

# The Global Oil & Gas Report

## Client Alert

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Dear Reader,

The aim of this newsletter is to provide a quick update into important developments in the oil & gas industry across the globe.

We hope you enjoy this and future editions of the Global Oil & Gas Report. Should you have any comments, please let us know.

Kind regards,

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## Recent developments in Australian petroleum law

High world oil & gas prices have contributed to at least two significant developments in Australian petroleum law and policy in recent years.

First, in October 2006 the Western Australian State Government under Alan Carpenter introduced a policy aimed to secure domestic gas supplies for the State, amid concerns that high oil prices would lead to future production being locked into long-term export contracts at the expense of domestic markets. As Western Australia houses roughly 80% of national gas reserves, however, the implications of the policy extend far beyond the State.

The policy requires project proponents of export natural gas (LNG) projects to agree with the State Government to a domestic gas supply commitment of up to the equivalent of 15% of production volumes as a condition of access to Western Australian land. The State negotiates the terms of each commitment on a case-by-case basis, giving proponents some flexibility as to when the commitment becomes effective and with respect to alternative mechanisms for meeting the commitment, such as utilizing production from other fields or trading commitments with other producers. The commitment itself is usually documented in the form of a State Agreement, if such an agreement is entered into between the project and the State.

To date, both the Woodside-led Pluto project and Chevron's Gorgon project have committed to domestic gas supply obligations under this policy. However, as the policy only applies to projects that require access to Western Australian land for processing or other facilities, it may have the result of encouraging potential proponents to consider alternative locations for their onshore plants. Commentators have suggested that this was one of the reasons for the Inpex Browse project deciding to locate its onshore facilities in the Northern Territory instead of in Western Australia.

A second more recent development has seen the Federal Government removing the exemption for condensate under the crude oil excise, which was originally introduced in the late 1970's to encourage the development of petroleum resources in the North West Shelf and Cooper Basin at a time when gas was not as valuable a commodity as crude oil. Currently the North West Shelf is the only offshore petroleum development still subject to the excise regime, with other offshore projects now subject to the profit-based Petroleum Resource Rent Tax (PRRT) introduced in 1987. The motive behind removing the condensate exemption appears to be an attempt to capture some of the benefit from high petroleum prices, with the Federal Government arguing that it 'will increase the return to the Australian community from allowing private interests to extract non-renewable energy resources located in the North West Shelf project area and onshore'. The change is estimated to create AUS\$2.5bn in revenue for the Federal Government over the next four years. The Federal Government has agreed to compensate the Western Australian State Government to the amount of \$80 million in 2007-2008 (in addition to future adjustments) for reduced State revenues.

The *Excise Tariff Amendment (Condensate) Bill 2008* and *Excise Legislation Amendment (Condensate) Bill 2008* were introduced by the Government into the House of Representatives on 15 May 2008, passed on 25 September 2008 and assented to on 18 October 2008. Prior to being passed, both Bills were referred to the Senate Economic Committee for review of the likely impacts on retail gas and

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electricity prices, exploration, the industry generally and international and domestic investment confidence. It is interesting to note that Committee acknowledged that producers were subject to increasing development costs, but took that view that the current profitability of the petroleum industry looked set to continue for the foreseeable future with the trend being for rising oil prices.

Condensate produced after midnight (Australian Capital Territory time) on 13 May 2008 is subject to the excise, which is levied as a percentage of crude oil production values. Currently, the first 30 million barrels of condensate produced from a field is exempt from the excise.

Both of the above policy changes were introduced against a back-drop of high oil prices. It goes without saying that it would be much more difficult for the relevant Governments to justify these changes in the current economic climate.

## Pre-salt Prospects

Soon after the recent announcements surrounding the huge pre-salt discoveries, the Brazilian government started to review the current upstream model, intending to introduce a special regime for the new oil and gas province. The existing estimates indicate that the oil potential of the pre-salt layer is around seventy billion barrels, which is equivalent to five times the current volume of the country's reserves. If these estimates are confirmed, Brazil may be placed among the ten largest producing countries in the world, after the development of the pre-salt area.

The pre-salt layer measures approximately eight hundred kilometers in length, two hundred kilometers in width and appears to extend from the coast of Espírito Santo to Santa Catarina. Its thickness is about two thousand meters and the final depth of the wells can reach more than seven thousand meters below the surface of the sea. According to Petrobras' press office, the exploration activities in the pre-salt area started in 2005. It was only in November 2007, however, that the Brazilian oil company publicly announced Tupi's potential. Until now, and still according to press releases, nine mega-discoveries have been made by Petrobras and its partners in other concession areas.

In July 2008, an Inter-Ministerial Commission ("IC") was established with the purpose of studying and proposing legislative amendments to the exploration and production legislation<sup>1</sup>. The IC shall soon present to the Brazilian President a report providing the guidelines for the new legal framework. The main proposals under discussion indicate the Government's intention to extract greater revenues from the newly discovered area.

Because of the expectations for further massive oil discoveries in the pre-salt area, one of the proposals under discussion involves a Government increase of the special participation rate, which is the Government take, in addition to regular royalties, in connection with fields with large production volume or high profitability. The special participation rules could be made by presidential decree – that is to say, it would not require the National Congress to pass a new law on the subject.

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<sup>1</sup> Decree of 7.17.2008. The Inter-Ministerial Commission is composed of the Minister of Mines and Energy, the Chief of the Presidential Staff Office, the Minister of Development, Industry and Foreign Trade, the Minister of Treasury, the Minister of Planning, Budget and Management, the President of the Brazilian Development Bank, the Director-General of the National Petroleum Agency and the President of Petrobras.

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Another proposal being considered is the capital increase of Petrobras. The Brazilian Government holds approximately 40% of Petrobras' shares and it seems that it is considering increasing this percentage to 60%. To this end, a capital increase of around 100 billion dollars has been discussed. However, this would only lead to an effective increase of the Government's participation in Petrobras, if the private investors do not subscribe new shares in this operation, which seems unlikely.

The proposal that has been attracting the most attention, however, is the creation of a new wholly state-owned company to manage the reserves of oil and natural gas discovered in the pre-salt layer<sup>2</sup>. For this to happen a specific legislative authorization<sup>3</sup> is necessary, but it is not known precisely which role this company would play or how the nature of its relationship with Petrobras would be. In this regard, it is said that the Norwegian model can influence the new Brazilian legislation.

Indeed, the Norwegian State owns around 62% of the shares of Statoil – a company that was partially privatized in 2001 and merged with Hydro to create StatoilHydro in 2007, and Petoro, a wholly state-owned company which handles the financial and accounting management of the Norwegian State participation in the petroleum sector, the SDFI (*State's Direct Financial Interest*). The revenues raised by Petoro go directly to a government pension fund that operates as a sovereign fund.

So, in emulating the Norwegian entity, the Brazilian Government would be inclined to create a state company to manage the pre-salt assets, but it would not have any exploratory and production capacity. Petrobras would continue executing these tasks in other areas and would act as an operator, just like other international oil companies in the pre-salt regions. In the case of Brazil, the revenues from the pre-salt exploitation would go to a sovereign fund established in order to promote education and health care programs.

In response to the uncertainty generated by the pre-salt discoveries and the discussions regarding changes to legislation, the National Council of Energy Policy (CNPE) has already expressed its position, stating that all bidding rounds already completed, and contracts in force will be respected<sup>4</sup>.

The oil and gas industry is anxiously waiting for the IC's report on the proposals to be submitted for the Brazilian President's evaluation and decision.

## **Russia enacts new law on foreign investments in strategic areas**

On 29 April 2008, in the last days of his presidency, Vladimir Putin signed the much anticipated law 'On Procedures for Foreign Investments in Companies of Strategic Significance for National Defense and Security'. This law is aimed at restricting foreign investments in sectors deemed strategic and has been fiercely criticised for allegedly creating uncertainty for foreign businesses and worsening the investment climate in Russia. It is important to understand the extent to which the new law and

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<sup>2</sup> Which has already been nicknamed Petrosal.

<sup>3</sup> Constitution of the Federative Republic of Brazil, article 173: "With the exception of the cases set forth in this Constitution, the direct exploitation of an economic activity by the State shall only be allowed whenever needed by the imperative necessities of the national security or by a relevant collective interest, as defined by law."

<sup>4</sup> Resolution CNPE n° 6, of 11.8.2007

related amendments to the law 'On Subsoil' change the rules of the game for foreign companies operating in the strategic oil and gas and mining sectors.

Under the enacted law, 42 different areas of activity are considered strategic and foreign investments in these sectors now require approval from a governmental commission. These strategic sectors include sensitive industries, such as oil and gas, old mining, defence, nuclear energy, certain activities in telecommunications and the media, aviation and aerospace, fishing, and specialty metals processing. It should be noted that although, the list of strategic areas may vary from country to country, Russia is by no means unique in limiting foreign control over strategic companies. The 'International Investment Perspectives: Freedom of Investment in a Changing World' study conducted by the Organisation of Economic Co-operation and Development (OECD) in 2007 revealed that several countries have recently tightened their regulation and administrative practices to restrict foreign presence in sensitive areas. France and Germany have introduced closed lists of sectors and activities that restrict access for foreign investors on security grounds. The US Congress last year amended the procedures under the Exon-Florio Amendment (first enacted in 1988 to counter the perceived threat of the Japanese expansion), adding critical infrastructure and foreign government controlled transactions to items for review by the Committee on Foreign Investment in the United States. In Canada and Japan an overhaul of foreign investment regulations related to national security is also under consideration.

While advocating the need to maintain an open investment environment, the OECD report admits that ownership of mineral producing companies has become a political issue. According to the report, these concerns have been further strengthened by deliberate investment strategies in some countries to secure control over such resources. Therefore, Russia's move to establish a framework for addressing national security concerns in investment policy is quite comprehensible in the context of this global trend.

The enacted law stipulates that foreign investors have to obtain preliminary consent to acquire more than 50 percent of the shares in strategic companies. Reacting to the increased activity of sovereign wealth funds, the law states that companies controlled by foreign governments will have to go through the same procedure if they plan to acquire more than 25 percent of a strategic Russian company. Furthermore, the enacted law prohibits foreign governments and their controlled companies to acquire control over strategic companies. It is noteworthy that the law expressly covers not only direct but also indirect control over strategic entities.

The enacted law introduces even more stringent restrictions on the activity of foreign investors in natural resources. Thus for transactions with the shares of companies holding the right to use subsoil plots of federal significance, preliminary consent is needed for foreign investors to acquire control of 10 percent or more of the shares. The amendments to the Subsoil Law define subsoil plots of federal significance as follows: (i) subsoil plots containing deposits and showings of uranium, diamonds, high purity quartz, the yttrium group of rare earths, nickel, cobalt, tantalum, niobium, beryllium, lithium, or the platinum group of metals (irrespective of the size of the deposits); (ii) subsoil plots containing recoverable oil reserves above 70 million tons, gas reserves above 50 billion cubic meters, hard rock gold reserves above 50 tons and copper reserves above 500 thousand tons; (iii) subsoil plots located in the inland sea waters, territorial sea waters, or on the continental shelf of the Russian Federation; and (iv) subsoil plots that can only be developed using land classed as defence and security land. In addition, the transfer of rights to such subsoil plots to a company

with 10 percent or more shares controlled by a foreign investor is permitted only in exceptional cases and only upon a decision of the Russian government.

The list of the subsoil plots of federal significance is yet to be published by the Federal Agency for Subsoil Use, but the Ministry for Natural Resources has previously made public a list of undistributed deposits considered strategic using the same criteria as the new amendments. Far from being comprehensive, as it encompassed undistributed deposits only, the list contained 10 oil fields, 24 gas fields, five copper and one gold deposit. Judging by this list most of these deposits are likely to be of interest to international majors.

Even further restrictions are introduced with respect to subsoil plots located on the Russian continental shelf. In accordance with the amendments, the development of such deposits is restricted to the legal entities with at least 50 percent of the shares either directly or indirectly controlled by the Russian State. This provision has drawn a lot of criticism as Russian companies lack the technologies, equipment and funds needed to develop massive oil and gas resources on the shelf on their own. That said, the law doesn't prohibit foreign investors from establishing joint ventures with Russian state controlled companies. As the latest trend in the oil and gas industry reveals, in order to succeed in doing business in Russia, Western majors have to find the right Russian state-controlled partner. In this respect, the amendments don't seem to drastically change the rules of the game in the oil and gas sector, but serve to clarify them.

More worrying are the implications of the amendments for geological exploration in Russia. Since the collapse of the Soviet Union, both Russian and foreign investors have been reluctant to invest in geological exploration as exploration licenses effectively carried no guaranteed conversion rights into a production licence once a commercial discovery had been made. The standard procedure involves the holder of an exploration licence applying to the authorities for production rights, which implies a governmental review of the application and adds an element of discretion into this process. In these circumstances the investor potentially risks seeing production rights for the discovered deposit being ultimately awarded to a luckier competitor. This partially explains why resource companies have focused on acquiring licences to deposits already recorded in the state register of reserves in Soviet times rather than on conducting prospecting and appraisal at their own risk and expense. This trend has resulted in significant underinvestment in exploration of hydrocarbon resources. Oil output, in particular, is declining at the older oil fields, and this decrease can't be offset by production at the new oil fields coming on stream. The World Outlook 2007 prepared by the International Energy Agency stated that even in the best case scenario growth of the oil production in Russia might stall in 2010 to 2012 and is not likely to resume until 2015.

The amendments to the law 'On Subsoil' were intended to counter underinvestment in geological exploration by increasing transparency in this area of subsoil use. However, the amendments are more likely to reduce foreign investors' incentive to invest in exploration rather than stimulate investments. Under the amended law, if in the process of geological exploration conducted under an exploration licence a foreign investor makes a discovery of a deposit that qualifies as a subsoil plot of federal significance, the government may refuse to grant production rights to the discovering entity. If the deposit was discovered in the course of a geological exploration on the basis of a combined licence (for geological survey, exploration and production) the government may decide to terminate the licence on national security grounds. The only solace for the investor is that in both cases compensation

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of the expenditures related to prospecting and appraisal will be provided, as well as repayment of the bonus for the original grant of the rights. Moreover, the investor may be entitled to a premium payable by the Russian state. Thus, although commercially these amendments may potentially work against any additional investment in geological exploration, it can be argued that these amendments nevertheless clarify the position that the government may take once a strategic discovery is made.

So, should foreign investors be alarmed by these developments? Not at all. The new regulation hasn't altered the status quo - that is - a delicate balance maintained between the interests of businesses and the national interest, between the pressing need to attract considerable investment in the industry and the obvious intention to safeguard strategic assets. One important point says it all - there is no outright prohibition on foreign companies owning stakes in strategic companies - the decision to block or let the deal go ahead will be taken by the governmental commission on a case by case basis. What the strategic law definitely does do is encourage foreign investors to think strategically.

## **Tightening the Screws on Contractors - New PSC Terms**

New Production Sharing Contracts ("PSC") for both the most recent 2008 tender round, and for coal bed methane ("CBM") contracts, have been rolled out in Indonesia. The changes to the conventional PSC (and bid terms) seem to be driven by a combination of concerns covering, amongst others, escalating industry costs, the fuel subsidy, environmental protection, Pertamina's demands for greater participation rights, and the creativity with which oil and gas companies were side-stepping the need for transfer approvals. The key changes to the conventional oil and gas PSC are highlighted below:

- **Ring Fencing.** Exploration costs may only be recovered from a subsequent POD. All other costs in respect of a field may only be recovered from that field. As the PSC still contains an obligation to carry out exploration post the exploration period, the new PSC is likely to further hamper exploration efforts. In this regard, previous proposals designed to prohibit cost recovery on relinquished acreage have been shelved for the time being, although query whether these may be reintroduced in subsequent rounds.
- **Tax in Kind.** The PSC now anticipates that tax may be payable in kind. There seem to be no mechanisms, however, to allow recognition of tax paid in kind and the industry has expressed concerns about how this clause would work in practice.
- **Joint and Several Liability.** Some drafts we have seen expressly recognize the joint and several liability of the Participating Interest holders under the PSC, with BPMIGAS having the right to communicate directly with any holder of a Participating Interest, and to enforce obligations against it. In our view, this is merely a restating of what was implicit in previous generations of PSCs.
- **Pertamina Participation.** The tender conditions for the 2008 round state that Pertamina will have a right to acquire a fifteen percent interest in any working area offered through a tender or direct proposal. This right is exercised by way of a notice submitted to the winning bidders following contract award, and the

participation will be carried out on "business to business" terms. The tender offer does not stipulate whether Pertamina will have a restricted right to farm-out all or part of its fifteen percent interest to third parties.

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- **Assignment.** All assignments, whether to affiliates or otherwise, now require BPMIGAS and DirGen approval. This seems intended to prevent inter-affiliate transfers followed by share sales, as a means of circumventing the approvals process. In addition, changes in control (i.e. changes in the ownership of at DirGen approval. There is no limit on how far up the corporate chain such a change of control takes place, before it is no longer triggers an approval requirement. However, in some drafts we have seen, changes in control relate only to transactions in which the Participating Interest is the sole substantive asset.
- **Third Party Access.** Third parties may now gain access to existing infrastructure.
- This merely seems to be a restating of powers that BPMIGAS already exercises. The compensation payable for such access is credited to PSC Contractor's operating costs, or treated as profit oil or gas.
- **Field Carve-Outs.** In respect of subsequent discoveries, in respect of which the PSC contractor fails to submit a POD, such areas will be carved out from the PSC area and relinquished, presumably with a view to it being offered to third parties.
- **Associated Products.** The PSC seeks to encourage Contractors to develop associated products (which are not hydrocarbons), from petroleum operations. Presumably this relates primarily to sulphur. Proceeds from the sales of such products are credited to operating costs, or treated as profit oil or gas.

The net result of the changes is to make the PSC terms more onerous. At a time when oil prices are seesawing between US\$90 - US\$150 a barrel, the overall effect is likely to make oil and gas companies more cautious in upcoming tender rounds.

## **MEMR Decree No, 1 of 2008 - Money in Old Assets**

A little-remembered decree from 1996 has been recast for the post-2001 oil and gas regime in Indonesia. The regulation, designed to encourage the re-development of old wells, raises significant health, safety and environmental issues.

The decree requires Contractors to identify and commercialise old wells (i.e. wells drilled pre-1970), failing which village cooperatives and local government companies ("KUD / BUMD") may seek to commercialise them, with DirGen's approval. The decree envisages that the Contractors will have the right to vet the applications made by the KUD / BUMD on the grounds of health, safety, technical and financial capability.

Significantly, the PSC Contractor has the right to reject the application made by the KUD / BUMD, but must report its decision to BPGMIGAS. What happens then is not entirely clear; presumably BPMIGAS may seek further clarification of the grounds on which the proposal was rejected, and ask PSC Contractor to reconsider its decision in light of such further clarification.

In the (perhaps unlikely) event that a proposal is accepted by PSC Contractor, then it requires the further approval of DirGen. Thereafter, the KUD / BUMD term of the agreement is five years, extendable (presumably more than once) for five years. Each extension requires DirGen's approval.

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Oil produced under the oil production agreement is supplied to the PSC Contractor. In return, the PSC Contractor pays a service fee to the KUD / BUMD. There is little indication as to what level the fee should be set at. The KUD / BUMD will seek to tie any third party financing into market pricing. However, it remains open to Contractors to push back on this.

The fee will be treated as an operating cost of PSC Contractor and will, presumably, be cost recoverable under the terms of current PSCs. Where a PSC extension is agreed, however, (which in all likelihood, would introduce current-round PSC terms), query whether such fees could be cost recovered, given the new POD ring-fencing.

The key issue arising out of the decree relates to health, safety and the environment. Under the decree, this is the responsibility of the KUD / BUMD. However, the decree goes on to state that the "Contractor shall carry out technical supervision". Arguably, this may be sufficient, particularly if the KUD / BUMD has shallow pockets, to pin tortious, or environmental, liabilities on the PSC Contractor. Given this, the likelihood of getting Contractors to approve development proposals for old oil wells seems remote.

## Developments in the Philippine Energy Sector

The Philippine government has affirmed its commitment to promote a globally competitive energy sector and the development of indigenous and renewable energy resources. During the Philippine Economic Briefing held on 17 September 2008, the Philippine Department of Energy ("DOE") affirmed the government's commitment to pursue the objectives of the Philippine Energy Plan.

The objectives of the Philippine Energy Plan are as follows:

- accelerating the exploration, development, and utilization of indigenous energy resources;
- intensifying renewable energy resources development;
- increasing the use of alternative fuels;
- enhancing energy efficiency and conservation; and
- continuing reforms in the power sector, and in the downstream oil and gas industries.

In January 2007, the Philippine Congress passed the Biofuels Act of 2006 (Republic Act No. 9367). Prior to this, on 24 February 2004, President Gloria Macapagal-Arroyo issued Executive Order ("EO") No. 290 implementing the Natural Gas Vehicle Program for Public Transportation.

In December 2008, the Renewable Energy Act of 2008 (Republic Act No. 9513) was signed into law. It will take effect 15 days after its publication in at least two newspapers of general circulation.

In addition, the DOE has expressed its support for a number of energy-related bills that have been filed in Congress aimed at achieving the Philippine Energy Plan. These proposed legislative measures relate to the Downstream Natural Gas Industry (House Bill No. 1628, House Bill No. 1936, and Senate Bill No. 1240), and the Liquefied Petroleum Gas Industry (House Bill 551).

### **The Biofuels Act**

On 24 July 2006, Congress passed the Biofuels Act which took effect on 6 February 2007 ("Effective Date").

It declared as state policy the reduction of the Philippines' dependence on imported fuels by mandating the use of biofuels.

The law defines "biofuel" as bioethanol and biodiesel and other fuels made from biomass primarily used for motive, thermal and power generation, with quality specifications in accordance with Philippine national standards. "Bioethanol" is defined as ethanol produced from feedstock and other biomass. "Biodiesel" is defined as Fatty Acid Methyl Ester or mono-alkyl esters derived from vegetable oils or animal fats and other biomass-derived oils that shall be technically proven and approved by the DOE for use in diesel engines.

The Biofuels Act mandates that all liquid fuels for motors and engines sold in the Philippines shall contain locally sourced biofuels components as follows:

- within two years from the Effective Date, at least 5% of bioethanol shall comprise the annual total volume of gasoline fuel actually sold and distributed by every oil company in the country, subject to the requirement that all bioethanol blended gasoline shall contain a minimum of 5% bioethanol fuel by volume, provided that the ethanol blend conforms to Philippine national standards;
- within four years from Effective Date, a government body called the National Biofuel Board ("NBB") is empowered to determine the feasibility and thereafter recommend to DOE to mandate a minimum of 10% blend of bioethanol by volume into all gasoline fuel distributed and sold by every oil company in the country;
- within three months from Effective Date, a minimum of 1% of biodiesel by volume shall be blended into all diesel engine fuels sold in the country, provided that the biodiesel blend conforms to the Philippine national standards for biodiesel; and
- within two years from Effective Date, the NBB is empowered to determine the feasibility and thereafter recommend to DOE to mandate a minimum of 2% blend of biodiesel by volume which may be increased taking into account considerations including but not limited to domestic supply and availability of locally sourced biodiesel component.

The implementing rules of the Biofuels Act provide that fuels derived from biomass other than bioethanol and biodiesel, which have been technically validated by the

Department of Science and Technology, can be given the same incentives under the law upon the recommendation of the NBB. The implementing rules also require that supply of biofuel must be sourced only by the oil companies from biofuel producers that the DOE has accredited. End users who are direct importers of diesel or gasoline will also be subject to the required use of the mandated fuel blend.

Fiscal incentives for the production, distribution, and use of locally-produced biofuels are as follows:

- 0% specific tax on local or imported biofuels component per liter of volume;
- sale of raw materials used in the production of biofuels, such as but not limited to coconut, jathropa, sugarcane, cassava, corn and sweet sorghum shall be exempt from the value added tax; and
- all water effluents, such as but not limited to distillery slops from the production of biofuels used as liquid fertilizer and for other agricultural purposes are considered "reuse," and are therefore exempt from government wastewater charges.

### **Natural Gas Vehicle Program for Public Transport ("NVGPPT")**

The Malampaya gas reserve in Palawan, Southern Philippines contains estimated deposits of 3.4 trillion cubic feet of natural gas. Aside from the application of natural gas in the power sector, EO 290 recognizes that natural gas may be used as fuel for vehicles in the transport sector. The DOE is the lead implementing agency for the NVGPPT.

The NVGPPT has the following objectives:

- to enhance energy supply security in the transportation sector through fuel diversification using indigenous natural gas; and
- to use Compressed Natural Gas ("CNG") as a clean alternative fuel for transportation.

EO 290 seeks to encourage the public transportation sector to use natural gas as fuel. It also mandates that existing natural gas vehicle technology in the world for refueling systems and transportation vehicles will be adopted locally in compliance with applicable local and international standards. Among other activities, EO 290 calls for the following:

- CNG refueling stations and all related facilities to be established in strategic locations along major thoroughfares in Metro Manila and Luzon, Philippines to serve the fuel needs of CNG-powered public utility vehicles; and
- pursuit of local technical capability and expertise on NGV retrofitting; conversion, fabrication of conversion systems, NGV and refueling station operation and maintenance, and other related activities as well as the capability to locally produce NGV chassis, biodiesel and engines through technology transfer and training.

NVGPPT participants are entitled to certain privileges and incentives, including the following:

- income tax holiday for pioneering projects qualifying under the Board of Investment's ("BOI") Investments Priorities Plan;
- 1% rate of duty on imported NGVs, NGV engines and other NGV industry related equipment, facilities, parts and components as certified by the DOE; and
- preferential and exclusive franchises from the government for NGVs to newly opened routes.

## Renewable Energy Act

The Renewable Energy Act declares as state policy the acceleration of the exploration and development of renewable energy resources such as, but not limited to:

- biomass;
- solar;
- wind;
- hydro;
- ocean energy sources; and
- hybrid systems.

"Renewable energy resources" are defined under the law as energy resources that do not have an upper limit on the total quantity to be used. Such resources are renewable on a regular basis, and whose renewal rate is relatively rapid considering its availability over an indefinite period of time. These include, among others, biomass, solar, wind, geothermal, ocean energy, and hydropower conforming with internationally accepted norms and standards on dams, and other emerging renewable energy technologies.

For on-grid<sup>1</sup> renewable energy development, the law provides for the creation of a National Renewable Energy Board ("NREB"). The NREB will set the minimum percentage of generation from eligible renewable energy resources and determine to which sector Renewable Portfolio Standard<sup>2</sup> shall be imposed on a per grid basis within one year from the effectivity of the law.

The law also provides for off-grid<sup>3</sup> renewable energy development through the "Small Power Utilities Group" ("SPUG")<sup>4</sup>. The SPUG (or its successors-in-interest<sup>5</sup> and/or qualified third parties in off-grid areas), which is mandated to provide missionary electrification in off-grid areas will, within one year from the effective date of the law, source a minimum percentage of its total annual generation upon

<sup>1</sup> "On-Grid System" refers to electrical systems composed of interconnected transmission lines, distribution lines, substations, and related facilities for the purpose of conveyance of bulk power on the grid of the Philippines.

<sup>2</sup> "Renewable Portfolio Standards" refer to a market-based policy that requires electricity suppliers to source an agreed portion of their energy supply from eligible renewable energy resources.

<sup>3</sup> "Off grid systems" refer to electrical systems not connected to the wires and related facilities of any mini-grid system or the on-grid systems of the Philippines.

<sup>4</sup> "Small Power Utilities Group" ("SPUG") is the functional unit of the National Power Corporation ("NPC") tasked to pursue missionary electrification.

<sup>5</sup> "Successors-in-interest" refer to entities deemed technically and financially capable to serve/take over existing NPC-SPUG areas

recommendation of the NREB from available renewable energy resources in the area concerned, as may be determined by the DOE.

Incentives given for renewable energy projects and activities under the law are the following:

- income tax holiday for the first seven (7) years of its commercial operations of a duly registered renewable energy developer;

Additional investments in the project shall be entitled to additional income tax exemption on the income attributable to the investment. The discovery and development of new renewable energy resource will be treated as a new investment and will be entitled to a fresh package of incentives, provided that the entitlement period for additional investments shall not be more than three times the period of the initial availment of the income tax holiday.

- duty free importation of renewable energy machinery, equipment and materials within the first ten years upon the issuance of a certification of a renewable energy developer;
- special real property tax rates on machinery, equipment and other improvements not to exceed 1.5% of their original cost less accumulated normal depreciation or net book value;

In case of an integrated resource development and generation facility, the real property tax shall only be imposed on the power plant.

- net operating loss during the first three years from the start of commercial operation which had not been previously offset as deduction from gross income will be carried over as a deduction from gross income for the next seven consecutive taxable years immediately following the year of such loss;
- after seven years of income tax holiday, all renewable energy developers will pay a corporate tax of ten percent (10%) on net taxable income (instead of the regular corporate income tax rate currently at 30%), provided, that the renewable energy developer must pass on the savings to the end-users in the form of lower power rates;
- if a renewable energy project fails to receive an income tax holiday before full operation, it may apply for accelerated depreciation in its tax books and be taxed based on such, in which case the project or its expansions shall no longer be eligible for an income tax holiday;
- 0% value added tax on the sale of fuel or power generated from renewable sources of energy such as, but not limited to, biomass, solar, wind, hydropower, geothermal, ocean energy and other emerging energy sources using technologies such as fuel cells and hydrogen fuels;
- a renewable energy developer, established after the effectivity of the law, will be entitled to a cash generation-based incentive per kilowatt hour rate generated, equivalent to 50% of the universal charge for power needed to service missionary areas where it operates the same, to be chargeable against the universal charge for missionary electrification.;

- all proceeds from the sale of carbon emission credits will be exempt from any and all taxes;
- a tax credit equivalent to 100% of the value of the value-added tax and custom duties that would have been paid on the renewable energy machinery, equipment, materials and parts had these items been imported will be given to a Renewable Energy Service (Operating) Contract<sup>6</sup> holder who purchases machinery, equipment, materials, and parts from a domestic manufacturer, subject to prior approval by the DOE obtained by the local manufacturer.

All manufacturers, fabricators and suppliers of locally-produced renewable energy equipment and components duly recognized and accredited by the DOE, in consultation with the Department of Science and Technology, Department of Finance and Department of Trade and Industry, will, upon registration with the BOI, be entitled to the following privileges:

- tax and duty-free importation of components, parts and materials;
- tax credit on domestic capital components, parts and materials;
- income tax holiday and exemption for seven years starting from the date of recognition/accreditation of a renewable energy manufacturer, fabricator and supplier of renewable energy equipment; and
- all manufacturers, fabricators and suppliers of locally produced renewable energy equipment shall be subject to zero-rated value added tax on its transactions with local suppliers of goods, properties and services.

Renewable energy developers and local manufacturers, fabricators and suppliers of locally-produced renewable energy equipment need to register with the DOE, through the Renewable Energy Management Bureau. Upon registration, a certification shall be issued to each renewable energy developer and local manufacturer, fabricator and supplier of locally-produced renewable energy equipment to serve as the basis of their entitlement to incentives provided under the law.

The Government Share<sup>7</sup> on existing and new renewable energy development projects will be equal to one percent (1%) of the gross income of renewable energy resource developers resulting from the sale of renewable energy produced and such other income incidental to and arising from the renewable energy generation, transmission, and sale of electric power except for indigenous geothermal energy, which will be at one and a half percent (1.5%) of gross income.

## Proposed Legislative Measures

### Downstream Natural Gas Industry

<sup>6</sup> "Renewable Energy Service (Operating) Contract" refers to the service agreement between the Government, thru the DOE, and renewable energy developer over a period in which the renewable energy developer has the exclusive right to a particular renewable energy area for exploration and development. The contract shall be divided into two (2) stages: the pre-development stage and the development/commercial stage. The preliminary assessment and feasibility study up to financial closing will correspond to the pre-development stage. The construction and installation of facilities up to operation phase will correspond to the development stage.

<sup>7</sup> "Government Share" refers to the amount due the national government and local government units from the exploitation, development, and utilization of naturally-occurring renewable energy resources such as geothermal, wind, solar, ocean and hydro excluding biomass.

*House Bill No. 1628*

This bill divides the downstream natural gas industry into three sectors, i.e., the transmission<sup>8</sup>, distribution<sup>9</sup> and supply<sup>10</sup> of natural gas.

The bill provides that the transmission and distribution of natural gas are considered to be public utility operations, requiring a franchise or similar legislative authorization. Under the Philippine Constitution, no franchise certificate, or any other form of authorization of a public utility shall be granted except to citizens of the Philippines or to corporations or associations organized under the laws of the Philippines at least 60% of whose capital is owned by such citizens.

However, the bill also provides that any person who has entered into a Petroleum Service Contract with the DOE that authorizes the construction and operation of facilities for the transmission or distribution of natural gas will not be required to obtain a franchise or other legislative authorizations only to the extent that such facilities are:

- located in the production area and upstream of gas processing or refining facilities and are not used to serve end-users; or
- used exclusively to provide service to existing customers or to an entity who is a holder of a Petroleum Service Contract under a gas supply contract entered into prior to the bill becoming a law, which gas supply contract shall not be affected by the enactment of such law.

*House Bill No. 1936*

House Bill No. 1936 is another bill filed with the House of Representatives on the development of the downstream natural gas industry. It contains provisions similar to those in House Bill No. 1628.

*Senate Bill No. 1240*

Similar to House Bill No. 1628, Senate Bill No. 1240 divides the downstream natural gas into three sectors, i.e., the transmission of natural gas, distribution of natural gas, and supply of natural gas.

The bill also declares the transmission and distribution of natural gas as public utility operations, requiring a congressional franchise.

The bill further provides that the franchise requirement shall not apply to the following:

- holders of Service Contracts which authorize the construction and operation of facilities for the transmission of natural gas only to the extent such facilities are:

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<sup>8</sup> Gas transmission system refers generally to the system of pipelines, storage and related facilities that are used to transport natural gas from the interconnection with gathering facilities, liquified natural gas regassification facilities or other gas transmission systems to the interconnections with gas distribution systems, other gas transmission systems, or end-users. "Gathering Facilities" refers to Natural Gas pipelines and related facilities used to gather gas in the field and bring it to a location for processing or for delivery at an interconnection with the gas transmission system.

<sup>9</sup> Gas distribution system refers to the system of pipelines, storage and related facilities extending from the delivery points where the gas distribution system receives the natural gas to the point of connection to the premises of the end-user.

<sup>10</sup> Supply refers to the domestic trading and/or sale of natural gas for wholesale or retail.

- i. for own use;
  - ii. used to transport natural gas from the point of extraction or production to the processing or gathering facility; and
  - iii. used to provide service to existing customers or such person under a gas supply contract entered into prior to the bill becoming a law, which gas supply contract shall not be affected by the enactment of the law.
- operators of pipeline facilities to transport natural gas for their own use; and
  - operators of related facilities that are operated independently from the pipeline.

To encourage initial capital investment in new infrastructure that is critical for developing a viable downstream natural gas industry, the bill provides that gas transmission utilities and gas distribution utilities will, during the infrastructure development period be exempted from government regulation of rates for the transmission and distribution of natural gas to large end-users that have the ability to use alternative fuels in lieu of natural gas in accordance with the criteria to be set by the government.

The infrastructure period shall be for a 15-year period beginning in a particular franchise area, on the date of commencement of operation of the pioneer gas transmission system or gas distribution system constructed after the bill becomes a law. The expiration of the infrastructure development period shall not affect any contract for the transmission or distribution of natural gas entered during such period.

In recognition of the substantial investments needed for the construction, operation and maintenance of gas transmission and gas distribution systems, the bill provides that gas transmission utilities and gas distribution utilities shall, upon prior endorsement by the DOE and approval by the BOI, be entitled to income tax holiday and such other incentives granted to pioneer enterprises under the Philippine investment laws.

### **Liquefied Petroleum Gas Industry**

#### *House Bill No. 551*

This bill seeks to establish the regulatory framework and standards for the Liquefied Petroleum Gas ("LPG") industry, which covers all persons or entities engaged in the manufacture, importation, transportation, sale and distribution of LPG to end-users and the consumers.

If the bill becomes a law, any person or entity engaged or intending to engage in any business or activity which shall render it an industry participant must first secure a Standards Compliance Certificate ("SCC") from the DOE or the Department of Trade and Industry ("DTI") depending on the particular classification of the industry participant.

Bulk consumers<sup>11</sup> shall be required to secure an SCC from the DOE prior to its storage of LPG, and annually thereafter prior to its renewal of business permit.

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<sup>11</sup> Bulk Consumer refers to any person or entity whose regular use or consumption of LPG requires bulk storage of LPG at a minimum volume, as may be determined by the DOE, in consultation with the industry stakeholders.

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Under the bill, the DOE is tasked to do the following:

- formulate, in consultation with LPG industry participants, and implement policies, programs and regulations on the LPG industry, including the importation, export, stockpiling, storage, shipping, transportation, refining, processing, marketing and distribution of LPG, whether distributed in cylinders, through pipelines or other means, to ensure that product quality, environmental and worker safety, and consumer welfare standards are met;
- establish safety standards for refilling plants, depots, storage areas, hauling equipment and other facilities of LPG industry players;

On the other hand, the DTI shall be the lead agency on all matters concerning LPG cylinders and ancillary equipment. Under the bill, the DTI is tasked to do the following:

- establish a scheme that will govern the certification for the manufacture and importation of brand new LPG cylinders, requalification, and repair of LPG cylinders;
- inspect and evaluate LPG cylinders, whether local or imported, prior to any sale or distribution to LPG refiners, importers, marketers, dealers, retail outlets or refillers and upon repair or requalification, and certify to their conformity to Philippine National Standards and their fitness for public sale and distribution; and
- grant, suspend or revoke license to manufacturers, importers and repairers or accreditation to requalifiers and other independent and competent private persons and entities that provide services to ensure compliance by industry participants with Philippine national standards for LPG cylinders.

Due to the recent spate of oil price increases and the importance being placed that the Philippine government has placed on energy security, Congress is expected to prioritize deliberations on these pending legislative measures. As part of the process of the bills being passed into laws, public consultations will be held in Congress during which the views and concerns of the industry and other stakeholders will be heard.

## **Investment-State Disputes in the Oil and Gas Sector in Bolivia, Ecuador and Venezuela**

By Grant Hanessian and David Fraser<sup>1</sup>

### **Introduction**

In the last twenty years, several Latin American countries opened their energy sectors to private investment, leading to an influx of foreign direct investment to develop significant oil and gas reserves. In recent years, however, governments in some of those countries, particularly Bolivia, Ecuador and Venezuela, have sought to exercise greater state control of natural resources, and to extract a higher percentage of

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revenues flowing from the exploitation of those resources. This new wave of "Resource Nationalism" has provoked a number of conflicts between these countries and foreign investors in the oil and gas sector.

Foreign investors have often sought the protection of Bilateral Investment Treaties ("BITs") concluded between the investor's state and the state in which the investment has been made (the "host state"), generally through initiation of international arbitration proceedings as provided in the BITs. Recently Bolivia, Ecuador and Venezuela have all taken steps to limit or avoid the jurisdiction of these tribunals.

This article surveys the current state of BIT-based arbitrations in the oil and gas sector in Bolivia, Ecuador and Venezuela, with a focus on current legislative or judicial measures within these countries regarding investment disputes and pending disputes regarding the oil and gas sector.

## I. BOLIVIA

Since the election of President Evo Morales in January 2006, Bolivia has taken majority stakes in the nation's main gas and oil production companies as well as refineries and pipelines and granted itself the exclusive right to market natural gas and other hydrocarbons. The government has sent its armed forces into Bolivian gas and oil fields and nationalized Bolivia's energy sector, including the Bolivian operations of Petrobras, a Brazilian state-owned oil and gas company. A proposed revision to the Bolivian Constitution aims to reinforce the principle that all natural resources belong to the state, and that the method, means and rights for their exploitation are to be decided exclusively by the state.<sup>2</sup>

On May 2, 2007, Bolivia notified ICSID of its formal withdrawal from the ICSID (Washington) Convention. Bolivia's withdrawal became effective on November 3, 2007, when the 6 months notice period provided in Art. 71 of the ICSID convention expired.

Bolivia has also expressed its intent to seek revisions to the 23 BITs as to which it is a state party and is believed to have notified several countries of its intention to renegotiate such treaties. According to Bolivia's Charge D'affaires for Trade, revisions will be sought in three areas: the definition of investment (limitation to investments that "truly generate a value to the country"), performance requirements (setting of requirements for the use of domestic inputs and rules for the transfer of technology), and dispute resolution (limitation of investor-state arbitrations to domestic fora, rather than international venues such as ICSID).<sup>3</sup> Bolivia is also in the process of finalizing a new model BIT, which aims to bring its investment treaties in line with the revision of the Constitution, discussed above.<sup>4</sup>

With respect to Bolivia's denunciation of the ICSID Convention, Article 72 of the Convention provides that denunciation shall not affect the rights and obligations of a state party under the Convention arising out of consent given by it prior to the receipt of its notice of denunciation by the World Bank. Also, Article 25 provides that the

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<sup>2</sup> See for instance Art. 359, 362 and 366 of the proposed Constitution, available at [http://www.presidencia.gob.bo/asamblea/nueva\\_cpe\\_aprobada\\_en\\_grande\\_en\\_detalle\\_y\\_en\\_revision.pdf](http://www.presidencia.gob.bo/asamblea/nueva_cpe_aprobada_en_grande_en_detalle_y_en_revision.pdf)

<sup>3</sup> Damon Vis-Dunbar, Luke Eric Peterson and Fernando Cabrera Diaz, *Bolivia notifies World Bank of withdrawal from ICSID, pursues BIT revisions*, Investment Treaty News (ITN), May 9, 2007.

<sup>4</sup> Damon Vis-Dunbar, Analysis: *Latin America's new model bilateral investment treaties*, Investment Treaty News (ITN), July 17, 2008.

consent of a contracting state to submit a dispute to ICSID may not be withdrawn unilaterally.

It is unresolved whether the consent to ICSID arbitration given by Bolivia in its BITs had to have been perfected by acceptance by the investor prior to 2 May 2007 in order to preserve the rights and obligations arising out of the consent. Such acceptance is normally manifested by the investor filing a claim. For claims arising under BITs after 2 November 2007, investors have argued in at least two cases that consent may be perfected as long as the consent given by Bolivia has not been withdrawn, for example by the termination of the BIT containing the arbitration provision. The investors have argued that this would preserve expectations based upon the terms of the BIT at the time the investment was made.

A number of foreign energy firms formally notified Bolivia of its intention to bring claims in international arbitration, among them Repsol, Total, British Gas and Exxon Mobil.<sup>5</sup> To date, however, only one arbitration claim in the oil and gas sector is known to have been filed against Bolivia. In June 2008, AEI Luxembourg Holdings S.a.r.l. requested arbitration against Bolivia before the Stockholm Chamber of Commerce's Arbitration Institute pursuant to the Luxembourg-Bolivia bilateral investment treaty, alleging expropriation of its share of the natural gas pipeline company Transredes.

There is one case pending in ICSID concerning post-denunciation BIT claims against Bolivia. This claim, by ETI under the Netherlands-Bolivia BIT, relating to a telecoms investment, is the subject of a petition submitted by a large number of NGOs in protest against the decision taken by ICSID to register the claim. It remains unclear whether the Bolivian Government will participate in the ETI proceeding.

## II. ECUADOR

Since 2001, Ecuador, under President Rafael Correa, has canceled certain foreign oil concessions, renegotiated others on terms more favorable to the government, and imposed various new taxes on the operations of foreign oil companies. This has led to the commencement of a number of arbitrations before ICSID and the London Court of International Arbitration ("LCIA").

A number of recent government decisions have demonstrated Ecuador's resolve to modify the existing regime of investor protection and related international arbitration. On December 4, 2007, Ecuador submitted a notice to ICSID stating that

The Republic of Ecuador will not consent to submit to the jurisdiction of the International Centre for Settlement of Investment Disputes the disputes that arise in matters concerning the treatment of an investment in economic activities related to the exploitation of natural resources, such as oil, gas, minerals or others. Any instrument containing the Republic of Ecuador's previously expressed will to submit that class of disputes to the jurisdiction of the Centre, which has not been perfected by the express and explicit consent of the other party given prior to the date of submission of the present notification, is hereby withdrawn by the Republic of Ecuador with immediate effect as of this date.

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<sup>5</sup> Luke Eric Peterson, *Contrary to press rumors, foreign energy firms still on arbitration stand-by in Bolivia*, Investment Treaty News (ITN), January 31, 2006.

In addition, the new Ecuadorian Constitution, ratified by referendum on September 29, 2008 and effective October 20, 2008, prohibits the government from entering into contracts containing international arbitration contracts, except if the arbitration seat is in a Latin American country and the arbitration is conducted by a regional arbitration institution or domestic courts designated by the parties.

Finally, on October 23, 2008, Ecuador gave notice of its cancellation of BITs in place with eight Latin American countries, Cuba, El Salvador, Guatemala, Honduras, Nicaragua, Paraguay, the Dominican Republic and Uruguay.<sup>6</sup>

Four foreign energy firms have instituted ICSID arbitrations to challenge a "windfall profit" tax instituted in October 2007. All of these cases are still in their preliminary stages.<sup>7</sup>

Another arbitration brought by a foreign investor is worthy of note. In 2006 Occidental Exploration and Production Company instituted an ICSID arbitration challenging Ecuador's decision to cancel a Participation Contract and related Operating Agreements that granted Occidental exclusive rights to the development and exploitation of certain oil-producing lands, and demanding \$3 billion in compensation (Ecuador's tax revenue in 2007 was only \$5.1 billion).<sup>8</sup> On September 8, 2008, the tribunal denied Ecuador's argument that the dispute was not within the tribunal's jurisdiction.

Other recent oil and gas arbitrations involving Ecuador have been concluded. In 2006 Panama-based City Oriente Limited instituted an ICSID arbitration disputing the propriety of a windfall tax on oil company profits.<sup>9</sup> Despite the institution of the arbitration, Ecuador continued domestic legal action to collect the disputed payment, threatened to terminate City Oriente's contract, and opened criminal investigations of several City Oriente employees for embezzlement. City Oriente applied to the ICSID tribunal for provisional measures enjoining this conduct. Ecuador did not defend itself at the hearing, and the tribunal granted interim relief. The tribunal stated that it "acknowledges Ecuador's sovereign right to prosecute and punish crimes of all kinds perpetrated in its territory. However, it is the tribunal's view that such undisputed right of the Republic of Ecuador should not be used as a means to coactively secure payment of the amounts allegedly owed pursuant [to the hydrocarbon law]."<sup>10</sup> The dispute was then settled without further arbitral proceedings.

In 2001, Occidental Exploration and Production Company instituted an LCIA arbitration under the US-Ecuador BIT, seeking to avoid payment of a newly-imposed Value Added Tax on purchases required for Occidental's exploration and exploitation

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<sup>6</sup> Ecuador Official Register No. 452, October 23, 2008. *See also, Ecuador terminates BITs with eight LatAm states*, Global Arbitration Review, November 5, 2008.

<sup>7</sup> *Repsol YPF Ecuador, S.A. and others v. Republic of Ecuador and Empresa Estatal Petróleos del Ecuador (PetroEcuador)* (ICSID Case No. ARB/08/10) (tribunal not yet constituted); *Perenco Ecuador Limited v. Republic of Ecuador and Empresa Estatal Petróleos del Ecuador (Petroecuador)* (ICSID Case No. ARB/08/6) (tribunal not yet constituted); *Burlington Resources, Inc. and others v. Republic of Ecuador and Empresa Estatal Petróleos del Ecuador (Petroecuador)* (ICSID Case No. ARB/08/5) (tribunal not yet constituted); *Murphy Exploration and Production Company International v. Republic of Ecuador* (ICSID Case No. ARB/08/4) (tribunal recently constituted).

<sup>8</sup> *Occidental Petroleum Corporation and Occidental Exploration and Production Company v. Republic of Ecuador* (ICSID Case No. ARB/06/11) (pending; respondent's motion to dismiss for lack of jurisdiction denied)

<sup>9</sup> *City Oriente Limited v. Republic of Ecuador and Empresa Estatal Petróleos del Ecuador (Petroecuador)* (ICSID Case No. ARB/06/21)

<sup>10</sup> *City Oriente Limited v. Republic of Ecuador and Empresa Estatal Petróleos del Ecuador (Petroecuador)*, Decision on Provisional Measures, November 19 2007 ¶ 62 (ICSID Case No. ARB/06/21); see also Damon Vis- Dunbar and Luke Eric Peterson, *Tribunal orders Ecuador to cease legal action against foreign oil company*, Investment Treaty News (ITN), December 14, 2007.

activities and the ultimate exportation of the oil produced under its contract with the Ecuadorian government. Occidental claimed that the tax violated inter alia, Ecuador's obligation to afford no less favorable treatment to foreign investors, and its duty to provide fair and equitable treatment and full protection and security to foreign investments. The arbitral tribunal agreed and awarded Occidental approximately \$75 million in damages.<sup>11</sup> Ecuador subsequently challenged the tribunal's jurisdiction before the High Court of London. The Court held in 2005 that it could entertain a challenge to the subject matter jurisdiction of the tribunal even though the right to commence the arbitration was derived from public international law.<sup>12</sup> However, both the High Court in 2006 and, the UK Court of Appeals in 2007 found that the LCIA tribunal did in fact have jurisdiction over the dispute.<sup>13</sup>

In 2003, EnCana Corporation instituted an LCIA arbitration under the Canada-Ecuador BIT challenging the same VAT at issue in the Occidental decision. However, due to substantive differences in the US-Ecuador BIT and the Canada-Ecuador BIT, in 2006 the tribunal reached a different result.<sup>14</sup>

As characterized by the *EnCana* tribunal, the *Occidental* tribunal had jurisdiction because US-Ecuador BIT invoked by Occidental grants an arbitral tribunal jurisdiction over claims concerning taxation which arise out of or relate to "an investment agreement between [a party] and a *national or company of the other Party*." The US-Canada BIT, on the other hand, only grants jurisdiction over claims concerning taxation if the conduct complained of constitutes rises to the level of an expropriation or if the taxation of the investor was "in breach of an agreement between the *central government authorities* and [an investor] concerning an investment." Because the relevant agreement was concluded between EnCana and Petroecuador, rather than directly with the government, the tribunal held it did not have jurisdiction over EnCana's claims that the VAT violated Ecuador's obligation to afford no less favorable treatment to foreign investors, or its duty to investments.<sup>15</sup> As in *Occidental*, the tribunal found the VAT did not constitute an expropriation.<sup>16</sup>

## II. VENEZUELA

The petroleum sector dominates the economy of Venezuela, accounting for roughly a third of GDP, around 80% of export earnings, and more than half of government operating revenues. Venezuela is the fifth biggest member in OPEC. From the 1950s to the early 1980s the Venezuelan economy was the strongest in South America. The economy then contracted during the collapse of oil prices during the 1980s.

During the 1990s, Venezuela opened much of the hydrocarbon sector to foreign investment, promoting multi-billion dollar investment in heavy oil production, reactivation of old fields, and investment in several petrochemical joint ventures. During this period known as the "Apertura", almost 60 foreign companies representing 14 different countries participated in Venezuela's oil sector. The Venezuelan national oil company Petroleos de Venezuela, S.A. (PDVSA) and foreign oil companies signed 33 operating service agreements (OSA) and risk/share

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<sup>11</sup> *Occidental Exploration and Production Company v. The Republic of Ecuador* LCIA Case No. UN3467.

<sup>12</sup> *Republic of Ecuador v. Occidental Exploration & Petroleum Co.*, [2005] EWHC 774 (Comm), [2006] EWHC 345 (COMM); [2007] EWCA Civ 656.

<sup>14</sup> *EnCana Corporation v Ecuador*, Award and Partial Dissenting Opinion, LCIA Case No UN3481, IIC 91, ¶ 166 (2006)

<sup>15</sup> *Id.*

<sup>16</sup> *Id.*, ¶¶ 169-200.

profit agreements (RSPA) and four strategic associations for the production of heavy crude and its eventual upgrade to synthetic crude.<sup>17</sup>

On November 13, 2001, under the enabling law authorized by the National Assembly, President Hugo Chávez enacted the new Organic Hydrocarbons Law, which came into effect in January 2002<sup>18</sup> and replaced the Hydrocarbons Law of 1943 and the Nationalization Law of 1975. This law granted the Venezuelan government a majority equity stake in any new hydrocarbon project and increased the royalty schedule for private oil companies. The law also abolished all former equity arrangements, such as the OSAs, RPSAs, and strategic associations for future agreements with IOCs, and required that all subsequent contracts be joint ventures with State-entities. To give force to the law, the Venezuela Ministry of Energy and Mines (MEM) mandated that PDVSA's thirty-three OSAs, the four original strategic associations, the Sinovensa Natural Bitumen strategic association and the RPSAs be handled by the subsidiary Corporación Venezolana de Petróleo (CVP).

In 2005, the Chavez administration sought to implement the contractual changes as stipulated by the 2001 Hydrocarbon law. In April 2005, MEM required that all foreign operators convert existing OSA projects into a new JV structure. By the following year, MEM created new JV's out of the former OSA projects and vested CVP with a minimum sixty-percent equity stake.

In October 10, 2004, Venezuela raised the royalty rate for IOCs operating in the Orinoco heavy oil fields from 1% of the sales price to 16.67% overnight. President Chavez stated on Venezuelan national television that the increased royalty/tax move represented the "second and true phase of the nationalization of the country's oil." Most foreign investors accepted the raise under protest.<sup>19</sup>

In 2006 the Venezuelan government adopted several new measures aimed at terminating all preexisting oil agreements.<sup>20</sup> Additionally, tax measures were taken increasing the royalty rate to 30%, creating an "extraction tax," which is calculated in a similar way to the royalty, among others.<sup>21</sup>

In April 2008, Venezuela imposed a windfall tax of 50% on oil revenues above \$70 per barrel and 60% of revenues over \$100 per barrel.<sup>22</sup>

Three major oil companies have initiated arbitrations to challenge some of these measures. ConocoPhillips filed an ICSID arbitration in October 2007.<sup>23</sup> Exxon-Mobil has begun two international arbitrations; the first was filed before ICSID in

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<sup>17</sup> See R. Chirinos et al., *Survey of Recent Governmental Measures in Key Latin-American Countries*, Transnational Dispute Management, April 2008 at 2-4.

<sup>18</sup> Published in Official Gazette Nr. 37.323 of November 13, 2001, as amended by law reprinted in the Official Gazette Nr 38.493 on August 4, 2006.

<sup>19</sup> See R. Chirinos et al. Id.

<sup>20</sup> *Ley de Regularización de la Participación Privada en las Actividades Primarias Previstas en el Decreto N° 1510 con Fuerza de Ley Orgánica de Hidrocarburos*, published in Official Gazette Nr. 38419 of April 18, 2006; *Decreto N° 5,200, con Rango, Valor y Fuerza de Ley de Migración a Empresas Mixtas de los Convenios de Asociación de la Faja Petrolífera del Orinoco, así como de los Convenios de Exploración a Riesgo y Ganancias Compartidas*, published in Official Gazette Nr. 38,632 of February 26, 2007; *Ley sobre los Efectos del Proceso de Migración a Empresas Mixtas de los Convenios de Asociación de la Faja Petrolífera del Orinoco, así como de los Convenios de Exploración a Riesgo y Ganancias Compartidas*, published in Official Gazette Nr. 38.785 of October 8, 2007.

<sup>21</sup> Amendment to the Organic Law on Hydrocarbons, reprinted in Official Gazette Nr 38.493 on August 4, 2006.

<sup>22</sup> *Ley de Contribución Especial sobre Precios Extraordinarios del Mercado Internacional de Hidrocarburos*, published in Official Gazette Nr. 38.910 of April 15, 2008.

<sup>23</sup> *ConocoPhillips Company and others v. Bolivarian Republic of Venezuela* (ICSID Case No. ARB/07/30).

September of 2007,<sup>24</sup> and another before the International Chamber of Commerce ("ICC") on January 28, 2008. Each body convened proceedings under the terms of the initial contracts between Venezuela and Exxon-Mobil. As a precautionary measure to ensure that PDVSA would not liquidate its holdings in the event of an unfavorable holding, Exxon-Mobil filed lawsuits in New York, the United Kingdom, the Netherlands and the Netherlands Antilles.

On February 7, 2008, courts in the United Kingdom, the Netherlands and the Netherlands Antilles granted Exxon-Mobil request to freeze \$12 Billion in international assets of PDVSA.<sup>25</sup> The High Court in London prohibited Venezuela from selling its worldwide assets. Subsequently, however, a British Judge on February 18, 2008, dismissed the freeze, ruling for Venezuela that the U.K. was not a proper jurisdiction for this action, and that there was no urgent risk of PDVSA hiding its assets to avoid paying compensation.<sup>26</sup>

In New York, Exxon-Mobil secured a temporary injunction in aid of arbitration pursuant to FRCP 64 against \$300 million of PDVSA's assets, after the judge determined that that Exxon-Mobil would likely prevail in its arbitral action.<sup>27</sup> It remains to be seen how the New York action will proceed; an appeals court affirmed the temporary injunction, rejecting Venezuela's argument in that it was entitled to sovereign immunity.

The Italian oil firm ENI initiated an ICSID arbitration in February of 2007 over the nationalization of the Dacion oil field, to which ENI had had a concession. However, ENI settled its claim for \$700 million, less than the book value of the nationalized assets, after it signed a lucrative deal with Venezuela potentially worth more than \$4 billion to develop a bloc of the Orinoco basin.<sup>28</sup>

On April 30, 2008, the Venezuelan government informed its Dutch counterpart about its decision not to extend the Netherlands-Venezuela BIT, which had been in force since 1993. Consequently, the BIT terminated on November 1<sup>st</sup>, 2008. The survival clause of this BIT protects preexisting investments for an additional 15-year term following its termination date.

Besides investment protection contained in bilateral and multilateral agreements, since 1999, Venezuela has offered protection to foreign investments pursuant to the Venezuelan Law for the Promotion and Protection of Investments ("IPPL"). Particularly, Article 22 of the IPPL provides:

Disputes which arise between an international investor whose country of origin has a treaty or agreement in force with Venezuela on the promotion and protection of investments, or disputes to which the provisions of the Convention Establishing the Multilateral Investment Guarantee Agency (OMGI – MIGA) or of the Convention on the Settlement of Investment Disputes between States and Nationals of Other States (ICSID) are applicable, shall be submitted to international arbitration according to the

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<sup>24</sup> *Mobil Corporation and others v. Bolivarian Republic of Venezuela* (ICSID Case No. ARB/07/27) (the Tribunal was scheduled to hold a first session in Paris on November 7, 2008)

<sup>25</sup> See, Steven Mufson, *Exxon Is Awarded Freezes On Venezuelan Oil Assets*, Washington Post, February 8, 2008 at D01.

<sup>26</sup> *Mobil Cerro Negro Ltd v Petroleos De Venezuela SA*, Queen's Bench Division (Commercial Court), 20 March 2008.

<sup>27</sup> *Mobil Cerro Negro, Ltd v. PDVSA Cerro Negro S.A.* Civil Action No. 07 CV 11590 (S.D.N.Y. December 27, 2007).

<sup>28</sup> Jad Mouawad, *Eni of Italy in Oil Deal in Venezuela*, N.Y. Times, March 1, 2008,

terms of the respective treaty or agreement, if so established therein, without prejudice to the possibility of using, when applicable, the judicial means contemplated in the Venezuelan legislation in force.

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Foreign investors have argued that this provision constitutes an open offer of ICSID arbitration by Venezuela, which is of particular interest to investors who come from jurisdictions that have not entered into BITs with Venezuela, such as the United States. The Venezuelan government has taken the position that Article 22 does not contain such an offer, but rather a mere reiteration that Venezuela is a signatory to the ICSID Convention. Under this view, an additional or ad hoc consent by Venezuela would be required in order to be brought to arbitration pursuant to the ICSID Convention (i.e., a binding contract or a BIT).

This issue recently reached the Constitutional Chamber of the Venezuelan Supreme Court in the form of a "Recurso de Interpretacion" filed by the "Procuraduria General de la Republica" on June 12, 2008. On October 17, 2008, the Venezuelan Supreme Court issued a decision finding that Article 22 does not imply and should not be interpreted as an advance consent to arbitration but rather merely reiterates the ability of the state to submit to arbitration in principle. Ultimately, it will be for international arbitral tribunals to analyze, pursuant to the principle of Kompetenz-Kompetenz, whether they have jurisdiction with respect to each particular case in which Article 22 has been or will be invoked. In doing so, these tribunals will not only take into account the arguments under Venezuelan law but also international law and the facts of each case.<sup>29</sup>

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<sup>29</sup> See e.g., *Southern Pacific Properties(Middle East) Limited v. Arab Republic of Egypt* (ICSID Case No. ARB/84/3)