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# Arbitration Panel Holds That the 1994 Energy Charter Treaty Protects Foreign Energy Sector Investments in Former Soviet Union

In three important decisions published on February 1, 2010[1], an international arbitration tribunal sitting in The Hague has held that the 1994 Energy Charter Treaty (ECT), a multilateral investment protection covering the energy sector, entitled certain former shareholders in Yukos Oil Corporation OJSC (Yukos) to seek damages against Russia for the alleged loss of their investment. The Tribunal held that, even though the Russian Parliament (the Duma) never ratified the ECT, it nevertheless was binding on Russia from the date of its signature (in 1994) up to October 18, 2009, because Russia had agreed to be bound through the international law doctrine of "provisional application." (In August 2009, Russia announced it would not ratify the ECT, and its announcement took effect from October 18, 2009).

Besides its significance for the various parties involved, the decisions have important potential ramifications for other investors from ECT member states in Western and Eastern Europe, the former Soviet Union and Japan. If other tribunals follow this Tribunal's reasoning, a wide range of energy-related investments within the ECT's zone[2] may be treated as subject to the ECT's "provisional application" rules, even where (as in the case of Russia) the ECT has not been ratified. Indeed, some investors may argue that the ECT's investment protections and arbitration provisions remain binding on Russia for a further 20 years.

## The ECT: a Key Instrument for the Protection of Foreign Energy Investments

The ECT ranks among the most significant multilateral investment treaties in the world. With 52 members, its geographical scope is wide enough to capture natural gas extraction in Russia, oil and gas pipelines in the Caucasus, electricity grids in Japan, solar energy projects in Turkey, and wind farms in Spain. The ECT extends to projects as diverse as prospecting for oil, gas, coal and uranium; constructing and operating a power plant, a power grid or oil and gas pipelines; removing waste from energy related facilities; decommissioning energy related facilities; and marketing energy products.

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1 *Hulley Enterprises Ltd. v. Russia, Yukos Universal Ltd. v. Russia,* and *Veteran Petroleum Ltd. v. Russia* (UNCITRAL 2009) (collectively *Hulley*).

2 Members of the Energy Charter Conference are as follows: Albania, Armenia, Australia*, Austria, Azerbaijan, Belarus*, Belgium, Bosnia and Herzegovina, Bulgaria, Croatia, Cyprus, Czech Republic, Denmark, Estonia, European Communities, Finland, France, Georgia, Germany, Greece, Hungary, Iceland*, Ireland, Italy, Japan, Kazakhstan, Kyrgyzstan, Latvia, Liechtenstein, Lithuania, Luxembourg, Malta, Moldova, Mongolia, the Netherlands, Norway*, Poland, Portugal, Romania, Russian Federation**, Slovakia, Slovenia, Spain, Sweden, Switzerland, Tajikistan, the former Yugoslav Republic of Macedonia, Turkey, Turkmenistan, Ukraine, United Kingdom and Uzbekistan. * Denotes a state in which ratification of the Energy Charter Treaty is still pending. ** The Russian Federation signed the Energy Charter Treaty but announced on October 18, 2009 that it would not be ratified.

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The ECT reaffirms states' sovereignty over energy resources (Article 18), but also binds its members to a system of comprehensive protection for foreign investments in the energy sector. These protections include:

- guarantees of fair and equitable treatment (Article 10(1));
- full protection and security for foreign investments (Article 10(1));
- a prohibition against arbitrary or discriminatory measures (Article 10(1));
- a requirement to observe any obligations which the state has entered into with respect to a foreign investment, such as in a contract signed with a foreign investor - an "umbrella clause" (Article 10(1));
- guarantees of national treatment (ensuring that foreign investors receive benefits at least equivalent to those conferred on domestic investors) and most-favored nation treatment (providing treatment no less favorable than that granted to investors of a third state) (Article 10(7));
- a requirement to pay prompt, adequate and effective compensation (no less than market value) if the state expropriates a foreign investment or subjects it to measures equivalent to an expropriation (Article 13); and
- rights to freely transfer capital and returns in and out of the host state (Article 14).

Importantly, the ECT also allows investors to resolve their disputes with a host state through international arbitration (Article 26), rather than through the state's national courts.

## The *Hulley* Claims

The *Hulley* claims were commenced by three former majority shareholders in the now bankrupt Yukos: Hulley Enterprises Ltd, Yukos Universal Ltd and Veteran Petroleum Ltd. Two of the claimants are incorporated in Cyprus and the third is incorporated in the Isle of Man. The dispute arises out of the collapse of Yukos between 2003 and 2006. The investors claim that the Russian government expropriated their investments, in violation of the ECT.

The three claimants, invoking the ECT's international arbitration provisions, commenced arbitration under the rules of the United National Commission on Trade Law (UNCITRAL). An international tribunal, based at The Hague, was constituted comprising L. Yves Fortier CC QC (of Canada), Dr. Charles Poncet (of Switzerland) and Judge Stephen M. Schwebel (of the United States and formerly president of the International Court of Justice).

## Interim Awards on Jurisdiction

In three identical awards published on February 1, 2010, the Tribunal ruled that Russia's signature of the ECT in 1994 meant that it had committed to "apply" the ECT "provisionally," pending its consideration and eventual ratification by the Duma. The Tribunal's analysis turned on Article 45(1) of the Treaty, which states: "Each signatory agrees to apply this treaty provisionally pending its entry into force for such signatory [...] to the extent that such provisional application is not inconsistent with its constitution, laws or regulations."

Russia had argued that the "provisional application" of the ECT was inconsistent with Russian law. The Tribunal held, however, that:

- Russian law permitted the provisional application of international treaties, including the ECT (a finding the Tribunal reached after hearing expert evidence on the content of Russian law).
- When Russia agreed to apply the ECT provisionally, its agreement produced binding legal effects which were equivalent to the full entry into force of the treaty, for so long as the ECT remained provisionally applicable.
- Even though Russia officially terminated provisional application of the ECT with effect from October 18, 2009, the claimants' investments made in Russia prior to that date qualified for ongoing protection by virtue of Article 45(3) of the ECT. The Tribunal also stated that: "pursuant to Article 45(3)(b) of the Treaty, investment-related obligations, including the obligation to arbitrate investment-related disputes . . . remain in force for a period of 20 years following the effective date of termination of provisional application. In the case of the Russian Federation, this means that any investments made in Russia prior to October 19, 2009 will continue to benefit from the Treaty's protection for a period of 20 years – i.e. until 19 October 2029."[3]
- Russia could not avoid jurisdiction by invoking the "denial of benefits" clause in Article 17(1) of the ECT, which gives ECT Contracting Parties the option to deny treaty protection to companies with "no substantial business activities" in their country of incorporation if they are owned or controlled by citizens or nationals of a "third state." In the Tribunal's analysis, even if the claimants were ultimately owned by Russian nationals, as Russia alleged, the option to deny treaty benefits under Article 17(1) of the ECT had to be affirmatively invoked and operated only prospectively. Russia could not deny treaty benefits after a dispute had arisen.[4]

The *Hulley* claims (which apparently involve large sums) will now be heard on their merits and are likely to be vigorously contested by Russia. A number of other international investment claims under the ECT involving states of the former Soviet Union remain pending before various international arbitral tribunals. The ECT can therefore be expected to be the focus of attention for numerous investors and host governments active in the energy sector.

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3 *Hulley*, para. 388 (emphasis added).

4 The Tribunal's analysis is consistent with the previous decision rendered on the same issue in *Plama v Bulgaria* ICSID Case No. ARB/03/24, Decision on Jurisdiction of February 8, 2005.