International Centre for Settlement of Investment Disputes

Burlington Resources Inc.

The Claimant

v.

Republic of Ecuador

The Respondent

ICSID Case No. ARB/08/5

DECISION ON LIABILITY

Rendered by an Arbitral Tribunal composed of

Prof. Gabrielle Kaufmann-Kohler, President
Prof. Brigitte Stern, Arbitrator
Prof. Francisco Orrego Vicuña, Arbitrator

Secretary of the Tribunal
Marco Tulio Montañés-Rumayor

Assistant to the Tribunal
Gustavo Laborde

Date: 14 December 2012

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TABLE OF ABBREVIATIONS

Arbitration Rules	ICSID Rules of Procedure for Arbitration Proceedings
BIT or the Treaty	Bilateral Investment Treaty; specifically “Treaty between the United States and Ecuador concerning the Encouragement and Reciprocal Protection of Investments” of 11 May 1997
CPHB	Burlington's Post-Hearing Brief of 6 May 2011
CSM	Burlington's Supplemental Memorial on Liability of 29 September 2010
COSS	Claimant [Burlington]'s Opening Statement Slides for the liability hearing
DJ	Decision on Jurisdiction of 2 June 2010
ER	Expert Report
Exh. C-	Claimant [Burlington]’s Exhibits
Exh. CL-	Claimant [Burlington]’s Legal Exhibits
Exh. E-	Respondent [Ecuador]’s Exhibits
Exh. EL-	Respondent [Ecuador]’s Legal Exhibits
ICSID	International Centre for Settlement of Investment Disputes
ICSID Convention	Convention on the Settlement of Investment Disputes between States and Nationals of other States
Mem.	Initial Claimants' Memorial of 20 April 2009
LET	Ley de Equidad Tributaria
PO1	Procedural Order No. 1 of 29 June 2009
PO2	Procedural Order No. 2 of 29 October 2009
PSC	Production Sharing Contract
RA or Request	Burlington's Request for Arbitration of 21 April 2008
RCM	Ecuador's Counter-Memorial on Liability of 17 January 2011
ROSS	Respondent [Ecuador]'s Opening Statement Slides for the liability hearing
RPHB	Ecuador's Post-Hearing Brief of 6 May 2011
Tr. [page:line]	Transcript of the hearing on liability of 8-11 March 2011, as revised by the parties on 6 May 2011.
WS	Witness Statement

I. FACTS

A. THE PARTIES

1. The Claimant

1. The Claimant, Burlington Resources Inc. ("Burlington" or the "Claimant"), is a corporation existing under the laws of the State of Delaware, United States of America, founded in 1988, and active in the exploitation of natural resources. On 31 March 2006, Burlington was acquired by ConocoPhillips, a multinational energy company with headquarters in the State of Texas, United States of America.

2. The Claimant is represented in this arbitration by Jan Paulsson, Nigel Blackaby, Alexander Yanos, Christopher Pugh, Noiana Marigo, Jessica Bannon Vanto, Viren Mascarenhas, Sam Prevatt and Ruth Teitelbaum of FRESHFIELDS BRUCKHAUS DERINGER US LLP; by Prof. James Crawford of Matrix Chambers, Gray's Inn, London; and by Javier Robalino-Orellana of PAZ HOROWITZ, Quito.

2. The Respondent

3. The Respondent is the Republic of Ecuador ("Ecuador" or the "Respondent").

4. The Respondent is represented in this arbitration by Dr. Diego García Carrión, Álvaro Galindo Cardona (until March 2011), Francisco Larrea, and Christel Gaibor from the PROCURADURÍA GENERAL DEL ECUADOR; and Eduardo Silva Romero, Pierre Mayer, José Manuel García Represa, Maria Claudia Procopiak, Philip Dunham, Ella Rosenberg, George Foster and Ana Carolina Simoes e Silva of DECHERT (Paris) LLP. Dr. Galindo joined DECHERT in March 2011.

B. ECUADOR'S OIL INDUSTRY: THE PRODUCTION-SHARING CONTRACT MODEL

5. This Section summarizes the facts of this dispute insofar as they bear relevance to rule on Respondent's purported liability under the Treaty between the United States and Ecuador concerning the Encouragement and Reciprocal Protection of Investment" (the "Treaty" or "BIT").

6. This dispute arose in the wake of the oil price spike that began in 2002 and that, though with some intermittence, continues to this date. The Parties are in dispute as to how the economic benefits of this oil price spike must be distributed between them. At the heart of this dispute lie the production sharing contracts ("PSCs") for Blocks 7 and 21, entered into between a Burlington wholly-owned subsidiary and Ecuador. Before

entering into the specifics of the dispute, a review of the recent history of Ecuador's hydrocarbons industry is warranted to place the dispute in proper context.

7. Along its history, Ecuador has adopted different contract models for the exploration and exploitation of its hydrocarbon resources. In the 1980s, the prevalent contract model for the exploitation of hydrocarbons in Ecuador was the so-called service contract. Under the service contract model, the government remained the sole owner of any oil produced in the exploration area (the "Block") awarded to the private contractor. If the contractor discovered oil reserves, it had the right to a reimbursement of its costs and to a fee. If it found no oil reserves within a four-year period, the contractor lost its exploration investment and the contract was terminated.[1]

8. The service contract model appeared ill-suited to meet the interests of the State or the investors alike. The State often incurred losses on oil-producing blocks operated under service contract models, in part because the contractor's costs frequently spiraled out of control and the State was contractually bound to reimburse the full measure of these costs.[2] The model was thus unfit to curb cost inefficiencies.[3] On the other hand, investors showed little interest in the service contract model, in part because the profit margins under this model, albeit steady, were fixed. Investors seemingly preferred to shoulder part of the exploration and exploitation risk in exchange for a share of the oil produced. Tellingly, no service contract was executed in the five-year period between 1989-1993. In a nutshell, with the service contract model, Ecuador's hydrocarbons industry remained stagnant.

9. Beginning in 1992, the newly-elected Ecuadorian President Durán Ballén set out to impart new vigor to the sluggish national oil industry. To bring that goal to fruition, the legal regime applicable to hydrocarbons was overhauled. In October 1993, in the context of a general program of economic reforms designed to increase the role of the private sector, President Durán Ballén submitted a bill to Congress calling for the adoption of a new contract model for the exploration and exploitation of hydrocarbons: the so-called production-sharing contract (or "PSC"). Under this contract model, the contractor would assume the entire risk of oil exploration and exploitation, and would in exchange receive a share of the oil produced in accordance with the allocation formulas specified in each contract.

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1 Mem., ¶ 41 n. 42.

2 Mem., ¶¶ 50, 62.

3 Tr. 590:15-591:10.

10. The new PSC model was expected to redress the problems that emerged under the service contract model. It would shift the exploration and exploitation risks from the State to the contractor and would thus put an end to the problem of excessive and inefficient costs incurred at the State's expense. In the letter to the Ecuadorian National Congress (the "Ecuadorian Congress") enclosing the bill, President Durán Ballén observed that:

> "[T]he limited financial resources that the country has […] do not justify PetroEcuador's assumption of all the risk involved in exploration activities; such risk must be shared with international petroleum companies. […] [T]he stipulation for mandatory reimbursement of the contractor's investments, costs and expenditures has significantly reduced the participation of the State in the economic benefits of oil exploration and production in medium and small fields."[4]

11. In addition, the new PSC would help to attract foreign investment. In the letter to the Ecuadorian Congress, President Durán Ballén noted that "the current [service contract model] has exhausted its possibilities of attracting foreign capital."[5] One of the reasons why the service contract model failed to attract foreign investment was that it did not allow contractors to receive a share of the oil production. In the words of President Durán Ballén:

> "[T]he service contract does not permit the contracting company to have a production flow of its own. This characteristic goes against the interest and *raison d'être* of international petroleum companies, for the majority of whom the availability of production is an essential aspect of marketing in international markets. […] The new contract […] will allow Ecuador to position itself at an internationally competitive level for attracting venture capital […]."[6]

12. The overall purpose of the proposed shift from service contracts to PSCs was, in sum, to increase Ecuador's competitiveness in the global oil industry. On 29 November 1993, the Ecuadorian Congress approved the bill authorizing the State to enter into PSCs with private companies. In passing this amendment to the Hydrocarbons Law, the Ecuadorian Congress underlined that it was "indispensable to introduce in the Ecuadorian legislature contractual models that make the exploration and exploitation of hydrocarbons competitive."[7] In conjunction with this amendment, Ecuador issued Decree 1417 which regulated in detail various aspects of the Hydrocarbons Law (collectively, the Law and the Decree will be referred to in this award as the "Hydrocarbons Legal Framework").

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[4] Exh. C-78, pp. 2-4 (Claimant's translation); Mem., ¶ 63.

[5] Exh. C-78, at p. 3 (Claimant's translation); COSS, # 3; Tr. 16:8-10.

[6] Exh. C-78, at p. 4 (Claimant's translation); Mem., ¶ 64.

[7] Exh. C-15, Preamble (Tribunal's translation).

13. Subsequently, Ecuador opened international bidding rounds aimed at concluding PSCs with private companies. The purpose of this bidding process was to "promote foreign investment in the Country and expand the hydrocarbons reserves."[8] On 20 March 1995, Ecuador awarded the production sharing contract for the exploration and exploitation of Block 21 to foreign investors.[9] Furthermore, on 23 March 2000, Ecuador converted the existing service contract for the exploration and exploitation of Block 7 into a production sharing contract.[10]

C. BURLINGTON'S INTERESTS IN THE PSCS FOR BLOCKS 7 AND 21

14. Beginning in mid-2001, Burlington acquired interests in the PSCs executed by the Ecuadorian State for the exploration and exploitation of Blocks 7 and 21. Burlington acquired these interests through its wholly-owned subsidiary Burlington Oriente (or the "Burlington subsidiary"). Burlington also acquired interests in the PSCs for Blocks 23 and 24. While Burlington originally asserted claims against Ecuador in relation to Blocks 23 and 24, which were not yet in production, the Parties have since settled these claims. Therefore, this decision is confined to Burlington's outstanding claims in relation to Blocks 7 and 21, which were in production at the time this dispute arose.

15. Burlington is the minority partner of Blocks 7 and 21. The Blocks are located in the Ecuadorian Amazon Region, and each covers an area of 200,000 hectares. Burlington holds a 42.5% interest in the PSC for Block 7[11], and a 46.25% interest in the PSC for Block 21.[12] The majority partner and operator of the Blocks, the French oil company Perenco, holds the remaining interests in the Blocks. Under an Ecuadorian tax regulation issued on 23 September 2005, partners in PSCs for the exploration and exploitation of hydrocarbons must form a consortium for the joint payment of taxes. In accordance with this regulation, Burlington Oriente and Perenco established a consortium in late 2005, which became effective on 1 January 2006 (the "Tax Consortium" or simply the "Consortium").

16. The PSCs for Blocks 7 and 21 regulated at length the parties' rights and obligations in relation to the exploration and exploitation of hydrocarbons in the Blocks. The PSC for

[8] Exh. C-90, Preamble, 4th paragraph (Claimant's translation); Mem., ¶74.

[9] Exh. C-2.

[10] Exh. C-1.

[11] With respect to Block 7, Burlington Oriente acquired a 25% interest on 25 September 2001, a 5% interest on 13 December 2001, and a 12.5% interest in September 2006. Each of these transactions was followed by the requisite government approvals and registrations.

[12] With respect to Block 21, Burlington Oriente acquired a 32.5% interest in September 2001, a 5% interest on 7 December 2011, and a 8.75% interest on 7 September 2005. Each of these transactions was followed by the requisite government approvals and registrations.

Block 7 was set to expire in 2010; the PSC for Block 21 in 2021. In particular, the PSCs (i) contained participation formulas allocating the oil produced between the State and the contractors, (ii) included choice of law provisions in favor of Ecuadorian law and, (iii) of pivotal importance to this case, incorporated certain tax clauses whose meaning is considerably disputed by the Parties.

17. First, the PSCs contained participation formulas allocating the oil produced between Ecuador, on the one hand, and the contractors (Burlington and Perenco), on the other. The PSCs allocated oil production on the basis of the volumes of oil produced, with a possible upward or downward adjustment based on the quality of the oil.[13] The Parties vigorously disagree over whether these participation formulas were also linked to the price of oil at the time the PSCs were concluded. Burlington submits that the participation formulas were grounded solely on the volume and quality of oil produced. Ecuador, on the other hand, claims that the participation formulas were also premised on the price of oil at the time of the PSCs, which would yield a specific internal rate of return ("IRR") for the contractor.

18. The PSC for Block 7 established the following participation formula:

Block 7[14]	
Daily average production per year (barrels)	**Contractor's Participation**
< 5,000	76.2%
5,000 – 10,000	74.2%
> 10,000	65%

19. The PSC for Block 21 stipulated the following participation formula:

Block 21[15]	
Daily average production per year (barrels)	**Contractor's Participation**
< 30,000	67.5%
30,000 – 60,000	60%
> 60,000	60%

20. Second, the PSCs included choice of law provisions in favor of Ecuadorian law. The Parties are in dispute as to whether or not these provisions are legal stabilization

13 Exhs. C-1 and C-2, at clause 8.1.

14 Exh. C-1, at clause 8.1; Mem., ¶ 103.

15 Exh. C-2, at clause 8.1; Mem., ¶ 103.

clauses, *i.e.* clauses whereby the contract is governed by the laws in force at the time of its execution, as opposed to laws as subsequently modified. Clause 22.1 of the PSCs for Blocks 7 and 21 provide that:

> "Applicable Legislation: This Contract is governed exclusively by Ecuadorian legislation, and *laws in force at the time of its signature are understood to be incorporated by reference*."[16] (emphasis added)

21. Third, the PSCs incorporated tax clauses regulating the tax treatment that would be afforded to the contractor. Thus, the PSCs stipulated an employment contribution of 15%, an income tax of 25%[17], and exempted the contractor from the payment of royalties or other additional fees. Moreover, the PSCs contained tax modification clauses, that is, clauses calling for the application of a "correction factor" whenever tax changes – be it tax increases or decreases – had an impact on the economy of the contract. The Parties strongly disagree about the import of these clauses: for Burlington, these are tax stabilization clauses; for Ecuador, these are merely renegotiation clauses. Until it has reached a conclusion about their nature, the Tribunal will refer to these clauses as the "tax modification clauses", for it is undisputed that they regulate the parties' conduct in the event of a modification to the tax system. The tax modification clause of the PSC for Block 7 provides:

> "Modification to the tax system: In the event of a modification to the tax system or the creation or elimination of new taxes not foreseen in this Contract or of the employment contribution, in force at the time of the execution of this Contract and as set out in this Clause, which have an impact on the economy of this Contract, a correction factor will be included in the production sharing percentages to absorb the impact of the increase or decrease in the tax or in the employment contribution burden. This correction factor will be calculated between the Parties and will be subject to the procedure set forth in Article thirty-one (31) of the Regulations for Application of the Law Reforming the Hydrocarbons Law."[18]

22. For its part, the tax modification clause of the PSC for Block 21 states:

> "Modification to the tax system and to the employment contribution: In the event of a modification to the tax system, the employment contribution or its interpretation, which have an impact on the economics of this Contract, a correction factor will be included in the production sharing percentages to absorb the increase or decrease in

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[16] Exhs. C-1 and C-2 at clause 22.1.

[17] The combined tax burden of the employment contribution (15%) and the income tax (25%) is 36.25% and not 40% (Exh. C-1, at 11.2.4; Exh. C-2, at 11.2.2). This is because the employment contribution applies to the gross profits, but the income tax applies only to the lower amount that results following the application of the employment contribution.

[18] Exh. C-1, clause 11.12 (Tribunal's translation).

> the tax. This adjustment will be approved by the Administrative Board on the basis of a study that the Contractor will present to that effect."[19]

D. ORIGIN OF THE DISPUTE: OIL PRICE INCREASES AND ECUADOR'S RESPONSE

23. As noted above, Burlington initially acquired interests in the PSCs for Blocks 7 and 21 in September 2001.[20] The crude oil produced in Block 7 is called Oriente crude and it is a high-quality crude, with a gravity ranging between 26°-29° API[21]; the crude oil produced in Block 21 is known as Napo crude and is of somewhat lower quality, with a gravity oscillating between 17°-19° API. Thus, the market price of Oriente crude is higher than the market price of Napo crude. In September 2001, when Burlington acquired its initial interests in the PSCs for the Blocks, the price of Oriente crude was USD 20.15 per barrel.[22] Block 21 was not in production at that time, and would not be in production until late 2003.[23]

24. Beginning in 2002, oil prices began to rise. In 2005, the price of a barrel of oil had more than doubled, exceeding USD 50/bbl for Oriente crude between August and October 2005. By 2006, the price of Oriente crude reached over USD 60/bbl, and Napo crude went over USD 50/bbl. Towards the end of 2007, Oriente crude was trading at around USD 80/bbl and Napo crude at around USD 74/bbl. By 2008, the price of oil surpassed the USD 100/bbl landmark for both Oriente and Napo crude from May to July, reaching USD 121.66/bbl for Oriente crude in June 2008[24] – that is, more than USD 100/bbl above its September 2001 price. Thereafter, oil prices fell sharply to below USD 30/bbl at the end of 2008 and beginning of 2009, only to increase again and stabilize in the range of USD 60-70/bbl for most of 2009 and 2010.[25]

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19 Exh. C-2, clause 11.7 (Tribunal's translation).

20 See *supra*, notes 11 and 12.

21 API is a scale developed by the American Petroleum Institute (API): the higher the API, "the lighter – and hence, more valuable – the crude becomes" (Mem., ¶ 42 n.44.)

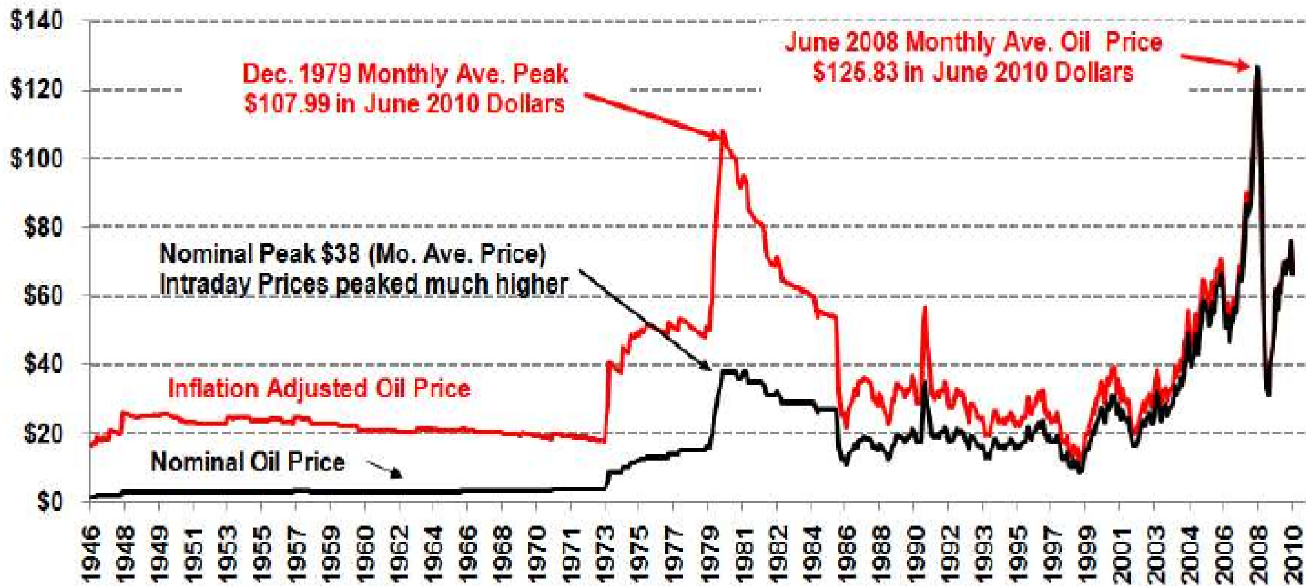
22 Martinez Direct Examination binder, Oil Prices tab (hereinafter "Martinez, Oil Prices tab").

23 *Id.*; also, Mem., ¶ 161 ("Production in Block 21 began in 2003").

24 Napo crude reached a peak of USD 114.67/bbl in June 2008.

25 See *supra* note 22.

25. The Parties disagree on whether the increase in oil prices was foreseeable or not. Burlington argues that the parties foresaw the possibility that oil prices would increase. Moreover, as illustrated in the graph below[26], in the late 1970s oil prices had experienced the same type of increase as in 2008.



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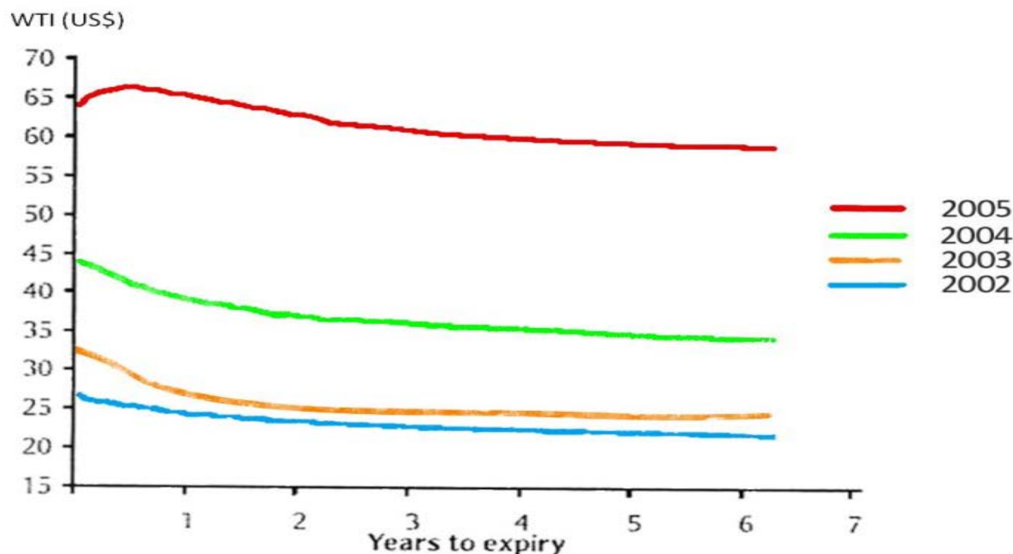
[26] Ecuador has noted that the graph fails to specify what kind of oil it refers to: "[T]here are different kinds of crude oils with different prices. The Ecuadorian crude oil has one price, the WTI has another, the Brent crude oil has another price." (Tr. 619:11-19; also RPHB, ¶ 39). WTI stands for West Texan Intermediate. (Martinez, Oil Prices tab). The WTI is an international benchmark for oil prices. Ecuadorian crude oil prices are lower than WTI prices (RCM, ¶ 176 n.113) but nonetheless "follow the evolution of WTI" (Dávalos, Tr. 620:5-10). Counsel for Burlington assumed that the graph referred to WTI prices (Tr. 620:11-17).

26. Ecuador, on the other hand, maintains that the increase in oil prices was "completely unforeseen and unforeseeable."[27] Oil prices remained stable from the mid-1980s to the beginning of the 2000s. Ecuador claims that the oil price increases of the 1970s were brought about by specific events, to wit, "the Arab world's tightening of oil production"[28] following the Yom Kippur War, and the Iranian revolution together with the Iran-Iraq war.[29] The graph below illustrates how oil price forecasts evolved from 2002 to 2005.[30]



27. According to Ecuador, this price increase "destroyed the economic stability" of the PSCs, including the PSCs for Blocks 7 and 21.[31] More generally, Ecuador believed that the allocation of oil production under the PSCs was no longer fair in view of the remarkable increase in oil prices. It considered that, because the State is the owner of the oil, it should benefit from the increase in oil prices to a greater extent than the contractor; however, under the terms of the PSCs, which allocated the majority of oil production to the contractor, the contractor would benefit from the increase in oil prices to a greater extent than the State.[32]

28. In November 2005, at a time when the prices of Oriente and Napo crude were about USD 40/bbl, Ecuador invited Burlington to renegotiate the terms of the PSCs. Ecuador

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27 RCM, ¶ 179.

28 RCM, ¶ 178.

29 RCM, ¶¶ 176-181.

30 Expert Report of Fair Links, January 2011 (hereinafter “Fair Links ER”), ¶ 65, Figure 6; RPHB, ¶ 59.

31 RCM, ¶ 172.

32 RCM, ¶ 188; RPHB, ¶ 246.

wished to increase its share of participation from around 22% to 50%.[33] Burlington, however, rejected this proposal.[34] According to Burlington, the allocation of oil production was independent of the price of oil. In addition, while the PSCs could be amended under certain circumstances, these circumstances did not "include a change in oil prices or the perceived inequity of the production participations to which the parties agreed."[35] As a result, Ecuador's proposed renegotiations failed.

29. On 1 March 2006, following the breakdown of the renegotiations, Ecuadorian President Palacio submitted a bill to Congress proposing an additional participation for the State of "at least 50%"[36] on so-called extraordinary profits, *i.e.* profits resulting from oil prices in excess of the price of oil as it stood when the PSCs were executed. In the letter explaining the purposes of the bill, President Palacio stated that the PSCs "breach the principle of equity" insofar as there is no clause that allows for a modification of the oil participation share in favor of the State in case of an increase in oil prices.[37] The overall purpose of the bill was "to restore equity" in favor of the State.[38] In the meantime, ConocoPhillips acquired Burlington on 31 March 2006.[39]

30. On 19 April 2006, Congress approved President Palacio's bill and enacted Law 42, which amended the Hydrocarbons Law as follows:

> "**Participation of the State over non agreed or unforeseen surpluses from oil selling contracts. Contracting companies** having Hydrocarbons exploration and exploitation participation agreements in force with the Ecuadorian State pursuant to this Law, without prejudice to the volume of crude oil which may correspond thereto according to their participation, in the event the actual monthly average selling price for the FOB sale of Ecuadorian crude oil exceeds the monthly average selling price in force at the date of execution of the agreement expressed at constant rates for the month of payment, **shall grant the Ecuadorian State a participation of at least 50%**

33 Mem., ¶ 207; First Supplemental Witness Statement of Alex Martínez, 17 April 2009 (hereinafter “Martinez Second WS”), ¶ 14.

34 *Id.*

35 Mem., ¶ 104 n. 141.

36 RCM, ¶ 215; Exh. E-130.

37 Exh. C-174, Explanatory Memorandum enclosed with letter of 1 March 2006, p. 2, first paragraph (Tribunal’s translation).

38 *Id.*, pp. 2-3 (Tribunal’s translation).

39 According to Ecuador, this was a very important event because ConocoPhillips "knew about the negotiation of the contracts. They knew that Ecuador wanted to do that [renegotiate the PSCs]. They bought Burlington. They knew that Windfall Profits Taxes could be enacted. They had the China experience. And they also knew that Law 42 could be enacted. Why? Because President Palacio had already submitted the draft law, the bill, to Congress on the 1st of March 2006." (Tr. 1360:21-1361:11).

> **over the extraordinary revenues caused by such price difference** […]."[40] (emphasis added).

31. As the Tribunal previously concluded, Law 42 is a tax measure for purposes of this Treaty dispute.[41] While Ecuador has argued that Law 42 is a "levy" rather than a "tax" under its domestic law, it has conceded that "for the purposes of the present case, any dispute as to the legal nature of Law 42 under Ecuadorian law is irrelevant."[42] Any such dispute would be irrelevant because the Parties agree that, be it a tax or a levy, Law 42 is part of Ecuador's "tax system" within the meaning of the PSCs and its tax modification clauses.[43] Therefore, for purposes of this decision, the Tribunal deems that Law 42 created a tax.

32. Under the Law 42 tax, oil companies had to pay 50% of the amount, if any, by which the market price of oil exceeds the price of oil at the time the PSCs were executed.[44] In order to calculate the tax, it is necessary to determine:

    (i) First, the current market price of oil, defined as the actual monthly average oil spot prices (the "market price");

    (ii) Second, the market price of oil at the time the PSCs were executed adjusted for inflation (the "statutory reference price");

    (iii) Third, the tax which is equivalent to 50% of the difference, if any, between the market price and the statutory reference price.

33. The statutory reference price was about USD 25/bbl[45] for Block 7 and USD 15/bbl[46] for Block 21. This statutory reference price was adjusted for inflation and crude quality.[47] In July 2006, for instance, the market price of Oriente crude from Block 7 was USD 66.56/bbl and the adjusted statutory reference price was USD 30.01/bbl. Therefore, the Law 42 tax was USD 18.28 per barrel of oil produced in Block 7 (50% of the difference between USD 66.56/bbl and USD 30.01/bbl).[48] The market price of Napo

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[40] Exh. C-7, Article 2.

[41] DJ, ¶ 167.

[42] RCM, ¶ 287.

[43] Mem., ¶¶ 369-370; RCM, ¶ 287.

[44] The Law 42 tax applies to the oil company's gross income. Once other taxes and levies envisaged in the PSCs are deducted from this gross income, the base income is obtained. The employment contribution and the income tax are then assessed on this base income to determine the oil company's net income or profits (RCM, ¶ 219).

[45] The exact initial statutory reference price for Block 7 was USD 25.111383 (Mem., ¶ 219; Exh. C-178).

[46] The exact initial statutory reference price for Block 21 was USD 15.358274 (Mem., ¶ 219; Exh. C-178).

[47] RCM, ¶¶ 218, 342, 500, 502.

[48] RPHB, ¶ 299; ROSS # 118.

crude from Block 21 at that time was USD 57.43/bbl[49] and the statutory reference price about USD 18/bbl.[50] Accordingly, the Law 42 tax was roughly USD 19.72 per barrel of oil produced in Block 21 (50% of the difference between USD 57.43/bbl and USD 18/bbl).

34. On 6 September 2006, the Ecuadorian Constitutional Court declared that Law 42 was constitutional.[51] Burlington paid the Law 42 tax under protest.[52] By letters dated 18 December 2006, the Tax Consortium requested PetroEcuador to apply a correction factor that would absorb the effects of Law 42, allegedly in accordance with the tax modification clauses contained in the PSCs. Ecuador did not reply to these requests, allegedly on the ground that Burlington had failed to present evidence that Law 42 had an impact on the economy of the PSCs – an essential prerequisite for the application of the tax modification clauses.[53]

35. In November 2006, Rafael Correa won the presidential elections, taking office in January 2007 and replacing President Palacio. On 18 October 2007, Ecuador issued Decree 662, which increased the Law 42 tax rate from 50% to 99% ("Decree 662" or "Law 42 at 99%"). In November 2007, for instance, the market price for Oriente crude from Block 7 was USD 83.20/bbl and the statutory reference price was USD 30.85/bbl. Thus, the Law 42 at 99% tax was USD 51.83/bbl (99% of the difference between USD 83.20/bbl and USD 30.85/bbl).[54] In that month, the market price of Napo crude was USD 79.09/bbl[55] and the statutory reference price of about USD 18/bbl.[56] It follows that the Law 42 at 99% tax was roughly USD 60.48/bbl (99% of the difference between USD 79.09/bbl and USD 18/bbl).

36. Burlington paid the Law 42 at 99% tax under protest.[57] By letters of 28 November 2007, the Tax Consortium again requested PetroEcuador to apply a correction factor to

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49 Martinez, Oil Prices tab.

50 As there appears to be no evidence of the adjusted statutory reference price for Block 21 in July 2006, the Tribunal has applied to the Block 21 statutory reference price the same adjustment rate that was applied to the Block 7 statutory reference price, *i.e.* 20%. This computation is thus meant to be approximate and not exact.

51 RCM, ¶ 217; Exh. CL-62.

52 Mem., ¶ 220; Exh. C-9.

53 Witness Galo Chiriboga, then Executive President of PetroEcuador, testified that the Consortium's requests were mistimed in light of the looming change of administration (Tr. 782:15-783:8).

54 RPHB, ¶ 299; ROSS # 118.

55 Martinez, Oil Prices tab.

56 See *supra* note 50.

57 Mem., ¶ 225; Exh. C-42.

its oil participation share that would absorb the effects of Law 42 at 99%, allegedly in accordance with the tax modification clauses of the PSCs. As was the case with Law 42 at 50%, Ecuador did not respond to these requests, allegedly because Burlington had failed to prove that Law 42 at 99% had affected the economy of the PSCs and therefore that the requirements for the application of the tax modification clauses were met.

37. In December 2007, Ecuador passed the *Ley de Equidad Tributaria* ("LET"), whose purported goal was to open a "new avenue for negotiations with the oil companies"[58] which would allow "them to avoid the application of Law 42"[59] at 99%. According to Ecuador, the LET allowed the State and the oil companies to agree "fairer terms"[60] for the allocation of oil revenues. The LET presented the following three differences with respect to Law 42 at 99%: (i) its tax rate was 70%; (ii) the statutory reference price was not fixed by Ecuador but was subject to negotiation on a case-by-case basis; and (iii) it would apply only to those oil companies that agreed to enter into so-called "transitory agreements" – in the absence of such agreements, Law 42 would continue to apply.[61]

38. On 26 January 2008, in the wake of the enactment of Law 42 at 99% and the LET, President Rafael Correa gave a public radio address where he declared that oil companies had the following three options:

> "We are renegotiating the oil contracts. Oil companies have three options:
>
> [1] either they comply with the 99-1 Decree, that is, of the extraordinary profits, extraordinary! […] Out of the extraordinary gains: 99 percent for the state and 1 percent for the company because the resource is ours. If they disagree, that's the first option, perfect.
>
> [2] We can renegotiate the contract into a services contract which always should have been the preponderant model in the oil industry. Why? Because if the oil is ours we hire somebody to take our oil out, right? We pay for the job, $10 for each barrel of oil extracted, but the rest is for us. So, that's the contract to which we want to go, which was in force at the beginning of the'90s [...]. What does "participation contract" mean? They exploit 100 barrels, they take out 100 barrels of our oil, the private and transnational oil companies, and they give us a little piece and the rest they take away [...]. And there are people who defend this. How shameful. They want to take us back into that opprobrious past, when they took away with no shame the resources of our country. This revolutionary, patriot and citizen government is renegotiating oil contracts and we want to go to such special service

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58 RCM, ¶ 221.

59 *Id.*

60 *Id.*, ¶ 223.

61 *Id.*, ¶¶ 222-224.

> contracts, that's how they are called, where we pay $10 per each barrel of oil, whatever they consider appropriate...negotiating obviously, but the rest is for us, the owner of the resource. So that's the second option.
>
> [3] And the third option: If they are not happy, no problem. We don't want to rip-off anybody here. How much have they spent in investments? $200 million? Here, have your $200 million and have a nice day, and PetroEcuador will exploit that field. But we will not allow! My compatriots, for them to keep taking away our oil. […] We have to put a limit: 45 days, or if not, they have to continue to comply with the 99-1."[62]

39. Spurred on by the LET and the new government policy, PetroEcuador, on behalf of Ecuador, and Perenco, on behalf of the Consortium, began renegotiations to reallocate oil revenues following the increase in oil prices, though this time against the background of Law 42 at 99%. In March 2008, PetroEcuador and Perenco reached a preliminary agreement to reallocate oil revenues from Blocks 7 and 21. The March 2008 Transitory Agreement provided that: (a) the Blocks would be operated under the PSC model for a period of five years and then would be migrated to another contract model (presumably service contracts); (b) the contract, whatever its modality, would be extended until 2018; (c) the State's oil participation share would be increased for the period 2008-2010, and then would be linked to oil prices for the period 2010-2018; (d) finally, the Law 42 statutory reference price would be increased to USD 42.5/bbl.[63]

40. Burlington complains that it was excluded from these negotiations because Ecuador requested to negotiate exclusively with Perenco. At the hearing, Alex Martinez, the Manager of Latin American Operations for ConocoPhillips and member of the Board of Directors of Burlington Oriente[64], testified that "the [PetroEcuador] negotiation team wants only the operator at the table, and they only want one person – one voice at the table. They don't want Burlington at the table, and they don't want Burlington to talk."[65] Burlington argues, however, that although Perenco was the operator of the Block, it could not by itself renegotiate Burlington's rights under the PSCs.[66]

41. According to Ecuador, on the other hand, Burlington has wrongly sought to create the impression that it was left out of the negotiation table and that Perenco failed to apprise it of the status of the negotiations. Ecuador claims that, by virtue of the Joint

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62 Exh. C-183; Mem., ¶¶ 20, 231, 416; CPHB ¶¶ 53, 83. (Tribunal's translation)..

63 *Id.*, ¶ 228; RCM, ¶ 228; Exh. E-133.

64 Witness Statement of Alex Martinez, 20 February 2009 (hereinafter "Martinez First WS"), and Martinez Second WS; ¶1.

65 Tr. 367:4-8; CPHB, ¶ 225.

66 CPHB, ¶ 226.

Operations Agreement, Perenco, as the operator of the Block, was "to conduct negotiations with the State on behalf of the Consortium."[67] In addition, whether Perenco apprised Burlington or not of the progress on the contract renegotiations was an internal matter for the Block partners to which Ecuador was alien.[68]

42. At any rate, in April 2008, when Burlington was still "in the midst of evaluating"[69] the terms of the March 2008 Transitory Agreement, Ecuador adopted a new "single model"[70] policy with respect to the renegotiation of oil contracts. Under this new policy, all transitory agreements, including the March 2008 Transitory Agreement, would only be valid for a year, after which the parties would have to migrate to a service contract. In a public radio address delivered in mid-April, President Correa explained the rationale for this new policy and, referring back to his January public address, stated:

> "I said 45 days, I think in January, for the renegotiation of the [oil] contracts… We were close to a deal, but I stopped it, because even though we've secured major benefits, I think that we can do better.
>
> [....]
>
> I believe that one of the best alternatives is to reach a transitory agreement, removing a series of absurd clauses from the current contracts, by which we practically surrendered our national sovereignty. It wasn't business being subjected to the country's sovereignty, but rather the country's sovereignty being subjected to business, [which] we cannot admit [...].
>
> So it seems that the best alternative is to sign a transitory agreement until there is a new Constitution, and move toward a single contractual model for all of the [oil] companies. Basically, what was being done was to modify existing contracts, and we've improved a lot, but we think it is better to move toward this definitive solution of a "single model"[71] (emphasis added).

43. As Ecuador itself acknowledged, the decision to migrate to service contracts within a year "suspended the negotiations with all oil companies, including Perenco and Burlington, for a few weeks."[72] This decision would have even broader consequences in the case of Burlington, which filed a Request for Arbitration within days of President Correa's announcement of the new "single model" policy.[73] According to Burlington, the decision to migrate to service contracts "meant that Ecuador would reap the benefits of

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67 RPHB, ¶ 202.

68 *Id.*, ¶¶ 202-203.

69 Tr. 369:8; CPHB, ¶ 229.

70 Exh. C-184; CPHB, ¶ 229.

71 Exh. C-184.

72 RCM, ¶ 229.

73 Mem., ¶ 233; RCM, ¶ 230.

Burlington's substantial investment in and development of the Blocks, and at the same time would be the sole beneficiary of then-existing high oil prices and any future oil price increases."[74]

44. Negotiations were resumed in May 2008. Consistent with President Correa's announcement, Ecuador submitted to Burlington a new draft Transitory Agreement by virtue of which (a) the Parties would make their "best efforts" to migrate to a service contract within 120 days[75], (b) Burlington would maintain the levels of investment initially proposed for 2008[76], and (c) it would suspend the ICSID proceedings against Ecuador.[77] Burlington did not accept the terms of this May 2008 Transitory Agreement.[78]

45. On 10 July 2008, Ecuador proposed still another draft Transitory Agreement whereby Perenco and Burlington would undertake to migrate to a service contract within one year of its execution.[79] In a joint letter dated 16 July 2008, Burlington and Perenco replied that the terms of this new draft Transitory Agreement, which were "substantially similar"[80] to those of the May 2008 Transitory Agreement, were "unacceptable."[81] On 20 August 2008, Roy Lyons, Burlington's Vice-President, wrote to Galo Chiriboga, Minister of Mines and Oil, to inform that Burlington "would prefer to proceed with the divestment of its assets in Ecuador, rather than migrating its current Production Sharing Contracts positions into the model of a Services Contract."[82]

46. According to Ecuador, from that point on, Burlington blocked every attempt to renegotiate the terms of the PSCs. Since Burlington's consent was indispensable for renegotiating the PSCs for Blocks 7 and 21, this effectively forestalled an agreement between Ecuador and Perenco.[83] In October 2008, Ecuador and Perenco recommenced negotiations and reached a preliminary agreement with respect to both Blocks 7 and 21. Perenco "agreed to the principle of migrating to a services

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74 Mem., ¶ 233.

75 Exh. C-448, §§ 4.2, 4.3.

76 *Id.*, at § 4.1.

77 *Id.*, at § 4.3. While Ecuador alleges that no transitory agreement contained an obligation "to suspend" the ICSID arbitration (RPHB, ¶ 208), the May 2008 Transitory Agreement appears to contain just such an obligation at § 4.3.

78 CPHB, ¶ 231; Tr. 372:8-375:22.

79 Exh. E-135, § 8.

80 Exh. E-136.

81 *Id.*

82 Exh. E-138.

83 RCM, ¶ 236.

contract"[84], a higher statutory reference price (USD 42.5/bbl for Block 7 and USD 48/bbl for Block 21), and the application of the LET tax rate (70%) instead of Law 42 at 99%. The agreement also required the investor to commit to make a USD 110 million investment and to back up that commitment with a parent company guarantee.[85]

47. Perenco was "keen"[86] to have its minority partner in the Blocks sign these preliminary agreements (the "November 2008 Transitory Agreements"). Accordingly, in early November, Perenco provided Burlington with copies of the November 2008 Transitory Agreements[87] and, on 27 November 2008, Perenco wrote to Burlington:

> "In the continued spirit of keeping you apprised of developments between Perenco and the Government of Ecuador, I write to inform you that after extensive negotiations we have a draft transitory agreement that is acceptable to both Perenco on the one hand, and the Government of Ecuador and PetroEcuador on the other [...]. Perenco believes that the attached agreement is the best present alternative regarding Blocks 7 and 21.
>
> The transitory agreement cannot become effective as to the consortium without Burlington's participation in it. We invite you to consider joining this agreement. If Burlington refuses to do so, there may be adverse consequences for both our companies and Perenco will be compelled to explore all possible means of preserving the value of its investments."[88]

48. Burlington, however, stated that it would "not sign the draft transitory agreements" because it was not "interested in replacing the PSCs with Service Contracts."[89] By letter dated 22 December 2008, Burlington replied to Perenco as follows:

> "Our clear position has been and continues to be that Law 42 is unlawful and that we are entitled to recover all payments made to Ecuador in connection with Law 42 [...]. Similarly, as we look to the future, we expect to enjoy the benefits of the economics promised to us under the PSCs and the BITs [...]. As a result, we see no point in comparing the economics of the Transitory Agreement to the economics in place after Law 42 was initially implemented. The evaluation we have made, for our purposes, is how this agreement compares to the contracts, as written. In our view, it fails that test."[90]

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84 RCM, ¶ 242.

85 CPHB, ¶ 232; Exh. C-422; clauses 3.3 and 5.

86 Tr. 482:12-14.

87 Exh. C-422.

88 Exh. C-423, p. 1.

89 Exh. C-46; Exh. C-425.

90 Exh. C-425. At the hearing, Mr. Martinez testified that under the November 2008 Transitory Agreements "basically I'm giving up my Contract [the PSC]" (Tr. 380:8-9). Mr. Martinez stated that "unless you sign a Service Contract, by [the way] which I don't know what it looks like […] you get liquidated based on your nonamortized investments […]. How can I sign that? No businessman will sign that" (Tr. 380:5-13).

49. On 23 December 2008, Derlis Palacios, Minister of Mines and Oil, invited Perenco, the operator of the Blocks, to designate a negotiating team to begin the reversion process of Block 7 – whose PSC was set to expire in August 2010 – and to "terminate ahead of time and by mutual agreement"[91] the PSC for Block 21, as it was not possible to reach a final agreement due to the "unchanging position of your partner Burlington Resources."[92] On 7 January 2009, Burlington wrote to Minister Palacios requesting compensation for what was, in its understanding, the intended cancellation of the PSCs for Blocks 7 and 21.[93] On 21 January 2009, Minister Palacios reportedly stated that negotiations with Burlington and Perenco "are 'practically impossible'"[94] and the PSCs are "headed toward 'termination'."[95]

50. In sum, the renegotiation process failed again. According to Ecuador, Burlington's refusal to accept the terms of the November 2008 Transitory Agreements "only shows its complete bad faith and lack of true intention to find an amicable solution, agreeable to both sides."[96] Burlington, on the other hand, argues that "[r]enegotiating in good faith does not imply an obligation to accept *any* proposal by Ecuador"[97] (emphasis in original), and that it had valid reasons not to accept Ecuador's offers[98]; in the meantime, the terms of the PSCs should have been respected under the *pacta sunt servanda* principle.[99]

51. The Parties disagree on the number of oil companies that agreed to enter into transitory agreements to migrate from PSCs into service contracts. According to Ecuador, almost all major oil producers which were invited to negotiate entered into transitory agreements with Ecuador. Out of a total of twenty-three contracts, fifteen were migrated to service contract.[100] Burlington, by contrast, maintains that most oil

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91 Exh. C-49 (Tribunal's translation).

92 *Id.* (Tribunal's translation); Mem., ¶ 234; CSM, ¶ 34;

93 Exh. C-47; Mem., ¶ 235; CSM, ¶ 35; RCM, ¶ 245.

94 Exh. C-50.

95 *Id.*

96 RCM, ¶ 242.

97 CPHB, ¶ 236.

98 Burlington argued *inter alia* that the terms of the service contracts to which the PSCs would have been migrated were unknown (CPHB, ¶ 227; Martinez, Tr. 379:4-9; 380:10-12).

99 CPHB, ¶ 236.

100 RPHB, ¶¶ 227-230. The record is slightly inconsistent on this point, partly on account of technical difficulties with the video link examination at the hearing. In the English transcript, Mr. Pastor Morris appears as testifying that 14 out of 24 contracts were migrated to services contract (Tr. 952:11-14). In the Spanish transcript, Mr. Pastor Morris appears as testifying that 15 out of 23 contracts were migrated to services contracts (Spanish Tr. 940:4-8), although it later testified that only 14 out of 23 were so migrated (Spanish Tr. 986:21-987:3). The variations, nevertheless, are of little consequence.

companies did not accept the new service contract proposed by Ecuador. Of the fourteen PSCs in force when Law 42 at 50% was enacted in April 2006, only four were successfully converted into service contracts; the remaining oil companies either settled their claims before signing transitory agreements or signed transitory agreements but no service contracts.[101]

E. *COACTIVA* PROCEEDINGS, INTERVENTION IN THE BLOCKS AND *CADUCIDAD* DECREES

52. While the contract renegotiations were ongoing, Burlington continued to pay the Law 42 tax. Burlington paid the Law 42 tax to Ecuador for two consecutive years, from April 2006 to May 2008. In June 2008, however, Burlington stopped paying the Law 42 tax to Ecuador. By that time, the Tax Consortium, which had paid around USD 400 million in Law 42 taxes, grew "concerned about the exponential increase in the amounts in dispute and the lack of a clear path to reach a negotiated solution."[102] Therefore, on 19 June 2008, the Tax Consortium wrote to Ecuador to propose that future Law 42 payments be made "into an escrow account, maintained by an independent escrow agent in a neutral location, pending resolution of our dispute either by settlement or award."[103]

53. At the time, Ecuador did not respond to the Tax Consortium's request.[104] At the hearing, Germánico Pinto, who would simultaneously become Minister of Non-Renewable Resources and President of the Board of Director of PetroEcuador and PetroAmazonas for a ten-month stint[105], testified that no country in the world would accept the Tax Consortium's proposal.[106] In the same vein, former Minister of Mines and Oil Galo Chiriboga stated that "tax laws in Ecuador, and I think in many parts of the world, are mandatory", for which reason accepting the Tax Consortium's proposal would not be "possible anywhere in the world."[107]

54. Having commenced this arbitration and received no answer from Ecuador on its escrow account proposal, the Tax Consortium decided to make future Law 42 payments into a segregated account. From June 2008 to April 2009, Burlington paid around USD 150 million into this segregated account located in the United States. Ecuador referred to this decision as a "blatant and unlawful act of defiance on the

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101 CPHB, ¶¶ 237-244.

102 Mem., ¶ 229 (quotation marks omitted); Exh. C-48.

103 Exh. C-48, pp. 3-4.

104 Mem., ¶ 229.

105 Witness Statement of Germanico Pinto, 17 January 2011 (hereinafter "Pinto WS"), ¶¶ 11-12.

106 Tr. 724:8-12.

107 Tr. 802:4-12.

Consortium's part."[108] At the hearing, Minister Pinto gave evidence to the effect that the Consortium's decision to stop paying the Law 42 tax to Ecuador "was creating a challenging situation."[109] Similarly, Minister Chiriboga testified as follows:

> "[C]itizens [..] do not have the power to decide whether they pay a tax or not. We do have the option to discuss--pay the tax, and discuss before a court whether this is legal or not, but we cannot accept that tomorrow a taxpayer will tell an authority "I am not going to pay to the State. I am going to deposit this money in an account, and whenever the judge or the court that is hearing the case decides on this, we'll see what we do."[110]

55. On 14 February 2009, following the breakdown of the renegotiations, President Correa stated at a press conference that:

> "[T]wo companies, Perenco and Repsol, with which Burlington is also allied, have wasted our time. When an agreement was near, they backed out. I believe, I fear, that they thought they were still dealing with previous administrations. Which, gentlemen, we will not permit
>
> [....]
>
> [S]ince they have not paid their taxes on extraordinary profits, I have ordered enforcement actions against Repsol and Perenco, and these companies can go wherever they like. This country will not pay attention to extra-regional authorities that attempt to tell us what to do or not to do."[111]

56. On 19 February 2009, Ecuador began *coactiva* proceedings against the Consortium to enforce outstanding taxes in the amount of USD 327.3 million. In accordance with this proceeding, the Executory Tribunal of PetroEcuador (the "Executory Tribunal") sent three *coactiva* notices to Perenco, the operator of the Blocks, ordering payment of the overdue tax within three days, failing which assets would be attached. On 3 March 2009, the Executory Tribunal ordered the seizure of the crude production and cargo from Blocks 7 and 21, appointing a judicial custodian of the crude. This decision was confirmed on 9 March 2009 by an Ecuadorian judicial court.[112]

57. On 6 March 2009, upon the application of Burlington Oriente[113], this Tribunal recommended "that the Respondents [Ecuador and PetroEcuador[114]] refrain from

108 RCM, ¶ 13.

109 Tr. 743:3-14.

110 Tr. 802:16-803:3.

111 Exh. C-51, pp. 2-3 (Claimant's translation); Mem., ¶ 237; CSM, ¶ 37.

112 Exh. C-60.

113 Originally one of the claimants in this arbitration, Burlington Oriente ceased to be a party to these proceedings after the contract claims were withdrawn (DJ, ¶¶ 53, 78-80).

114 PetroEcuador was initially one of the two respondents to the case, along with Ecuador (DJ, ¶ 53).

engaging in any conduct that aggravates the dispute between the Parties and/or alters the *status quo* until it decides on the Claimants' Request for Provisional Measures or it reconsiders the present recommendation, whichever is first."[115] Despite this recommendation, Ecuador held the first auction of seized crude on 15 May 2009, but no bids were submitted and the seized oil remained unsold.[116]

58. On 29 June 2009, the Tribunal issued Procedural Order No. 1 on provisional measures, wherein it generally ordered that the Parties "refrain from any conduct that may lead to an aggravation of the dispute."[117] In order to carry out this objective, the Tribunal specifically directed the Parties to "make their best efforts"[118] to open a joint escrow account into which Law 42 payments would be made, and the Respondents to "discontinue"[119] the *coactiva* proceedings pending against Burlington Oriente. Procedural Order No. 1 notwithstanding, a second auction was conducted in early July 2009: PetroEcuador, the sole bidder on this occasion, acquired the seized crude at 50% of its market value – as allowed under Ecuadorian law.[120]

59. At subsequent auctions, PetroEcuador, still the sole bidder, acquired the seized oil in the first round for about two-thirds of its value – again in conformity with Ecuadorian law. The Parties present diverging accounts on why PetroEcuador was the sole bidder at the auctions. Burlington conjectures that "potential bidders were aware that ownership of the cargoes was in dispute and subject to the provisional measures rulings of the *Burlington* and *Perenco* tribunals."[121] Ecuador retorts that this explanation is misleading, and that the real reason why there were no bidders other than PetroEcuador is that the Consortium threatened legal action against any company that would acquire the seized crude.[122]

60. Although Burlington stopped paying the Law 42 tax in June 2008, it was not until February 2009 that Ecuador took enforcement action. The Parties disagree on the reasons behind this timing. Burlington claims that this delayed enforcement of the law

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[115] Tribunal's recommendation of 6 March 2009, ¶ 13; Mem., ¶ 246; CSM, ¶ 43.

[116] CSM, ¶ 47.

[117] PO1, *Order* at 8.

[118] *Id.*, at 1-6.

[119] *Id.*, at 7.

[120] CSM, ¶ 53. In accordance with the Ecuadorian Code of Civil Procedure, offers in the first auction round may not be lower than two-thirds of the appraised value of the auctioned asset; if there are no bidders in the first round, a new round is to be organized and the minimum offer this time may not be lower than 50% of the appraised value of the auctioned asset (RCM, ¶ 539).

[121] CSM, ¶ 53.

[122] RCM, ¶ 548.

is evidence that the *coactiva* process was nothing but retaliation for its refusal to surrender its rights under the PSCs during the renegotiation process, which essentially ended in December 2008.[123] For its part, Ecuador denies this as a complete mischaracterization of the facts. Ecuador argues that it did not take enforcement action before because the Law 42 tax was liquidated on an annual basis and also to avoid a "heavy-handed"[124] environment that could have marred the negotiations.[125]

61. The seizures of the Consortium's crude stretched from March to July 2009. All in all, by the time the last recorded auction was held in April 2010, Ecuador had auctioned 3,960,000 barrels of crude Oriente from Block 7 and 3,640,000 barrels of crude Napo from Block 21.[126] The following chart[127] summarizes the outcome of eight auction rounds of the Consortium's crude, covering most of the crude seized from the Consortium and acquired by PetroEcuador.

	Block 7 Crude Oriente				Block 21 Crude Napo				
	Amount (Barrels)	Bidding Price (US$)	Valuation (US$)	**Benefit to the State** (US$)	**Amount** (Barrels)	Bidding Price (US$)	Valuation or Nominal Price (US$)	**Benefit to the State** (US$)	**Discount**
1	**720,000**	20,962,441	41,924,880	**20,962,439**	**720,000**	20,052,361	40,104,720	**20,052,359**	**50%**
2	**720,000**	27,980,642	41,970,960	**13,990,318**	**360,000**	13,382,641	20,073,960	**6,691,319**	**33%**
3	**360,000**	14,455,201	21,682,800	**7,227,559**	**360,000**	13,975,201	20,962,800	**6,987,599**	**33%**
4	**360,000**	16,044,001	24,066,000	**8,021,999**	**360,000**	16,044,001	21,546,000	**5,501,999**	**33%**
5	**360,000**	16,620,001	24,930,000	**8,309,999**	**400,000**	14,737,601	22,106,400	**7,368,799**	**33%**
6	**360,000**	16,140,001	24,210,000	**8,069,999**	**360,000**	14,472,001	21,708,000	**7,235,999**	**33%**
7	**360,000**	18,300,001	27,450,000	**9,149,999**	**360,000**	17,712,001	26,568,000	**8,855,999**	**33%**
8	**360,000**	18,369,601	27,554,400	**9,184,799**	**360,000**	17,827,201	26,740,800	**8,913,599**	**33%**
Total per Block	**3,600,000**	148,871,899	233,789,040	**84,917,151**	**3,280,000**	128,203,008	199,810,680	**71,607,672**	

62. On account of the *coactiva* seizures and auctions, the Consortium decided to cease operations in the Block. By letter of 13 July 2009, the Consortium informed the Ministry of Mines and Oil (the "Ministry") that "[u]nder the circumstances, […] we are left with no choice but to suspend" operations in Blocks 7 and 21.[128] The Consortium noted that it planned to "commence suspension of activities at noon July 16th, 2009" unless Ecuador

[123] CSM, ¶¶ 87, 90; CPHB, ¶¶ 88-106.

[124] Tr. 842:6-11.

[125] RPHB, ¶¶ 365-375.

[126] CSM, ¶ 76.

[127] CPHB, ¶ 104.

[128] Exh. C-208, p. 3.

and PetroEcuador "remedy their current breaches and deliver back to the Consortium the entirety of the seized crude volumes, or pay a cash equivalent market value."[129]

63. On 15 July 2009, the Consortium sent a new letter to the Ministry detailing a schedule of the planned suspension.[130] On the same date, the Ministry replied to the Consortium that this decision was "illegal"[131] and "would cause serious technical and economic losses to the government of Ecuador."[132] On 16 July 2009, after the suspension was scheduled to occur, Ecuador entered the Blocks, without using force, to ensure their continued operation.[133] On the same day, PetroEcuador passed a resolution declaring the state of emergency in the Blocks, and authorizing PetroAmazonas to adopt any measure necessary to guarantee the continuity of operations.[134] Ever since, Ecuador has been in possession of the Blocks.[135]

64. The Parties differ on how the Consortium's decision to discontinue operations in the Blocks should be characterized. Burlington refers to this decision as a "suspension" of operations, because the Consortium could have "resume[d] normal operations in relatively short order should Ecuador [have] cease[d] its unlawful actions."[136] At the hearing, Mr. Martinez testified on direct examination that the Consortium had not contemplated suspending operations prior to the seizures.[137] Ecuador, on the other hand, describes the Consortium's decision as an "abandonment" of the Blocks.[138] At the hearing, Mr. Martinez conceded that the suspension could have lasted for the entire duration of the *Perenco* and the *Burlington* arbitrations.[139]

65. In September 2009, at PetroEcuador's request, the Minister of Non-Renewable Natural Resources initiated the so-called *caducidad* process to terminate the PSCs for Blocks 7 and 21. Perenco, on behalf of the Consortium, opposed the initiation of the process, albeit to no effect: the Minister did not accept the Consortium's objections.[140] Thus, on 20 July 2010, one year after Ecuador's entry into the Blocks, the Minister of Non-

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129 *Id.*; CSM, ¶¶ 59-60; RCM, ¶ 571.
130 Exh. C-213; CSM, ¶ 62; RCM, ¶ 572.
131 Exh. C-214.
132 *Id.*
133 CSM, ¶ 65; RCM, ¶¶ 578-579.
134 CSM, ¶ 65; RCM, ¶ 580.
135 CSM, ¶¶ 66-67;
136 *Id.,*, ¶ 62.
137 Tr. 547:3-5.
138 RCM, ¶¶ 572, 578, 588.
139 Tr. 519:7-13.
140 Exhs. C-244 and C-245.

Renewable Natural Resources declared the termination – or *caducidad* – of the PSCs for Blocks 7 and 21.[141]

66. On 27 July 2010, one week after the termination of the PSCs for Blocks 7 and 21, the Ecuadorian Congress passed an amendment to the Hydrocarbons Law and Tax Law. Pursuant to this amendment, all PSCs had to be migrated to service contracts within a 120-day period – *i.e.* by the end of November 2010; if the PSCs were not migrated within that time period, they would be unilaterally terminated – albeit through a process other than *caducidad* – and the Ministry of Hydrocarbons would at that point "determine the value and method of payment for each contract."[142]

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[141] CSM, ¶¶ 77-78.

[142] Exh. C-246 (Claimant's translation); CSM, ¶ 79; CPHB, ¶¶ 120, 142; RPHB, ¶ 167.

II. PROCEDURAL HISTORY

A. INITIAL PHASE

67. On 21 April 2008, Burlington and the Burlington Subsidiaries (collectively, the "Initial Claimants"), filed a Request for Arbitration (the "Request") with the International Centre for Settlement of Investment Disputes ("ICSID" or the "Centre") against Ecuador and PetroEcuador (the "Initial Respondents"), enclosing forty-five exhibits.[143] In the Request, the Initial Claimants asked for the following relief:

> "(a) DECLARE that Ecuador has breached:
>
> (i) Article III of the Treaty by unlawfully expropriating and/or taking measures tantamount to expropriation with respect to Burlington's investments in Ecuador;
>
> (ii) Article II of the Treaty by failing to treat Burlington's investments in Ecuador on a basis no less favorable than that accorded [to] nationals; by failing to accord Burlington's investments fair and equitable treatment, full protection and security and treatment no less than that required by international law; by implementing arbitrary and discriminatory measures against Burlington's investments; and by failing to observe its obligations with regard to Burlington's investments; and
>
> (iii) Each of the PSC;
>
> (b) ORDER Ecuador: (i) to pay damages to Burlington for its breaches of the Treaty in an amount to be determined at a later stage in these proceedings, including payment of compound interest at such a rate and for such period as the Tribunal considers just and appropriate until the effective and complete payment of the award of damages for the breach of the Treaty; and/or (ii) to specific performance of its obligations under the PSCs and pay damages for its breaches of the PSCs in an amount to be determined at a later stage in the proceedings, including interest at such a rate as the Tribunal considers just and appropriate until the complete payment of all damages for breach of the PSCs.
>
> (c) AWARD such other relief as the Tribunal considers appropriate; and
>
> (d) ORDER Ecuador and PetroEcuador to pay all of the costs and expenses of this arbitration, including Burlington's legal and expert fees, the fees and expenses of any experts appointed by the Tribunal, the fees and expenses of the Tribunal and ICSID's other costs."[144]

[143] Exhs. C-1 to C-45.

[144] Request, ¶ 136.

68. On 25 April 2008, the Centre transmitted a copy of the Request to Ecuador and to PetroEcuador in accordance with Rule 5 of the ICSID Rules of Procedure for the Institution of Conciliation and Arbitration Proceedings (the "Institution Rules"). On 2 June 2008, the Acting Secretary-General of the Centre registered the Request pursuant to Article 36(3) of the Convention on the Settlement of Investment Disputes between States and Nationals of other States (the "ICSID Convention" or the "Convention") and dispatched the Notice of Registration to the Parties, inviting them to proceed to constitute the arbitral tribunal.

69. Since the Parties did not agree on a different procedure within the meaning of Rule 2(3) of the ICSID Rules of Procedure for Arbitration Proceedings (the "Arbitration Rules"), the Initial Claimants opted to constitute the arbitral tribunal pursuant to the formula established in Article 37(2)(b) of the ICSID Convention. Under this formula, "the Tribunal shall consist of three arbitrators, one arbitrator appointed by each party and the third, who shall be the president of the Tribunal, appointed by agreement of the parties."

70. On 4 August 2008, the Initial Claimants appointed as arbitrator Prof. Francisco Orrego Vicuña, a Chilean national. On 22 September 2008, the Respondent appointed as arbitrator Prof. Brigitte Stern, a French national. On 27 October 2008, the Parties agreed to appoint Prof. Gabrielle Kaufmann-Kohler, a Swiss national, as President of the Arbitral Tribunal. All three arbitrators accepted their appointments. In addition, the Centre selected Mr. Marco Tulio Montañés-Rumayor to serve as Secretary of the Tribunal. On 18 November 2008, the Arbitral Tribunal (the "Tribunal") was deemed to be constituted and the proceedings to have begun.

71. On 20 January 2009, the Tribunal held a first procedural session at the World Bank's office in Paris. At the first session, the Parties agreed that the Tribunal had been properly constituted and raised no objection to the appointment of the members of the Tribunal. Furthermore, the Parties and the Tribunal agreed on a number of procedural issues. The first session was audio-recorded and transcribed in both English and Spanish. Minutes of the first session were drafted, signed by the President and the Secretary of the Tribunal, and transmitted to the Parties on 18 February 2009. Later that month, the Parties also expressed their consent to the procedural calendar proposed by the Tribunal.

72. On 20 February 2009, Burlington Oriente, the subsidiary holding Claimant's ownership interests in Blocks 7 and 21, filed a Request for Provisional Measures (the "RPM"),

together with a request for a temporary restraining order with immediate effect (the "TRO Request"), asking that the Initial Respondents refrain from (i) enforcing payments allegedly due under Law 42; (ii) affecting the legal situation or terminating the Block 7 and 21 PSCs; and (iii) engaging in any conduct that may aggravate the dispute between the Parties. The RPM was accompanied by twelve exhibits[145], thirteen legal exhibits[146], and the witness statement of Alex Martinez. On 4 March 2009, Ecuador filed a Preliminary Reply to Burlington Oriente's RPM, enclosing three exhibits[147] and nineteen legal exhibits.[148]

73. On 6 March 2009, the Arbitral Tribunal recommended "that the [Initial] Respondents refrain from engaging in any conduct that aggravates the dispute between the Parties and/or alters the *status quo* until it decides on the Claimants' Request for Provisional Measures or it reconsiders the present recommendation, whichever is first."[149] On 17 March 2009, Ecuador filed a Reply to Burlington Oriente's RPM and a request for reconsideration of the Tribunal's 6 of March 2009 recommendation, along with five exhibits[150] and seven legal exhibits.[151] Eight days later, Burlington Oriente objected to Ecuador's request for reconsideration of the Tribunal's 6 of March 2009 recommendation. On 27 March 2009, Burlington Oriente filed its Response to Ecuador's Reply to the RPM, accompanied by eleven exhibits[152] and eight legal exhibits.[153]

74. On 3 April 2009, the Tribunal denied Ecuador's request for reconsideration of its 6 March 2009 recommendation on the double ground that there were no changed circumstances that would warrant such reconsideration, and that the hearing on provisional measures would take place shortly thereafter. On 6 April 2006, Ecuador filed its Rejoinder to Burlington Oriente's RPM, enclosing six exhibits[154] and fifteen legal exhibits.[155] On 17 April 2009, the Arbitral Tribunal held the hearing on provisional measures in Washington D.C., at which counsel for the Parties presented oral

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145 Exhs. C-46 to C-57.
146 Exhs. CL-1 to CL-13.
147 Exhs. E-3 to E-5.
148 Exhs. EL-1 to EL-19.
149 Tribunal's recommendation of 6 March 2009, ¶13 (emphasis added).
150 Exhs. E-6 to E-10.
151 Exhs. EL-20 to EL-26.
152 Exhs. C-58 to C-68.
153 Exhs. CL-14 to CL-21.
154 Exhs. E-11 to E-16.
155 Exhs. EL-27 to EL-41.

arguments and answered questions from the Tribunal. The hearing was transcribed in English and Spanish and copies of the transcript were distributed to the Parties.

75. On 29 June 2009, the Tribunal issued Procedural Order No. 1 on provisional measures. It ordered the Parties to "refrain from any conduct that may lead to an aggravation of the dispute."[156] In order to implement this general objective, it specifically ordered that the Parties "make their best efforts"[157] to open a joint escrow account into which Law 42 payments would be made, and that the Respondent "discontinue"[158] the *coactiva* proceedings then pending against Burlington Oriente.[159] This order replaced the Tribunal's recommendation of 6 March 2009.

76. On 18 September 2009, the Initial Claimants withdrew their contract claims (the "Contract Claims") on the alleged ground that Ecuador had physically occupied the Blocks, bringing "to completion the expropriation that began with the enactment of Law 42."[160] Burlington was to continue to pursue its claims under the Treaty (the "Treaty Claims"). The Initial Claimants wrote:

> "In this context, and as announced at the First Session, the Claimants respectfully inform the Tribunal that the Contract Claimants [the Burlington Subsidiaries] hereby withdraw their contractual claims, including those relating to Block 23 and 24, without prejudice, and confirm that Burlington maintains its claims under the Treaty [the "Treaty Claims"]".[161]

77. On 22 September 2009, the Initial Respondents denied that it had expropriated Blocks 7 and 21, but agreed to the withdrawal of the Contract Claims provided that the withdrawal was "with prejudice".[162] The Initial Respondents also requested that the Tribunal withdraw Procedural Order No. 1 because Burlington Oriente had abandoned operations in Blocks 7 and 21.[163]

78. On 10 October 2009, the Initial Claimants "accept[ed] that any withdrawal of the contractual claims should be with prejudice" because they saw "no reason to preserve

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156 PO1, *Order* at 8.

157 *Id.*, at 1-6.

158 *Id.*, at 7.

159 The Tribunal's order notwithstanding, a second auction was conducted in early July 2009: PetroEcuador, the sole bidder on this occasion, acquired the seized crude at 50% of its market value – as allowed under Ecuadorian law. (CSM, ¶ 53).

160 The Initial Claimants' letter of 18 September 2009, Exh. C-189, p. 2.

161 *Id.*

162 Exh. E-118, p. 2

163 Exh. C-189, p. 3

[the] right to re-file the contractual claims in the future."[164] By the same token, they agreed that Procedural Order No. 1 be withdrawn as "[m]aintaining the Order would therefore serve no purpose."[165] Subsequently on 20 October 2009, the Initial Claimants confirmed that "PetroEcuador is no longer a party to these proceedings" following the withdrawal of the Contract Claims.[166]

79. On 29 October 2009, the Arbitral Tribunal issued Procedural Order No. 2, which reads in pertinent part as follows:

> "1. Provided that the [Initial] Respondents make no objection by 6 November 2009, the Contract Claims will be deemed withdrawn with prejudice as of that date. Consequently, as of 6 November 2009, PetroEcuador and, subject to the [Initial] Claimants' confirmation by 2 November 2009, [the Burlington Subsidiaries] will cease to be parties to this dispute. As a result, this arbitration will deal solely with Burlington's Treaty Claims against Ecuador.
>
> 2. Procedural Order No. 1 is hereby revoked. Any funds in the escrow account are therefore released to the [Initial] Claimants." [The Tribunal nonetheless "specified that the Parties remain under a duty not to further aggravate the dispute"].[167]

80. In accordance with such order, the Initial Claimants confirmed on 2 November 2009 that the Burlington Subsidiaries were no longer parties to these proceedings and that the Contract Claims were withdrawn. For their part, the Initial Respondents did not object to the withdrawal with prejudice of the Contract Claims by the specified date. Accordingly, as of 6 November 2009, the Contract Claims were withdrawn with prejudice and PetroEcuador and the Burlington Subsidiaries ceased to be parties to these proceedings. From that time on, this arbitration is confined to Burlington's Treaty Claims against Ecuador.

B. JURISDICTIONAL PHASE

81. On 20 April 2009, the Initial Claimants submitted their Memorial, accompanied by one hundred and twenty exhibits[168], one hundred and six legal exhibits[169], the witness statements of Taylor Reid and Herb Vickers, and the first supplemental witness statement of Alex Martinez. In addition, the Initial Claimants submitted complete

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[164] The Initial Claimants' letter of 10 October 2009, Exh. C-190, pp. 1 and 2.

[165] *Id.*, at 2.

[166] The Initial Claimants' letter of 20 October 2009, Exh. E-121, p. 1.

[167] PO2, *Order* at 1-2 and ¶ 29.

[168] Exhs. C-69 to C-188.

[169] Exhs. CL-22 to CL-127.

versions of the PSCs for Blocks 7, 21, 23 and 24[170], with authorizations, annexes and English translations.

82. On 20 May 2009, Ecuador and PetroEcuador announced in separate correspondence that they would object to the jurisdiction of the Arbitral Tribunal. On 20 July 2009, Ecuador and PetroEcuador filed separate Objections to Jurisdiction. Ecuador filed its Objections to Jurisdiction together with ninety-nine exhibits[171], fourteen legal exhibits[172], the witness statement of Dr. Christian Dávalos, and the expert reports of Prof. Juan Pablo Aguilar and Prof. Luis Parraguez Ruiz.

83. On 20 October 2009, Burlington filed a Counter-Memorial on Jurisdiction, enclosing ten exhibits[173] and twenty-one legal exhibits.[174] Burlington did not append any witness statement of expert opinion to its submission. Because the Burlington Subsidiaries would soon cease to be parties to this arbitration, only Burlington filed a Counter-Memorial on Jurisdiction.[175]

84. On 30 October 2009, the Tribunal and the Parties held a pre-hearing telephone conference to organize the hearing on jurisdiction. Shortly thereafter, the Tribunal circulated Procedural Order No. 3 addressing a number of procedural issues related to the impending hearing. The hearing on jurisdiction took place on 22 January 2010 at the World Bank's offices in Paris. On 2 June 2010, the Arbitral Tribunal dispatched the Decision on Jurisdiction to the Parties.

85. In the Decision on Jurisdiction, the Tribunal declared that: (i) it had jurisdiction over the expropriation claim; (ii) it lacked jurisdiction over the fair and equitable treatment claim, the arbitrary impairment claim, and the full protection and security claim; (iii) it would join to the merits the issue of whether it had jurisdiction over Burlington's Law 42 first umbrella clause claim and over the first limb of its third umbrella clause claim; (iv) Burlington's second umbrella clause claim and the second limb of its third umbrella clause claim had lapsed on their own terms; and (v) Burlington's full protection and security claims for Blocks 23 and 24 were inadmissible.[176]

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170 Exhs. C-1 to C-4.

171 Exhs. E-17 to E-115.

172 Exhs. EL-41 to EL-55.

173 Exhs. C-189 to C-198.

174 Exhs. CL-128 to CL-148.

175 See *supra*, ¶¶ 80-81.

176 DJ, ¶ 342, A-E.

C. LIABILITY PHASE AND COUNTERCLAIMS

86. From the time Burlington began this arbitration in April 2008, significant new events took place – most notably, the *coactiva* proceedings, Ecuador's intervention in the Blocks, and the termination of the PSCs for Blocks 7 and 21. For this reason, the Parties agreed that Burlington would have the opportunity to file a supplemental memorial. Thus, on 29 September 2010, Burlington submitted a Supplemental Memorial on Liability, together with fifty-two exhibits[177], eighteen legal exhibits[178], and the second supplemental witness statement of Alex Martinez.

87. On 17 January 2011, Ecuador presented its Counter-Memorial on Liability (the "Counter-Memorial"), accompanied by seventy exhibits[179], ninety-seven legal exhibits[180], and the witness statements of Wilson Pastor, Germánico Pinto, Derlis Palacios, Galo Chiriboga, Celio Vega, Pablo Luna, the second witness statement of Christian Dávalos, the expert reports of Fair Links, RPS, IEMS, and the second expert report of Juan Pablo Aguilar. In the Counter-Memorial, Ecuador asserted counterclaims against Burlington for damage to the environment and the infrastructure in Blocks 7 and 21.[181]

88. On 20 January 2011, the Tribunal and the Parties held a telephone conference to discuss various procedural matters in connection with the forthcoming hearing on liability. On 28 January 2011, the Tribunal issued Procedural Order No. 4, deciding that, while the hearing on liability would be devoted solely to Burlington's claims, the Tribunal and the Parties would hold a procedural discussion at the end of the hearing to address Ecuador's counterclaims. The Tribunal also issued directions with respect to various matters related to the organization of the hearing, and proposed the appointment of Mr. Gustavo Laborde as assistant to the Tribunal.

89. On 7 February 2011, the Tribunal circulated Procedural Order No. 5 granting in part Ecuador's request for document disclosure. On 21 February 2011, Burlington objected to Ecuador's planned cross-examination of Herb Vickers on the ground that this examination would exceed the scope of Mr. Vickers' witness statement. On 2 March 2011, the Tribunal issued Procedural Order No. 6 allowing Ecuador to cross-examine Mr. Vickers on limited and specified topics. Furthermore, having received the consent

177 Exhs. C-199 to C-250.

178 Exhs. CL-149 to CL-166.

179 Exhs. E-117 to E-186.

180 Exhs. EL-64 to EL-162 (with two exhibits intentionally left blank).

181 RCM, § 9.

of both Parties, the Tribunal confirmed the appointment of Mr. Gustavo Laborde as assistant to the Tribunal.

90. The hearing on liability was held from 8 to 11 March 2011 at the World Bank offices in Paris. At the hearing, both Parties submitted new exhibits into the record. Burlington submitted two hundred and five new exhibits[182] and sixty-eight legal exhibits[183]. Ecuador submitted fifty-seven new exhibits[184] and ten legal exhibits.[185]

91. In addition to the members of the Arbitral Tribunal, the ICSID secretary and the assistant to the Tribunal, the following individuals were in attendance at the hearing:

(i) On behalf of Burlington:

- Ms. Janet Kelly, CONOCOPHILLIPS
- Mr. Clyde Lea, CONOCOPHILLIPS
- Mr. Jason Doughty, CONOCOPHILLIPS
- Ms. Laura Robertson, CONOCOPHILLIPS
- Ms. Kelli Jones, CONOCOPHILLIPS
- Mr. Fernando Avila, CONOCOPHILLIPS
- Ms. Ann Morgan, CONOCOPHILLIPS
- Prof. James Crawford, MATRIX CHAMBERS
- Mr. Jan Paulsson, FRESHFIELDS BRUCKHAUS DERINGER LLP ("FRESHFIELDS")
- Mr. Nigel Blackaby, FRESHFIELDS
- Mr. Alex Yanos, FRESHFIELDS
- Ms. Noiana Marigo, FRESHFIELDS
- Ms. Jessica Bannon Vanto, FRESHFIELDS
- Mr. Viren Mascarenhas, FRESHFIELDS
- Ms. Ruth Teitelbaum, FRESHFIELDS

182 Exhs. C-251 to C-455.

183 Exhs. CL-167 to CL-234.

184 Exhs. E-187 to E-243. With leave of the Tribunal, Ecuador submitted six additional exhibits on 21 March 2011, after the hearing (Exhs. E-245 to E-250).

185 Exhs. EL-163 to EL-172.

- Mr. Sam Prevatt, FRESHFIELDS
- Mr. Javier Robalino-Orellana, PEREZ BUSTAMANTE & PONCE
- Mr. Rodrigo Jijón, PEREZ BUSTAMANTE & PONCE
- Mr. Juan González, PEREZ BUSTAMANTE & PONCE

(ii) On behalf of Ecuador:

- Dr. Diego García Carrión, ATTORNEY GENERAL OF ECUADOR
- Dr. Álvaro Galindo Cardona, HEAD OF INTERNATIONAL AFFAIRS
- Ms. Gianina Osejo, ATTORNEY GENERAL'S OFFICE
- Mr. Francisco Paredes-Balladares, ATTORNEY GENERAL'S OFFICE
- Mr. Agustín Acosta, ATTORNEY GENERAL'S OFFICE
- Ms. Cristina Viteri, ATTORNEY GENERAL'S OFFICE
- Prof. Pierre Mayer, DECHERT (PARIS) LLP ("DECHERT")
- Mr. Eduardo Silva Romero, DECHERT
- Mr. Philip Dunham, DECHERT
- Mr. José Manuel García Represa, DECHERT
- Ms. Maria Claudia De Assis Procopiak, DECHERT
- Ms. Ella Rosenberg, DECHERT
- Ms. Ana Carolina Simoes e Silva, DECHERT
- Mr. Eliot Walker, DECHERT

92. The hearing on liability was interpreted to and from English and Spanish. It was also sound-recorded and transcribed verbatim, in real time, in both English and Spanish. Copies of the sound recordings and the transcripts were delivered to the Parties. At the end of the hearing, the Tribunal and the Parties held a procedural discussion in relation to the post-hearing briefs and the procedural treatment of Ecuador's counterclaims.

93. On 15 March 2011, the Tribunal issued Procedural Order No. 7, where (i) it took note of the discontinuance of the proceedings in relation to Burlington's pending claims for Blocks 23 and 24 following settlement agreements; (ii) fixed the date for the simultaneous submission of post-hearing briefs; and (iii) set a date by which Burlington

would inform whether it intended to raise jurisdictional objections to Ecuador's counterclaims. On 6 May 2011, the Parties simultaneously filed their post-hearing briefs. On 27 May 2011, Burlington advised the Tribunal that it would raise no jurisdictional objections in respect of Ecuador's counterclaims, in accordance with an agreement executed the previous day.[186]

94. On 21 July 2011, after consulting the Parties, the Tribunal released Procedural Order No. 8, whereby it established a procedural calendar for Ecuador's counterclaims, and laid down the procedural rules applicable to these claims. In accordance with this procedural calendar, on 30 September 2011, Ecuador submitted a Supplemental Memorial on Counterclaims, enclosing fifty-one exhibits[187], nine legal exhibits[188], the witness statements of Diego Montenegro, Marco Puente, Manuel Solis, the second witness statement of Pablo Luna, the expert report of Prof. Ricardo Crespo Plaza, and the second expert report of IEMS.

95. On 13 February 2012, the Claimant wrote to the Centre to inform that the Parties had reached an agreement to amend the procedural calendar for Ecuador's counterclaims, subject to the Tribunal's approval. On 15 February, the Tribunal approved the Parties' amendment to the procedural calendar, subject to Ecuador's approval.

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186 This agreement was entered into between Burlington Resources, Burlington Oriente, and Burlington Resources International, on the one hand, and Ecuador, on the other hand (*see* Exh. E-251).

187 Exhs. E-251 to E-301.

188 Exhs. EL-173 to EL-181.

III. POSITIONS OF THE PARTIES AND REQUESTS FOR RELIEF

A. BURLINGTON'S POSITION

96. Following the Decision on Jurisdiction, Burlington's case can essentially be summarized as follows:

    (i) The Tribunal has jurisdiction over Burlington's umbrella clause claims; with respect to the merits, Ecuador has failed to observe its obligations, contained both in laws and regulations and in the PSCs, with respect to Burlington's investments (the "umbrella clause claim");

    (ii) Ecuador unlawfully expropriated Burlington's investment; specifically, Ecuador's measures, to wit, (i) Law 42, (ii) the coactiva process and seizures, (iii) the physical occupation of Blocks 7 and 21, and (iv) the termination of the PSCs in the caducidad process, individually and in the aggregate, effected an unlawful expropriation of Burlington's investment (the "expropriation claim");

    (iii) As a result of the foregoing Treaty breaches, Ecuador must pay damages to Burlington in an amount to be determined in the quantum phase of these proceedings.

1. Burlington's Umbrella Clause Claim

97. Burlington presents claims under the observance of obligations clause of Article II(3)(c) of the Treaty, *i.e.* the so-called umbrella clause. Burlington alleges that the Tribunal has jurisdiction over these claims (1.1) and that Ecuador breached the umbrella clause by failing to observe its obligations with regard to Burlington's investment (1.2).

1.1. Jurisdiction over the umbrella clause claims

98. Burlington submits that (i) Ecuador's obligations to Burlington arise not only from the PSCs but also from its hydrocarbons-related laws and regulations; (ii) that the withdrawal of the contract claims under the PSCs does not preclude it from pursuing Treaty claims under the umbrella clause; and (iii) that, for purpose of the umbrella clause claims based on the PSCs, the Treaty does not require privity of contract between Burlington and Ecuador.

99. First, Ecuador's obligations to Burlington are not limited to contractual obligations under the PSCs, but also encompass the Hydrocarbons Legal Framework. Unilateral commitments made with respect to a reasonably specific class of investors are within

the scope of application of the umbrella clause. Support for this broad construction of umbrella clauses is to be found in *Noble Energy*, *Continental Casualty*, *Revere Copper* and *Noble Ventures*. Investors such as Burlington rely on these unilateral commitments to plan and make their investments.[189]

100. Second, Ecuador's argument that there is no underlying contractual obligation that could be elevated to the Treaty level because of the withdrawal of the contract claims is flawed. In fact, contract and Treaty claims have "separate lives."[190] When Ecuador breached the PSCs, two separate and independent sets of claims arose; one under the contracts, another under the Treaty. These sets of claims involve different parties and different legal sources. Burlington may pursue one set of rights without pursuing the other. The Tribunal's Decision on Jurisdiction already confirmed that these two sets of claims are independent; yet, an undaunted Ecuador reiterates its objections at the merits phase.[191]

101. Third, the Treaty's umbrella clause does not require privity between Burlington and Ecuador. This follows from the plain language of the Treaty. The umbrella clause applies to (i) "any obligation" (ii) that Ecuador "may have entered into with regard to" (iii) Burlington's "investments." All three elements are met in this case. The PSCs contain legal obligations. Ecuador has indisputably assumed the obligations contained in the PSCs, *i.e.* it has "entered into" these obligations. These obligations have been entered into "with regard to [Burlington's] investments." This is all the Treaty requires.

102. The umbrella clause refers to obligations entered into with regard to "investments", not with regard to "investors." This choice of words is significant. The Contracting Parties to the Treaty – Ecuador and the United States – could have used a narrower formulation incorporating a privity element, but instead "deliberately chose the broader term."[192] Additionally, Ecuador's allegation that there is a "series of consistent cases"[193] requiring privity for purposes of the umbrella clause is belied by the decision in *Continental Casualty*. Further, a privity component would be contrary to the spirit of

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189 CPHB, ¶¶ 266-278; Tr. 1314:17-1315:16.

190 CPHB, ¶ 262.

191 Tr. 151:11-153:21, Tr. 1294:2-1296:16. Counsel for Burlington further added that "Ecuador is surely estopped as a matter of good faith from alleging that […] Burlington's treaty claim, which had been there from the beginning and was quite visibly not being withdrawn, somehow evaporated" as a result of the subsidiary's withdrawal of the contract claims (Tr. 1294:18-22).

192 Tr. 148:4-6.

193 Tr. 199:2-3.

the Treaty, which in accordance with Article I of the Treaty is also to protect indirect investments.[194]

1.2. Ecuador breached its obligations with regard to Burlington's investments

103. According to Burlington, Ecuador breached the umbrella clause because it failed to observe its obligations with respect to Burlington's investment. First, Ecuador failed to absorb the effects of Law 42 on Burlington. While Ecuador denies being under such obligation, Burlington argues that its share of oil production was independent of the price of oil – the rationale behind Law 42 – and that Ecuador was bound to indemnify Burlington for any tax having an impact on the economy of the PSCs. Second, Ecuador failed to deliver to Burlington its share of oil production according to the formulas set out in the PSCs.[195] These breaches are not excused under the principle *rebus sic stantibus*[196], upon which Ecuador denies relying despite referring to the requirements for its application.[197]

104. Burlington had the right to receive the upside of any oil price increase.[198] Under the PSCs, its share of oil production was not dependent on the price of oil. It follows that Burlington was entitled to receive the full market value of its share of oil production, subject only to the payment of the taxes and employment contributions specified in the PSCs. In addition, in the event that a tax had an impact on the economy of the contract, a correction factor would have to be applied in order to absorb the effect of that tax. In this case, Law 42 had an impact on the economy of the PSCs, and Ecuador was therefore under an obligation to absorb its effects.[199]

105. The *rebus sic stantibus* principle has no application to this case.[200] On the one hand, both the fact of the oil price increase and the magnitude of the increase were foreseeable. The negotiating history shows that the original parties to the PSC expressly contemplated the possibility that oil prices could increase, but ultimately

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194 CSM, ¶¶ 125-131, 135.

195 Mem., ¶ 369; CSM, ¶ 123.

196 A party invoking the *rebus sic stantibus* principle must show (i) that an extraordinary and unforeseeable or unforeseen event caused an imbalance in the obligation of the parties; (ii) that the imbalance is such that performance of the contract would be excessively burdensome for one of the parties; and (iii) that the event causing the imbalance should not be a consequence of the actions or omissions of the party invoking the principle (CPHB, ¶ 203).

197 Burlington claims that Ecuador refers to the requirements underlying the principle *rebus sic stantibus* in its submissions and expert reports (CPHB, ¶ 201).

198 Mem., ¶ 354; CSM, ¶ 19; Tr. 24:17-25:15; CPHB, ¶ 323.

199 Tr. 31:18-19.

200 Mem., ¶¶ 386-391; CPHB, ¶ 204.

decided not to include a price adjustment factor.[201] Further, the magnitude of the oil price increase was not unprecedented, but was actually similar to that of the 1970s.[202] On the other hand, the oil price increase did not render Ecuador's performance of the PSCs more burdensome.[203] Thus, Ecuador does not meet the requirements *of the rebus sic stantibus* principle.[204]

2. Burlington's Expropriation Claim

106. Burlington claims that Ecuador has expropriated its investment (2.1) in breach of the Treaty requirements for expropriation, *i.e.* unlawfully (2.2).

2.1. Ecuador expropriated Burlington's investment

107. According to Burlington, Ecuador has deprived Burlington of the use and enjoyment of its investments by adopting the following measures which, both individually and in the aggregate, run afoul of Article III of the Treaty:

(i) Enactment of Law 42 (at the 50% rate as of April 2006, and at the 99% rate as of October 2007);

(ii) Seizure and auctioning – at below market prices – of the Consortium's share of crude oil production through the *coactiva* proceedings;

(iii) Physical takeover of Blocks 7 and 21;

(iv) Termination of the PSCs for Blocks 7 and 21 through the *caducidad* process.

2.1.1. Law 42

108. Burlington claims that the application of Law 42 to its investment was an expropriatory measure. While Burlington agrees that the power to tax is part of a State's regulatory power, it observes that the sovereign power to tax might also entail the power to destroy. As Professor Ian Brownlie explained, a tax is unlawful when it has the "precise object and effect of confiscation."[205] The Treaty itself accepts the possibility that a tax may be expropriatory; thus, contrary to what Ecuador alleges, tax measures are not entitled to any special deference.[206] Accordingly, a tax that substantially

201 CPHB, ¶¶ 209-210.

202 *Id.*, at ¶ 213.

203 *Id.*, at ¶ 216.

204 *Id.*, at ¶ 219.

205 *Id.*, ¶ 187.

206 *Id.*, at ¶ 188.

deprives an investor of the value of its investment is expropriatory.[207] Whether a tax results in a substantial deprivation and is thus expropriatory is ultimately a fact-specific question.[208]

109. Law 42 was "a measure tantamount to expropriation".[209] Its effect was to transfer virtually all of Burlington's revenues to Ecuador, and to deprive Burlington of practically all of the profits to which it was entitled under the PSCs. At the 50% rate, Law 42 had a devastating impact on Burlington's investment: Burlington was unable to recover past investments and forced to scale back its development plans, and operations in Block 21 became uneconomic.[210] At the 99% rate, Law 42 had a destructive impact on Burlington's investment: Burlington operated at a loss in 2008 and ceased to make any new investment in the Blocks – even in the Oso field where it did make additional investments with Law 42 at 50%.[211]

110. In the words of counsel for Burlington, Law 42 at 99% transformed operations in the Blocks "into a form of subsistence farming, hand-to-mouth, day-to-day operation."[212] Law 42 at 99% diminished the Consortium's share of total revenues from 38.3% to 9.9% in Block 7, and from 48.6% to 8.3% in Block 21.[213] In July 2008, for example, Napo crude had a market price of USD 122 per barrel. Under Law 42 at 99%, Burlington had to pay a Law 42 tax of over USD 107 per barrel.[214] Therefore, according to Burlington, the evidence shows that Law 42 was a measure tantamount to expropriation both at the 50% and at the 99% rates.

111. Ecuador claims that under international law a tax is expropriatory only if (i) the State acts with expropriatory intent, and (ii) the tax is discriminatory. Yet, Burlington counters that there is no basis in the Treaty for these requirements. In any event, Burlington meets the requirements of expropriation even under Ecuador's own standard. In fact, as further elaborated below, the intent behind Law 42 was to deprive Burlington of its valuable rights under the PSCs. There was also a discriminatory application of the tax rates, because a lower tax rate of 70% applied to those oil companies who signed transitory agreements with Ecuador.

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207 Mem., ¶ 441; CSM, ¶ 82.

208 CPHB, at ¶ 189.

209 CSM, ¶ 82.

210 CPHB, ¶¶ 162-163, 165-168.

211 *Id.*, at ¶¶ 173, 175-176.

212 Tr. 45:21-46:3.

213 COSS, ## 37 and 40 ("Overview and Legal Framework"); CPHB, ¶ 312, pp. 180-181.

214 Mem., ¶ 432.

112. Contrary to what Ecuador argues, the purpose of Law 42 was *not* to restore the economic equilibrium of the PSCs.[215] Had that been Ecuador's real intention, it would have conducted an analysis of each individual PSC in order to determine what the equilibrium point was. No such analysis was conducted. On the contrary, Ecuador imposed across the board tax rates that applied on a general basis and could thus not be tailored to the specificities of each individual PSC.[216] In addition, Ecuador imposed three different tax rates at different points in time – 50, 99 and 70 –, thereby showing that its intent was not to restore the economic equilibrium of the PSCs.[217]

113. In actuality, the purpose of Law 42 was to force Burlington to surrender its rights under the PSCs. President Correa himself characterized Law 42 as a "pressuring measure"[218] that would prompt oil companies to negotiate with Ecuador.[219] Likewise, President Correa stated that the oil companies had three options: to pay the Law 42 tax – at that point at the 99% rate –, to renegotiate the PSC into a service contract, or else to receive the sunk costs of their investment and leave the country.[220] Further evidence on record supports a similar conclusion. Accordingly, the purpose of Law 42 was to compel Burlington to relinquish its rights under the PSCs, not to restore the economic equilibrium of the PSCs.

114. After passing Law 42, Ecuador had a contractual duty to apply the tax stabilization clauses under the PSCs. Pursuant to these clauses, Ecuador was bound to readjust Burlington's oil participation share in order to absorb the impact of the tax increase. However, Ecuador ignored Burlington's requests that its oil participation share be readjusted. This is consistent with Ecuador's goal of unilaterally changing the economic terms of the PSCs.[221] By ignoring Burlington's request for a readjustment, Ecuador extinguished Burlington's rights to its participation share under the terms of the PSCs.[222] As a result, Ecuador's enactment of Law 42 and its subsequent refusal to absorb the effects of this tax effected a taking of Burlington's contract rights.[223]

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[215] CPHB, ¶ 201.
[216] *Id.*, ¶ 221.
[217] *Id.*, at ¶ 222-223.
[218] Exh. C-182.
[219] CSM, ¶ 28.
[220] Mem., ¶¶ 231, 416.
[221] CPHB, ¶ 82.
[222] *Id.*, at ¶¶ 128-130.
[223] *Id.*, at ¶ 127.

115. Finally, Ecuador wrongly seeks to create the impression that Burlington was an unreasonable partner. It is not true that Burlington failed to renegotiate the PSCs in good faith following the surge in oil prices. In reality, Burlington was unable to accept Ecuador's renegotiation proposals simply because they were unreasonable. These proposals required Burlington to forgo its rights under the PSCs without even knowing what it would receive in return.[224] In addition, Ecuador's allegation that all other oil companies accepted to renegotiate their contracts is disingenuous.[225] In fact, most initiated arbitration proceedings against Ecuador after Law 42 was passed, and only four out of the fourteen PSCs in force when Law 42 was enacted were successfully converted into service contracts.[226]

2.1.2. The *coactiva* process, seizures and auctions

116. Burlington maintains that the *coactiva* process, seizures and auctions constituted a direct and complete taking because they had the effect of destroying the value of its investment.[227] Ecuador carried out the *coactiva* process in breach of both the PSCs and this Tribunal's provisional measures order. Under the PSCs, a share of oil production had to be allocated to Burlington. Under the Tribunal's provisional measures order, Ecuador had to discontinue the *coactiva* process. Notwithstanding the PSCs and the provisional measures order, Ecuador continued to seize and auction Burlington's share of oil production.[228]

117. The *coactiva* process was commenced in retaliation for Burlington's refusal to accept Ecuador's renegotiation proposals.[229] In June 2008, the Consortium began making the disputed Law 42 payments into a segregated account. Ecuador raised no protest to this course of action for the next eight months.[230] It was only after the renegotiation process broke down in December 2008 that Ecuador commenced the *coactiva* process.[231] Ecuador had discretion to decide whether and when to start this process. Therefore, both the discretionary nature and the timing of the *coactiva* process show

[224] *Id.*, at ¶ 227.
[225] *Id.*, at ¶ 237.
[226] *Id.*, at ¶¶ 239-240, 244.
[227] CSM, ¶ 88.
[228] *Id.*
[229] CSM, ¶ 87.
[230] CPHB, ¶ 247.
[231] *Id.*, at ¶ 93.

that it was initiated to retaliate against Burlington's opposition to surrender its rights under the PSCs.[232]

118. Burlington submits that the *coactiva* process was an expropriatory measure.[233] As an initial matter, Burlington notes that the auction process was a failure because there were no bidders other than PetroEcuador. This allowed PetroEcuador to acquire the seized oil at discounts of 33% and 50% below market prices, harming Burlington in the process as the auctions resulted in reduced offsets of the alleged Law 42 debts.[234] Moreover, by dint of the *coactiva* process, Burlington was deprived of the right to earn a revenue, and hence of the economic benefits of its investment.[235] All in all, the *coactiva* process effected a "complete taking" because it destroyed the value of Burlington's investment.[236]

2.1.3. The physical takeover of Blocks 7 and 21

119. Burlington asserts that Ecuador's physical takeover of Blocks 7 and 21 completely expropriated its investment.[237] This physical occupation was the culmination of Ecuador's chain of expropriatory measures. As a consequence of the *coactiva* process, Burlington's investment became uneconomic to the point where the Consortium had no rational choice other than to suspend operations in the Blocks.[238] Using as a pretext the alleged risks that this suspension would bring about, Ecuador physically took over the Blocks. Accordingly, Ecuador's arbitrary takeover of the Blocks was a complete and direct expropriation of Burlington's investment.

120. Burlington's decision to suspend operations in Blocks 7 and 21 was justified both from an economic and a legal standpoint. From an economic standpoint, Burlington could not reasonably be expected to continue to fund an investment from which it no longer obtained any revenues.[239] With the *coactiva* process, Burlington found itself in a position where it was liable for the entire costs and risks of oil production, but received

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232 *Id.*, at ¶¶ 90, 93.
233 CSM, ¶¶ 88, 90-91.
234 *Id.*, at ¶¶ 53-54, 74; CPHB, ¶¶ 103-104.
235 CSM, ¶¶ 90-92.
236 *Id.*, ¶ 88.
237 *Id.*, ¶ 93.
238 *Id.*, ¶ 96; CPHB, ¶¶ 71-73.
239 CSM, ¶ 89.

no revenues in exchange.[240] In those circumstances, Burlington had no rational course of action other than to suspend operations and to reduce costs to the minimum.[241]

121. From a legal standpoint, Burlington's suspension found justification in the principle of *exceptio non adimpleti contractus*, by virtue of which a party to a contract may suspend performance in the event that the other party is in breach.[242] Burlington could rely on this principle as a matter of both Ecuadorian and international law. Under Ecuadorian law, Burlington could invoke this principle because, contrary to what Ecuador alleges, hydrocarbons production is not a public service and thus there is no need to guarantee its continued operation.[243] Under international law, ICSID tribunals have held that an investor may suspend operations when it would be unreasonable to continue operating in light of State measures.[244]

122. Additionally, Ecuador's takeover of the Blocks was not justified because there was no real risk of damage to the Blocks.[245] The risks of damage on which Ecuador has focused are unsubstantiated and theoretical. They are unsubstantiated because the RPS study at the root of Ecuador's allegations is based on admittedly incomplete and partial information.[246] They are theoretical because the RPS study draws no meaningful conclusions as to the likelihood that these risks may actually come to pass.[247] As a matter of fact, Burlington's suspension plan was meant to follow a well-developed protocol, based on the experience of previous suspensions, which would have mitigated the risks identified in the RPS report.[248]

123. Since there was no proper justification for this measure, Ecuador's physical takeover of Blocks 7 and 21 was a complete and direct expropriation of Burlington's investment. The physical takeover of the Blocks was the last of a series of expropriatory measures prompted by Burlington's refusal to abandon its rights under the PSCs.[249] It culminated Ecuador's campaign to migrate to a contract model more beneficial to the State in a

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[240] CPHB, ¶ 10.
[241] Tr. 59:19-22.
[242] Tr. 64:17-65:14.
[243] Tr. 1292:14-15.
[244] Tr. 65:7-66:12; COSS, ## 61, 64 ("Overview and Legal Framework").
[245] CPHB, ¶ 107.
[246] *Id.*, at ¶¶ 25, 28.
[247] *Id.*, at ¶ 107.
[248] *Id.*, at ¶¶ 108-109.
[249] *Id.*, at ¶ 120.

period of high oil prices.[250] Through this measure, Ecuador took possession of Burlington's entire investment.[251]

124. For the foregoing reasons, Ecuador's measures – namely, Law 42, the *coactiva* process, and the physical takeover of the Blocks – both individually and cumulatively expropriated Burlington's investment.

2.1.4. The *caducidad* process

125. According to Burlington, the termination of the PSCs for Blocks 7 and 21 in the context of the *caducidad* process was merely "symbolic" because its investment had already been fully expropriated with the physical occupation of the Blocks.[252] With this measure, Ecuador "foreclosed any possibility of Burlington returning to the legal and fiscal regime it had been guaranteed prior to Ecuador's expropriation."[253] For its part, Ecuador first submitted that "*caducidad* is simply not part of this case",[254] and then raised jurisdictional and admissibility objections against the Tribunal entertaining *caducidad*-related claims. While Burlington has not specifically answered these submissions, it is apparent from its argumentation that it opposes them.

2.2. Ecuador's expropriation of Burlington's investment was unlawful

126. Ecuador's expropriation of Burlington's investment was unlawful because it failed to meet the requirements of Article III(1) of the BIT. First, under the BIT, compensation is an absolute requirement for a lawful expropriation. An expropriation cannot be lawful except upon payment of "prompt, adequate and effective compensation."[255] Therefore, Ecuador's failure to offer Burlington any compensation for the expropriation renders it unlawful. Second, Ecuador carried out the expropriation in contravention of the general principles of treatment articulated in Article II(3) of the Treaty – fair and equitable treatment, freedom from arbitrary measures and observance of obligations.[256] The Tribunal has jurisdiction over these principles, which are expressly referred to in Article III(1)[257] and are thus part of Burlington's expropriation claim.[258]

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250 *Id.*, at ¶ 94.

251 *Id.*, at ¶¶ 81 and 93.

252 *Id.*, ¶ 80.

253 *Id.*

254 Tr. 301:20-21

255 Exh. C-6, Article III(1); CSM, ¶¶ 99-101.

256 CSM, ¶¶ 108-122.

257 *Id.*,at ¶¶ 102-103.

B. BURLINGTON'S REQUEST FOR RELIEF

127. On the basis of this position, Burlington requests that the Tribunal grant the following relief:

> "(a) DECLARE that this Tribunal has jurisdiction over Burlington's claims under Article II(3)(c) of the Treaty;
>
> (b) DECLARE that Ecuador has breached:
>
> (i) Article II(3)(c) of the Treaty by failing to observe its obligations with regard to Burlington's investments; as well as
>
> (ii) Article III of the Treaty by unlawfully expropriating Burlington's investments in Ecuador;
>
> (c) ORDER Ecuador to pay damages for its breaches of the Treaty, in an amount to be determined during the Quantum phase of these proceedings […] including payment of compound interest at such a rate and for such period as the Tribunal considers just and appropriate until the effective and complete payment of the award of damages;
>
> (c) [sic] AWARD such other relief as the Tribunal considers appropriate; and
>
> (d) ORDER Ecuador to pay all of the costs and expenses of this arbitration, including Burlington's legal and expert fees, the fees and expenses of any experts appointed by the Tribunal, and ICSID's other costs."[259]

C. ECUADOR'S POSITION

128. Following the Decision on Jurisdiction, Ecuador's case can essentially be summarized as follows:

> (i) The Tribunal has no jurisdiction over the (a) umbrella clause claims, (b) the fair and equitable treatment and arbitrary impairment claims that Burlington seeks to reintroduce through the back door, and (c) any claim related to the *caducidad* decrees. In addition, any *caducidad* claim is inadmissible;
>
> (ii) Law 42 was necessary and appropriate under the circumstances. In particular, Law 42 did not modify or breach the PSCs and, at any rate, any alleged contract breach cannot amount to a Treaty breach;
>
> (iii) Ecuador did not expropriate Burlington's investment in Blocks 7 and 21, whether (a) through Law 42, (b) the

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[258] *Id.*, at ¶¶ 104-107, 121. Burlington specifically stated: "Finding that the expropriation was carried out contrary to the principles articulated in Article II(3) does not depend on a stand-alone violation of Article II(3) and thus does not contravene this Tribunal's determination that it does not have jurisdiction under Article X to assess whether tax measures violated Article II(3) of the Treaty" (*Id.*, at ¶ 106).

[259] *Id.*, at ¶ 137; CPHB, ¶339.

> *coactiva* process, or (c) Ecuador's necessary intervention following Burlington's abandonment of the Blocks. At any rate, Ecuador did not unlawfully expropriate Burlington's investment in Blocks 7 and 21.

1. Burlington Pursues Claims over which the Tribunal has no Jurisdiction

129. Ecuador objects to the jurisdiction of the Tribunal over Burlington's surviving umbrella clause claims, over Burlington's fair and equitable treatment and arbitrary impairment claims, which Burlington is seeking to reintroduce "through the back door"[260], and over the c*aducidad* decrees. It adds that the *caducidad* claims are inadmissible.

1.1. The Tribunal has no jurisdiction over Burlington's surviving umbrella clause claims

130. Ecuador objects to the Tribunal's jurisdiction over Burlington's surviving umbrella clause claims because (i) there is no "obligation" that could be elevated to the Treaty level, and (ii) if *par impossible* there were any such obligation, Burlington is not privy to it. The ordinary meaning of "obligation" involves a *ratione personae* element, a relationship between an obligee and an obligor, between a creditor and a debtor.[261]

131. Here there is no obligation that could be elevated to treaty level either in the PSCs or under the Ecuadorian Hydrocarbons Law ("EHL"). There is none in the PSCs because the Burlington Subsidiaries withdrew the Contract Claims with prejudice. Therefore, Burlington has waived the rights underlying these claims and there is thus no corresponding obligation.[262] In addition, Burlington may not invoke the EHL to elevate an "obligation" to treaty level because (i) Ecuador has not "entered into" any obligation in enacting the EHL, (ii) the EHL is of a general nature, and is not related to any specific investment, and (iii) at any rate, the EHL imposes no obligation upon Ecuador.[263]

132. Moreover, if there were nevertheless any "obligations" that could be elevated to treaty level, Burlington could not rely on them for lack of privity. The principle of privity is "essential to contractual obligations."[264] An obligation implies an obligor and an obligee, a creditor and a debtor. In short, privity is part of the ordinary meaning of the term "obligation." The *CMS* annulment decision, other ICSID decisions, and commentators confirm this analysis. Burlington simply disregards the ordinary

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260 RCM, ¶¶ 26, 141, § 2.2.

261 *Id.*, ¶¶ 43-45.

262 *Id.*, ¶¶ 48-97.

263 *Id.*, ¶¶ 99-112.

264 *Id.*, ¶ 123.

meaning of "obligation" and focuses on the expression "with regard to investments". However, this expression is intended to narrow the scope of the umbrella clause, not to broaden it.[265]

1.2. The Tribunal has no jurisdiction over Burlington's *caducidad* claims (if any) nor over claims in relation to fair and equitable treatment and arbitrary impairment

133. Ecuador also objects to the jurisdiction over and admissibility of the c*aducidad* claims. As a preliminary matter, Ecuador understands that Burlington does not contest the validity of the *caducidad* decrees. Indeed, Burlington alleges that these decrees are of "symbolic" value and that the expropriation would in any event have occurred "well before" these decrees were issued. However, if Burlington does contest the validity of the *caducidad* decrees or the procedure leading up to them, then Ecuador objects to the jurisdiction over and admissibility of these claims.

134. The *caducidad* claims do not fall within the jurisdiction of the Tribunal for several reasons. Initially, because the PSCs for Blocks 7 and 21 exclude *caducidad* from the scope of their arbitration clauses. In addition, because the PSCs also exclude Treaty claims from the *ratione materiae* scope of the Tribunal's jurisdiction: that is what the parties to the PSCs intended, and the PSCs were concluded after the Treaty entered into force.[266] Lastly, the *caducidad* claims are not admissible because Burlington has not made a reasonable attempt to pursue redress in relation to these measures before the Ecuadorian administrative courts.[267]

135. Finally, Ecuador also objects to the Tribunal's jurisdiction over Burlington's already dismissed fair and equitable treatment and arbitrary impairment claims. Although Article III(1) of the Treaty refers to Article II(3), Burlington abuses this reference to surreptitiously put before the Tribunal, once again, its fair and equitable treatment and arbitrary impairment claims, over which the Tribunal has already held that it lacks jurisdiction. Thus, Ecuador requests that Section III(B)(2) of Burlington's Supplemental Memorial on Liability (¶¶ 102-122) be struck from the record.[268]

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265 *Id.*, ¶¶ 101, 113-137.

266 *Id.*, ¶¶ 155-162.

267 *Id.*, ¶¶ 163-168.

268 *Id.*, ¶¶ 142-147.

2. Ecuador Did not Breach its PSCs' Obligations Towards Burlington

2.1. Law 42 was necessary and appropriate under the circumstances

136. Contrary to what Burlington alleges, Law 42 was not passed simply to capture a larger share of the revenues generated by increased oil prices. It was passed in a context marked by an unexpected and unprecedented increase in oil prices between 2002 and 2008. Neither Burlington nor Ecuador foresaw or could foresee this course of events. Such unprecedented price increase affected the economic equilibrium of the PSCs, which are based on the reasonably foreseeable expectations of the parties at the time of contract negotiations.[269]

137. When an unforeseen increase in prices affects the economics of the contract, the contract must be readjusted, taking into account the widely accepted assumption that the State, as the owner of the non renewable resource, is to be the main beneficiary of extra revenues resulting from high oil prices.[270] Numerous other countries have acted just like Ecuador in similar circumstances. In 1980, the United States enacted an Oil Windfall Profit Tax in response to the oil price spike of the 1970s. And since 2002, no less than 16 countries, including developed countries such as the United States, the United Kingdom and Canada, have adopted similar measures. Tellingly, ConocoPhillips, Burlington's parent company, has been subject to tax adjustments in the United Kingdom and Norway. Therefore, Burlington's portrayal of Ecuador as a "renegade State" is misguided.[271]

138. The PSCs were predicated upon economic models prepared by Engineer Celio Vega, Member of the Board of Directors of PetroEcuador and Financial Head of the Petroleum Contract Administration Unit.[272] These models are mathematical formulas that take into account the economic variables of the contract at the time of contracting, such as the risk assumed by the investor and the reasonable income that the investor would make. One of the principal variables of these formulas was the oil market price. For Blocks 7 and 21, the market price taken into account at the time of contracting was US$ 15/bbl, and the projections of the reciprocal benefits for the investor and the State during the whole life of the contract was based on this price. At a market price of US$

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[269] *Id.*, ¶¶ 171-183.

[270] *Id.*, ¶ 188.

[271] *Id.*, ¶¶ 7, 190-194.

[272] Vega WS, ¶ 9.

15/bbl, the investor could cover its expenses and obtain a reasonable return on its investment.[273]

139. The unprecedented increase in oil prices affected the economic equilibrium on which the contract was based. While Ecuador initially attempted to redress this economic disequilibrium through negotiations, this attempt was unsuccessful. In point of fact, Burlington refused outright Ecuador's request for a fairer distribution of the oil production.[274]

140. As a result, Ecuador sought to restore the economic equilibrium of the PSCs via the enactment of Law 42. The original proposals discussed were for a State participation of 80% of the extraordinary revenues. Eventually, Congress approved the bill with a State participation of 60%. However, President Palacio vetoed this bill and recommended that the formula "at least 50%" be used. With this modification, Law 42 was enacted on 19 April 2006. On 6 September 2006, the Ecuadorian Constitutional Court declared Law 42 constitutional.[275]

141. However, Law 42 proved to be insufficient to attain the equilibrium point. Therefore, in October 2007, a year and a half after Law 42 was passed, Decree 662 increased the State's participation in extraordinary revenues from 50% to 99%.[276]

142. Two months later, Ecuador passed the *Ley de Equidad Tributaria* ("LET"), aimed to open a new avenue of negotiations with oil companies. Under the LET, the State's participation on extraordinary revenues would be 70%, and the reference price could be increased on a case-by-case basis. Except for Burlington and Perenco, all major companies operating in Ecuador took advantage of the LET. In April 2008, Ecuador announced that these transitory agreements would be in force for a maximum of a year before they would be migrated to service contracts. In the same month, on 21 April 2008, Burlington started arbitration proceedings against Ecuador.[277]

143. In August 2008, Burlington revealed its plan to leave Ecuador. From that point on, Burlington blocked all of Ecuador's attempts to reach an agreement in relation to the PSCs. In fact, Perenco and PetroEcuador reached an agreement on terms that were fair and reasonable. However, Burlington, displaying both bad faith and a lack of a

[273] RCM, ¶¶ 195-200.
[274] *Id.*, ¶¶ 201-208.
[275] *Id.*, ¶¶ 209-217.
[276] *Id.*, ¶ 220.
[277] *Id.*, ¶¶ 221-230.

genuine intention to reach a negotiated solution, refused to accept this agreement. This was in marked contrast with Ecuador's attitude, which was always open to dialogue and willing to reach an amicable solution.[278]

2.2. Law 42 did not modify or breach the PSCs and, at any rate, any alleged contract breach cannot amount to a Treaty breach

144. Ecuador advances the following six propositions. First, Law 42 did not modify the PSCs. Second, Law 42 did not breach the PSCs' clause ensuring Burlington a fixed participation in crude production. Third, Law 42 is not a "royalty" and thus Burlington has no right to be exempt from its application. Fourth, the renegotiation clauses have not been triggered nor breached. Fifth, clauses 3.1 and 22.1 of the PSCs are of no assistance to Burlington. Sixth and alternatively, if the Tribunal were to find that Ecuador somehow breached the PSCs, these contract breaches could not amount to a Treaty breach.[279]

145. First, Law 42 did not modify the PSCs. Law 42 deals only with oil prices. The PSCs, in turn, deal only with oil volumes and contain no provisions on oil prices. Thus, Law 42 simply cannot modify the PSCs. This is the conclusion which the Constitutional Court of Ecuador also reached. The Constitutional Court ruled that Law 42 did not modify the PSCs.[280]

146. Second, Law 42 did not breach the PSCs' clause ensuring Burlington a fixed participation in crude production. It is undisputed that Law 42 did not hinder Burlington's right to dispose of its share of crude production. However, Burlington self-servingly reads into this clause a right to not be subject to any measures the effect of which would be to reduce its revenues. Yet, if Burlington had this right – it does not – there would be no purpose in the renegotiation clauses, which apply precisely when there is a modification of the tax regime.

147. Third, and although it appears that Burlington has abandoned this argument following the Decision on Jurisdiction, Law 42 is not a "royalty" and thus Burlington has no right to be exempt from its application. Law 42 is not a royalty because it is part of Article 55 of the EHL, not of Article 54, where royalties are mentioned, and because, if it were a royalty, there would have been no need to amend Article 44 of the EHL, which already

[278] *Id.*, ¶¶ 235-250.

[279] *Id.*, ¶¶ 255-260.

[280] *Id.,* at ¶¶ 268-272

included the term royalties. Moreover, Law 42 does not have the characteristics of a royalty. It is a levy and, as such, is governed by the renegotiation clauses.[281]

148. Fourth, the renegotiation clauses have been neither triggered nor breached by the application of Law 42. Indeed, Law 42 had no "impact on the economy" of the PSCs, which is an indispensable requirement for the application of these clauses. The "economy" of a PSC, under Ecuadorian law, is determined "as of the date it was executed"[282] (emphasis in the original). At that time, the Parties agreed to use the economic model prepared by Eng. Celio Vega (the "Vega Model"). Amid other variables, the Vega Model included a constant oil price of US$ 15/bbl for the entire life of the PSCs. Yet, crucially, Law 42 applied only to oil prices higher than the US$ 15/bbl mark upon which the Vega Model was predicated. Thus, Law 42 did not impact the economy of the PSCs.[283]

149. On the other hand, if the Tribunal found that Law 42 did affect the economy of the PSCs, Ecuador has not breached the renegotiation clauses because "an obligation to negotiate does not imply an obligation to reach an agreement."[284] Ecuador was always available to negotiate with Burlington; if no agreement was reached, it was due to Burlington. Moreover, this Tribunal does not have the power to rewrite the terms of the PSCs in case the Parties failed to negotiate or to reach an agreement. It would not even have jurisdiction to do so, because this would not be a "legal" dispute under Article 25 of the ICSID Convention.[285]

150. Fifth, Clauses 3.1 and 22.1 of the PSCs are of no assistance to Burlington. These are not stabilization clauses. Clause 3.1 merely incorporates the principle of *pacta sunt servanda.* Law 42 does not affect this principle because it addresses a matter – extraordinary revenues – which was not regulated in the PSCs. Nor is Clause 22.1 a stabilization clause because (i) it does not expressly exclude the application of future laws and regulations; (ii) it is a mere rule of contract interpretation which does not preclude the application of subsequent laws and regulations; (iii) it operates as a choice of law provision; (iv) other clauses in the PSCs fail to distinguish between laws

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[281] *Id.*, ¶¶ 304-315.

[282] *Id.*, ¶ 329.

[283] *Id.*, ¶¶ 320-343.

[284] *Id.*, at ¶ 349; Exh. EL-102, at 116.

[285] *Id.*, ¶¶ 344-363.

enacted before the entry into force of the PSCs and thereafter; (v) otherwise the renegotiation clauses would serve no purpose.[286]

151. Sixth and alternatively, if the Tribunal found that Ecuador somehow breached the PSCs, these purported contract breaches could not amount to a treaty breach. As explained by the *Vivendi ad hoc* annulment Committee, not every breach of contract amounts to a breach of treaty.[287] A contract breach amounts to a treaty breach if there is an "effective repudiation of the right [...] which has the effect of preventing its exercise entirely or to a substantial extent."[288]

3. Ecuador did not expropriate Burlington's investment

3.1. Law 42 did not expropriate Burlington's investment in Blocks 7 and 21

152. Burlington's expropriation claim does not stand. As a threshold matter, Burlington bears a high burden of proof. Since Burlington is challenging a tax measure, it must prove, in accordance with *EnCana*, that Law 42 was "extraordinary, punitive in amount or arbitrary in its incidence",[289] and that its effects amount to expropriation of its investment. Burlington has failed to establish that these elements are met.[290]

153. In any event, Law 42 (i) was a legitimate and *bona fide* exercise of its sovereign tax powers, and (ii) it did not expropriate Burlington's investment.[291]

154. First, Law 42 was a legitimate and *bona fide* exercise of Ecuador's tax powers. Under international law, legitimate and *bona fide* State regulatory measures, such as Law 42, do not constitute expropriation and, consequently, are non compensable. Specifically, Law 42 must be presumed to be a valid measure not entitling Burlington to compensation unless proven otherwise. To rebut this presumption, Burlington must show with clear and convincing evidence that Ecuador's exercise of its sovereign power was illegitimate or abusive. However, Burlington has made no such showing.[292]

155. Law 42 was a legitimate and *bona fide* exercise of Ecuador's tax power because its goal was to remedy the imbalance caused by the massive and unforeseen increase in oil prices. As a result of this imbalance, Burlington had an obligation to renegotiate the

[286] *Id.*, ¶¶ 365-376.
[287] *Id.*, ¶¶ 386-388.
[288] *Id.*, ¶ 388.
[289] *Id.*, ¶ 397
[290] *Id.*, ¶¶ 394-398.
[291] *Id.*, ¶ 399.
[292] *Id.*, ¶¶ 400-437.

PSCs in good faith and Ecuador had a duty to legislate to obtain a fair allocation of oil revenues. Nevertheless, Burlington "obstinately refused" to renegotiate the PSCs.[293] In view of the failed renegotiations, Ecuador was under a constitutional mandate to seek a fair allocation of the revenues derived from its hydrocarbons. Law 42 was an appropriate means of furthering that mandate.[294]

156. Second, even if the Tribunal were to find that Law 42 is an illegitimate regulatory measure, Law 42 did not expropriate Burlington's investment. Law 42 has not expropriated Burlington's investment, whether directly or indirectly. Law 42 did not directly expropriate Burlington's investment because it did not physically seize Burlington's investment, nor did it revoke, cancel or repudiate Burlington's rights under the PSCs.[295] Likewise, Law 42 did not indirectly expropriate Burlington's investment. There is an indirect expropriation when the effects of the challenged measure are equivalent to a taking. In particular, the investor must show that the challenged measure caused a total and permanent loss of value or control of the investment. Burlington has shown neither.[296]

157. Burlington has failed to show that Law 42 at 50% expropriated its investment. The following evidence in fact proves that there was no expropriation: (i) the Consortium's tax reports show that, even with the Law 42 payments, 2006 and 2007 were more profitable than 2005; (ii) the Fair Links expert report concludes that Burlington's operations were not "uneconomic" as alleged by Burlington; (iii) the Consortium submitted an amended plan for additional developments in Block 7, demonstrating that, even with the Law 42 payments, it made economic sense to invest additional capital (the "Oso Development Plan"); (iv) ConocoPhillip's annual reports for the years 2006-2008 show no losses in Ecuador.

158. In addition, as previously demonstrated, Law 42 did not breach the PSCs. Hence, there can be no expropriation, since Burlington claims precisely the value of its rights under the PSCs. Finally, Law 42 cannot constitute expropriation because it does not cause a *permanent* deprivation of Burlington's investment: it applies if and only if the market price of Ecuadorian crude exceeds the reference price. In fact, contrary to the impression that Burlington seeks to create, oil market prices have not always been

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293 *Id.*, ¶ 449.

294 *Id.*, ¶¶ 440-460.

295 *Id.*, ¶¶ 464-469.

296 *Id.*, ¶¶ 464-477.

above the reference price, *e.g.* January and February 2009. In sum, Law 42 at the 50% rate did not expropriate Burlington's investment.[297]

159. Similarly, Law 42 at the 99% rate did not expropriate Burlington's investment. Law 42 at the 50% rate was insufficient to induce oil companies operating in Ecuador to negotiate a new contractual framework. Decree 662, which increased the rate to 99%, had the effect of prompting companies to sign new service contracts, with the exception of Burlington and Perenco[298]. Burlington has submitted no evidence that Law 42 at 99% deprived its investment of value. In actuality, Law 42 at 99% did not produce effects tantamount to expropriation, as shown by the same facts as those referred in connection with Law 42 at 50%.[299] In particular, Fair Links concluded that Decree 662 "did not alter the global trend of positive cash flows."[300]

3.2. Ecuador's enforcement of Law 42 through the c*oactiva* process was not an expropriatory measure under Article III of the Treaty

160. Contrary to Burlington's allegations, the *coactiva* process did not constitute an expropriation. Ecuador resorted to the *coactiva* process to enforce its laws and in doing so, it did not expropriate Burlington's investment.

161. PetroEcuador is an agency authorized to use the *coactiva*, a process whereby an administrative agency may enforce obligations without the need for an order or authorization from State courts. In particular, PetroEcuador was entitled to collect Law 42 payments. In the *coactiva* process, if the debtor does not pay his debt after being notified on two occasions, his assets are seized and eventually auctioned off. In the first auction round, offers may not be lower than two thirds of the appraised value of the asset. If no bids are submitted during the first round, a second round is convened, at which offers may not be lower than 50% of the appraised value of the auctioned asset.[301]

162. The *coactiva* process did not expropriate Burlington's investment. Burlington seeks to create the appearance that PetroEcuador benefitted from the auction process by acquiring the Consortium's oil at a "steep discount." However, PetroEcuador simply purchased the seized production at the discounts authorized under Ecuadorian law. Moreover, it was only in the first auction that PetroEcuador waited until the second

[297] *Id.*, ¶¶ 478-507.
[298] *Id.*, ¶¶ 511-512.
[299] *Id.*, ¶¶ 508-529.
[300] Fair Links ER, ¶ 94; RCM, ¶ 517.
[301] RCM, ¶¶ 532-540.

round to present its offer, for it was unaware that no other company would take part in the auctions. After the first auction, PetroEcuador always submitted its bids during the first round, offering a price slightly above the minimum authorized by law. Other companies were dissuaded from participating in these auctions because the Consortium threatened to take legal action against any prospective buyer of the seized crude.[302]

163. Further, the *coactiva* process did not constitute a direct expropriation of Burlington's investment because Ecuador did not intend to deprive Burlington of its investment but merely to enforce a legitimate credit. In any event, the effect of this process was neutral since, as recognized by the Tribunal in Procedural Order No. 1, every time oil was seized, previous Law 42 payments were extinguished. Finally, Burlington fails to explain how Ecuador's non-compliance with the Tribunal's recommendation in Provisional Order No. 1 can be deemed an expropriation.[303]

3.3. Ecuador's intervention following Burlington's abandonment of Blocks 7 and 21 in July 2009 neither completed the alleged expropriation nor effected a direct expropriation

164. Ecuador's intervention in Blocks 7 and 21 did not constitute an expropriation of Burlington's investment. It was provoked by Burlington's unilateral decision to suspend operations and aimed at preventing significant harm to the Blocks. Hence, Ecuador's intervention was necessary, adequate, proportionate under the circumstances, and meant to be temporary.[304] Ultimately, Burlington's decision to suspend operations was a "calculated act" intended to force Ecuador to act in order to avoid damage to the Blocks.[305]

165. Burlington adopted active steps to suspend operations in the Blocks even though (i) this course of action was not economically justified, as Burlington had the financial resources to continue operating the Blocks, *e.g.* the Law 42 payments made into the segregated bank account; (ii) the suspension would have resulted in the breach of both the PSCs and Ecuadorian law; and (iii) the suspension would have caused significant economic loss and serious damage to the Blocks. As part of its self-expropriation

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302 *Id.*, ¶¶ 541-552.
303 *Id.*, ¶¶ 553-559.
304 *Id.*, ¶¶ 560-561.
305 *Id.*, ¶ 565.

strategy, Burlington knew that this would prompt Ecuador to act in order to prevent damage to the Blocks.[306]

166. Burlington announced that the suspension would take place at noon on 16 July 2009. Ecuador, in turn, indicated that, if the Consortium suspended operations, It would take appropriate measures to prevent the suspension. On 16 July 2009, Ecuadorian government officials entered the Blocks at 2:00 PM. Contrary to what Burlington has alleged, the entry was amicable, not by force. In fact, the Blocks were still in operation at that time because the Consortium's employees had decided to ignore Perenco's instructions. Furthermore, on the same day, PetroEcuador issued a Resolution declaring the state of emergency in the Blocks and authorizing PetroAmazonas – PetroEcuador's subsidiary – to adopt the necessary measures to ensure the continuity of operations.[307]

167. Burlington's decision to unilaterally suspend operations in the Blocks was not economically justified. Burlington had the funds necessary to continue operating the Blocks, as shown by the Law 42 payments it had made into a segregated off-shore account. After the enactment of Law 42 and Decree 662, it had also made minimum investments in the Blocks and, if the seized oil was auctioned at below market prices, this was due to the Consortium's active hostility against potential bidders.[308]

168. Burlington's unilateral suspension of operations was in breach of Ecuadorian law and of the PSCs. Under the Ecuadorian Constitution, suspension of public services, which expressly include "hydrocarbon production", is forbidden. In addition, Burlington had no justification to suspend operations because the principle *exceptio non adimpleti contractus* finds almost no application under Ecuadorian administrative law. Accordingly, Burlington was bound to perform its obligations despite any alleged breach on Ecuador's part.[309]

169. Ecuador intervened in the Blocks to enforce its laws within its police powers and to avoid the significant economic loss and damage to the Blocks that the Consortium's unilateral suspension of operations would have caused. Barring intervention, the Consortium's abandonment of the Blocks would have caused reservoir, mechanical and environmental damage to the Blocks, and significant economic loss to the State.

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[306] *Id.*, ¶¶ 562-565.
[307] *Id.*, ¶¶ 566-580.
[308] *Id.*, ¶¶ 589-595.
[309] *Id.*, ¶¶ 596-606.

Burlington suspended operations only to induce Ecuador to intervene in the Blocks, in furtherance of its self-expropriation strategy.[310]

170. Ecuador's intervention in the Blocks was appropriate. Burlington was duly informed of the consequences that the suspension of operations would carry, whereas Ecuador entered the Blocks amicably and expressly assured Burlington that its rights under the PSCs would remain unaffected.[311] Ecuador's intervention was a means proportionate to the goal of avoiding damage to the Blocks.[312] Finally, expropriation requires permanent deprivation. This requirement is not met in this case because Ecuador's intervention was a temporary measure meant to cease once the Consortium resumed operations.[313]

3.4. In any event, Ecuador did not unlawfully expropriate Burlington's investment in Blocks 7 and 21

171. In the event that the Tribunal were nevertheless to conclude that the measures discussed in the previous sections constituted an expropriation of Burlington's investment, such expropriation was a lawful one. Ecuador submits that the failure to pay compensation pursuant to Article III(1) of the Treaty does not render the expropriation unlawful if the expropriation is disputed. Moreover, the expropriation was not unfair and inequitable, arbitrary or in contravention of Ecuador's obligations to Burlington.[314]

172. First, Ecuador's failure to compensate Burlington does not render the expropriation unlawful, because the expropriation is disputed. The expropriation must occur *before* compensation is offered. This case is first and foremost about whether *there is expropriation* in the first place. Compensation becomes a relevant question only after it is established that there is expropriation. Were it otherwise, every single case of indirect expropriation would almost invariably become a case of unlawful expropriation.[315]

173. Second, had there been expropriation, it was not unfair and inequitable because Law 42 sought to restore the "economy" of the PSCs. Law 42 was a *bona fide*, legitimate exercise of Ecuador's sovereign tax powers, which did not cause Burlington to

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310 *Id.*, ¶ 620.
311 *Id.*, ¶¶ 654-657.
312 *Id.*, ¶¶ 658-661.
313 *Id.*, ¶¶ 662-665.
314 *Id.*, ¶¶ 667-675.
315 *Id.*, ¶¶ 676-697.

surrender any right under the PSCs. In addition, the alleged expropriation would not have been arbitrary because Ecuador has submitted itself to the jurisdiction of this Tribunal, never interfering with its authority; nor were the *coactiva* measures arbitrary for they merely enforced Ecuador's Law 42 tax. Finally, the expropriation would not have been in breach of Ecuador's obligations as the PSCs were neither modified nor breached.[316]

D. ECUADOR'S REQUEST FOR RELIEF

174. On the basis of this position, Ecuador requests the Tribunal to render an award:

> "**10.1 Declaring**
>
> **10.1.1 On jurisdiction**
>
> 793. that it lacks jurisdiction over Burlington's (i) Law 42 first umbrella clause claim and (ii) the first limb of its third umbrella clause claim under Article II(3)(c) of the Treaty as defined in the Tribunal's Decision on Jurisdiction;
>
> 794. that, to the extent that Burlington seeks to reintroduce its Law 42 fair and equitable treatment claim and Law 42 arbitrary impairment of the investment claim, Section III(B)(2), paragraphs 102 to 122, pages 56 to 68 of Burlington's Supplemental Memorial are struck off the record;
>
> 795. that it lacks jurisdiction over Burlington's claims regarding the *Caducidad* decrees and all matters related thereto;
>
> **10.1.2 On admissibility**
>
> 796. alternatively, that Burlington's claims regarding the *Caducidad* decrees and all matters related thereto are inadmissible;
>
> **10.1.3 On liability**
>
> 797. that Law 42 did not modify the Participation Contracts and all of Burlington's claims related thereto are therefore dismissed;
>
> 798. that Ecuador's enactment of Law 42 did not breach the Participation Contracts and all of Burlington's claims related thereto are therefore dismissed;
>
> 799. that the Renegotiation Clauses were not triggered nor breached by Ecuador's enactment of Law 42 and all of Burlington's claims related thereto are therefore dismissed;
>
> 800. that, given that the Participation Contracts have not been breached, the Treaty has not been breached either and all of Burlington's Treaty claims related thereto are therefore dismissed;
>
> 801. alternatively to the finding on jurisdiction requested above, that Ecuador has not breached the Umbrella Clause in Article II(3)(c)

316 *Id.*, ¶¶ 698-721.

of the Treaty and all of Burlington's claims related thereto are therefore dismissed;

802. that Law 42 was a legitimate and *bona fide* exercise by Ecuador of its sovereign taxation powers;

803. that Ecuador's enactment of Law 42 does not amount to an expropriation under Article III of the Treaty and all of Burlington's claims related thereto are therefore dismissed;

804. that Ecuador's institution of the *coactiva* procedures does not amount to an expropriation under Article III of the Treaty and all of Burlington's claims related thereto are therefore dismissed;

805. that Ecuador's assumption of operations in Blocks 7 and 21 does not amount to an expropriation under Article III of the Treaty and all of Burlington's claims related thereto are therefore dismissed;

806. that, in any event, the measures in dispute do not amount to an unlawful expropriation under Article III of the Treaty;

807. that Burlington is liable towards Ecuador for the costs of remedying the environmental damages in areas within Blocks 7 and 21 of the Ecuadorian Amazon Region; and

808. that Burlington is liable towards Ecuador for the costs required to bring back the infrastructure of Blocks 7 and 21 into good working condition in accordance with the best standards and practices generally accepted in the international hydrocarbons industry.

10.2 Ordering

809. Burlington to bear the full costs of the remaining environmental studies for Blocks 7 and 21;

810. Burlington to remedy any and all environmental damage in Blocks 7 and 21 or pay the full costs of remedying the environmental damage, in an amount to be determined in the Quantum phase of this arbitration;

811. Burlington to pay damages for its breaches of the Participation Contracts for Blocks 7 and 21 and Ecuadorian law in an amount to be determined in the Quantum phase of this arbitration;

812. Burlington to pay all the costs and expenses of this arbitration, including Ecuador's legal and experts fees and ICSID's other costs; and

813. Burlington to pay compound interest at an adequate commercial interest rate on the amounts stated in the two preceding paragraphs from the date of disbursement thereof until the date of full payment.

10.3 Award

814. Such other relief as the Tribunal considers appropriate."[317]

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[317] *Id.*, ¶¶ 793-814. In RPHB, ¶ 589, the Respondent incorporated these requests for relief.

IV. ANALYSIS

175. The Arbitral Tribunal has deliberated and considered the Parties' written and oral submissions and arguments. To the extent that these arguments have not been referred to expressly, they must be deemed to be subsumed in the analysis. This analysis addresses Ecuador's outstanding jurisdictional and admissibility defenses and Burlington's Treaty claims on the merits.[318] If Ecuador is found liable to Burlington, a quantum phase will be held at a later stage of the proceedings. In parallel to Burlington's claims, this arbitration will also deal with Ecuador's counterclaims.

176. At the outset of the analysis, the Tribunal will consider some preliminary matters, including the law applicable to the merits and the relevance of previous decisions of international courts and tribunals (A); subsequently, it will examine Ecuador's outstanding jurisdictional and admissibility objections (B) and Burlington's claims on the merits (C). Finally, the Tribunal will set forth its decision (Section V).

A. PRELIMINARY MATTERS

1. Law Applicable to the Merits

177. Burlington's claims are based upon the United States - Ecuador BIT, which is thus the primary source of law for this Tribunal. With respect to matters not covered by the BIT, the latter contains no choice of law. The Tribunal must thus resort to Article 42 (1) of the ICSID Convention, which provides that:

> "(1) The Tribunal shall decide a dispute in accordance with such rules of law as may be agreed by the parties. In the absence of such agreement, the Tribunal shall apply the law of the Contracting State party to the dispute (including its rules on the conflict of laws) and such rules of international law as may be applicable.

178. Except for the undisputed application of the BIT, the Parties to this dispute have not agreed on the rules of law that govern the merits of this dispute in the sense of Article 42(1), first sentence. Therefore, according to the second sentence of Article 42(1), the Tribunal must "apply the law of the Contracting State party to the dispute [...] and such rules of international law as may be applicable." Indeed, the Parties have made their submissions under the correct assumption that both Ecuadorian law and international law govern the merits of this dispute.

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[318] The Tribunal has already determined that it has jurisdiction over Burlington's expropriation claims, but must still ascertain whether it has jurisdiction over the umbrella clause claims (DJ, ¶ 342).

179. As a result, the Tribunal will apply (i) first and foremost the BIT and, if need be, (ii) Ecuadorian law and those rules of international law "as may be applicable". In this latter respect, the Tribunal is of the view that the second sentence of Article 42(1) of the ICSID Convention does not allocate matters to either law. It is thus for the arbitrators to determine whether an issue is subject to national or international law. In this context, it should be noted that the PSCs include a choice of Ecuadorian law.[319] It should further be noted that a party may not rely on its internal law to avoid an obligation under international law.

2. Ecuador's Request that Section III(B)(2) of Burlington's Supplemental Memorial on Liability be Struck From the Record

180. Ecuador requests that Section III(B)(2) of Burlington's Supplemental Memorial on Liability be struck from the record on the ground that it reintroduces, under the guise of its surviving expropriation claim, the fair and equitable treatment and arbitrary impairment claims over which the Tribunal has already ruled that it has no jurisdiction. Ecuador argues that, whereas Article III(1) of the Treaty undoubtedly refers to the principles of treatment of Article II(3), Burlington improperly relies on this reference to establish that there was expropriation. However, the principles of treatment of Article II(3) of the Treaty only become relevant once it has been established that there was expropriation to begin with.[320]

181. Article III(1) of the Treaty provides that "*investments shall not be expropriated except [...] in accordance with the general principles of treatment provided for in Article II(3).*" The Tribunal agrees that this provision is only triggered if it is established that there is an expropriation. If there is an expropriation, it must be effected in accordance with the principles of treatment spelled out in Article II(3) of the Treaty. If there is no expropriation, this provision is inapposite.

182. Burlington's submissions do not suggest a different interpretation of this provision. In the Tribunal's understanding, Burlington relies on the principles of treatment of Article

[319] Clause 22.1 of the PSC for Block 7 provides that "[t]his Contract is governed exclusively by Ecuadorian legislation, and laws in force at the time of its signature are understood to be incorporated by reference" (Exh. C-1). Likewise, clause 22.1 of the PSC for Block 21 sets forth that "[t]his Contract is governed exclusively by Ecuadorian legislation, and laws in force at the time of its signature are understood to be incorporated by reference" (Exh. C-2).

[320] Tr. 210:2-213:7. In particular, Ecuador's assertion that "realizing that it's not easy for [Burlington] to characterize Law 42 as an expropriation, they in fact rely on Article II [of the Treaty] to characterize it as an expropriation, and that they cannot do. The Treaty does not permit that" (Tr. 213:3-7).

II(3) of the Treaty merely to establish that the purported expropriation of its investment was effected unlawfully:

> "Article X of the Treaty and this Tribunal's ruling in its Decision on Jurisdiction do not affect the applicability of the principles of Article II(3) to assess the lawfulness of Ecuador's measures as an expropriation under Article III. This Tribunal has jurisdiction over Burlington's Article III expropriation claim under Article X of the Treaty. As a result, once it finds that an expropriation has occurred, it has jurisdiction to assess the lawfulness of the expropriation by determining whether, as Article III(1) requires, the expropriation was consistent with the principles of treatment enunciated in Article II(3). Finding that the expropriation was carried out contrary to principles articulated in Article II(3) does not depend on a stand-alone violation of Article II(3) and thus does not contravene this Tribunal's determination that it does not have jurisdiction under Article X to assess whether tax measures violated Article II(3) of the Treaty.
>
> [...]
>
> In sum, Ecuador has expropriated Burlington's investments through means contrary to the principles of fair and equitable treatment, the obligation not to impair investment through arbitrary treatment and the duty to observe obligations. Ecuador has offered no compensation whatsoever for its unlawful expropriation. Ecuador is therefore liable under the *Chórzow* standard for an unlawful expropriation in violation of the Treaty and in violation of general principles of international law."[321] (emphasis added).

183. On this basis, the Tribunal sees no reason to strike Section III(B)(2) of Burlington's Supplemental Memorial on Liability from the record.

3. Undisputed Matters

184. Most of the facts of this case are not in dispute. At the hearing, counsel for the Claimant noted that this "case [...] is relatively simple on the facts because[,] for the most part, the facts are not in dispute."[322] While there are a few disputed issues of fact, the Claimant and the Respondent agree on most of the facts that gave rise to this dispute – their disagreement being, at its core, about how the petroleum rent should be allocated between them.

185. In particular, the Parties do not dispute that (i) beginning in 2002, oil prices rose well above the prevailing oil price at the time when the PSCs for Blocks 7 and 21 were executed; (ii) in November 2005, Ecuador sought to renegotiate the PSCs with Burlington (and its partner Perenco) for the first time; (iii) after those renegotiations failed, Ecuador passed sequentially Law 42 in April 2006, Decree 662 in October 2007,

321 CSM, ¶¶ 106, 122.

322 Tr. 14:4-6.

and the LET in December 2007; (iv) Burlington made Law 42 payments to Ecuador under protest from the time they were first imposed in mid-2006 until May 2008; (v) in June 2008, Burlington stopped making Law 42 payments to Ecuador, and instead began making Law 42 payments into a segregated account located in the United States.

186. It is further common ground that, following a new round of failed renegotiations in 2008, (vi) Ecuador initiated *coactiva* proceedings against Burlington in February 2009 and began to seize Burlington's share of oil production the following month; (vii) from March 2009 to around mid-2010, PetroEcuador auctioned and, being the sole bidder, acquired Burlington's share of oil production at below market prices in the context of the *coactiva* proceedings; (viii) on 16 July 2009, Burlington and Perenco ceased to operate Blocks 7 and 21; (ix) on that same day, Ecuador took possession of Blocks 7 and 21; (x) in July 2010, Ecuador terminated the PSCs for Blocks 7 and 21 pursuant to the so-called *caducidad* process.

4. Relevance of Decisions of Other International Courts and Tribunals

187. As stated in the Decision on Jurisdiction, the Tribunal considers that it is not bound by previous decisions. Nevertheless, the majority considers that it must pay due regard to earlier decisions of international courts and tribunals. It believes that, subject to compelling contrary grounds, it has a duty to adopt solutions established in a series of consistent cases. It further believes that, subject to the specifics of a given treaty and of the circumstances of the actual case, it has a duty to seek to contribute to the harmonious development of investment law, and thereby to meet the legitimate expectations of the community of States and investors towards the certainty of the rule of law. Arbitrator Stern does not analyze the arbitrator's role in the same manner, as she considers it her duty to decide each case on its own merits, independently of any apparent jurisprudential trend.

B. JURISDICTIONAL AND ADMISSIBILITY OBJECTIONS

1. Does the Tribunal Have Jurisdiction over Burlington's Umbrella Clause Claims under Article II(3)(c) of the Treaty?

188. In the Decision on Jurisdiction, the Tribunal joined to the merits "the determination of whether it has jurisdiction over Burlington's Law 42 first umbrella clause claim and over the first limb of its third umbrella clause claim under Article II(3)(c) of the Treaty"[323] (the "umbrella clause claims"). It did so, on the ground that the Parties had not sufficiently

[323] DJ, ¶ 342 (B).

discussed Ecuador's lack of privity objection, which had been raised for the first time at the hearing on jurisdiction[324]. As the Parties have since then argued this point at length, the issue is now ripe for the Tribunal's determination.

189. Ecuador maintains that the Tribunal has no jurisdiction over Burlington's umbrella clause claims for the following three reasons: (i) by withdrawing the Contract Claims "with prejudice", Burlington waived its rights under the PSCs and thus the umbrella clause has no object; (ii) Burlington has no independent rights deriving from the so-called Hydrocarbons Legal Framework; and (iii) contrary to what the Treaty requires, there is no privity of contract between Burlington and Ecuador. The Tribunal will address Ecuador's objections sequentially.

1.1. Is the umbrella clause without "object" as a result of the withdrawal of the Contract Claims with prejudice?

1.1.1. Positions of the Parties

190. Ecuador alleges that the Treaty's umbrella clause is of no avail to Burlington because there is no surviving contractual obligation that could be elevated to the Treaty level via the umbrella clause. In point of fact, the Burlington Subsidiaries withdrew their contract claims against Ecuador "with prejudice."[325] This amounts to a waiver of all underlying rights and obligations under the PSCs. Support for this conclusion is to be found in decisions by ICSID tribunals in *Cementownia v. Republic of Turkey* (*Cementownia*)[326] and *Waste Management v. United Mexican States* (*Waste Management II*).[327] Hence, Burlington may not elevate extinct contractual obligations to the Treaty level through the umbrella clause.[328] This argument is submitted as a jurisdictional objection or, alternatively, as a defense on the merits. In addition, Ecuador assumed no independent obligations vis-à-vis Burlington under the Hydrocarbons Law.[329] For these reasons, the Treaty's umbrella clause has "no object."[330]

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324 *Id.*, ¶ 197.

325 Letter from Burlington and the Burlington Subsidiaries to the Tribunal dated 10 October 2009; Exh. C-190.

326 *Cementownia "Nowa Huta" S.A. v. Republic of Turkey* (hereinafter "*Cementownia*"), Award of 17 September 2009 (Exh. EL-66).

327 *Waste Management, Inc. v. United Mexican States*, (hereinafter "*Waste Management II*"), Award of 30 April 2004 (Exh. EL-67).

328 RCM, ¶¶ 30-98.

329 *Id.*, ¶¶ 99-112.

330 Tr. 191:20 and 1326:8.

191. Burlington argues that the Tribunal already dismissed this objection in its Decision on Jurisdiction.[331] In any event, Ecuador's objection is flawed insofar as Contract and Treaty Claims have "separate lives."[332] Once the PSCs were breached, two sets of claims arose: a set of Contract Claims and a set of Treaty Claims. It is entirely possible to pursue one set of claims without pursuing the other. These independent sets of claims involve different Parties – Burlington Resources as opposed to Burlington Oriente – and different sources of rights – the Treaty as opposed to the PSCs.[333] Moreover, Ecuador also assumed obligations towards Burlington through the specific regulatory regime embodied in the Hydrocarbons Legal Framework.[334]

1.1.2. Analysis

192. In its submissions on the merits, Ecuador raised the argument of the waiver of the contract rights. To the extent that it deals with jurisdiction, this objection would be barred because the jurisdictional phase was closed but for the privity issue. Indeed, in the Decision on Jurisdiction, the Tribunal held that "the Parties may not re-argue or present new arguments on any jurisdictional issue other than the privity objection with respect to Burlington's outstanding umbrella clause claims."[335]

193. Be this as it may, Ecuador has also submitted this argument as one on the merits. At the hearing on liability, counsel for Ecuador stated: "[I]f the Tribunal was to decide that this is not an admissible jurisdictional objection at this stage, we deal with it as a defense on the merits […]."[336] As a defense on the merits, Ecuador's argument is not precluded by the terms of the Tribunal's Decision on Jurisdiction. It raises an issue that bears an obvious connection to the merits, to wit, whether Burlington has any umbrella clause rights at all. Hence, the Tribunal will entertain Ecuador's new argument as a defense on the merits.

194. Ecuador's defense is based on the premise that a withdrawal of claims with prejudice results in a waiver of the rights underlying those claims. In this way, the Burlington Subsidiaries' withdrawal of their contract claims with prejudice waived the underlying

331 Tr. 151:19-21.

332 CPHB, ¶ 262.

333 *Id.*, ¶¶ 260-262; Tr. 152:4-10.

334 Tr. 1295:3-16.

335 DJ, ¶ 199.

336 Tr. 189:11-14. Counsel for Ecuador also pointed out: "Where does the Umbrella Clause stand in that context [of substantive and jurisdictional clauses]? They [umbrella clauses] can reasonably achieve two objectives, and that's reflected in Mr. Vandevelde's commentary which both Jan Paulsson and I mentioned in the opening." (Tr. 1336:22-1337:4).

contractual rights. Ecuador finds support for this argument in two ICSID decisions: *Cementownia* and *Waste Management II*. In *Cementownia*, the tribunal quoted the following passage from the *Waste Management II* decision:

> "In international litigation the withdrawal of a claim does not, *unless otherwise agreed*, amount to a waiver of any underlying rights of the withdrawing party."[337] (emphasis added).

195. On the basis of *Cementownia* and *Waste Management II*, Ecuador argues that a withdrawal with prejudice amounts to an agreement to waive the rights underlying those claims. Applied to this case, the withdrawal of the Contract Claims with prejudice would be the equivalent of a waiver of the underlying rights. The Tribunal cannot follow this argument for the following reasons.

196. First, it arises from the two cases referred to by Ecuador that the rule is that a withdrawal of claims does not amount to a waiver of rights. It further arises that as an exception to the rule, the parties may agree otherwise, in which case the withdrawal of claims operates as a waiver of substantive rights. Albeit not directly applicable to the withdrawal of claims in this arbitration, Ecuadorian procedural law seems to apply the same rule. Specifically, Article 377 of the Ecuadorian Code of Civil Procedure provides that the party who withdraws a claim "cannot re-file" this claim against the same person or against its legal representative.

197. Thus, the question here is whether the Tribunal should apply the exception rather than the rule, that is whether the Parties intended the withdrawal of the Subsidiaries' Claims to operate as a waiver of the underlying substantive rights. The evidence on record suggests the contrary. By letter of 10 October 2009, counsel for the Initial Claimants confirmed that the Burlington Subsidiaries would withdraw their contract claims "with prejudice" because they saw "no reason to preserve [their] right to re-file the contractual claims in the future."[338] In other words, the avowed purpose of the withdrawal with prejudice was to renounce the possibility to "re-file the contractual claims in the future,"[339] it was not to waive contractual rights for purposes of this proceeding. Therefore, no intent to waive the contract rights may be inferred from the letter of 10 October 2009 confirming the withdrawal with prejudice.

198. More generally, Burlington's continuing prosecution of the umbrella claim under the Treaty belies an intent by its Subsidiaries to waive their rights under the PSCs. As

337 Exh. EL-141, ¶ 36; *Cementownia* Award, at ¶ 109 (Exh. EL-66)..

338 Exh. C-190, p. 2.

339 *Id.*

counsel for the Claimant stressed at the hearing, Burlington's umbrella clause claims were "present from the beginning of this arbitration and were never waived."[340] The Treaty's umbrella clause can only become operative if underlying rights arising from another source do exist. Considering that the umbrella clause claim was pending at the time of withdrawal of the Subsidiaries' claims, one cannot understand the Burlington Subsidiaries to have intended to waive the very rights on which Burlington's umbrella clause claim was predicated.

199. In sum, the Burlington Subsidiaries have waived the possibility of ever re-filing their claims under the PSCs in any form in the future. They have not waived the underlying rights and Burlington may thus rely on these underlying rights to pursue its Treaty claims in this arbitration.

1.2. May Burlington rely on the Treaty's umbrella clause to enforce its purported rights under the Hydrocarbons Legal Framework?

1.2.1. Positions of the Parties

200. According to Ecuador, Burlington may not rely on the Treaty's umbrella clause to enforce its purported rights under the Hydrocarbons Legal Framework because (i) Ecuador has not "entered into" any obligation in enacting the Hydrocarbons Legal Framework, (ii) the Hydrocarbons Legal Framework is of a general nature and unrelated to any specific investment, and (iii) in any event, the Hydrocarbons Legal Framework imposes no obligation upon Ecuador. On the other hand, Burlington submits that the Treaty's umbrella clause covers the specific, unilateral commitments Ecuador made to oil companies under the Hydrocarbons Legal Framework. In particular, Ecuador committed to indemnify oil companies for any increase in the tax burden and to adjust the oil participation formulas.

1.2.2. Analysis

201. Article II(3)(c) of the Treaty, the so-called umbrella clause, provides the following:

> "Each Party shall observe any obligation it may have entered into with regard to investments."

202. The umbrella clause only becomes operative to the extent that a State party to the BIT has entered into an "obligation." Burlington contends that, by enacting the Hydrocarbons Legal Framework, Ecuador entered into (i) an obligation to absorb the effects of any tax increase pursuant to Article 16 of Decree of No. 1417 and (ii) an

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340 Tr. 1294:2-6.

obligation to ensure that Burlington would receive its fixed participation of monthly crude production according to Article 4 of Law No. 1993-44.

203. Article 16 of Decree No. 1417 ("Article 16") lays down the following:

> "Economic stability: The parties' production shares in the contract area will be adjusted when the tax system applicable to the contract has been modified, in order to restore the economics of the contract in place before the tax modification"[341] (emphasis added).

204. Article 4 of Law No. 1993-44 ("Article 4") provides in its relevant part that:

> "Once production is initiated, the contractor will have the right to a share of production in the contract area, which will be calculated in accordance with the production shares offered and agreed upon therein, based upon the volume of hydrocarbons produced"[342] (emphasis added).

205. Both legal provisions presuppose the existence of a "contract." Without a contract, these provisions are inoperative. Thus, Article 16 refers to "production shares *in the contract*"[343] and to "the tax system applicable *to the contract*."[344] For its part, Article 4 provides that the "*contractor* will have the right to a share of production *in the contract area*."[345] This prerequisite "contract" that would trigger the application of these provisions is naturally one that would be executed in the future. This explains why Article 4 states that the contractor "will have the right" – that is, the contractor has no vested right at that point, but "will have the right" once the PSC containing such "right" is executed.

206. Under these legal provisions, Ecuador bound itself to include certain rights in the PSCs to be executed in the future. Hence, the purpose of these provisions was to guarantee future contractors certain contractual rights. But once these contractual rights were effectively incorporated into the actual PSCs, the purpose of these legal provisions would be exhausted. No "obligation" under the legal provisions would survive beyond that point. In this case, it appears that the purpose of these provisions was fulfilled: Ecuador entered into PSCs with the Burlington Subsidiaries, and these PSCs did reproduce the terms of Article 16 and of Article 4. As counsel for Ecuador pointed out at the hearing on liability:

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341 Exh. C-89, p. 23 in the original pagination (Tribunal's translation).

342 Exh. C-15, p. 3 in the original pagination (Tribunal's translation).

343 *Supra,* at note 341 (emphasis added).

344 *Id.* (emphasis added).

345 *Supra,* note 342 (emphasis added).

> "Suppose there was no [production sharing] contract or [that we] plac[e] ourselves before there is a contract. What is promised by this Article [16] and to whom? One could argue, well, it's a promise to offer that to a foreign investor and to accept a contract containing a clause more or less reproducing this. All right. Let's admit that, and then we shall see. We do see that the promise was kept. The Participation Contracts contained this undertaking. And from the moment the Participation Contracts are signed, there is an undertaking but it is a contractual undertaking"[346] (emphasis added).

207. In fact, the purpose of these legal provisions was exhausted when the promises made under law were turned into contractual obligations. Accordingly, these provisions no longer contain an "obligation" independent of the PSCs upon which Burlington may rely for purposes of the umbrella clause.[347] For these reasons, Burlington may not avail itself of the umbrella clause to bring claims based solely on Ecuador's Hydrocarbons Legal Framework. On account of this finding, the Tribunal does not need to examine Ecuador's remaining objections to Burlington's umbrella clause claim based on Ecuador's laws and regulations.

1.3. May Burlington rely on the Treaty's umbrella clause to enforce its subsidiary's rights under the PSCs despite the alleged absence of privity between Burlington and Ecuador?

1.3.1. Positions of the Parties

208. Ecuador alleges that Burlington may not rely on the umbrella clause to enforce its subsidiaries' rights under the PSCs because, contrary to the requirement of the umbrella clause, there is no privity of contract between Burlington and Ecuador. Privity between a creditor and a debtor is part of the ordinary meaning of the term "obligation" in the umbrella clause. The expression "with regard to investments" narrows down the scope of the "obligations" and thus of the umbrella clause. "Not being a creditor under the [PSCs], Burlington Resources cannot become a creditor under the umbrella clause, the scope of which must reflect the scope of the contractual obligations."[348] In support of its position, Ecuador relies primarily on the ICSID decisions in *Azurix*, *Siemens* and the *CMS* annulment. It also invokes *Gustav Hamester v. Ghana*. Hence, there is a "series of consistent cases" which construe the umbrella clause as requiring privity.[349]

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346 Tr. 208:12-22.

347 This is not to say, however, that the provisions of the Hydrocarbons Law upon which Burlington relies serve no purpose whatsoever. Since the PSCs were to reproduce these provisions – which they did as Ecuador has admitted – they may assist in construing those provisions that were incorporated into the PSCs pursuant to the promises made in the Hydrocarbons Legal Framework.

348 Tr. 193:18-21.

349 Tr. 199:2-3.

Finally, Ecuador states that the decisions upon which Burlington relies, *Continental Casualty* and *Duke Energy*, are of no assistance on this issue.

209. Burlington, on the other hand, submits that the Treaty's umbrella clause requires no privity. The umbrella clause applies to "any obligation [...] entered into with regard to investments."[350] The reference to "*any* obligation" shows that the clause is meant to be broad and cover all obligations. The choice of the word "investment" is telling. The Treaty only requires that the obligations be entered "with regard to [Burlington's] investments", and not the investor, *i.e.* Burlington. In accordance with Article I of the Treaty, "investments" covers both direct and indirect investments. Thus, the plain language of the Treaty does not require privity. A narrower formulation calling for privity could have been used, but Ecuador and the United States "deliberately chose the broader term in the Umbrella Clause."[351] In addition, Ecuador's interpretation of the umbrella clause is contrary to the purpose of the Treaty, which protects both direct and indirect investments. Burlington denies that there is a "series of consistent cases" requiring privity and points to the decision in *Continental Casualty*.

1.3.2. Analysis

210. The Tribunal will focus on the Treaty's umbrella clause and its interpretation under international law (i), and then turn to the ICSID case law dealing with the issue of the umbrella clause's scope (ii).

(i) The interpretation of the Treaty's umbrella clause

211. The Treaty's umbrella clause reads as follows:

> "Each Party shall observe any obligation it may have entered into with regard to investments."

212. In application of the Vienna Convention on the Law of Treaties, the Tribunal will interpret the umbrella clause in accordance with the ordinary meaning of the terms in their context and in light of the object and purpose of the Treaty. To avoid any ambiguity in the context of the debate on the significance of umbrella clauses, the Tribunal stresses that the interpretation question it faces is not whether the term "obligation" comprises commitments deriving from laws and regulations in addition to contract as some tribunals have found.[352] Here, there is no doubt that the obligations at

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350 *Supra*, ¶ 201.

351 Tr. 148:4-6.

352 *Noble Energy Inc. and MachalaPower Cia. Ltda. v. Ecuador and Consejo Nacional de Electricidad*, Decision on Jurisdiction dated 5 March 2008, at ¶ 157 (Exh. CL-32); *Continental*

issue arise out of a contract. Nor is the question whether obligations resulting from a commercial contract should be protected under the umbrella clause, or in other words whether a distinction should be made depending on the State's acting as a sovereign or as a merchant.[353] Here, if the hurdle of the contract partner is overcome, there is no question that Ecuador entered into the PSCs as a sovereign.[354] The question at hand is exclusively whether the umbrella clause protection applies to obligations entered into not between the State and the investor and Claimant, but between the State and an affiliate of the investor.

213. Bearing these delimitations in mind, the Tribunal first notes that the Treaty's umbrella clause imposes an obligation on the Contracting States ("shall observe"). Their obligation consists in observing "any obligation", which terms are further specified by the words "entered into" and "with regard to investments."

214. The word "obligation" is thus the operative term of the umbrella clause. The Treaty does not define "obligation". The Parties agree – and rightly so – that the clause refers to legal obligations. This is of little assistance, however, to resolve the question of privity. To answer this question, the Tribunal relies primarily on two elements which in its view inform the ordinary meaning of "obligation." First, in its ordinary meaning, the obligation of one subject is generally seen in correlation with the right of another. Or, differently worded, someone's breach of an obligation corresponds to the breach of another's right.[355] An obligation entails a party bound by it and another one benefiting from it, in other words, entails an obligor and an obligee. Second, an obligation does not exist in a vacuum. It is subject to a governing law. Although the notion of obligation is used in an international treaty, the court or tribunal interpreting the treaty may have to look to municipal law to give it content. This is not peculiar to "obligation"; it applies to other notions found in investment treaties, *e.g.* nationality, property,

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Casualty Company v. Argentine Republic, (hereinafter "*Continental Casualty")*, Award of 5 September 2008, at ¶ 297 (Exh. EL-74).

353 *El Paso Energy International Company v. Argentine Republic*, Decision on Jurisdiction dated 27 April 2007, at ¶ 79 (Exh. CL-40); *Joy Mining Mach. Ltd. v. The Arab Republic of Egypt,* Award on Jurisdiction dated 6 August 2004, at ¶ 72 (Exh. CL-73).

354 While the Decision on Jurisdiction held that the PSCs did not qualify as "investment agreements" under Art. VI(1)(a) and X(2)(c) of the BIT, it did so only because there was no privity between the Claimant and the Respondent, not because the PSCs were commercial contracts (DJ, ¶ 235).

355 *E.g.* with respect to the notion of obligation under international law, *Draft Articles on Responsibility of States for Internationally Wrongful Acts,* Text adopted by the International Law Commission at its fifty-third session, in 2001, and submitted to the General Assembly as a part of the Commission's report covering the work of that session (A/56/10); *Yearbook of the International Law Commission, 2001,* vol. II, Part Two (Exh. CL-127).

exhaustion of local remedies to name just these.[356] In this case, the PSCs are governed by Ecuadorian law. It is that law that defines the content of the obligation including the scope of and the parties to the undertaking, *i.e.* the obligor and the obligee.

215. Applying these two elements to this case, one cannot but conclude that the umbrella clause does not protect obligations arising from the PSCs. Whose right is correlated to the obligation? The answer is found in the law governing the obligation, here Ecuadorian law. Burlington has not alleged, not to speak of established, that under Ecuadorian law the non-signatory parent of a contract party may directly enforce its subsidiary's rights.

216. The context of the term "obligation" confirms this conclusion. Although not conclusive in and of themselves, the words "entered into" can be regarded as reinforcing the idea of privity. As to the terms "with regard to investments" also employed by the relevant treaty provision, they denote a "link between the obligation and the investment" as Burlington argued at the hearing. This is certainly in keeping with the object and purpose of the Treaty, which are to encourage and protect investments. However, as Ecuador pleaded, this link "does not replace but qualifies" the notion of obligation.

217. If there is no obligation in the first place, there is nothing to qualify. Nor can these qualifications create an "obligation" where there is none to begin with. Burlington argues that, because the definition of investment in Article I of the Treaty covers both direct and indirect investment, it is a co-obligee of Ecuador's obligations under the PSCs. Broad as the definition of investment in the Treaty may be, it cannot compensate for the absence of an "obligation."

218. The object and purpose of the Treaty lead to no different conclusion. Burlington claims that reading a privity component into the umbrella clause would be "contrary to the spirit of the Treaty"[357] which, by virtue of the definition of investment in Article I, seeks to protect both direct and indirect investments. The Tribunal cannot agree. The umbrella clause is only one of the various substantive protections that the Treaty

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[356] *E.g.*, *SGS Société Générale de Surveillance S.A. v. Republic of the Philippines,* (hereinafter "*SGS*"*)*, ¶ 126; (Exh. EL-73). *Nottebohm Case (second phase), Judgment of April 6th, 1955 : I.C.J. Reports 1955, p.4; and Case concerning certain German interests in Polish Upper Silesia (The Merits), Judgment of 25 May 1926, PCIJ, Series A – No. 27.* BROWNLIE, Ian. *Principles of Public International Law.* Oxford University Press, Seventh Edition (2008), p. 36; and WEERAMANTRY, J. Romesh. *Treaty Interpretation in Investment Arbitration*, Oxford University Press (2012), *at* 6.36, p. 167.

[357] CSM, ¶ 135.

bestows upon investors, with the scope of protection depending on the terms of each specific provision. Other Treaty provisions unquestionably protect both direct and indirect investments, such as for instance the expropriation clause. The object and purpose of the Treaty do not impose that all standards of protection have the same scope.

219. Burlington further maintains that it would be ironic for it to not be able to rely on the umbrella clause on the ground that it did not sign the PSCs, when Ecuador has asserted counterclaims precisely on the basis of the PSCs.[358] Here again, the Tribunal cannot follow this argument for the reason that its jurisdiction over the counterclaims is based on a specific submission agreement.

220. As a result, the Tribunal holds that, Burlington may not rely on the Treaty's umbrella clause to enforce against Ecuador its subsidiary's contract rights under the PSCs for Blocks 7 and 21. This conclusion is supported by ICSID case law, the import and meaning of which has been heavily debated by the Parties. Arbitrator Orrego Vicuña disagrees with these findings for the reasons explained in the attached dissenting opinion.

(ii) ICSID case law

221. Before examining the specific cases upon which the Parties rely, the Tribunal must address a threshold matter concerning the precedential value of ICSID cases. Burlington has sought to diminish the relevance of some of the cases upon which Ecuador relies on the ground that statements which Ecuador cites are *obiter dicta*. Ecuador for its part has argued that in the context of investment arbitration, "[e]verything counts."[359] The Tribunal tends to agree with Ecuador. It is correct that there is no formal rule of *stare decisis* in international investment arbitration. At the same time, the Tribunal considers that it should "contribute to the harmonious development of investment law" and promote a predictable legal order.[360] In this light, there is no reason to distinguish between *obiter dicta* and holding. Whether peripheral or central to the decision, the statements of an international investment tribunal may provide guidance to investors and host States alike, and may serve to predict the decisions of future tribunals.

358 CPHB, ¶ 307.

359 Tr. 198:12.

360 DJ, ¶ 100.

222. The decisions in *Azurix*, *Siemens* and the *CMS* annulment proceedings appear to require privity of contract between the investor and the host State for purposes of the umbrella clause. In an award rendered in July 2006, the *Azurix* tribunal dealt with an umbrella clause contained in the United States-Argentina BIT, the wording of which is identical to the u*mbrella clau*se under examination here. The *Azurix* tribunal held as follows:

> "As already stated by the Tribunal in affirming its jurisdiction within the limits permitted by the Convention and the BIT, the Tribunal finds that none of the contractual claims as such refer to a contract between the parties to these proceedings; neither the Province [of Buenos Aires] nor ABA are parties to them. While Azurix may submit a claim under the BIT for breaches by Argentina, there is no undertaking to be honored by Argentina to Azurix other than the obligations under the BIT. Even if for argument's sake, it would be possible under Article II(2)(c) to hold Argentina responsible for the alleged breaches of the Concession Agreement by the Province, it was ABA and not Azurix which was the party to this Agreement."[361] (emphasis added).

223. The implication of this reasoning is evident. The parties to the underlying agreement were the Province of Buenos Aires and ABA, Azurix's subsidiary. Azurix itself was not a party to the agreement. For this reason, even assuming *arguendo* that Argentina had been bound by the agreement, Azurix could not have relied on the treaty's umbrella clause to bring claims based on that contract against Argentina. The unstated but obvious premise is that the umbrella clause required privity between the investor and Argentina.[362]

224. Some time later, the tribunal in *Siemens*[363] dealt with an umbrella clause contained in the Germany-Argentina BIT. This umbrella clause provided that "[e]ach Contracting Party shall observe any other obligation it has assumed with regard to investments by nationals or companies of the other Contracting Party in its territory." In its award of February 2007, the *Siemens* tribunal stated as follows:

> "The Tribunal considers that Article 7(2) has the meaning that its terms express, namely, that failure to meet obligations undertaken by one of the Treaty parties in respect to any particular investment is converted by this clause into a breach of the Treaty. Whether an arbitral tribunal is the tribunal which has jurisdiction to consider that

[361] *Azurix Corp. v. The Argentine Republic* (hereinafter "*Azurix*"), Award of 14 July 2006, at ¶ 384 (Exh. CL-121).

[362] The contract between ABA and the Province of Buenos Aires was governed by Argentine law. The *Azurix* Tribunal held that, while its inquiry on the merits was governed by the ICSID Convention, by the BIT and by applicable international law, the law of Argentina would assist its inquiry "into the alleged breaches of the Concession Agreement to which Argentin[e] law applies". *Azurix* Award, at ¶ 67 (Exh. CL-121).

[363] The *Azurix* and the *Siemens* Tribunals were both chaired by the same arbitrator, Andrés Rigo Sureda.

breach or whether it should be considered by the tribunals of the host State of the investor is a matter that this Tribunal does not need to enter. The Claimant is not a party to the Contract and SITS is not a party to these proceedings."[364] (emphasis added).

225. Just like in *Azurix*, the implication is clear. The parties to the underlying contract were Argentina and SITS, Siemens' subsidiary.[365] Siemens itself was not a party to the contract. Therefore, Siemens could not invoke the treaty's umbrella clause in order to bring contract claims against Argentina. Once again, the implicit premise is that the umbrella clause requires privity.

226. In September 2007, the CMS *ad hoc* Committee issued its decision. While this Tribunal stated in the Decision on Jurisdiction that "no general rule"[366] on privity could be extrapolated from the *CMS* annulment decision, it joined the issue to the merits because the Parties had not sufficiently discussed it in the course of the jurisdictional phase.[367] Now with the benefit of the Parties' extensive submissions and legal authorities, the Tribunal is better poised to construct the scope of the Treaty's umbrella clause.

227. In the *CMS* annulment proceedings, Argentina alleged that the tribunal had manifestly exceeded its powers because it had allowed CMS to bring claims against Argentina under the umbrella clause even though CMS "was not a party to any of the applicable instruments."[368] As in *Azurix*, the applicable umbrella clause was that of the United States-Argentina BIT, which is identical to the present one. Although the *ad hoc* Committee annulled the award for failure to state reasons and not for manifest excess of powers, it made the following observation in the context of its umbrella clause analysis:

> "The effect of the umbrella clause is not to transform the obligation which is relied on into something else; the content of the obligation is unaffected, as is its proper law. If this is so, it would appear that the *parties* to the obligation (*i.e.*, the persons bound by it and entitled to

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[364] *Siemens A.G. v. Argentine Republic*, Award and Separate Opinion of 6 February 2007, at ¶ 204 (Exh. CL-79).

[365] Once again, Argentine law governed the Contract – that is, the underlying obligation that Siemens was seeking to enforce via the umbrella clause.

[366] DJ, ¶ 195. The reason being that the *ad hoc* Committee annulled the tribunal's award for failure to state reasons, not for manifest excess of powers. *CMS Gas Transmission Company v. Argentine Republic* (hereinafter "*CMS*"), Annulment Proceeding, Decision of the *Ad Hoc* Committee on the Application for Annulment of the Argentine Republic of 25 September 2007 (Exh. CL-72, ¶¶ 97-98).

[367] DJ, ¶¶ 197-198.

[368] *Id.*, ¶ 46.

rely on it) are likewise not changed by reason of the umbrella clause"[369] (emphasis in original).

228. The *CMS ad hoc* Committee expressed the premise which the *Azurix* and the *Siemens* tribunals had left unstated. First, in keeping with this Tribunal's analysis, the *ad hoc* Committee stated that an obligation has an obligor ("the person bound by it") and an obligee ("the person […] entitled to rely on it"). Second, still in conformity with the Tribunal's view, the *ad hoc* Committee stated that the obligation remains governed by its proper law and that the parties to the obligation are not changed by reason of the umbrella clause. Thus, the umbrella clause does not expand the universe of obligees who may rely on the underlying obligation.

229. Burlington has sought to distinguish the *CMS* annulment decision on the ground that CMS was a minority shareholder, whereas in this case Burlington wholly owns the special investment vehicle party to the PSCs – Burlington Oriente. The Tribunal does not see why this is a distinguishing factor. Both the *CMS* annulment Committee and this Tribunal held that the notion of "obligation" presupposes a person entitled to rely on it or an obligee. Not being a party to the PSCs, Burlington is not an obligee and cannot become one for the reason that it owns all the shares of a signatory party.

230. Burlington also submits that the *CMS* tribunal – as opposed to the *ad hoc* Committee – indicated that there is "no bar in current international law to the concept of allowing claims by shareholders independently from those of the corporation concerned"[370] and that it went on to note that "[w]hether the protected investor is in addition a party to a concession agreement or a license agreement with the host State is immaterial for the purpose of finding jurisdiction under those treaty provisions, since there is a direct right of action of shareholders."[371] Although counsel for the Claimant argued that "[a]d hoc committees are not inherently superior to [a]rbitral [t]ribunals, whether in their composition or in their entitlement to create jurisprudence",[372] one cannot disregard that the ICSID Convention entrusts *ad hoc* committees with the power to annul awards and that this *ad hoc* Committee annulled this award on this very point.[373]

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369 *CMS* Annulment Decision, at ¶ 95(c) (Exh. CL-72).

370 *CMS* Decision on Jurisdiction, at ¶ 48 (Exh. CL-180); CPHB, ¶ 300.

371 *CMS* Decision on Jurisdiction, at ¶ 65 (Exh. CL-180); CPHB, ¶ 301.

372 Tr. 1303:9-12.

373 *CMS* Annulment Decision, at ¶ 97 (Exh. CL-72).

231. In support of the requirement of privity, Ecuador also invokes *Gustav Hamester v. Ghana.*[374] The facts of that case were different because the contract at issue was between the investor and a State entity, as opposed to a contract between a subsidiary of the investor and the State. In spite of this difference, this case equally confirms the need for privity. The *Gustav Hamester* tribunal observed that the *CMS* annulment decision "made it clear that […] a contractual obligation between a public entity distinct from the State and a foreign investor cannot be transformed by the magic of the so-called "umbrella clause" into a treaty obligation of the State towards a protected investor[.]"[375] By the same token, the umbrella clause cannot transform a contract obligation of the State towards an investor's subsidiary into an obligation to the investor itself.

232. Finally, Burlington relies on *Continental Casualty,* a decision of September 2008.[376] Construing the umbrella clause of the United States-Argentina BIT invoked in *Azurix* and *CMS*, the *Continental Casualty* tribunal stated that it was "conscious that the interpretation of umbrella clauses […] remains controversial and that there is a lack of consistency" with respect to its scope.[377] It eventually dismissed all umbrella clause claims because the underlying obligations were either too general or covered by the necessity defense.[378] It also mentioned that the obligations covered by the umbrella clause "may have been entered with persons or entities other than foreign investors themselves."[379]

233. It is debatable whether the *Azurix*, *Siemens,* and *CMS* annulment decisions constitute a "series of consistent cases" stating that the umbrella clause requires privity. Indeed, the views expressed in these cases are supported by few reasons, if any, and a different opinion is adopted in *Continental Casualty.*[380] Be this as it may, it is certain

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[374] *Gustav F W Hamester GmbH & Co KG v. Republic of Ghana* (hereinafter "*Gustav Hamester*"), Award, 18 June 2010 (Exh. EL-150); RPHB, ¶ 580.

[375] *Gustav Hamester*, at ¶ 346.

[376] Burlington also relied on *Duke Energy Electroquil Partners & Electroquil S.A. v. Republic of Ecuador*, Award of 18 August 2008 (Exh. CL-41). However, as Ecuador noted, there was no privity issue in *Duke Energy* because the investor's majority-owned subsidiary - Electroquil - was a party to the case and jurisdiction was premised on both an arbitration agreement and an investment treaty (*Id.* ¶¶ 119, 170). ¶

[377] *Continental Casualty*, at ¶ 296.

[378] *Id.*, ¶¶ 302-303.

[379] *Id.*, ¶ 297.

[380] Burlington has also cited the Reader's Guide to the Energy Charter Treaty to buttress its argument that the umbrella clause in the Treaty must cover both direct and indirect investments (CSM, ¶ 132). First, as the Claimant conceded, the umbrella clause's formula in the Energy Charter Treaty is "broader" than in the Treaty under examination (*Id.*). Second, there is no

that the majority of the ICSID cases law supports the Tribunal's conclusion that the protection granted under the umbrella clause requires privity between the investor and the host State.

234. For these reasons, the majority concludes that the Tribunal has no jurisdiction over Burlington's umbrella clause claims according to which Ecuador would have failed to adjust the contractor's oil production share and to guarantee the contractor's participation in oil production.

2. Are the *Caducidad* Decrees Part of Burlington's Case?

235. The Tribunal issued its Decision on Jurisdiction on 2 June 2010. Only a few weeks later, on 20 July 2010, Ecuador's Minister of Non-Renewable Natural Resources declared the termination of the PSCs for Blocks 7 and 21 by issuing the so-called *caducidad* decrees. The *caducidad* decrees thus post-date the Tribunal's Decision on Jurisdiction, as a consequence of which neither Party had the opportunity to address the *caducidad* decrees in its jurisdictional pleadings. In this Section, the Tribunal will examine (i) whether Burlington has challenged the *caducidad* decrees; if so, (ii) whether the Tribunal has jurisdiction over the *caducidad* decrees, and (iii) whether the allegations based on the *caducidad* decrees are admissible.

2.1. Has Burlington challenged the *caducidad* decrees?

236. Ecuador argues that "*caducidad* is simply not part of this case."[381] It submits that Burlington contests neither the *caducidad* decrees nor the procedures leading up to their declaration.[382] Burlington has portrayed the *caducidad* decrees as being merely "symbolic" because the purported expropriation of its investment had already been consummated at the time those decrees were issued. Burlington has not specifically answered Ecuador's allegations that Burlington has not challenged the *caducidad* decrees and that, as a result, the *caducidad* decrees are not part of this case. Therefore, the Tribunal will have to determine whether Burlington has challenged the *caducidad* decrees on the basis of the whole record.

237. As part of the factual background to the case, Burlington alleged that Ecuador terminated the PSCs for Blocks 7 and 21 via the *caducidad* process.[383] Subsequently,

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similar explanatory guide to the Treaty showing that the United States and Ecuador intended the umbrella clause to cover both direct and indirect investments.

[381] Tr. 301:20-21.

[382] RCM, ¶ 153.

[383] CSM, § II(C)(4), ¶¶ 77-78.

at the very outset of its legal discussion in the same memorial, Burlington argued that "Ecuador's *measures* have deprived [it] of the use and enjoyment of its investments"[384] (emphasis added). Burlington then listed six measures which, "both individually and in the aggregate"[385], allegedly expropriated its investment: the last measure includes the termination of the PSCs via the *caducidad* decrees. While Burlington remarked that this termination was "symbolic"[386] because its "investment already had been expropriated",[387] it also claimed that "[w]ith this action [...] Ecuador foreclosed any possibility of Burlington returning to the legal and fiscal regime it had been [previously] guaranteed […]."[388]

238. In other words, in the Supplemental Memorial, Burlington (i) characterized the *caducidad* decrees as one of the measures which both individually and in combination with other measures allegedly expropriated its investment, and (ii) argued that the *caducidad* decrees made it impossible to revert to the *status quo* which it had enjoyed before the measures of which it complains in this arbitration were adopted. In the view of the Tribunal, these allegations show that Burlington does challenge the *caducidad* decrees.

239. Similarly, Burlington devoted some attention to the *caducidad* decrees at the hearing. First, counsel for Burlington cross-examined Minister Wilson Pástor Morris extensively on the subject of the *caducidad* decrees.[389] Second, counsel for Burlington referred to the *caducidad* decrees as follows during the Parties' closing statements:

> "Next, proceedings were commenced for *caducidad*, a contract termination method that sought to excuse Ecuador. The allegation was a breach of Article 74(4) of the Hydrocarbons Law which allegedly did not permit suspension of operations without ["*justa causa*"], without just cause.
>
> [….]
>
> Now, of course, the *caducidad* Decision – let's not be under any illusions – was reverse-engineered so that Ecuador sought to escape from its contractual obligations with the Claimant. The idea that there could have been any fair consideration of the Claimants' position in a process whereby the Minister has to judge acts of the Government that appointed him has no logic, particularly where he was being advised by Government lawyers whose very description of this Tribunal's order used the verb "*recomendar*" in just the description of

384 CSM, ¶ 80.

385 *Id.*

386 *Id.*, last bullet point.

387 *Id.*

388 *Id.*

389 Tr. 874:17-902:5.

> the document when that verb appears nowhere in your order. He was a judge in his own cause assisted by lawyers to his own cause."[390] (emphasis added).

240. According to Burlington, Ecuador's goal in enacting the *caducidad* decrees was to "escape from its contractual obligations with the Claimant" and the *caducidad* process could not be "fair", as the Minister who issued the decrees was a "[j]udge in his own cause."[391] These statements show once again that Burlington contests both the process leading to, and the substance of, the *caducidad* decrees.

241. In sum, the Tribunal cannot but conclude that Burlington has challenged the *caducidad* decrees, which are thereby part of this case. In light of this conclusion, the Tribunal must address Ecuador's jurisdictional and admissibility objections to the *caducidad* decrees.

2.2. Does the Tribunal have jurisdiction over the *caducidad* decrees?

242. Ecuador contends that the Tribunal has no *ratione materiae* jurisdiction over the *caducidad* decrees for Blocks 7 and 21. While Burlington has not specifically countered these jurisdictional objections, it is clear from its argumentation on the merits that it considers that there is jurisdiction over the *caducidad* decrees. Therefore, the Tribunal will address these objections on the basis of Ecuador's arguments and relevant elements on record.

243. Ecuador argues that the Tribunal has no contractual or Treaty jurisdiction over the *caducidad* decree for Block 7. The Tribunal has no contractual jurisdiction over the *caducidad* decrees because clauses 21.2.3[392] and 21.2.4[393] of the PSC for Block 7 carve out this form of contract termination from the contractual jurisdiction of the Tribunal. Furthermore, the Tribunal has no Treaty jurisdiction over the *caducidad* decree for Block 7 under these clauses because (i) the PSC for Block 7 was signed after the Treaty was signed, and (ii) that is what the parties to the contract intended to achieve through the language of clause 20.4.

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390 Tr. 1288:10-15 and 1291:13-1292:3.

391 Tr. 1291:13-1292:3.

392 Clause 21.2.3 of the PSC for Block 7 states that when " the Contract is terminated for reasons other than *caducidad*, the procedures to which the Parties have agreed in Clause [20] will be followed." (RCM, ¶ 156); (Exh. C-1).

393 Clause 21.2.4 of the PSC for Block 7 sets forth that "for purposes of caducidad and other sanctions, the provisions of Chapter IX of the Hydrocarbons Law will apply." (Exh. C-1); (RCM, ¶ 156).

244. In the same vein, Ecuador maintains that the Tribunal has no contractual or Treaty jurisdiction over the *caducidad* decree for Block 21. The Tribunal has no contractual jurisdiction over *caducidad* because this is a "legal matter" excluded from the scope of the arbitration agreement pursuant to clause 20.2 of the contract. In addition, the Tribunal has no Treaty jurisdiction over the *caducidad* decrees because (i) the PSC for Block 21 was signed two years after the Treaty was signed, and (ii) that is what the parties to the contract intended to achieve through the language of clause 20.2.20.

245. In other words, Ecuador argues that the original parties to the PSCs for Blocks 7 and 21 intended to carve out *caducidad* not only from the scope of the PSC, but also from the scope of the Treaty. Since the jurisdiction of the Tribunal is premised exclusively on the Treaty, the Tribunal does not need to address *per se* the question of whether the original parties intended to remove *caducidad* from the scope of the PSCs. It must, however, address the Treaty-based objections.

246. Ecuador argues that the original parties to the PSC for Block 7 intended to remove *caducidad* from the scope of the Treaty, and thus from the scope of the Treaty's jurisdiction. They did so by inserting clause 20.4 into the PSC, which reads as follows:

> "In addition and without prejudice to the provisions of clauses [20.2][394] and [20.3][395] of this participation contract, the Parties also agree to submit any investment-related dispute to the Treaties, Conventions, Protocols and other international law agreements signed and ratified by Ecuador in accordance with the law."[396]

247. This clause does not appear to reflect an intent by the original parties to the PSC for Block 7 to remove *caducidad* from the scope of the Treaty. The *caducidad* process is not specifically mentioned in this clause. Far from signalling an intent to remove *caducidad* from the scope of the Treaty, this clause underscores the will of the original parties to the contract to submit "any investment-related dispute" to international treaties, of which the United States-Ecuadorian BIT is undoubtedly one. This clause

394 Clause 20.2 of the PSC for Block 7 provides that "all controversies arising from this Participation Contract will be settled by arbitration of law in accordance with the provisions of Article 10 of the Hydrocarbons Law as amended, the Arbitration and Mediation Law […] and the rules and procedures laid down in this clause" (Tribunal's translation). There is no mention of *caducidad* in clause 20.2 of the PSC for Block 7 (Exh. C-1).

395 Clause 20.3 of the PSC for Block 7 provides that "[n]otwithstanding the foregoing, from the date on which the [ICSID Convention] (the "Convention“), signed by the Republic of Ecuador, be ratified by the Ecuadorian Congress, the Parties commit to submit the controversies or disputed relating to or arising from the execution of this Participation Contract to the jurisdiction and competence of the [ICSID] so that they may be settled and resolved in conformity with the provisions of that Convention […]" (Tribunal's translation). There is no mention of *caducidad* in clause 20.3 of the PSC for Block 7 (Exh. C-1).

396 Exh. C-1 (Tribunal's translation).

appears to reinforce, not to undermine, the Tribunal's Treaty jurisdiction. Even assuming that the original parties to the PSC for Block 7 intended to remove *caducidad* from the scope of the contract's arbitration agreement, there is no evidence that they intended to remove *caducidad* from the scope of the Treaty. Therefore, the Tribunal finds that it has jurisdiction over the *caducidad* decree for Block 7.

248. Ecuador similarly argues that the original parties to the PSC for Block 21 intended to remove *caducidad* from the scope of the Treaty. According to Ecuador, this follows from clause 20.2.20 of the PSC, which provides that:

> "In the event that the Ecuadorian State or PETROECUADOR enter or have entered into an international treaty which, in accordance with the law, provides for the resolution of technical or economic disputes by a different arbitration mechanism, or if so allowed by Ecuadorian law, the Parties agree that they will be able to submit the issue in dispute to that arbitration."[397]

249. This clause does not suggest that the original parties to the PSC for Block 21 intended to remove *caducidad* from the scope of the Treaty, nor does it signal an intent to diminish the scope of Treaty jurisdiction. It rather shows an intent "to submit"[398] to Treaty arbitration "technical or economic disputes."[399] There is no reason to infer that the terms "technical or economic disputes"[400] aim to remove *caducidad*-related disputes from the scope of Treaty arbitration – especially since the termination of a PSC has evident economic implications. On the contrary, this clause aims to bolster, not to weaken, Treaty arbitration. Even assuming that the original parties to PSC for Block 21 intended to remove *caducidad* from the scope of the contract's arbitration agreement, there is no evidence that they intended to remove *caducidad* from the scope of the Treaty.[401] Thus, the Tribunal finds that it has jurisdiction over the *caducidad* decree for Block 21.

250. For these reasons, the Tribunal finds that it has *ratione materiae* jurisdiction under the Treaty over the *caducidad* decrees relating to the PSCs for Blocks 7 and 21.

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397 Exh. C-2 (Tribunal's translation).

398 *Id.*

399 *Id.*

400 *Id.*

401 Ecuador also argues that the original parties to the PSC for Block 21 intended to remove *caducidad* from the scope of the US-Ecuador BIT because the contract was executed after the Treaty was signed. Indeed, while the Treaty was signed on 27 August 1993, the PSC for Block 21 was signed on 20 March 1995, – but only entered into force on 11 May 1997, after the execution of the PSC. At any rate, the conclusion that clause 20.2.20 of the PSC for Block 21 does not remove *caducidad* from the scope of the Treaty is unaffected by this chronology.

2.3. Are the allegations based on the *caducidad* decrees admissible?

251. Ecuador argues that Burlington's allegations relating to *caducidad* are premature because Burlington has not challenged the *caducidad* decrees before the Ecuadorian administrative courts. It notes that, whereas Burlington was not required to exhaust local remedies before commencing this arbitration, it was required to make a reasonable attempt to seek redress before domestic courts. Hence, Burlington's allegation relating to the *caducidad* decrees is inadmissible. Although Burlington has not specifically answered this objection, its argumentation shows that it opposes it. The Tribunal will thus address it on the basis of Ecuador's arguments and other relevant elements in the record.

252. In the Supplemental Memorial on Liability, Burlington made the following allegations in relation to the *caducidad* decrees:

> "On September 28, 2009, PetroEcuador petitioned the Minister of Non-Renewable Natural Resources to terminate the PSCs for Blocks 7 and 21. PetroEcuador took the position that the Consortium had abandoned the Blocks 7 and 21 operations and that this was sufficient cause to terminate the PSCs under the Hydrocarbons Legal Framework. Perenco, on behalf of the Consortium, immediately objected to the initiation of the *caducidad* process, because the determination of the legality of Law No. 2006-42 payments and the physical occupation of Blocks 7 and 21 were pending before the *Burlington* and *Perenco* tribunals"[402] (emphasis added).

253. Ecuador has not disputed these allegations. It therefore appears that Perenco "immediately objected to the initiation of the *caducidad* process" and that it did so "on behalf of the Consortium." In fact, Ecuador has expressly admitted that, as the operator of the Block, Perenco was contractually bound to "deal with the government" on behalf of the Consortium.[403] Hence, Perenco's objection to the *caducidad* process was raised on behalf of both Consortium partners, including Burlington Oriente. Under the facts of this case, this constituted a reasonable enough attempt to seek local redress. Thus, the Tribunal sees no reason to declare Burlington's allegations relating to the *caducidad* decrees inadmissible.

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402 CSM, ¶ 77.

403 "[T]here is a specific provision saying very clearly that only the operator should deal with the government. So the operator of this Consortium, as you know, Members of the Tribunal, was Perenco. This is a simple application of a contractual provision." Tr. 1349:18-22; *see* also RPHB, ¶ 202.

C. EXPROPRIATION

254. The Tribunal must now address the merits of the claim over which it has jurisdiction, the expropriation claim. The nub of Burlington's case is that each of Ecuador's measures individually[404] (the Law 42 tax, the *coactiva* seizures and the takeover of the Blocks) and all of them collectively constituted an unlawful expropriation of its investment. Ecuador denies that any of these measures expropriated Burlington's investment, whether considered individually or collectively. In the alternative, Ecuador argues that, if there was expropriation, it was lawful under the circumstances.

255. The Treaty contains the following provision on expropriation:

> "Article III
>
> 1. Investments shall not be expropriated or nationalized either directly or indirectly through measures tantamount to expropriation or nationalization ("expropriation") <u>except</u>: 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) [transcribed below]. 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; be 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."[405]

Article II (3) to which Article III refers reads as follows:

> "Article II
>
> 3. (a) Investment 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.
>
> (b) Neither Party shall in any way impair by arbitrary or discriminatory measures the management, operation, maintenance, use, enjoyment, acquisition, expansion, or disposal of investments. For purposes of dispute resolution under Articles VI and VII, a measure may be arbitrary or discriminatory notwithstanding the fact that a party has had or has exercised the opportunity to review such measure in the courts or administrative tribunals of a Party.

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404 Specifically, Burlington measure-by-measure case is that the Law 42 tax (at both 50% and 99%) constituted an indirect expropriation of its investment ("a measure tantamount to expropriation" (CSM, ¶ 82)); and that the *coactiva* seizures and the physical takeover of the Blocks constituted a direct expropriation of its investment ("a direct confiscation", "a direct taking" and "a direct expropriation"; CSM, ¶¶ 90, 91 and 94).

405 The Treaty at Article III (Exh. C-6).

> (c) Each Party shall observe any obligation it may have entered into with regard to investments."[406]

256. The Treaty thus establishes a general prohibition against expropriation of investments unless certain specified requirements are cumulatively met, in which case the expropriation is lawful. In order to adjudicate Burlington's expropriation claim, the Tribunal must first determine what Burlington's investment was (Section 1) and in particular what rights Burlington had under the PSCs (Section 2). In so doing, the Tribunal does not act as a contract judge but exclusively as a treaty judge, addressing contract matters as preliminary issues insofar as it is necessary to rule on a Treaty claim. Subsequently, the Tribunal's task will be to decide whether Ecuador expropriated Burlington's investment (Section 3) and, if there was expropriation, whether the expropriation was unlawful (Section 4).

1. Burlington's Investment in Ecuador

257. The Treaty provides that "investments shall not be expropriated." The Tribunal understands from this formulation that the focus of the expropriation analysis must be on the investment as a whole, and not on discrete parts of the investment. Other international tribunals have adopted the same approach. The tribunal in *Telenor v. Hungary*, for instance, stated that in the context of a claim for expropriation "the investment must be viewed as a whole […]."[407] Likewise, the tribunal in *Merrill v. Canada* noted that "the business of the investor has to be considered as a whole […]."[408] In the same vein, the tribunal in *Feldman v. Mexico* held that a State measure that effectively extinguished an entire line of the investor's business – cigarette exports – did not amount to an expropriation of its investment as a whole.[409]

258. The Parties seem, however, to have focused on a narrower view of investment. In its initial Memorial, for instance, Burlington alleged that Ecuador's measures had injured its "investments" in Ecuador, defining these "investments" as the "rights in the four contracts [at the time the PSCs for Blocks 23 and 24 were still part of the dispute] for the exploration and exploitation of crude reserves in Ecuador."[410] Burlington claimed to

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406 The Treaty at Article II (Exh. C-6).

407 *Telenor Mobile Communications A.S. v. Republic of Hungary*, Award of 13 September 2006, ¶ 67 (Exh. EL-112)

408 *Merrill & Ring Forestry L.P. v. Canada*, NAFTA/UNCITRAL, Award of 31 March 2010, ¶ 144 (Exh. CL-155).

409 *Marvin Roy Feldman Karpa v. United Mexican States*, (hereinafter "*Feldman*"), Award on Merits of 16 December 2002, ¶ 152 (Exh. EL-80).

410 Mem., ¶ 299.

possess those rights "[t]hrough its ownership of [Burlington Oriente]."[411] Hence, according to Burlington, the rights under the PSCs constituted in and of themselves the investment. Consistent with this submission, counsel for Burlington expressed the following view at the hearing:

> "Well, surely the nexus between the PSCs and Burlington's investment is undeniable: Not only were the PSCs linked to Burlington's investments, no, they were Burlington's investments"[412] (emphasis added).

259. Ecuador neither explicitly accepted Burlington's definition of investment, nor did it challenge it as unduly narrow but it made its arguments within the framework of that definition. For instance, in its Counter-Memorial on Liability, Ecuador submitted that the Law 42 tax did not expropriate Burlington's investment because it was not in breach of the PSCs, noting at the same time that "the investment Burlington alleges is precisely the value of those contract rights".[413]

260. Nevertheless, in line with the cases referred to above, the Tribunal considers that a broader view of investment must be adopted, a view that encompasses Burlington's investment "as a whole." Burlington's investment is not composed solely of the rights of its subsidiary under the PSCs, even if those rights constituted the most valuable portion of Burlington's investment. Burlington's investment included its shares in Burlington Oriente, the infrastructure and equipment employed to exploit oil reserves, any other tangible property related to the project, the monetary and asset contributions made to carry out its operations, and the physical possession of the Blocks.[414]

2. The Rights under the PSCs

261. Without being *per se* investments, the contract rights under the PSCs represented a key component of Burlington's investment. It is by virtue of these contract rights that, through its subsidiary, Burlington had access to a share of the oil produced. These contract rights have a direct incidence on the economic value of Burlington's

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411 Mem., ¶ 303.

412 Tr. 145:17-20. Admittedly, Burlington also invoked its rights derived from the Hydrocarbons Legal Framework. However, as the Tribunal previously concluded, the Hydrocarbons Legal Framework contains no existing "obligation" (*see supra*, Section IV(B)(1.2)).

413 RCM, ¶ 501.

414 The Tribunal finds its understanding confirmed by other decisions, such as *Saipem S.p.A v. Bangladesh*, (hereinafter "*Saipem*"), Decision on Jurisdiction of 21 March 2007, ¶ 31 (Ex. CL-14) and the very first ICSID Decision on Jurisdiction of 12 May 1974 in *Holidays Inns v. Morocco*, reported in Pierre Lalive, *The First 'World Bank' Arbitration (Holiday Inns v. Morocco"), - Some Legal Problems*, 1 ICSID Reports 645 (1993) at p. 680 in the original pagination (Exh. CL-137).

investment. For this reason, the Parties have devoted considerable attention to the identification of Burlington's rights under the PSCs. Thus, the Tribunal will start by identifying the rights which the PSCs conferred upon Burlington's subsidiary.

262. The disagreement of the Parties with respect to the meaning of the PSCs is confined to two main issues. First, the Parties disagree on the meaning of the term "economy" of the PSC, a term of crucial importance to understand the economic bargain at the heart of the contracts. Second, under the assumption that the economy of the PSC is affected by a given State measure, they disagree on whether the application of the so-called "correction factor" to re-establish the economy is mandatory or not.

2.1. Burlington's position

263. Burlington claims (i) that it had the contractual right to receive the full economic value of its oil production share *regardless* of the price of oil, and (ii) that if the economy of the PSCs was affected, the parties were bound to apply a correction factor..

264. First, Burlington claims that under the PSCs it had a right to enjoy the upside of any price increase. Otherwise stated, it claims that it had the right to realize the full economic value of its oil production share without regard to the price of oil – and subject only to the employment contributions and income tax agreed upon in the PSCs.[415] Contrary to what Ecuador argues, the participation formulas were *not* based on the price of oil. The participation formulas were subject to change solely on the basis of increased oil production, quality of the oil, or changes in the tax system. By contrast, the participation formulas were not subject to change because of oil price increases. As counsel for Burlington indicated at the hearing:

> "So, these [participation] percentages would change, amongst other things, with regard to the application of new taxes or with regard to volume [or quality[416]], but nowhere is any mention made of price as a factor to determine such [oil] share.
>
> And consistently, Burlington and the State never agreed that the State's participation would change as the price of oil increased. That was simply part of the risk and reward of the original terms of the Contract. […] This is entirely consistent with industry practice. Price is not normally included as a factor to determine production share in PSCs. Essentially price is one of the elements of risk and reward that the oil companies insist is not part of any kind of limitation" (emphasis added).[417]

[415] CSM, ¶ 19.

[416] "[T]here may be an adjustment [of the oil share] for the quality of the crude found – that's another aspect" (Tr. 24:8-9).

[417] Tr. 24:17-25:15.

265. As a result, Burlington's income was not fixed but entirely contingent on the price of oil. If the price of oil increased, Burlington was entitled to the higher revenues resulting from such increase. There was no mathematical-economic equation included in the PSCs:

> "[T]he agreed, fixed equilibrium of the PSCs defined by a mathematical formula simply does not exist. These were risk contracts, which are at odds with any concept of fixed equilibrium, let alone a fixed (therefore guaranteed) rate of return."[418]

266. The participation formulas constituted the entire agreement between the parties, with each party entitled to realize the full economic value of its oil share regardless of price:

> "[T]he PSCs struck a particular balance between [Ecuador] and private investors, with those investors carrying the risk associated with developing the projects, but also enjoying any potential upside regarding price (and, at the same time, suffering from any downside)."[419]

267. In sum, for Burlington, the economy of the PSCs meant that it was entitled to realize the full economic value of its oil production share without regard to the price of oil, and subject only to those income and other taxes specifically provided for in the PSCs.

268. Second, if a tax measure affected the economy of the PSCs, the parties were under an obligation to apply a correction factor that would absorb the effects of the tax. This followed from the language of the PSCs. The contracts stated that "if a triggering event occurs, a correction factor will be included."[420] The terms "will be included" implied that the application of a correction factor was mandatory, and not, as argued by Ecuador, merely subject to renegotiation. Thus, the PSCs contained tax stabilization provisions.

2.2. Ecuador's position

269. According to Ecuador, (i) the term economy of the PSCs meant that Burlington only had the right to the price projections upon which the original parties to the PSCs had allocated oil production, that is a price of USD 15 per barrel and a resultant IRR of 15%; and (ii) even assuming that the economy of the PSCs was affected, the contracts merely imposed upon the parties an obligation to renegotiate a correction factor, there being no mandatory adjustment of the parties' participations nor tax stabilization clauses.

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418 CPHB, ¶ 323.

419 Mem., ¶ 354.

420 Tr. 31:18-19.

270. First, Burlington had no right to windfall profits under the PSCs and thus no right to extraordinary profits resulting from unexpectedly high prices. The PSCs merely allocated oil production volumes between Ecuador and the contractor. This oil allocation was based on the so-called "Vega model", a precise mathematical-economic equation upon which the economy of the PSCs was calculated. In other words, the oil participation percentages were but a reflection of the Vega model calculations on the date of conclusion of the PSCs.[421]

271. Under the Vega model, the contractor's income ("R") was calculated on the basis of the following three variables: the production of the Block ("Q"); the contractor's participation percentage ("X"); and the oil price projections estimated over the life of the contract ("P"). In short: $R = Q \times X \times P$. Once the contractor's income was calculated, it was possible to determine the internal rate of return ("IRR") by factoring in costs, employment contribution and income tax.[422]

272. The PSCs were based on an oil price projection of USD 15 per barrel, and an IRR of 15%. The price projection based on a price per barrel of USD 15 is part of the Vega model formula. The application of this formula would then yield an IRR of 15% for the contractor. Hence, these two key considerations – the oil price projections and the contractor's IRR – were incorporated in the calculation of the contractor's oil participation share. Moreover, in the case of Block 7, the parties' oil price projections over the life of the contract were reflected in Annex V of the PSC. At the hearing, counsel for Ecuador stated:

> "The equation [the Vega model] in the contracts factors among other things the reserves figures and production profile, how much it would cost to get those reserves [from] the ground, revenues – and this is the important part. I was telling you before we would get to speak about revenues – here we are – <u>the revenues that the Parties considered in negotiating this agreement were based on a projection of a price per barrel of $15. This projection, along with the other projections, resulted in an internal rate of return for the Contractor of about 15 percent</u>, and I say about 15 percent because, depending on the Contracts and the risk involved, the figure was more or less around 15.
>
> [….]
>
> Well, as we know, the assumption at the time of contracting was that as long as the price per barrel remained at or around $15 a barrel, obviously adjusted for inflation […] the Contractor would be able to recover its costs and make a reasonable profit on the basis of an

421 RCM, ¶¶ 335-337.

422 RCM, ¶¶ 338-340; see also Celio Vega WS, ¶¶ 27-28.

> internal rate of return of 15 percent throughout the life of the Contract."[423]

273. In sum, Burlington had *no* contractual right to revenues stemming from oil prices in excess of the parties' price assumptions at the time the PSCs were executed, *i.e.* in excess of an inflation-adjusted USD 15 per barrel. The economy of the PSCs meant that Burlington *only* had the right to USD 15 per barrel, which would yield an internal rate of return of 15% – anything above this oil price was a windfall profit not envisaged by the contracting parties.

274. Second, even assuming that the economy of the PSCs were affected, the contracts merely provided for renegotiation. The PSC for Block 7 states that any correction factor "will be calculated by agreement of the Parties."[424] The PSC for Block 21, in turn, provides that any adjustment to the participation formulas "shall be approved by the Administrative Council [...]."[425] It follows from such language that these are merely renegotiation clauses. The Tribunal has no jurisdiction to decide what the parties would have agreed to pursuant to these clauses. In short, even if the economy of the PSCs is affected, the contracts do not impose an obligation to apply a correction factor but merely to renegotiate.[426]

2.3. Analysis

275. In light of the Parties' positions, the Tribunal must determine (a) what the economy of the PSCs was, and (b) whether the tax modification clauses calling for the application of a correction factor are mandatory or not, *i.e.* whether they are tax stabilization or renegotiation clauses.

2.3.1. The economy of the PSCs

276. In order to determine what the economy of the PSCs was, the Tribunal will analyze (a) the letter of the PSCs; (b) Annex V of the PSC for Block 7; (c) the Tarapoa contract; (d) Ecuador's conduct; (e) Ecuador's Hydrocarbons Law; and (f) the purpose of the shift from service contracts to production sharing contracts.

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423 Tr. 266:1-13, 267:6-17.

424 Exh. C-1, clause 11.12.

425 Exh. C-2, clause 11.7.

426 RCM, ¶¶ 345-364.

a. The letter of the PSCs

277. Clause 8.1 of the PSC for Block 7 provides the following in respect of the calculation of the contractor's oil production share:

> "Calculation of the Contractor's Production Share:
>
> The Contractor's share will be calculated using the following formula:
>
> $$PC = \frac{X . Q}{100}$$ [427]
>
> Where:
>
> PC = Contractor's Production Share
>
> Q = Measured Production
>
> X = Average factor, expressed as a percentage rounded to the third decimal place, corresponding to the Contractor's Share of Production. [...]"[428] (emphasis added).

278. Likewise, Clause 8.1 of the PSC for Block 21 sets forth the following:

> "Calculation of the Contractor's Share of Production:
>
> The Contractor's share will be calculated pursuant to the parameters agreed to in this Contract, in accordance with the following formula:
>
> **PC = X . Q**[429]
>
> Where:
>
> PC = Contractor's Share of Production
>
> Q = Inspected annual production in the Contract Area
>
> X = average factor, as a percentage, corresponding to the Contractor's share of production [...]."[430] (emphasis added).

279. For Ecuador, the contractor's production share is to be calculated in accordance with the following formula: PC = X x Q x P, where "X" (contractor's share of production in percentage terms) and "Q" (total measured production) coincide with the definitions of clauses 8.1 transcribed above. In addition, Ecuador argues that the contractor's share of production includes the "P" factor, *i.e.* the oil price projections estimated over the life of the contract, which would yield an IRR of 15%. However, there is no mention of any

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427 The period signifies multiplication.

428 Exh. C-1, clause 8.1.

429 The period signifies multiplication.

430 Exh. C-2, clause 8.1.

such "P" factor in clauses 8.1 of the PSCs. Similarly, these clauses do not mention any link between the formula for calculating the contractor's production share and the purported IRR.

280. More generally, the formula "PC = X x Q x P" – or the Vega model – appears nowhere in the PSCs (subject to Annex V of the PSC for Block 7 which will be examined separately), nor is there any mention of the contractor's purported IRR anywhere in the PSCs. This is telling, especially considering how detailed and lengthy the PSCs are. Without counting authorizations and annexes, the PSC for Block 7 contains over 120 pages, and the PSC for Block 21 over 80 pages. If authorizations and annexes are included, both contracts run into the several hundreds of pages – over 400 pages for the PSC for Block 7 and over 600 pages for the PSC for Block 21. In these circumstances, it is hard to conceive how the original parties to the contract would have left unstated such pivotal aspect of the PSCs, had they intended to include it.

281. Accordingly, the letter of the PSCs suggests that the economy of the PSCs was linked neither to a price assumption of USD 15 per barrel nor to an IRR of 15%. Instead, it tends to show that the contractor was entitled to the economic value of its oil participation share irrespective of the price of oil or of the contractor's internal rate of return – subject to the contract's tax provisions examined below.

b. Annex V of the PSC for Block 7

282. Ecuador argues that Annex V of the PSC for Block 7 contains the mathematical-economic equation upon which the original parties to the contract purportedly determined the contractor's oil production share, *i.e.* the so-called Vega model. In accordance with clause 24.2,[431] Annex V is an integral part of the PSC. Ecuador points in particular to Tables 15, 22 and 27 A of Annex V.[432] At the hearing, counsel for Ecuador stated as follows:

> "[T]he economy [of the PSCs] referred to the mathematical and economic equation agreed at the time of the Contract, and you will find such equation, for example, at Annex V of the Block 7 Participation Contract [...]. Well, I think the Contract [for Block 7] is both the text [...] but also its Annexes [...], so I would invite you to keep an eye on Annex V […]."[433]

283. The Tribunal will examine the purpose of Annex V, whether there is evidence of the Vega Model in Annex V, and whether the notion of the economy of the PSC

[431] RPHB, ¶ 110 at n. 119.

[432] Exh. C-1, Annex V (pp. 005212, 005218-005224 in the original pagination).

[433] Tr. 265:12-21.

purportedly arising from Annex V is consistent with the other elements on record, particularly with Law 42.

284. First, Annex V is an internal memorandum from Ecuador's Negotiation Commission for the modification of the Block 7 PSC (the "Negotiation Commission") to the President and the Board of Directors of PetroEcuador, dated 3 November 1999. Block 7 was subject to a service contract and thus, unlike blocks such as Block 21, was not part of an international bidding process. At the hearing, counsel for Burlington offered the following explanation in this respect:

> "[T]here needs to be some kind of review by the State as best they can at that moment to work out whether or not it's in the interest of the State to make that migration [to the PSC]. So, Article 10 [of the Hydrocarbons Law] stated, if it's convenient to the interests of the State, the contracts for the exploration and exploitation of hydrocarbons may be modified by agreement of the Contracting Parties. […] Annex V is simply the memorandum to the PetroEcuador board [which] provides the basis for the approval of the new [PSC] Contract"[434] (emphasis added).

285. This explanation finds support in the letter of Annex V and in Article 10 of the Hydrocarbons Law.[435] Indeed, the Negotiation Commission concluded that, in accordance with Article 10 of the Hydrocarbons Law, modifying the Block 7 service contract into a PSC would "suit the interests of the State."[436] On this basis, the Commission recommended to the President and the Board of PetroEcuador, the addressees of the internal memorandum, to approve the modification of the Block 7 service contract into a PSC if they "deem[ed] it appropriate."[437] Hence, Annex V was not intended to set out the terms of the prospective PSC, but merely to establish whether it would be in Ecuador's interest to enter into a PSC in lieu of a service contract from an economic standpoint.

286. In order to determine whether a PSC was in Ecuador's interest, the Negotiation Commission sought to determine whether the value of a PSC, on a net present value basis, was greater than that of a service contract. To carry out this calculation, it had to assume the price of oil over the life of the contract, expected to run from 2000 to 2010. It used a price assumption of USD 15 per barrel, which explains the price of USD 15 per barrel in Tables 15, 22 and 27 A, upon which Ecuador has focused. Under this price assumption, it concluded that the net present value of a PSC would be greater

434 Tr. 168:15-22, 169:18-20, 172:6-7.

435 Exh. C-15, p. 4 in the original pagination, Art. 10.

436 Exh. C-1, Annex V, p. 005155 in the original pagination (Tribunal's translation).

437 *Id.*

than that of a service contract for Ecuador, whereas the net present value would be the same for the contractor.[438] The price of USD 15 per barrel was thus used to assess whether the modification of the Block 7 services contract was in Ecuador's interest – *not* to determine the Contractor's participation share or its IRR.

287. Second, there appears to be no evidence of the Vega Model in Annex V. While the Commission used a price assumption of USD 15 per barrel, there is no evidence that this assumption was applied in connection with the Vega Model. As seen above, under the Vega Model, the contractor's participation share is based on its percentage ("X") of total oil production ("Q") under a specific price assumption ("P"). However, Annex V contains no evidence linking "P" to "Q" or to the contractor's participation share. There is likewise no formula similar to that of clause 8.1 of the contract (PC = X x Q/100) that would suggest a connection between the contractor's participation share and the Commission's price assumption of USD 15 per barrel.

288. On the contrary, Annex V contains indications that the contractor's participation share was *not* linked to the price of oil. As part of its description of the negotiation with the contractor, the Negotiation Commission states:

> "As an alternative, it was proposed that an average of USD 17 per barrel be set, with the parties equitably sharing the surplus at 50% each. This proposal was not accepted by the [contractor] either [...]"[439]

289. From the Negotiation Commission's memorandum, it appears that the original parties to the contract specifically discussed the possibility of sharing equally the oil revenues in case the price of oil were to exceed USD 17 per barrel. However, Annex V suggests that the contractor rejected this proposal. The fact that no agreement to this effect was reproduced in the PSC for Block 7 that was concluded about five months after the date of the Annex V suggests that parties did not reconsider this matter, or, if they did, reached no agreement on sharing excess profits.[440] In conclusion, Annex V contains no evidence of the Vega Model. On the contrary, it shows that the contractor's participation share was *not* linked to the price of oil.

290. Third, the economy of the PSC for Block 7 as it allegedly results from Annex V appears inconsistent with the remaining evidence on record as to how the economy of the PSCs is to be ascertained. Under Annex V, the economy of the PSC for Block 7 would be

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438 *Id.*, at pp. 005176-005177 in the original pagination.

439 *Id.*, at p. 005153 in the original pagination (Tribunal's translation); Mem., ¶ 102.

440 The Annex V memorandum is dated 3 November 1999. The PSC for Block 7 was concluded on 23 March 2000 – that is, nearly five months after the date of the Annex V memorandum.

tied to a price of USD 15 per barrel. At the same time, Ecuador has argued that the economy of the PSCs was determined on the date of execution. In the words of counsel for Ecuador:

> "Well, Ecuador's submission, Members of the Tribunal, is that the starting point [...] in this case is the economy of the participation contracts as defined on the date of their execution.[441]
>
> [....]
>
> [Ecuador's witnesses] all established very clearly that the economy of the Participation Contract – and it couldn't be otherwise – is to be established on the date of execution of the Participation Contract"[442] (emphasis added).

291. On the date when the PSC for Block 7 was executed *i.e.*, on 23 March 2000, the price of Block 7 oil was USD 25.11 per barrel. In keeping with Ecuador's submission, Law 42 also operates on the basis that the relevant price is the one on the date of execution. This is why Law 42 regards as "extraordinary" only those revenues resulting from oil prices in excess of the price of oil on the date the PSCs were executed. As counsel for Ecuador stated:

> "Law 42 takes the price of oil from the market at the time of execution of the Participation Contracts and the extraordinary revenues above that price as corrected by the inflation pursuant to American figures, is to be allocated between the State and the Contractor.
>
> [....]
>
> [T]he Law 42 [reference] price was always above the $15 a barrel price agreed to define the economy of the participation contracts. In fact [...] the [reference] price for Block 7 was $25.11 as of March 2000 – that is, the date of execution of the Block 7 Participation Contract [...]" (emphasis added).[443]

292. Therefore, there would be two different ways to ascertain the economy of the PSC for Block 7: one based on Annex V, with a price of USD 15, and the other one based on the date of execution of the PSC, with a price of about USD 25. In other words, the economy of the contract purportedly arising from Annex V is inconsistent with Ecuador's submission that the economy of the PSCs is determined on the date of execution, which is the basis upon which Law 42 operates. These inconsistencies reinforce the previous conclusions that Annex V contains no evidence of the Vega model.

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441 Tr. 262:22-263:4.

442 Tr. 1354:22-1355:3.

443 Tr. 237:5-10, 269:14-20.

293. In summary, Annex V does not show that the economy of the PSC for Block 7 was a function of either a price projection of USD 15/bbl or a 15% internal rate of return for the contractor. Thus, Annex V does not appear to set a limit on the revenues that the contractor could derive from its oil participation share.

c. The Tarapoa Contract

294. On 25 July 1995, Ecuador and City Investing Company concluded a PSC for the exploration and exploitation of the Tarapoa Block. Under clause 8.1 of the so-called Tarapoa Contract, the contractor's participation share is a function of its percentage ("X") over total oil production ("Q"). The Tarapoa Contract is thus premised on the participation formula "*PC = X.Q",* as were the PSCs for Blocks 7 and 21. Yet, at the end of clause 8.1, the Tarapoa Contract adds the following:

> "If the price of crude oil in the Block exceeds USD 17 per barrel, the surplus of the benefit brought about by the price increase in real terms (calculated at constant values of [1995]) will be distributed between the Parties in equal shares."[444]

295. This language creates a link between the economic benefits the contractor may draw from the contract and the price of oil. If the price of oil exceeds USD 17 per barrel, the additional revenues are apportioned between Ecuador and the contractor on a 50/50 basis. This apportionment does not affect the contractor's participation share in terms of oil volumes, but it does affect the economic benefits the contractor may draw from that share by conferring on the State half of the revenues stemming from oil prices in excess of USD 17 per barrel. No such Tarapoa-like clause was included in the PSCs for Blocks 7 and 21. This is particularly enlightening if one remembers that the PSC for Block 21 and the Tarapoa Contract were negotiated at the same time.[445]

296. Christian Dávalos represented Ecuador in the contemporaneous negotiations of hydrocarbons PSCs for the Tarapoa Block and Block 21. On cross-examination, Mr. Dávalos confirmed that the Tarapoa Contract contained a clause that adjusted the allocation of oil revenues when the price of oil exceeded the USD 17 per barrel threshold:

> "**[Mr Blackaby]:** And you […] said that a [price adjustment] clause had been included in the Tarapoa Contract; correct?
> **[Mr Dávalos]:** I mentioned that the Tarapoa contract was being negotiated at the same time [as Block 21], and that [in] the Tarapoa Contract, at the request of the Contractor, the possibility was included for the price to be over the price that was being negotiated [as] the

444 Exh. C-95, clause 8.1 *in fine* (Tribunal's translation).

445 Tr. 597:9-14 and 614:18-19.

["economy"] of the Contract. [...] They [the contractors] had agreed on $17 [per barrel as] the ["economy"] of the Contract [...]. So, over [USD] 17 [per barrel], they [the contractors] said okay, you can include whatever you want, and so it was decided that this be done on a 50/50 basis, this in the Tarapoa Contract"[446] (emphasis added).

297. At the same time, Mr. Dávalos acknowledged on cross-examination that, despite his own suggestion during the contract negotiations, no Tarapoa-like price adjustment clause was included in the PSC for Block 21:

> "**[Mr Blackaby]:** When you were involved in the negotiation of Block 21, you suggested the possibility of including in the Contract a clause to have a share for the State in the event that the price of crude oil rose to 17 or $18 a barrel; correct?
> **[Mr Dávalos]:** Yes, sir.
> [....]
> **[Mr Blackaby]:** So, in the Block 21 Contract, the negotiating group rejected your idea of including that clause in Block 21.
> **[Mr Dávalos]:** Yes [...] They [the contractors] said let's not talk about scenarios, scenarios that will only be scenarios"[447] (emphasis added).

298. By the same token, Mr. Vega, who negotiated the Block 7 PSC on behalf of Ecuador, conceded on cross-examination that, despite his suggestion in the course of the contract negotiations, no Tarapoa-like clause was included in the PSC for Block 7:

> "**[Mr Blackaby]:** You suggested, in the context of Block 7, that a correction clause be included based on the price.
> **[Mr Vega]:** Yes, that's right.
> **[Mr Blackaby]:** But at the end of the day, that wasn't done in Block 7. It was rejected by the Contractor.
> **[Mr Vega]:** Yes, that's right" (emphasis added).[448]

299. These exchanges lend support to the following two propositions. First, while the Tarapoa Contract parties accepted a clause linking the distribution of oil revenues to the price of oil, the Block 7 and 21 contract parties did *not* accept such a clause. Second, the possibility of linking the distribution of oil revenues to oil prices was specifically discussed during the negotiations for the Block 7 and 21 PSCs. On the basis of these premises, it is safe to conclude that the non-inclusion of a Tarapoa-like clause in the PSCs for Blocks 7 and 21 was not the product of inadvertence but a deliberate choice of the contracting parties.

300. As the product of a deliberate choice, the non-inclusion of an adjustment clause in the PSCs for Blocks 7 and 21 suggests that the economy of the contracts was not a function of either oil price projections or of a specific IRR. By contrast, this choice

446 Tr. 614:16-615:20.

447 Tr. 614:10-15 and 615:21-616:7.

448 Tr. 685:7-13.

suggests that the economy of the contract was one where the contractor was entitled to the economic value of its oil participation share without regard to either the price of oil or its IRR.

d. Ecuador's conduct

301. Ecuador's conduct may also help to elucidate the meaning of the economy of the PSCs. The Tribunal will focus its attention on Ecuador's initial requests to renegotiate the PSCs for Blocks 7 and 21; the deliberations relating to the passage of Law 42; and the reaction to Burlington's requests for adjustment of the "X" factors following the enactment of Law 42 and Decree 662.

302. First, Ecuador invited Burlington to renegotiate the PSCs for Blocks 7 and 21 in November 2005.[449] It alleges that, through these renegotiations, it intended to restore the economic equilibrium of the PSCs. However, there is no indication that Ecuador relied on the PSCs in these renegotiations or that it invoked clause 8.1 of the PSCs, which allegedly reflected the price projections upon which the parties allocated the petroleum rent.[450] This suggests that Ecuador did not believe at that time in the notion of economy of the PSCs it now propounds.

303. Second, following the failure of these renegotiations, the then President of Ecuador, Palacio González, submitted to the Ecuadorian Congress a bill that eventually became Law 42. In the course of the legislative deliberations relating to this bill, an Ecuadorian congressman expressed:

> "What does this clause [from the Tarapoa PSC] say? 'If the price of crude oil in the Block exceeds USD 17 per barrel, the surplus of the benefit brought about by the price increase in real terms, calculated at constant values of 1995, will be distributed between the parties in equal shares.' Look, it's as if it were copied, that is the proposal that the Government is making, what is already envisaged in one contract [the Tarapoa contract], and we want that this, which is already envisaged in one contract, be incorporated in the rest of the contracts"[451] (emphasis added).

304. At a later stage of the deliberations, another Ecuadorian congressman added:

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449 Exh. C-173.

450 Ecuador alleged that the oil price projections that the parties would have taken into account to allocate the petroleum rent are "reflected in the participation percentages in clauses 8 of the Participation Contracts" (RPHB, ¶ 43). Likewise, Ecuador maintained that the "economy of the Participation Contracts is reflected in the participation percentages in Clause 8" (internal quotations omitted) (*Id.*, at ¶ 73). In the same vein, Ecuador stated that the economy of the PSCs "includes the internal rate of return for the contractor and translates into the participation percentages" of clause 8 (*Id.*, at ¶ 105).

451 Exh. C-177, p. 73 (Tribunal's translation).

> "By virtue of this Law [42] various [oil] contracts were renegotiated. One of the contracts that was renegotiated in the first place was [that of] the Tarapoa block, and that renegotiation was so well done that it included [the clause] that the [first congressman] read out, by which, when the barrel of oil exceeds USD 17, [the revenues] are shared between the State and the contractor on a 50/50 basis. Then there were other renegotiations [...], and in those renegotiations, strangely, the clause that exists in the [Tarapoa] contract was not included. <u>Now, faced with the bill sent by the President of the Republic, we have discussed whether or not we can by law unilaterally modify oil contracts with retroactive effect. That and no other is the legal issue</u>" [452] (emphasis added).

305. By calling attention to this congressional debate, the Tribunal does not intend to attribute responsibility to Ecuador for the statements of individual congressmen. However, in the overall assessment of the facts and the evidence on record, these statements shed light on the manner in which at least some members of Congress understood the context leading to the enactment of Law 42. The understanding of these congressmen was not that Law 42 gave effect to the terms of the PSCs. On the contrary, these congressmen were aware that Law 42 would modify the PSCs which included no Tarapoa-like clause like those of Blocks 7 and 21.

306. Third, Burlington requested from Ecuador an upward readjustment of its participation share, or X factor, following the enactment of Law 42 and Decree 662.[453] Ecuador did not respond to these requests, allegedly because Burlington had failed to submit the economic studies required for such readjustment.[454] Yet, had Ecuador believed that Burlington had no right to a readjustment, it could simply have responded by stating as much. Ecuador's failure to give any answer to Burlington tends to demonstrate once again that Ecuador did not at the time embrace the notion of economy of the PSCs which it now advocates.

307. In sum, Ecuador's actions and omissions reveal that it did not believe in the notion of economy of the PSCs it has proffered in this arbitration. This intimates that the economy of the PSCs was not based either upon a price assumption of USD 15/bbl or upon an IRR of 15% for the contractor.

e. Ecuador's Hydrocarbons Law

308. As concluded in the discussion of the umbrella clause obligations, Ecuador's Hydrocarbons Law contains no surviving obligation upon which Burlington may directly rely. This does not mean, however, that it is wholly without relevance in order to

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452 *Id.*, at p. 103 (Tribunal's translation).

453 Exhs. C-11, C-12 and C-43; CPHB, ¶¶ 130, 311, 315-320.

454 RPHB, ¶¶ 10, 174-179, 187-190 and 304

ascertain the scope of the contract obligations. Indeed, as Ecuador itself noted, the PSCs reproduced some of the provisions of the Hydrocarbons Law on which Burlington relies. Thus, these legal provisions may shed light on the meaning of the contract by the very reason that they were to be replicated in the PSCs. Specifically, the Hydrocarbons Law may serve to establish the meaning of the "economy" of the contracts in the tax modification clauses.

309. Article 4 of Law No. 1993-44, which according to Ecuador contains the "legal definition of participation contracts",[455] provides the following:

> "Once production is initiated, the contractor will have the right to a share of production in the contract area, which will be calculated in accordance with the production shares offered and agreed-upon therein, based upon the volume of hydrocarbons produced. This share, valued at the selling price of hydrocarbons in the contract area, which in no case will be lower than the reference price, will constitute the contractor's gross income, from which [the contractor] will make deductions and pay income tax in accordance with the rules envisaged in the Internal Tax System Law"[456] (emphasis added).

310. In accordance with this provision, the contractor's share of production constitutes its "gross income."[457] According to Ecuador, the contractor's share under the PSCs would be a function of oil price projections and a specific internal rate of return. The legal provision just quoted contains, however, no indication that the gross income – the equivalent of the oil participation shares – would be calculated on the basis of oil price projections or a specific internal rate of return. These indications would have been expected if they were to be replicated in the PSCs. Therefore, this provision of the Hydrocarbons Law tends to confirm that the economy of the PSCs was not a function of oil prices or an internal rate of return.

f. The purpose of the shift to production sharing contracts

311. In 1982, Ecuador introduced the so-called service contract model. Under this model, Ecuador reimbursed oil companies for their costs and expenses and paid a service fee. By 1993, however, the then President Durán Ballén submitted a bill to Congress where he noted that "the current [service contract model] ... has exhausted its possibilities of

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455 RCM, ¶ 111.

456 Exh. C-15, p. 3 in the original pagination (Tribunal's translation).

457 *Id.* Ecuador has also argued that the PSCs did not "limit the deductions, contributions, or taxes that could be levied or applied such as Law 42" (Tr. 254:1-3). It is common ground that Law 42 is part of Ecuador's "tax system" within the meaning of the tax modification clauses. Accordingly, the Tribunal will address this argument in the context of its analysis of the tax modification clauses (*infra* section 2.4).

attracting foreign capital."[458] In support of this conclusion, the bill stated that, "[i]n the last five years, no contract for the exploration and exploitation of hydrocarbons has been executed under the service contract model introduced by the reforms of 1982."[459] The bill explained that the service contract model was on the decline for the following three main reasons:

> "[1] The evolution of the international conditions of the oil industry has created more competitive models for attracting the ever scarcer available capitals, such as for instance those that are being implemented in the countries of Eastern Europe and the former Soviet Union. [...]
>
> [2] The Service Contract model [...] has become an extremely complicated contract in terms of management and control. On the other hand, the mandatory reimbursement provisions of the contractor's investments, costs and expenses, has significantly reduced the State's participation in the economic benefits of oil exploration and exploitation in medium-sized and small blocks.
>
> [3] Finally, the Service Contract model does not allow the contracting company to have a production flow of its own. This feature militates against the interest and *raison d'être* of international oil companies, for most of which it is essential to be able to market [oil] production in international markets"[460] (emphasis added).

312. With respect to the contractor's participation share, the bill, which would be passed into law and amend the Hydrocarbons Law,[461] further noted that:

> "With regard to the availability of production, the contractor will freely dispose of the production percentage submitted in the bidding, so that it may be traded in the domestic or external market; but in no case may the selling price be lower than the price PetroEcuador receives for its external sales"[462] (emphasis added).

313. While it is not for this Tribunal to judge what type of contract was preferable from a policy standpoint or would have brought about a fairer allocation of the oil rent, it is its role to determine the intent of the parties to the PSCs to the extent that such intent plays a role for the resolution of this Treaty claim. One of the elements that may assist in this determination concerns the reason why Ecuador abandoned the service contract in favour of the PSC.

314. The purpose of the shift from the service contract model to the production sharing model was, according to the text of the bill, to "allow Ecuador to position itself at an

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458 Exh. C-78, p. 3 (Claimant's translation).

459 *Id.*, at 2 (Tribunal's translation).

460 *Id.*, at 3-4 (Tribunal's translation).

461 Exh. C-15.

462 Exh. C-78, at 4 (Tribunal's translation).

internationally competitive level for attracting venture capital."[463] It is difficult to see how a PSC could be more attractive than a service contract, knowing that the former imposes all costs, exploration and exploitation risks on the investor and the latter does not, if both models set an apparently similar maximum limit on revenues – revenues which are guaranteed under a service contract but not under a PSC.

315. For all the foregoing reasons, the Tribunal finds that the economy of the PSCs was not a function of either a projected oil price of USD 15/bbl or of a contractor's IRR of 15%. Rather, the economy of the PSCs entitled the contractor to receive its oil participation share, dispose of it on the market irrespective of price, and thus to obtain its oil share's market value – subject to the applicable taxes and to the contract provisions on new taxes examined below.

2.3.2. The tax modification clauses

316. The Parties disagree on whether the tax modification clauses, which call for the application of a correction factor when the economy of the contracts is affected, are mandatory or not. Burlington claims that the tax modification clauses were mandatory and, therefore, that they amounted to tax stabilization clauses. Ecuador contends that the tax modification clauses were not mandatory and constituted mere renegotiation clauses. The Tribunal will examine each PSC separately in order to determine whether or not the application of a correction factor was mandatory.

a. The tax modification clause of the PSC for Block 7

317. The tax modification clause included in clause 11.12 of the PSC for Block 7 provides as follows:

> "Modification to the tax system: In the event of a modification to the tax system or the creation or elimination of new taxes not foreseen in this Contract or of the employment contribution, in force at the time of the execution of this Contract and as set out in this Clause, which have an impact on the economics of this Contract, <u>a correction factor will be included in the production sharing percentages to absorb the impact of the increase or decrease in the tax or in the employment contribution burden</u>. <u>This correction factor will be calculated between the Parties</u> and will be subject to the procedure set forth in Article thirty-one (31) of the Regulations for Application of the Law Reforming the Hydrocarbons Law"[464] (emphasis added).

318. This clause must be interpreted in conjunction with clauses 8.6 and 15.2 of the Contract. Clause 8.6 states:

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[463] *Supra* ¶11.

[464] Exh. C-1, clause 11.12 (Tribunal's translation).

> "Economic stability: In the event that, by the action of the Ecuadorian State or PetroEcuador, any of the events described below were to occur and have an impact on the economy of this Contract, a correction factor will be applied to the production sharing percentages in order to absorb the increase or decrease in the economic burden: a) Modification of the tax system as described in clause [11.12] […]"[465] (emphasis added).

319. Clause 15.2 in turn provides that:

> "Contract amendments: There shall be negotiation and execution of contract amendments, with prior agreement of the Parties, particularly in the following cases:[…] c) When the tax system [...] applicable to this type of Contract in the country is modified, in order to restore the economy of the Contract in accordance with clause [11.12[466]]"[467] (emphasis added).

320. In order to determine whether the application of a correction factor is mandatory or not, the Tribunal will examine the language of these clauses, their purpose, and the relevant provision of the Hydrocarbons Legal Framework which these clauses are meant to replicate, that is, Article 16 of Decree No. 1417.

321. First, all the three provisions transcribed above contain mandatory language calling for the parties to apply a correction factor in order to absorb the impact of a tax increase or decrease on the economy of the Contract. Under clause 11.12, a correction factor will be included if there is a modification to the tax system which has an impact on the economy of the Contract; under clause 8.6, a correction factor will apply if there is a modification to the tax system which has an impact on the economy of the Contract; under clause 15.2, if there is a modification to the tax system, the parties shall negotiate and execute a contract amendment with a view to re-establishing the economy of the Contract. Those formulations show that the application of a correction factor is not optional. In the event of a modification to the tax system impacting the economy of the Contract, there must be a correction.

322. At the same time, both parties to the PSC are to agree on the implementation of this correction factor. According to clause 11.12, the correction factor "will be calculated between the Parties." According to clause 15.2(c), a contract amendment for the application of such correction factor shall be negotiated and executed "with prior

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465 *Id.*, at clause 8.6 (Tribunal's translation).

466 Clause 15.2(c) in fact refers to clause 11.11 – not to clause 11.12. As Ecuador's reliance on this clause indicates, this is a mistake. Clause 11.11 refers to the "amortization of investments" and not to modifications to the tax system, which is what clause 15.2(c) addresses. Thus, it is to be understood that the reference in clause 15.2(c) to clause 11.11 was intended to be a reference to clause 11.12.

467 Exh. C-1, at clause 15.2 (Tribunal's translation).

agreement of the Parties." In the Tribunal's reading, this requirement does not make the application of a correction factor optional. Otherwise, the content of the clause would be inherently contradictory, with mandatory language being followed in short order by contrary optional language.

323. The provision that the parties must jointly calculate the readjustment does not address *whether* a correction factor will be applied. The contract already provides that such a factor "will be included" for the purpose of absorbing the impact of the tax. Rather, this provision assists in determining *how* the correction factor will be calculated. The apparent purpose of this provision is to prevent a situation where a party unilaterally imposes its computation of the share of oil production needed to offset the effect of a tax increase or decrease, an admittedly complex calculation.[468] This joint calculation notwithstanding, the parties remain under an obligation to apply a correction factor that will counterbalance the effects of a tax change on the economy of the contract.

324. Second, pursuant to the relevant clauses, the purpose of the correction factor is "to absorb the impact of the increase or decrease in the tax"[469] and "to restore the economy of the Contract."[470] The purpose is to avoid that tax increases or decreases alter the economic foundation upon which the parties entered into the contract.[471] This purpose would be defeated if a party could simply refuse to apply a correction factor in the event of a tax increase or decrease. Hence, the purpose of the tax modification clause suggests that the parties intended the application of a correction factor to be mandatory.

325. Finally, this interpretation finds confirmation in the Hydrocarbons Legal Framework. As Ecuador itself recognizes,[472] the tax modification clause of the PSCs reflects the content of Article 16 of Decree No. 1417, which states:

> "Economic stability: The parties' production shares in the contract area <u>will be adjusted when the tax system applicable to the contract has</u>

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468 At the hearing, counsel for Ecuador stated that "if the economy of the Participation Contract was affected, the Parties need to negotiate, among others, how the different factors, X-factors in this clause [8.1] should be adjusted. And as I said to you, <u>these negotiations are very complex</u>" (emphasis added) (Tr. 261:13-17).

469 Exh. C-1, at clauses 11.2 and 8.6.

470 *Id.*, at clause 15.2 (Tribunal's translation).

471 At the hearing, counsel for Burlington indicated that the right to a share of oil production "in itself [] could be meaningless because if the State did not provide protection against changes in a tax and royalty regime, the State could simply neutralize the income realizable from a share in production at will" (Tr. 29:2-8).

472 Tr. 208:12-22.

> been modified, in order to restore the economics of the contract in place before the tax modification"[473] (emphasis added).

326. The language of this provision is also mandatory: the parties' oil production shares "will be adjusted" in the event of a change in the tax system. And the purpose of the adjustment is to "restore the economics of the contract in place before the tax modification." Thus, Article 16 provides for a mandatory adjustment clause to be inserted into production sharing contracts.

327. In sum, the Tribunal is of the view that the tax modification provision contained in clause 11.12 of the PSC for Block 7 calls for the application of a mandatory correction factor that absorbs any impact of a tax increase or decrease on the economy of the Contract.

b. The tax modification clause of the PSC for Block 21

The tax modification clause of the PSC for Block 21

328. The tax modification clause of the PSC for Block 21 is set forth in clause 11.7:

> "Modification to the tax system and to the employment contribution: In the event of a modification to the tax system, the employment contribution or its interpretation, which have an impact on the economics of this Contract, a correction factor will be included in the production sharing percentages to absorb the increase or decrease in the tax. This adjustment will be approved by the Administrative Board on the basis of a study that the Contractor will present to that effect"[474] (emphasis added).

329. In addition, clause 15.2 of the PSC for Block 21 provides as follows:

> "Contract amendments: There shall be negotiation and execution of contract amendments, with prior agreement of the Parties, particularly in the following cases:[…] c) When the tax system [...] applicable to this type of Contract in the country is modified, in order to restore the economy of the Contract [...]"[475] (emphasis added).

330. As with the analysis of the tax modification clause in the PSC for Block 7, the Tribunal will focus on the language, the purpose and the relevant part of the Hydrocarbons Legal Framework.

331. First, clause 11.7, first sentence, provides that a correction factor "will be included" in the event of a modification to the tax system. In addition, the second sentence of this clause states that this adjustment "will be approved" by the Administrative Board ("the

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[473] Exh. C-89, p. 23 in the original pagination (Tribunal's translation).

[474] Exh. C-2, at clause 11.7 (Tribunal's translation).

[475] *Id.,* at clause 15.2 (Tribunal's translation).

Board"). This approval requirement means that the Board may verify and eventually suggest modifications to the correction factor proposed by the contractor. However, the Board has no discretion to refuse the application of a correction factor, which "will be included." Clause 15.2, in turn, stipulates that a contract amendment "shall" be negotiated and executed in order to restore the economy of the contract in the event of a tax change. Like for the PSC for Block 7, this language suggests that the application of a correction factor is mandatory.

332. Second, the purpose of the application of this correction factor is "to absorb the increase or decrease in the tax"[476] in order "to restore the economy of the Contract."[477] This purpose would be defeated if a party could simply refuse to apply a correction factor. While the computations required for the application of the correction factor are subject to the "prior agreement of the Parties",[478] this does not mean that the application of a correction factor is optional. As Mr. Dávalos, Ecuador's head negotiator for the Block 21 PSC, acknowledged on examination by the Tribunal, "if the [p]arties do not agree on a correction factor", this disagreement "could be subject to international arbitration", *i.e.* resolved by a third-party adjudicator.[479]

333. All in all, both the language and the purpose of these contractual provisions show that the tax modification clause of the PSC for Block 21 is mandatory. This conclusion is confirmed by Article 16 of Decree No. 1417, reproduced in the tax modification of the PSC for Block 21, the language of which calls for the mandatory adjustment of the parties' oil production shares "in order to restore the economics of the contract in place before the tax modification."[480]

334. For the foregoing reasons, the Tribunal deems that the application of a correction factor is mandatory when a tax affects the economy of the PSCs for Blocks 7 or 21. This correction factor must be of such extent as to wipe out the effects of the tax on the economy of the PSC. Otherwise stated, the correction factor must restore the economy of the PSC to its pre-tax modification level.

335. In conclusion, and for the sole purpose of the resolution of the Treaty claim before it, the Tribunal considers that the PSCs provided for the following rights: (i) the right to receive and sell the contractor's share of oil production irrespective of the price of oil

476 *Id.*, at clause 11.7 (Tribunal's translation).
477 *Id.*, at clause 15.2 (Tribunal's translation).
478 *Id.*
479 Tr. 640:12-15.
480 Exh. C-89, p. 23 in the original pagination (Tribunal's translation).

and its internal rate of return, subject to the payment of the taxes and employment contributions specified in the PSCs; and (ii) the right to the application of a mechanism that would absorb the effects of any tax increase affecting the economy of the PSCs, *i.e.* a right to tax absorption under certain conditions.[481]

3. Did Ecuador Expropriate Burlington's Investment?

3.1. What is the proper approach to examine Burlington's expropriation claim?

336. The Parties disagree on the approach which the Tribunal should adopt to analyze Burlington's expropriation claim. While it argues that the measures are expropriatory whether taken separately or together, Burlington favors a creeping expropriation approach. By contrast, Ecuador alleges that the Tribunal must first determine whether Law 42 is expropriatory or not. The Tribunal must therefore determine under which approach it must review Burlington's expropriation claim.

3.1.1. Positions of the Parties

337. Burlington alleges that Ecuador expropriated its investment through the following series of measures: (i) the enactment of Law 42 (initially at the 50% rate and subsequently at the 99% rate); (ii) the initiation of *coactiva* proceedings, which lead to the seizure and auction of Burlington's share of oil production; (iii) the physical takeover of Blocks 7 and 21; and (iv) the termination of the PSCs for Blocks 7 and 21 through the *caducidad* process.[482] Burlington maintains that these measures constituted an unlawful expropriation of its investment "both individually and in the aggregate."[483]

338. At the hearing and in its post-hearing brief, Burlington stressed that Ecuador's measures, taken collectively, constituted a creeping expropriation of its investment.[484] Burlington relied on the definition of creeping expropriation adopted in *Generation Ukraine Inc. v. Ukraine*:

> "Creeping expropriation is a form of indirect expropriation with a distinctive temporal quality in the sense that it encapsulates the situation whereby a series of acts attributable to the State <u>over a</u>

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481 The term tax absorption clause hereinafter supersedes the locutions "tax indemnification clause" (DJ, ¶ 18 n. 1) and "tax modification clause" (*supra* ¶¶ 21-22) previously employed to refer to these clauses.

482 CSM, ¶ 80.

483 CSM, ¶¶ 80, 86, 98.

484 Tr. 70:7-12, 73:16-22, 81:9-14, 110:10-15,

period of time culminate in the expropriatory taking of such property"[485] (emphasis in original).

339. Without a creeping expropriation approach, "Ecuador will receive a discount for having destroyed much of the value of [Burlington's] investment prior to the physical takeover [of the Blocks]."[486] This would create "perverse incentives" that would reward a State "for measures that it takes to progressively diminish the value and rights underlying an asset prior to the final step in the expropriation."[487] As a result, "[u]nder international law, the Tribunal should consider the acts of Ecuador in the aggregate and judge the final toll on the Claimants' investments based on all the measures."[488] In brief, Burlington favors a creeping expropriation approach over a step-by-step approach.[489]

340. Ecuador argues that Burlington's case "has evolved at [the] hearing."[490] Prior to the hearing, Burlington's case was that Law 42 was a measure tantamount to expropriation – an indirect expropriation – and that the *coactiva* seizures and the takeover of the Blocks constituted a direct expropriation. In a nutshell, Burlington's case was one of indirect and direct expropriation. Yet, for Ecuador, Burlington "radically changed its case" at the hearing and adopted a new creeping expropriation theory in lieu of the expropriation theories it previously advocated.[491] For this reason, Ecuador has "reserve[d] all its rights in this regard."[492] In any event, Ecuador contends that Burlington's creeping expropriation theory is wrong because Law 42 was the initial cause of the subsequent chain of events:

> "We cannot analyze this very case as a creeping expropriation case. This is intellectually incorrect. And it's intellectually incorrect because here what we have is different events that are related in a cause-effect relationship.[493] [...] The facts of this case happened in a way that Law 42 should be the cause of the rest of the events, so any theory on cumulative events going towards something is simply against simple logic.[494]
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> [...]

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485 *Generation Ukraine Inc. v. Ukraine*, Award of 15 September 2003, at ¶ 20-22 (Exh. CL-145); Tr. 74:7-14.

486 Tr. 75:14-18.

487 Tr. 74:15-19,

488 Tr. 1264:21-1265:2.

489 CPHB, ¶¶ 55-59.

490 Tr. 217:3-4.

491 RPHB, ¶ 5.

492 *Id.*

493 Tr. 1343:1-6.

494 Tr. 217:9-13.

> Burlington's cumulative indirect [creeping] expropriation case is nonsense, in our opinion. It is a question of logic. The Tribunal cannot overlook the cause-effect relationship between Law 42, the *coactiva*, the abandonment of the fields, and the declaration of *caducidad*. You need to deal with the first event, which is Law 42, and the effects of Law 42 on the economics of the deal between the Contractor and Ecuador."[495]

341. Ecuador further asserts that "Law 42 [was] not an internationally wrongful act."[496] Law 42 did not modify or breach the PSCs. Thus, "Burlington had to comply with [Law 42]."[497] It was Burlington's failure to comply with Law 42 that set in motion the remaining events of the case: "[T]he subsequent events of this case, the *coactiva*, the abandonment of the fields by the Consortium, and the declaration of *caducidad*, are consequences of [...] [Burlington's] breach of both Ecuadorian law and the [PSCs] for Blocks 7 and 21."[498] In short, a proper analysis of Burlington's expropriation claim must begin with Law 42 and a cumulative approach is inapposite under the facts of this case.

3.1.2. Analysis

342. As a preliminary matter, the Tribunal wishes to address Ecuador's allegation that Burlington "radically changed"[499] its case at the hearing by endorsing a creeping expropriation theory. According to Ecuador, Burlington "brought up an entirely new case premised on a 'creeping expropriation' theory."[500] While Burlington did place greater emphasis on a creeping expropriation theory from the hearing onwards, the record does not support Ecuador's allegation that this was a "new" theory. Already in the Supplemental Memorial on Liability, Burlington alleged that Ecuador's measures "both individually *and in the aggregate*"[501] (emphasis added) constituted an expropriation of its investment. Burlington's reference to measures "in the aggregate" encompasses, albeit with a different label, the creeping expropriation theory favored from the hearing on.

343. In its post-hearing brief, Burlington continued to allege that Ecuador's measures individually, and all of them collectively, were expropriatory – again, as at the hearing, with an emphasis on a collective approach. Hence, while Burlington shifted the

495 Tr. 246:5-13.

496 Tr. 217:16-18.

497 Tr. 217:18.

498 Tr. 217:18-218:2.

499 RPHB, ¶ 5.

500 *Id.*

501 CSM, ¶ 80 (with similar allegations at ¶¶ 86, 98).

emphasis of its case, it does not appear that it has changed its case at the hearing.[502] Furthermore, Ecuador has had the opportunity to refute Burlington's creeping expropriation theory and has in fact availed itself of such opportunity.[503]

344. The Tribunal will now turn its attention to the two competing analytic approaches according to which it is possible to examine Burlington's expropriation claims. Under the individualized approach, the evidence of an expropriation is examined measure-by-measure while under a collective approach all measures are considered together.

345. In the view of the Tribunal, when the investor puts forward both an individualized and a collective case of expropriation, one should begin the analysis with the measure-by-measure approach; the reason being that a collective or creeping approach is typically employed only when no single measure is in itself expropriatory. This proposition finds supports both in literature and in previous cases. Michael Reisman and Robert Sloane, for instance, approvingly refer to an arbitrator's view to the effect that "a creeping expropriation is comprised of a number of elements, *none of which can – separately – constitute the international wrong*"[504] (emphasis added). By contrast, these authors note that "if one or two events in [a] series [of measures] can readily be identified as those that destroyed the investment's value, then to speak of a creeping expropriation may be misleading."[505]

346. Arbitral awards confirm this view. In *Vivendi II*, upon which Burlington has heavily relied, the tribunal stated that "[i]t is well-established under international law that *even if* a single act or omission by a government may not constitute a violation of an international obligation, several acts taken together can"[506] (emphasis added). The term "even if" implies that the collective approach is to be applied only after an individualized analysis has resulted in a finding of no expropriation. The tribunal in *Santa Elena* made the point even more explicitly when it held, in a passage quoted in

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502 *E.g.* COSS, Expropriation Part, ## 45 ff.; Tr. 73:6-110:6.

503 RPHB, ¶¶ 481-493.

504 W. Michael Reisman & Robert D. Sloane, *Indirect Expropriation and Its Valuation in the BIT Generation*, 74 THE BRITISH YEARBOOK OF INTERNATIONAL LAW 115, (2004), at 123 in the original pagination, quoting the dissenting opinion of Keith Highet in *Waste Management v. Mexico*, Award of 2 June 2000 (Exh. CL-177).

505 *Id.*.

506 *Compañía de Aguas del Aconquija S.A. and Vivendi Universal S.A. v. Argentine Republic*, (hereinafter "*Vivendi II*"), Award of 20 August 2007, ¶ 7.5.31 (Exh. CL-123).

Vivendi II, that "a measure or series of measures *can still eventually amount to a taking*, though the individual steps in the process do not [...]"[507] (emphasis added).

347. Finally, Burlington has submitted that "[i]t is well established under international law that tribunals must assess whether the cumulative effect of measures constitute an expropriation."[508] At the same time, Burlington has admitted that, when it is simultaneously argued that "each and every measure analyzed individually constitute[s] an expropriation",[509] a focus on the cumulative effect of measures is but a "possibility."[510] In other words, Burlington has *not* submitted that, when both an individualized and a collective approach to expropriation are advanced, the collective approach *must* be adopted first.[511]

348. Accordingly, the Tribunal will first analyze each of the challenged measures individually. In particular, the Tribunal will successively examine (i) Law 42 (both at 50% and 99%), (ii) the *coactiva* proceedings, (iii) the physical occupation of the Blocks, and (iv) the *caducidad* decrees. In the event that none of these measures individually were found to be expropriatory, it would then consider their cumulative effect.

3.2. Were the application of Law 42 and the failure to absorb its effects measures tantamount to expropriation?

349. The Tribunal must determine whether Law 42 and Ecuador's subsequent failure to absorb its effects was a measure tantamount to expropriation at the rate of 50% and 99%.

3.2.1. Burlington's position

350. Burlington argues that Law 42, together with Ecuador's failure to absorb its effects, was "a measure tantamount to expropriation."[512] In other words, Law 42 had the effects of an expropriation. Law 42 transferred virtually all of Burlington's revenues to Ecuador.[513] Thus, Law 42 permanently deprived Burlington of practically all of the

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507 *Compañía del Desarrollo de Santa Elena S.A. v. Costa Rica*, Award of 17 February 2000, ¶ 76 (Exh. CL-175).

508 CPHB, ¶ 57.

509 *Id.*, at ¶ 121.

510 *Id.*

511 Burlington has made the argument that "a State should not be rewarded for measures that it takes to progressively diminish the value and rights underlying an asset prior to the final step in the expropriation." (Tr. 74:15-19). However, this argument does not assist in the determination of whether an individualized or a creeping approach should initially be adopted; rather, it may help for *quantum* purposes in case a creeping approach were finally adopted.

512 CSM, ¶ 82.

513 Mem., ¶ 432.

profit to which it was entitled under the PSCs.[514] By way of example, in July 2008, the price of Napo crude oil was over USD 122 per barrel. Under Law 42 at 99%, Burlington had to pay to Ecuador over USD 107 per barrel. By 2008 Burlington was operating at a loss. Hence, Law 42 has substantially deprived Burlington of its revenue and expropriated its investment.[515]

351. More specifically, a State's power to tax may devolve into the power to destroy. As Ian Brownlie wrote, "[t]axation which has the precise object and effect of confiscation is unlawful."[516] Although the Treaty does not define the term expropriation, it recognizes the possibility that a tax may be expropriatory. Any government measure which results in a substantial deprivation of an investor's property is a taking.[517] Whether a tax causes a substantial deprivation and is thus expropriatory is ultimately a fact-specific question.[518]

352. There is no basis for arguing, as Ecuador does, that under the Treaty a tax is expropriatory only if (i) it is discriminatory, and (ii) intended to confiscate property rights – a test based on the Restatement of the Law (Third) of Foreign Relations of the United States.[519] At the same time, Burlington conceded at the hearing that it did "not object to that [Restatement] standard."[520] It added that if this standard were applied, it would be met in this case.[521]

353. Furthermore, a tax that is contrary to a tax stabilization provision is expropriatory: "[i]t is clear that a tax measure will make the leap from a *bona fide* [g]overnment regulation to an expropriatory measure when the tax measure violates specific commitments [made to] a foreign investor."[522] In support of this proposition, Burlington relies on the decisions in *Revere Copper*, *Benvenuti*, and *Methanex*, which held that tax measures can effect a taking if they impair contract rights.

354. In this case, the purpose of Law 42 was to force Burlington to abdicate its rights under the PSCs. There is ample evidence to this effect. President Correa characterized Law

[514] CSM, ¶ 82.
[515] Mem., ¶ 432.
[516] CPHB, ¶ 187; Exh. CL-105.
[517] CSM, ¶ 82; Mem., ¶ 441.
[518] CPHB, ¶ 189.
[519] Tr. 1269:19-1270:6
[520] *Id.*
[521] CPHB, ¶¶ 190-195.
[522] Tr. 1266:10-13.

42 as a "pressuring measure"[523] that would prompt oil companies to "sit down to negotiate."[524] Furthermore, in a public radio address, President Correa stated that oil companies had the following "three options"[525]: (i) continue paying the 99% tax, (ii) renegotiate the contract into a service contract, or (iii) receive the sunk costs of the investments and leave the country.[526] That this was the purpose of Law 42 was also confirmed by Celio Vega at the hearing:

> "But when the State calls on companies to renegotiate [the PSCs], the companies don't heed the call. They don't sit down to negotiate because they obviously wanted to continue taking in those high profits. <u>And so the State basically felt obligated to issue Law 42, and the contractors at that moment just at that point realized they needed to negotiate with the State</u> [...]. Some did not sit down to negotiate, and well, you know better than me what happened there."[527] (Burlington's emphasis).

355. In carrying out this purpose, Ecuador stepped out of its role as an ordinary commercial partner, using its sovereign power to contravene the specific commitments it had made to Burlington and, in particular, the tax stabilization clauses contained in the PSCs. These clauses were "crucial [...] as an inducement to long-term investment"[528] because they ensured that the value of the contractor's share of oil would not be "eroded by future Government action […]."[529] They required Ecuador to adjust the contractor's share of oil production in order to absorb the effects of tax increases having an impact on the economy of the PSCs.

356. However, when Law 42 was passed and Burlington requested a readjustment of its share of oil pursuant to the PSCs, Ecuador ignored these requests. This was no accident but the fruition of the purpose of Law 42. Compliance with the tax stabilization clauses would have been incompatible with Ecuador's goal of unilaterally changing the economic terms of the PSCs.[530] Thus, in passing Law 42 and then ignoring the requests for readjustment, Ecuador extinguished Burlington's right to the participation share to which it was entitled under the PSCs.[531] In this way, Ecuador effected a taking of Burlington's contract rights, a conclusion that finds support in the *Revere*

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523 Exh. C-182; CSM, ¶ 28.
524 *Id.*
525 Mem. ¶¶ 231, 416.
526 *Id.*
527 CPHB, ¶¶ 77 Tr. 695:18-696:7.
528 Mem., ¶ 69.
529 CPHB, ¶ 309.
530 *Id.*, ¶ 82.
531 *Id.*, ¶¶ 128-130.

Copper and *Benvenuti* decisions, where the tribunals held that tax measures that impair contract rights can effect a taking.[532]

357. Contrary to what Ecuador claims, the goal of Law 42 was *not* to restore the economic equilibrium of the PSCs.[533] First, Ecuador conducted no analysis of each individual PSC in order to determine what its equilibrium point was, an exercise that would have been required taking into account that the different PSCs were "all signed at different moments in time and had different production levels and different reference prices […]."[534] In these circumstances, a general across the board measure could not have served to re-establish an equilibrium point that had not been established in the first place. Second, Ecuador imposed three different tax rates: 50, 99 and 70. This is strong evidence that the goal of this tax was not to re-establish the economic equilibrium of the PSCs. Upon examination by the Tribunal, Mr. Vega conceded that "a fixed percentage may be able to re-establish [the] equilibrium [point] for some contracts and not for others."[535]

358. Although Ecuador denies relying on the *rebus sic stantibus* principle (or *théorie de l'imprévision*), its own submissions and the expert evidence refer to the requirements underlying this principle.[536] The party invoking the *clausula rebus sic stantibus* must show that (i) an extraordinary and unforeseeable or unforeseen event caused an imbalance in the obligations of the parties; (ii) this imbalance must be such that performance of the contract would be too burdensome for one of the parties; and (iii) the event causing the imbalance should not be a consequence of actions or omissions of the party invoking the principle. Ecuador, however, cannot meet the first two requirements of the *rebus sic stantibus* principle.[537]

359. Even before the enactment of Law 42, Ecuador was receiving the majority of the benefits of the oil production. Ecuador claims that it enacted Law 42 because the oil companies "were even benefitting *more* than Ecuador from the surge of oil prices"[538] (emphasis in original). This is incorrect as a matter of fact. With respect to Block 7, Ecuador received a total take on oil revenues of 51.1 percent, whereas the Consortium's share of oil production was 38.3 percent and its operating costs 10.6

[532] *Id.*, ¶ 127.
[533] *Id.*, ¶¶ 201, 220-223.
[534] *Id.,* ¶ 221.
[535] *Id.*, ¶ 223 (quoting from Tr. 700:12-19).
[536] *Id.*, ¶ 201.
[537] *Id.*, ¶ 204.
[538] *Id.*, ¶ 205 (quoting from RCM, ¶ 440).

percent.[539] With respect to Block 21, Ecuador's total take on oil revenues was 42.6 percent; whereas the Consortium's share was 48.6 percent and its operating costs 8.8 percent.[540]

360. Furthermore, the increase in oil prices was foreseeable.[541] The parties foresaw the possibility that oil prices could increase and discussed the possibility of including a price adjustment clause. Such a clause was included in the Tarapoa Contract, where the parties agreed that oil revenues resulting from oil prices in excess of USD 17 per barrel would be shared on a 50/50 basis.[542] Ecuador secured this clause in the Tarapoa negotiations because it offered in return "an extension of the term of the contract in relation to a highly profitable and productive Block."[543] In this case, however, a Tarapoa-like clause was discussed and rejected, as documented in Annex V of the PSC for Block 7:

> "As an alternative, it was proposed that an average of USD 17 per barrel be set, with the parties equitably sharing the surplus at 50% each. This proposal was not accepted by the [contractor] either [...]."[544]

361. Contrary to Ecuador's allegation, the magnitude of the price increase was also foreseeable. Ecuador's view is belied by the evolution of oil prices in the twenty-year period preceding the conclusion of the PSCs. Since the term of the PSCs was twenty years, it was logical to look at the evolution of oil prices over the twenty-year period *prior* to the conclusion of the PSCs. This evolution shows that crude oil prices experienced the same type of increase in the 70s as they did in the years 2000, *i.e.* over USD 100 per barrel in real terms.[545]

362. Finally, the oil price increase did not render the performance of the PSCs more burdensome for Ecuador. On the contrary, Ecuador was receiving more benefits from the PSCs than expected at the time when the contracts were executed. Ecuador's participation share was more valuable than expected and it was receiving higher income taxes than anticipated. As a result, Ecuador has not met the requirements to invoke the doctrine of *rebus sic stantibus*. Furthermore, it is doubtful that the PSCs are

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539 *Id.*, ¶¶ 206-207.

540 *Id.*, ¶ 208.

541 *Id.*, ¶¶ 209-210.

542 *Id.*, at ¶ 210.

543 *Id.*, at ¶ 211.

544 Exh. C-1, Annex V, at p. 005153 in the original pagination (Tribunal's translation); Mem., ¶ 102.

545 CPHB, ¶ 213.

public service contracts entitled to the protection of this doctrine in the first place. But even if they were, Ecuador has failed to meet the relevant requirements.

363. Moreover, Ecuador's allegation that Burlington refused to renegotiate in good faith is untrue.[546] The reason why Burlington was ultimately unable to accept Ecuador's renegotiation proposals is that they were unreasonable, as they required Burlington to abandon its rights under the PSCs without even knowing what it would receive in return.[547] In March 2008, after the opening of renegotiations two months earlier, Burlington was evaluating a Draft Partial Agreement that contemplated continuing operations under the PSCs for up to five years, a proposal that was "particularly interesting"[548] for Block 7. However, President Correa suddenly announced that Ecuador "could do better"[549], and Ecuador submitted a new draft agreement which called for a migration to an undetermined service contract within 120 days. Burlington could not agree to this proposal or to the similar proposal that ensued, and legitimately stood on its rights.[550]

364. Ecuador portrays Burlington as an unreasonable partner because almost all other companies renegotiated their PSCs. This allegation is disingenuous.[551] Most investors commenced arbitration proceedings against Ecuador following the enactment of Law 42, including Petrobras, Repsol, City Oriente, Murphy, and Perenco.[552] Of the fourteen PSCs in effect when Law 42 was enacted, only four were successfully converted into service contracts. Most companies either settled their claims or signed transitory agreements but no service contracts.[553] At the end of the day, Ecuador successfully renegotiated PSCs into service contracts with only two consortia out of ten.[554]

365. With respect to the standard for expropriation, Ecuador wrongly argues that Law 42 is entitled to a presumption that it is a *bona fide* taxation measure under international law.[555] If a tax measure were entitled to a presumption of validity, Article X would have stated so.[556] By contrast, Article X makes clear that a tax may be expropriatory. Thus,

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546 *Id.*, ¶ 227.

547 *Id.*

548 *Id.*, ¶ 228 n. 300.

549 Exh. C-184; CPHB, ¶ 229.

550 CPHB, ¶¶ 87, 93.

551 *Id.*, at ¶ 237.

552 *Id.*, at ¶ 239.

553 *Id.*, at ¶ 240.

554 *Id.*, at ¶ 244.

555 *Id.*, at ¶ 185.

556 *Id.*, at ¶ 188.

tax measures are entitled to no special deference under the Treaty. Similarly, there is no basis for Ecuador's claim that there is expropriation only if (i) the State intends that the tax be expropriatory, and (ii) the tax is discriminatory. Because the Treaty provides no definition of expropriation, the inquiry is a fact specific one.[557]

366. At any rate, the tax measures would be expropriatory even under Ecuador's own standard. The evidence shows that the purpose behind Law 42 was expropriatory, for it was intended to force Burlington and other investors to surrender their rights under the PSCs. Law 42 was also discriminatory because a lower 70% tax rate would apply to those who signed a transitory agreement, as opposed to the higher 99% tax rate applicable to others. Ecuador also relies on *EnCana v. Ecuador* for the proposition that a tax is expropriatory only if it is "extraordinary, punitive in amount or arbitrary."[558] The evidence shows that this standard is met. President Correa himself called Law 42 at the 99% rate "an exaggeration."[559] Fair Links, for its part, conceded on cross-examination that no other country had enacted measures as severe as Law 42 at the 99% rate.[560]

367. Law 42 at the 50% rate had a devastating impact on Burlington's investment.[561] First, it prevented Burlington from recovering past investments, as 2006 was the year in which it would begin to recoup those investments.[562] Second, it forced Burlington to scale back its development plans, thereby diminishing its ability to exploit the Blocks during the contract term.[563] Third, Burlington submitted the Oso Plan despite Law 42 at 50% because the PSC for Block 7 was to expire in 2010, thus leaving a "short time frame to develop the reserves available."[564] Fourth, Block 21 was no longer viable with Law 42 at the 50% rate. At that point, Block 7 "carried the Consortium."[565] Finally, as illustrated below, Law 42 at 50% had a significant impact on Burlington's total take on oil revenues.[566]

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557 *Id.*, at ¶¶ 188-189, 200.

558 Exh. EL-45, ¶ 177; CPHB, ¶ 195.

559 Exh. C-179 (Claimant's translation); Mem., ¶¶ 223, 350; CPHB, ¶¶ 79, 148, 152 and 195..

560 CPHB, ¶ 195.

561 *Id.*, at ¶ 162.

562 *Id.*, at ¶ 163.

563 *Id.*, ¶¶ 165-168.

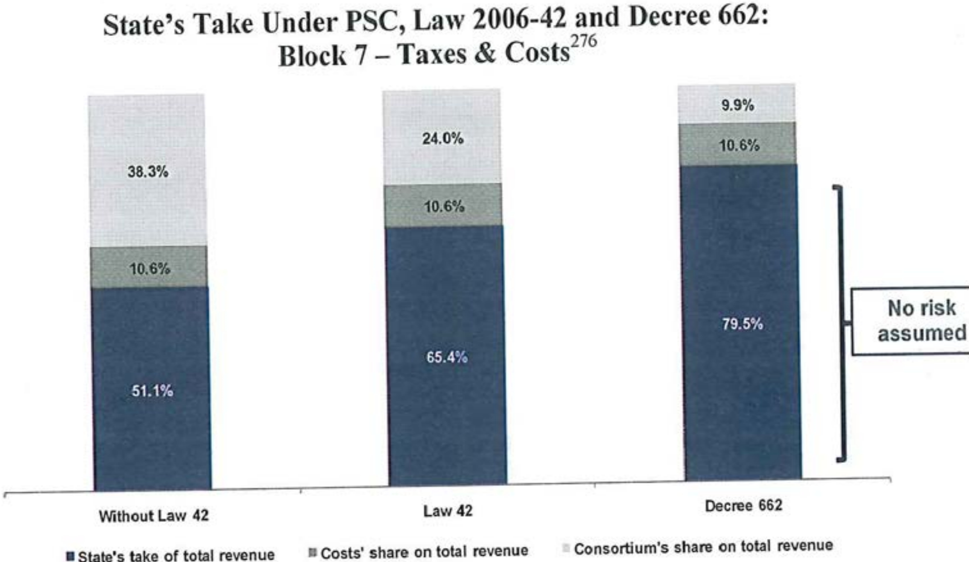
564 *Id.*, at ¶ 167 (quoting from Tr. 356:15-16; Burlington's emphasis omitted.)

565 *Id.*, at ¶ 171 (quoting from Tr. 544:5-6).

566 The "total take" includes taxes and other mandatory contributions.

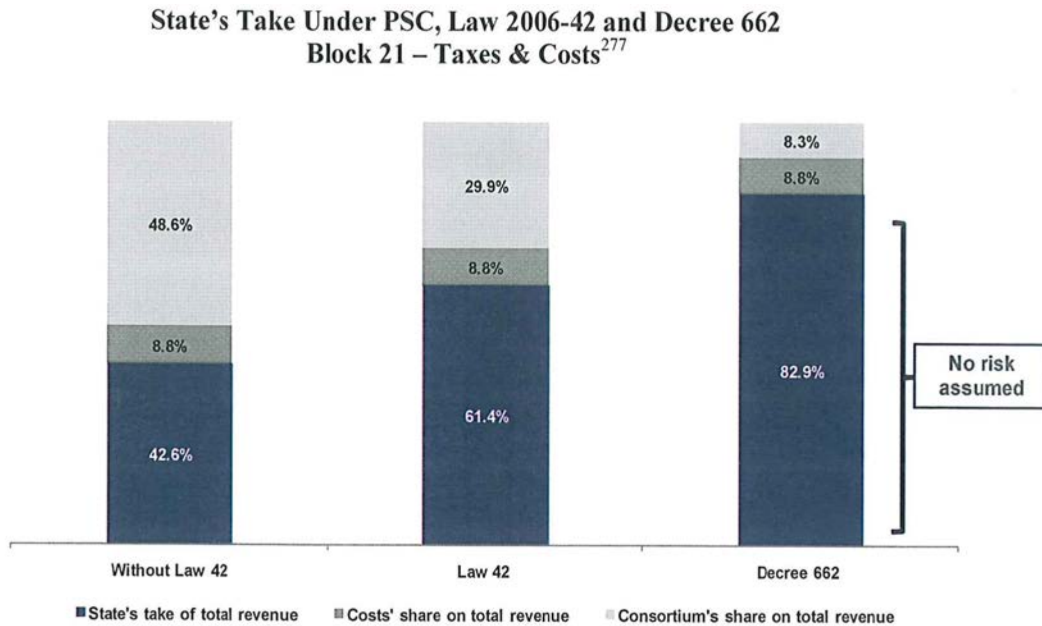
368. Law 42 at the 99% rate destroyed the value of Burlington's investment.[567] First, the financial statements show that in 2008 Burlington sustained a loss of slightly over USD 60 million in Blocks 7 and 21. Although both Blocks sustained losses, the impact on Block 7 was of lesser magnitude.[568] Second, the Consortium did not undertake any new investment, not even in the Oso field.[569] Finally, as the graph below shows, Law 42 at 99% destroyed the value of Burlington's investment. It turned the operation of the Blocks "into a form of subsistence farming, hand-to-mouth, day-to-day operation, no capital expenditure, trying to deal with past CAPEX [capital expenditures]."[570]

369. The following graph shows the effects of Law 42 on Block 7 at both the 50% and 99% rates: [571]



[567] CPHB, at ¶ 173.
[568] *Id.*, at ¶ 175.
[569] *Id.*, at ¶ 176.
[570] Tr. 45:21-46:3.
[571] CPHB, at ¶ 207

370. Likewise, the graph below shows the effects of Law 42 on Block 21 at both the 50% and 99% rates:[572]



371. Finally, the Fair Links analysis about the impact of Law 42 is flawed. First, Fair Links improperly excluded from its analysis the Consortium's capital expenditures – USD 60 million worth of past investments.[573] Second, Fair Links gave an inaccurate version of the Consortium's IRR because (i) it considered outdated cost projections instead of actual costs, and (ii) it undervalued the magnitude of the Consortium's investment. Finally, Fair Links provided an inaccurate picture of the Consortium's profitability as it did not consider (i) the time value of money, (ii) the deterrent effect of Law 42, and (ii) a cash flow analysis for the entire life of the PSCs instead of one ending in July 2009.[574]

372. For these reasons, Burlington submits that Law 42 was a measure tantamount to expropriation both at the 50% and at the 99% rates.

3.2.2. Ecuador's position

373. Ecuador argues that Law 42 did not expropriate Burlington's investment, be it at the 50% rate or at the 99% rate. On the contrary, Law 42 was a legitimate and *bona fide* exercise of Ecuador's police powers.[575]

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[572] CPHB, at ¶ 208

[573] CPHB, at ¶¶ 178-180.

[574] *Id.*, ¶¶ 177-184.

[575] RCM, ¶ 392.

374. Taxation is part of the State's regulatory powers and in principle does not give rise to a duty to compensate as a matter of public international law. Ecuador refers to Ian Brownlie's observation that, absent special facts, tax measures are in principle "not unlawful and do not constitute expropriation."[576] In conformity with this principle, the tribunals in *Saluka, Sedco*, *Tecmed* and *Telenor* stated that the State was not liable for economic injury resulting from the exercise of its regulatory powers. Taxation is one of the most important aspects of the State's sovereign powers;[577] as such, it is in a "special category" with respect to expropriation claims.[578]

375. Because taxes are in a special category, only in exceptional circumstances will a tax be expropriatory. Case law and doctrinal writings suggest that a tax measure may be tantamount to expropriation if (i) it produces the effects required for any indirect expropriation and (ii) in addition, it is discriminatory, arbitrary, involves a denial of due process or an abuse of rights. Thus, in *EnCana*, the tribunal held that "[o]nly if a tax is extraordinary, punitive in amount or arbitrary in its incidence would issues of indirect expropriation be raised."[579] In short, only in "extreme" cases will a tax be expropriatory.[580]

376. Under the Restatement of the Law (Third) of Foreign Relations of the United States, a tax will be "extreme" and thus expropriatory only if it is "discriminatory [and] designed to cause the alien to abandon the property to the state or sell it at a distress price."[581] Expressly invoking this principle, the tribunal in *Emanuel Too v. Greater Modesto* held that the seizure of the claimant's liquor license, home and bank account for failure to pay tax obligations was not expropriatory.[582] Similarly, in *Paushok v. Mongolia*, the tribunal stated that an investor had no immunity from windfall profit taxes in the absence of a tax stabilization clause.[583]

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576 *Id.*, ¶¶ 404-405; Exh. EL-121, p. 509 in original pagination.

577 RCM, ¶¶ 412-413.

578 Tr. 226:6-7.

579 RCM, ¶ 416; Exh. EL-45, ¶ 177.

580 RCM, ¶ 421; Exh. EL-45, ¶ 173.

581 Exh. EL-164; ROSS, # 84.

582 RCM, ¶ 427; *Emanuel Too v. Greater Modesto Insurance Associates and the United States of America*, Iran – United States Claims Tribunal, Award of 29 December 1989 (Exh. EL-114 at ¶ 26). The Respondent has also relied on the decision in *Feldman* for the proposition that a tax measure is not expropriatory unless it entails an "unreasonable interference with an alien's property." Under this test, the tribunal found that there was no expropriation (*Feldman* Award, at ¶ 106. Exh. EL-80).

583 Because this decision was made on 28 April 2011, it was not fully available at the time Ecuador submitted its Post-Hearing Brief on Liability. However, Ecuador has relied on reports of the case.

377. Law 42 was a necessary and appropriate measure under the circumstances. As of 2002, there was an unprecedented and unforeseen rise of oil prices. This unforeseen increase in the price of oil destroyed the economic equilibrium of the PSCs. This economic equilibrium must reflect the oil industry's widely accepted assumption that the State, as the owner of the non-renewable resource, "is to be the main beneficiary of extra revenue resulting from high oil prices."[584] However, the PSCs have limited price elasticity, *i.e.* the State's participation share remains the same even though prices increase. With the massive and unforeseen increase of oil prices, Ecuador was no longer the main beneficiary of the oil revenues. As a result, the PSCs no longer reflected a fair division of extractive oil rent between the State and the contractor.[585]

378. Ecuador's adoption of Law 42 was unexceptional. Since 2002, as many as sixteen States have adopted measures similar to Law 42 in the wake of soaring oil prices, including countries such as the United Kingdom and Norway.[586] In particular, ConocoPhillips, Burlington's parent company, has likely been subject to measures similar to Law 42 in various other States, such as Algeria, China or Alaska. Thus, Ecuador's attempt to restore the economy of the PSCs was in accordance with industry practice. Initially, Ecuador sought to restore the economy of the PSCs through negotiations.[587] But Burlington obstinately refused to do so, even though it was under a good faith duty to renegotiate in light of the changed circumstances.[588] Faced with Burlington's intransigence, Ecuador had a constitutional duty to pass Law 42, which granted the State a participation of "at least 50%" over the oil companies' extraordinary revenues.[589]

379. Law 42 at the 50% rate was, however, insufficient to restore the economic equilibrium of the PSCs. That is why, in October 2007, Decree 662 increased the Law 42 rate from 50% to 99%.[590] Shortly thereafter, in December 2007, Ecuador passed the *Ley de Equidad Tributaria* ("LET"), which set the tax rate on extraordinary profits at 70% and allowed for a new reference price to be negotiated on a case-by-case basis.[591] Ecuador reached an agreement with all major oil companies except Burlington and

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[584] RCM, ¶ 188.
[585] *Id.*, at ¶¶ 171-188.
[586] *Id.*, at ¶¶ 10, 191.
[587] *Id.*, at ¶¶ 206-209.
[588] *Id.*, at ¶¶ 442-449.
[589] *Id.*, at ¶¶ 188-194 and 206-216.
[590] *Id.*, at ¶ 220.
[591] *Id.*, at ¶ 221.

Perenco. Despite Ecuador's continuing efforts, Burlington simply refused to negotiate fairer terms for the PSCs.[592]

380. Contrary to what Burlington alleges, Ecuador does not rely on the *rebus sic stantibus* doctrine or *théorie de l'imprévision*.[593] Rather, Ecuador alleges that the massive and unforeseen increase of oil prices altered the economic premises upon which the parties entered into the PSCs.[594] Under these economic premises, which were incorporated into participation percentages in the PSCs, the price of oil was projected to be around USD 15 per barrel over the life of the contract and the contractor's IRR at 15%.[595] Because subsequent events disproved these economic premises, the PSCs had to be renegotiated.[596]

381. Law 42 did not modify the PSCs. Law 42 deals solely with oil prices while the PSCs allocate oil volumes and nowhere refer to oil prices.[597] Law 42 cannot modify the PSCs because it addresses an issue not covered by the PSCs. The Ecuadorian Constitutional Court (the "Constitutional Court"), the country's highest court, reached this conclusion.[598] Because the PSCs are governed by Ecuadorian law, the Tribunal cannot disregard or overrule the Constitutional Court's decision, for this would be contrary to international law.[599] In particular, the Constitutional Court held that Law 42:

> "[C]reates obligations over matters that have not been the subject of contractual stipulation, that have not been agreed upon or foreseen, situations that were impossible to foresee, and had they been foreseeable, by the very nature of the contract, could not have been part of the [parties'] understanding, and therefore they did not affect or influence the consent of the parties." [600]

382. Likewise, Law 42 did not breach the renegotiation clauses in the PSCs.[601] Under Ecuadorian law, Law 42 is a "levy" and, as such, part of the tax system referred to in the renegotiation clauses.[602] Yet, Law 42 did not breach these clauses. To begin with, Law 42 did not affect the economy of the PSCs. This is because Law 42 only applied

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592 *Id.*, at ¶¶ 220-250.

593 RPHB, ¶¶ 4 and 104.

594 RCM, ¶¶ 195-204.

595 RPHB, ¶¶ 73, 107-109.

596 RCM, ¶¶ 205-207.

597 *Id.*, at ¶¶ 267-271.

598 *Id.*, ¶¶ 265-279.

599 *Id.*

600 Exh. EL-19, p. 25 (Tribunal's translation).

601 Clause 11.12 of the PSC for Block 7 (Exh. C-1) and clause 11.7 of the PSC for Block 21 (Exh. C-2).

602 RCM, ¶¶ 283-289.

above the price assumption of USD 15 per barrel upon which the PSCs were based.[603] Moreover, even if the economy had been affected, Ecuador did not breach its obligation to renegotiate the PSCs, as it was in fact always willing to negotiate with Burlington. The Parties, however, failed to reach an agreement. In light of this failure, the Tribunal has neither the jurisdiction nor the power to fill in the gap and determine what the Parties would have agreed to.[604]

383. Moreover, not every contract breach amounts to a treaty breach. Even if Law 42 breached the PSCs, this purported contract breach would not amount to a treaty breach. As the tribunal in *Waste Management v. Mexico* held, "the mere non-performance of a contractual obligation is not to be equated with a taking of property […]."[605] A contract breach amounts to expropriation only if there is "an effective repudiation of the [contractual] right, unredressed by any remedies available to the Claimant, which has the effect of preventing its exercise entirely or to a substantial extent."[606] Burlington has not met this standard.

384. With respect to the expropriation claim, Burlington bears a heavy burden. The standard for expropriation is high when the challenged measure is a tax.[607] A State's regulatory measure is to be presumed valid and Burlington has failed to rebut this presumption. Contrary to Burlington's arguments, Law 42 was a legitimate and *bona fide* exercise of Ecuador's regulatory power.[608] The purpose of Law 42 was to "remedy a disequilibrium caused by a massive and unforeseen increase in oil prices."[609] As a result of the inelasticity of the PSCs, oil companies were drawing more benefits than Ecuador from this price increase.[610] Law 42 was ultimately intended to ensure a "fair allocation" of the revenues stemming from the exploitation of Ecuador's natural resources.[611]

385. In particular, the tribunal in *EnCana v. Ecuador* noted that, in the context of expropriation, "taxation is in a special category."[612] It is only in an "extreme case" that a tax of general application may become expropriatory. Specifically, the *EnCana*

603 *Id.*, ¶¶ 323-344.
604 *Id.*, ¶¶ 345-364.
605 *Waste Management II* Award, at ¶ 174 (Exh. EL-67).
606 *Id.*, ¶ 175.
607 RCM, ¶¶ 397-398.
608 *Id.*, at ¶ 400, § 5.1.3.
609 RCM, ¶ 440.
610 *Id.*
611 RCM, ¶ 453.
612 Tr. 226:3-7; Exh. EL-45, ¶ 177.

tribunal held that a tax may be expropriatory only if it is "extraordinary, punitive in amount or arbitrary in its incidence."[613] A tax measure is "extreme" when the State acts "with a discriminatory intention [and] with a designated purpose to confiscate the property rights of the investor."[614] However, Burlington has failed to submit evidence that would meet this standard.[615]

386. At any rate, Law 42 was not expropriatory, whether at the 50% or at the 99% rate. First, as shown above, Law 42 did not breach the PSCs. Therefore, Law 42 could not, by definition, expropriate Burlington's rights under the PSCs. Second, Law 42 did not constitute a *permanent* deprivation of Burlington's investment. This is because Law 42 applies if and only if the price of oil is above the reference price. Since Law 42 has been enacted, the price has not always been above the reference price, such as for instance in January and February 2009. Third, as specified below, Burlington's rights under the PSCs did not become worthless.

387. Law 42 at the 50% rate did not cause Burlington's rights to become worthless.[616] The Consortium's tax returns show that its gross and after-Law 42-tax profits in 2006 and 2007 were higher than its gross and after-tax profits in 2005.[617] The Fair Links experts also concluded that Burlington's operations were not "uneconomic."[618] In November 2006, the Consortium submitted the Oso Plan in order to make additional investments for USD 100 million.[619] The purpose of the Oso Plan was to show that these additional investments were "economically viable" both for Ecuador and the contractor.[620] Finally, ConocoPhillips' annual reports for the period 2006-2008 show no impairment of its Ecuadorian assets.[621]

388. Likewise, Law 42 at the 99% rate did not render Burlington's rights worthless. Fair Links confirmed that Law 42 at 99% "did not alter the global trend of positive cash flows."[622] The Consortium's Oso Plan shows that the increase from 50% to 99% did not substantially alter the economic viability of the project.[623] Again, ConocoPhillips'

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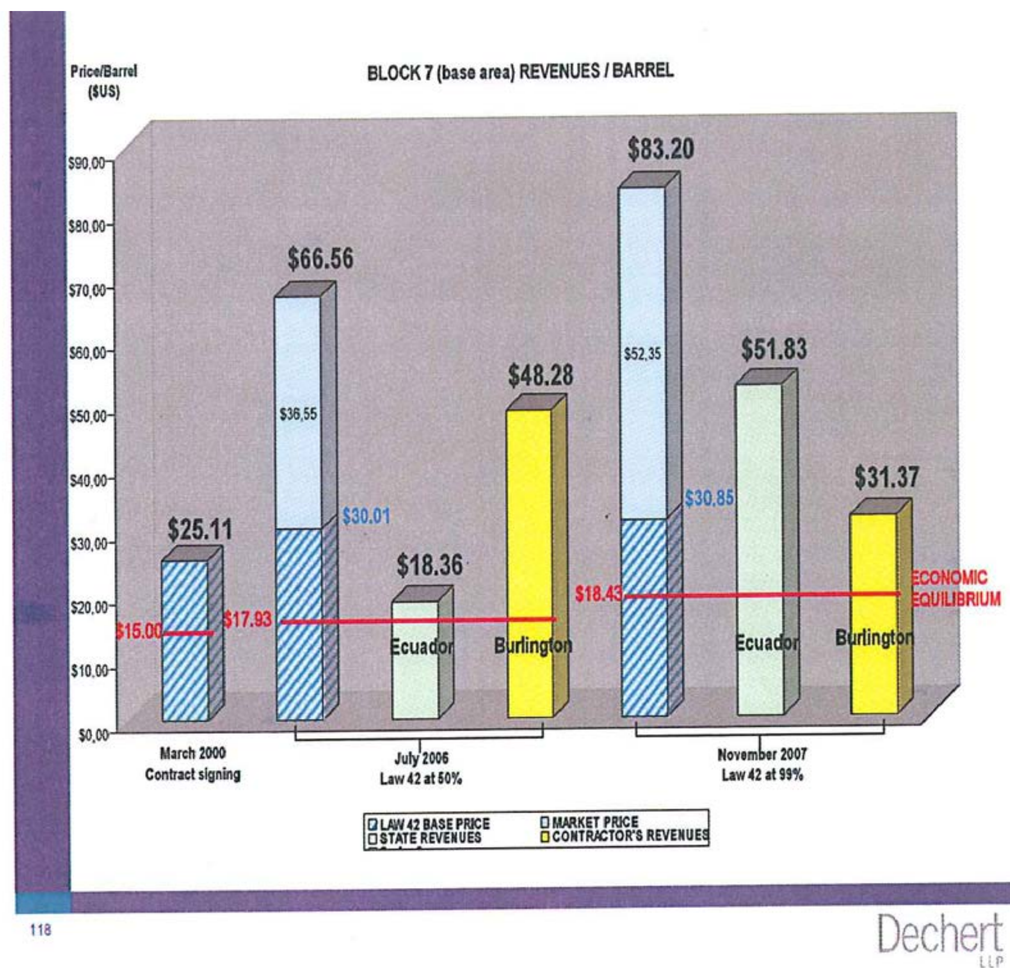
613 Exh. EL-45, ¶ 177.
614 Tr. 232:12-15.
615 RCM, ¶¶ 391-399.
616 *Id.*, ¶ 480.
617 *Id.*, at ¶¶ 481-482.
618 Fair Links ER, ¶ 90; RCM, ¶ 483.
619 RCM, ¶¶ 484-494.
620 *Id.*, at ¶ 486.
621 *Id.*, at ¶¶ 495-497.
622 Fair Links ER, ¶ 94.
623 RCM, ¶¶ 519-521.

annual reports for the period 2006-2008 show no impairment of its Ecuadorian assets. There is an impairment for the year 2009, but only because the Consortium decided to suspend operations in that year.[624]

389. Burlington has centred its case around the percentages of the Law 42 tax rates, in order to convey an image that the take of the State was significant. However, what Burlington does not show is its revenues per barrel in absolute terms.[625] In July 2006, when Law 42 applied for the first time at the 50% rate, Burlington was realizing USD 48.28 per barrel of oil.[626] And in November 2007, when Law 42 first applied at the 99% rate, Burlington was realizing USD 31.37 per barrel of oil.[627] As shown by the graph below[628], these figures are significantly above the equilibrium point the parties agreed to in the PSCs, and allowed Burlington to make a reasonable profit.



624 *Id.*, at ¶¶ 522-523.

625 Tr. 274:4-11.

626 Tr. 272:22-273:7.

627 Tr. 274:6-11.

628 RPHB, ¶ 299.

390. In sum, Ecuador alleges that Law 42, be it at the rate of 50% or of 99%, did *not* expropriate Burlington's investment.

3.2.3. Analysis

a. Standard for expropriatory taxation

391. Taxation is an essential prerogative of State sovereignty. By virtue of this sovereign prerogative, States may tax not only their own nationals but also aliens, including foreign investors, if they effectuate investments in those States.[629] A tax is by definition an appropriation of assets by the State.[630] It is also by definition non-compensable. In the well-known phrase of Judge Oliver Wendell Holmes, taxes are "the price we pay for civilized society."[631] In other words, general taxation is the result of a State's permissible exercise of regulatory powers. It is not an expropriation.

392. There are, however, limits to the State's power to tax. There are limits that arise from customary international law on taxation and limits that arise from the protections granted under international law to foreign investments, the only relevant one for present purposes being the protection against expropriation under the Treaty. In the absence of guidance in the Treaty as to the relationship between taxation and expropriation, the Tribunal will consider the limits existing under customary international law recognizing that "[i]n interpreting a treaty, account has to be taken of any relevant rules of international law applicable in the relations between the parties – a requirement which the International Court of Justice ("ICJ") has held includes relevant rules of general customary international law."[632]

393. Customary international law imposes two limitations on the power to tax. Taxes may not be discriminatory and they may not be confiscatory.[633] Confiscatory taxation essentially "takes too much from the taxpayer."[634] The determination of how much is too much constitutes a fact specific inquiry.[635] Among the factors to be considered one

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629 "Taxation is, in a sense, a partial confiscation." A.R. Albrecht, *The Taxation of Aliens under International Law*, (hereinafter "Albrecht"), 29 THE BRITISH YEARBOOK OF INTERNATIONAL LAW 145, (1952) at p. 173 in the original pagination (Exh. EL-124).

630 Andrew Newcombe and Lluís Paradell, *Law and Practice of Investment Treaties: Standards of Treatment*, (hereinafter "Newcombe & Paradell"), Kluwer (2009), pp. 321-398, at 360.

631 J. Holmes, dissenting opinion in Compañia General de Tabaco de Filipinas v. Collector of Internal Revenue, 275 U.S. 87, at 100 (1927).

632 *Saluka Investments BV v. The Czech Republic*, (hereinafter "*Saluka*"), UNCITRAL, Partial Award of 17 March 2006, ¶ 254 (Exh. CL-100; internal quotation marks omitted).

633 Albrecht, *supra* note 629, at 169 and ss. (Exh. EL-124).

634 *Id.*, at 173.

635 Newcombe & Paradell, *supra* note 630, at 366.

counts first and foremost the tax rate and the amount of payment required.[636] If the amount required is so high that taxpayers are forced to abandon the property or sell it at a distress price, the tax is confiscatory.

394. The concept of confiscatory taxation appears to correspond to that of expropriatory taxation. The US Restatement Third of the Law of Foreign Relations provides that states are responsible for "expropriation [...] when it subjects alien property to taxation [...] that is confiscatory […]."[637] Under the Harvard Draft Convention, the execution of tax laws is not wrongful provided that the tax "is not an abuse of [...] powers [...] for the purpose of depriving an alien of his property."[638] Similarly, in an article on the interface between investment protection and fiscal powers, Thomas Wälde and Abba Kolo, for instance, refer to the concepts of "confiscatory taxation" and "expropriatory taxation" interchangeably.[639] Consequently, the notion of confiscatory taxation under customary international law may inform the Tribunal's understanding of unlawful expropriation by way of taxes under the Treaty.

395. The most important factor to distinguish permissible from confiscatory taxation is the effect of the tax.[640] The effects required for a tax to be deemed confiscatory do not appear to be different from those required to assess the existence of an indirect expropriation. In other words, confiscatory taxation constitutes an expropriation without compensation and is unlawful.[641] The Parties have also attached importance to the effects of the tax. Burlington alleged that Law 42 was a measure tantamount to expropriation because it "resulted in a substantial deprivation."[642] Ecuador has in turn submitted that a tax measure may be tantamount to expropriation only if it causes "the effects required for any indirect expropriation."[643]

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[636] Albrecht, *supra* note 629, at 174-175 (Exh. EL-124).

[637] *Restatement Third of the Law of Foreign Relations of the United States*, American Law Institute (1987), p. 200 in the original pagination (Exh. EL-164).

[638] Louis B. Sohn and Richard R. Baxter, (hereinafter "Sohn & Baxter"), *Responsibility of States for Injuries to the Economic Interests of Aliens*, 55 AMERICAN JOURNAL OF INTERNATIONAL LAW 545, 554 (1961) (Exh. CL-161).

[639] Thomas Wälde and Abba Kolo, *Investor-State Disputes: The Interface Between Treaty-Based International Investment Protection and Fiscal Sovereignty*, Intertax, vol. 35, Issue 8/9, p. 441 (2007). These authors also refer to the concept of "confiscatory expropriation" to explain that investment treaties often concern themselves only with extreme fiscal measures (p. 424).

[640] Albrecht, *supra* note 629, at 173-175 (Exh. EL-124).

[641] *Id.*, at 172-173; s*ee also RosInvestCo UK Ltd. v. The Russian Federation*, SCC Case No. ARB V079/2005, Final Award of 12 September 2010, ¶ 629(e) (Exh. CL-168).

[642] Mem., ¶ 441; CSM, ¶ 82.

[643] Emphasis omitted. RCM, ¶ 426.

396. When assessing the evidence of an expropriation, international tribunals have generally applied the sole effects test and focused on substantial deprivation. By way of example, one may cite *Pope & Talbot v. Canada*, where the tribunal stated that "under international law, expropriation requires a 'substantial deprivation'"[644], or *Occidental v. Ecuador*, where in relation to tax measures, the tribunal referred to the same "criterion of 'substantial deprivation' under international law […]."[645] In *Archer Daniels v. Mexico*, the tribunal noted that "expropriation occurs if the interference is substantial."[646]

397. When a measure affects the environment or conditions under which the investor carries on its business, what appears to be decisive, in assessing whether there is a substantial deprivation, is the loss of the economic value or economic viability of the investment. In this sense, some tribunals have focused on the use and enjoyment of property.[647] The loss of viability does not necessarily imply a loss of management or control. What matters is the capacity to earn a commercial return. After all, investors make investments to earn a return. If they lose this possibility as a result of a State measure, then they have lost the economic use of their investment.

398. Most tribunals apply the test of expropriation, however it is phrased, to the investment as a whole.[648] Applied to the investment as a whole, the criterion of loss of the economic use or viability of the investment implies that the investment as a whole has become unviable. The measure is expropriatory, whether it affects the entire investment or only part of it, as long as the operation of the investment cannot generate a commercial return.[649]

399. The inquiry under the test of loss of economic use or viability goes beyond the issue of whether the challenged measure caused a reduction or loss of profits. In *Archer Daniels*, for instance, the tribunal concluded that a "loss of benefits or expectation [...]

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644 *Pope & Talbot v. The Government of Canada*, UNCITRAL (NAFTA), Interim Award of 26 June 2000, ¶ 102 (Exh. EL-138).

645 *Occidental Exploration and Production Company v. Ecuador*, London Court of International Arbitration Case No. UN3467, Final Award of 1 July 2004, ¶ 89 (Exh. CL-86).

646 *Archer Daniels Midland Company and Tate & Lyle Ingredients Americas, Inc. v. The United Mexican States*, (hereinafter "*Archer Daniels*"), Award of 21 November 2007, ¶ 240.

647 *Middle East Cement Shipping and Handling Co. S.A. v. The Arab Republic of Egypt*, (hereinafter "*Middle East Cement*"), Award of 12 April 2002, ¶107 (Exh. EL-91).; *Parkerings-Compagniet AS v. Republic of Lithuania*, (hereinafter "*Parkerings*), Award of 11 September 2007, ¶ 437 (Exh. CL-119).

648 See cases cited in n. 407, 408 and 409.

649 *Metalclad Corporation v. the United Mexican States*, (hereinafter "*Metalclad*"), Award of 30 August 2000, ¶¶104-108 (Exh. CL-110); *S.D. Myers v. Canada*, UNCITRAL (NAFTA), Partial Award of 13 November 2000, ¶ 283. (Exh. EL-127).

is not a sufficient criterion for an expropriation."[650] In the same vein, the tribunal in *Paushok v. Mongolia* held that "a loss of that size [around USD 1 million] for one year is not a matter leading to the destruction of an ongoing enterprise."[651] While losses in one year may indicate that the investment has become unviable and will not return to profitability, this is not necessarily so and a finding of expropriation would need to assess the future prospects of earning a commercial return. It must be shown that the investment's continuing capacity to generate a return has been virtually extinguished.

400. Having circumscribed the test applicable to expropriation by way of taxation, additional questions arise in respect of the role of the State's intent, the discriminatory character of the tax and the weight of contractual stabilization clauses.

401. In addition to the impact of the tax, the State's intent is another factor that tribunals sometimes consider to draw the line between permissible and confiscatory taxation.[652] Therefore, a finding that a State measure is designed to "depriv[e]"[653] the investor of its property or to cause it to "abandon [...] or sell it at a distress price"[654] would tend to support a finding of expropriation. However, it is clear that the intent plays a secondary role relative to the effects test. In *Tippetts*, the tribunal held that "the intent of the government is less important than the effects of the measures [...]."[655] Thus, evidence of intent may serve to confirm the outcome of the effects test, but does not replace it.

402. Under general international law, a tax is illegal not only if it is confiscatory but also if it is discriminatory.[656] This does not mean, however, that a discriminatory tax amounts *per se* to an expropriation. To reach the level of an expropriation, the discriminatory tax must still meet the test of substantial deprivation discussed above.

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650 *Archer Daniels* Award, at ¶ 251.

651 *Sergei Paushok et al. v. the Government of Mongolia*, (hereinafter "*Paushok*"), UNCITRAL arbitration, Award on Jurisdiction and Liability of 28 April 2011, ¶ 334.

652 *Petrobart Ltd. v. Kyrgyzstan*, Stockholm Chamber of Commerce, Award of 29 March 2005, p. 55. ("Nor does it appear that the measures taken by the Kyrgyz Government and state authorities [...] were directed specifically against Petrobart's investment [...].") (Exh. CL-98). *See also RosInvestCo UK Ltd. v. The Russian Federation*, SCC Case No. ARB V079/2005, Final Award of 12 September 2010 at ¶ 620(e) (the State measure "fitted into the obvious general pattern and obvious intention of the totality of the scheme to deprive Yukos of its assets") (Exh. CL-168).

653 Sohn & Baxter, *supra* note 638.

654 *Restatement Third of the Law of Foreign Relations of the United States*, American Law Institute (1987), § 712 (Exh. EL-164).

655 *Tippetts, Abbett, McCarthy, Stratton v. TAMS-AFFA Consulting Engineers of Iran*, 6 Iran-U.S. C.T.R. 219, (hereinafter "*Tippetts*"), at 225.

656 Albrecht, *supra* note 633, at 170-171 (Exh. EL-124).

403. Relying on *Revere Copper,*[657] Burlington has also argued that a tax that is contrary to a tax stabilization or similar clause amounts to expropriatory. According to Burlington, such a tax would "make the leap from a *bona fide* government regulation to an expropriatory measure." [658] It is unquestionable that such a tax would amount to a breach of contract. However, to determine whether it constitutes an expropriation, the question remains whether the tax causes a substantial deprivation of the investment as a whole.

404. A final comment is in place in this context in connection with the nature of the tax at issue. The Law 42 tax is a so-called windfall profits tax, *i.e.* a tax applying to oil revenues exceeding the ones prevailing at the time the PSCs were executed. By definition, such a tax would appear not to have an impact upon the investment as a whole, but only on a portion of the profits. On the assumption that its effects are in line with its name, a windfall profits tax is thus unlikely to result in the expropriation of an investment. A definitive conclusion, however, may only be reached after taking into account the specific circumstances of the case, which the Tribunal will do in the subsequent sections.

b. Did Law 42 and Ecuador's failure to absorb its effects breach the tax absorption clauses in the PSCs?

405. The tax absorption clauses contained in the PSCs were part and parcel of the value of Burlington's investment. In order to determine the effects of Law 42, the Tribunal must first determine whether Ecuador's measures were in breach of these clauses and thus affected the value of Burlington's investment. Although this analysis involves an issue of breach of contract, it is carried out for the sole purpose of deciding whether there has been an expropriation.

406. As an initial matter, the Parties disagree on whether Ecuador relies or not on the doctrine of *rebus sic stantibus.*[659] According to Burlington, Ecuador relies on this

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657 In *Revere Copper and Brass, Inc. v. Overseas Private Investment Corporation*, (hereinafter "*Revere Copper*"), Award of 24 August 1974, the majority of the tribunal held that, although the effects of the tax – the "Bauxite Levy" – were "not confiscatory", the tax was nonetheless "expropriatory" because it amounted to a repudiation of the contractual commitment to tax stability that had deprived the investor of effective control over its investment. (Exh. CL-104 at pp. 45, 52-55 and 57-60).

658 Tr. 1266:10-13.

659 The *rebus sic stantibus* doctrine has three requirements: (i) an extraordinary and unforeseeable or unforeseen event must cause an imbalance in the obligations of the parties; (ii) this imbalance must be severe enough as to render performance of the contract by one of the parties too burdensome; and (iii) the event in question should not be a consequence of the actions or omissions of the party invoking the doctrine (CPHB, ¶ 203, citing to Aguilar Second ER, ¶¶ 27-28).

doctrine, because it refers to the requirements underlying this doctrine. This is evidenced, for instance, in the reports of Ecuador's experts, Fair Links and Juan Pablo Aguilar. Ecuador, on the other hand, expressly denies relying on the *rebus sic stantibus* doctrine, retorting that Burlington has pushed the wrong "door."[660]

407. The Tribunal notes that certain documents on record contain references to the *rebus sic stantibus* doctrine. Notably, the bill that President Palacio submitted to the Ecuadorian Congress and which subsequently became Law 42 stated that the PSCs were executed "considering the *rebus sic stantibus* clause."[661] Further, Ecuador's legal expert Mr. Aguilar stated, in the section of his report entitled "economic equilibrium of the contract", that supervening events can affect this economic equilibrium; when they occur, he explains, "[w]e are faced with the *rebus sic stantibus* principle."[662] Finally, Fair Links devoted a section of its report to describe how substantial price changes between 2002 and 2008 affected the economy of the PSCs. These would support Burlington's contention that Ecuador relies on the *rebus sic stantibus* doctrine.

408. In its post-hearing brief, however, Ecuador expressly disclaimed reliance on the *rebus sic stantibus* doctrine in this arbitration. It is true that it alleged that "a massive and unforeseen increase in oil prices"[663] affected the economy of the PSCs. While this coincides with one of the elements of the *rebus sic stantibus* doctrine, Ecuador does not argue that these events subjected it to a burdensome imbalance of obligations, but rather that they invalidated the economic premises upon which the allocation of oil production in the PSCs was based. Because these economic premises were, according to Ecuador, an integral part of the PSCs, they could be relied upon directly as a matter of contract interpretation. Therefore, the Tribunal comes to the conclusion that Ecuador does not invoke the *rebus sic stantibus* doctrine, and that there is thus no need to examine the requirements of this doctrine.

409. The Tribunal's next task is to review whether Law 42 modified or breached the PSCs. Ecuador argues that Law 42 did neither. According to Ecuador, Law 42 did not modify the PSCs because it dealt solely with oil prices, an issue the PSCs left unaddressed. The Tribunal is of a different opinion. As was discussed in Section IV(C)(iii) above, the possibility of including a price adjustment factor similar to the one included in the Tarapoa Contract was expressly discussed and rejected at the time of the negotiation

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660 RPHB, ¶¶ 3-4.

661 Exh. C-174, p. 3 (Tribunal's translation).

662 Aguilar Second ER, ¶¶ 18, 20 (Tribunal's translation).

663 RCM, ¶ 440.

of the PSCs. The non-inclusion of such an adjustment clause in the PSCs was the product of a deliberate choice by the contracting parties. Thus, the issue *was covered* in the PSCs: the parties agreed that oil production would be allocated irrespective of oil prices.[664] By introducing an oil price factor to allocate oil revenues, Law 42 modified the parties' choice to exclude such a factor.

410. Ecuador notes that the Ecuadorian Constitutional Court has already decided that Law 42 did not modify the PSCs, and submits that this Tribunal cannot overrule or disregard such decision.[665] However, while international tribunals should certainly consider decisions rendered by national courts, they are not bound by them. The purpose of investment arbitration is neutral adjudication of a dispute by a tribunal independent from both parties. If the international tribunal adjudicating the dispute were bound by the decision of an organ that forms part of one of the parties to the dispute, this purpose would be seriously jeopardized, if not defeated.

411. Ecuador subsequently argues that Law 42 did not breach the PSCs and the renegotiation clauses, because Law 42 did not affect the economy of the PSCs and, even if it did, the application of a correction factor was not mandatory. In Section IV(C) the Tribunal concluded, however, that the economy of the PSCs meant that the contractor was entitled to its share of oil production regardless of the price of oil and of its internal rate of return. The Tribunal considers that in allocating to the State a large part of oil revenues to which Burlington was entitled under the PSCs, Law 42 had an impact on the economy of the PSCs.

412. The impact of Law 42 on the economy of the PSCs was not in and of itself a breach of the PSCs. As Ecuador has noted, the PSCs expressly contemplated the possibility that taxes could be increased or decreased. But Law 42 did trigger the contractual mechanism applicable in the event of a modification to the tax system. As the Tribunal concluded in Section IV(C), these clauses provided for the mandatory application of a correction factor in the event of a modification of the tax system. Accordingly, Ecuador

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664 The distinction between oil volumes and oil revenues would, from an economic point of view, be artificial. The contractor's interest is in the economic value of its share – whether in the form of oil or cash. This is apparent from the text of Article 4 of Law 1993-44, which provides that "[t]he contractor's participation share may be received in cash, subject to prior agreement with PetroEcuador" (Exh. C-15, p. 3 in the original pagination; Tribunal's translation).

665 The Ecuadorian Constitutional Court held that Law 42 "[c]reates obligations over matters that have not been the subject of contractual stipulation, that have not been agreed upon or foreseen […] and therefore that did not affect or influence the consent of the parties [in concluding the PSCs]." (Exh. EL-19, p. 25; RCM, ¶ 280).

was under an obligation to apply a correction factor that would absorb the effects of Law 42, which had an impact on the economy of the contract.

413. The record shows that Burlington twice requested Ecuador to comply with this obligation: once after Law 42 at 50% was passed, and once after the rate was increased to 99%. In a letter dated 18 December 2006, Burlington first requested Ecuador to apply a correction factor absorbing the effects of Law 42 at 50%.[666] After Decree 662 increased the rate to 99%, Burlington again requested Ecuador to apply a correction factor that would absorb the effects of Law 42 at 99%.[667] It is undisputed that Ecuador did not respond to Burlington's requests that the effects of Law 42 be absorbed.

414. Ecuador explains its silence by the fact that Burlington did not provide an "economic analysis demonstrating that Law 42 had affected the economy of the Participation Contracts, nor did it put forward what the appropriate adjustment should have been to re-establish that 'economy'."[668] The explanation is unpersuasive. No economic analysis was required to show that the economy of the PSCs was affected: Law 42 deprived Burlington of an important portion of oil revenues from its oil participation share to which it was entitled under the PSCs – oil revenues which were redirected to the State in the form of taxes. The impact of Law 42 on the economy of the PSCs was therefore evident.

415. Additionally, Ecuador's explanation that it failed to respond to the requests for adjustment because Burlington did not "put forward what the appropriate adjustment should have been"[669] is no more persuasive. After all, the chief purpose of these letters was to request the opening of the administrative procedure for the application of a correction factor.[670] The Consortium's pledge to submit "the figures"[671] in order to calculate the correction factor – a pledge made only in the December 2006 letters and

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666 Exhs. C-11 and C-12; CPHB, ¶¶ 82, 130, 317.

667 Letter of 28 November 2007, Exh. C-43; CPHB, ¶¶ 82, 130, 317.

668 RPHB, ¶ 189.

669 *Id.*

670 On 18 December 2006, the Consortium's representative wrote to PetroEcuador to request "the opening of the applicable administrative proceeding for the parties to analyze the economic impact on the contract of […] the aforementioned taxes and fees for which the Consortium shall present the figures" (Exh. C-11 and C-12). On 28 November 2007, Burlington's representative – as opposed to the Consortium's representative – wrote to the Attorney General of Ecuador and to PetroEcuador to request that PetroEcuador agree "to engage forthwith in the process of calculating and implementing a correction factor pursuant to" the tax absorption clauses in the PSCs for Blocks 7 and 21 (Exh. C-43).

671 Exh. C-11, p. 17.

not repeated in the November 2007 letters[672] – was not intended to act as a condition precedent for the opening of such procedure. Rather, those figures were supposed to be submitted *in the context* of that administrative procedure.

416. In the same vein, Dr. Galo Chiriboga, who was the Chief Executive Officer of PetroEcuador at the time the Consortium sent the requests for readjustment of the oil participation shares in December 2006, further explained that Ecuador failed to respond to these requests because of their inappropriate timing, considering the forthcoming year end holidays and change of administration. In the words of Dr. Galo Chiriboga:

> "We are talking about the last weeks of December; in Ecuador and, I think, in the rest of the world as well, well, these are very complicated weeks, not only because of Christmas but also because of New Year's. And also, added to that, there was a new administration that was going to take office. [...] To submit a document such as this [the requests for adjustment] to a Government that ended its administration, I think it's a very inappropriate moment to submit that kind of document, in my modest opinion."[673]

417. This explanation, however, does not appear to be any more persuasive than the previous one. Even if the timing of the request had not been appropriate, nothing prevented Ecuador from responding at a later time. Moreover, Burlington reiterated its requests for readjustment in November 2007, after Law 42 at 99% was passed, and still received no response. In sum, Ecuador's failure to respond to Burlington's requests for readjustment demonstrates its unwillingness to even entertain the possibility of applying a correction factor. It was this refusal to absorb the effects of Law 42 that ultimately breached the PSCs.

418. Ecuador finally argues that, even if the PSCs were breached, these breaches do not amount to a Treaty breach because they do not amount to "an effective repudiation of the right [...] which has the effect of preventing its exercise entirely or to a substantial extent."[674] However, by enacting Law 42 and then refusing to absorb its effect pursuant to the tax absorption clauses, Ecuador has in effect nullified Burlington's right

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[672] Indeed, no similar pledge was made in Burlington's letters of 28 November 2007, which make no reference to the submission of "figures" and solely request the immediate opening of the process to calculate and implement a correction factor. Thus, Ecuador's argument that it did not react to the requests for application of a correction factor because it was awaiting the figures cannot apply with respect to Burlington's letters of 28 November 2007 (Exh. C-43). At any rate, it is clear from both sets of letters – those of December 2006 and those of November 2007 – that the gist of the request was the opening of the process that would allow for the calculation of a correction factor.

[673] Tr. 782:19-783:8.

[674] *Waste Management II* Award, at ¶ 175 (Exh. EL-67).

to a correction factor by preventing the exercise of this right. Moreover, this nullification was made possible through the use of Ecuador's sovereign powers. While both parties to the PSCs may invoke the tax absorption clauses, only Ecuador, as a sovereign State, may increase taxes and disregard this clause.[675]

419. For these reasons, the Tribunal concludes that Law 42 affected the economy of the PSCs and that Ecuador failed to apply a correction factor pursuant to the tax absorption clauses. Accordingly, Ecuador breached the tax absorption clauses of the PSCs. This is a relevant, although by no means decisive, consideration for purposes of the expropriation analysis, which entails a broader inquiry into the investment's overall capacity to generate commercial returns for the benefit of the investor. The Tribunal must next determine whether Law 42, first at 50% and then at 99%, amounted to an expropriation of Burlington's investment.

c. The effects and purpose of Law 42 at 50%

420. The Parties disagree on the effects of Law 42 at 50%. Burlington claims that Law 42 at 50% had a "devastating" impact on Burlington's investment; specifically, it contends that Law 42 at 50% "had a significant negative impact on the economics of Block 7 and destroyed the economics of Block 21."[676] Ecuador counters that Law 42 at 50% is not a measure tantamount to expropriation because (i) it did not effect a "permanent" deprivation of Burlington's investment, (ii) nor did it cause Burlington a near total loss of the value of its PSCs rights.

421. With respect to the first objection, Ecuador contends that there is no permanent deprivation because Law 42 only applied when the price of oil was above the reference price, which was not always the case. In January and February 2009, for instance, the price of oil was below the reference price. This suffices, according to Ecuador, to conclude that Law 42 is not expropriatory. The Tribunal is unable to follow this line of argument. Law 42 permanently applies to "non agreed or unforeseen surpluses,"[677] that is, windfall profits as defined in the law. Just like an income tax is not temporary because it does not apply in a period in which the taxpayer has no income, the fact that

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[675] In the Decision on Jurisdiction, the Tribunal observed that the tax absorption clauses may be invoked by both parties to the contract and thus work "symmetrically" (DJ, ¶¶ 182-183). Thus, for the sake of accuracy, it should be noted that these clauses are symmetrical only in the sense that both the State and the contractor may *invoke* their application. The State, however, is the only party to the PSC that may increase and decrease taxes and therefore trigger the application of these clauses. In this other sense, the clauses are asymmetrical.

[676] CPHB, ¶ 172.

[677] Exh. C-7, at Article 2.

there may be a period without windfall profits does not turn Law 42 into a temporary measure.

422. In other words, while the windfall profits may not be permanent, the application of Law 42 to those profits is permanent. Whenever the price of oil was above the reference price, half of the revenues in excess of the reference price would be reallocated to the State. Ecuador's subsequent failure to absorb the effects of Law 42, in accordance with the tax absorption clauses in the PSCs, confirmed the permanent effects of this tax. Therefore, Law 42 at 50% effected a permanent deprivation.

423. In connection with Ecuador's second objection and the substantial loss of the value of Burlington's investment, Burlington's case is that Law 42 at 50% was "devastating" because (i) it prevented Burlington from recovering past investments, (ii) it forced it to scale back its development plans, which would adversely affect its ability to seek an extension of the PSCs, and (iii) it rendered Block 21 economically non-viable. Burlington has provided no expert evidence to buttress these allegations. Ecuador replies that Law 42 at 50% did not cause a near total loss of the value of Burlington's rights under the PSCs. It bases its reply on the Consortium's tax returns for the years 2005 to 2007, the Fair Links report, the Consortium's Oso Development plan, and ConocoPhillips' annual reports for 2006 to 2008.

424. Law 42 at the 50% rate applied between April 2006 and October 2007. From April to December 2006, Burlington made Law 42 payments in the amount of USD 15.85 million for Block 7 (42.5% of total Law 42 payments of USD 37.303 for Block 7),[678] and USD 23.04 million for Block 21 (46.25% of total Law 42 payments of USD 49.814 million for Block 21).[679] In the aggregate, Burlington made Law 42 payments for a total of USD 38.89 million in 2006. The real impact of Law 42 is, however, lower than what the total Law 42 payments reflect: had Law 42 payments not been made, the corresponding amounts would have become additional income for Burlington, to which the ordinary income tax and employment contributions would have applied. As the income tax (25%) and the employment contribution (15%) alone add up to about

[678] As previously noted, Burlington's ownership interest in Block 7 is 42.5% and the total Law 42 payments are reflected in its financial statements for 2006 (Exh. C-419, p. 6).

[679] Burlington's ownership interest in Block 21 is 46.25% and the total Law 42 payments are reflected in its financial statements for 2006 (Exh. C-419, p. 9).

40%[680], the real impact of Law 42 is approximately 60% of the total Law 42 payments, *i.e.* about USD 23 million.[681]

425. Still in 2006, Burlington made net profits of USD 30.85 million in Block 7 (42.5% of total net profits of USD 72.579 for Block 7)[682] and USD 13.33 million in Block 21 (46.25% of total net profits of USD 28.821 for Block 21).[683] In the aggregate, Burlington made net profits of USD 44.18 million in 2006. However, since Law 42 only applied for three-fourths of the year, the impact of Law 42 in 2006 must be measured on three-quarters of the total profits (or 75% of USD 44.18 million), which equal USD 33.14 million. Had Law 42 not applied, Burlington's three quarter profits of USD 33.14 million would have been USD 56.14 million (USD 33.14 million + USD 23 million). Thus, Law 42 at 50% reduced Burlington's net profits by around 40% (USD 23 million out of a total of USD 56.14 million).

426. In 2007, Law 42 at 50% applied for the ten-month period spanning from January to October 2007. As of November 2007, Burlington was subject to the higher 99% rate. The overall impact of Law 42 on Burlington's investment was greater in 2007 than in 2006. Burlington's Law 42 payments in 2007 totalled USD 87.74 million (42.5% of USD 98.128 million for Block 7 plus 46.25% of USD 99.552 million for Block 21).[684] The real impact of these payments (taking into account the taxes that Burlington would have paid had it not been subject to Law 42) was of approximately USD 52.64 million. Burlington's profits, in turn, totalled USD 30.95 million (42.5% of USD 57.28 million for Block 7 plus 46.25% of USD 14.3 million for Block 21).[685] Thus, Law 42 diminished Burlington's net profits by around 62.9 % in 2007 (USD 52.64 million out of USD 83.6 million).[686] However, because Burlington's financial statements do not appear to distinguish between Law 42 payments at the 50% rate from those at the 99% rate, it is not possible to precisely determine the impact of Law 42 at 50% in 2007. This impact is certainly lower than 62.9%, since Law 42 applied at the 99% rate during November and December 2007. The figures for 2006 appear therefore more reliable to evaluate the impact of Law 42 at 50%.

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680 As explained *supra* at note 17, the combined impact of the income tax and the employment contribution is 36.5%, not 40%. However, since municipal taxes and reinvestment obligation must also be taken into account, it appears reasonable to round it up at 40% for computation purposes.

681 The exact figure is USD 23.33 million.

682 Exh. C-419, p. 6.

683 *Id.*, at 9.

684 Exh. C-420, pp. 6 and 9.

685 *Id.*

686 *Id.*

427. Another way to appreciate the effects of Law 42 on Burlington's investment is to focus on the distribution of the proceeds from the sale of a barrel of oil.[687] From the proceeds of a barrel of Oriente crude oil from Block 7, the market value of which was USD 66.56 in July 2006, Burlington would have received USD 48.28 and would have made Law 42 payments at 50% for USD 18.36. The Law 42 tax would amount to 27.6% of the total value of the Oriente crude oil barrel, or slightly more than one-fourth.

428. The impact would have been greater for a barrel of Napo crude from Block 21. Although the price of Napo oil from Block 21 was lower (in July 2006 it was USD 57.43 per barrel; Oil Prices tab at the end of Martinez's direct examination bundle), the Law 42 reference price was also lower (USD 15 in April 2006). Assuming that the reference price of Law 42, adjusted for inflation, had been USD 20 per barrel in Block 21, the impact of Law 42 would have been close to one-third (the Law 42 payment would have been USD 18.715 per barrel of Napo oil, or 32.6% of the value of a Napo oil barrel).

429. In relative terms, Law 42 at 50% reduced Burlington's take on the total oil revenues (after taxes and including operating costs) produced by the Blocks from 48.9% to 34.6% in Block 7 (a 29.2% reduction), and from 57.4% to 38.6% in Block 21 (a 32.8% reduction). If Burlington's operating costs are subtracted from its revenues, Law 42 at 50% reduced Burlington's take on total oil revenues from 38.3% to 24% in Block 7 (a 37.3% reduction), and from 48.6% to 29.9% (a 38.5% reduction) in Block 21.

430. On the basis of these figures, the Tribunal is of the opinion that the effects of Law 42 at 50 % do not amount to a substantial deprivation of the value of Burlington's investment. Arbitrator Orrego Vicuña disagrees with this finding for the reasons explained in the attached dissenting opinion.

431. This conclusion is reinforced by the following facts. First, despite the enactment of Law 42 at 50%, the Consortium submitted a plan for additional investments of USD 100 million in the Oso field, which according to Burlington's own description was the "largest field in Block 7 and the center of the Block's development plans."[688] As Ecuador noted, in submitting the Oso plan, the Consortium implicitly conceded that Block 7 was economically viable even with Law 42 at the 50% rate. Second, Burlington's allegation that Block 21 was "not viable" with Law 42 at 50% is not supported by the record. As Fair Links pointed out, Burlington's financial statements

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[687] Law 42 applied whether there was an actual sale or not. Hence, actual proceeds were not a prerequisite for the application of Law 42.

[688] Mem., ¶ 174.

for Block 21 do not show a loss but a "positive figure."[689] Third, Burlington acknowledged that there were bidders willing to acquire its interest in the Blocks despite the effects of Law 42 at 50%.[690]

432. The Parties disagree on the purpose of Law 42 at 50%. According to Burlington, the purpose of Law 42 at 50% was to force it to abdicate its rights under the PSCs and was thus expropriatory. Ecuador maintains that the purpose of Law 42 was to restore the economics of the PSCs, to prompt oil companies to negotiate with the State, and ultimately to strike a fair allocation of the oil revenues. The record does not support Burlington's allegation that the purpose behind Law 42 at 50% was expropriatory. The purpose seems rather to have been to replicate in the PSCs the effects that the price adjustment clause in the Tarapoa Contract would produce in a scenario of high oil prices, *i.e.* to share the windfall profits resulting from the higher prices on a 50/50 basis between the State and the oil company. As one Ecuadorian congressman observed in the context of the discussions of President Palacio's bill that would later become Law 42:

> "Look, it's as if it were copied, that is the proposal that the Government is making, what is already envisaged in one contract [the Tarapoa contract], and we want that this, which is already envisaged in one contract, be incorporated in the rest of the contracts."[691]

433. These facts corroborate the Tribunal's earlier conclusion that Law 42 at 50% did not substantially deprive Burlington of the value of its investment, and was therefore *not* a measure tantamount to expropriation.

d. The effects and purpose of Law 42 at 99%

434. The Parties also disagree on the effects of Law 42 at 99%. Burlington asserts that Law 42 at 99% "destroyed" the value of its investment. As a result of Law 42 at 99%,

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689 At the hearing, Mr. Mélard de Feuardent, testifying on behalf of Fair Links, explained the following in connection with the Consortium's 2006 financial statement for Block 21: "On these figures you will see the profit and loss account for Block 21. What do we see? Total income is 171.9 million […]. Total cost, 117.8 million, which leads you to a result before tax of [USD] 54 million and after tax of [USD] 28.8 million. That is not a taxable income loss. That is a positive figure. Costs are less than revenues" (Tr. 1170:5-12; Exh. C-419, p. 9). A similar analysis and conclusion would result from the 2007 financial statement for Block 21 (Exh. C-420, p. 9). Law 42 at 50% was in force from April 2006 to October 2007; thus, the 2006 and 2007 financial statements cover the entire period in which the 50% tax was applicable. This evidence appears to belie Mr. Martinez's testimony to the effect that Law 42 at 50% "effectively made Block 21 go negative in income" (Tr. 339:6-8).

690 Burlington's specifically alleged that when Law 42 at 99% was enacted, "prospective purchasers" of its Ecuadorian assets "rescinded their offers" (Mem., ¶ 261; CSM, ¶ 31.). This presupposes that these offers were valid before the Law 42 rate was increased to 99%, that is, when Law 42 at 50% was in effect.

691 Exh. C-177, at 73.

Burlington claims that it sustained a loss of USD 60 million in 2008, and it made no additional investments in either Block 7 or Block 21. In contrast, Ecuador essentially argues that Burlington sustained no loss in 2008 because Law 42 at 99% "did not alter the global trend of positive cash flows", that the Oso plan shows that Law 42 at 99% did not substantially alter the viability of Burlington's investment, and that ConocoPhillips' annual reports for 2006 to 2008 show no impairment of its Ecuadorian assets.[692]

435. Law 42 at the 99% rate applied from November 2007 to around March 2009. In 2008, the only year in which Law 42 at 99% applied for the entire year, Burlington made Law 42 payments in the amount of USD 102.33 million (42.5% of total Law 42 payments of USD 240.78 million) for Block 7,[693] and USD 100.76 million (46.25% of total Law 42 payments of USD 217.86 million) for Block 21.[694] In combination, in 2008, Burlington made Law 42 payments for a total of USD 203.09 million. The real impact of Law 42, considering that Burlington would in any event have had to pay income tax (25%) and employment contributions (15%) over this amount, amounts to USD 121.85 million.

436. The Parties specifically disagree on whether Burlington sustained losses or made profits in 2008. Their disagreement appears to stem from the different analytical tools on which they rely to value Burlington's operations. Burlington relies on its financial statements, which include amortizations for USD 106.29 million in 2008. Ecuador, by contrast, argues that financial statements and amortizations present a distorted picture of the economic reality of Burlington's operations, and that the correct analysis should focus on cash flows.

437. According to Burlington, amortization helps to assess the impact of Law 42 at 99% on its investment. In order to properly ascertain this impact, the Consortium's past investments must be taken into account, *i.e.* amortized. Burlington maintains that Fair Links wrongly excluded from its analysis the impact of the Consortium's capital expenditures. On direct examination, Mr. Martinez explained that amortization meant that a dollar spent in a given year for capital investments did not need to be accounted for in that particular year, but could be spread out over the next three to five years depending on the type of asset and the amortization rate. Mr. Martinez testified that the financial statements properly include the amortization of past investments because:

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692 Ecuador also argues that Law 42 at 99% was not expropriatory because it did not cause Burlington a "permanent" deprivation. That objection has already been disposed of in the context of Law 42 at 50% for reasons that apply with the same force here as well.

693 Fair Links ER, Appendix 11; CPHB, Annex 3.

694 Fair Links ER, Appendix 11.

> "You have to account for your capital. You have to account for the investment that you made in order to [...] generate the income. And it's, you know. If you're going to go out and buy a car, you don't buy a car with nothing. You have to account for that price, and you have to account for that investment.
>
> The amortization is just a countermeasure to account for that investment. If you summed up all the amortizations and you looked at the total investment, they'll sum up, so you have to account for that capital investment that you made, and accounting-wise that's how you do it."[695]

438. Upon examination by the Tribunal, Mr. Martinez testified that Fair Links failed to account for USD 60 million worth of capital expenditures made by the Consortium:

> "[T]he Fair Links Report [is] inaccurate. It doesn't have about $60 million worth of investment accounted for in that table [...]. When you look at what the full investments are, they don't account for it all. I can't tell you where they missed it, but they missed it. [...] [W]e spent quite a bit of money in Block 21 in 2006. We drilled, I believe, almost 11 wells, and that's not – it doesn't get reflected enough [in the Fair Links Report]"[696] (emphasis added).

439. According to Ecuador, the tool to evaluate Burlington's economic operations is a cash flow analysis, because it is not affected by accounting conventions, such as amortization, which "may distort the economic understanding" of a project.[697] On direct examination, Mr. Mélard de Feuardent of Fair Links defined cash flows, annual cash flows and cumulative cash flows:

> "What are cash flows? A very simple process. This is what you take out of your pocket when you [make] an investment, what you take out of your pocket to finance the [investment's] operation, and then what you get into your pocket as revenue for operation. The sum of these three out-of-pocket issues are what constitutes the annual cash flows. [In the graphs below], the annual cash flows are represented by the gray bars. [...].
>
> Annual cash flow will not help you to look at the overall profitability of the project [...]. The profitability of the long-term project is to be considered as the sum of the annual cash flows over the whole life of the project [...]. This sum is represented in our graph by the red line, which represent[s the] cumulative cash flow of the project starting [from] 2000 onwards"[698] (emphasis added).

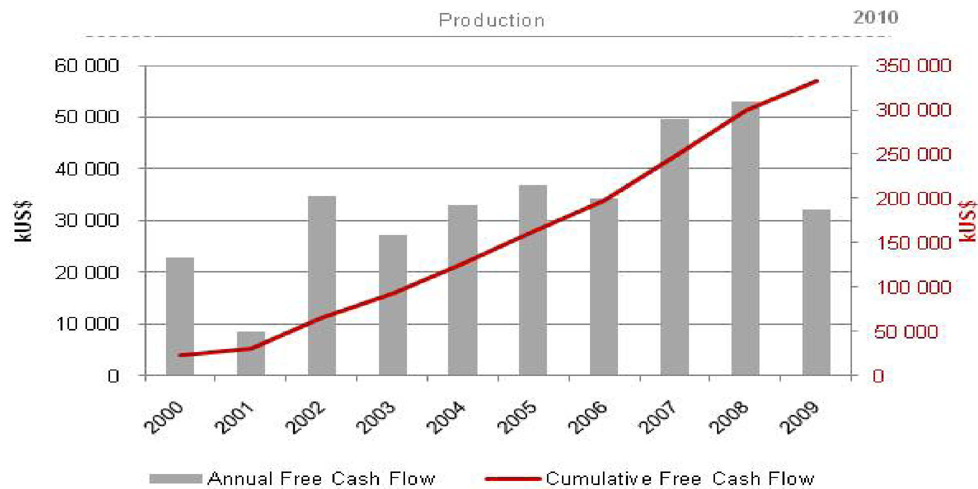
695 Tr. 346:8-20.

696 Tr. 540:10-541:8.

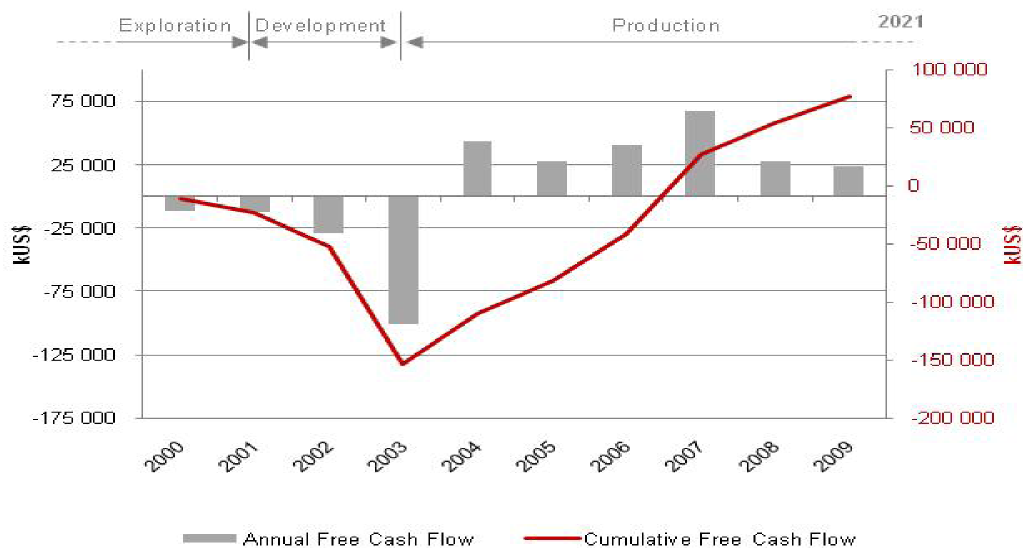
697 Fair Links ER, ¶¶ 92-93; Tr. 1163:9-16.

698 Tr. 1159:10-1161:21.

440. According to the Fair Links report,[699] the annual and cumulative free cash flows for Block 7 were as follows:



441. With respect to Block 21, the annual and cumulative free cash flows were the following:



442. On the basis of this cash flow analysis, Fair Links concluded that:

> "Law 42 and Decree 622 did not alter the global trend of positive cash flows. In fact, for both Blocks the most significant annual cash contributions over the life of the Projects are either in 2007 (Block 21) or 2008 (Block 7), i.e. when Law 42 then Decree 622 were fully applicable"[700] (emphasis added).

443. Ecuador additionally argues that Burlington's financial statements evince an excessive amortization rate. By 2008, the financial statements report an accumulated

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[699] Fair Links ER, p. 32

[700] Fair Links ER, ¶ 94.

amortization for both Blocks of approximately 80%.[701] Fair Links further observed that by 2006, only two years after Block 21 started to produce, the amortization was at 42%. Since the PSC's life did not end until 2021, this "clearly shows that [...] there is an overburden of [] amortization."[702] As a result, Fair Links concludes that this is "a good illustration why financial statements such as [the Consortium's] are not the [right] approach to understand the profitability of a long-term contract."[703]

444. The Tribunal agrees that past investments must be accounted for and that it thus appears fair to consider amortization. At the same time, the Tribunal notes that the cumulative rate of amortization is considerable, reaching about 80% in Block 21 by 2008 – even though the Consortium was entitled to operate this Block until 2021. Even if the amortization rates used were required by Ecuadorian law, as Burlington has alleged[704], and/or are in conformity with accounting standards, this does not mean that the Tribunal must necessarily rely on those rates to determine whether there was expropriation under the Treaty.

445. It appears that the loss Burlington suffered in 2008 was attributable to such high rate of amortization.[705] Indeed, before amortization, the Consortium made profits of USD 62.3 million in 2008,[706] paying nearly USD 10 million in income taxes for that year.[707] Thus, the Tribunal considers that even if Burlington sustained an accounting loss in 2008, this

701 Tr. 441:7-442:19.

702 Tr. 1171:1-13.

703 Tr. 1171:13-16.

704 Investments were amortized in accordance with a distinction between pre-production and production investments. Pre-production investments were amortized on a linear basis over a five-year period. Production investments, on the other hand, were amortized on a unit-of-production basis, *i.e.* seemingly as a function of the level of production, although there is no clear indication on record of how this method is to be applied (CPHB, ¶179 n. 221; Exhs. C-258 and C-259; Notes 3(f) and (g); Exhs. C-260 to C-263, Notes 3(f) and (h)).

705 Indeed, Burlington made virtually no investments in the Blocks in 2008: it invested USD 1.39 million in Block 7 and made no investment in Block 21 (CPHB, ¶ 50; Exhs. C-258 to C-260 and C-418 to C-419). Yet, its financial statements reflect amortizations for a total of USD 106.29 million. This does not allow to properly assess the effects of Law 42 at 99% in 2008, because of the weight of previous capital expenditures. In fact, in 2008, the Consortium's amortizations account for nearly 50% of the Consortium's total expenses – USD 106.29 million out of USD 224.66 million (Fair Links ER, Appendix 11; CPHB, Annex 2).

706 In 2008, the Consortium's gross profits totaled USD 180.7 million; its total costs before amortization amounted to USD 118.369. Thus, before amortization, the Consortium made profits of USD 62.3 million (Fair Links ER, Appendix 11; CPHB, Annex 2).

707 The Consortium paid income taxes for USD 9.78 million and employment contributions for USD 6.9 million. Fair Links ER, Appendix 11; CPHB, Annex 2.

is not in itself sufficient evidence that Law 42 at 99% caused a substantial deprivation of the value of its investment.[708]

446. Furthermore, the Fair Links cash flow approach, which did not disregard the Consortium's past capital expenditures but rather took them into account in the year in which they were incurred,[709] leads to the conclusion that, despite Law 42 at 99%, the Consortium was still experiencing a "global trend of positive cash flows",[710] both annual and cumulative, in each of the Blocks.[711] At the hearing, Mr. Mélard de Feuardent testified, on behalf of Fair Links, that "the cash flow was positive in 2008 [...] which mean[s] that the company was not getting money out of its pocket during operation [but] was getting money in its pocket."[712] This evidence tends to disprove Burlington's allegation of substantial deprivation.

447. Burlington has relied on the Consortium's 2008 five-year plan as evidence of its future earning projections following the enactment of Law 42.[713] The five-year plan shows that Burlington would seemingly not make new investments, that total annual oil production would decline year after year, and that as a result the production cost per barrel of oil extracted would increase.[714] The five-year projection, however, does not show that the investment would lose its capacity to generate a commercial return for Burlington in the future.[715]

448. On the other hand, the effects of Law 42 at 99% on Burlington's investment may also be evaluated by focusing on how the proceeds of a barrel of oil allocated to Burlington Oriente pursuant to the PSCs would have been distributed. For Block 7, the proceeds of a barrel of Oriente crude oil priced at USD 83.20 in November 2007, at which time the reference price adjusted for inflation was of USD 30.85,[716] would have been

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708 The Tribunal finds a similar conclusion in *Paushok*, where the tribunal made the following observation: "[A] loss of that size for one year is not a matter leading to the destruction of an ongoing enterprise […]", *Paushok*, at ¶ 334.

709 Fair Links ER, ¶ 92.

710 Fair Links ER, ¶¶ 94, 96.

711 *Id.*

712 Tr. 1228:22-1229:4.

713 Exh. C-187; Tr. 547:8-548:4, where, in response to a question from the Tribunal as to earning projections, counsel for Burlington referred to the five-year plan.

714 Exh. C-187, pp. 13, 22, 27 and 34.

715 Alex Martinez testified that, on account of the declining production and the increased production costs per barrel shown in the five-year plan, "you get to the point where you can see where it's going to cross", *i.e.* presumably where costs would exceed revenues (Tr. 547:22-548:4). On the basis of this document alone, however, it is not possible to reach the conclusion that production costs per oil barrel would have exceeded revenues in that five-year time frame.

716 RPHB, p. 89; ROSS, # 118.

allocated as follows: USD 31.37 per barrel to Burlington (USD 30.85 plus one percent of USD 52.35), and USD 51.83 per barrel to Ecuador.[717] Hence, Law 42 at 99% deprived Burlington of 62.3% of the value of each barrel of Oriente crude oil allocated to its subsidiary under the PSCs.

449. For Block 21, the original reference price as of March 1995 was USD 15.36.[718] There does not appear to be evidence on record of the statutory reference price of a barrel of Napo crude oil, adjusted for inflation, in November 2007. Assuming that the reference price was USD 19 at the time,[719] the proceeds of a barrel of Napo oil priced at USD 79.09 in November 2007[720] would have been apportioned as follows: USD 20.6 per barrel for Burlington (USD 20 plus one percent of USD 59.09) and USD 58.5 per barrel for Ecuador. Consequently, Law 42 at 99% deprived Burlington of approximately 73.9% of the value of each barrel of Napo crude oil allocated to its subsidiary under the PSCs.

450. Yet another approach to ascertain the effects of Law 42 at 99%, one that Burlington has favored in presenting its case, is to consider the percentage reduction of Burlington's total oil revenues as a result of the tax. Law 42 at 99% reduced Burlington's take on the total oil revenues produced by the Blocks – after taxes but including operating costs – from 48.9% to 20.5% in Block 7[721] (a 58% reduction), and from 57.4% to 17.1% in Block 21[722] (a 70.2% reduction). This approach confirms that Law 42 at 99% considerably diminished Burlington's profits, but does not prove that Burlington's investment became unprofitable or worthless.

451. Additionally, Ecuador has relied on the Consortium's Oso Plan and on ConocoPhillips' annual reports to show that Law 42 at 99% was not expropriatory. However, Burlington submitted the Oso Plan when the Law 42 rate was at 50% and as such this consideration is of little assistance for the 99% tax rate inquiry. Further, the fact that ConocoPhillips' annual reports show no impairment for the 2006-2008 periods tends to suggest that the group did not consider that Law 42 at 99% had substantially deprived

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717 *Id.*

718 Tr. 270:1-4.

719 The evidence shows that the reference price for Block 21 was USD 19.06 in April 2008 (COSS, Overview, ## 39-40). Thus, it may be assumed that the reference price for Block 21 would have been approximately USD 19 in November 2007.

720 Fair Links ER, Exhs. 4.3.1 and 4.3.2, also included at the end of Martinez, Oil Prices tab.

721 CPHB, p. 180; COSS (Overview), # 36.

722 CPHB, p. 181; COSS (Overview), # 39.

it of its investment in Ecuador at the time.[723] On the other hand, the lack of impairment report in the annual accounts may have other explanations: the group could have considered, for instance, that it could still be compensated for the tax pursuant to the terms of the PSCs, or that it could reach a settlement with Ecuador. Thus, these considerations do not appear to be dispositive of the issue under examination.

452. With respect to the purpose of Law 42 at 99%, the Parties have presented diverging views. Burlington argues that the purpose of Law 42 was to force it to abdicate its rights under the PSCs. Ecuador, by contrast, contends that the purpose of Law 42 was threefold: (i) to restore the economic equilibrium of the PSCs; (ii) to achieve a fair allocation of the petroleum rent between the oil companies and the State; and (iii) to prompt oil companies to negotiate with the State.

453. Ecuador's allegation that Law 42 was intended to restore the economic equilibrium of the PSCs is unsupported by the record. As examined in Section IV(C)(iv), Ecuador did not invoke the PSCs when it sought to renegotiate terms with Burlington. Similarly, Ecuador applied the same tax rate to all PSCs, which suggest that such tax rate was not calibrated to restore the specific economic equilibrium of each PSC. Furthermore, when the Ecuadorian Congress discussed the bill that eventually became Law 42, an Ecuadorian congressman noted that the issue was whether the PSCs could be modified:

> "By virtue of this Law [44] various [oil] contracts were renegotiated. One of the contracts that was renegotiated in the first place was [that of] the Tarapoa block, and that renegotiation was so well done that it included the [clause] that the [first congressman] read out, by which, when the barrel of oil exceeds USD 17, [the revenues] are shared between the State and the contractor on a 50/50 basis. Then there were other renegotiations [...], and in those renegotiations, strangely, the clause that exists in the [Tarapoa] contract was not included. Now, faced with the bill sent by the President of the Republic, we have discussed whether or not we can by law unilaterally modify oil contracts with retroactive effect. That and no other is the legal issue"[724] (emphasis added).

454. Ecuador further claims that it passed Law 42 to achieve a fair allocation of the petroleum rent. The record indeed supports the proposition that Ecuador perceived the significant increase in oil prices as having created an inequitable situation where oil companies obtained undeserved windfall profits to the detriment of the State. The Tribunal acknowledges that a fair sharing of the rent may well have been Ecuador's

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723 By contrast, ConocoPhillips' annual reports for 2009, the year in which Ecuador intervened in the Blocks, do show an impairment.

724 Exh. C-177, p. 103 (Tribunal's translation).

general and indeed legitimate goal. However, under the specific facts of this case, Ecuador had an obligation to respect the tax absorption clauses included in the PSCs.

455. Finally, Ecuador argues that Law 42 was intended to prompt oil companies to negotiate with the State. While this goal may have been related to Ecuador's view that the allocation of oil revenues under the PSCs was unfair, it provides no ground to disregard Burlington's rights under the PSCs. Ecuador appears to have passed Law 42 without intending to apply the correction factor required by the tax absorption clauses of the PSCs. This course of action lends credence to Burlington's allegation that Law 42 was intended to force Burlington to abdicate its rights under the PSCs. At any rate, as the tribunal in *Tippetts* stated, "the intent of the government is less important than the effects of the measures [...]."[725] In particular, the State's intent alone cannot make up for the lack of effects amounting to a substantial deprivation of the investment.

456. Having considered all the evidence, the Tribunal is not persuaded that Law 42 at 99% substantially deprived Burlington of the value of its investment. While Law 42 at 99% diminished Burlington's profits considerably, Burlington's allegations that its investment was rendered worthless and unviable have not been substantiated. Rather, the evidence shows that, notwithstanding the enactment of Law 42 at 99%, the investment preserved its capacity to generate a commercial return. Finally, although the evidence shows that Ecuador passed Law 42 without intending to comply with the tax absorption clauses, there can be no expropriation in the absence of substantial deprivation.

457. For the foregoing reasons, the Tribunal concludes that the effects of Law 42 at 99% were not tantamount to expropriation and, accordingly, that Law 42 at 99% did not expropriate Burlington's investment. Arbitrator Orrego Vicuña disagrees with this finding for the reasons explained in the attached dissenting opinion.

3.3. Did Ecuador expropriate Burlington's investment by enforcing Law 42 through the *coactiva* process, seizures and auctions?

3.3.1. Burlington's position

458. Burlington argues that the *coactiva* seizures and auctions constituted a direct and complete taking because they had the effect of destroying the value of its investment.[726] Specifically, Burlington alleges that (i) the *coactiva* process was in breach of the PSCs and the Tribunal's provisional measures order; (ii) the *coactiva*

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[725] *Tippetts*, *supra* note 655.

[726] CSM, ¶ 88.

process was a retaliation for Burlington's refusal to abdicate its rights under the PSCs; and (iii) the *coactiva* process was an expropriatory measure.[727]

459. First, the *coactiva* process breached the PSCs, which established that a percentage of the oil production would be allocated to Burlington. The process was also contrary to the Tribunal's provisional measures order.[728] On 14 February 2009, President Correa stated at a press conference that his country would "not pay attention to extra-regional authorities that attempt to tell us what to do or what not to do."[729] In line with this policy, Ecuador paid no heed whatsoever to the Tribunal's order that the *coactiva* process be discontinued.[730]

460. Second, Burlington submits that the *coactiva* process was a retaliation for its refusal to abandon its rights under the PSCs.[731] In June 2008, the Consortium began paying the Law 42 dues into a segregated account. For eight months, Ecuador voiced no objection against that practice. It did not register any complaint, place Burlington on notice of forfeiture, or make any effort to enforce Law 42.[732] It was only after Burlington stood its ground during the renegotiations, which broke down in December 2008, that Ecuador initiated the *coactiva* process.[733] The timing and discretionary nature of this process demonstrate that it was used as a retaliatory measure against Burlington following the breakdown of the renegotiations.[734]

461. Third, Burlington contends that the *coactiva* process was an expropriatory measure.[735] It notes that the auction process was a failure because no entity other than PetroEcuador was willing to participate in the auctions. Potential bidders were apparently dissuaded from participating because ownership over the oil cargoes was disputed.[736] This allowed PetroEcuador to acquire the auctioned oil at steep discounts ranging from 33% to 50%. The failed auction process prejudiced Burlington in that it resulted in reduced offsets of the alleged Law 42 debts. PetroEcuador, by contrast,

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727 *Id.*, at ¶ 87-88.
728 *Id.*, at ¶ 88.
729 Exh. C-51, p. 2; Mem., ¶ 237; CSM, ¶ 37.
730 CPHB, ¶¶ 94, 97, 99.
731 CSM, ¶ 87.
732 CPHB, ¶ 247.
733 *Id.*, at ¶ 93.
734 *Id.*, at 90, 93.
735 CSM, ¶¶ 88, 90-91.
736 *Id.*, at ¶ 53.

benefited from this failed process as it could acquire the oil at below-market prices, only to resell it at market prices.[737]

462. The *coactiva* process was a "complete taking" because it had the effect of destroying the value of Burlington's investment.[738] The *coactiva* process deprived Burlington of any income.[739] As a result, Burlington had to fund an investment from which it derived no revenue. Like the investors in *Benvenuti v. Congo* and *Starrett Housing v. Iran*, Burlington was deprived of the "right to earn revenue from the receipt of its production share."[740] Thus, the *coactiva* process was a direct taking of Burlington's tangible assets and of the economic benefits of its investment.[741] In addition, as it was found in *Saipem*, the *coactiva* process also expropriated Burlington's right to have this dispute adjudicated by an ICSID tribunal, as it was in breach of the Tribunal's provisional measures order.[742]

3.3.2. Ecuador's position

463. Ecuador states that the *coactiva* process merely enforced Law 42.[743] This process was the normal legal consequence of Burlington's failure to make its Law 42 payments.[744] Contrary to Burlington's allegations, (i) Ecuador duly considered the Tribunal's provisional measures before commencing the *coactiva* process; (ii) the *coactiva* process was initiated in application of Ecuadorian law and not in retaliation for Burlington's decision not to sign the transitory agreements; and (iii) the *coactiva* process was not an expropriatory measure.

464. First, it is not true, as Burlington would have the Tribunal believe, that Ecuador ignored the provisional measures. At the hearing, Ministers Pastor, Palacios and Pinto testified that they had given serious consideration to the Tribunal's recommendations.[745] Minister Pinto testified that Ecuador examined with great "caution the statements made by the Tribunal."[746] Under Ecuadorian law, public officials were under a duty to enforce Law 42, the breach of which would have resulted in civil and criminal liability. The

737 *Id.*, ¶¶ 54, 74; CPHB, ¶¶ 103-104; Tr. 738:10-739:2.
738 CSM, ¶ 88.
739 CPHB, ¶ 8.
740 CSM, ¶ 92.
741 *Id.*, at ¶ 90-91.
742 CPHB, ¶ 137.
743 RCM, ¶ 531.
744 RPHB, § 3.1.
745 RPHB, ¶ 359.
746 Tr. 728:6-8.

enforcement of Law 42 was therefore not a matter of discretion under Ecuadorian law.[747]

465. Second, Ecuador argues that the *coactiva* process was intended to enforce Law 42, not to retaliate against Burlington. Under Ecuadorian law, PetroEcuador was empowered to collect outstanding Law 42 payments.[748] In connection with the alleged eight-month delay in initiating the *coactiva* process, Ecuador claims that it did not want to hamper the ongoing negotiations with Burlington and that Law 42 dues were calculated and liquidated annually. Thus, Ecuador had to await the end of 2008 before enforcing Law 42.[749]

466. Third, Ecuador counters Burlington's argument that the *coactiva* process was expropriatory because PetroEcuador purchased the seized production at a "steep discount." [750] At the first auction, no bids were submitted; thus, a second auction round was arranged. At this second auction, PetroEcuador submitted a bid for 50% of the appraised value of the oil, as allowed under Ecuadorian law. In all subsequent auctions, PetroEcuador submitted bids at the first round for slightly more than two-thirds of the appraised value of the oil, again in conformity with Ecuadorian law.[751]

467. PetroEcuador submitted bids only because there were no other bidders due to the Consortium's fault. In fact, the Consortium threatened legal action against any company that would acquire the seized oil. Dissuaded by these threats, no other company submitted bids.[752] This interference with the auctions harmed both the State and the Consortium, as it delayed the settlement of the outstanding Law 42 payments. Therefore, Burlington and Perenco have only themselves to blame if the auction process resulted in "reduced offsets" of the overdue Law 42 payments.[753]

468. At any rate, Burlington has failed to show that the *coactiva* process had the effect of destroying the value of its entire investment. The *coactiva* process was economically neutral, since Burlington's Law 42 debts were extinguished as its oil was seized.[754] Additionally, Burlington has wrongly argued, relying on *Saipem*, that Ecuador's decision

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747 RPHB, ¶¶ 361-364.

748 RCM, ¶¶ 531-532, 536.

749 RPHB, ¶¶ 372-375.

750 RCM, ¶¶ 541-544.

751 *Id.*, at ¶¶ 545-546.

752 *Id.*, at ¶¶ 547-549.

753 *Id.*, at ¶¶ 550-551.

754 *Id.*, at ¶ 556; PO1, ¶ 84.

not to comply with the Tribunal's recommendation amounted to expropriation. *Saipem's* broad interpretation of the term investment, expressly dismissed in *GEA v. Ukraine*, is inapplicable to provisional measures the goal of which is merely to prevent an aggravation of the dispute.[755] In short, Burlington has not shown that the *coactiva* process was expropriatory.[756]

3.3.3. Analysis

a. Standard for expropriation

469. Burlington argues that the *coactiva* measures constituted a direct and complete expropriation of its investment. Relying on *LG&E v. Argentina*, Ecuador has alleged that direct expropriation is the "forcible appropriation by the State of the tangible or intangible property of individuals by means of administrative or legislative action."[757] Burlington has not taken issue with this definition, and rightly so.

470. In this investment dispute, the "property" protected by the Treaty's expropriation clause is Burlington's entire investment in Ecuador ("[i]nvestments shall not be expropriated [...]"). The forcible appropriation or taking, however, only concerned the oil that was seized and not the entire investment as it was defined above. Thus, under the Treaty, there can be no direct expropriation of the investment as a result of the seizures *per se*.

471. This being so, Burlington's submission goes further in the sense that it argues that the effect of the *coactiva* measures was not only to deprive it of the oil seized and the related revenue but more generally to destroy the economic value of its investment. In the Tribunal's view, such an effect comes closer to indirect expropriation than to a direct taking. As a result, it will resort to the same test as the one applied to the alleged expropriation by way of Law 42. In fact, Ecuador has argued – and Burlington has not objected – that the following requirements needed to be met:

(i) a substantial deprivation of the value of the whole investment ("Burlington has [] failed to demonstrate how the *coactiva* procedure has the alleged effect of destroying the value of [its] entire investment";

(ii) a permanent measure ("[a]n ephemeral taking is not expropriation"); and

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755 RPHB, ¶¶ 382-390.

756 RCM, ¶ 559.

757 RCM, ¶ 466; *LG&E v. Argentina*, Decision on Liability of 3 October 2006, at ¶ 187 (Exh. EL-140).

(iii) a measure not justified under the police power doctrine ("a State may justify deprivations of private property on the basis of its police powers in order to promote the general welfare and enforce its laws on its territory.")[758]

b. Did the *coactiva* measures enforcing Law 42 expropriate Burlington's investment?

472. The first *coactiva* seizure took place on or around 27 March 2009, when the Consortium received notice from the *coactiva* judge that an oil shipment had been seized and valued by an expert.[759] On 16 July 2009, Ecuador took possession of the fields, a new measure which, although it is part of a continuous causal chain, is analytically independent from the *coactiva* measures.[760] Thus, the *coactiva* measures proper, *i.e.* those *coactiva* measures not overlapping with Ecuador's intervention in the Blocks, only took place between 27 March and 15 July 2009. It is this three-and-a-half month period that the Tribunal will address here.

473. Pursuant to the standard set forth above, the Tribunal must ascertain whether the *coactiva* measures were a "forcible appropriation" that (i) substantially deprived Burlington of the value of its investment, (ii) on a permanent basis, and (iii) found no justification in the police powers doctrine.

474. The Tribunal must first ascertain whether the *coactiva* measures caused a substantial deprivation of the value of Burlington's investment. In principle, the economic impact of the *coactiva* measures should have been no greater than the economic impact of the tax they were designed to enforce, *i.e.* Law 42 at 99%. As Ecuador has submitted, the economic effect of the *coactiva* measures should be "economically neutral"[761]: for every dollar of oil seized and auctioned off, a dollar of Law 42 debt would have been extinguished. After all, in its letter of 2 July 2009, Ecuador had vouched to confine the *coactiva* measures to the "oil equivalent in value to the outstanding debt."[762]

475. In reality, the *coactiva* measures did not prove to be "economically neutral." They compounded the effects of the Law 42 tax at 99%. This happened because there were no bidders other than PetroEcuador during the various auction rounds held. As the sole bidder, PetroEcuador consistently made below market price bids, as is allowed under Ecuadorian law in those circumstances. The end result was that the auction

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758 RCM ¶ 556, ¶ 662 and ¶ 626.

759 CSM, ¶ 45.

760 *Id.*, ¶ 65; RCM, ¶ 578.

761 RCM, ¶ 556.

762 Ecuador's letter to ICSID of 2 July 2009, p. 4 (Exh. C-202).

proceeds from the oil seized were consistently lower than the actual market value of that oil.[763] Consequently, more oil than the "oil equivalent in value to the outstanding debt" would have to be seized and auctioned off to cancel that Law 42 debt. In short, the *coactiva* procedure as a matter of fact aggravated the economic impact of Law 42 at 99%.

476. The Tribunal must thus ascertain whether the compounded economic effects of the *coactiva* measures, over and above the effects of Law 42 at 99%, were attributable to Ecuador. This boils down to determine whether the absence of bidders other than PetroEcuador during the multiple auction rounds was attributable to Ecuador. Burlington initially conjectured that the reason for the absence of other bidders was that "ownership of the [oil] cargoes was in dispute and subject to the provisional measure rulings of the *Burlington* and *Perenco* tribunals."[764] Apart from the witness statement of Alex Martinez,[765] there is no evidence in support of this assertion.

477. For its part, Ecuador countered, with evidentiary support, that the reason why no other bidders participated in the auctions was that "the Consortium threatened to take legal action against any company that would purchase the [seized] oil."[766] Burlington has not denied this allegation, nor submitted evidence that would offer a different explanation for the way in which the auctions unfolded.[767] Accordingly, there is no proper evidentiary basis to attribute to Ecuador the absence of bidders other than PetroEcuador during the auction rounds. For this reason, the Tribunal finds that the compounded effects of the *coactiva* measures, over and above the effects of Law 42 at 99%, are not attributable to Ecuador.

478. Burlington claims that the *coactiva* measures were expropriatory insofar as they had "the effect of destroying the value of [its] investments."[768] These measures would have destroyed the value of Burlington's investment because they deprived it of the right to

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763 CSM, ¶¶ 53, 57, 74-76; RCM, ¶¶ 543-547.

764 CSM, ¶ 53.

765 Second Supplemental Witness Statement of Alex Martinez, 29 September 2010 (hereinafter Martinez Second Supp. WS), ¶ 10.

766 RCM, ¶ 548.

767 Burlington did argue that "private parties submitted higher bids than PetroEcuador" at the last recorded auction of 16 April 2010, but these bids "were invalidated by the *coactiva* judge" (CSM, ¶ 75). The Tribunal notes that this occurred only at the last auction in April 2010, that is, well beyond the March-July 2009 period under analysis herein. In addition, Burlington has not alleged that the invalidated bids were wrongly invalidated. Thus, this allegation is insufficient to demonstrate that the reason why there were no bidders other than PetroEcuador during the various auction rounds was attributable to Ecuador.

768 CSM, ¶ 88.

earn a revenue. The Tribunal cannot agree. Barring the issue of the absence of bidders at the auctions – which is not attributable to Ecuador –, the economic effects of the *coactiva* measures were coterminous with those of Law 42 at 99%. Since Law 42 at 99% did not deprive Burlington of the right to earn a revenue from its investment, the same conclusion must hold true with respect to the *coactiva* measures. It is true that oil seizures appear to be a more intrusive form of deprivation than tax liabilities, but from an economic standpoint the impact of the *coactiva* measures is indistinguishable from that of Law 42 at 99%.[769]

479. Burlington specifically argues that it was deprived of the right to earn a revenue, like the investors in *Benvenuti v. Congo* ("*Benvenuti*") and in *Starrett Housing v. Iran* ("*Starret Housing*").[770] Indeed, Ecuador's *coactiva* measures seized Burlington's entire oil participation share – and hence its entire revenues – for the period in which they were in place. But this was simply because they were enforcing the sum total of Burlington's unpaid Law 42 taxes for 2008.[771] Once these overdue taxes had been collected, Burlington would have continued to receive its share of oil production – with its economic value diminished by any new Law 42 taxes. At the end of the day, the economic effect of the *coactiva* measures would have been no greater than that of the Law 42 tax itself.

480. In addition, neither *Benvenuti* nor *Starret Housing* are entirely apposite to this case. While the tribunal in *Benvenuti* "held Congo liable for confiscating the first shipment of bottled water" produced by the joint venture between Benvenuti and Congo, it did not hold that such measure was expropriatory.[772] In *Starrett Housing*, on the other hand,

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769 In PO1, the Tribunal noted that Respondent's argument that the *coactiva* measures were economically neutral relative to the Law 42 tax "misse[d] the point" (PO1, ¶ 84). The context in which the Tribunal made this statement bears little resemblance to the present one. The purpose of PO1 was to provisionally forestall an aggravation of the dispute on the basis of the Tribunal's *prima facie* acquaintance with the case. Because oil seizures are more intrusive than tax liabilities, they posed a greater risk of "deteriorat[ing] the relationship" between the Parties and thus of aggravating the dispute.

770 CSM, ¶¶ 91-92.

771 Burlington did not pay the Law 42 tax to Ecuador, but rather placed the monies directly into a segregated account (CSM, ¶ 33; RCM, ¶¶ 562, 590).

772 CSM, ¶ 91; *S.A.R.L. Benvenuti & Bonfant v. Government of the People's Repulic of Congo*, Award of 8 August 1980 (Exh. CL-21). In reality, Congo did not "confiscate[] the first shipment of bottled water", as argued by Burlington. Rather, Siacongo, a State corporation, simply failed to pay for the 800,000 bottles delivered by Plasco, the joint venture between Benvenuti and Congo (*Id.,* at ¶¶ 2.17, 4.38-4.40). Specifically, Benvenuti complained that "[t]he Government did not fulfil its contractual economic obligations with respect to Plasco […] [as it did not] take steps to force Siacongo, a State company, to perform its contract with Plasco" (*Id.,* at ¶ 4.8(3)). The issue was thus one of contract performance, not of expropriation. While there was an expropriation claim, this claim concerned Benvenuti's shares in Plasco, not a shipment of bottled water) (*Id.,* at ¶¶ 4.61-62, 4.73).

the tribunal held that Iran had expropriated the claimants' right to "collect the proceeds of the [apartment] sales",[773] but only after finding that the claimants had been deprived of the "effective use and control"[774] of its property rights in the investment – a finding this Tribunal has not made at this juncture. Despite the *coactiva*, Burlington kept effective use and control over the Blocks, the oil wells and its subsidiary. These cases are thus of limited assistance for purposes of this case.

481. Furthermore, relying on *Saipem v. Bangladesh,* Burlington contends that the continuation of the *coactiva* process despite the Tribunal's provisional measures "constituted an expropriation of Burlington's right under the PSCs to have this dispute resolved by an ICSID tribunal."[775] While the Tribunal certainly does not condone Ecuador's failure to abide by the provisional measures, it cannot agree with Burlington's contention. Even assuming Burlington had a right to ICSID arbitration under the PSCs, *quod non*, the non-compliance with an order for provisional remedies, which only creates procedural rights during the arbitration (the situation here) cannot be assimilated to a court's decision to annul a final award (the situation in *Saipem*).[776] In any event, the very fact that Burlington continues to pursue this arbitration condemns this argument.

482. With respect to the purpose of the *coactiva* measures, Burlington also argues that the timing and discretion of the *coactiva* measures show that they were in retaliation for its adopting self-protective measures and insisting on preserving its contractual rights.[777] Ecuador objects that it did not wish to create a heavy-handed environment during negotiations with Burlington and that the Law 42 payments were calculated and liquidated annually, so that enforcement action could not have started in 2008.[778] The Tribunal finds that both Parties' explanations are plausible and certainly not mutually exclusive. In any event, the Tribunal regards the effects of the measures, rather than their underlying motivation, as the dispositive consideration.

483. Having reached the conclusion that the *coactiva* measures did not effect a substantial deprivation of Burlington's investment, it is unnecessary to review whether these measures were permanent or not. In point of fact, what must be permanent for

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773 *Starrett Housing Corporation v. Islamic Republic of Iran*, Iran-US CTR 122, Interlocutory Award of 19 December 1983, p. 29 (Exh. CL-20).

774 *Id.*, at p. 27.

775 CPHB, ¶ 137.

776 *Saipem*, Award of 30 June 2009. (Exh. CL-159).

777 CPHB, ¶¶ 90-93.

778 RPHB, ¶¶ 365-375.

purposes of expropriation is the substantial deprivation. If there is no substantial deprivation, the question of whether such deprivation is permanent becomes moot. This is why Burlington's reliance on *Tecmed v. Mexico* ("*Tecmed*") and *Metalclad v. Mexico* ("*Metalclad*") is not entirely germane to the facts of this case.

484. Burlington relies on *Tecmed* and *Metalclad* to argue that ICSID tribunals "have not countenanced a State's confiscation of the fruit that is an investor's reward for its efforts."[779] But in *Tecmed*, the tribunal held that measures are expropriatory only if they are "irreversible and permanent"[780] and so deprive the investor of the "use and enjoyment"[781] of its investment *as if the right to earn revenue "had ceased to exist."*[782] For its part, the *Metalclad* tribunal stated that Mexico's measure "permanently prevented"[783] the use of the investment and negated "the possibility of any meaningful return", as a result of which the investor had "*completely lost its investment.*"[784] By contrast, it cannot here be affirmed that Burlington's right to earn revenue ceased to exist or that its investment was completely lost.

485. In sum, the Tribunal finds that the *coactiva* measures did not substantially deprive Burlington of the value of its investment. In these circumstances, there is no need to examine whether the effects of these measures were permanent or whether they were justified under the police powers doctrine. For these reasons, the Tribunal cannot but conclude that the *coactiva* measures did not constitute an expropriation of Burlington's investment. Arbitrator Orrego Vicuña disagrees with this finding for the reasons explained in the attached dissenting opinion.

3.4. Did Ecuador expropriate Burlington's investment by taking possession of Blocks 7 and 21?

3.4.1. Burlington's position

486. Ecuador's physical takeover of Blocks 7 and 21 in July 2009 completely expropriated Burlington's investment. This was the final step in a series of expropriatory measures.[785] As in *Vivendi II*, Ecuador's measures rendered the investment so unprofitable that Burlington was left with no rational choice other than to suspend

[779] Mem., ¶¶ 446-449.

[780] *Tecnicas Medioambientales TECMED S.A. v. The United Mexican States*, Award of 29 May 2003, ¶ 116 (Exh. CL-88).

[781] *Id.*, at ¶ 115.

[782] *Id.* (emphasis added).

[783] *Metalclad*,at ¶ 96

[784] *Id.*, at ¶ 113 (emphasis added).

[785] CSM, ¶ 93.

operations.[786] Burlington submits (i) that its decision to suspend operations in the Blocks was legally and economically justified; (ii) that Ecuador's takeover of the fields was arbitrary as there is no evidence that there was a real risk of damage to the Blocks; and (iii) that Ecuador's takeover of the Blocks constituted a complete and direct expropriation of Burlington's investment.

487. First, Burlington argues that the suspension of operations was legally justified. It "was a direct consequence of Ecuador's violations of its international law obligations, including the violation of this Tribunal's Provisional Measures Order."[787] In these circumstances, Burlington could rely on the *exceptio non adimpleti contractus*, "whereby a party to a contract may suspend performance in the event that the other party is in breach […]."[788]

488. Burlington may rely on this exception under both Ecuadorian and international law. Ecuador wrongly alleges that, as a matter of Ecuadorian law, this exception does not apply to administrative contracts such as the PSCs. However, "Ecuador's own legal expert, Dr. Aguilar [...] recognizes that there is no decision or legislation in Ecuador [...] to support this."[789] Moreover, it is clear "from any logical analysis [that] hydrocarbons production is not a public service"[790] and there is thus no need to guarantee its continuous operation.[791] Thus, Burlington argues that "the Consortium's suspension was justified under Ecuadorian law."[792]

489. Burlington also relies on the *exceptio non adimpleti contractus* as a matter of international law.[793] International tribunals have held that this exception does apply "when the continued operation of services becomes unreasonable in light of State measures."[794] In *Azurix*, the tribunal stated that it would take this exception "into

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786 *Id.,* at ¶ 96; CPHB, ¶¶ 71-73.

787 Tr. 63:1-4; see also Tr. 63:5-8.

788 Tr. 64:17-20.

789 Tr. 65:2-6.

790 Tr. 1292:14-15.

791 Tr. 1292:8-18. Burlington acknowledges that hydrocarbons production may be an activity "in the public interest as a revenue generator for the State", but argues that it is not a public service by noting that one does not usually receive a "monthly bill from [the] local hydrocarbons producer" (Tr. 1292:16-18).

792 CSM, ¶ 78 n. 134.

793 Burlington states that the legality of its decision to suspend operations cannot be negated "as purely a question of Ecuadorian law", for that would "deny Burlington the autonomous protection of international law and frustrate the purpose of the Treaty" (Tr. 64:9-14). It further maintained that it is well-established that "international law prevails over domestic law" (Tr. 64:4-7).

794 Tr. 65:12-14.

account" despite the respondent's allegations that it did not apply.[795] In *Vivendi II*, the tribunal held that the State had undermined the investment to the point where it was "utterly unrealistic to suggest that" the investor "should simply have stayed put, continuing to provide services for which it was not being paid and accepting ever increasing losses."[796]

490. At any rate, the Hydrocarbons Law itself allowed the suspension of operations "for up to 30 days without just cause"[797] and "indefinitely for just cause"[798] before the State could consider terminating the PSCs. Here, Burlington's suspension was for "just cause" because "the only reason for the suspension"[799] was Ecuador's breach of the Tribunal's order. On the other hand, Ecuador's reliance on its 2008 Constitution is self-serving and should be rejected.[800] The 2008 Constitution, which declared that hydrocarbons production was a "public service" and hence not subject to suspension, only entered into effect *after* foreign investors brought international claims against Ecuador based on Law 42.[801]

491. Burlington further maintains that the suspension of operations was economically justified. It was unreasonable to expect that Burlington should have continued to fund an investment from which it could no longer derive any revenue.[802] As a result of the *coactiva*, the Consortium was responsible for all the costs and risks of production, but received zero revenue in return.[803] At the hearing, counsel for Burlington stated that, "despite reducing operational costs to the minimum"[804], the Consortium's "costs still totalled some $ 15 million from the first seizure of crude until the physical takeover of the Blocks."[805] In these circumstances, Burlington had no rational choice other than to suspend operations in the Blocks.[806]

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795 Tr. 65:14-66:12; COSS, # 61 ("Overview and Legal Framework").
796 Tr. 68:17-69:6; COSS, # 64 ("Overview and Legal Framework").
797 Tr. 67:18-19.
798 Tr. 67:16-18.
799 Tr. 1289:7-9.
800 CPHB, ¶ 119.
801 *Id.*
802 CSM, ¶ 89.
803 CPHB, ¶ 10.
804 Tr. 59:19-20.
805 Tr. 59:20-22.
806 CPHB, ¶ 10.

492. Second, Burlington submits that Ecuador's physical takeover of the fields was arbitrary as there was no real risk of damage to the Blocks.[807] Ecuador's evidence only shows a theoretical risk of damage following a shut-in. However, there is also a theoretical risk of damage when the wells are in operation. Specifically, the RPS report draws no meaningful conclusion on the likelihood that such theoretical risks would actually materialize.[808] The report is, moreover, based on incomplete information,[809] and its conclusions regarding the risks of damage to the Blocks following suspension are unsubstantiated.[810]

493. The Consortium planned to suspend operations using a well-developed protocol to minimize the risk of harm. This protocol was based on the Consortium's historical experience of suspending well operation for routine reasons.[811] Isolation tools would have prevented cross-flow, and there were no concerns of solids migrating into the reservoir or of water incompatibility.[812] As Mr. Martinez declared, "it was in the best interest of the Consortium to ensure that suspension was conducted in a proper way."[813] Thus, the theoretical risks of damage mentioned in the RPS report did not apply to Blocks 7 and 21.[814]

494. The following facts belie Ecuador's alleged fears of economic and environmental damage: (i) six months prior to the scheduled suspension, Ecuador itself asked Burlington and Ecuador to suspend operations in response to OPEC restrictions; (ii) recent field suspensions due to power failures showed no negative effects on either production or the environment; and (iii) the day of the suspension Ecuador's Minister left the country to attend celebrations in Bolivia.[815] In reality, Ecuador has raised concerns about the risks of suspension for the first time in this arbitration only to justify its takeover and final expropriation of Blocks 7 and 21.[816]

495. Third and last, Burlington argues that Ecuador's physical takeover of the Blocks was a complete and direct expropriation of Burlington's investment. This was the final step in

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807 *Id.*, at ¶ 107.
808 *Id.*
809 *Id.*, at ¶¶ 22, 28.
810 *Id.*, at ¶¶ 25, 28.
811 *Id.*, at ¶¶ 108-109.
812 *Id.*, at ¶¶ 112-114.
813 *Id.*, at ¶ 108; Martinez Second Supp. WS, ¶ 16.
814 CPHB, at ¶ 112.
815 *Id.*, at ¶ 11.
816 *Id.*, at ¶ 118.

Ecuador's series of unlawful expropriatory measures[817] and the inevitable consequence of Burlington's refusal to abdicate its rights under the PSCs.[818] It culminated Ecuador's campaign to force Burlington to migrate to a legal regime that was more beneficial to the State in times of high oil prices. As a result of this measure, Ecuador is in possession of Burlington's entire investment.[819] Thus, although no formal decree of expropriation was issued, the takeover was a complete and direct expropriation of Burlington's investment.[820]

3.4.2. Ecuador's position

496. Ecuador alleges that its intervention in the Blocks was not expropriatory.[821] On the contrary, Burlington's illegal decision to suspend operations was a "cynical gamble" designed to force Ecuador to intervene and thus create the appearance of direct expropriation.[822] Specifically, Ecuador submits (i) that Burlington's threatened suspension of operations in the Blocks was illegal[823] and not economically justified;[824] (ii) that Burlington's decision threatened significant economic loss to Ecuador and other serious harm to the Blocks;[825] and (iii) that the intervention was not expropriatory but was a temporary measure adopted in response to Burlington's unlawful conduct – as such, it was necessary, appropriate and proportionate under the circumstances.[826]

497. First, Ecuador submits that Burlington's decision to suspend operations in the Blocks was in breach of Ecuadorian law and the PSCs.[827] Under Ecuadorian law, the suspension of operations was contrary to the Constitution and to the Hydrocarbons Law.[828] Under the PSCs, Burlington committed to comply with Ecuadorian laws and regulations; further, the PSC for Block 7 specifically provided that the contractor had to continuously "perform operations in the Contract Area."[829] In accordance with

817 CSM, ¶ 93.
818 CPHB, ¶ 120.
819 CSM, ¶ 81.
820 *Id.*, at ¶ 93.
821 RCM, § 7.
822 *Id.*, at ¶¶ 565, 620.
823 *Id.*, at ¶¶ 596-602.
824 *Id.*, at ¶¶ 589-595.
825 *Id.,*at ¶ 560.
826 *Id.*, at ¶ 561.
827 *Id.,* at 560; RPHB, ¶ 425.
828 RCM, at ¶¶ 597-600.
829 *Id.*, at ¶¶ 601-602.

Ecuadorian administrative law, Burlington was bound to perform its obligations despite any alleged breach on the part of Ecuador.[830]

498. Burlington had no legal justification to suspend operations in the Blocks.[831] Whether as a matter of Ecuadorian or international law, it may not rely on the *exceptio non adimpleti contractus*. As a matter of Ecuadorian law, Burlington cannot rely on this exception because this exception does not apply to administrative contracts such as the PSCs and because Ecuador did not breach the PSCs.[832] As a matter of international law, the cases upon which Burlington relies are distinguishable from this case. Unlike Burlington, the investors in *Azurix* and *Vivendi II* sought to terminate their contract with the State and did not suspend operations because they were a party to a public service contract.[833]

499. In addition, Burlington did not have "just cause" to suspend operations within the meaning of the Hydrocarbons Law. Ecuador's non-compliance with the Tribunal's recommendations could not constitute "just cause" for suspension. In fact, "the recommendations were 'recommendations', *i.e.* not legally binding on Ecuador." [834] At the hearing, Ministers Palacios, Pastor and Pinto all testified that, in Ecuador's understanding, the Tribunal's provisional measures were recommendations and therefore non-binding. In the *caducidad* decrees, Minister Pastor specifically dismissed the Consortium's argument that there was "just cause" for suspension under the Hydrocarbons Law.[835]

500. Nor was Burlington's decision to unilaterally suspend operations economically justified. The *coactiva* did not leave Burlington with the "crippling prospect of continuing to operate the Blocks for the exclusive benefit of Ecuador."[836] On the contrary, as confirmed by Fair Links, Burlington had the financial wherewithal to continue operating the Blocks. The Consortium placed USD 327.4 million into a segregated account after it illegally stopped making Law 42 payments in June 2008. Those funds could have been used to keep the Blocks in operation.[837] And as Burlington itself conceded, only

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830 *Id.*, at ¶¶ 604-605.

831 RPHB, ¶ 408.

832 *Id.*, at ¶¶ 415-420.

833 *Id.*, at ¶¶ 422-424.

834 *Id.*, at ¶¶ 409-410 (internal parentheses omitted).

835 *Id.*, at ¶¶ 411-412; Witness Statement of Wilson Pastor Morris of 17 January 2011, Annex 4 (p. 20) and Annex 5 (p. 20).

836 RCM, at ¶ 589.

837 *Id.*, at ¶¶ 590-592; Tr. 461:17-466:12.

minimum investment was necessary to keep operating the Blocks after Law 42 was passed.[838]

501. Second, Burlington's decision to suspend operations in the Blocks threatened significant economic loss to Ecuador and other serious and permanent harm to the Blocks. As explained by RPS, Burlington's decision to shut down the oil wells created four types of risk: risk of economic loss to Ecuador, and risk of reservoir, mechanical and environmental damage.[839] As RPS observed, the shut-in of oil production would have caused economic loss to Ecuador "as a result of the deferment of production and the associated revenue."[840] The extent of this loss would be a function of the length of the shut-in and of the production rate of the wells that are shut in.[841]

502. The shut-in also threatened to cause serious and permanent reservoir, mechanical and environmental damage to Blocks 7 and 21.[842] Reservoir damage is the deterioration of flow capacity and/or the physical loss of oil reserves. This risk was significant in Blocks 7 and 21, as most of their reservoirs are water driven.[843] Mechanical damage is corrosion to the production stream of the wells, such as the wellbore tubular and pumps.[844] RPS concluded that there is "little doubt"[845] that this damage will occur to the wells in Blocks 7 and 21. Finally, environmental damage can be caused by leaks and spills related to the shut-in.[846]

503. Third, Ecuador submits that its intervention was not expropriatory but was rather a temporary measure adopted in response to Burlington's unlawful conduct – as such, it was necessary, appropriate and proportionate under the circumstances.[847] In *Saluka v. Czech Republic*, the tribunal held that "a deprivation can be justified if it [...] [is] aimed at the maintenance of public order."[848] The *Saluka* tribunal determined that the context of the impugned measure was "critical"[849] to determine its validity. As the

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838 *Id.*, at ¶¶ 593-595.
839 *Id.*, at ¶¶ 613, 618-619.
840 RPS ER, ¶ 144 (4th bullet point).
841 *Id.*; RCM, ¶ 618.
842 *Id.,* at ¶¶ 610-613.
843 *Id.*, at ¶¶ 614-615.
844 *Id.*, at ¶ 616.
845 *Id.*; RPS ER, ¶ 55.
846 RCM, ¶ 617; RPS ER, ¶ 56.
847 RCM, ¶ 624.
848 *Saluka*, at ¶ 254 (Exh. CL-100.); RCM, ¶ 628.
849 *Saluka*, at ¶ 264 (Exh. CL-100.); RCM, ¶ 628

State's measure in *Saluka*, Ecuador's intervention was permissible regulatory action because it enforced Ecuadorian law.[850]

504. The intervention in the Blocks merely enforced Ecuadorian law in light of Burlington's "manifestly illegal" decision.[851] In similar circumstances, the tribunal in *Payne v. Iran* recognized that a State's decision to take control of a company could be justified on the ground that the claimant had "abandoned or […] ceased"[852] its activities. Additionally, Ecuador's measure was necessary to avoid significant economic loss and the risk of permanent damage to the Blocks. It was also appropriate because Ecuador entered the Blocks without using force. It was equally proportionate as the means employed were suited to the ends of protecting the Blocks.[853]

505. Likewise, Ecuador's intervention did not expropriate Burlington's investment because it was intended to be temporary.[854] In *Motorola v. Iran*, the tribunal held that if a State measure is temporary and necessary on account of claimant's actions or omissions, it cannot constitute expropriation.[855] As in *Motorola*, Ecuador's intervention would have ceased once the Consortium resumed operations.[856] The goal of this measure was not to permanently transfer the investor's property to the State. Accordingly, Ecuador's intervention in the Blocks cannot constitute expropriation.[857]

3.4.3. Analysis

a. Standard for expropriation

506. Burlington argues that the takeover of the Blocks constituted a direct expropriation of its investment. Ecuador does not object to reviewing the takeover under the standard applicable to direct expropriation and the Tribunal agrees. Accordingly, a State measure constitutes expropriation under the Treaty if (i) the measure deprives the investor of his investment; (ii) the deprivation is permanent; and (iii) the deprivation finds no justification under the police powers doctrine. The Tribunal will examine these elements in reverse order.

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850 *Id.,* at ¶¶ 632-661.

851 *Id.,* at ¶ 633.

852 *Thomas Earl Payne v. The Government of the Islamic Republic of Iran*, Iran-U.S. Cl. Tribunal, Award of 28 June 1988, ¶ 21 (Exh. EL-153); RCM, ¶ 645.

853 RCM, ¶¶ 647-661.

854 *Id.,* at ¶ 624.

855 *Motorola Inc. v. Iran National Airlines Corporation and The Government of the Islamic Republic of Iran*, Iran-U.S. Cl. Tribunal, Award of 28 June 1988, at ¶ 59 (Exh. EL-154); RCM, ¶ 645.

856 RCM, ¶¶ 663-666.

857 *Id.,* at ¶ 662.

b. Did Ecuador's taking of possession of Blocks 7 and 21 expropriate Burlington's investment?

507. On 16 July 2009, Ecuador entered and took possession of Blocks 7 and 21 after Burlington had announced, three days earlier, that operations in the Blocks would be suspended. The Tribunal must determine whether Ecuador's taking of possession of Blocks 7 and 21 constituted an expropriation of Burlington's investment. To that end, the Tribunal will first review whether Ecuador's measure was justified under the police powers doctrine. This review raises two sub-issues, namely, (i) the conditions under which Ecuador could intervene in Blocks 7 and 21 as a result of the Consortium's decision to suspend operations in Blocks 7 and 21, and (ii) the nature of the risks that the Consortium's decision to suspend operations posed to Ecuador and to the Blocks. Thereafter, the Tribunal will address (iii) the effects of Ecuador's measure on Burlington.

(i) *The conditions under which Ecuador could intervene in Blocks 7 and 21*

508. The Tribunal agrees with Ecuador's submission that, as held in *Saluka*, the context of a State measure is "critical"[858] to determine the nature of the resulting deprivation. In this case, the context of Ecuador's intervention revolves around the legality of Burlington's decision to suspend operations. According to Burlington, the decision to suspend operations was legally justified under Ecuadorian and international law; according to Ecuador, the decision was in breach of Ecuadorian law, international law and the PSCs.

509. Ecuadorian law governed the PSCs, which regulated in detail the rights and obligations of Ecuador and of Burlington's subsidiary, Burlington Oriente. The Tribunal therefore considers that Ecuadorian law should at least initially govern the question of whether the suspension was legal. In keeping with this opinion, both Parties have expressly relied on Ecuadorian law to argue for or against the legality of Burlington's suspension of operations.

510. It is true that Burlington has *also* relied on the *exceptio non adimpleti contractus* under international law. In the words of counsel for Burlington, this exception means that "a party to a contract may suspend performance in the event that the other party is in breach […]."[859] However, when that contract is, as the PSCs are here, specifically

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[858] *Saluka*, at ¶ 264. ("[I]nternational tribunals must consider the circumstances in which the question [of whether there is expropriation] arises. The context within which an impugned measure is adopted and applied is critical to the determination of its validity.") (Exh. CL-100).

[859] Tr. 64:17-20.

governed by the law of the host State, the issue of whether a party is in breach and, consequently, whether the other party may suspend performance, are to be answered initially by reference to that law.

511. Under Ecuadorian law, the most relevant provision on the issue of suspension of operations is Article 74 of the Hydrocarbons Law ("Article 74"). This provision spells out the circumstances under which the Ministry of Non-Renewable Resources (formerly the Ministry of Energy and Mines) may terminate a hydrocarbons contract by way of a *caducidad* declaration. As counsel for Ecuador explained at the hearing, "*[c]aducidad* is such an important element in the participation contracts in Ecuador that the [contracting] [p]arties expressly incorporated Article 74 [...] into the [PSCs]. It wasn't enough to say [that] the Hydrocarbons Law applies to the [c]ontract."[860] Although *caducidad* and the taking of possession are two different measures – one *de facto*, one *de jure* –, the conditions under which *caducidad* may be declared are also relevant to examine whether Ecuador was entitled to intervene in the Blocks by reason of an unlawful suspension.

512. In its relevant part, Article 74 of the Hydrocarbons Law provides the following:

> "Article 74. The Ministry of [Non-Renewable Natural Resources] may declare the *caducidad* of contracts provided that the contractor:
>
> […]
>
> 4. <u>Suspends exploitation operations for more than thirty days without just cause</u>, previously determined by the Ministry to be so, except for force majeure or act of God, which shall be notified to PETROECUADOR within a ten-day period […]"[861] (emphasis added).

513. Ecuador argues that the Consortium was under a legal and contractual duty to continuously operate the Blocks. The Tribunal is not convinced that this was the case. Under the plain terms of Article 74, the Ministry may not terminate a PSC if there is no suspension "for more than thirty days", regardless of whether there is "just cause" for the suspension or not. Nor may the Ministry terminate a PSC if the suspension is longer than thirty days but there is "just cause." In brief, the Hydrocarbons Law authorizes contractors to suspend operations without incurring the risk of *caducidad* for up to 30 days, regardless of "just cause", and for more than 30 days with "just cause."

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[860] Tr. 303:15-20.

[861] Exh. EL-92, p. 25 (Tribunal's translation).

514. The 2008 Ecuadorian Constitution does not lead to a different conclusion. It prohibits the “suspension of [...] hydrocarbons production"[862] *qua* public service, but it also provides that "the law shall establish the limits"[863] to ensure the operation of these services. In the case of hydrocarbons production, these limits are those set in Article 74. Ecuador has not alleged that the 2008 Constitution somehow amended the scope of the pre-existing Article 74.

515. According to Article 74, Ecuador has the power to declare the *caducidad* of a PSC by reason of the suspension of operations, and hence eventually to intervene in the face of a an unlawful suspension, if the suspension of operations lasts for more than 30 days.[864] This condition is not met here.

516. Ecuador took possession of the Blocks on 16 July 2009, the very day on which suspension was scheduled to begin: "on 16 July 2009 – 2 hours after the scheduled suspension [...] government officials entered the Blocks and took the necessary measures [...] to guarantee the continuance of operations […]."[865] By Ecuador's own admission, the Blocks were still operating at that moment: "Blocks 7 and 21 were [] still operating at 2 pm, on 16 July 2009."[866] Ecuador submits that the suspension did not go into effect at the scheduled time because the Consortium's employees ignored the instructions to suspend operations.[867] Whatever the exact cause, the fact remains that the operations were not suspended before Ecuador took possession of the Blocks. The Consortium merely "threatened suspension",[868] as Ecuador conceded in its submissions. This is manifestly insufficient to justify *caducidad* and intervention under the terms of Article 74 of the Hydrocarbons Law.

517. Moreover, even if the suspension of operations had occurred and lasted more than 30 days,[869] the Tribunal would have concluded that the Consortium had "just cause". This

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862 Exh. P-12 (exhibit submitted by PetroEcuador when it was still part of this case), Art. 326, para. 15.

863 *Id.*

864 This is an essential but not a sufficient condition for a *caducidad* declaration. In addition to a more than 30-day suspension, the contractor must have no "just cause" for suspension. Hence, the contractor can suspend operations for more 30 days without being subject to *caducidad* on condition that it has "just cause" to do so.

865 RCM, ¶ 578.

866 *Id.*

867 *Id.*, at ¶ 577.

868 RCM, ¶¶ 560, 564, 566, 567, 569, 572, 575, 576, 589, 607 and 617.

869 At the time the Consortium took the decision to suspend operations, it was unclear how long the suspension would last. The evidence suggests, however, that the Consortium was prepared to suspend operations for a period longer than 30 days (Tr. 519:7-22).

follows from a review of the events preceding the suspension: Ecuador enacted the Law 42 tax, failed to absorb its effects as it should have done pursuant to its commitments under the PSCs, and eventually collected the tax by way of seizures and auctions. Hence, even if the suspension had lasted more than 30 days, Ecuador would not have been entitled to intervene in the Blocks.

518. Having reached the conclusion that the conditions for an intervention under Article 74 of the Hydrocarbons Law were not fulfilled, the Tribunal can dispense with analyzing whether Burlington could also rely on the *exceptio non adimpleti contractus* under Ecuadorian or international law. Nor is it necessary to establish whether Burlington's decision to suspend was economically justified for purposes of this analysis.

(ii) *Risks resulting from the suspension of operations*

519. The Tribunal must now examine the nature of the risks that Burlington's *decision* to suspend operations posed to Ecuador and to the Blocks. Ecuador claims that it intervened in the Blocks in order to avoid incurring significant economic losses and serious and permanent *dam*age to the Blocks. Burlington, on the other hand, submits that Ecuador's allegations are not properly substantiated and that the theoretical risks of damage identified in the RPS report did not apply to Blocks 7 and 21. The Tribunal is not persuaded that the suspension posed such a significant risk of damage as to justify Ecuador's immediate intervention.

520. The Tribunal notes that (i) RPS did not conclude that there was a significant risk of damage, but rather a "potentially" significant risk of damage; (ii) RPS's conclusions are admittedly based on incomplete information; (iii) the evidence suggests that the risks of reservoir and mechanical damage required an extended suspension, such that an immediate intervention in the Blocks would not have been warranted; (iv) the evidence does not show that there was a significant risk of environmental damage; and (v) the evidence does not suggest that the risk of economic loss was such as to justify the intervention. These considerations are expanded upon below.

521. First, RPS did not conclude that the Consortium's suspension would have caused significant risk of damage, but rather "potentially" significant risk of damage. In its conclusions, RPS stated that shutting in producing wells caused a "potentially significant"[870] risk of reservoir and well damage. Furthermore, at the hearing, Mr. Gene Wiggins, testifying on behalf of RPS, emphasized the potential nature of the risk:

[870] RPS ER, ¶ 144 (5th bullet point).

> "**[Mr Yanos]:** Now, you sum up all your thinking on the issue of the significance of these risks [of suspension] in the last bullet [of the RPS Report], and your conclusion, as I understand it, is that each of the four categories of risks that we went through in the previous bullets [...] add up to a significant risk, is that correct?
> **[Mr Wiggins]:** Potentially a significant risk, yes.
> **[Mr Yanos]:** Potentially, right"[871] (emphasis added).

522. Second, the Tribunal notes that the RPS report is based on incomplete information. Specifically, it contains the following caveat with respect to the risk of reduced oil recovery owing to the encroachment from aquifer water: "Further study beyond the scope of this report is necessary to quantify the damage that will occur as a result of this phenomenon [...]."[872] Similar caveats are included in connection with other risks of reservoir, mechanical and environmental damage.[873] On cross-examination, Mr. Wiggins acknowledged that the word "potentially" was used because, in order to reach a more conclusive opinion, he would have to "look at the complete dataset and develop a more comprehensive understanding about what's going on."[874]

523. Similarly, there was some uncertainty about the reliability of the tests employed for the report. Ecuador submitted evidence of a trend showing a lower oil production rate in the Mono fields 1, 4 and 11 following a community strike between 27 October and 12 November 2006.[875] The Tribunal notes that the descending trend in Mono field 1 appears to be the continuation of a trend that predated the shut-in; in Mono 4, the production rate dropped to approximately 2004-2005 levels; and in Mono 11, the production rate actually increased immediately after the shut-in, before plummeting shortly thereafter to approximately 2003 production levels.[876] Referring to this evidence, Mr. Wiggins stated on direct examination that:

> "[I]nherent inaccuracies [] may exist in the data set that we deal with. We do not have flow gauges on the wells measuring production. The way the process works is [...] operators conduct intermittent tests; and, then on the basis of those tests, production is allocated to a well for a given month. So, it's--there can be some error that comes about by virtue of the tests, how they were performed, whether they were performed properly, whether they were representative"[877] (emphasis added).

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871 Tr. 1111:18-1112:4.

872 RPS ER, ¶ 43.

873 *Id.*, at ¶¶ 43, 46, 48, 50, 52, 53, 55 and 65.

874 Tr. 1112:7-9.

875 Tr. 1086:5-8.

876 G. Wiggins Direct Testimony Binder, Documents 26-28.

877 Tr. 1088:3-14.

524. Third, the evidence suggests that the risks of reservoir and mechanical damage would not have materialized before an extended suspension, so that an immediate intervention in the Blocks would not have been warranted. With respect to the risk of reservoir damage due to aquifer water encroachment, the RPS report refers to a study which states that this type of damage may occur after "a *prolonged* production shutdown"[878] (emphasis added). This bolsters Mr. Martinez's testimony to the effect that the risk of aquifer water encroachment "takes a very long time"[879] to come to pass. The RPS report appears to echo this when it concludes that the extent of this damage will "depend on the duration of the shut-in period."[880] Likewise, in relation to another risk of reservoir damage, another study quoted by RPS notes that "scale commonly forms after long periods of well shut-in […]."[881]

525. RPS's evidence props up a similar conclusion with respect to the risk of mechanical damage. On direct examination, Mr. Wiggins explained that he was familiar with oil fields which were shut-in and experienced corrosion "after a period of years".[882] He concluded that if, after a shut-in, the oil well equipment is "left down-hole for *an extended period of time*, there are just very much limits to what [one] can do from a corrosion inhibition standpoint"[883] (emphasis added). Thus, the evidence does not support the proposition that the suspension of operations would have caused an immediate risk of reservoir and mechanical damage.

526. Fourth, the evidence does not suggest that there was a significant risk of environmental damage. As stated in the RPS report and readily admitted by Mr. Wiggins on cross-examination, two factors create a risk of environmental damage: naturally flowing wells and lack of supervision that could cause leaks or spills.[884] However, at the time of the scheduled suspension, only 2 of the 88 active wells in Blocks 7 and 21 were naturally flowing wells. In addition, the evidence shows that the Consortium was to keep personnel on the ground throughout the suspension.[885] The Tribunal is thus unconvinced that the suspension would have created a significant risk of environmental damage.

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878 RPS ER, ¶ 40.
879 Tr. 517:15-16.
880 RPS ER, ¶ 43.
881 RPS ER, ¶ 52; Tr. 1065:3-6.
882 Tr. 1058:20-1059:3.
883 Tr. 1080:9-12.
884 RPS ER, ¶¶ 62, 66, 144 (12th bullet point); Tr. 1110:12-22.
885 Tr. 1111:5-10; Exhs. C-200 and C-213.

527. Finally, Ecuador also relies on a risk of economic loss.[886] It is true that a suspension of operations will generally produce a loss of revenues. Yet, there is no evidence of its magnitude nor of the period during which it would have accrued. Moreover, at the beginning of its direct examination, RPS qualified its conclusion that economic loss will "invariably result"[887] from a suspension of operations by noting that this conclusion "assumed a fairly constant oil price."[888] This clarification was an implicit acceptance of Mr. Martinez's testimony to the effect that the economic consequences of a shut-in depend "on the economics of the future price of crude."[889] In conclusion, the Tribunal is not persuaded that this risk was significant enough to justify the takeover.

528. Therefore, the evidence does not persuasively establish that the suspension of operations would have created a significant risk of damage. Accordingly, the Tribunal finds that Ecuador's immediate intervention in the Blocks may not be justified on the ground that it was necessary to prevent serious and permanent damage to the Blocks.

529. For these reasons, the Tribunal deems that Ecuador's entry and taking of possession of the Blocks was not justified under the police powers doctrine because (i) At the time of the taking of possession of the Blocks, Burlington's decision to suspend operations was legally justified as a matter of Ecuadorian law and (ii) the evidence does not show that Ecuador's immediate intervention in the Blocks was necessary to prevent serious and significant damage to the Blocks. The next question is to gauge the effects of Ecuador's occupation of the Blocks on Burlington.

(iii) *The effects of Ecuador's intervention in the Blocks*

530. As a purely factual matter, Ecuador's entry into and occupation of Blocks 7 and 21 dispossessed Burlington of the oil fields. Such dispossession deprived Burlington not only of its oil production share – and thus of its revenues – but also of the means of production that made those revenues possible. In a nutshell, the occupation of the Blocks deprived Burlington of all the tangible property embodying its investment in Ecuador. While Burlington still had its subsidiary's rights in the PSCs as well as the subsidiary's shares, these rights and shares had no value without possession of the oil fields and access to the oil.

886 RPS ER, ¶ 144 (4th bullet point).
887 *Id.*, at ¶ 144 (last bullet point).
888 Tr. 1050:6-11.
889 Tr. 396:21-397:18.

531. Therefore, once Ecuador entered the oil fields, Burlington could no longer be deemed to exercise "effective use and control" over its investment. Ecuador argues that the takeover was not expropriatory because it was intended to be a temporary measure which would have ceased once the Consortium accepted to resume operations. The Consortium, however, was under no obligation to resume operations. On the contrary, as previously concluded, Burlington – and hence the Consortium – was entitled to suspend operations for 30 days without cause and had "just cause" to suspend operations for more than 30 days.

532. It is nevertheless true that Ecuador's occupation of the Blocks was not a permanent measure from the outset. Indeed, in the weeks following the occupation of the Blocks, Ecuador continued to communicate with the Consortium with a view to handing back possession of the Blocks on condition that the Consortium were to resume operations. At that time, there still appeared to be – in the words of the tribunal in *Sedco v. Iran* – a “reasonable prospect" that the investor could "return [to] control"[890] its investment. As long as there was such prospect, Ecuador's occupation could not be deemed to be a permanent measure.

533. On 19 August 2009, little over a month after Ecuador's occupation of the Blocks, the Minister of Mines and Oil, Germánico Pinto, sent a letter to the Consortium urging it to resume operations "within a maximum period of ten (10) days."[891] However, this demand was inconsistent with Burlington's right to suspend operations with "just cause" on account of Ecuador's breaches of the PSCs and of provisional measures order. As Ecuador had by that time neither cured those breaches nor expressed an intent to do so, Burlington still had "just cause" to suspend operations. In other words, the *status quo* at the time of this demand was no different from that which had given rise to Burlington's right to suspend operations with "just cause" to begin with. Therefore, Burlington had no obligation to accept Ecuador's demand.

534. On 28 August 2009, the Consortium answered that it "would be prepared to resume"[892] operations provided that Ecuador came "into full compliance"[893] with its legal and contractual obligations. There is no evidence that Ecuador responded to this letter or further communicated with the Consortium in relation to the possible resumption of

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890 *Sedco, Inc. v. national Iranian Oil Company and the Islamic Republic of Iran*, Interlocutory Award of 28 October 1985, p. 23 (Exh. CL-160).

891 Letter from the Ministry of Mines and Oil of 19 August 2009, p.2 (Exh. C-223; Tribunal’s translation.)

892 Letter from the Consortium of 28 August 2009, p.2 (Exh. C-224).

893 *Id.*

operations. Thus, Minister Pinto's letter of 19 August 2009, with its 10-day time limit, is the last evidence on record showing that Ecuador still entertained the possibility that the Consortium could regain possession of the Blocks.

535. On this basis, the Tribunal deems that, by the end of the 10-day period mentioned in Minister Pinto's letter of 19 August 2009, the possibility that the Consortium could resume operations, and hence that Burlington could regain control of the Blocks, had vanished altogether. Accordingly, the Tribunal considers that Ecuador's takeover of the Blocks became a permanent measure on 30 August 2009. As of this date, Ecuador deprived Burlington of the effective use and control of Blocks 7 and 21 on a permanent basis, and thus expropriated its investment.

536. Ecuador argues that the takeover of the Blocks did not affect the rights of Burlington's subsidiary under the PSCs. Even though these contract rights were still nominally in force after the takeover – as *caducidad* would not be declared until almost a year later, in July 2010 –, they were bereft of any real value from the moment Burlington permanently lost effective use and control of its investment. The termination of the PSCs for Blocks 7 and 21 through the *caducidad* process in July 2010 merely formalized an already prevailing state of affairs, but is otherwise irrelevant for purposes of the expropriation analysis. As a result, the Tribunal will dispense with reviewing the specific submissions and arguments made in relation to *caducidad.*

537. For the foregoing reasons, the Tribunal concludes that Ecuador's physical occupation of Blocks 7 and 21 expropriated Burlington's investment as of 30 August 2009. This being so, the next question that arises is whether this expropriation was unlawful. But prior to the examination of this question, the Tribunal will briefly address Burlington's submission that this is a case of creeping expropriation.

538. In light of the conclusion that the physical occupation effected an expropriation, the Tribunal does not believe that Ecuador's measures taken together constituted a creeping expropriation. As previously noted, creeping expropriation only exists when "none" of the challenged measures separately constitutes expropriation. In this case, the physical takeover of the Blocks does constitute expropriation in and of itself. In *Vivendi II*, for instance, no single measure was deemed to be individually expropriatory; specifically, there was no physical takeover of the investor's operations. *Vivendi II* is thus distinguishable from this case. Hence, the definition of creeping expropriation does not appear to fit the facts of this case.

539. Burlington has relied on *Revere Copper* to suggest that finding expropriation at the time of the physical takeover was too late, since the expropriation had commenced at an earlier stage. In *Revere Copper*, the tribunal held that it would be too "narrow"[894] an interpretation to require physical impact to make a finding of expropriation. On the basis of this precedent, counsel for Burlington argued at the hearing that:

> "What is significant for our purposes is the Tribunal's recognition that the cumulative impact of the inability to make rational decisions related to an investment can be as harmful to an investor as a physical, outright, troops-in weapons-out expropriation. An investor should not have to operate under conditions that substantially deprive it of the benefit of its investment before crying foul."[895]

540. The Tribunal takes no issue with this general statement, but considers that it has no application to this case. As was previously concluded, Burlington was not operating under conditions of substantial deprivation *before* Ecuador physically occupied the Blocks. Nor is it possible to conclude that before that point Burlington had lost its ability to "make rational decisions." By way of example, Burlington's decision to place the contested Law 42 payments into a segregated account while continuing to negotiate with Ecuador is but one token that such ability had not been annihilated. Accordingly, the Tribunal does not believe that this is a case of creeping expropriation.

4. Was Ecuador's Expropriation Unlawful?

4.1. Positions of the Parties

541. According to Burlington, Ecuador's expropriation was unlawful because it failed to meet the requirements of Article III(1) of the Treaty.[896] It was unlawful because Ecuador failed to offer Burlington any compensation for the expropriation[897] and because Ecuador contravened the general principles of treatment articulated in Article II(3) of the Treaty.[898] In effect, Ecuador carried out the expropriation in a manner that was

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[894] The full passage reads as follows: "if physical impact on a substantial portion or all of the property or on the operation of the enterprise is needed to trigger [the expropriation clause in the contract], one must ask at what point, if ever, in a complex industrial operation such as we have here, involving large investments, will the cumulative impact of the inability to make rational decisions in fact trigger this subsection? Must one wait until there has occurred something akin to the troops coming in, little by little or all at once, in a nineteenth century sense? Must there be some physical impact? In our view such narrow interpretation of the contract of insurance does not fit the realities of today and was not intended by the [contract] framers […]", *Revere Copper* Award, at p. 60 (Exh. CL-104).

[895] Tr. 79:3-10.

[896] CSM, § III(B).

[897] *Id.*, at ¶¶ 99-101.

[898] *Id.*, at ¶¶ 102-107.

unfair and inequitable, arbitrary, and in contravention of Ecuador's specific obligations to Burlington – in particular, the tax absorption clauses.[899]

542. According to Ecuador, if there was expropriation, it was not unlawful.[900] First, Ecuador's failure to pay compensation does not render the alleged expropriation unlawful because it is disputed whether there was an expropriation in the first place. If it is not first established that there was in fact expropriation, there is no duty to offer compensation.[901] In *Goetz v. Burundi*, the tribunal refused to characterize the taking as unlawful because, in Ecuador's words, the State "had not yet been given an opportunity to fulfill the condition of compensation."[902] Second, at any rate, the alleged expropriation was *not* carried out in a manner that was unfair and inequitable, arbitrary, or in contravention of Ecuador's obligations to Burlington.[903]

4.2. Analysis

543. It is undisputed that Ecuador has neither paid nor offered compensation to Burlington. Many tribunals have held that the lack of payment is sufficient for the expropriation to be deemed unlawful.[904] Ecuador asserts that it offered no compensation to Burlington because it was disputed whether there was expropriation at all. While this may have been true at the time of Law 42 and the *coactiva*, there can be no legitimate dispute that Ecuador appropriated for itself the benefits of Burlington's investment from the time of the physical takeover. There can be no dispute either that Ecuador was aware that compensation was due, for it offered to pay compensation to other oil companies when it took over their operations.[905]

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899 *Id.*, at ¶¶ 108-120. As per the Tribunal's previous analysis, these are in reality tax absorption clauses (see *supra* ¶ 335).

900 RCM, § 8.

901 *Id.*, at ¶¶ 680-697.

902 *Id.*, at ¶ 685.

903 *Id.*, at ¶¶ 698-721.

904 *ADC Affiliate Ltd. and ADC & ADMC Management Ltd. v. The Republic of Hungary*, Award of 2 October 2006, at ¶ 444 (Exh. CL-101); *Bernardus Henricus Funnekotter and Others v. Republic of Zimbabwe*, Award of 22 April 2009, at ¶¶ 106-107 (Exh. CL-150); *Rumeli Telekom and Telsim Mobil Telekomunikasyon Hizmetleri A.S. v. Kazakhstan*, Award of 29 July 2008, at ¶ 706 (Exh. CL-158); *Vivendi II,* at ¶ 7.5.21.

905 At the hearing, counsel for Burlington stated that "in this one case, in this one case alone and that of Burlington's partner Perenco, Ecuador claims that no compensation needs to be paid. It argues that it may […] benefit a hundred percent from the future sales of oil produced as a consequence of the massive investments […] whilst at the same time in the most recent law, the law of [July] 2010 [], those other Contractors who have had their contracts terminated because they refused to move to a Service Contract recognized that compensation is to be payable." (Tr. 69:13-70:6; *see also* Tr. 120:3-7).

544. In spite of these considerations, Ecuador made no offer of compensation. The fact thus remains that Ecuador made no "prompt, adequate and effective" payment to compensate for the expropriation of Burlington's investment. Ecuador's reliance on *Goetz v. Burundi*,[906] in which the Tribunal gave the State the option between paying compensation or withdrawing the expropriatory measure, does not change this fact. At any rate, nothing prevents Ecuador from making an offer after this decision, and possibly reaching a settlement with Burlington which would put an end to this arbitration.

545. Accordingly, the Tribunal cannot but conclude that Ecuador's expropriation was unlawful.

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906 *Antoine Goetz and others v. Republic of Burundi*, Award of 10 February 1999 (Exh. EL-22). Ecuador relied on this precedent in its original pleading; it did not insist on its application either at the hearing or in its post-hearing brief.

V. DECISION

546. For the reasons set forth above, the Arbitral Tribunal:

A. Denies Ecuador's request that Section III(B)(2) of Burlington's Supplemental Memorial on Liability be struck from the record;

B. On the outstanding jurisdictional and admissibility issues:

1. Declares that it lacks jurisdiction over Burlington's umbrella clause claims under Article II(3)(c) of the Treaty;

2. Declares that it has jurisdiction over the *caducidad* decrees in relation to the PSCs for Blocks 7 and 21;

3. Declares that Burlington's submissions in relation to the *caducidad* decrees are admissible;

C. On liability:

1. Declares that Ecuador breached Article III of the Treaty by unlawfully expropriating Burlington's investment in Blocks 7 and 21 as of 30 August 2009;

2. Declares that all different or contrary requests for relief in connection with Ecuador's liability are dismissed;

D. On further procedural steps:

1. Will take the necessary steps for the continuation of the proceedings toward the quantum phase;

2. Reserves the decision on costs for adjudication at a later stage of the proceedings.

Done on 14 December 2012

[*singed*]

Prof. Brigitte Stern

[*signed*]

Prof. Francisco Orrego Vicuña
(with dissenting opinion)

[*singed*]

Prof. Gabrielle Kaufmann-Kohler