.16.

[168] *Ibid.* at paragraphs 5.395-5.397.

such liability must be proved with sufficient certainty.[169] In this connection, Marboe notably refers to the previously-cited ICSID case of *Siemens A.G. v. The Argentine Republic*, in which the "potential liability" of the plaintiff to subcontractors (that is, liability under claims that might be made in the future) was the subject of an award.

797. Therefore, the Tribunal accepts the submission of the Claimants that, in principle, consequential damage is a valid head of loss in international law. In this regard, the Tribunal recalls that even the Respondent, in its written submissions, conceded that "consequential damages are compensable under international law under certain circumstances."

798. Furthermore, the Claimants argue that, even if Ecuadorian law applied, they would be entitled to consequential damages. The Respondent, however, contends that consequential damages are by definition "indirect" damages and hence unrecoverable under Ecuadorian law. In the words of the Respondent's expert, Dr. Alfredo Corral Borrero, under Ecuadorian law, "the debtor has no indemnification obligations for *mediate* or *indirect* damages that might have been caused to the creditor." (Emphasis in original) But the Tribunal also notes that the Claimants' expert on this issue, Dr. Pérez Loose, explained that, under Ecuadorian law, compensation must "retur[n] the obligee to the economic situation he should have been in were it not for the act attributable to the liable party." It is thus clear that Ecuadorian law does not bar the recovery of consequential damages in a situation such as that which obtains in the present case.

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[169] *Ibid*. at paragraphs 5.404-5.407.

(b) The Claimants' Position

(i) Ship-or-Pay damages

799. As mentioned earlier in this Award[170], in order to transport production from various fields in eastern Ecuador, including from Block 15, to the port of Balao, Ecuador contracted with a consortium of companies to build and operate the OCP pipeline.

800. To finance the construction and continued operation of the pipeline, OCP S.A. entered into a number of transportation contracts with individual shippers (the previously-defined "ISTAs"), including with OEPC.

801. The ISTAs provide that, for a certain period, the shippers pay a monthly tariff rate sufficient to cover the costs of the pipeline. In addition, the ISTAs contain a provision known as a "ship-or-pay" requirement whereby a shipper is responsible for paying tariffs based on a certain minimum level of throughput even if the shipper's actual production is insufficient to meet this minimum level.

802. From the date of the *Caducidad* Decree and the resulting termination of the Block 15 Participation Contract, OEPC continues to bear the contractual obligation to pay tariffs pursuant to the ship-or-pay requirement under its ISTA with OCP S.A.

803. The Claimants claim damages from the Respondent in respect of a portion of these tariffs. That portion is the difference between (i) tariffs for oil that OEPC cannot ship because of the Respondent's breach (*i.e.* the full extent of OEPC's ship-or-pay

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[170] <u>See</u> *supra* at paragraph 143.

commitment, because it can ship *no* oil); and (ii) tariffs for oil that OEPC could not have shipped in any event (*i.e.* because of its inevitable non-use of some capacity due to Block 15 production levels falling short of its total ship-or-pay commitment).

(ii) Employee Termination Costs

804. As a direct result of the *Caducidad* Decree, say the Claimants, they had to pay approximately $7 million in employee severance costs for early termination of the Participation Contract.

805. While the Claimants acknowledge that they would have had to pay some of these costs at the conclusion of the Participation Contract in 2019, they state that "it is Ecuador's burden to demonstrate how much of the $7M claimed should be reduced."

(iii) Value of a Stranded Cargo

806. According to the Claimants, at the time of the *Caducidad* Decree, OEPC had a "cargo at the port of Esmeralda which it was forced to abandon". They aver that by the terms of the *Caducidad* Decree, the title to all of OEPC's assets in Ecuador passed to the Respondent, including this stranded cargo which they value at $1 million.

(c) The Respondent's Position

(i) Ship-or-Pay Damages

807. The Respondent submits that the Claimants' claim for this head of damages should be dismissed on the following five grounds:

> *First,* Claimants' claim fails for lack of causation. The Ship-or-Pay expenses were based, required, and caused by Claimants' own obligations towards OCP S.A., not by the *Caducidad* Decree. As explained in prior submissions, claims for payments made in fulfillment of contractual obligations that are *res inter alios*

acta with respect to the respondent State are commonly rejected by international tribunals on grounds of lack of causation and/or remoteness.

Second, it remains undisputed that (*i*) to be compensable, damages have to be foreseeable, and (*ii*) the Ship-or-Pay costs were not foreseeable at the time the Participation Contract was executed in May 1999. As Mr. Rivkin reminded the Tribunal at the damages hearing, "*the OCP pipeline was constructed in 2001-03*," *i.e.*, more than two years after the Participation Contract. In 1999, the OCP pipeline project did not even exist, nor had any contracts related to the OCP been entered into.

Ecuador already noted in its Rejoinder on Quantum that "Claimants have remained silent" on the issue of foreseeability of their Ship-or-Pay damages. Claimants' continued silence is an implicit recognition that their claims fails for lack of foreseeability.

Third, Claimants do not dispute that they had a duty to mitigate their Ship-or-Pay costs. They have remained silent, however, as to their wilful assumption of risk in relation to the Ship-or-Pay costs. Ecuador pointed out numerous times that despite contemplating in the OCP contract the risks of "Upstream Expropriatory Action" and "Equity Expropriatory Event," Claimants failed to secure a contractual provision allowing termination of the OCP contract, or the suspension of tariff payments, in the event of *caducidad*. Consistent with international law, this Tribunal should not protect Claimants against willingly taken investment risks.

Fourth, Claimants are still at a loss to satisfy their burden of proof. In particular, Claimants do not dispute the inherently speculative nature of their claim. Nothing prevents Claimants from finding someone else to take over their shipping commitment. In fact, Claimants' shipping contract expressly allowed them to assign their Ship-or-Pay rights. Were Claimants to prevail on this claim and, thereafter, sell their OCP capacity, they would be unjustly enriched.

Finally, Claimants have inflated their Ship-or-Pay claim by (*i*) estimating their costs on the basis of an incorrect assumption of reserves; and (*ii*) failed to take into account OEPC's release of rigs immediately prior to *caducidad*, which would have diminished Block 15's production and its ability to allocate oil towards its OCP capacity even if *caducidad* had not been declared. (Emphasis in original)

(ii) Employee Termination Costs

808. The Respondent avers, principally, that OEPC would have had to pay employee termination costs, in any event, at the conclusion of the Participation Contract in 2019 and that, therefore, such costs were not caused by the *Caducidad* Decree. In other words,

such costs would have been incurred in the normal course of business at the expiration of the Participation Contract's contractual term.

809. In addition, says the Respondent, employee termination costs are part of the operational costs (OPEX) for the last year of contract performance and accordingly should have been included in the Claimants' DCF analysis. The Claimants have failed to factor in these costs which would have reduced the value a willing buyer would have paid for Block 15 as of May 2006.

810. Finally, the Respondent argues that, by seeking to shift to it the burden of proof as to how much of the $7 million claimed "would have had to be paid and when," the Claimants have recognized that they have not been able to meet their burden of proof.

(iii) Value of a Stranded Cargo

811. According to the Respondent, the Claimants were not obliged to abandon any cargo as a result of the *Caducidad* Decree. The Claimants, the Respondent says, have failed to satisfy their burden of proof. They have not adduced any evidence, the Respondent maintains, of the existence of the cargo or its value.

(d) The Tribunal's Conclusions

(i) Ship-or-Pay Damages

812. At the outset, the Tribunal notes that, quite properly, the Claimants have included their ship-or-pay payments as costs in their DCF model since, had there been no *Caducidad* Decree, they would have made those payments to OCP S.A. in order to ship the oil produced in Block 15.

813. In addition to arguing that consequential damages are not recoverable under international law nor under Ecuadorian law, arguments which the Tribunal disposed of earlier, the Respondent raises several defenses to this claim:

> (i) there was a lack of causation, because the ship-or-pay losses were caused by the Claimants' obligations to third parties;
>
> (ii) the losses were not foreseeable;
>
> (iii) the Claimants' quantification of these losses is wrong, because it is based on incorrect assumptions of reserves and a failure to account for the two missing rigs;
>
> (iv) the Claimants have failed to mitigate these losses;
>
> (v) the Claimants were contributorially negligent in failing to negotiate terms with the other OCP parties that would protect them from *caducidad* or similar events; and
>
> (vi) finally, these losses are speculative, because the Claimants can still assign OEPC's ship-or-pay rights, and if they did so a damages award would leave them unjustly enriched.

814. After having considered carefully the parties' written and oral arguments in respect of these several defenses, the Tribunal has come to the conclusion that the Claimants' claim for "ship-or-pay" damages fails principally on account of the Respondent's defenses iii) and vi) set out in the previous paragraph. Put simply, the Tribunal concludes that the Claimants have failed to discharge their burden of proof.

815. The Claimants have admitted that their release, prior to the *Caducidad* Decree, of two drilling rigs in Block 15 impacted negatively their production of oil. Yet, they failed to take account of the impact on production of these released rigs in the calculation of their ship-or-pay damages.

816. The Tribunal has ruled earlier in this Award that the absence of these two rigs necessitated an adjustment to OEPC's production profile. To be logical, the absence of these two rigs also requires an adjustment by the Tribunal to the quantification of post-*caducidad* ship-or-pay losses. The evidence in the record as to the precise level of that adjustment is, to say the least, unclear. The Claimants have failed to meet their burden of proof and left the Tribunal to speculate as to the calculation of the necessary adjustment. This the Tribunal will not do.

817. The Claimants have also failed to satisfy their burden of proof when they were met by the Respondent's argument that, since the ISTA with OCP S.A. allowed them to assign the ship-or-pay rights, the Claimants would be unjustly enriched if, after having prevailed on this claim, they were able to sell some or all of their OCP capacity.

818. While there is a possibility that the Claimants may not be able to assign any of their OCP capacity in the future[171], the Tribunal cannot rule out the possibility that other oil producers who have also contracted with OCP will, in the future, until 2019, use the Claimants' capacity in the OCP pipeline.

819. This leads the Tribunal to conclude that the Claimants' claim for ship-or-pay damages is inherently speculative. There is no satisfactory evidence in the record which allows the Tribunal to value the possibility of an assignment in the future. The Tribunal therefore finds that the Claimants' claim for ship-or-pay damages fails for lack of proof and their claim for $194 million is accordingly denied.

[171] Except to the extent of $6.1 million which they have already deducted from their claim.

(ii) Employee Termination Costs

820. The Tribunal agrees with the Respondent that the employee termination costs payable in 2019 cannot be attributed to the *Caducidad* Decree. The Tribunal also agrees that the Claimants should have included in their DCF analysis, as part of their operational costs (OPEX) for the last year of the Participation Contract, these employee termination costs.

821. By factoring in these costs and using Professor Kalt's economic model, "the FMV impact of Termination Costs in 2019 would be $7.6 M." These costs will thus be incorporated into the Tribunal's DCF analysis.[172]

(iii) Value of a Stranded Cargo

822. The Tribunal has noted Mr. Ellis' statement that OEPC "had to abandon" a cargo which reverted to the Respondent upon the *Caducidad* Decree. However, the Claimants have been unable to refer to any contractual provision under the Participation Contract to support Mr. Ellis' statement.

823. In addition, the Claimants' claim also fails for lack of sufficient and satisfactory evidence as to both the existence and the value of the cargo. The Claimants' claim of $1 million is therefore denied.

[172] See Joint Expert Report at paragraph 23.

11. Calculation of Damages

824. Using the economic model agreed by Professor Kalt and Mr. Johnston, the Tribunal, informed by all the findings that it has made in the present Section of its Award and assisted by Professor Kalt and Mr. Johnston's agreed calculations, determines that the Net Present Value of the discounted cash flows generated by the Block 15 OEPC production as of 16 May 2006 is US$ 2,359,500,000 (US Two billion, three hundred fifty nine millions and five hundred thousand dollars).[173]

825. Having determined earlier that the Claimants' damages should be reduced by a factor of 25% because of their own wrongful act which contributed in a material way to the damages which they subsequently suffered when the *Caducidad* Decree was issued on 15 May 2006, the Claimants' damages for the expropriation by Ecuador of their interest in the Participation Contract amount to US$ 1,769,625,000 (US One billion, seven hundred sixty nine millions, six hundred twenty five thousand dollars)[174] which the Tribunal orders the Respondent to pay.

12. Interest

826. The Tribunal must now determine the interest to be awarded to the Claimants, *i.e.* the rate, whether simple or compound interest will be awarded, and the period during which interest will accrue.

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[173] See Table 1 provided by the parties' experts, Professor Kalt and Mr. Johnston, at the hearing on 30 June 2011.

[174] US$ 2,359,500,000 – US$ 589,875,000 (25%)= US$ 1,769,625,000

(a) The Claimants' Position

827. The starting point is to identify what the Claimants have sought with regard to interest. Their Request for Arbitration claimed an award, *inter alia*, "[d]irecting Respondents to pay Claimants interest on all sums awarded, in amounts to be determined at the hearing […]".

828. In their Memorial on Damages, the Claimants sought compound interest and indicated that Professor Kalt "used a conservative rate in calculating interest: the monthly rate paid on U.S. Government T-bills compounded on a monthly basis. As of the date of this filing that interest rate was 4.188%."

829. Professor Kalt calculated interest in his DCF model at the monthly interest rate paid on U.S Government Treasury Bills compounded on a monthly basis from the day after the expropriation date of 15 May 2006, *i.e.* 16 May 2006.[175] Claiming interest from the expropriation date accords with the normal principle usually applied in cases of expropriation, since it is from that date that the deprivation has been suffered. This principle is supported by the doctrine and the jurisprudence of international tribunals.[176]

830. In their Memorial on Damages, the Claimants requested that interest calculated on the basis above be awarded "through the date of full and effective payment" of any damages awarded by the Tribunal.

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[175] Appendix 1 and Rebuttal Witness Statement of Joseph P. Kalt dated 12 June 2009 at paragraph 11.

[176] See *e.g. Southern Pacific Properties (Middle East) v. The Arab Republic of Egypt* (ICSID Case No. ARB/84/3), Award of 20 May 1992 at paragraph 234.

(b) The Respondent's Position

831. Although the Respondent has not specifically challenged the Claimants' approach to calculating interest, reference was made by the Respondent to a recent award by an ICSID tribunal where Ecuador was also the respondent.[177] In this award, the tribunal applied Ecuadorian, not international law, noting that the "prohibition of compound interest contained in the local law must be enforced". Reference to this award was made by the Respondent in this case to support a different point, namely its submission that the Claimants' claim for consequential damages should be rejected as it cannot be awarded under Ecuadorian law. As seen earlier in this Award, this submission ultimately failed.

832. Mr. Johnston, on behalf of the Respondent, provides as follows: "Just as Claimants have accounted for interest (at 5% annually) from *caducidad* to the effective date of Dr. Kalt's rebuttal witness statement (June 12, 2009), I have calculated interest from May 16, 2006 to June 12, 2009." [178] Mr. Johnston then sets out the following table:[179]

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[177] *Duke Energy Electroquil Partners & Electroquil S.A. v. The Republic of Ecuador* (ICSID Case No. ARB/4/19), Award of 18 August 2008.

[178] Rebuttal Report of Daniel Johnston dated 8 September 2009 at page 5.

[179] *Ibid.*

Johnston Damages Valuation

(as of May 16, 2006)

Block 15 Production $MM	OCP Ship-or-Pay $MM	Termination Costs $MM	Total $MM
$1,500	**$133**	**$8**	**$1,641**

Johnston Damages Valuation

(as of June 12, 2009)

Block 15 Production $MM	OCP Ship-or-Pay $MM	Termination Costs $MM	Total $MM
$1,743	**$154**	**$9.3**	**$1,906**

833. It is not possible to calculate the precise components of Mr. Johnston's calculations but it appears from the above that he has generally followed Professor Kalt's approach, albeit by applying an annual rate of 5% as opposed to the monthly rate paid on U.S. Government T-bills.

(c) Recent Trends in Relation to Interest in ICSID Awards

(i) Simple v. Compound Interest

834. The traditional norm was to award simple interest. However, this practice has changed and, in fact, most recent awards provide for compound interest.[180] This practice accords with the *Chorzów* principle as an award of compound interest will usually reflect the actual damages suffered.[181]

835. An analysis of recent interest awards demonstrates that in 2007, all tribunals, expect one, awarded compound interest.[182] In the 2008-2009 period, six out of ten tribunals awarded compound interest.[183] Several more recent cases have also awarded compound interest.[184]

836. Of the four tribunals which awarded simple interest in the 2008-2009 period, only one case was in relation to damages awarded for expropriation, namely *Saipem S.p.A. v.*

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[180] Peter Muchlinski, Federico Ortino & Christoph Schreuer, *The Oxford Handbook of International Investment Law* (Oxford University Press, 2008) at page 1107.

[181] The situation was helpfully summarized in *Compañía de Aguas del Aconquija S.A. & Vivendi Universal S.A. v. The Argentine Republic* (ICSID Case No. ARB/97/3), Award of 20 August 2007 at paragraphs 9.2.1-9.2.8.

[182] Karl P. Sauvant, ed., *Yearbook on International Investment Law and Policy 2009-2010* (Oxford University Press, 2010) at page 156.

[183] *Ibid.*

[184] See *El Paso International Company v. Argentine Republic* (ICSID Case No. ARB/03/15) (31 October 2011) at paragraph 746; *Impregilo S.p.A v. Argentine Republic* (ICSID Case No. ARB/07/17) (21 June 2011) at paragraph 382; *Joseph Charles Lemire v. Ukraine* (ICSID Case No. ARB/06/18) (28 March 2011) at paragraphs 360-361; *Alpha Projektholding GMBH v. Ukraine* (ICSID Case No. ARB/07/16) (8 November 2010) at paragraph 514 and *Gemplus S.A. and Talsud S.A. v. The United Mexican States* (ICSID Case Nos. ARB(AF)/04/3 and ARB(AF)/04/4) (16 June 2010) at paragraphs 16-26.

The People's Republic of Bangladesh.[185] That case arose from a prior ICC award that had been declared non-existent by the courts of Bangladesh, an act which among others, the ISCID tribunal held amounted to an illegal expropriation. In the ICSID arbitration, the claimants claimed the amount awarded to it by the ICC tribunal plus interest. The claimants requested that simple interest be awarded up until the date of the expropriation (being the interest awarded in the ICC award) with compound interest to accrue from that date. However, the tribunal was not prepared to award interest going beyond that allocated by the ICC arbitrators and a simple rate was subsequently awarded for the entire interest period.

837. Simple interest was awarded in *Desert Line Projects LLC v. The Republic of Yemen*.[186] In this case, the claimant had claimed compound interest on the damages awarded at a rate of 7%. The respondent argued, *inter alia*, that compound interest could not be awarded on the basis that (i) international tribunals generally rule against the award of compound interest; (ii) the award of compound interest was contrary to Yemeni law; (iii) and the claimants had not advanced any reason for an award of compound interest.[187] The tribunal considered that the appropriate rate of interest was a simple rate of 5% per annum.[188] No reasons were provided in this regard.

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[185] ICSID Case No. ARB/05/7.

[186] ICSID Case No. ARB/05/17.

[187] Award of 6 February 2008 (ICSID) at paragraph 294.

[188] *Ibid.* at paragraph 295.

838. Simple interest was also awarded in the case *Duke Energy Electroquil Partners & Electroquil S.A. v. The Republic of Ecuador*[189] referred to earlier, where the tribunal applied the domestic Ecuadorian law to the issue of interest. In that case, the tribunal ruled that the Government breached both Ecuadorian law and the U.S.-Ecuador investment treaty. However, the damages awarded related to the breach of contract claims under Ecuadorian law only and no additional damages were awarded for the breach of international law. It was not an expropriation case. The tribunal further observes that in that case, the respondent had objected to the use of compound interest on the ground that it is prohibited under Ecuadorian law and added that, even under international law, an award of compound interest would not be in conformity with earlier decisions in investment disputes. In reliance on *Compañía del Desarrollo de Santa Elena, S.A. v. The Republic of Costa Rica*[190], in particular, as well as on *Autopista Concesionada de Venezuela, C.A. v. The Bolivarian Republic of Venezuela*[191] and *Marvin Roy Feldman Karpa v. The United Mexican States*[192], it noted that compound interest may be awarded for expropriation but not for contract claims.[193] The tribunal agreed with the respondent's argument in favour of simple interest.[194]

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[189] *Supra* note 177.

[190] ICSID Case No. ARB/96/1.

[191] ICSID Case No. ARB/00/5.

[192] ICSID Case No. ARB(AF)/99/1.

[193] Supra note177, at paragraph 432.

[194] *Ibid.* at paragraph 457.

839. The fourth award where simple interest was awarded, which is the case of *Duke Energy International Peru Investments No. 1, Limited v. The Republic of Peru*[195], was in relation to claims regarding tax stabilization where the rate stipulated by the national tax authority for tax refunds applied.

840. In summary, it may be seen that compound interest is the norm in recent expropriation cases under ICSID. The Tribunal sees no reason to depart from the norm and from the basis pleaded by both parties

(ii) Interest Rate

841. Of the six tribunals who awarded compound interest rates in 2008-2009, the majority applied the U.S. 6 month LIBOR rate though a "commercially reasonable rate" and a "reasonable rate" were also used.[196] More recent cases have either adopted a fixed percentage or a LIBOR plus margin rate.[197]

842. In the present case, the Claimants have requested the US Government Treasury bill rate which reflects a prudent, risk-free and conservative re-investment practice. As noted earlier, at the time of filing their Memorial on Damages, that interest rate was

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[195] ICSID Case No. ARB/03/28.

[196] Karl P. Sauvant, ed., *Yearbook on International Investment Law and Policy 2009-2010* (Oxford University Press, 2010) at page 156.

[197] See *El Paso International Company v. Argentine Republic* (ICSID Case No. ARB/03/15) (31 October 2011) at paragraph 745 (LIBOR plus 2%); *Impregilo S.p.A v. Argentine Republic* (ICSID Case No. ARB/07/17) (21 June 2011) at paragraph 383 (6%); *Joseph Charles Lemire v. Ukraine* (ICSID Case No. ARB/06/18) (28 March 2011) at paragraph 356 (LIBOR plus 2%); *Alpha Projektholding GMBH v. Ukraine* (ICSID Case No. ARB/07/16) (8 November 2010) at paragraph 514 (9.11%) and *Gemplus S.A. and Telsud S.A. v. The United Mexican States* (ICSID Case Nos. ARB(AF)/04/3 and ARB(AF)/04/4) (16 June 2010) at paragraphs 18-7 (2%).

4.188%. The Respondent's expert, on the other hand, has applied an annual interest rate of 5% which, at the time of filing his report, was very similar to the monthly rate paid on U.S. Government T-bills as calculated by the Claimants' expert. The Tribunal therefore considers that a 4.188% annual interest rate is reasonable in the circumstances.

(iii) Compounding Intervals

843. There are no general rules regarding the compounding intervals.[198]

844. Of the six tribunals who awarded compound interest rates in 2008-2009, two awards compounded annually and the remaining four compounded semi-annually.[199] More recent awards have also favoured annual or semi-annual compounding.[200]

845. In the present case, although monthly compounding has been used by the Claimants' expert, Professor Kalt, with no apparent objection by the Respondent's expert, Mr. Johnston, the Tribunal is of the view that granting monthly compounding would be unduly favourable to the Claimants in view of recent trends in investment arbitration. It may be argued that, given this decision, semi-annual compounding would be appropriate, as the interest rate adopted by the Tribunal is not high. However, not without hesitation, the Tribunal has decided, in its discretion, that annual compounding is appropriate, given

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[198] Irmgard Marboe, *Calculation of Compensation and Damages in International Investment Law* (Oxford University Press, 2009) at paragraphs 6.210-6.212.

[199] Karl P. Sauvant, ed., *Yearbook on International Investment Law and Policy 2009-2010* (Oxford University Press, 2010) at Table 1 "Damages" at pages 165 and following.

[200] The *El Paso* Award (ICSID Case No. ARB/03/15) compounded semi-annually, as did the *Lemire v. Ukraine* Award (ICSID Case No. ARB/06/18). *Impregilo* (ICSID Case No. ARB/07/17), *Alpha Projektholding* (ICSID Case No. ARB/07/16) and *Gemplus and Talsud* (ICSID Case Nos. ARB(AF)/04/3 and ARB(AF)/04/4) all provided for annual compounding of interest.

the large amount of the Award and the number of years that have passed since the violation.

(d) The Period during which Interest Must Accrue

846. It is undisputable that the period during which interest must accrue begins on 16 May 2006, the day after the expropriation, as in Professor Kalt's DCF calculation.

847. Furthermore, the Tribunal concludes that (as requested by the Claimants) interest should run until the date of payment of the present Award, in accordance with established practice as illustrated, for example, by the cases *Walter Bau Ag (in liquidation) v. The Kingdom of Thailand*[201], *RSM Production Corporation and others v. Grenada*[202] and *Desert Line Projects LLC v. The Republic of Yemen*.[203]

(e) The Tribunal's Conclusion

848. For all of these reasons, the Tribunal finds that the Claimants are entitled to pre-award interest at the rate of 4.188% per annum, compounded annually from 16 May 2006 until the date of the present Award. The Tribunal observes that this approach is consistent with the terms of the BIT, which expressly provides at Article III for "interest at a commercially reasonable rate from the date of expropriation."

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[201] Award of 1 July 2009 (UNCITRAL).

[202] ICSID Case No. ARB/10/6.

[203] ICSID Case No. ARB/05/17.

849. As noted above, the Claimants did not specifically distinguish between pre-award and post-award interest, requesting that interest be awarded on the basis proposed by the Claimants up to the date of full and effective payment. It is not uncommon for tribunals to distinguish between pre- and post-award interest[204] and in the present case it seems appropriate to do so, given the current LIBOR interest rates, used as a base rate by banks and other financial institutions, are very low; but, of course, the rates will fluctuate before the Award is settled. In the circumstances, and since the Tribunal cannot predict when the Respondent will settle the sums which it has been ordered to pay to the Claimants, the Tribunal considers that it would be fair to order that post-award interest should accrue in favour of the Claimants at the U.S. 6 month LIBOR rate compounded on a monthly basis.

13. Ecuadorian Taxes

850. The damages sought by the Claimants in this proceeding have been calculated by the Claimants on an after-tax basis. More particularly, the Claimants have deducted the following from their damages calculations: (i) Ecuadorian income tax, (ii) labor participation or "*utilidades*" tax, (iii) an asset-based tax, and (iv) the ECORAE tax, which is a per-barrel assessment on oil.

851. During the quantum phase of this proceeding, the Claimants have sought confirmation on the part of the Respondent that it will not seek to collect taxes on any

[204] *Emilio Agustín Maffezini v. Kingdom of Spain (*ICSID Case No. ARB/97/7) (9 November 2000) at paragraph 97; *Metalclad Corporation v. The United Mexican States* (ICSID Case No. ARB(AF)/97/1) (25 August 2000) at paragraph 131; and *ADC Affiliate Ltd. and ADC & ADMC Management Ltd. v. The Republic of Hungary* (ICSID Case No. ARB/03/16) (27 September 2006) at paragraph 522.

award that the Claimants may receive. In response, the Respondent asserts that the Claimants' request for such confirmation is irrelevant and speculative at best.

852. The Claimants accordingly submit that "the Tribunal may need to determine damages on a *pre*-tax basis." (Emphasis in original) Alternatively, the Claimants make the following request:

> If the Tribunal awards damages on an after-tax basis, Claimants request that the award explicitly state that taxes have already been deemed to have been paid to avoid future litigation over these issues. In the event that the Tribunal awards damages based on the Treaty and those damages are no different in quantum from the contract damages, the Tribunal could award damages solely to Occidental Petroleum Corporation. OPC is not an Ecuadorian entity and is not subject to Ecuadorian tax or labor participation claims.

853. The Tribunal observes that both Professor Kalt and Mr. Johnston have indicated that their respective quantum calculations have been made on an after-tax basis. In the circumstances, the Tribunal agrees with the Respondent that the Claimants' request is speculative and premature. The request is accordingly denied.

H. The Tribunal's Findings in connection with the Respondent's Counterclaim

854. In this arbitration, the Respondent, as noted earlier, has put forward a counterclaim on the basis of the four following allegations:

(i) malicious prosecution (*abuso del derecho)* in relation to this ICSID proceeding;

(ii) breach of Clause 22.2.1 of the Participation Contract regarding waiver of the right to use diplomatic or consular channels;

(iii) the Claimants' destructive and unlawful conduct following the *Caducidad* Decree, including lost Block 15 production due to the release of drilling rigs and damage to data and software; and

(iv) the Claimants' failure to pay the required assignment fee and negotiate a new participation contract more favourable to the Respondent.

855. Each of these four allegations is addressed in turn next.

1. The Respondent's Allegation that the Claimants Initiated and Prosecuted this Case in Bad Faith

856. This allegation on the part of the Respondent is expressly based on the contention that the Claimants have launched the present proceeding knowing that their claims in relation to the *Caducidad* Decree are objectively baseless and cannot succeed. However, as set forth earlier in this Award, the Tribunal has already concluded that notwithstanding OEPC's breach of Clause 16.1 of the Participation Contract and its actionable violation of Article 74.11 of the HCL, the *Caducidad* Decree was not a proportionate response in the particular circumstances and that it was accordingly issued in breach of Ecuadorian law, in breach of customary international law, and in violation of Article II.3(a) of the Treaty. The Tribunal has also concluded that the Respondent had breached Article III.1 of the Treaty.

857. In the circumstances, it follows that this proceeding as brought by the Claimants cannot be deemed to have been baseless or otherwise malicious or abusive. The Respondent's allegation and counterclaim in this regard accordingly fails.

2. The Respondent's Allegation that OEPC Breached Clause 22.2.1 of the Participation Contract Through its Use of Diplomatic Channels

858. The Tribunal recalls that Clause 22.2.1 of the Participation Contract provides as follows:

> In the event of controversies that may arise as a result of the performance of this Participation Contract, in accordance with Ecuadorian law, Contractor expressly waives its right to use diplomatic or consular channels, or to have recourse to any national or foreign jurisdictional body not provided for in this Participation Contract. Lack of compliance with this provision shall constitute grounds for the *caducidad* of this Participation Contract.

859. The Claimants have argued that the Respondent's counterclaim in this regard fails because Clause 22.2.1 cannot be invoked to prevent OEPC from seeking government assistance to remedy violations by the Respondent of international law and that, in any event, the Respondent has failed to produce evidence of any requests by the Claimants for assistance from the U.S. Government in connection with the threatened *caducidad* dispute. The Claimants also aver that since the Respondent participated in discussions of the VAT dispute with the U.S. Government prior to the commencement of the VAT arbitration in 2002, the Respondent cannot now in good faith claim that these very discussions are in breach of Clause 22.2.1.

860. The Tribunal has found no evidence in the voluminous record of this case that the Claimants ever sought assistance from the U.S. Government in connection with the *caducidad* dispute through diplomatic channels in breach of Clause 22.2.1. The Respondent's counterclaim in this regard accordingly fails.

3. The Respondent's Allegation of Destructive and Unlawful Conduct on the part of the Claimants

861. In the third head of its counterclaim, the Respondent seeks damages for losses it allegedly suffered as a result of the Claimants' "destructive actions" regarding Block 15. These "destructive actions" consist of the release by the Claimants shortly before the date of the *Caducidad* Decree of two drilling rigs required to maintain production levels at

Block 15, the deactivation of 108 software programs used to operate Block 15 and the Unified Fields, as well as the deletion of "approximately 3,705 gigabytes of data from the Block's computer system." These actions, the Respondent contends, resulted in damages of over $80 million.

862. The Claimants reject the Respondent's allegations of "destructive actions." With respect to the release of the drilling rigs, the Claimants maintain that nothing in the Participation Contract or the HCL required OEPC to maintain at the site such equipment that was no longer in use. And in connection with the deactivation of Block 15's operational software, the Claimants submit that OEPC took all steps necessary to ensure the smooth transition of Block 15 from OEPC to PetroEcuador, and that any ensuing difficulties were the result of PetroEcuador's own failure to plan adequately for the transition.

863. This counterclaim will now be considered and analyzed in more detail.

(a) Lost Block 15 Production Due to Release of Drilling Rigs

864. As found earlier in this Award, the Tribunal is not satisfied that the release of the drilling rigs by OEPC prior to 15 May 2006 was dictated by anything other than economic considerations. It was certainly not caused by the *Caducidad* Decree or, indeed, any wrongful action on the part of the Respondent.

865. On the basis of the evidence which it has analyzed, the Tribunal concludes that the Respondent has not discharged its burden of proving that, by releasing the two rigs on

3 January 2006 and 15 April 2006, the Claimants caused damages to the Respondent. This counterclaim accordingly fails.

866. As was seen earlier in the Tribunal's determination of quantum, the absence of these two rigs has been taken into consideration in the calculation of the fair market value of Block 15.

(b) Damages to Data and Software

867. The Claimants maintain, essentially, that the software licenses for the Block 15 operations are intellectual property owned by them and that they were perfectly justified to cancel these licenses. Such licenses, say the Claimants, cannot be equated with "equipment, tools, machinery or installations" referred to at Clause 5.1.21 of the Participation Contract.

868. Although the Tribunal is of the view that, in today's modern world of electronic technology, software licenses are "tools" which needed to be transferred to the Respondent under clause 5.1.22 of the Participation Contract following the *Caducidad* Decree, there is no evidence in the record that the Claimants destroyed any software data in retaliation for the declaration by the Respondent of *Caducidad*. Accordingly, the Respondent's counterclaim in this regard fails.

4. The Respondent's Allegation that the Claimants Failed to Pay the Assignment Fee and to Negotiate a New Participation Contract More Favourable to the Respondent

869. The fourth and final head of the Respondent's counterclaim, based on the allegation that the Claimants failed to pay the assignment fee and negotiate a new

participation contract more favourable to the Respondent in accordance with Article 79 of the HCL, is no longer pursued by the Respondent. This appears logical. The Tribunal so notes and thus need not make any ruling.

VII. COSTS

870. The Claimants submit that, as the ultimate successful party, they should recover from the Respondent all of their legal costs as well as the fees and expenses of the Tribunal and the administrative charges of ICSID.

871. The Tribunal, for the following reasons, has formed the view that it would not be appropriate in the circumstances of this lengthy and complex arbitration to grant the Claimants' prayer.

872. The Tribunal recalls, in particular, that it dismissed the Claimants' Application for Provisional Relief.

873. The Tribunal also recalls that, while the Respondent's challenge to the jurisdiction of the Tribunal was dismissed earlier and, in the present Award, the Claimants have been awarded significant damages, the Tribunal has found that the Claimants breached Clause 16.1 of the Participation Contract and were guilty of an actionable violation of Article 74.11 of the HCL, which violation contributed to the prejudice which they suffered when the *Caducidad* Decree was issued.

874. Thus, in the exercise of its discretion, the Tribunal decides that each party shall bear its own legal costs and that the fees and expenses of the Tribunal and the

administrative charges of ICSID shall be borne equally as between the Claimants and the Respondent.

875. In closing, the Tribunal acknowledges the quality of the extensive written and oral submissions of both parties in respect of the myriad of factual and legal questions which were raised in the course of these lengthy and very complex arbitral proceedings.

VIII. AWARD

876. For all of the foregoing reasons, and rejecting all submissions and contentions to the contrary, the Tribunal DECLARES, AWARDS and ORDERS as follows in respect of the issues arising for determination in these proceedings:

(i) Ecuador acted in breach of Article II.3(a) of the Treaty by failing to accord fair and equitable treatment to the Claimants' investment, and to accord the Claimants treatment no less than that required by international law;

(ii) Ecuador acted in breach of Article III.1 of the Treaty by expropriating the Claimants' investment in Block 15 through a measure "tantamount to expropriation";

(iii) Ecuador issued the *Caducidad* Decree in breach of Ecuadorian law and customary international law;

(iv) OEPC breached Clause 16.1 of the Participation Contract by failing to secure the required ministerial authorization for the transfer of rights under the

Farmout Agreement; as a result of this breach, the damages awarded to the Claimants will be reduced by a factor of 25% (see subparagraph (v));

(v) Claimants are awarded the amount of US$ 1,769,625,000 (US One billion, seven hundred sixty nine millions, six hundred twenty five thousand dollars), as calculated in paragraph 825 of this Award, for damages suffered as a result of the breaches set out above in subparagraphs (i), (ii) and (iii);

(vi) Ecuador is ordered to pay pre-award interest on the above amount at the rate of 4.188% per annum, compounded annually from 16 May 2006 until the date of this Award;

(vii) Ecuador is ordered to pay post-award interest from the date of this Award at the U.S. 6 month LIBOR rate, compounded on a monthly basis; and

(viii) Ecuador's counterclaims, except that counterclaim specified in sub-paragraph (iv) above, are dismissed; and

(ix) Each Party is ordered to bear its own costs of the proceedings and the Claimants and the Respondent are ordered and mandated each to pay half of ICSID's and the Tribunal's costs of and incidental to the proceedings.

877. In accordance with Article 48(4) of the ICSID Convention, Arbitrator Stern dissents from the above majority and her statement of dissent is attached.

[See attached dissenting opinion]	[signed]
Professor Brigitte Stern	David A.R. Williams, Q.C. Date: 24 September 2012

[signed]

L. Yves Fortier, C.C., Q.C.
President
Date: 20 September 2012