

**Arbitration pursuant to the  
Canada-Ecuador Bilateral Investment Treaty  
and the UNCITRAL Rules**

**EnCana Corporation**

**(Claimant)**

**versus**

**Republic of Ecuador**

**(Respondent)**

**AWARD**

**Professor James Crawford, President**

**Mr. Horacio Grigera Naón**

**Mr. Christopher Thomas**

**Secretariat**

**London Court of International Arbitration**

**3 February 2006**

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### Award

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**EnCana Corporation  
(Claimant)**

**versus**

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**AWARD**

**A. PROCEDURAL HISTORY**

1. By Notice of Arbitration dated 14 March 2003, EnCana Corporation (“EnCana”) a Canadian corporation, commenced the present proceedings against the Government of the Republic of Ecuador pursuant to Article XIII(2) of the Canada-Ecuador Agreement for the Promotion and Reciprocal Protection of Investments of 29 April 1996 (the BIT).<sup>1</sup> The claim concerned measures taken by Ecuador in respect of two wholly-owned EnCana subsidiaries, AEC Ecuador Ltd (previously named City Investing Co Ltd) (AEC) and City Oriente Limited (COL), both incorporated in Barbados. In its Notice EnCana alleged that Ecuador’s action (in particular, through resolutions of the tax authorities, the *Servicio de Rentas Internas* (SRI)) in denying to its subsidiaries refunds of value added tax (VAT) violated provisions of the BIT. It sought declarations to that effect as well as consequential relief, including reimbursement of tax credits denied and which might be denied in future. The value of tax credits already denied was put at approximately US\$80m.

2. Article XIII of the BIT provides for disputes concerning covered investments to be submitted, at the investor’s election, to arbitration under the ICSID Convention (if both the Respondent State and the State of the investor’s nationality are parties to the Convention), under the ICSID Additional Facility Rules (if only one is a party), or under the UNCITRAL Arbitration Rules. Ecuador is, but Canada is not, a party to the ICSID Convention. EnCana elected for UNCITRAL arbitration, nominating as its arbitrator, pursuant to Article 7(1) of the UNCITRAL Arbitration Rules (the Rules), Dr Horacio Grigera Naón, an Argentine national. Pursuant to the same Article, Ecuador nominated Dr Alfonso Barrera Valverde, an Ecuadorian national. The two arbitrators subsequently appointed Professor James Crawford SC, an Australian national, as presiding arbitrator.

3. On 1 July 2003 the resignation of Dr Alfonso Barrera Valverde was notified to the Tribunal. Subsequently Ecuador appointed Mr Patrick Barrera Sweeney, an Ecuadorian national. On 18 August 2004, Mr. Barrera resigned and was replaced by Mr J Christopher Thomas QC, a Canadian national.

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<sup>1</sup> 2027 UNTS 196 (in force: 6 June 1997). Relevant provisions are set out in Appendix 2.

4. At an initial teleconference held on 4 September 2003, agreement was reached on a number of issues related to the conduct of the arbitration. These were embodied in a procedural order of 9 September 2003. In particular it was agreed (a) that the place of the arbitration would be London, without prejudice to the power of the Tribunal to hold hearings and to deliberate in any other appropriate place, in accordance with Article 16 of the Rules; (b) that the Registrar would be the London Court of International Arbitration,<sup>2</sup> (c) that the languages of the arbitration would be English and Spanish, and (d) that the Respondent would file a summary Statement of Defence, and a detailed statement of its Preliminary Objections, by 27 October 2003. This was duly done. Subsequently, in accordance with a further procedural order, the Claimant on 8 December 2003 filed its Written Observations on the Respondent's Jurisdictional Objections.

5. As to confidentiality of proceedings, with the agreement of the parties the Tribunal stipulated in its procedural order of 9 September 2003 that:

“(a) While the arbitration is pending, the confidentiality of pleadings, witness statements and other documents submitted in the arbitration, as well as minutes of meetings and transcripts of hearings, shall be maintained.

(b) Hearings of the Tribunal shall be in private unless otherwise decided by the Tribunal with the consent of the parties.

(c) Decisions and awards of the Tribunal are public documents.”<sup>3</sup>

6. This left unresolved one issue of confidentiality on which the parties were not agreed, viz. the treatment of pleadings and witness statements in the *Occidental* arbitration, a parallel arbitration between a United States company and the Respondent involving similar issues.<sup>4</sup> The Respondent had retained the same law firm to represent it in the two arbitrations, and, following the resignation of Dr Barrera Valverde, had appointed the same arbitrator (Mr Patrick Barrera Sweeney). There was thus at that time one arbitrator common to the two

<sup>2</sup> In addition Mr Simon Olleson, Barrister of Lincoln's Inn, acted as Clerk to the Tribunal. The Tribunal puts on record its thanks to Mr Olleson for his considerable assistance.

<sup>3</sup> Procedural Order No. 1, 9 September 2003.

<sup>4</sup> In these proceedings a US company, Occidental, challenged equivalent VAT treatment under the United States of America-Ecuador, Treaty concerning the Encouragement and Reciprocal Protection of Investments, Washington, 27 August 1993. The Final Award of the Tribunal was rendered in London on 1 July 2004: *Occidental Exploration and Petroleum Company v Republic of Ecuador*, LCIA Case No. UN3467 (hereafter *Occidental Award*). The Tribunal held that refund of VAT paid on account of importation or local acquisition of goods and services used in the production of oil for export was not included in the X Factor in the Occidental Participation Agreement and that the refusal of VAT refunds by SRI was a violation of the national treatment standard under Article II(1) of the US-Ecuador BIT, of the fair and equitable treatment standard under Article II(3)(a) and “to an extent” of the guarantee against arbitrariness under Article II(3)(b) (see para. 200, and the operative paragraph of the award, paras. 4 and 5, and in relation to the final point, see also paras. 163). It held that Occidental was entitled to retain VAT reimbursed and not yet recovered back by SRI, and that it was also entitled to damages in the sum of \$71,533,649 on account of VAT refunds refused in breach of the BIT, together with interest. The *Occidental Award* has been challenged by Ecuador before the English courts, and Occidental has issued a cross-application challenging the Tribunal's approach to the question of expropriation. At the date of the present award, the Court of Appeal had rejected an appeal against a preliminary judgment dismissing an objection based on the justiciability of the jurisdictional challenge: see *Republic of Ecuador v. Occidental Exploration and Production Company* [2005] EWCA Civ 1116 (CA), on appeal from [2005] EWHC 774 (Comm.) (Aikens J). Pending final determination of that issue, the proceedings on the substance of the challenge are in abeyance.

panels; in the Claimant's view, this raised a serious question of how confidentiality could be maintained as between the two arbitrations. Furthermore the Claimant argued that it was disadvantaged in the preparation and presentation of its case by alone not having access to information which was available to the Respondent and the Tribunal. At the hearing on 5 January 2004, it was agreed that this issue would be addressed by a further decision of the Tribunal, subject to the outcome of the Respondent's Jurisdictional Objections.

7. A hearing on the jurisdictional objections was held on 5 January 2004. The Tribunal's Decision on Jurisdiction was rendered on 27 February 2004. As concerns the Respondent's objection to the sufficiency of the waiver given under Article XIII(3) of the BIT, the Tribunal distinguished between consent to jurisdiction under Article XIII(3)(a) and waiver of other proceedings under Article XIII(3)(b). In relation to the former, what was important was that consent be given vis-à-vis the Tribunal itself; the consent recorded in the Statement of Claim was sufficient for this purpose, and Article XIII(3)(a) was thus satisfied.<sup>5</sup> As to the latter, EnCana was required to provide a separate instrument complying with the requirements of Article XIII(3)(b). There was no requirement under the BIT going to jurisdiction for a separate waiver by the subsidiaries where, as here, the subsidiaries were incorporated in a third State and not in the host State.

8. The Tribunal joined certain other jurisdictional objections to the merits. In particular these concerned the Respondent's objections (a) that the claim concerned "taxation measures" exempted from the BIT by Article XII, and (b) that there was no *prima facie* evidence of expropriation of any investment or return of EnCana. It did so on the ground that without a clearer understanding both of the Ecuadorian legal situation and of the facts relating to EnCana's claim, it was not possible to say which if any aspects of the claim fell outside the scope of Article XII.<sup>6</sup> A similar approach was taken in relation to the question whether the changing tax position could amount to an expropriation; this too was joined to the merits.<sup>7</sup>

9. Immediately following the hearing on the jurisdictional objections, the Claimant made a Request for Interim Measures of Protection in relation to certain enforcement measures taken by the Respondent against the Claimant's subsidiary AEC and counsel for AEC, Dr Roque Bustamante. Having heard the parties, the Tribunal rejected the request by an Interim Award dated 31 January 2004.

10. As to the outstanding confidentiality issue, the Tribunal decided that for the time being no further order was required. The matter was rendered moot when Mr Barrera Sweeney resigned from the present Tribunal. Subsequently Ecuador sought from the *Occidental* tribunal a lifting of the confidentiality restrictions on the record in that arbitration. By a notification of 10 September 2004 the President of the tribunal communicated to the parties the tribunal's conclusion that it was *functus officio*.

11. On 26 April 2004, EnCana submitted its Memorial on the merits and accompanying witness statements, expert reports and documents.

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<sup>5</sup> Tribunal's Decision on Jurisdiction, 27 February 2004, §§13-15.

<sup>6</sup> *Ibid.*, §38.

<sup>7</sup> *Ibid.*, §39.

12. On 25 June 2004, the Respondent filed its Counter-Memorial on the Merits, by which it also raised a number of further jurisdictional objections in addition to those which the Tribunal had joined to the merits by its decision of 27 February 2004.<sup>8</sup>

13. On 10 August 2004, EnCana served a Response to Ecuador's Counter-Memorial on the Merits, accompanied, *inter alia*, by additional witness statements.

14. On 24 September 2004 EnCana filed certain additional materials. Following an exchange of correspondence, the Tribunal granted EnCana additional time to file its Rejoinder.

15. Ecuador filed a Rejoinder on 8 October 2004, accompanied by exhibits and additional witness statements.

16. A hearing on the merits was held in London from 8-13 November 2004 involving legal argument and the presentation of factual testimony and expert evidence by both parties.

17. Both parties presented post-hearing briefs, as scheduled, on 23 December 2004 accompanied by certain additional documents.

18. Following the filing of the post-hearing briefs, the Respondent wrote objecting that the Claimant had introduced new claims concerning, *inter alia*, the dismissal of most of the judges of the Constitutional Court and the Supreme Court and referring to statements made by the President of Ecuador in that regard. The Tribunal noted that the information was capable of being relevant to issues pleaded in the arbitration and gave the Respondent an opportunity to reply to the allegations. This the Respondent did by letter of 11 February 2005 (leading to a further exchange of 17 and 18 February 2005).

19. Following deliberations on a draft Award, the Tribunal on 4 April 2005 put a number of further questions to the Parties and asked the parties to respond by 25 April 2005. On 22 April 2005 the Respondent, noting that the President of Ecuador had been removed by Congress, sought a 21-day extension to respond to these questions. Both parties subsequently filed statements and responses, on 16 and 27 May 2005. The content of these further filings, as far as relevant to the present case, is described below.

## **B. THE FACTUAL BACKGROUND**

20. The aim of this section is to give a brief account of the factual underpinning of the dispute. In general there are no crucial differences between the parties as to the sequence of events (see the chronology set out in Appendix 1). By contrast there are wide differences of views as to the legal consequences of the actions taken and not taken.

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<sup>8</sup> Ecuador's Counter-Memorial on the Merits, §69.

(1) EnCana's Acquisition of AEC and COL

21. EnCana acquired Pacalta Resources Limited ("Pacalta") in May 1999. Pacalta was a Canadian corporation which owned AEC (at that time called City Investing Company Ltd).<sup>9</sup> AEC in turn was the indirect owner of COL. At the time of filing of the Notice of Arbitration on 14 March 2003, both AEC and COL were indirect wholly-owned subsidiaries of EnCana.<sup>10</sup>

22. On 28 November 2003 EnCana sold its interest in COL to Condor Petroleum Ltd, a United States company ("Condor").<sup>11</sup> Furthermore, on 13 September 2005 EnCana announced its intention to sell the rest of its Ecuadorian assets to a Chinese joint venture with closure expected before the end of 2005.<sup>12</sup> The implications of these sales of the EnCana subsidiaries are dealt with later in this Award.

(2) The Contracts

23. The present claims concern claims for VAT refunds arising out of the performance of four Contracts providing for rights of exploration and exploitation of oil and gas reserves in Ecuador, entered into by AEC and COL before and after their acquisition by EnCana. Specifically EnCana alleges that "measures taken by Ecuador, including the issuance of SRI Resolutions 233, 669, 670, 736 and 3191, the past and ongoing denial of tax credits and refunds, and the amendments to regulations which seek to deny the right of VAT credits and refunds to oil companies, violate its obligations contained in the Treaty and international law and have caused and continue to cause the Claimant significant loss and damage".<sup>13</sup> It goes on to specify, *inter alia*, that Ecuador through SRI grounded the denial of VAT credits and refunds on the incorrect conclusion that the Ecuadorian State oil company, Petroecuador, had recognised and granted these amounts through the negotiation of the Tarapoa X Factor and the execution of the contract related thereto, despite information from Petroecuador to the contrary.<sup>14</sup> It also alleged discriminatory treatment of foreign oil companies as compared with other exporters in extractive industries such as mining and agriculture, and the expropriation of investments or returns of investors through the denial of VAT refunds.

24. Historically, there have been three types of contracts for the exploitation of petroleum resources in Ecuador. Initially, oil companies entered into "association contracts", under which the initial burden of investment lay on the oil company, and thereafter both the company and the State could have an obligation to provide further investment. The company had to pay a royalty in respect of its production, plus an additional participation percentage as

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<sup>9</sup> City Investing Company Limited changed its name to AEC Ecuador on 21 May 2002: see Claimant's Memorial, 26 April 2004, §26.

<sup>10</sup> For the corporate structure, see Keplinger 2<sup>nd</sup> Witness Statement, 5 August 2004, Response W/S, vol. II, Tab 2, Annex A. Cf Exhibit 89 to the Respondent's Rejoinder, Exhibits, vol. I, Tab 89.

<sup>11</sup> The Sale Agreement is at Respondent, Exhibits to Rejoinder, vol. I, Tab 88; the sale was in fact of City Oriente Holding Company Ltd, also a Barbadian corporation, the direct owner of all the shares in COL.

<sup>12</sup> Claimant's Letter to the Tribunal of 19 September 2005 with attached press release.

<sup>13</sup> Notice of Arbitration and Statement of Claim, 14 March 2003, para 36.

<sup>14</sup> *Ibid*, para 41(iv) & (v).

well as income tax. Contracts of this type were concluded in the 1970s, including by AEC in 1973.

25. In a second period, oil companies were able to enter into “service contracts”, under which the oil produced was owned by Petroecuador and the oil company was paid a fee to extract the oil. All costs incurred were reimbursed. Under these contracts, the oil companies bore no risk, except in the case that no oil was discovered during the exploration period.

26. The current regime for exploration and exploitation of hydrocarbons derives from the amendment of the Hydrocarbons Law in 1993 which permitted the conclusion of “participation contracts”. Those contracts are defined in an unnumbered article inserted in Chapter III after Article 12 as contracts

“entered into by the State, through PETROECUADOR, by which it delegates to the contractor, subject to the provisions of number one, Article 46 of the Political Constitution of the Republic, the power to explore and exploit hydrocarbons in the contract area, affecting on its account and risk all the investments, costs and expenses required for exploration, development and production. The contractor has the right to a share in the production of the contract area, which shall be computed based on the percentages tendered and agreed in the contract, depending on the volume of produced hydrocarbons.

Once production has started, the contractor has the right to a share in the production of the contract area, which shall be calculated on the basis of the percentages tendered and agreed in the same contract, depending on the volume of produced hydrocarbons.”

Under this form of contract the oil company bears all of the risk of exploration and exploitation, including all the costs and expenses involved. In return, the oil company receives a percentage of the oil extracted under the “participation factors”. Under the standard form of such contracts, there are typically three participation factors, each corresponding to different levels or bands of the total output.

27. On 29 March 1995, COL entered into the “Block 27 Participation Contract” with Petroecuador.<sup>15</sup>

28. On 25 July 1995, AEC entered into the “Tarapoa Participation Contract”, which modified (and in effect, replaced) the association contract which it had concluded with Petroecuador on 23 October 1973.<sup>16</sup>

29. On 27 October 1995, AEC entered into the “18B Fanny Unitization Agreement” with Petroproducción (the Ecuadorian State Company for Exploration and Exploitation of Petroleum, an affiliate of Petroecuador).<sup>17</sup>

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<sup>15</sup> See Bustamante 1, vol. I, 26 April 2004, Exhibit A (English Translation at A1). COL was originally co-contractant with Consolidated Ramrod Gold Corporation; the rights and obligations of Consolidated Ramrod Gold were assigned to COL on 30 April 1997.

<sup>16</sup> See Bustamante 1, vol. II, 26 April 2004, Exhibit B (English Translation at B1).

30. On 25 November 1999, AEC entered into the “Mariann 4A Unitization Agreement” with Petroproducción.<sup>18</sup>

31. Under each of these contracts, the companies were entitled to retain shares of the oil extracted. The share to which each company was entitled varied according to the average daily oil production levels. The percentage shares of production agreed upon with Petroecuador were referred to as “X Factors”.

32. At the time of conclusion of the four contracts, oil production was predicted to reach only a relatively low level and accordingly the X Factors were set only up to low levels of output. Production subsequently increased for two of the concessions (the 18B Fanny unitized field (AEC) and the adjacent Tarapoa field (AEC)), and a new round of negotiations was commenced in order to fix the “X3” Factor for the increased production.

33. Outline agreement for both the Fanny 18B and Tarapoa agreements was reached on 12 December 1997. However, completion was subject to approval by various state bodies.<sup>19</sup> In the event the amendment in relation to X3 factor for the 18B Fanny Participation Contract was concluded on 14 July 1999;<sup>20</sup> the amendment in relation to the X3 factor under the Tarapoa Participation Contract was concluded on 2 August 2001.<sup>21</sup>

34. Both the Block 27 and Tarapoa Participation Contracts contain a provision for renegotiation of the X Factors in the event that the economic balance of the contract is affected by some unforeseen change. For example, the Tarapoa Participation contract provides, in relevant part:

**“Eleven.Nine (11.9) Tax Regime Amendment.**- In case of any amendment to the tax regime or labor participation effective at the date of execution of this Contract as described in this Clause, or its interpretation, or creation of new taxes or liens not provided for in this Contract, which may affect this Contract’s economy, a correction factor in the participation percentages shall be included to absorb the increase or decrease of a tax charge or labor participation aforementioned.”

35. The preceding sub-clauses of clause 11 make reference to income tax and labor participation payments (11.1 and 11.2), a contribution for use of water and use of natural construction materials (11.3), a contribution to the Superintendency of Companies (11.4), a tax on total assets (11.5), contributions to the “Fund for the Amazon Region Ecodevelopment and Strengthening of its Sectional Organizations” (11.6); and notarial fees in connection with the execution of the contract as a public deed (11.7). The equivalent clause in the Block 27 Participation Contract is in broadly similar terms, although there is some divergence in the recitals of the relevant taxes and charges. Neither of the Participation Contracts made any express reference to value added tax.

<sup>17</sup> See Bustamante 1, vol. III, 26 April 2004, Exhibit C.

<sup>18</sup> See Bustamante 1, vol. III, 26 April 2004, Exhibit D.

<sup>19</sup> Claimant’s Memorial, 26 April 2004, §75.

<sup>20</sup> See Bustamante 1, vol. III, 26 April 2004, Exhibit E.

<sup>21</sup> See Bustamante 1, vol. IV, 26 April 2004, Exhibit F (English translation at F1).

36. Further, Clause 6.12.8 of the Block 27 Participation Contract and Clause 6.3 of the Tarapoa Participation Contract envisaged the conclusion between the parties of an operating agreement for the exploitation of unitized fields in the case of “common deposits”, i.e. deposits extending outside the conceded area. Clauses 6.12.8(d) and 6.3.8(d), respectively, envisaged that those operating agreements would include “procedures for adjustments of the participation share percentages, investments, costs, and expenses in recognition of the periodic updating” of proven reserves and other conditions for operation of the common deposit.

37. Under each of the Unitization Agreements, a Unified Operations Committee was provided for, which had power to revise or modify the terms of the agreements or their annexes prior to submitting them to the Ministry of Energy and Mines for approval.

38. Each of the Participation Contracts contained as Clause 20 a provision providing for arbitration, following consultations between the parties, in accordance with Article 10 of the Ecuadorian Law on Hydrocarbons. Those clauses also foresaw the possibility of ICSID arbitration (once Ecuador become a party to the Washington Convention) (Clause 20.3), and other systems of international arbitration recognised by Ecuadorian law (Clause 20.4). Further, Clause 22.1.3 in each of the two Participation Contracts provided:

“In compliance with the provisions of Article Three (3), Law number forty four (44), the Parties have agreed to submit the controversies that may arise from the interpretation or execution of this Contract, to arbitration, pursuant to the provisions of Clause twenty.”

39. The two Unitization Agreements each contained a different form of arbitration clause. The Mariann 4A Unitization Agreement, Clause 21, provided for arbitration to be carried out in accordance with the relevant Ecuadorian legislation on arbitration and the Rules of the Arbitration and Mediation Centre of the Quito Chamber of Commerce and excluded recourse to the ordinary courts except to challenge an arbitral award on the basis of nullity. The 18B Fanny Unitization Agreement provided simply for arbitration in accordance with the relevant portions of the Code of Civil Procedure (Clause 19).

40. As the Fanny 18B and Tarapoa X3 Agreements constituted modifications of, respectively, the Fanny 18B Unitization Agreement and the Tarapoa Participation Contract, they contained no arbitration clauses.

(3) Development of VAT law and administration in Ecuador

41. The present dispute is rendered more complex by the numerous amendments and modifications made to the tax regime in general and the VAT regime in particular during the relevant period. The basic scheme of the tax system in Ecuador is contained in the Internal Tax Regime Law (ITRL). The ITRL is implemented by the Regulations to the Internal Tax Regime Law (the Regulations).

42. At the time of conclusion of the Block 27 Participation Contract on 29 March 1995 and the Tarapoa Participation Contract on 25 July 1995, Article 65 ITRL provided in relevant part as follows:

**“Tax Credit.** VAT payers shall have a right to a tax credit equal to the tax paid on the local acquisition or importation of goods or on the use of services levied with VAT, that are itemized in the respective invoices or analogous documents, so long as they are marketed in the country or employed in the production of a new good or in the provision of a service assessed with this tax.

The amount of this tax paid when acquiring assets that become part of the purchaser’s fixed assets is also a tax credit.

There shall also be a tax credit for VAT paid on the acquisition or importation of goods or supplies destined for the production and marketing of goods transferred to entities of the public sector, even if said transfers are exempt from payment of this tax...”

43. Article 65 was amended on 22 August 1995 by the insertion of extra paragraphs, the relevant part providing that “Tax credits returned to VAT payers and to exporters will not bear interest.” As amended, Article 65 remained in force until 30 April 1999 when it was replaced.

44. Article 68 ITRL provided that if the declaration revealed a difference in favour of the taxpayer between inputs and outputs that sum was to be considered a tax credit, effective in the declaration for the following month.

45. Prior to the conclusion of the Participation Contracts, Article 36 of the ITRL provided for tax credits in relation to VAT paid on the acquisition of any input or raw material used in the manufacture (*fabricación*) of export products.

46. On 30 December 1994 Article 36 was repealed and replaced by Article 163. That provision (as subsequently amended on 21 November 1995) remained in force until 29 June 1999 and provided in relevant part as follows:

“General rule: As a general principle, natural persons and companies who are VAT payers and have paid VAT on the importation or local acquisition of goods or the use of taxable services, are entitled to a tax credit. The credit is equal to the tax paid on the local acquisition or importation of goods or in the use of services taxed with VAT, itemized in an invoice or analogous document. Pursuant to the provisions of the [ITRL] and this Regulation, such goods or services must have been exported, marketed in the country or employed in the production of a new product or in the provision of a service levied with this tax [in accordance with the ITRL and this Regulation].

In order for VAT paid on the local acquisition of goods or services to be used as a tax credit by the purchaser of the goods or recipients of the services, as the case may be, the purchaser or recipient must credit VAT in sales contracts, invoices, notes or tickets or similar original documents [...]

VAT paid on purchases, imports and services for the production or marketing of goods and services taxed at the zero rate shall be entered into books as production costs and shall not produce a tax credit.

When due to the nature of the transactions made or to any other circumstance, a taxpayer or whoever is subject to the tax assumes that it cannot compensate the tax credit within six months after being created, the taxpayer or whoever is subject to the tax can request a refund [...] in accordance with Art. 149 of this Regulation and Article 65 of the [ITRL]...”

47. Article 169 of the Regulations, enacted on 30 December 1994, provided in relevant part:

“Tax Credit for sales of export goods: Natural persons and companies that have paid VAT on the acquisition of any input or raw material employed in the manufacture [*fabricación*] of export products are entitled to a tax credit for such payment once the exportation is made...

Agricultural, livestock or like production for foreign markets is also understood as *fabricación*...”

Article 169 was repealed on 29 June 1999.

48. In the periods immediately prior to and following the conclusion of the Participation Contracts, according to the literal text of the legislation it was not clear whether all exporters were entitled to a VAT tax credit in relation to input VAT associated with acquisition or importation of raw materials under Article 65 of the ITRL. Although Article 163 of the Regulations appeared to envisage entitlement to a credit as a matter of general principle, Article 169 of the Regulations only expressly granted the right to a credit to exporters involved in manufacture (*fabricación*). It was also not entirely clear under what circumstances there was an entitlement to a refund under Article 163 of the Regulations, rather than merely the setting off of a tax credit against future liabilities.

49. The new version of Article 65 ITRL, which came into force on 30 April 1999, as amended on 14 May 2001, provided:

“The use of a tax credit shall be subject to the following rules.

1. VAT payers engaged in: the production or marketing of goods for the domestic market taxed at a rate of twelve percent (12%), the provision of services taxed at a rate of twelve percent (12%), or the exportation of goods and services, shall have a right to a tax credit for all of the VAT paid on local acquisition or the importation of goods that become part of their fixed assets; of goods, raw materials or supplies and of services necessary for the production [*producción*] and marketing of said goods and services.

2. VAT payers engaged in the production, marketing of goods or provision of services, part of which are taxed at a rate of zero percent (0%) and part at a rate of ten percent (10%), shall have a right to a tax credit...”

The change from 10% to 12% in the VAT rate was part of a wider reform which took place in order to broaden the activities subject to VAT.

50. Article 69A ITRL was also enacted on 30 April 1999. As originally enacted, it provided:

“VAT paid on export activities: Natural persons and companies that have paid value-added tax on local acquisitions or on the importation of goods, employed in the manufacture [*fabricación*] of exported products, are entitled to a refund for said tax, without interest. The refund shall be made in a term not to exceed ninety (90) days and shall be in form of a note of credit, cheque or other means of payment. Interest shall be paid when the said term expires and the VAT claimed has not been refunded. The SRI must refund payment when the taxpayer’s legal representative formally files a declaration attaching certified copies of the invoices documenting VAT payment. [...]”

Subsequent amendments made Article 69A applicable also to the providers of services.

51. On 18 November 1999, an unnumbered Article was inserted after Article 55 ITRL (hereafter “Article 55A”). That Article provided:

“Tax credit for the exportation of goods: Natural and juridical persons who export and have paid VAT on the acquisition of the goods they export, have a right to a tax credit for said payments. They shall have this same right for the tax paid on the acquisition of raw materials, inputs and services used in the products produced and exported by the manufacturer [*fabricante*]. Once the exportation is made, the taxpayer shall request from the SRI the corresponding refund, attaching a copy of the appropriate exportation documents. [...]”

The oil business shall be governed by its specific laws.”

It was not disputed that no laws were in force relating specifically to the oil business at the relevant time.

52. The new Article 169 of the Regulations, enacted on 29 June 1999 and repealed on 31 December 2001, provided:

“Refund of value-added tax to State institutions, exporters of goods and the disabled: In order for exporters of goods to obtain a refund of the value-added tax paid on the importation or local purchases of inputs, raw materials and services used in products made and exported by the manufacturer [*fabricante*] or producer [*productor*], as the case may be, once the exportation is made, they shall file with SRI an application...”

53. Accordingly, although Article 65 ITRL as enacted in April 1999 (and as subsequently amended) appeared to envisage an entitlement to tax credits for various categories of taxpayers, including exporters engaged in production (*producción*) in relation to input VAT paid on acquisitions or imports, Article 55A seemed to provide for a right to tax-credit and

envisaged a refund only in relation to exporters who were manufacturers (*fabricantes*). Similarly, Article 69A ITRL provided for the right to a refund to exporters involved in manufacture (*fabricación*). On the other hand, from 29 June 1999 until 31 December 2001, Article 169 of the Regulations appeared to envisage the possibility of refunds in relation to both *fabricantes* and *productores*.

54. Upon repeal of Article 169 of the Regulations from 31 December 2001, a new Article 147 of the Regulations was inserted which provided in its paragraph 3 as follows:

“Cases in which there is no right to a tax credit. There shall be no right to a tax credit in the following circumstances:

[...]

3. when VAT paid by a purchaser has been reimbursed to it in any manner”

55. Article 148 of the Regulations (also enacted on 31 December, and as amended on 4 December 2002) provided:

**“Refund of value-added tax to the exporters of goods:** In order for exporters of goods to obtain a refund for the value-added tax paid on the importation or local acquisition of goods and services used in the manufacture [*fabricación*] of export goods, that has not been used as a tax credit or reimbursed in any manner whatsoever, they shall, once the exportation has been made, file with the SRI an application...”<sup>22</sup>

56. The legal position was thus, on any view, complex and obscure. It must be said however that nothing was put before the Tribunal which indicated that the legislator intended by these provisions to draw a sharp distinction between extractive and other industries, or what purpose such a distinction might serve in terms of the rationale for a VAT-type tax. Nor, given that many industries (e.g. agriculture) combine elements of production and manufacture, was any criterion laid down for determining the degree of ‘fabrication’ required to qualify for VAT recovery.<sup>23</sup>

57. That said, the application of the tax legislation to the contracts entered into by AEC and COL (and the other oil companies) gave rise to a number of issues of legal interpretation in relation to the question of whether they were entitled to a refund, including:

- (a) Whether only manufacturers (*fabricantes*) were entitled to a tax refund;
- (b) Whether the extraction of oil constituted “*fabricación*” within the meaning of Article 69A ITRL, given the various processes to which hydrocarbons pumped out of the ground must be subjected prior to export;
- (c) Whether the participation factors in the Participation Contracts entered into by the oil companies were calculated so as to include VAT in the costs and expenses of the oil companies;

<sup>22</sup> Notice of Arbitration and Statement of Claim, 14 March 2003, §34. See EM, Witness Statements, vol. 1, Tab. 6, David Paredes, 23 April 2004, §5.22.

<sup>23</sup> The original version of Art. 169, which was repealed in June 1999, stipulated that “agricultural, livestock or like production for foreign markets is also understood as *fabricación* of export products” It appears that no equivalent provision was subsequently re-enacted.

- (d) If so, whether it was possible for VAT refunds to be made through such a contractual mechanism;
- (e) If VAT refunds were included in the participation factors and could validly be refunded through a contractual mechanism, whether this was to be taken as including the difference resulting from the change from 10% VAT on goods to 12% VAT on both goods and services which occurred in April 1999.

Various responses to these questions were given by the different levels of Ecuadorian courts in cases involving both AEC and COL, and other oil companies.

(4) Treatment of oil companies for the purposes of VAT

58. According to the Claimant, the Government of Ecuador changed its interpretation of Article 87 of the Law on Hydrocarbons, relating to exemption from various taxes imposed on imports; this is said to have occurred three years after the execution of the Participation Contracts.<sup>24</sup> It appears that the change in interpretation occurred in about November 1997.<sup>25</sup> Prior to this time, Article 87 of the Law on Hydrocarbons was interpreted as meaning that no input VAT was chargeable on imports.

59. The Claimant does not rely upon this change in interpretation as a breach of the BIT but rather as helping to explain why VAT refunds were not claimed by AEC and COL prior to March 2000.

60. However that may be, in the period between March 2000 and March 2001 AEC applied for, and by a series of resolutions SRI granted, refunds in respect of VAT paid in connection with the production of oil for export between May 1999 and August 2000 (“the Original Resolutions”). In order to grant these refunds, SRI issued credit notes amounting to \$7,567,091.87.<sup>26</sup>

61. Subsequently, both AEC and COL made applications for refunds to SRI, in relation to VAT paid between January 1998 and April 1999 and September 2000 and May 2001 in the case of AEC, and for the period January 1999 to December 2000 in the case of COL.<sup>27</sup> The applications for refunds for VAT paid prior to March 2000 were based on a restatement of the accounts of AEC and COL, with VAT being included in the accounts as a tax credit and account receivable. Prior to EnCana’s acquisition of the companies in May 1999 and the restatement of the accounts, VAT payments had been recorded in the accounts as an operating expense.

62. As with many national VAT schemes, Ecuador’s VAT regime operates on the basis that if a VAT payer has a claim for a tax credit or a refund of VAT, an appropriately

<sup>24</sup> Claimant’s Memorial, 26 April 2004, §§105-107.

<sup>25</sup> See Claimant, Witness Statements accompanying Memorial, vol. 1, Tab. 1, Pablo Buenaño, 26 April 2004, §15; Claimant, Witness Statements accompanying Memorial, vol. 1, Tab. 6, David Paredes, 23 April 2004 (English translation in Claimant, Witness Statements accompanying Response to Counter-Memorial, vol. 1, Tab 1), §§4.4-4.5

<sup>26</sup> Resolution 736 appears to relate at least in part to VAT paid by AEC prior to its acquisition by EnCana.

<sup>27</sup> See the table in the Claimant’s Notice of Arbitration and Statement of Claim, §27.

documented application to the tax authorities must be made. Any refund paid would be subject to subsequent audit and verification by the tax authorities.

63. It was the evidence of Dr de Mena, the Director General of SRI during the relevant period, that once the VAT refund mechanism was put in place, SRI received a large number of applications for refunds. These claims were on the whole paid.<sup>28</sup>

64. In mid-2001, SRI assembled a team of auditors to look at the refunds which were being granted following the change in the law, and in particular as regards refunds being made to oil companies.<sup>29</sup>

65. Apparently as part of this process, the Northern Regional Director of the IRS wrote to Dr Rodolfo Barniol, the President of Petroecuador, on 14 June 2001 requesting information related to the Participation Contracts and their amendments.<sup>30</sup> Although this letter was not produced to the Tribunal, it seems clear from the reply that its purpose was to discover whether VAT was included among the costs of the contractors in the calculation of the participation factors.

66. Dr Barniol replied on 11 July 2001,<sup>31</sup> attaching a memorandum dated 9 July 2001 from the Chief of the Contracts Administration Unit of Petroecuador, Mr Francisco Rendón.<sup>32</sup> The attached memorandum provided in relevant part as follows:

“This Unit considered that for points 2, 3 and 4 of the official letter of the reference it was necessary to personally explain to the officers of the Northern Regional Office of the [SRI], the reason why it was not possible to favourably attend to the request [...]:

- In accordance with the Regulation of the Special Bidding system, Petroecuador produces all of the documents inherent in the bid.
- Based upon internal working papers, the technical and economic conditions and parameters of responsibility to rate tenders are established in order for there to exist a balance between possible expenditures and income the project produces, under reasonable return conditions for the Parties and keeping a concordant logic in the cost-benefit investment this kind of project requires.
- The parties interested in participating in the bid prepare their tenders based upon the principle mentioned above, and it is not a requirement to submit a detail of their economic, financial and technical studies in order to participate in the called bid.
- Obviously, the bidder is cognizant of all national legislation applicable to hydrocarbon matters, including tax legislation, and could discern which taxes directly increase the cost of the project and which have an indirect effect since they are reimbursable, as in the case of VAT.”

<sup>28</sup> 1<sup>st</sup> Witness Statement of Dr de Mena, para 16.

<sup>29</sup> 1<sup>st</sup> Witness Statement of Dr de Mena, para 17; Transcript, Day 4: p. 83, line 22, p. 84, line 12. Cf. the closing submissions of Mr Barrack, Day 5: pp. 28-9.

<sup>30</sup> Official Letter No 002098, 14 June 2001.

<sup>31</sup> Official Letter No. 0378-PEP-2001 2866.

<sup>32</sup> Memorandum No. 392-ACP-2001, 9 July 2001.

67. Despite its apparently negative tone in relation to the question whether the VAT factors were included in the Participation Factors, the memorandum of Mr Rendón was subsequently relied upon by the SRI in issuing some of the resolutions denying AEC's and COL's requests for refunds.

68. Subsequently, on 12 September 2001, Dr de Mena wrote to Dr Barniol, following a meeting which apparently took place on 5 September 2001, requesting a *consulta* on the question of the inclusion of VAT within the participation factors under the Participation contracts.<sup>33</sup> Having referred to the changes in the law in 1999, in particular Article 69A ITRL and Article 169 of the Regulations, Dr de Mena continued:

“Pursuant to these amendment to the Law and its regulation, exporters may request a VAT refund for sales made abroad and for which a tax credit has been generated but cannot be compensated because there are no domestic sales and also because they export their entire production, as indicated by the oil companies exporting hydrocarbons. Consequently, oil companies that have executed upstream [participation] contracts with the State, through Petroecuador, have requested a refund of the VAT on their hydrocarbon exports.”

69. There followed an analysis of the tax situation in relation to participation contracts, relying on the Article inserted after Article 12 in the Hydrocarbons Law (above para. 26); the conclusion put forward was that “[t]herefore, investments, costs and expenses are considered in bids for the awarding of participation contracts”. Reference was further made to Article 16 of the Hydrocarbons Law relating to economic stability, which provided for adjustment of the participation percentages “when the tax system applicable to the contract has been modified, in order to restore the economy of the contract in effect prior to the tax modification”; the conclusion was again that “taxes were deemed to have been incorporated into the participation of the parties, and, consequently, included in the costs and expenses influencing the economy of the contract.” The analysis continued:

“On the basis of the analysis of said rules, it is understood that under this form of contract, the contractor, on its own account and risk, agrees to make all investments, costs and expenses required for exploration, development and production. In exchange, the State delivers to the contractor a participation in audited production. Then in order to arrive at the calculation of said participation as a form of payment and, pursuant to the legislation mentioned up to this point, the participation that the contractor receives included the contractor's investments, costs and expenses for obtaining crude petroleum, plus the taxes that such activity would generate as value-added tax (VAT).”

70. In the light of those considerations, the *consulta* requested by Dr de Mena was as follows:

“Under participation contracts, when the State of Ecuador, through Petroecuador, reimburses the contractor for its investments, costs and expenses through the

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<sup>33</sup> Official Letter No. 000567, 12 September 2001.

participation percentage, does such reimbursement include the value-added tax (VAT) and other taxes affecting the contractor's activities?"

Evidently SRI continued to assume at this stage that, but for the participation contracts, there was an entitlement to a tax credit or refund.

71. Dr Barniol replied on 20 November 2001;<sup>34</sup> having set out the background to the *consulta* requested (including meetings with officials of the Northern Directorate of the SRI), he referred to various relevant provisions. His analysis first of all emphasised that participation contracts do not involve "reimbursement" by the State of the contractor's investments, costs and expenses. After referring to several other points, the analysis continues:

"- Before participating, companies interested in the bid have complete knowledge of the Contract Bases. Based on that knowledge, they draw up their bids and subsequently submit them in accordance with pre-established requirements for bid participation. It is not mandatory to submit a description of their economic, financial, technical, market studies, etc. For this reason, PETROECUADOR cannot certify whether the bids of interested companies consider VAT as a cost.

- Bidding companies are cognizant of all of the Ecuadorian legislation applicable to the contracts, as expressly cited in their bids, and in every executed contract. Consequently, they are aware of the economic and tax obligations they must satisfy once their contracts are executed. To state otherwise would be to covertly affirm that the STATE OF ECUADOR has not acted in good faith.

Petroecuador has considered the above exposition, the fact that the Participation Contracts [...] do not contemplate reimbursements of investments, costs and expenses but rather a share in production in accordance with the tenders of the bidders, now Contractors, and the fact that PETROECUADOR does not have the capacity to document whether Contractors have included VAT as a cost in their tenders. Therefore, I believe that because of the fact that the legal rule, thoroughly expounded in this letter exists, it must be applied. If, nevertheless, there is a dispute, it must be resolved by the appropriate authorities, in this case the [SRI], in the first instance, and the District Tax Court, in the case of an appeal.

It is important to note that, if the case, PETROECUADOR will await a ruling by the appropriate authorities to determine whether or not the participation factors should be renegotiated in order to maintain the economic balance of the Contract and to be faithful to its policy to respect the legal framework in effect."

72. In her oral evidence, Dr de Mena stated that she had found the letter from Dr Barniol, which was received after three of the denying resolutions had been issued, surprising:

**Mr Barrack.** So in fact in their response Petroecuador could not tell you or did not tell you that VAT was included in the participation factors, did they?

**Dr de Mena.** I wrote that letter because Mr Barniol said that, on the basis of his analysis of the situation he had discovered that Occidental had clearly included the

<sup>34</sup> Official Letter No. 1274-ACP-2001-4744, 20 November 2001.

VAT paid for and entered in – their costs had been included in their contract. We just about drafted the letter together. And the reply is something that surprised me, because he had confirmed to me that it could not be clearer in any other company than this that VAT was included in the contract as a cost, and the reply of Mr Barniol, you can understand what you like from that really.

[...]

**Mr Barrack.** By the time you had received this letter, in fact you had issued another denying resolution, and that denying resolution was 24th September 2001. So that by the time you had received this letter you had issued three of the denying resolutions; correct?

**Dr de Mena.** Yes. Could I clarify? I did this because I was convinced, after talking to him, that he would confirm what we said when we discussed the matter and that he would confirm then what we had discussed, and that he was quite clear in his mind as to what was happening with the different oil companies as per what we had discussed. But the only authorities that can act as regards the tax matters is the tax authority.

**Mr Thomas.** I am just reflecting on the comment that you made earlier. Did I understand it to be the case that you had consulted Petroecuador on the question of whether the participation contracts included VAT and this letter from the president of Petroecuador surprised you; in other words, did you see this as a change in position from what you had previously understood from Petroecuador?

**Dr de Mena.** Yes, that is it. It was a change of position in respect to what we had discussed.

**Mr Thomas.** Prior to this letter, it was your understanding from your discussions with Petroecuador that VAT was included in the participation contracts?

**Dr de Mena.** The participation contracts covered all expenses and costs, including, obviously, VAT, which is an intrinsic part of costs and expenses.<sup>35</sup>

73. Starting on 28 August 2001, SRI issued resolutions denying the applications of AEC and COL (“the Denying Resolutions”).<sup>36</sup> According to the Claimant, this was done on the basis that VAT refunds were included in the X Factors under the Participation Contracts.

74. It appears that all but Resolution 3191 (COL) were dealt with personally by Dr de Mena. Resolution 3191 was issued by the Regional Director for the Northern Region.

75. Resolution 00669 and Resolution 00670, were issued by SRI on 28 August 2001, in relation to AEC and COL respectively. In justifying the decision to refuse a large number of applications for refunds, covering October 2000 to May 2001 in the case of AEC, and September to December 2000 in the case of COL, the Denying Resolutions relied on a number of arguments.

76. Taking by way of example Resolution 00669, first, in the considerations of fact, the resolutions referred to and quoted the letter from the Northern Directorate of the SRI of 14

<sup>35</sup> Day 4, p. 89, lines 11-24; p. 90, line 8 – p. 92, line 11.

<sup>36</sup> See the table in the Claimant’s Notice of Arbitration and Statement of Claim, 14 March 2003, §27, and see Exhibits 4, 5, 6 and 7.

June 2001 and the reply dated 9 July 2001, enclosing the memorandum dated 11 July 2001, quoted above at paragraph 66.

77. Second, in the considerations of law the resolutions referred to the unnumbered article inserted following Article 12 of the Law on Hydrocarbons in 1993 making provision for participation contracts (quoted above at paragraph 26) and other pieces of legislation relating to the contents of bids to be included in the bidding process, concluding:

“e) Based on the foregoing, it is understood that under this form of contract the contractor is committed to carry out on its account and risk all of the investments, costs and expenses required for exploration, development and production. In exchange, the State gives the contractor a share in audited production. Then to arrive at the calculation of the said share as a form of payment and in conformity to the legislation noted up to now, the contractor’s share must have considered in its investments, costs and expenses for obtaining crude, the taxes such activity would generate. And, as one of the taxes with the greatest presence in the tax spectrum of any economic activity is the value-added tax, it would be unusual for it not to have been included...”

Reference was then made to the memorandum of 11 July 2001 in support of that conclusion. The considerations of law continued:

“f) Therefore the provision of Article 69A of the Internal Tax Regime Law is not applicable because when the State of Ecuador reimbursed the contractor for its investment, costs and expenses through the participation percentage, said reimbursements included the value-added tax – VAT – and other taxes affecting the activity.”

At this point in time, there was no mention of any argument based on the fact that the extraction of oil does not fall within the concept of “*fabricación*” contained in Art. 69A ITRL.

78. The next of the denying resolutions was Resolution No. 00736, dated 24 September 2001, which was the ruling by Dr de Mena on an appeal brought by COL against Resolution No. 001730 of 31 August 1999 issued by the Northern Regional Director of SRI denying a request for a refund.

79. Resolution No. 00736 adopted language which was in essentials the same as that used in Resolutions 00669 and 00670, and upheld the resolution under appeal. The decision of the Northern Regional Director under appeal had recited the cost accounting rules laid down for participation contracts, which required “all the costs and expenses incurred in the different stages of Exploration, Development, Production, Transport, Commercialisation, etc.” to be registered as such; this precluded the right to a tax credit including for VAT paid.

“... the amount paid by the VAT [payer] in the importation and local purchases carried out by [AEC] shall be registered as part of the cost of goods, as foreseen by the [Cost Accounting Rule]; ...

... in accordance with Article 65 of the [ITRL] the VAT paid in such acquisitions does not grant the right to a tax credit. Therefore Article 169 of the [Regulations] is inapplicable.”

80. On 12 November 2001, prior to receipt of the letter dated 20 November 2001 from Dr Barniol, a response was filed on behalf of SRI in relation to challenges to Resolutions 00669 and 00670 by AEC and COL respectively. This response relied on both the argument that the VAT was to be treated as being refunded under the participation factors, and the argument that extraction of oil did not constitute “*fabricación*”.<sup>37</sup>

81. Resolution No. UR-0003191 was issued on 20 December 2001 by the Northern Regional Director of the SRI in relation to a claim for VAT refunds made by COL. It contained language similar to the previous denying resolutions, referring to the nature of participation contracts, and the fact that VAT was to be treated as having been compensated in the participation factor (para. 3(f)), although there was no reference to the memorandum from Petroecuador dated 11 July 2001, nor to the letter from Dr Barniol dated 20 November 2001. At this point, there was still no reliance on the argument that the extraction of oil did not constitute “*fabricación*” within the meaning of Article 69A ITRL.

82. On 1 April 2002 the Director-General of SRI issued Resolution 233 purporting to annul each of the Original Resolutions under which refunds had been paid to AEC and ordering the commencement of proceedings to collect the sum of \$7,567,091.87 previously granted as a VAT refund. The proceedings were brought by way of an appeal initiated by the Northern Regional Director of the SRI on 7 September 2001 against resolutions granting refunds to various oil companies. The alleged grounds for the annulment was the VAT refunds had been mistakenly paid as the sums had already been compensated under the Participation Contracts; additionally, it was said that there was no right to a refund as the right to a refund only applied to input VAT in respect of exported goods where the materials and services acquired were used in the manufacture (“*fabricación*”) of the exported product.<sup>38</sup>

83. Resolution 233, in the paragraph containing the reasoning of SRI, as with the earlier resolutions, made reference to the article providing for participation contracts in the Hydrocarbons law. It then set out the “*fabricación*” argument:

“e) Article 69A... is clear when stating the following: ‘Natural persons and companies that have paid Value-Added Tax in local acquisition or importation of goods employed in the manufacture [*fabricación*] of exported products, are entitled to a refund’ [...] (emphasis added).

f) Petroleum is not a good that is manufactured or that undergoes a process; simply it is extracted from reservoirs owned by the State of Ecuador. According to the Diccionario de la Lengua Española, manufacture [*fabricar*] means ‘to produce objects in series, generally through mechanical means’. In the case of extraction of petroleum,

<sup>37</sup> Compendium of Materials Prepared by EnCana, vol. 1, tab 4, p. 11.

<sup>38</sup> See Exhibit 8 to the Claimant’s Notice of Arbitration and Statement of Claim, 14 March 2003.

a product is not made or produced, it is extracted and exported, without undergoing any transformation whatsoever.”

It continued, in language reminiscent of the early resolutions:

“k) ...whoever invests in a risky activity such as oil, always considers that all of its investments costs and expenses are recoverable in whole or its percentage of risk is covered with a high return. In petroleum activities, this is contemplated in the participation percentage granted by the State of Ecuador and determined at the time of contract negotiation. This is a generally accepted practice in hydrocarbon matters throughout the world and was considered by the company in the negotiation of the participation percentage. The tax rules in effect on the date of contract execution, in which VAT refunds were not contemplated, were also taken into account.

l) Because the contractor’s participation percentages already recognized payment of all taxes, the State of Ecuador duplicates said recognition by accepting the VAT refund application the contractor, as exporter, filed with the SRI. Such recognition was made in due time by Petroecuador, which acts on behalf of the State, and the same State has governmental authority to create taxes.

p) [...] neither the legal framework applicable on the date of execution of the Amendment of the Contract into a Participation Contract (July 25, 1995), nor the current rules, contemplate that crude oil extraction and exportation activities give a right to a tax credit, and even less to a refund of VAT. The reason is that the VAT paid by the Contractor was already considered in the contractor’s participation percentage at the time of contract negotiation. So were the other taxes, encumbrances, contributions and charges affecting the Contractor’s business and which are paid as established in the Law [...]

r) [...] As with the legal rule contained in Art. 69A of the [ITRL], the current Art. 169 of [the Regulations] only provides refunds for VAT paid in the importation or local acquisition of supplies, raw materials and services manufactured and exported by the manufacturer or producer. In other words, the regulation is also inapplicable to activities concerning the exploitation of non-renewable natural resources owned by the State of Ecuador. Furthermore, the State of Ecuador already has reimbursed this tax to the contractor by having accepted the contractor’s proposed participation percentage, which contained that cost...”

Although the memorandum of 11 July 2001 was referred to in the application brought by the Northern Regional Director of the SRI to quash the various granting resolutions, it was not referred to in the reasoning of Dr de Mena. There was also no reference to the letter from Dr Barniol of 20 November 2001.

84. It will be seen that Resolution 233 gave two distinct reasons for denying the right to a VAT refund (and consequently demanding repayment of VAT refunds already paid): first, that “the VAT paid by the Contractor was already considered in the contractor’s participation percentage at the time of contract negotiation”; secondly, that Article 69A ITRL is applicable only to goods which are manufactured and has no application to “activities concerning the exploitation of non-renewable natural resources owned by the State of Ecuador”. The latter argument, apparently first employed by the Northern Regional Director of the SRI on 7

September 2001 in bringing the appeal against the previous resolutions granting refunds, was now taken up as an additional ground by the Director-General of SRI.<sup>39</sup>

85. Thus as concerns the justification for denying refunds and for revoking the previous resolutions granting refunds, the position of SRI changed significantly between Resolutions 00669 and 00670, adopted on 28 August 2001 and Resolution 233, adopted on 1 April 2002. Dr de Mena in her oral evidence freely admitted as much:

**Mr Ordway.** The subject of this arbitration is five resolutions issued by the SRI with respect to VAT refunds concerning those companies, City Investing and City Oriente. Those resolutions, however, do not focus on Article 69A. They discuss the contract, for example. Has your position on this issue evolved over time?

**Dr de Mena.** The SRI -- yes, their thinking of course has evolved and as one point of justification of the reasoning behind the resolutions is that it does not affect the legality of the provisions of 69A which do not allow refund to goods that are not manufactured.<sup>40</sup>

She also freely admitted that there was a policy of providing refunds to exporters of agricultural products (even if at all times the law was not entirely clear in that regard), and of not granting refunds to oil companies exporting oil, although she maintained the position that after the passing of Article 69A, refunds were not permitted to oil companies as a matter of the law:

**Mr Ordway.** With respect to their position that they had an entitlement, was there any policy with respect to oil companies that you believe is pertinent?

**Dr de Mena.** The law does not allow it, or did not allow it. But Ecuador had been consistent in their policy of not refunding VAT to oil companies. We had been consistent since the time when the ministry of finance was in charge of tax administration, and then it was the national internal revenue system and then the SRI when there was the most recent restructuring of tax administration in Ecuador. The consistency remained.

We had always been consistent then through the different restructuring in our policy with regards to that sector and the agricultural sector, for instance, we treated it as a policy to promote exports there. This policy to promote exports was very well known, well known and familiar to companies that embarked on the process of negotiation to invest in Ecuador, with the Ecuadorian Government. So there could not have been any expectations, because of this policy that we had applied consistently and because of the law and the legal provisions in force at the time there was no law that permitted a refund, legally anyway or through 69A, for instance.<sup>41</sup>

**Mr Ordway.** You testified earlier that you agreed with Ecuador's position as stated in its papers, submissions, that the oil companies were not entitled to VAT refunds under 69A because they were not manufacturers. Yet you also issued refunds to cut flower

<sup>39</sup> As noted above, it had been relied upon by the SRI in its response filed in November 2001 in relation to the challenge to Resolutions 00669 and 00670 brought by AEC and COL.

<sup>40</sup> Day 4: p. 63, line 22 – p. 64, line 7. Cf also Mr Venegas, Day 3, p. 94, lines 18-19.

<sup>41</sup> Day 4: p. 65, line 10 – p. 66, line 8.

exporters, banana exporters and other exporters of goods that also were not manufactured. How can you explain that?

**Dr de Mena.** Under a regulation there was something that said that under manufacturers, that that concept would also cover economic agents in the agricultural sector, and that had been Ecuador's policy since the tax authorities had begun to administer matters, or tax matters had been administered by the Ministry of Finances, that had always been the policy, it was a policy aimed at promoting exports, around the Ministry of Finances could abide by that authority, as did the tax authorities and the SRI after various processes of restructuring. The legal norms perhaps do not necessarily cover the agricultural sector, but the fact is that we had this policy in our country which we applied consistently, and perhaps we should make that more specific.

**Mr Ordway.** Do you think, given the language of 69A, that the granting of VAT refunds to those companies is something that perhaps should have been reconsidered or should be reconsidered?

**Dr de Mena.** I do not think so, because that was based on a policy that had been traditionally followed in our country. However, if Ecuador finds it appropriate, perhaps they could -- I do not know, we could enact a law, that might be a good idea.<sup>42</sup>

**Mr Barrack:** Ms de Mena, one of the things you testified this morning was that prior to Article 69A becoming part of the law, that oil companies did not have the right to a refund. What was your understanding of the basis for that?

**Dr de Mena.** They did not have a right before, nor do they now, is what I said. Before, Article 69A, the regulation, the regulatory norm did not have the same prerequisites as now. Ecuador's policy was to reimburse all, and there had been no refunds for oil companies.

**Mr Barrack.** But there were refunds for other exporters?

**Dr de Mena.** There were refunds for agricultural exporters particularly.

**Mr Barrack.** Even when there was nothing in the regulation which spoke about agriculture, there were refunds to exporters, prior to that regulation as well; correct?

**Dr de Mena.** There were refunds. The norm said that you can interpret products of the agricultural sector as manufactured products.

**Mr Barrack.** Even before that was in the regulation, the specific provision that you are referring to, there was a time when that did not exist in the regulations; correct?

**Dr de Mena.** I am not a lawyer, and I have not really looked at prior regulations. But I know -- all I can say anyway is that there were refunds always to the agricultural sector following this policy of promoting the exports of our country, and this is a very well known policy, well known to investors who came to negotiate the contracts with the Ecuadorian state.

**Mr Barrack.** As far as you are concerned, there has always been a policy, at least from the SRI's point of view, of not granting refunds to oil companies?

**Dr de Mena.** As far as the SRI is concerned, we were complying with the law, namely Article 69A.

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<sup>42</sup>

Day 4: p. 69: 12 – p. 70: 9.

**Mr Barrack.** But even before 69A, the policy of not granting refunds to oil companies existed?

**Dr de Mena.** SRI was set up pursuant to law 41 in 1997, and before that it was the Ministry of Finance and the national tax administration that governed tax affairs, and the policy was to refund VAT to those that exported agricultural goods. There were never any refunds to the oil companies.

**Mr Barrack.** So the answer is yes, it was always the policy not to refund VAT to the oil companies, throughout the entire history of the SRI; correct?

**Dr de Mena.** There is a nuance here, that policy did exist, but now it is a legal prerequisite. You cannot do it according to law because of Article 69A, it is not allowed now legally, so we are complying with the law.<sup>43</sup>

86. It is not disputed that, if VAT refunds should not have been granted before August 2001, SRI had the right to recover them back.

(5) Disputes over VAT refunds: Ecuadorian court proceedings

87. This change in policy on the part of the SRI gave rise to disputes not only on the part of AEC and COL but also on the part of other foreign oil companies in Ecuador.

88. For their part AEC and COL brought proceedings in the Ecuadorian District Tax Court within the 20 day period prescribed by Ecuadorian law, challenging each of the Denying Resolutions and Resolution 233. The District Tax Court rendered its decisions on 8 November 2002 and 19 November 2002; the District Tax Court held that the tax laws (including Art. 69A ITRL) were not applicable in relation to 10% of the VAT as the matter was to be resolved in the context of the economic adjustment provisions of the Participation Contracts, and thus fell outside the province of the tax system. In relation to the difference between VAT at 10% and VAT at 12%, which resulted from amendment to the tax legislation which entered into force after the conclusion of the Participation Contracts, and thus could not have been included in the Participation Contracts, or be subject to the economic adjustment clauses in those contracts, the District Tax Court held that AEC and COL were entitled to the refund of the difference. This decision was reached on the basis that although Art. 69A was not applicable to oil companies as crude oil was not “fabricated” or manufactured, a provision of the tax legislation (Art. 16(2) ITRL) permitted the courts to grant refunds to tax payers subjected to taxes which caused a modification fo the economic relationship between the parties.

89. AEC and COL filed appeals against these decisions before the Ecuadorian Supreme Court. These appeals were subsequently discontinued at the same time as EnCana commenced the present arbitration proceedings, although Article XIII(12) of the BIT only requires the discontinuance or waiving of claims before the courts of the host State in the case of locally-incorporated subsidiaries.<sup>44</sup>

<sup>43</sup> Day 4: p. 81, line 23 – p. 83, line 21.

<sup>44</sup> See the Decision on Jurisdiction, 27 February 2004, §20.

90. Despite the discontinuance by the two companies, SRI nevertheless continued in its cross-appeal against the decisions of the District Tax Court. SRI's argument was essentially on the narrow point that since the 2% difference ordered to be refunded concerned the Participation Contracts, the District Tax Court had erred in ordering SRI to provide the refund, rather than leaving the matter to be dealt with by Petroecuador. The Supreme Court affirmed the entitlement to a refund in relation to the difference between a 10% and a 12% VAT rate on the basis relied upon by the District Tax Court (which was not expressly challenged by SRI), and rejected SRI's argument that it should not be made liable for the refund of the 2% difference on the basis that VAT can only be refunded via the mechanisms created by the relevant law, and that the obligation of SRI in this respect cannot be overridden by contractual provisions.<sup>45</sup>

91. By contrast, the Supreme Court in the *Bellwether* case<sup>46</sup> rejected the argument based on "*fabricación*" under Article 69A ITRL, and held that the oil producer was entitled to a refund.

92. Notwithstanding the *Bellwether* decision, the District Tax Courts have continued to issue rulings in the line of their earlier decisions, reinforced by the Interpretative Law; in particular, a further decision at first instance of the District Tax Court in the *Repsol* case confirmed the interpretation relied upon by SRI in relation to "*fabricación*", relying on the legislative history of Article 69A.<sup>47</sup>

93. Apparently the lower courts may do so under Ecuadorian law because Supreme Court decisions do not constitute binding jurisprudence until the Supreme Court has ruled the same way three times. Whether the Supreme Court has ruled three times on the issue in question here was strongly disputed between the parties. However, pending the resolution of the dispute over the composition of the Supreme Court, the legal system is unable to bring all pending cases to final resolution at this stage.

94. Accordingly, the parties take opposing positions as to whether Ecuadorian law granted a right to a VAT refund to AEC and COL at the relevant time. A substantial amount of expert opinion has been provided, as well as views from several of the witnesses of fact, as to the applicable Ecuadorian law. The Tribunal will return to this issue at a later stage.

(6) Interpretative Law No. 2004-41 (2004)

95. On 2 August 2004, the Ecuadorian National Congress passed law No. 2004-41, an Interpretative Law concerning Article 69A of the ITRL.<sup>48</sup> The Interpretative Law was

<sup>45</sup> *City Oriente Ltd. v. Director-General of the SRI*, Supreme Court of Justice, Case 42-2003, 14 January 2004 (Exhibit R-27, Ecuador's Counter-Memorial on the Merits, Exhibits, vol. 1); and *City Investing Ltd. v. Director-General of the SRI*, Supreme Court of Justice, Case 48-2003, 12 February 2004 (Exhibit R-28, Ecuador's Counter-Memorial on the Merits, Exhibits, vol. 1).

<sup>46</sup> *Bellwether International v. Director General of the SRI*, Case No. 4-2003-12-4, 12 November 2003 (Exhibit R-30, Ecuador's Counter-Memorial on the Merits, Exhibits, vol. 1 (corrected version)).

<sup>47</sup> *Repsol YPF v. Director-General of the SRI, District Tax Court*, First Chamber, Case No. 19803-2288-B, 19 March 2004 (Exhibit R-29, Ecuador's Counter-Memorial on the Merits, Exhibits, vol. 1 (corrected version)); cf. Respondent's Counter-Memorial, 25 June 2004, §§37-38;

<sup>48</sup> See Exhibits to Respondent's Rejoinder, vol. 1, R-83.

published in the Official Journal on 11 August 2004. The operative paragraph provides that Article 69A ITRL “is interpreted to mean that the refund of the Value Added Tax (VAT) is not applicable to petroleum activity as it refers to extraction, transportation and marketing of crude petroleum, since petroleum is not manufactured, but is extracted from the respective deposits”.

96. The recitals to the Interpretative Law provided as follows:

“Whereas, Art. 69A incorporated into the Internal Tax Regime Law by Law No. 99-24, published in the Supplement of Official Gazette No. 181 of April 30, 1999, establishes the reimbursement of Value-Added Tax paid in the purchases of goods used in the fabrication of export goods in order to promote the exportation of goods with the greatest national value added;

Whereas, petroleum is not a good that is fabricated but rather is extracted from petroleum reservoirs and, therefore, in the International Standard Industrial Classification of All Economic Activities (ISIC), the activity of extracting petroleum falls under Section C, Division 12, Group 120 while fabrication or manufacturing activities fall under Section D of said International Classification;

Whereas the article after Art. 55 of the Internal Tax Regime Law added by Law 99-41, published in the Supplement of Official Gazette No. 321 of November 18, 1999, expressly excludes petroleum activities from the treatment established in said norm;

Whereas, in accordance with the norms established in the Law on Hydrocarbons, the participation percentages of petroleum companies are established so as to enable them to recover the costs, expenses, contributions and other taxes affecting petroleum activities, in addition to a reasonable profit;

Whereas, the same Law on Hydrocarbons and its Regulations establish that in the case of tax amendments or any other legal norm affecting the economy of contracts, such economy shall be restored through an adjustment to the participation percentages;

Whereas, despite the clear and explicit provisions contained in the Ecuadorian legislation with respect to this matter, multinational companies that are dedicated to the exploitation of hydrocarbons have been claiming, before Ecuadorian Courts and other international courts, the refund of the Value Added Tax, invoking illegitimate arguments;

Whereas, overriding the jurisdiction of Ecuadorian Tribunals, the analysis and resolution of this matter has been taken abroad, where it is possible to confuse the content and scope of our legislation;

Whereas, the incorrect application of Article 69-A of the Internal Tax Regime Law has caused grave economic damages to the Ecuadorian State;

Whereas, in accordance with number 5 of Art. 130 of the Political Constitution of the Republic of Ecuador, it is the duty of the National Congress to interpret laws of a generally mandatory nature;

In use of its constitutional and legal powers...”

97. There was some discussion before the Tribunal as to the constitutionality and legal effect of the Interpretative Law. Nonetheless as far as the Tribunal is aware no action has been taken to challenge its validity. The question whether it was purely prospective in effect was also debated.

(7) Attempts to renegotiate the participation factor with Petroecuador

98. Thus by a combination of executive acts, judicial decisions and eventually (after the adverse decision in the *Occidental* case) an Interpretative Law, Ecuador took the position that VAT payable by oil companies was not to be refunded because the companies were not engaged in manufacture (“*fabricación*”) for the purposes of Article 69A ITRL, and that any remedy was to be sought under by changes in the participation factor under the adjustment clause in the Petroecuador contracts.

99. But this position was not arrived at immediately or unequivocally. When some of the affected companies sought an adjustment to the Participation Contracts, Petroecuador rejected such claims on the ground that VAT refunds were a matter for SRI.<sup>49</sup> The position of SRI, by contrast – and eventually that of the President of Ecuador<sup>50</sup> – was that any adjustment was to be achieved under the contracts, and in terms of Ecuadorian tax law and practice this position must be taken to have prevailed, at the latest, at the time of the Interpretative Law.

(8) Dismissal of Supreme Court justices and related events

100. In December 2004 almost all of the judges of the Supreme Court and the Constitutional Court were dismissed by resolution of the Congress. These events gave rise to considerable criticism in Ecuador and elsewhere.<sup>51</sup> According to the Claimant’s Post-Hearing Brief, the President of Ecuador said in a television interview that “two or three days before the Court was changed, the judges apparently ruled against the interests of the State and admitted the claims for oil-related reimbursements brought by various foreign companies”.<sup>52</sup>

101. The Respondent reacted by a letter of 11 February 2005, to which it attached a Statement of the President of Ecuador, HE Lucio Gutiérrez Borbúa, addressed to the Tribunal. The President noted (a) that the judges, appointed for a 4-year term in 1998, had been extended in office on a temporary basis, and that Congress had decided by majority to reorganise the Supreme Court, appointing 31 new members; (b) that at the time of the reorganization, neither EnCana nor any present or former EnCana subsidiary had any cases pending before the Supreme Court. President Gutiérrez referred to the television interview but stated:

“In my capacity as Constitutional President of the Republic, I emphatically deny any presumption that could lead the Tribunal to conclude that my Government interfered

<sup>49</sup> See *Occidental Award*, para. 35.

<sup>50</sup> See the letter of 27 October 2003 (DPR-2003-229) from the President Gutiérrez to Dr de Mena, which instructed her to resolve the disputes with the oil companies through the application of the economic stability provisions of the Hydrocarbons Law. Dr de Mena subsequently communicated these instructions to the Executive President of PetroEcuador: see the letter of 21 July 2004 (No. 0240).

<sup>51</sup> See e.g., E/CN.4/2005/60/Add.4 (29 March 2005).

<sup>52</sup> Television interview by President Gutiérrez, 14 December 2004, EnCana Post-hearing Brief, 23 December 2004, Exhibit 2.

in the reorganization of the Judges of the Supreme Court of Justice, and that said reorganization had any relation to the lawsuits filed by the oil companies before the Ecuadorian Courts.”

He went on to affirm the independence of the judiciary in Ecuador and Ecuador’s commitment to comply with arbitration proceedings as provided in treaties to which Ecuador is a party.

102. It is true that there were no proceedings by EnCana subsidiaries at this time; these had been withdrawn when the present proceedings were commenced. On the other hand certain proceedings brought by other oil companies were pending before the Supreme Court.

103. Following deliberations on a draft Award, the Tribunal on 4 April 2005 addressed certain questions to the parties. Specifically it asked:

1. In relation to the letter from the President of Ecuador dated 27 October 2003 to Dr de Mena, in the period from October 2003 to July 2004, what was done by Ecuador, including PetroEcuador, to give effect to the terms of that letter?
2. For the period after July 2004, what concrete steps, if any, were taken by Ecuador, including PetroEcuador, to give effect to the matters set out in the recitals to the Interpretative Law of 11 August 2004?
3. Did EnCana, or any EnCana subsidiary, or any other affected oil company, request PetroEcuador:
  - a. to give effect to the terms of the President’s letter of 27 October 2003;
  - b. to act to resolve outstanding questions in the light of the matters set out in the recitals to the Interpretative Law?

104. On 20 April 2005, President Gutiérrez was removed by a vote of Congress and subsequently left the country, being granted asylum in Brazil.

105. The responses of the parties to the Tribunal’s questions of 4 April 2005 were filed on 16 May 2005, with replies on 27 May 2005. These statements revealed a number of discrepancies on points of fact. According to Ecuador, considerable efforts had been made to renegotiate contracts through the economic stability clauses, with success in some cases. Moreover the Attorney-General stated that he had on several occasions invited EnCana to engage in these negotiations, something which Mr. Keplinger, the General Manager of AEC, declined to do. According to EnCana, while there was a meeting between Mr Keplinger and the Attorney-General on 5 August 2004, that meeting did not involve any concrete offer to negotiate, nor did the Attorney General’s communications with the Canadian Ambassador and other officials at the Canadian Embassy lead to a concrete proposal: apart from that there was “no other indication that Ecuador, either through the SRI or Petroecuador, is prepared to take any step to provide any additional amount owing to AEC or COL in respect of input VAT receivables”.<sup>53</sup> EnCana also denied that the renegotiated agreements reached by two marginal producers were comparable to the Participation Contracts with the EnCana subsidiaries.

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<sup>53</sup> Witness Statement of John Keplinger, 16 May 2005, para 33.

106. It is not necessary for the Tribunal to resolve the factual discrepancies between the parties revealed by the responses of 16 and 27 May 2005. It seems clear (a) that there was one unproductive meeting between EnCana and the Attorney-General; (b) that the Attorney General did on more than one occasion raise the issue of the Participation Agreements with Canadian Embassy officials; (c) that EnCana's general attitude, as it had been from the beginning, was that it was entitled to VAT refunds and that it was pursuing its claim in that regard before the present tribunal, and (d) that statements from the Ecuadorian side, as well as, at a later date, the political turmoil surrounding the action taken against the courts and the removal of the President, made renegotiation an unsatisfactory option. In Mr Keplinger's words the oil companies including EnCana subsidiaries "are therefore very reluctant to reopen any of their agreements with the Government of Ecuador".<sup>54</sup>

### C. ENCANA'S CLAIMS OF BREACHES OF THE BIT

107. As a result of the actions of SRI in denying VAT credits/refunds and seeking collection of credits/refunds previously granted to its subsidiaries, EnCana alleges a number of violations of the BIT. Specifically EnCana alleges Ecuador's violation of the following Articles:<sup>55</sup>

- Article II(1), by taking action inconsistent with its obligation to "encourage the creation of favourable conditions for investors of the other Contracting Party to make investments in its territory";
- Article II(2)(a), by failing to accord EnCana's investments and returns fair and equitable treatment in accordance with the principles of international law;
- Article IV(1), in that Ecuador has failed to accord EnCana national treatment;<sup>56</sup>
- Article VIII, in that the measures taken constitute expropriation or measures of equivalent effect to expropriation.

108. Relevant provisions of the BIT are set out in Appendix 2. Of particular significance in the present case is Article XII, dealing with taxation measures. This provides as follows;

"1. Except as set out in this Article, nothing in this Agreement shall apply to taxation measures.

...

3. Subject to paragraph (2), a claim by an investor that a tax measure of a Contracting Party is in breach of an agreement between the central government authorities of a Contracting Party and the investor concerning an investment shall be considered a claim for breach of this Agreement unless the taxation authorities of the

<sup>54</sup> Witness Statement of John Keplinger, 27 May 2005, para 23.

<sup>55</sup> Although a claim based on Article XVI and estoppel was originally put forward (Claimant, Memorial, 26 April 2004, §§179, 223-226), this is now effectively subsumed in EnCana's Article II claim: see Claimant, Response, 10 August 2004, §293; Post Hearing Brief, §§414-416.

<sup>56</sup> In the Claimant's Notice of Arbitration and Statement of Claim, 14 March 2003, there was also an allegation of violation of Article III by failing to provide most-favoured nation treatment. The claim based on Article III does not appear in the Claimant's, Memorial, 26 April 2004 and subsequent pleadings.

Contracting Parties, no later than six months after being notified of the claim by the investor, jointly determine that the measure does not contravene such agreement.

4. Article VIII may be applied to a taxation measure unless the taxation authorities of the Contracting Parties, no later than six months after being notified by an investor that he disputes a taxation measure, jointly determine that the measure is not an expropriation.

5. If the taxation authorities of the Contracting Parties fail to reach the joint determinations specified in paragraphs (3) and (4) within six months after being notified, the investor may submit its claim for resolution under Article XIII.”

109. In the present case, notice was given by EnCana under Article XII(4), but there was no determination by the tax authorities of Canada and Ecuador in terms of that provision within six months. Accordingly, even if the measures complained of are taxation measures under Article XII(1), it is open to EnCana to challenge them as an expropriation under Article VIII. On the other hand, there is no relevant agreement between EnCana and the central government authorities of Ecuador since (whether or not Petroecuador qualifies as such an authority) the Participation Contracts were made by EnCana subsidiaries which do not qualify as “investors” under Article I(h) of the BIT. For these reasons, unless and to the extent that the measures fall outside the scope of the exclusion of taxation measures in Article XII, it is not open to EnCana to complain of breaches of other provisions of the BIT than Article VIII.

110. Indeed, in that event the jurisdictional provision of the BIT lacks application also, since subject to the enumerated exceptions, *nothing* in the BIT applies to taxation measures, and this includes Article XIII.

111. By its Decision on Jurisdiction of 27 February 2004, the Tribunal joined this aspect of the Respondent’s jurisdictional objections to the merits, as noted above.

#### **D. THE JURISDICTIONAL ISSUES**

112. As noted in paragraphs 7-8 above, the Respondent raised a number of jurisdictional objections in its pleading of 27 October 2003. In its decision of 31 January 2004 the Tribunal rejected part of those submissions and joined the remainder to the merits. The Respondent raised further jurisdictional issues in its Counter-Memorial “in the light of the arguments and information contained in EnCana’s Memorial”.<sup>57</sup> At this stage of the case, the Respondent maintains the following jurisdictional objections:

- (1) EnCana cannot claim with respect to loss suffered by subsidiary companies having the nationality of a third State;
- (2) Even if a claim were maintainable on behalf of AEC, no claim can be brought in relation to COL given EnCana’s sale of its interests in COL on 28 November 2003;

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<sup>57</sup> Respondent’s Counter-Memorial on the Merits, 25 June 2004, §69.

- (3) The right to a VAT refund concerns a “taxation matter” and, unless it constitutes an expropriation, is excluded from BIT protection under Article XII(1).

113. Further, at the jurisdictional phase, the Respondent argued that the denial of a subsidiary’s right to a VAT refund was not the expropriation either of an “investment” or a “return”, and does not even *prima facie* fall within the scope of Article VIII. Subsequently this argument appears to have been pursued as one concerning the merits rather than as a jurisdictional objection. In the circumstances the Tribunal will deal with this aspect of EnCana’s claim as a matter of the merits.

114. The Tribunal will discuss the three remaining objections in turn, dealing with any factual disputes so far as necessary in order to dispose of them.

(1) EnCana’s standing to claim for treatment of third-State subsidiaries

115. The Respondent argues that the BIT envisages a distinction between, on the one hand, claims brought by the investor in respect of damage and loss which it itself has suffered under Article XIII(1), and on the other, claims brought on behalf of an enterprise which the investor “owns or controls directly or indirectly” under Article XIII(12). In the latter case it is only where the enterprise is “a juridical person incorporated or duly constituted in accordance with applicable laws” of the host State that a claim can be maintained. Neither AEC nor COL are Ecuadorian corporations. Accordingly there is no mechanism under the BIT whereby an investor can bring a claim on behalf of an enterprise not incorporated in the host State for loss and damage suffered by that enterprise; rather the investor can only claim for damage which it has suffered itself.<sup>58</sup> According to the Respondent, EnCana is not claiming in relation to its own loss but rather in relation to loss suffered by AEC and COL insofar as the relief sought is the reimbursement of sums of money to these subsidiaries.<sup>59</sup> In particular, having regard to Article XIII(12) the parties to the BIT could not have intended claims to be brought in respect of damage done to a subsidiary incorporated in a third State, otherwise Article XIII(12) would have been unnecessary.<sup>60</sup> The alleged “coverage gap” relied upon by the Claimant arises because of the general international law as to the nationality of claims, which has not been modified by the BIT.<sup>61</sup>

116. For its part EnCana argues that there is nothing in the language of Article XIII(1) which limits it to claims for direct or independent injury.<sup>62</sup> In EnCana’s view Article XIII(12) does not limit the application of Article XIII(1).<sup>63</sup> Rather Article XIII(12) is a special provision allowing an investor to bring proceedings on behalf of a subsidiary incorporated in the host State which has suffered loss or damage there. In this respect Article

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<sup>58</sup> Ibid., §74.

<sup>59</sup> Ibid., §77, referring to Claimant’s Memorial, 26 April 2004, §290(ii) and (iii); see also, *ibid.*, §290(v) & (vii). See also the prayer for relief in Claimant’s Notice of Arbitration and Statement of Claim, §60(b), (c), (e) & (f).

<sup>60</sup> Respondent’s Rejoinder, 8 October 2004, §§60, 64.

<sup>61</sup> *Ibid.*, §65.

<sup>62</sup> Claimant’s Response, 10 August 2004, §142.

<sup>63</sup> *Ibid.*, §§145-146.

XIII(12) is an exception to the international law rule excluding claims against a State by its own nationals.<sup>64</sup> In the present case, by contrast, EnCana insists that it is claiming for its own loss and not on behalf of subsidiaries. In this regard, EnCana submits that the evidence shows that the cash funding requirements of both subsidiaries were provided by EnCana; that the denial of the VAT refunds/credits are a “direct loss in cash value in the subsidiaries”, and that any recovery of such funds could be passed directly to EnCana without any deduction, or would increase the value of the investment by the increase in the liquid assets of the subsidiaries.<sup>65</sup> In any event, the power of the Tribunal to award restitution of property or damages in lieu under Article XIII(9) is not limited; it would be appropriate for the Tribunal to order restitution of property to the subsidiary if it finds that there has been a taking.<sup>66</sup>

117. The Tribunal would first observe that in accordance with general principle it is necessary to interpret the provisions of the BIT so as to give due effect to each of them having regard to the object and purpose of the treaty as a whole. In this respect the following provisions of the BIT are relevant:

- Article I(g) defines an investment to include “any kind of asset owned or controlled either directly, or indirectly through an investor of a third State”. In accordance with this definition, interests of Canadian investors in Ecuador can be held through third State corporations provided that the latter are owned or controlled by the investor. At the time of the events which EnCana complains of,<sup>67</sup> and at the time the present arbitration was commenced, AEC and COL were wholly owned and controlled by EnCana, which therefore had an investment in Ecuador covered by the BIT.
- Article I(h) defines an investor to include an enterprise incorporated in Canada “who makes the investment in the territory of the Republic of Ecuador”. Read in conjunction with the definitions of “investment” and “enterprise”, there is no doubt that EnCana qualifies as an investor for the purposes of the BIT.
- Article I(j) defines “returns” as “all amounts yielded by an investment”, and goes on to list, non-exhaustively, various forms of returns including “other current income”.
- The substantive provisions of the BIT (e.g., Articles II, IV and VIII) provide certain guarantees in relation to “investments or returns of investors of the other Contracting Party” without further specification. In other words, provided that the entity affected by treatment contravening these provisions is an “investment” of a Canadian investor as defined in Article I, there is no further specification that the investment vehicle should have either Canadian or Ecuadorian nationality.
- Against this background Article XIII(1) covers “*any* dispute between one Contracting Party and an investor of the other Contracting Party, relating to a claim by the investor that a measure taken or not taken by the former Contracting Party is in breach of this Agreement, and that the investor has

<sup>64</sup> Ibid., §150.

<sup>65</sup> Claimant’s Response, 10 August 2004, §§165-166.

<sup>66</sup> Ibid., §163.

<sup>67</sup> The Tribunal leaves to one side for the moment VAT claims concerning periods of time when the subsidiary in question was not owned or controlled by EnCana.

incurred loss or damage by reason of, *or arising out of*, that breach” (emphasis added): such disputes, if not settled within 6 months, may be submitted to arbitration in accordance with the remaining provisions of Article XIII. The generality of these words is clear enough. In order to bring a claim to investor-State arbitration, i.e. to attract the jurisdiction of a Tribunal under Article XIII(4), a qualified investor does not need to prove that it has suffered loss; it is sufficient that it alleges loss to a covered investment, which EnCana has done, and credibly done.

- Article XIII(12) goes on to make special provision for the case where a local enterprise in the host State which is directly or indirectly owned or controlled by an investor has suffered loss or damage by reason of or arising out of a breach of the BIT. In such a case the investor may bring a claim under Article XIII on behalf of the enterprise; in effect the investor is acting as an agent for the enterprise in bringing the claim, and any award is to be paid to the affected enterprise.

118. The Tribunal does not interpret Article XIII(12) as limiting the clear words of Articles I and XIII(1) which allow an investor to maintain a claim for loss suffered to itself arising from a breach of the BIT. Evidently the BIT proceeds on the basis that the separate identity of corporations incorporated in different States and territories is to be respected. Nonetheless it expressly allows investments to be held through third State corporations, and claims to be made for breaches involving such investments, provided the investor has suffered loss or damage as a result. True, it does distinguish between loss or damage suffered by a locally incorporated enterprise and loss or damage suffered directly or indirectly by the investor itself. Circumstances can be envisaged where a breach of the BIT affecting a locally incorporated subsidiary would have caused no loss or damage to the parent – e.g., where no consequence flowed from the breach either to the returns to the parent or to the share value of the subsidiary. In such a case, the investor could only recover by bringing proceedings in accordance with Article XIII(12). Alternatively the measure of loss to the foreign investor might be different from that to the locally incorporated enterprise, e.g. in case of a majority-owned enterprise or an enterprise required contractually to indemnify its parent for any loss. But an investor which alleges that it has suffered loss or damage, directly or indirectly, through a breach of the BIT is entitled to bring proceedings under Articles XIII(1) and (2). If it cannot prove compensable loss or damage, it will fail on the merits; that does not affect the jurisdiction of a tribunal constituted in accordance with Article XIII(4) to entertain its claim.<sup>68</sup>

119. The Tribunal notes that to some extent the Respondent’s complaint was provoked by the way in which the Claimant’s prayer for relief was formulated in its Application, insofar as it included claims for reimbursement and/or damages to be paid to COL and AEC. EnCana argues that “derivative” loss and damage are actionable on behalf of the subsidiary but its reliance on *SD Myers*<sup>69</sup> and *Pope & Talbot*<sup>70</sup> in this respect is misplaced. Both of these

<sup>68</sup> Articles I(g) and XIII do not allow shareholders in general to represent third-State enterprises; it is necessary that the enterprise be owned or controlled by an investor having the nationality of one of the two States.

<sup>69</sup> *SD Myers Inc. v Government of Canada* (2000) 8 ICSID Reports 18, 51 (para. 231).

<sup>70</sup> *Pope & Talbot Inc. v Government of Canada* (2002) 7 ICSID Reports 148, 166 (para. 80).

claims involved claims for loss and damage caused to the parent (the investor) arising from measures taken in relation to their subsidiaries (the investment) rather than claims made on behalf of the subsidiary under NAFTA Article 1117 for the subsidiary's loss and damage. (In any event, both claims involved subsidiaries incorporated in the host State.)

120. The BIT does not envisage that damages will be paid to enterprises which are not themselves investors as defined in Article I, except by way of the special provision under Article XIII(12) for curative proceedings on behalf of an enterprise incorporated in the host State. To the extent that it sought damages to be paid to AEC and COL as such, EnCana's request clearly went beyond what the BIT allows. But this does not affect the Tribunal's jurisdiction over EnCana's concurrent claim for loss or damage to itself.<sup>71</sup>

121. It is not necessary for the Tribunal to decide whether an investor could, pursuant to Article XIII(9)(b), seek restitution of property taken from a subsidiary incorporated in a third State. Even if it could do so, Article XIII(9)(b) makes it clear that the Respondent State is entitled to "pay monetary damages and any applicable interest in lieu of restitution", and for the reasons stated such a payment would have to be made either to the investor itself in respect of its own loss or damage (under Article XIII(1)) or, in proceedings brought under Article XIII(12), direct to a locally-incorporated enterprise. In the present case EnCana seeks an award of damages directly to itself, and no question of restitution arises.

122. To conclude, in the present case EnCana claims on its own behalf for loss or damage incurred by reason of or arising out of alleged breaches of the BIT affecting its investment. Such a claim falls within the express terms of Articles I and XIII(1) of the BIT and the Tribunal has jurisdiction over it.

(2) EnCana's progressive sale of its Ecuadorian interests

123. A further objection to jurisdiction related in the first place to the claim relating to COL. On 28 November 2003, while the present proceedings were pending, EnCana sold its interest in COL for US\$15 million to Condor. According to EnCana, pursuant to the sale agreement it is entitled on a "flow-through basis", i.e., without any deduction, to 70% of any amounts which may be awarded in respect of VAT refunds which should have been paid in the period when COL belonged to EnCana.<sup>72</sup> As noted above, in September 2005 EnCana announced the sale of its remaining Ecuadorian assets to a Chinese joint venture; in response the Respondent indicated that its objection to the claim as regards EnCana's interest in COL now extended to EnCana's interests overall.<sup>73</sup>

124. Ecuador argues that, even if EnCana would otherwise be entitled to maintain the claim in respect of COL, the effect of the sale of COL is to preclude any recovery by EnCana in relation to COL in the present proceedings.<sup>74</sup> This argument is based on a number of grounds.

<sup>71</sup> Claimant's Response, 10 August 2004, §§165-6. See also Claimant's Memorial, 26 April 2004, §290(iv) & (v); cf. Claimant's Notice of Arbitration and Statement of Claim, §60(d) & (e).

<sup>72</sup> Claimant's Memorial, 26 April 2004, §§128, 133.

<sup>73</sup> Respondent, letter of 22 December 2004.

<sup>74</sup> Respondent's Counter-Memorial on the Merits, 25 June 2004, §§79-88.

- (a) Under Article XIII(1), only an “investor” as defined in Article I(h) may make a claim. Insofar as EnCana no longer holds any interest in COL it is no longer the corporation “who makes the investment” in Ecuador, and accordingly is no longer an “investor”.<sup>75</sup>
- (b) Under Article XIII(12)(a), a claimant must be an “investor” through to the issuance of the award; in this respect the Respondent relies on the decision in *Loewen*.<sup>76</sup>
- (c) Finally, it is said, again relying on *Loewen*, that EnCana’s claim is an attempt to avoid the continuous nationality rule of international law.<sup>77</sup>

125. EnCana responds that once it has made an investment in Ecuador, it is an “investor” within the meaning of Article I(h) of the BIT; as it had already suffered loss and damage in relation to the measures taken in relation to COL at the time of the service of the Notice of Arbitration, it had standing to bring the claim to arbitration.<sup>78</sup> EnCana further notes that the Treaty does not expressly require continuity of ownership of an investment during the pendency of a claim, and that the Respondent had not cited any authority in support of its interpretation of the Treaty.<sup>79</sup> In relation to the argument as to continuity of nationality, EnCana stresses that it has at all times been a Canadian corporation, and that the sale of COL has not affected its nationality. EnCana further distinguishes *Loewen* on the basis that it was the claimant in that case which had changed nationality during the pendency of the proceedings. It relies on the decision in *Mondev*<sup>80</sup> to support the proposition that the fact that the Claimant no longer owns the investment at the time of the Award is not a bar to recovery. It is submitted in this context that a broad approach to interpretation of the notions of “investor” and “investment” in the BIT is appropriate, analogous to that taken by the Tribunal in *Mondev* in relation to Article 1139 of NAFTA.<sup>81</sup>

126. In the Tribunal’s view, the Respondent’s argument misconceives the basis on which a claim such as the present is brought. EnCana is not acting “on behalf of an enterprise which the investor owns or controls directly or indirectly” (cf Article XII(12)(a)); the BIT makes no provision for curative proceedings of this kind in respect of third-State subsidiaries. Rather it is bringing a claim on its own behalf, alleging loss or damage to itself arising out of the Respondent’s measures. The sale of COL did not affect that claim as to loss or damage which had accrued up to the time of the sale. Condor did not through the terms of sale agree to indemnify EnCana in any event for losses suffered as a result of Ecuador’s tax measures and no question of subrogation arises. The fact that EnCana may be contractually obliged to

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<sup>75</sup> Ibid., §83.

<sup>76</sup> *The Loewen Group Inc. v. United States of America, Award*, Case No. ARB(AF)/98/3, 26 June 2003, 7 ICSID Reports 442, 485 (para. 225).

<sup>77</sup> Respondent’s Counter-Memorial on the Merits, 25 June 2004, §83.

<sup>78</sup> Claimant’s Response, 10 August 2004, §§171-4.

<sup>79</sup> Ibid., §§175-7.

<sup>80</sup> *Mondev International Limited v. United States of America*, ICSID Case No. ARB(AF)/99/2, Award, 11 October 2002, 6 ICSID Reports 192, 214-5 (para. 91).

<sup>81</sup> Claimant’s Response, 10 August 2004, §§181-187.

pay to Condor 30% of any amount recovered on account of COL<sup>82</sup> is irrelevant to EnCana's standing in the present arbitration.

127. It is true that in its Notice of Arbitration EnCana sought continuing relief by way of reimbursement to AEC and COL of "the amounts that may become payable by the Companies after the date of the Tribunal's award and for which no corresponding VAT credits and refunds would have been granted to the SRI by the Companies".<sup>83</sup> At that time COL was still owned by EnCana, and continuing losses by COL on account of the measures complained of fell within the scope of Article XIII(1). Once COL was sold the position changed; no further losses could be incurred by EnCana in that regard and recognising this, EnCana abandoned the claim for future losses in respect of COL. But this development affected merely the scope of relief which EnCana could plausibly seek; it had no effect on the Tribunal's jurisdiction as to loss or damage previously suffered by EnCana.

128. As demonstrated by the reliance on the same passage from *Loewen* in respect of both arguments, the arguments as to continuous nationality and as to continuity of investment during the pendency of the claims are really two ways of making the same point. The response to each is likewise the same: the present claim is maintained by EnCana in its own right and not on behalf of the subsidiaries. EnCana's nationality has not changed and there has been no subrogation of claims into the ownership of any third State national. It is accordingly unnecessary to deal with the question whether and how far international law rules in the field of diplomatic protection such as the rule of continuous nationality apply to direct claims by investors under BITs, and if they do, to identify the *terminus ad quem* for the purposes of that rule.<sup>84</sup> The Tribunal notes that NAFTA's apparent co-mingling of diplomatic protection concepts with investor-State claims (see, for example, Article 1136(5)) is not reflected in the BIT applicable to this arbitration. In any event, whether or not continuous ownership is required in relation to a claim under Article XIII(12) brought on behalf of a subsidiary incorporated in the host State, that provision is not relevant to a claim in relation to damage to the investor under Article XIII(1), provided that the investor has already suffered the loss or damage at that time (which is a requirement under Article XIII in any event).

129. The Respondent's principal argument is based on the interpretation of the words "investment" and "investor" in Article I(g) and (h) respectively. As a preliminary matter it is undisputed that EnCana satisfies the requirements of the first limb of Article I(h) insofar as it is a "enterprise [as defined in Article I(b)] incorporated or duly constituted in accordance with the applicable laws of Canada". The central issue is whether the words "makes the investment in the territory of the Republic of Ecuador" impose a requirement that the relevant interest of the Claimant in the investment must continue up to the time of a final award on the Claim, or whether it is enough that the Claimant is able to show that at the time of their

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<sup>82</sup> Claimant's Memorial, 26 April 2004, §§133, 135; see also the Respondent's Counter-Memorial on the Merits, 25 June 2004, §82. For the Sale Agreement see Respondent, Exhibits to Rejoinder, vol. I, Tab 88.

<sup>83</sup> Notice of Arbitration, 14 March 2003, para 60(c).

<sup>84</sup> According to the ILC's Draft Articles on Diplomatic Protection (as adopted on first reading), art 5, the critical date in relation to the espousal of a claim by way of diplomatic protection by the national State is the "date of the official presentation of the claim": see ILC, *Report on the work of its 56<sup>th</sup> Session (3 May to 4 June and 5 July to 6 August 2004)*, A/59/10, 34-37 esp 36.

adoption the measures complained of in relation to its “investment” caused the Claimant as an investor loss or damage.

130. The relevant provisions of Article XIII(1)-(4) are in rather general terms and do not support a restrictive approach. Article XIII(1) refers to

“*Any* dispute between one Contracting Party and an investor of the other Contracting Party, relating to a claim by the investor that a measure taken or not taken by the former Contracting Party is in breach of this Agreement, and that the investor has incurred loss or damage by reason of, *or arising out of*, that breach.” (emphasis added)

The rest of the provision refers merely to the “dispute”, and takes matters no further.

131. The Claimant argues that a “dispute” arises upon the taking of measures in breach of the Treaty which cause loss and damage to an investor, and that this is sufficient to found jurisdiction. The Tribunal agrees, both on the basis of the actual language of the BIT and its object and purpose. Provided loss or damage is caused to an investor by a breach of the Treaty, the cause of action is complete at that point; retention of the subsidiary (assuming it is within the investor’s power to retain it) serves no purpose as a jurisdictional requirement, though it may be relevant to questions of quantum.

132. In the Tribunal’s view, the reasoning adopted by the Tribunal in *Mondev* in relation to Article 1139 is applicable in the present case, even though *Mondev* was concerned with repossession of property following default on a mortgage rather than the voluntary sale of a subsidiary. To adapt what the *Mondev* Tribunal said to the provisions of the present BIT:

“Article [II], and even more so Article [VIII], will frequently have to be applied after the investment in question has failed. In most cases, the dispute submitted to arbitration will concern precisely the question of responsibility for that failure. To require the claimant to maintain a continuing status as an investor under the law of the host State at the time the arbitration is commenced would tend to frustrate the very purpose of [the BIT], which is to provide protection to investors against wrongful conduct including uncompensated expropriation of their investment and to do so throughout the lifetime of an investment... On that basis, the Tribunal concludes that [the BIT] should be interpreted broadly to cover any legal claims arising out of the treatment of an investment as defined in Article [I]...”<sup>85</sup>

In this regard, disposal of a subsidiary pending resolution of a dispute may make quantification of the loss and damage suffered more difficult, and if the investor sells at an under-value it takes the risk that it has made a bad bargain if the Tribunal subsequently finds that the actual loss caused to the investment is less than the discount reflected in the price paid. But these considerations concern the extent and proof of loss, not jurisdiction to entertain the claim.

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<sup>85</sup> (2002) 6 ICSID Reports 182, 214 (para 91).

(3) The exclusion of taxation measures: Article XII(1) of the BIT

133. The Respondent's third and main jurisdictional objection is that the present claim is inextricably associated with a "taxation measure" and therefore excluded from the scope of the BIT by Article XII(1) except in so far as it concerns the expropriation claim under Article VIII. The terms of Article XII were set out in paragraph 108 above.

134. The Claimant's position at the jurisdictional phase, as summarised by the Tribunal in its Jurisdictional Award, was that:

"the essential dispute concerns the meaning of the participation factors agreed under the oil contracts; in particular, whether they were concluded on the assumption of a certain fiscal balance concerning the existing practice of VAT recovery. At most, in the Claimant's view, the dispute concerns the relationship between the participation factors and VAT liability, and therefore falls partly within and partly outside the scope of Article XII... A dispute as to the content and meaning of the oil contracts is not a dispute, or at least not exclusively a dispute, as to a taxation measure within the meaning of the BIT."<sup>86</sup>

By contrast, the Respondent took the position that the participation factors had no relevance whatsoever to VAT liability "which depends on nothing but the tax laws of Ecuador."<sup>87</sup>

135. In its pleadings in the present phase, the Respondent argued once more that all of EnCana's claims concern simply the issue of tax refunds, and they have no validity independent of the denial of VAT. It took issue with the Claimant's assertion that there is agreement at the level of principle that EnCana is entitled to be reimbursed in respect of VAT paid in respect of inputs to exports and that the only disagreement concerns whether the participation factors already allow for these costs. According to Ecuador, EnCana is not entitled to any refund of VAT as a matter of Ecuadorian law, both in terms of the original meaning of the law and in the light of Interpretative Law No. 2004-41 (2004). It expressly denies the position attributed to it by EnCana "that EnCana is entitled to a refund and that the refund was granted through a contract."<sup>88</sup>

136. As to the issue of the Participation Contracts, the Respondent argues that these do not entitle COL and AEC to a tax refund; this is a matter for the ITRL. Rather, it argues that the calculation of the X factors under the Contracts were intended to take account of all taxes and other costs, and it is in this sense that the companies are in effect compensated by the participation factors.<sup>89</sup>

137. As regards the Denying Resolutions, the Respondent admits (as is plainly the case) that SRI did initially justify its position on the basis that VAT costs were covered by the Participation Factor. But the significance of this fact is said to be eliminated by the fact that

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<sup>86</sup> Tribunal's Decision on Jurisdiction, 27 February 2004, §34.

<sup>87</sup> Ibid., §35.

<sup>88</sup> Respondent's Rejoinder, 25 June 2004, §93.

<sup>89</sup> Ibid., §§99-101.

in later resolutions and in the court proceedings, SRI justified the decisions on the basis that the companies were not entitled to refunds as a matter of Ecuadorian law in any case.<sup>90</sup>

138. In response EnCana stresses that SRI in the initial Denying Resolutions had claimed that the relevant provisions of the tax legislation was not applicable because of reimbursement through the Participation Contracts.<sup>91</sup> It notes that the Tribunal in the *Occidental* award characterised the dispute as one about whether the refund was secured under the X factors.<sup>92</sup> It submits that, despite Ecuador's efforts to frame the actions taken by SRI as "taxation measures", SRI's actions were based on a conclusion as to the scope of the Participation Contracts, and accordingly the claim does not relate solely to "taxation measures" within the meaning of Article XII.<sup>93</sup>

139. In addition, EnCana argues that:

- (1) the sums claimed were not taxes but rather "refunds and credits of amounts collected by [COL and AEC] in respect of which they are to act as collection agents only", since according to the "destination" principle universally adopted in VAT systems, exporters are not subject to taxation via VAT in respect of business-to-business transactions;<sup>94</sup>
- (2) the "idiosyncratic" application of VAT refund rules to exports of oil (in distinction with other like products such as cut flowers) amounts to discrimination; "taxation measures" are by definition measures of a general character, not *ad personam* exactions.<sup>95</sup>
- (3) that Article XII(1) should not be read as permitting measures of SRI adopted in clear disregard of the applicable provisions of domestic law, contrary to Andean Community Law and in violation of almost universal practice in relation to the granting of VAT credits and refunds.<sup>96</sup>

140. The Tribunal will consider, first, the extent to which matters concerning VAT liability fall in principle within the scope of the exemption for taxation measures in Article XII(1); secondly, whether SRI's initial reliance on the Participation Contracts takes EnCana's claim outside the scope of that exemption; thirdly, the position of Petroecuador; fourthly, the internal developments in Ecuador, including domestic decisions and the dismissal of the justices of the Supreme Court, apparently on grounds related to the dispute with the oil companies.

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<sup>90</sup> Ibid., §102.

<sup>91</sup> Claimant's Response, 10 August 2004, §§190, 194.

<sup>92</sup> Claimant's Response, 10 August 2004, §200, referring to *Occidental Award*, §74: "the parties do not dispute the existence of the tax or its percentage. What the parties really discuss is whether its refund has been secured under Factor X of the Contract, as claimed by the Respondent, or if that is not the case, whether, as argued by the Claimant, it should be recognized as a right under Ecuadorian Tax Law."

<sup>93</sup> Claimant's Response, 10 August 2004, §§201-202.

<sup>94</sup> Ibid., §§203-4.

<sup>95</sup> Ibid., §§205-6.

<sup>96</sup> Ibid., §§210-20.

(a) The scope of the exemption for “taxation measures”

141. The term “taxation measures” is not defined in the BIT, although Article I(i) of the Treaty defines the term “measure” to include “any law, regulation, procedure, requirement or practice”.

142. In the Tribunal’s view, the term “taxation measures” should be given its normal meaning in the context of the Treaty. In particular, the Tribunal would make the following observations as to the meaning of the term.

- (1) It is in the nature of a tax that it is imposed by law. Tax authorities are not robber barons writ large, and an arbitrary demand unsupported by any provision of the law of the host State would not qualify for exemption under Article XII. On the other hand, as the Respondent stressed, the Tribunal is not a court of appeal in Ecuadorian tax matters, and provided a matter is sufficiently clearly connected to a taxation law or regulation (or to a procedure, requirement or practice of the taxation authorities in apparent reliance on such a law or regulation), then its legality is a matter for the courts of the host State.
- (2) There is no reason to limit the term “taxation” to direct taxation, nor did the Claimant suggest it should be so limited.<sup>97</sup> Thus indirect taxes such as VAT are included.
- (3) Having regard to the breadth of the defined term “measure”, there is no reason to limit Article XII(1) to the actual provisions of the law which impose a tax. All those aspects of the tax regime which go to determine how much tax is payable or refundable are part of the notion of “taxation measures”. Thus tax deductions, allowances or rebates are caught by the term.
- (4) The question whether something is a tax measure is primarily a question of its legal operation, not its economic effect. A taxation law is one which imposes a liability on classes of persons to pay money to the State for public purposes. The economic impacts or effects of tax measures may be unclear and debatable; nonetheless a measure is a taxation measure if it is part of the regime for the imposition of a tax. A measure providing relief from taxation is a taxation measure just as much as a measure imposing the tax in the first place. In the case of VAT, the Tribunal does not accept that the system of collection and recovery of VAT, even if it may be revenue-neutral for the intermediate manufacturer or producer, is any less a taxation measure at each stage of the process. A law imposing an obligation on a supplier to charge VAT is a taxation measure; likewise a law imposing an obligation to account for VAT received, a law entitling the supplier to offset VAT paid to those from whom it has purchased goods and services, as well as a law regulating the availability of refunds of VAT resulting from an imbalance between an individual’s input and output VAT.

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<sup>97</sup> In the *Occidental* arbitration, the claimant argued that the somewhat differently worded US provision was limited to direct taxation – an argument rejected by the Tribunal: *Occidental Award*, §69.

143. Thus even if it were the case that the position of an intermediate producer was in substance that of a tax collector or a tax conduit (the actual incidence of the tax being on the ultimate consumer), nonetheless the legal provisions dealing with the position of the intermediate producer and its rights and obligations in relation to the process of VAT accountability, including an entitlement to refunds, would still be “taxation measures” within Article XII(1). And if a law is a taxation measure, then any executive act apparently (and not merely colourably) implementing that law is equally a taxation measure.

144. Claimant argues that Ecuador is acting inconsistently: on the one hand SRI is refusing to allow a VAT rebate on the basis that all the costs of oil operations are covered by the participation factor in the Participation Contract; on the other hand, it is not the case that the participation factor does so. VAT recovery was never an issue at the time the participation factors were negotiated, and (despite the direction given by the President of Ecuador in his letter of 27 October 2003) Petroecuador has declined to renegotiate under the “economic balance” clause of the participation agreements on the basis that VAT refunds are a matter for SRI. The Tribunal will turn in due course to the question of renegotiation of the participation factors. For present purposes, however, the point is that even if the Claimant is right in its characterisation of the situation, the dispute about VAT refunds is still one concerning “taxation measures”.

145. The same conclusion applies to the Respondent’s characterisation of the issue. In the Respondent’s view, whether oil companies can reclaim VAT has nothing to do with the participation factor; the question is whether they are engaged in “*fabricación*” within the meaning of the Ecuadorian law. That is self-evidently a matter covered by the phrase “taxation measures”; and this Tribunal is not a court of appeal in, and (subject to the two exceptions set out in Article XII) has no jurisdiction over taxation matters. It does not matter whether Ecuador is right or wrong about the “*fabricación*” argument. It is a question to be settled by the taxation courts of Ecuador in accordance with the law of Ecuador.

146. As noted above, EnCana argues that the SRI has been inconsistent in its application of the law, denying that oil producers are engaged in “*fabricación*” or manufacture while allowing VAT refunds to traders such as exporters of cut flowers or mineral exporters who do not alter the character or quality of their product through the process of extraction and transport. The Tribunal notes that at least one of the Ecuadorian tax officials who gave evidence admitted that it might well be necessary for SRI to examine such cases in the light of the interpretation now adopted.<sup>98</sup> But even if (as the Tribunal is inclined to conclude) SRI has not been consistent in its interpretation of Article 69A the essential point is that the obligations not to discriminate and to act in an equitable manner as between different classes of investors – obligations that may be derived from Articles II and IV of the BIT – do not apply to taxation measures. Even if SRI has applied the VAT rules in an “idiosyncratic” manner, this does not lead to the conclusion that its conduct falls outside the scope of the exclusion for taxation measures. The demands were made by authorised tax officials in purported compliance with the relevant law; they were subject to review by the tax courts and eventually by the Taxation Chamber of the Supreme Court. They bear all the marks of a

<sup>98</sup> Mr Venegas, Day 3: p. 5, lines 5-16; cf. Dr de Mena, Day 4, p. 70, lines 1-9.

taxation measure – whether a lawful one under Ecuadorian law it is not for the Tribunal to decide.

147. Similar considerations apply to EnCana’s argument that SRI’s denial of VAT refunds constitutes a breach of applicable Andean Community Law, or even of generally accepted international standards for the application of the destination principle in VAT laws. In *Occidental* the tribunal accepted the argument that Andean Community law at the relevant time required the adoption of a thorough-going version of the destination principle.<sup>99</sup> Even if this is so (the matter was earnestly re-debated before the present Tribunal), nonetheless a VAT law maintained in violation of Andean Community law would not cease to be a taxation measure for the purposes of Article XII(1). As to the argument about commonly accepted international standards (also extensively debated before it), the Tribunal has doubts as to the extent to which even widespread common practice in applying the destination principle would go to form a rule of customary international law in the absence of some articulated common sense of obligation to that effect (of which there is no evidence). But again the Tribunal need not decide the point: its jurisdiction does not extend beyond applying the BIT, and a taxation measure does not cease to qualify as such because it is arguably in breach of commonly accepted substantive standards for such measures.

148. In reaching this conclusion the Tribunal has not taken into consideration the Interpretative Law but has relied only on the legal situation as it existed previously. It notes but does not need to resolve the controversy as to the constitutional validity of the Interpretative Law published on 11 August 2004 and as to whether it has been given retrospective effect, e.g. by the decision of the District Tax Court of 26 April 2005.<sup>100</sup> In other contexts a retrospective change in the law, deeming some demand to be covered by a taxation law which was not so covered at the time, might well not attract immunity from scrutiny under Article XII(1). Thus conduct not involving a taxation measure which violated Article II of the BIT at the time it was committed would not acquire the character of a taxation measure for the purposes of the BIT by being retrospectively labelled as such.<sup>101</sup> But the Tribunal does not understand how an existing measure, in principle covered by the Article XII(1) exclusion, could cease to be so covered by reason of the passage of the Interpretative Law. Either the Interpretative Law is valid under the Constitution of Ecuador, in which case it partakes of the same character as the law it interprets; or it is not, in which case the previous law remains in place and has the same legal character in terms of the BIT.

149. For these reasons, the Tribunal concludes the EnCana’s claim so far as it relates to the entitlement of the subsidiaries to VAT refunds is excluded from the scope of the BIT by Article XII as a “taxation measure”, subject to the exception for expropriation.

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<sup>99</sup> *Occidental Award*, §§145-152.

<sup>100</sup> See *Petróleos Colombianos Ltd v. Director General of SRI* (No. 20115-2660 S-I-S-V), provided as an attachment to the letter sent by Counsel for the Respondent dated 16 May 2005 in response to the Tribunal’s Questions of 4 April 2005.

<sup>101</sup> The breach of the BIT having occurred could not be retrospectively excused, or responsibility for it excluded, by a provision of internal law: cf ILC Articles on Responsibility of States for Internationally Wrongful Acts, annexed to GA resolution 56/83, 12 December 2001, Articles 4, 32.

(b) SRI's reliance on the participation factor

150. As a matter of fact it is clear that one of the grounds, initially at least the principal ground, given by SRI for rejecting AEC's and COL's VAT refund claims, and for requiring repayment of refunds actually paid, was that VAT was a cost of doing business which was in principle covered by the participation factors.<sup>102</sup> The Tribunal also finds as a matter of fact that the participation factors in the various contracts did not take VAT payments into account as costs.<sup>103</sup> This was the evidence of Mr Keplinger, EnCana's chief officer in Ecuador and a direct participant in the negotiations; it was not contradicted by any first-hand evidence produced by the Respondent.<sup>104</sup> In particular, no witness from Petroecuador was tendered by the Respondent. The Tribunal notes that Dr de Mena's statements to the contrary effect were not based on evidence but on assumption (see paragraph 69 above), and were subsequently contradicted by Dr Barniol, the President of Petroecuador, in his letter to Dr de Mena of 20 November 2001. It is true that Ecuadorian officials, including Dr de Mena, subsequently urged EnCana and other oil companies to seek to resolve the VAT refund issue without litigation through an adjustment to the participation factor. But they could consistently do so without taking any position on the original intention of the parties to the participation contracts.

151. Several issues are however raised in this regard. One is whether SRI's conduct in denying entitlement to VAT refunds in part at least on a mistaken assumption about the scope and coverage of the participation factors still benefits from the Article XII exception for taxation measures. Another is whether any conduct of Petroecuador in this regard might fall within that exception.

152. As to the former question, the Tribunal would note the following:

- (a) From a fairly early stage the alternative argument based on the term "*fabricación*" was also being used.<sup>105</sup> Whatever the merits of that interpretation may be, to impose a tax or to deny a refund by reference to a term contained in a taxation law is itself a taxation measure.
- (b) Although one—chronologically the first—ground given for the SRI's position (viz., the inclusion of VAT among the participation factors) was wrong as a matter of fact in AEC and COL's case, SRI's decisions were reviewable by the tax courts of Ecuador, whose rulings (whether or not Dr de Mena approved of them) were complied with. A decision by a taxation authority, reviewable by the taxation courts, remains a taxation measure even if it is based in whole or part on a mistake of fact as to the intent of some other entity.

<sup>102</sup> See above, paragraphs 77-81. Although Mr Venegas said (Day 3, p. 95, lines 2-3) that SRI relied on Art. 69A from the beginning, this is not reflected by the record.

<sup>103</sup> The same conclusion was reached in relation to the conclusion of the participation agreement between Petroecuador and Occidental: see *Occidental Award*, paras. 98-113.

<sup>104</sup> Keplinger First Witness Statement, 26 April 2004, paras 10-11. Mr. Keplinger's testimony to this effect was not affected by cross-examination: Day 1 p. 35, line 13-p. 36, line 16 (examination in chief), p. 56, line 14-p. 57 line 6.

<sup>105</sup> See above, paragraphs 80-83.

153. For these reasons, in the Tribunal's view, the fact that the decisions of SRI and the Ecuadorian courts were based on a wrong factual premiss did not take them outside the scope of the exclusion for "taxation measures" in Article XIII of the BIT.

(c) The position of Petroecuador

154. The Tribunal turns to the third issue identified in paragraph 140 above, viz., the application of the taxation exemption to conduct of Petroecuador. The Respondent did not deny that in entering into Participation Contracts with foreign companies to exploit the natural resources of Ecuador, the conduct of Petroecuador as a State-owned and State-controlled instrumentality is attributable to Ecuador for the purposes of the BIT. In this respect it is relevant that Petroecuador was, in common with the SRI, subject to instructions from the President and others, and that the Attorney-General pursuant to the law had and exercised authority "to supervise the performance of... contracts and to propose or adopt for this purpose the judicial actions necessary for the defence of the national assets and public interest".<sup>106</sup> According to the evidence this power extended to supervision and control of Petroecuador's performance of the participation contracts and to their potential renegotiation. Thus the conduct of Petroecuador in entering into, performing and renegotiating the participation contracts (or declining to do so) is attributable to Ecuador. It does not matter for this purpose whether this result flows from the principle stated in Article 5 of the ILC's Articles on Responsibility of States for Internationally Wrongful Acts or that stated in Article 8.<sup>107</sup> The result is the same.<sup>108</sup>

155. Furthermore, to the extent that EnCana asserts a violation of the BIT by conduct of Petroecuador, the Article XII exemption for taxation measures can have no application. Whatever Petroecuador may or may not have done in relation to the participation contracts, those acts could not have amounted to a taxation measure.

156. The difficulty however is the extent to which EnCana's case can be treated as involving a claim under the BIT concerning the conduct of Petroecuador (cf the Tribunal's questions of 4 April 2005, set out in paragraph 103 above). In principle a BIT claim is to be judged in the terms in which it has been made. It is not the function of the Tribunal to recast

<sup>106</sup> Codification of the Organic Law of the State Attorney-General's Office, 2004, Art. 3 (g); *Registro Oficial* No. 312, 13 April 2004.

<sup>107</sup> Article 5 of the ILC's Articles provides:

"The conduct of a person or entity which is not an organ of the State under article 4 but which is empowered by the law of that State to exercise elements of the governmental authority shall be considered an act of the State under international law, provided the person or entity is acting in that capacity in the particular instance."

Article 8 provides:

"The conduct of a person or group of persons shall be considered an act of a State under international law if the person or group of persons is in fact acting on the instructions of, or under the direction or control of, that State in carrying out the conduct."

<sup>108</sup> In his Witness Statements of 16 May and 27 May 2005, the Attorney-General claimed to be acting as the person responsible for renegotiating the participation contracts and treats the Attorney-General's Office as "a controlling entity" in relation to the contracts. See e.g., Witness Statement of José María Borja Gallegos, 27 May 2005, para 6.

the claim in an attempt to bring some aspect of the factual situation within its jurisdiction and thereby to raise a case under the BIT.

157. As to the conduct of Petroecuador and a possible claim for a breach of the BIT arising from that conduct, the Tribunal would make the following points:

- (a) In EnCana's Notice of Arbitration, the measures complained of as violations of the BIT are all acts of central organs of the Ecuadorian State, including the legislature and SRI.<sup>109</sup> Although the conclusion of the participation contracts is said to have been based on a shared understanding as to how EnCana subsidiaries would be taxed, the crux of EnCana's claim is that this understanding reflected the true legal position and that the SRI and the tax courts acted inconsistently with it, thereby frustrating the legitimate expectations of the EnCana subsidiaries and unjustly enriching Ecuador to the extent of the tax refunds wrongly denied.
- (b) Although it is disputed to what extent Ecuador in general and Petroecuador in particular actively pursued the possibility of renegotiation of the participation factors (see paragraphs 105-106 above), the evidence is that Ecuador did raise the prospect of renegotiation with various oil companies, including EnCana, and it takes two to renegotiate. It is clear that from a relatively early stage EnCana elected to seek recovery from this Tribunal based on the position that its subsidiaries were entitled to VAT refunds. At no stage did it argue that they were entitled to renegotiate the participation factors on the ground that they were innocently misled as to the tax position.
- (c) Mr Keplinger admitted as much in his Witness Statement of 16 May 2005, when he stated:

“None of AEC, COL or EnCana has requested Petroecuador to give effect to the terms of the President's letter of 27 October 2003, or to act to resolve outstanding questions in the light of the matters set out in the recitals to the Interpretive Law, although AEC has participated in the informal discussions with the Attorney-General which are referred to above.”<sup>110</sup>

158. In the Tribunal's view it could well be a breach of Article II of the BIT for a State entity such as Petroecuador, having negotiated the terms of an investment agreement on a certain basis, subsequently to deny the other party the right to renegotiate in accordance with the agreement in the event that the basis for it has been changed as a result of decisions of other State organs. Under standards such as those in Article II of the BIT the State must act with reasonable consistency and without arbitrariness in its treatment of investments. One arm of the State cannot finally affirm what another arm denies to the detriment of a foreign investor.<sup>111</sup> But this claim is not made by EnCana, which never requested renegotiation. Whatever the position with respect to meetings and invitations to meetings between the

<sup>109</sup> See Notice of Arbitration, 14 March 2003, paras 10, 27-31, 36-44.

<sup>110</sup> Witness Statement of John Keplinger, 16 May 2005, para 39. See also his testimony, Day 1, p. 48, line 22-p.49 line 14 (examination in chief), p. 61 line 13-p. 65 line 10 (cross-examination).

<sup>111</sup> See e.g. *Occidental Award*, para. 114.

Attorney-General and EnCana representatives (see paragraph 106 above), it is not a claim which is sustainable on the facts presented to the Tribunal.

159. To summarise, though conduct of Petroecuador could be attributed to Ecuador in accordance with the principles of State responsibility, EnCana's claim for a breach of the BIT is not made on this basis.<sup>112</sup>

160. The Tribunal would add only two comments in this regard. First, its finding as to the basis of EnCana's claim in no way implies any criticism of EnCana or of its legal representatives. Evidently in any renegotiation there was a risk that other factors might be raised, including for example increases in oil prices or other actual or alleged changes in circumstances. Given the volatile political situation in Ecuador, this was very much a matter for EnCana to decide, having regard to its own strategic plans.<sup>113</sup> Secondly, although the Respondent argues that the only issue for renegotiation would have been the actual changes in the VAT regime since the conclusion of the participation contracts (viz, the extension of VAT to most services and the increase in the VAT rate from 10% to 12%),<sup>114</sup> this does not reflect the basis on which the participation factors were set. The economic stability clauses in the participation contracts apply in case of any amendment (*modificación*) to the tax regime or to its interpretation: see paragraph 34 above. At the time the X3 factor was set for the Tarapoa field, on 2 August 2001, VAT refunds were currently being allowed to AEC. In the Tribunal's view subsequent developments, including the Interpretative Law, produced a modification to the tax regime or to its interpretation as compared with the situation as at 2 August 2001.

161. Finally, the Tribunal notes that the renegotiation process is expressly contemplated by the Participation Agreements and in the event of a dispute between the parties to the contracts would be subject to the Agreements' dispute settlement procedures.

(d) Internal developments in Ecuador

162. The political difficulties in Ecuador in the period from December 2004 were referred to by EnCana in its Post-hearing Submissions not – evidently – in order to form a new basis of claim but in order to shed light on the situation with respect to the tax claims pending before the Ecuadorian courts. As noted already, the EnCana subsidiaries' tax claims were withdrawn by them at the time of the commencement of the present arbitration.<sup>115</sup>

<sup>112</sup> In its Notice of Arbitration, para 62 EnCana reserved the right "to supplement or amend this Notice of Arbitration... including the right to submit further claims... and any additional claims of loss and damage by reason of, or arising out of, any breaches of the Treaty". Having regard *inter alia* to Article XIII(1), such a reservation probably cannot allow amendment so as to bring within the scope of the proceedings entirely new and distinct claims: cf *Certain Phosphate Lands in Nauru*, ICJ Reports 1992 p. 240, at 264-7 (paras. 62-71); *LaGrand case (Germany v United States of America)*, ICJ Reports 2001 p. 466 at 483-4 (paras. 44-5). But in any event EnCana has maintained the claim identified in the Notice of Arbitration and in its correspondence with the States parties to the BIT.

<sup>113</sup> According to the Attorney-General of Ecuador, COL under its new ownership has agreed to discussions on the participation factors: Witness Statement of José María Borja Gallegos, 27 May 2005, paras 11, 16.

<sup>114</sup> See Respondent's letter of 27 May 2005, 3-4.

<sup>115</sup> There was no legal requirement for it to do so. AEC and COL are not investors as defined in Art. I(h) of the BIT but third State enterprises: see above, paragraphs 115-122. The requirement of waiver of other

163. In principle investor-State arbitration under a provision such as Article XIII of the BIT must relate to a measure in breach of the BIT which has caused loss to the Claimant by the time of the commencement of the arbitration. In terms of Article XIII(1) of the BIT, the investor must state a “claim... that a measure taken or not taken by the former Contracting Party *is* in breach of this Agreement, and that the investor *has* incurred loss or damage by reason of, or arising out of, the breach” (emphasis added). This does not mean that a claim cannot be made for losses incurred after the commencement of the arbitration. Similarly, it does not mean that factual developments subsequent to the commencement of proceedings are irrelevant or cannot be taken into consideration. For instance, such events subsequent to the commencement of the claim may relate to a continuing breach and serve to confirm earlier evidence of that breach, or they may constitute clear evidence of a breach of a BIT whereas earlier events which had occurred at the time of the commencement of the claim were equivocal and/or on the borderline of constituting a breach;<sup>116</sup> similarly subsequent events may affect the quantum of a breach of a claim which is raised and can be made out on facts existing at the time of commencement of the arbitration.

164. In sum, a balance must be struck between, on the one hand, unreasonably requiring that new proceedings be commenced where the substance of a claim of breach of the BIT may arguably have been made out or very nearly made out, and subsequent events put the question of breach beyond doubt, and on the other, allowing what are in essence new claims or new causes of action, which in reality have no real relation to the events initially relied upon, to be added on to existing proceedings on the basis of events subsequent to the commencement of proceedings.<sup>117</sup>

165. As already indicated, the Tribunal is of the view that the events between December 2004-April 2005 in Ecuador, were relied upon by EnCana not for the purpose of introducing a new claim or cause of action, but in order to inform the Tribunal of matters which might be of relevance in relation to the claims which had already been identified when the arbitration proceedings were commenced.

#### (4) Conclusion on jurisdiction

166. To conclude, EnCana’s claim before the Tribunal does not relate to the events of December 2004-April 2005 and has not changed its character or scope since the commencement of the arbitration. It was stated with clarity in EnCana’s last filing: “it is the

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procedures under Art. XIII(3)(b) applies only to the investor which brings the claim, or, when a claim is being made on behalf of a subsidiary incorporated in the host State, that subsidiary: Art. XIII(12)(a)(iii).

<sup>116</sup> See e.g. the finding of the Tribunal in *Metalclad v. Mexico* (Case No. ARB(AF)/91/1), Award of 30 August 2000, *ICSID Reports*, vol. 5, p. 209 at p. 231 (paras. 109-112) in relation to the effect of the “Ecological Decree”, passed subsequent to commencement of proceedings, as a further measure constituting expropriation. See also the decision of the Supreme Court of British Columbia (Tysoe J), 2 May 2001 *ICSID Reports*, vol. 5, p. 236, especially at pp. 255-260 for the unsuccessful challenge to that part of the Award.

<sup>117</sup> Cf. the decision of the International Court of Justice in *Certain Phosphate Lands in Nauru*, ICJ Reports 1992 p. 240, at p. 267 (para. 70) which declared claims not included in the original application inadmissible insofar as they constituted “both in form and in substance, a new claim, and the subject of the dispute originally submitted to the Court would be transformed if it entertained that claim”; see also the discussion *ibid.*, at pp. 264-267 (paras. 62-69).

position of EnCana that no portion of the input VAT receivables has ever been refunded through the participation factors and that according to the ITRL and the Andean law, such amounts must be refunded by the SRI”.<sup>118</sup> That is a claim concerning a taxation measure, and it falls within the Tribunal’s jurisdiction only if one of two conditions is satisfied: first, if the tax treatment of EnCana subsidiaries is “in breach of an agreement between the central government authorities [of Ecuador] and [EnCana] concerning an investment” (Article XII(3)) or second, if there has been an expropriation of EnCana’s rights (Article XII(4)).

167. As to the first alternative, it is not alleged in the present case that there has been a breach of any agreement between the central governmental authorities of Ecuador and EnCana. Indeed it is not clear that there has been any breach of the participation agreements at all. The fact that SRI misconceived the basis for those agreements does not amount to a breach of contract and has not been pleaded as such. Further the participation contracts were not concluded with SRI but with Petroecuador, and they were not concluded by the investor in these proceedings, EnCana, but by its third-State-incorporated subsidiaries. There is thus no basis under Article XIII(3) for this Tribunal to assume jurisdiction over the claim.<sup>119</sup>

168. Accordingly the Tribunal has no jurisdiction over EnCana’s claim except in relation to the issue of expropriation, which in the end the Respondent argued on the basis that it fell within the Tribunal’s jurisdiction and to which the Tribunal now turns.

#### E. MERITS OF THE EXPROPRIATION CLAIM

169. Article VIII of the BIT deals with expropriation. It provides as follows:

“1. Investments or returns of investors of either Contracting Party shall not be nationalized, expropriated or subjected to measures having an effect equivalent to nationalization or expropriation (hereinafter referred to as ‘expropriation’) in the territory of the other Contracting Party, except for a public purpose, under due process of law, in a non-discriminatory manner and against prompt, adequate and effective compensation. Such compensation shall be based on the genuine value of the investment or returns expropriated immediately before the expropriation or at the time the proposed expropriation became public knowledge, whichever is the earlier, shall

<sup>118</sup> Claimant’s letter of 27 May 2005, 2.

<sup>119</sup> In this respect there are significant differences between the BIT applicable in the present case and that which fell to be applied by the Tribunal in *Occidental*. The United States-Ecuador BIT, Art. X also contains a taxation exemption but it is in different terms to Art. XII of the Canada-Ecuador BIT; in particular, Art. X(2)(c) of the United States-Ecuador BIT allows claims relating to taxation provided they are claims with respect to “the observance and enforcement of terms of an investment Agreement”. Moreover under Art. VI(1) of the US-Ecuador BIT, jurisdiction is conferred on arbitral tribunals in relation to “investment disputes between a Party and a national or company of the other Party” which arise out of or relate, *inter alia*, to “an investment agreement between that Party and such national or company”. In *Occidental*, although the claimant had not invoked any claims of breach of contract or relied on contract-based rights as such (*Occidental Award*, §§46, 72) the Tribunal held that “because of the relationship of the dispute with the observance and enforcement of the investment Contract involved in this case, it has jurisdiction to consider the dispute in connection with the merits insofar as a tax matter covered by Article X may be concerned”: *ibid*, §77. For the characterisation of the participation contract as an investment agreement see *ibid*, §§44, 72.

be payable from the date of expropriation at a normal commercial rate of interest, shall be paid without delay and shall be effectively realizable and freely transferable.”

Article XII(4) provides that:

“Article VIII may be applied to a taxation measure unless the taxation authorities of the Contracting Parties, no later than six months after being notified by an investor that he disputes a taxation measure, jointly determine that the measure is not an expropriation.”

170. EnCana gave notice to the taxation authorities of the two States, who made no joint determination on the matter of expropriation. Thus from a procedural point of view it was open to EnCana to make an expropriation claim regarding “investments or returns of investors”.

171. In the Notice of Arbitration, the expropriation claim was put in the following terms.

“47. The effect of Ecuador’s actions, including the issuance of SRI Resolutions 233, 669, 670, 736, and 3191, the continuing denial of VAT Credits and refunds to the Companies, and the amendment to regulations intended to prevent the granting of VAT credits and refunds to the Companies, has been to deprive the Companies, and through the Companies, the Claimant, of their rights to such amounts under Ecuadorian law. Since, *inter alia*, the Claimant has not been compensated for this taking of monies owing to the Companies, Ecuador has failed to comply with its obligations under Article VIII of the Treaty.

48. Furthermore, and regardless of whether the Companies had a right to VAT credits and refunds under Ecuadorian law, these measures have had and continue to have an effect equivalent to expropriation. The sudden denial of VAT credits and refunds beginning in August of 2001, followed by a retroactive denial of previously granted VAT credits and refunds to foreign owned oil companies, constitute creeping expropriation and unreasonable interference with the ability of the Claimant and the Companies to make use of and benefit from their economic entitlements.”

The claim is thus put in two ways. Either Ecuador has wrongfully denied rights to refunds owing to EnCana subsidiaries under Ecuadorian law, or, irrespective of the legality of its measures, it has engaged in conduct having an equivalent effect to the expropriation of the investment.

(1) The indirect expropriation claim

172. It is convenient to deal first with the issue of indirect expropriation. Here the claim is that, even assuming the subsidiaries had no right to a tax refund under Ecuadorian law, yet the denial of the refunds had such a significant impact on the subsidiaries as to be equivalent to expropriation of the investment.

173. This way of putting the claim faces a double difficulty. In the first place, foreign investments like other activities are subject to the taxes and charges imposed by the host

State. In the absence of a specific commitment from the host State, the foreign investor has neither the right nor any legitimate expectation that the tax regime will not change, perhaps to its disadvantage, during the period of the investment.<sup>120</sup> Of its nature all taxation reduces the economic benefits an enterprise would otherwise derive from the investment; it will only be in an extreme case that a tax which is general in its incidence could be judged as equivalent in its effect to an expropriation of the enterprise which is taxed.<sup>121</sup>

174. In the second place, although the EnCana subsidiaries suffered financially from the denial of VAT and the recovery of VAT refunds wrongly made, they were nonetheless able to continue to function profitably and to engage in the normal range of activities, extracting and exporting oil (the price of which increased during the period under consideration). There is nothing in the record which suggests that the change in VAT laws or their interpretation brought the companies to a standstill or rendered the value to be derived from their activities so marginal or unprofitable as effectively to deprive them of their character as investments.

175. The facts of the present case may be compared with those in *Revere Copper & Brass, Inc v. Overseas Private Investment Corporation*, which involved a claim under the United States foreign investment program. A domestic arbitration tribunal held by majority that a combination of acts of the Jamaican Government and Parliament, including but not limited to new taxation measures, amounted to a repudiation of an investment agreement between Revere and Jamaica which prevented Revere “from exercising effective control over the use of disposition of a substantial portion of its property”.<sup>122</sup> The reasoning of the majority is reflected in the following passage:

“the effects of the Jamaican Government’s actions in repudiating its long term commitments to [Revere] have substantially the same impact on effective control over use and operation as if the properties were themselves conceded by a concession contract that was repudiated. In reaching this conclusion we are mindful that Government action impact [*sic*] must be on the *exercise* of control, and that the control referred to must be ‘effective’; that is, it must be practical and not merely theoretical control. This is not a legalistic but a practical problem. OPIC argues that RJA still has all the rights and property that it had before the events of 1974: it is in possession of the plant and other facilities; it has its Mining Lease; it can operate as it did before. This may be true in a formal sense but for the reasons stated below, we do not regard [Revere’s] ‘control’ of the use and operation of its properties as any longer ‘effective’ in view of the destruction by Government actions of its contract rights.”<sup>123</sup>

<sup>120</sup> Even if there were such a commitment (e.g. to a tax freeze or ‘tax holiday’), this would not convert a breach of contract or the denial of a legitimate expectation into an expropriation. Such conduct might violate other provisions of a BIT but under the Canadian-Ecuador BIT these do not apply to taxation measures.

<sup>121</sup> See e.g. the discussion in *Feldman v United Mexican States* (2002) 7 ICSID Reports 318, 367-70 (paras 101-11), citing *inter alia* the *Restatement Third, Foreign Relations Law of the United States* (1987) vol 2, 200-1 §712, comment (g) (“A state is not responsible for loss of property or for other economic disadvantage resulting from bona fide general taxation, regulation, forfeiture for crime, or other action of the kind that is commonly accepted as within the police power of states, if it is not discriminatory”).

<sup>122</sup> (1978) 56 ILR 258.

<sup>123</sup> *Ibid*, 291-2 (emphasis in original).

176. It is true that the dissenting arbitrator stressed that “[n]either the actual amount of the Bauxite Levy nor the manner of its imposition is unreasonable by normal standards of tax enactments in the international community”.<sup>124</sup> But the contrary proposition—the unreasonableness of the tax *per se*—was not the basis for the majority’s decision. In the *Revere* case the Levy was imposed in breach of an express tax stabilisation clause in the investment agreement and it involved a tax ranging from 15%-35% on gross receipts; it was not an income tax.<sup>125</sup> *Revere Copper* does not support the proposition that a refusal of VAT refunds amounts to an expropriation of the enterprise which has had to pay the VAT and is denied a refund. Nor did any other authority cited by EnCana support a holding that a general tax measure in itself amounted to expropriation.<sup>126</sup>

177. Under this aspect of its claim, EnCana also alleges “unreasonable interference with the ability of the Claimant and the Companies to make use of and benefit from their economic entitlements”. In this respect it relies on the dictum of the Tribunal in the *Metalclad* case, which treated as expropriation for the purposes of Article 1110 of NAFTA “not only open, deliberate and acknowledged takings of property... but also covert or incidental interference with the use of property which has the effect of depriving the owner, in whole or significant part, of the use or reasonably-to-be expected economic benefit of property even if not necessarily to the obvious benefit of the host State”.<sup>127</sup> It is true that the width of this dictum has been criticised,<sup>128</sup> but it must be read in the context of the facts of that case as found by the tribunal. Moreover *Metalclad* had nothing to do with taxation. From the perspective of expropriation, taxation is in a special category. In principle a tax law creates a new legal liability on a class of persons to pay money to the State in respect of some defined class of transactions, the money to be used for public purposes. In itself such a law is not a taking of property; if it were, a universal State prerogative would be denied by a guarantee against expropriation, which cannot be the case. Only if a tax law is extraordinary, punitive in amount or arbitrary in its incidence would issues of indirect expropriation be raised. In the present case, in any event, the denial of VAT refunds in the amount of 10% of transactions associated with oil production and export did not deny EnCana “in whole or significant part” the benefits of its investment.

178. For these reasons the claim that the subsidiaries were victims of indirect expropriation must be rejected.

## (2) The direct expropriation claim

179. Turning to the direct expropriation claim, here EnCana argues that Ecuador has wrongfully denied rights to refunds owing to EnCana’s subsidiaries under Ecuadorian law.

<sup>124</sup> Ibid, 322 (Arbitrator Bergan), citing *Gudmundsson v Iceland* (1960) 30 ILR 253, 266-7, applying Article 1 of the Additional Protocol to the European Convention on Human Rights, which preserves “the right of a State... to secure the payment of taxes or other contributions or penalties”.

<sup>125</sup> For the Jamaican proceedings see *Revere Jamaica Alumina, Ltd v Attorney-General* (1977) 74 ILR 219.

<sup>126</sup> Earlier cases in point (distinguishing taxation from expropriation) include *Kügele v Polish State* (1932) 6 ILR 69 (Upper Silesian Arbitral Tribunal).

<sup>127</sup> *Metalclad Corporation v United Mexican States*, (2000) 5 ICSID Reports 209, 230 (para 103).

<sup>128</sup> E.g., *United Mexican States v. Metalclad Corporation*, 2001 BCSC 664, 5 ICSID Reports 236, 259 (para 97), where Tysoe J noted that the definition was “sufficiently broad to include a legitimate re-zoning of property by a municipality or other zoning authority”.

This is a claim to rights under the law of Ecuador which the SRI denies exists and which the Congress through the Interpretative Law has also denied. This raises two preliminary questions, one concerning the scope of the BIT, the other concerning the applicable law.

180. As to the former point, Ecuador does not dispute that legal rights as well as physical assets can be protected by Article VIII. But it argues that the “investment” which is protected under the BIT is the physical assets of the subsidiaries in Ecuador, including their right to explore and export crude oil, and that the alleged right to a tax refund or credit does not constitute either an “investment” or “returns” as defined by Article I.

181. The relevant definitions were referred to in paragraph 117 above. There is apparently a secondary market in VAT refund certificates in Ecuador which are sold at a slight discount on their market value. But there is no indication that EnCana subsidiaries were engaged in that market, and the Tribunal accepts that EnCana did not, as such, invest in certificates entitling it to VAT refunds.

182. But this is not an end of the matter. An investment is widely defined to include “claims to money” (Article I(g)(iii)), and extends to assets owned or controlled “either directly, or indirectly through an investor of a third State”. Thus claims to money held through a third State investor can constitute an investment. Moreover the protection of Article VIII also extends to “returns” which are widely defined as...

“all amounts yielded by an investment and in particular, though not exclusively, includes profits, interest, capital gains, dividends, royalties, fees or other current income.” (Article I(j))

It is hard to imagine a broader definition, and its breadth is enhanced by the words “in particular, though not exclusively, includes” which says not once but three times that the examples given are not exhaustive and clearly implies that they are not intended to form a restrictive genus.

183. In the Tribunal’s opinion, a law which cancels a liability the State already has to an investor, including an investor of a third State which is owned or controlled by an investor of a State Party, is capable of amounting to expropriation. The right under the law of the host State to refunds of VAT in respect of the past acquisition of goods and services is a material benefit, and it does not matter whether refunds take the form of tax credits or rights to actual payment of the amount due. There is an important distinction here between a law which changes the incidence of taxation in respect of future transactions and one which seeks to do so retrospectively. If the State wishes to provide by law that in respect of future transactions there is liability to VAT and no right to a refund, then *prima facie* at least that falls within the scope of its normal prerogative to determine and vary the incidence of a tax. But once a right to a refund has accrued in respect of past transactions (so that all that remains is the question of accounting for receipts and payments) the corresponding right to be paid is capable of falling within the broad scope of “amounts yielded by an investment”, and it does not matter that the right arises under the public law of the State concerned. On that basis the right itself would be covered by Article VIII of the BIT and a claim concerning the retrospective

cancellation of the State's liability to pay money on account of tax refunds due would fall within the Tribunal's jurisdiction by virtue of Articles XII(4) and XIII(1) of the BIT.

184. The second preliminary question concerns the applicable law. The relevant clause, Article XIII(7) of the BIT, provides only a tribunal exercising jurisdiction under the BIT "shall decide the issues in dispute in accordance with this Agreement and applicable rules of international law". Unlike many BITs there is no express reference to the law of the host State. However for there to have been an expropriation of an investment or return (in a situation involving legal rights or claims as distinct from the seizure of physical assets) the rights affected must exist under the law which creates them, in this case, the law of Ecuador. The effect of the opening words of Article XII(4) is to permit this Tribunal to determine and apply the taxation law of Ecuador to the extent that it is necessary to do so in order to deal with a claim under Article VIII.

185. The right to tax refunds under Ecuadorian law has to be considered in relation to the period before and after the Interpretative Law of 2004. Although the Denying Resolutions related to trading periods well before 2004, the remedies sought by EnCana in its Statement of Claim covered VAT refunds in respect of periods after the Law was enacted, at least so far as AEC is concerned.

186. It is convenient to deal first with VAT refunds relating to transactions occurring after the adoption of the Interpretative Law—and leaving aside for the moment the circumstances of the effective closure of the courts (see above, paragraphs 100-106). The Claimant adduced some evidence that the Interpretative Law is unconstitutional, but no steps have been taken to contest its constitutionality in the manner provided for under the Political Constitution of Ecuador, and at least it must be presumed to be constitutional. It has been treated as valid and applied by at least one Ecuadorian court.

187. For the reasons given in paragraphs 177 and 183, it is for Ecuador to determine for the future the regime of its tax law, taking into account its international obligations including under Andean Community Law. From the Tribunal's perspective, unless and until action is successfully taken to annul the Interpretative Law on constitutional grounds or to bring it into line with what are said to be the obligations of Ecuador within the Andean Community, that Law must be taken to define the extent to which oil companies are entitled to VAT refunds in respect of the acquisition of goods and services. As things stand no question of expropriation can arise in respect of the period after the passage of the Interpretative Law.

188. The position is different with respect to the period before 2004, and in particular for the periods covered by the Denying Resolutions. Here there are two questions: (a) did the EnCana subsidiaries have a right under Ecuadorian law to VAT refunds in respect of purchases of goods and services during these periods? And if so: (b) was that right expropriated by Ecuador?

189. As to the first question, the *Occidental* tribunal held that such a right did exist, following analysis of the relevant legislation and cases.<sup>129</sup> Although this decision is not

<sup>129</sup> *Occidental Award*, §§75, 77.

binding on the present Tribunal, the Tribunal will proceed on the assumption that it is correct. The question is whether that right was expropriated by action of the Respondent, contrary to Article VIII.

190. The Tribunal will also assume—again *arguendo*—that a policy decision was made at some stage within SRI to do everything within its power to deny refunds to the oil companies.

191. On these two assumptions, the question is whether the policy manifested in the Denying Resolutions and similar action taken by SRI amounted to expropriation or conduct equivalent to expropriation of accrued rights to tax refunds, within the meaning of Article VIII of the BIT.

192. A NAFTA Tribunal in the *Waste Management* case analysed in some detail the test for expropriation of incorporeal rights by executive action.<sup>130</sup> After referring to earlier decisions and doctrine,<sup>131</sup> the *Waste Management* tribunal concluded as follows:

“The mere non-performance of a contractual obligation is not to be equated with a taking of property, nor (unless accompanied by other elements) is it tantamount to expropriation... [T]he normal response by an investor faced with a breach of contract by its governmental counter-party (the breach not taking the form of an exercise of governmental prerogative, such as a legislative decree) is to sue in the appropriate court to remedy the breach. It is only where such access is practically or legally foreclosed that the breach could amount to an outright denial of the right, and the protection of Article 1110 would be called into play.”<sup>132</sup>

Subsequently it expressed the test for executive expropriation in the following terms: “an effective repudiation of the right, unredressed by any remedies available to the Claimant, which has the effect of preventing its exercise entirely or to a substantial extent, thereby frustrating or negating the enterprise as a whole”.<sup>133</sup> In other words (and more succinctly) was there a “final refusal to pay (combined with effective obstruction of legal remedies)”?<sup>134</sup>

193. That case concerned breach of contractual rights by local government bodies, not rights under tax legislation. There are differences between alleged governmental non-performance of contractual obligations and governmental refusal to make payments allegedly

<sup>130</sup> *Waste Management, Inc v United Mexican States* (2004) 43 ILM 967.

<sup>131</sup> The tribunal in *Waste Management* examined the following cases on expropriation of intangible rights by repudiation: *Azinian, Davitian & Baca v. United Mexican States*, (1998) 5 ICSID Reports 269; *George W. Cook v. Mexico* (1928) 22 AJIL 189; *Singer Sewing Machine Co. v. The Republic of Turkey* in F.K. Neilsen, ed., *The American-Turkish Claims Commission. Opinion and Report* (Washington, Government Printing Office, 1937), 490; *Rudloff case*, (1905) 9 RIAA 255; *Libyan American Oil Company v. Government of the Libyan Arab Republic*, (1977) 61 ILR 141; *Revere Copper & Brass, Inc. v. Overseas Private Investment Corporation* (1978) 56 ILR 258; *Starrett Housing Corporation v. Government of the Islamic Republic of Iran* (1987) 16 Iran-US CTR 112; *Shufeldt Claim*, (1930) 2 RIAA 1083. See *Waste Management Inc v United Mexican States*, (2004) 43 ILM 967, 996-8 (paras 146-155).

<sup>132</sup> *Ibid*, 1002 (para 174).

<sup>133</sup> *Ibid* (para 175).

<sup>134</sup> *Ibid* (para 176).

required by statute, in particular tax refunds. Evidently only a government can engage in the latter conduct, and the determined exercise of executive authority by a host State may influence the situation decisively, notwithstanding such separation of powers as may exist under the constitutional practice of that State. As the tribunal said in *Revere Copper*, it is necessary to look at the substance and not only the form.

194. All this is true. But there is nonetheless a difference between a questionable position taken by the executive in relation to a matter governed by the local law and a definitive determination contrary to law. In terms of the BIT the executive is entitled to take a position in relation to claims put forward by individuals, even if that position may turn out to be wrong in law, provided it does so in good faith and stands ready to defend its position before the courts. Like private parties, governments do not repudiate obligations merely by contesting their existence. An executive agency does not expropriate the value represented by a statutory obligation to make a payment or refund by mere refusal to pay, provided at least that (a) the refusal is not merely wilful, (b) the courts are open to the aggrieved private party, (c) the courts' decisions are not themselves overridden or repudiated by the State.

195. This principle applies equally to tax authorities as to other executive agencies. In the Tribunal's view, the policy of a tax authority such as SRI is not reviewable under Article VIII of the BIT (having regard in particular to its Article XII) unless that policy in itself amounts to an actual and effective repudiation of legal rights.

196. Turning to the facts of the present case, even if SRI may have been looking for reasons to deny VAT recovery to oil companies, in the Tribunal's view this was tempered in a number of ways. In particular:

- (a) the oil companies could (and did) challenge SRI's rulings in the courts, on occasions with success;
- (b) when it lost, SRI complied promptly with the court decisions;
- (c) EnCana itself did not challenge Dr de Mena's good faith,<sup>135</sup> and the Tribunal, having heard Dr de Mena, accepts that she was indeed acting in good faith in a matter where the legal issues were unclear and unsettled;
- (d) there is no evidence, prior to the events of 2004-5, that the court decisions were partisan, biased against the oil companies or otherwise non-independent. Indeed the differences of opinion between the Tax Court and the Supreme Court suggest the contrary.

197. For these reasons in the period prior to November 2004, SRI's policy on oil refunds never rose to the level of the repudiation of an Ecuadorian legal right; it did not therefore amount to a violation of Article VIII.<sup>136</sup>

198. The position may well have been different so far as concerns claims to tax refunds still pending before the Ecuadorian courts at the time of the passage of the Interpretative Law.

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<sup>135</sup> Transcript, Day 4, p. 29, line 13; p. 30, line 15.

<sup>136</sup> The *Occidental* Tribunal agreed, striking out the expropriation claim in that case as inadmissible: *Occidental Award*, §§80-92.

Subsequent acts, such as the President's media statement following the first dismissal of judges, not to mention the dismissals themselves, reinforce this conclusion. It is difficult to see how any oil company litigant with a case pending at that time could have received impartial justice. Indeed, it appears that no attempt was made to adjudicate on pending cases during this period. According to the Respondent, the position as of 18 February 2005 was that the Ecuadorian Government was "considering now which process will be used to replace the current Supreme Court justices, who were temporarily appointed. We understand that the interim judges intend to refrain from deciding any pending cases".<sup>137</sup> But it is not necessary for the Tribunal to deal further with this period, since the EnCana subsidiaries had already withdrawn their claims well before.

199. For these reasons the Tribunal by majority rejects EnCana's claim based on Article VIII of the BIT.

200. Dr. Horacio Grigera Naón appends to this award a statement of his dissenting opinion on the question of expropriation.<sup>138</sup>

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<sup>137</sup> Letter from Counsel for Ecuador to the Tribunal, 18 February 2005, 3.

<sup>138</sup> The majority has carefully considered the partial dissenting opinion. In response to the dissent, the majority of the Tribunal would make only a few points. First, it notes that at paragraph 190, the Tribunal made clear that its analysis was based on the assumption that the SRI took the policy decision to do everything within its power to deny refunds to the oil industry. This was an assumption *arguendo* and it is tempered by the finding of fact at paragraph 196(c) that the head of the SRI, Ms. de Mena, acted in good faith, a point that EnCana itself noted it did not contest. This finding is crucial to the Tribunal's analysis. Had it been found that the authorities acted in bad faith the analysis would have led to a finding of State responsibility. Second, it should be stressed that the right which is alleged to have been expropriated is the right of a subsidiary to claim VAT refunds. There is no question that such denial did not amount to an indirect expropriation of the enterprises themselves; they continued to be controlled by EnCana and to operate profitably. Nor is there any question of the denial of a legitimate expectation as to tax treatment; at the time the investments were made, no claim to VAT refunds was being asserted or allowed. Thus the question is the narrow one, whether the denial of an incidental public law right (in an unclear, nascent domestic taxation regime) by an executive organ acting in good faith amounts to the expropriation of that right. In our view it does not, in the circumstances of the present case and in relation to the relevant period. Under a bilateral investment treaty executive agencies must be able to take positions on disputable questions of local law, provided that they act in good faith, the courts are available to resolve the resulting dispute, and judicial decisions adverse to the executive are complied with. Consistent with well-established international principle and doctrine, Article VIII of the BIT does not convert this tribunal into an Ecuadorian tax court, in particular having regard to its Article XII. The Tribunal cannot pick and choose between different and conflicting national court rulings in order to arrive at a view as to what the local law should be. Third, the Tribunal's holding on this narrow point does not, in our view, amount to reimposing a requirement of the exhaustion of local remedies which the BIT does not as a general matter require. The question is not whether the claim is admissible but whether the relevant rights have been expropriated as a matter of substance. Neither the taxpayer nor the tax collector can determine definitively whether certain rights exist, and in the circumstances set out in paragraph 196 of the Award, it cannot be said that the mere position of an executive agency, whether it is right or wrong at local law (and provided it is unaccompanied by any collateral abuse of authority or exercise of undue prerogative) perfects an expropriation. Fourth, we note that we have considered this question on the assumption (without deciding) that EnCana is correct on the substantive issues of Ecuadorian law. Even on that footing, for the reasons stated, the direct expropriation claim fails. Finally, we note that the attempts by Ecuador to resolve the dispute by offering to enter into negotiations on the participation factor cannot be dismissed out of hand. The foreign investor is of course free to reject such an offer and to prefer litigation or arbitration. But whatever the relevance and materiality of an untested offer to resolve a dispute with a foreign investor is, it cannot, in the majority's view, be taken as evidence of an expropriation.

## F. Costs

201. Article XIII(9) of the BIT permits the Tribunal to award costs in accordance with the applicable arbitral rules. Article 40 of the UNCITRAL Arbitration Rules states:

“1. Except as provided in paragraph 2, the costs of arbitration shall in principle be borne by the unsuccessful party. However, the arbitral tribunal may apportion each of such costs between the parties if it determines that apportionment is reasonable, taking into account the circumstances of the case.

2. With respect to the costs of legal representation and assistance referred to in article 38, paragraph (e), the arbitral tribunal, taking into account the circumstances of the case, shall be free to determine which party shall bear such costs or may apportion such costs between the parties if it determines that apportionment is reasonable...”

According to the general principle expressed in article 40(1), as the prevailing party Ecuador is in principle entitled to the costs of the arbitration. However, this is not an inflexible rule and the Tribunal has a discretion to order otherwise.

202. In view of the events giving rise to this proceeding, the Tribunal considers that it would not be equitable to require EnCana to pay Ecuador’s costs of arbitration. Indeed, the Tribunal has considered whether Ecuador should be required to meet EnCana’s costs, despite the fact that the limitations on its jurisdiction under the Treaty prevent the Tribunal from addressing most of EnCana’s complaints and despite its having found that no expropriation was effected by the Respondent. In the circumstances, the Tribunal considers that it would be just and equitable for Ecuador to bear the costs of the arbitration. Accordingly, Ecuador shall be responsible for reimbursing EnCana for all sums that it has deposited with the LCIA as deposit-holder in connection with the costs of the arbitration.

203. In fact the costs of the arbitration are as follows:

Professor Crawford’s fees	US\$147,786.07
Professor Crawford’s expenses	US\$5,798.51
Dr Grigera Naon’s fees	US\$175,404.30
Dr Grigera Naon’s expenses	US\$34,996.78
Christopher Thomas QC’s fees	US\$162,910.65
Christopher Thomas QC’s expenses	US\$16,345.90
Dr Barrera Sweeney’s fees	US\$46,481.40
Dr Barrera Sweeney’s expenses	US \$4,459.08
Hearing room costs	US\$24,395.34
Court reporting costs	US\$2,010.71
Translation costs	US\$12,746.14
Secretary to the Tribunal’s fees	US\$ 4,110.93
Secretary to the Tribunal’s expenses	US\$69.27
LCIA’s charges	US\$48,272.96
Total:	US\$685,788.04

EnCana has lodged deposits and registration fee of US\$355,544.61, including interest accrued. Ecuador has lodged deposits of US\$355,520.60, including interest accrued. Total deposits lodged by the parties amount, therefore, to US\$711,065.21, of which US\$685,788.04 has been applied to the costs of the arbitration, as above. The US\$25,277.17 held by the LCIA, being the residue of the funds deposited, is to be refunded by the LCIA to EnCana. Accordingly, the Tribunal decides that Ecuador shall reimburse EnCana in the amount of US\$330,267.44.

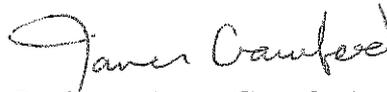
204. Having regard to article 38 of the UNCITRAL Arbitration Rules, the Tribunal concludes that each party must bear its own costs of representation and assistance.

**AWARD**

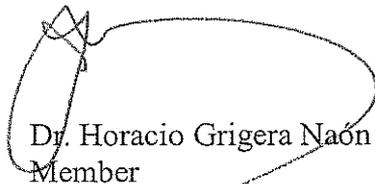
For the foregoing reasons, the Tribunal:

- (1) unanimously holds that the Claimant's claims, except as they relate to Article VIII of the BIT, are outside its jurisdiction by reason of Article XII of the BIT;
- (2) by majority rejects EnCana's claim based on Article VIII of the BIT;
- (3) unanimously holds that Ecuador shall be responsible for reimbursing EnCana the sums it has deposited with the LCIA as deposit-holder in connection with the costs of the arbitration, in the amount of \$330,267.44, and that otherwise each party shall bear its own costs of representation in these proceedings.

Done at London in English and Spanish, both versions being equally authoritative.



Professor James Crawford  
President of the Tribunal



Dr. Horacio Grigera Naón  
Member

3 February 2006



Mr. Christopher Thomas  
Member

10 February 2006

**APPENDIX 1****SELECT CHRONOLOGY**

<b>1993</b>	
29 November 1993	Hydrocarbon Law amended to allow for participation contracts
<b>1995</b>	
29 March 1995	City Oriente/Petroecuador, Block 27 Participation Contract
25 July 1995	AEC/Petroecuador, Tarapoa Participation Contract
27 October 1995	AEC/Petroecuador, 18b Fanny Unitization Agreement
<b>1996</b>	
29 April 1996	Ecuador/Canada BIT concluded (in force 6 June 1997)
23 August 1996	Publication in Official Journal of Decision 388 of the Cartagena Commission of the Andean Community of Nations (2 July 1996)
<b>1997</b>	
April 1997	Opening of negotiations for X3 factor on Tarapoa and Fanny 18B with AEC
6 June 1997	Ecuador/Canada BIT published in Official Gazette
12 December 1997	Outline agreement for X3 factors for Fanny 18B (70%) and Tarapoa (73%)
<b>1998</b>	
-	
<b>1999</b>	
1 May 1999	Art 69A, ITRL applies VAT to most services
4 May 1999	EnCana acquires Pacalta Resources Ltd, indirect owner of AEC, itself owner of City Oriente.
14 July 1999	Amendment of AEC/Petroecuador Fanny 18b Unitization

	Contract ("Fanny X3 Contract") (following ratification of level of 70% by <i>Comando Conjunto de Ecuador</i> )
31 August 1999	Resolution No. 1730 denying AEC's claim for VAT paid December 1998 and January to November 1998 (Northern Regional Directorate) (upheld by Resolution 00736 of 24 September 2001)
25 November 1999	AEC/Petroecuador, 1999 Mariann 4A Unitization Agreement.
1 December 1999	VAT rate increased from 10 to 12%
<b>2000</b>	
8 March 2000	SRI Resolution 47 approving refund to AEC of VAT paid May-July 1999 (Original Resolution)
30 March 2000	SRI Resolution UR, denying AEC VAT refund claim for January to April 1999. (Northern Regional Directorate)
5 April 2000	SRI Resolution 119 approving refund to AEC of VAT paid for July 1999 (Original Resolution)
12 April 2000	SRI Resolution 00129 annulling in part resolution 00047, and approving refund to AEC of VAT paid in relation to May 1999 (Original Resolution)
26 June 2000	SRI Resolution 00316 approving refund to AEC of VAT paid August-September 1999 (Original Resolution)
29 August 2000	SRI Resolution 700 approving refund to AEC of VAT paid October-December 1999 (Original Resolution)
13 December 2000	SRI Resolution 00929 approving refund to AEC of VAT paid for June 2000 (Original Resolution)
14 December 2000	SRI Resolution 00949 approving refund to AEC of VAT paid in relation to February, May & August 2000 (Original Resolution)
<b>2001</b>	
10 January 2001	SRI Resolution 00039 approving refund to AEC of VAT paid in relation to January, March & July 2000 (Original Resolution)
6 March 2001	SRI Resolution 00202 approving refund to AEC of VAT paid in relation to February, April & June 2000 (Original Resolution)

11 July 2001	Petroecuador tells SRI that it is unable to confirm whether or not VAT was included among the costs contemplated by the contractors when drawing up bids and agreeing the Participation Factors.
2 August 2001	Reduction of X3 factor under AEC/Petroecuador 1995 Tarapoa Participation Contract from 73% to 70% (following ratification by <i>Comando Conjunto de Ecuador</i> )
28 August 2001	SRI Resolution 00669 denying VAT credit/refund to AEC for VAT paid September 2000-May 2001
28 August 2001	SRI Resolution 00670 denying VAT credit/refund to COL September-December 2000
24 September 2001	SRI Resolution 00736 upholding resolution 001730 (31 August 1999) (Northern Regional Directorate) denying VAT credit and refund to AEC for VAT paid in relation to January to December 1998
20 November 2001	Letter from President of Petroecuador to SRI, stating that the Participation Factors do not contemplate "reimbursements" of investments, costs and expenses, but rather provide a share of the production to the Contractor; Petroecuador "will await a ruling by the appropriate authorities to determine whether or not the participation factors should be renegotiated" having regard to eventual VAT liabilities
20 December 2001	SRI Resolution UR-0003191 denying VAT credit/refund to COL for VAT in relation to August 2000 (Northern Regional Directorate)
<b>2002</b>	
1 January 2002	Amendment to Regulation of the Internal Tax Regime Law, denying right to a credit where "VAT paid by a purchaser has been reimbursed to it in any manner."
1 April 2002	SRI Resolution 00233 revoking the Original Resolutions, and requiring collection of sums refunded/credited in sum of \$7,567,091.87 plus interest against AEC.
21 May 2002	City Investing Company Ltd changes name to AEC.
11 July 2002	EnCana's Notice of dispute under the BIT
8 November 2002	Decision of First Chamber of Ecuadorian District Tax Court in <i>City Investing Ltd v. Director General of the SRI</i> (AEC's

	challenge to Resolution 00669). Appeal to Supreme Court filed within 5 days (later withdrawn)
19 November 2002	Decision of First Chamber of Ecuadorian District Tax Court in <i>City Oriente Ltd v. Director General of the SRI</i> (City Oriente's challenge to Resolution 00670). Appeal to Supreme Court filed within 5 days (later withdrawn)
<b>2003</b>	
14 March 2003	Claimant's Notice of Arbitration and Statement of Claim pursuant to Article XIII of the BIT; simultaneously AEC and COL discontinue proceedings in the Tax Court challenging SRI Resolution 233
27 October 2003	President of Ecuador writes to SRI instructing it to solve the refund issue by way of the participation factors
13 November 2003	Decision of Supreme Court in <i>Bellwether International v. General Director of SRI</i> (Case 4-2003)
28 November 2003	EnCana sells interest in City Oriente.
<b>2004</b>	
14 January 2004	Decision of Supreme Court on SRI's appeal in <i>City Oriente Ltd v. General Director of SRI</i> (Case 42-2003) (affirming refund of 2%)
12 February 2004	Decision of Supreme Court on SRI's appeal in <i>City Investing Ltd v. General Director of SRI</i> (Case 48-2003) (affirming refund of 2%)
19 March 2004	Decision of Ecuadorian District Tax Court in <i>Repsol YPF v. General Director of SRI</i>
1 July 2004	Final Award of UNCITRAL Tribunal (Orrego Vicuña, Brower, Barrera Sweeney) in <i>Occidental Exploration and Production Company v. Republic of Ecuador</i>
16 July 2004	Cartagena Commission Decision 599
21 July 2004	D-G SRI writes to Petroecuador stating (with reference to President's letter of 27 October 2003) that VAT input receivables are to be dealt with under the contracts
11 August 2004	Interpretative Law published in Official Journal

25 November/8 December 2004	Congress removes 27 Supreme Court judges (out of 31) and 7 Constitutional Court judges (out of 9)
<b>2005</b>	
15 April 2005	President Gutiérrez by decree removes entire Supreme Court; decree retracted within 24 hours.
17 April 2005	National Congress votes to dismiss Supreme Court
20 April 2005	National Congress removes President Gutierrez
26 April 2005	District Tax Court rejects Petróleos Colombianos Ltd's VAT refund claim in relation to March-April 2001 relying substantially on Interpretative Law

## Appendix 2

### **Agreement between the Government of Canada and the Government of the Republic of Ecuador for the Promotion and Reciprocal Protection of Investments Quito, 29 April 1996**

#### **Article I – Definitions**

For the purpose of this Agreement:

- (b) “enterprise” means
  - (i) any entity constituted or organized under applicable law...; and
  - (ii) a branch of any such entity;
  
- (g) “investment” means any kind of asset owned or controlled either directly, or indirectly through an investor of a third State, by an investor of one Contracting Party in the territory of the other particular, though not exclusively, includes:
  - (iii) money, claims to money, and claims to performance under contract having a financial value;
  - (iv) rights, conferred by law or under contract, to undertake any economic and commercial activity, including any rights to search for, cultivate, extract or exploit natural resources.

...
  
- (h) “investor” means
  - in the case of Canada:
    - (i) any natural person possessing the citizenship of or permanently residing in Canada in accordance with its laws; or
    - (ii) any enterprise incorporated or duly constituted in accordance with applicable laws of Canada,
 who makes the investment in the territory of the Republic of Ecuador; ...
  
- (i) “measure” includes any law, regulation, procedure, requirement or practice;
- (j) “returns” means all amounts yielded by an investment and in particular, though not exclusively, includes profits, interest, capital gains, dividends, royalties, fees or other current income;

#### **Article II: Establishment, Acquisition and Protection of Investments**

1. Each Contracting Party shall encourage the creation of favourable conditions for investors of the other Contracting Party to make investments in its territory.
2. Each Contracting Party shall accord investments or returns of investors of the other Contracting Party:
  - (a) fair and equitable treatment in accordance with principles of international law, and
  - (b) full protection and security.

#### **Article IV: National Treatment after Establishment and Exceptions to National Treatment**

1. Each Contracting Party shall grant to investments or returns of investors of the other Contracting Party treatment no less favourable than that which, in like circumstances, it grants to investments or returns of its own investors with respect to the expansion, management, conduct, operation and sale or disposition of investments.

...

#### **Article VIII: Expropriation**

1. Investments or returns of investors of either Contracting Party shall not be nationalized, expropriated or subjected to measures having an effect equivalent to nationalization or expropriation (hereinafter referred to as "expropriation") in the territory of the other Contracting Party, except for a public purpose, under due process of law, in a non-discriminatory manner and against prompt, adequate and effective compensation. Such compensation shall be based on the genuine value of the investment or returns expropriated immediately before the expropriation or at the time the proposed expropriation became public knowledge, whichever is the earlier, shall be payable from the date of expropriation at a normal commercial rate of interest, shall be paid without delay and shall be effectively realizable and freely transferable.

#### **Article XII: Taxation Measures**

1. Except as set out in this Article, nothing in this Agreement shall apply to taxation measures.
2. Nothing in this Agreement shall affect the rights and obligations of the Contracting Parties under any tax convention. In the event of any inconsistency between the provisions of this Agreement and any such convention, the provisions of that convention apply to the extent of the inconsistency.
3. Subject to paragraph (2), a claim by an investor that a tax measure of a Contracting Party is in breach of an agreement between the central government authorities of a Contracting Party and the investor concerning an investment shall be considered a claim for breach of this Agreement unless the taxation authorities of the Contracting Parties, no later than six months after being notified of the claim by the investor, jointly determine that the measure does not contravene such agreement.
4. Article VIII may be applied to a taxation measure unless the taxation authorities of the Contracting Parties, no later than six months after being notified by an investor that he disputes a taxation measure, jointly determine that the measure is not an expropriation.
5. If the taxation authorities of the Contracting Parties fail to reach the joint determinations specified in paragraphs (3) and (4) within six months after being notified, the investor may submit its claim for resolution under Article XIII.

**Article XIII: Settlement of Disputes between an Investor  
and the Host Contracting Party**

1. Any dispute between one Contracting Party and an investor of the other Contracting Party, relating to a claim by the investor that a measure taken or not taken by the former Contracting Party is in breach of this Agreement, and that the investor has incurred loss or damage by reason of, or arising out of, that breach, shall, to the extent possible, be settled amicably between them.
2. If a dispute has not been settled amicably within a period of six months from the date on which it was initiated, it may be submitted by the investor to arbitration in accordance with paragraph (4). For the purposes of this paragraph, a dispute is considered to be initiated when the investor of one Contracting Party has delivered notice in writing to the other Contracting Party alleging that a measure taken or not taken by the latter Contracting Party is in breach of this Agreement, and that the investor has incurred loss or damage by reason of, or arising out of, that breach.
3. An investor may submit a dispute as referred to in paragraph (1) to arbitration in accordance with paragraph (4) only if:
  - (a) the investor has consented in writing thereto;
  - (b) the investor has waived its right to initiate or continue any other proceedings in relation to the measure that is alleged to be in breach of this Agreement before the courts or tribunals of the Contracting Party concerned or in a dispute settlement procedure of any kind;
  - (c) if the matter involves taxation, the conditions specified in paragraph 5 of Article XII have been fulfilled; and
  - (d) not more than three years have elapsed from the date on which the investor first acquired, or should have first acquired, knowledge of the alleged breach and knowledge that the investor has incurred loss or damage.
4. The dispute may, at the election of the investor concerned, be submitted to arbitration under:
  - (a) The International Centre for the Settlement of Investment Disputes (ICSID), established pursuant to the Convention on the Settlement of Investment Disputes between States and Nationals of other States, opened for signature at Washington 18 March, 1965 (ICSID Convention), provided that both the disputing Contracting Party and the Contracting Party of the investor are parties to the ICSID Convention; or
  - (b) The Additional Facility Rules of ICSID, provided that either the disputing Contracting Party or the Contracting Party of the investor, but not both, is a party to the ICSID Convention; or
  - (c) an international arbitrator or ad hoc arbitration tribunal established under the Arbitration Rules of the United Nations Commission on International Trade Law (UNCITRAL).
5. Each Contracting Party hereby gives its unconditional consent to the submission of a dispute to international arbitration in accordance with the provisions of this Article.  
...
7. A tribunal established under this Article shall decide the issues in dispute in accordance with this Agreement and applicable rules of international law.  
...
9. A tribunal may award, separately or in combination, only:

- (a) monetary damages and any applicable interest;
- (b) restitution of property, in which case the award shall provide that the disputing Contracting Party may pay monetary damages and any applicable interest in lieu of restitution.

A tribunal may also award costs in accordance with the applicable arbitration rules

10. An award of arbitration shall be final and binding and shall be enforceable in the territory of each of the Contracting Parties.

...

12. (a) A claim that a Contracting Party is in breach of this Agreement, and that an enterprise that is a juridical person incorporated or duly constituted in accordance with applicable laws of that Contracting Party has incurred loss or damage by reason of, or arising out of, that breach, may be brought by an investor of the other Contracting Party acting on behalf of an enterprise which the investor owns or controls directly or indirectly. In such a case:

- (i) any award shall be made to the affected enterprise;
- (ii) the consent to arbitration of both the investor and the enterprise shall be required;
- (iii) both the investor and enterprise must waive any right to initiate or continue any other proceedings in relation to the measure that is alleged to be in breach of this Agreement before the courts or tribunals of the Contracting Party concerned or in a dispute settlement procedure of any kind; and
- (iv) the investor may not make a claim if more than three years have elapsed from the date on which the enterprise first acquired, or should have first acquired, knowledge of the alleged breach and knowledge that it has incurred loss or damage.

(b) Notwithstanding subparagraph 12(a), where a disputing Contracting Party has deprived a disputing investor of control of an enterprise, the following shall not be required:

- (i) a consent to arbitration by the enterprise under 12(a)(ii); and
- (ii) a waiver from the enterprise under 12(a)(iii).