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Who's Right? The Occidental Oil controversy from a viewpoint of Ecuadorian Laws.

In the next three years foreign investments in the oil sector in Ecuador are expected to exceed $4.5 billion[1]. However, these investments are currently being threatened by a controversy involving the Ecuadorian Government and Occidental Petroleum Corporation, referred here in after as Oxy. The controversy started with issues of Ecuador's tax system, the interpretation of an investment contract, and refund requests for value- added tax (VAT)[2].

Oxy's claims have derived in Ecuador's action to declare the expiration and nullity of the contract with Oxy concerning Block 15 in the Amazon region. Both issues will be addressed from the standpoint of Ecuadorian law in this paper.

Ecuadorian Background on Oil

Ecuador's economy is predominantly based on oil. The country produces approximately 390.000 barrels a day[3]. Petroleum is the country's greatest commodity in the foreign exchange area[4]. Petroecuador is the Ecuadorian petroleum corporation that controls the

[1] Hamed Amiri Ghaemmaghami, *Can't Live with'em, Can't Live without'em: Ecuadorian Value-Added Tax Laws, Foreign Oil Investors, and The Andean Trade Preferences Act*, 10 Sw. J.L. & Trade Am. 391

[2] Susan D. Franck, *Occidental Exploration & Production Co. v. Republic of Ecuador. Final Award. London Court of International Arbitration Administered Case No. Un 3467. Arbitral Tribunal*, July 1 2004, 99 Am. J. Int'l L. 675

[3] See Ghaemmaghami, supranote 1 at 394

[4] See Id.

exploration, exploitation, transportation, industrialization and commercialization of petroleum and products that derive from it.[5]

The petroleum company has discretion to operate by itself, or by contracting with domestic and foreign enterprises through association, participation, and service contracts[6].

In this manner, Oxy has been providing oil production services to Petroecuador since 1985[7].

The Tax Issues

In the contracts Oxy signed during this period, the parties stipulated that the VAT would be reimbursed to Oxy for payments of local acquisitions[8]. In 1999 Oxy and the government of Ecuador entered into a modified participation contract through which Oxy became an equity participant in the oil extraction, exported its portion of oil and received compensation through a participation formula known as "factor X"[9]. Also the contract changed how Oxy was reimbursed for its VAT payments[10]. In the modified contract, rather than having VAT reimbursements transferred from Petroecuador to Oxy as expenses of a contractor providing services, Oxy was required to pay VAT payments and collect all applicable refunds[11].

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[5] Petroecuador website, http://www.petroecuador.com.ec/web04/imagenes/pdf/mision.pdf
[6] See Ghaemmaghami, supranote 1 at 394
[7] Occidental page, http://www.oxy.com/OIL_GAS/world_ops/latin_america/ecuador.htm
[8] Franck, supranote 2 at 675
[9] See Id.
[10] See Id. At 675
[11] See Id.

At the time of the negotiation of the contract, Ecuador's tax laws were in a transitional phase[12]. Aware of the situation, Oxy sent a request for opinion to the Ecuadorian Internal Revenue Service (Servicio de Rentas Internas-SRI) to address this issue[13]. In the document Oxy inquired in writing about its liability of VAT for goods imported to support the contract[14].

Under Ecuadorian tax law, imported goods of a tangible nature are subject to VAT[15]. Consequently all the materials and equipment imported into Ecuador by the oil companies to assist in the activities related to the complying with its obligations under the contract are subject to the VAT[16]. According to Ecuadorian VAT regulations, a taxable person is "any person importing goods in the Ecuadorian territory, either on its own account or on behalf of another person"[17]. Oxy meets this definition and is therefore subject to the VAT[18].

In Ecuador, the VAT is calculated based on the "price of supplied goods or services including taxes, fees and any other charges legally applicable to the price"[19]. The VAT is calculated at a rate of twelve percent[20]. While exemptions from VATs do exist in the Ecuadorian tax law, none of them apply to the oil industry or foreign enterprises[21].

The Tax Controversy

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[12] See Id.
[13] See Id.
[14] See Id.
[15] Ecuadorian Tax Code, article 51
[16]
[17] See Ghaemmaghami, supranote 1 at 395
[18] See Id.
[19] See Id.
[20] See Id.
[21] See Id.

In August of 2001 the Ecuadorian Internal Revenue Service (Servicio de Rentas Internas-SRI) took the position that Ecuador's tax laws did not allow VAT drawbacks and therefore suspended the refund of nearly $ 200 million in value added tax[22]. Supporting this decision the authorities of the Ecuadorian Internal Revenue Service (Servicio de Rentas Internas-SRI) stated that unlike other exporters, oil companies sign contracts that include "economic stability clauses" which enumerate the terms of their presence in Ecuador[23]. Also the Ecuadorian tax authorities established that VAT refunds were provided through the Factor X payments[24]. To solve this dispute Oxy suggested that the matter should be sent to arbitration, which was an option established in a Bilateral Investment Treaty agreed by the United States of America and the Ecuadorian Government in 1993[25].

Different Standpoints of Arbitration in this case

Clause 22.1.2 of the Participation Contract between Ecuador and Oxy establishes that: "Claims that may arise from the activities of the Direccion Nacional de Hidrocarburos (the Ecuadorian Energy & Mining administration) would be heard by the Minister of Energy & Mining. Nonetheless, Oxy has the right to present any claim before the "Tribunal Distrital Numero Uno de lo Contencioso Administrativo" (Forum for

[22] See Id. at 393
[23] See Id.
[24] See Franck, supranote 2 at 676

[25]Treaty between the United States of America and the Republic of Ecuador concerning the Encouragement and Reciprocal Protection of Investment available at http://www.sice.oas.org/bits/usecu_e.asp

administrative claims in Ecuador)[26]. Considering this clause, jurisdiction for claims of the application of law was established in the administrative forum according to the laws of Ecuador.

Also the Treaty between the United States of America and the Republic of Ecuador concerning the Encouragement and Reciprocal Protection of Investment stipulated in its Article VIII, a) that:

"This Treaty shall not derogate from: (a) laws and regulations, administrative practices or procedures, or administrative or adjudicatory decisions of either Party[27].

This said, the treaty cannot oppose to the regulations and legal environment of Ecuador, as it cannot ignore its administrative procedures under which the parties to the contract had agreed.

In the case of Ecuador v. Oxy, the fiscal tribunal of Pichincha established jurisdiction over the case and litigation had started normally. By pressures of the United States Government and Oxy upon Ecuador, the matter was taken to arbitration, in which the Ecuadorian state under high pressure of the United States government, which threaten to withdraw benefits from the Andean Trade Preferences Act, had to "voluntarily" accept arbitration[28].

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[26] Augusto Tandazo, The Occidental Case: A Challenge to See if we Are in a Country that Applies Juridical Security (2005), 25-26

[27] Treaty between the United States of America and the Republic of Ecuador concerning the Encouragement and Reciprocal Protection of Investment, article VII, letter a) available at http://www.sice.oas.org/bits/usecu_e.asp

[28] Tandazo, supranote 26 at 16-17

Taking into account these aspects from the very beginning, it would seem that the United States forced arbitration of the dispute considering that it had a better chance to win the case in a "neutral" forum than in the supposedly "biased" courts of Ecuador.

The Position of Oxy

Oxy's position was that there had been an expropriation of its investment by Ecuador's refusal to refund the VAT to which it was entitled under Ecuadorian law. This expropriation breached the BIT with the United States of America by denying fair and equitable treatment[29]. Under its claims it requested that past and future VATs be refunded to them as matter of law[30]. It was also their position that Ecuador's tax laws needed to be reformed to nullify the provisions that exclude VAT reimbursements for oil companies[31].

The International Arbitration and decision

The matter was brought to the London Court of International Arbitration. In this forum the tribunal held that: 1) Ecuador had breached its national treatment obligation by failing to treat Occidental Oil Production investment's as it would treat the investments of its own nationals[32], and 2) Ecuador had violated the Bilateral Investment Treaty (BIT) with

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[29] *Occidental Exploration & Production Co. v. Republic of Ecuador. Final Award. London Court of International Arbitration Administered Case No. Un 3467. Arbitral Tribunal*, July 1 2004, available at http://ita.law.uvic.ca/documents/Oxy-EcuadorFinalAward_001.pdf, 7

[30] Id. at 7-8

[31] Id. at 7-8

[32] See Franck, supranote 2 at 675, see also Occidental Exploration & Production Co. v. Republic of Ecuador. Final Award. London Court of International Arbitration Administered Case No. Un 3467. Arbitral Tribunal, July 1 2004, at <http://ita.law.uvic.ca/documents/oxy-EcuadorFinalAward_001.pdf>

the United States by failing to provide equitable and fair treatment[33]. The argument in support of this decision was that by not providing a transparent and stable framework of tax law, the Government of Ecuador had breached its obligations under the agreement[34]. Also in reasoning the court emphasized that although no expropriation under the BIT was found and therefore the investment was not impaired through arbitrary measures, there was a breach in national-treatment obligation by failing to treat Oxy's investment as favorably as other investments[35].

Criticisms to the Decision

The main criticism that the decision of the tribunal faced was that Oxy's situation lacked distinguishability from any other investor subject to a complex regulatory regime[36]. No structured legal framework is perfect and free of inconsistencies[37]. Historically, states have been held liable for regulatory regimes that are considered too vague or unclear[38], but would this mean that states could also be responsible for changing the business and legal environment of its own country?[39]. If this is the case, one could wonder if tax reforms efforts enacted by the United States could be subject of a complaint by a foreign entity affected by such a measure[40].

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[33] See Id., See also Treaty between the United States of America and the Republic of Ecuador concerning the Encouragement and Reciprocal Protection of Investment, article VII, letter a) available at http://www.sice.oas.org/bits/usecu_e.asp

[34] See Id. at 677
[35] See Id.
[36] See Id. at 678
[37] See Id.
[38] See Id.
[39] See Id.
[40] See Id.

Another criticism made to the arbitral tribunal decision was the fact that it did not consider the treatment of national oil companies in Ecuador[41], which are not subject for VAT refunds. The tribunal avoided reference to this; hence the claim of not providing national treatment to Oxy would seem illogical.

Consequences of the Arbitral Award.

The decision of the arbitral tribunal had a strong negative response among Ecuador's highest spheres. Ecuador believed that its sovereignty to abide by its own laws had been violated and to avoid future disputes of this kind, manifestly expressed its desire to terminate the contract with Oxy[42]. In seeking this objective the country conducted a thorough revision of the contract. This revision established many flaws and irregularities in the contract with Oxy. Upon revising the contract under Ecuadorian laws, based on the inconsistencies found, the lapsing of its container can be inferred by 4 causes:

1. - The transfer of rights that Oxy passed onto the Canadian oil company EnCana without the authorization of the Minister of Energy & Mining of Ecuador. Such a practice under Ecuadorian law produces the lapsing of the contract.

Article 74, number 11 of the hydrocarbons law of Ecuador establishes that a petroleum contract will be lapsed:

[41] See Id. at 677
[42] See Id. at 681

"When the contractor transfers rights or signs a private contract without the authorization of the Minister of Energy & Mining" [43].

Article 79 of the said law states that:

"The transfer of a contract or the cession or rights to a third party, will be null, without the authorization of the Minister of Energy & Mining".[44]

In October of 2000, Oxy transferred 40% of the rights and obligations of block 15 Eden Yuturi and Limoncocha to EnCana[45]. The transfer involved a farmout and an operation agreement[46]. Instead of registering the operation with the competent authority, which was the Minister of Energy & Mining of Ecuador, Oxy registered it in the US securities & exchange commission (Sec)[47]. By doing this Oxy ignored completely the requirement of registration of transfers of rights under article 79 of the hydrocarbons law of Ecuador. The registration of rights in the United States securities & exchange commission (Sec) satisfied only the United States requirement, but ignored the Ecuadorian requirement. This violated the country's laws concerning oil transactions which penalize the stated behavior with the lapsing of the contract in dispute.

2. - The failure to invest minimum capital required, which under Ecuadorian law triggers the lapsing of the contract.

Oxy did not invest the minimum amount requirements under the hydrocarbons law,

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[43] See Tandazo, supranote 26 at 1 See also Hydrocarbons Law of Ecuador, article 74, number 11
[44] See Id. at 2. See also Hydrocarbons Law of Ecuador, article 79
[45] See Id.
[46] See Id.
[47] See Id.

Article 74, 6)[48]of this law states:

Cause for lapsing of a contract is:
6) "If the company does not invest the annual minimum quantity required, or does not carry on the proper activities outlined in the contract"[49].

In this case Oxy did not invest the minimum amount required contractually as evidenced in the documents presented to the President of Ecuador, Minister of Energy & Mining and authorities of Petroecuador[50]. According to a brief by the Attorney general of State of Ecuador, the quantities presented in the report to the Ecuadorian authorities were different than the ones presented to the United States Securities and Exchange Commission (Sec)[51]. The sole proof of such evidence could constitute corporate fraud by Oxy under the laws of Ecuador, as well as the laws of the United States of America.

3. - The continuous violations under Ecuadorian law, including fines for overproduction, failure to present reports of its activities to the Ecuadorian government and failure to present reports of financial status.

Article 74 of the hydrocarbons law of Ecuador, in number 13 establishes:

"A cause for the lapsing of a contract in the continuous violations of its laws and its regulations".[52]

[48] See Id. at 15. See also Hydrocarbons Law of Ecuador, article 74, number 6

[49] Hydrocarbons Law of Ecuador, Article 74, number 6
[50] Tandazo, supranote 26 at 15
[51] See Id.

[52] See Id. at 16. See also Hydrocarbons Law of Ecuador, article 74, number 13

In research conducted by the Attorney General of State's office of Ecuador, Oxy was found to violate this provision many times as it was fined for engaging in overproduction six times in a row, not notifying of the perforation of wells, not presenting a final report on perforation for fourteen times, among other violations[53].

4. - Diplomatic pressure and blackmail to the Ecuadorian government, which under Ecuadorian law produces the lapsing of a petroleum contract.

1. The constitution of the republic of Ecuador, in its article 14 states that: "the contracts celebrated between the state institutions and the national or foreign naturals have implicit the resigning of diplomatic claims"[54].
2. Article 26 of Hydrocarbons law of Ecuador establishes that: "The foreign enterprises that contract with the state of Ecuador or with Petroecuador will abide by the tribunals of the country and will resign to any diplomatic recourse".[55]

Considering these two provisions, in an official letter dated 22 November 2002 addressed to the Attorney General of State of Ecuador, the Ecuadorian Chancellor notified the decision of the government to go to arbitration with Occidental Oxy[56]. The main reason for this decision, as stated before, was that the United States government had threatened to suspend the Andean Trade Preferences Act benefits to the country[57]. Ecuador could not afford to lose these benefits as a developing country because it could be a major strike on its economy and trade in the region, therefore it agreed to arbitrate.

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[53] See Id.
[54] See Id. at 17. See also Constitution of the Republic of Ecuador, Article 14
[55] See Id. See also Hydrocarbons Law of Ecuador, article 26
[56] Id. at 18
[57] Id.

By violating the laws of Ecuador, arbitration was forced to condition the benefits of the Andean Trade Preferences Act on the country.

Conclusion

The inconsistencies stated briefly here have derived in the government of Ecuador's efforts to pass reforms to its energy and tax legislation in order to exclude oil companies from receiving VAT refunds. Also proceedings have started to terminate the contractual relations with Oxy.[58]

At the moment negotiations are being undertaken as Oxy does not want to leave the country because of high profits that derive from the exploration and exploitation of oil in the Amazon and the benefits of the Andean Trade Preferences Act[59].

Some Final Comments

The dispute between Oxy and the Ecuadorian Government is still a very controversial subject in the International Oil investment area. The fact that the arbitration tribunal did not consider that Ecuadorian oil companies received the same treatment as the foreign entities in tax issues[60] has very much brought doubts into whether the tribunal's approach was the correct way to address this problem and even talks of the tribunal being biased have been the topics of many a political and economic discussion forum in the Ecuadorian public sector. Also the fact that Oxy threaten to reconsider the extent of their

[58] See Franck, supranote 2 at 681
[59] See Ghaemmaghami, supranote 1 at 403
[60] See Franck, supranote 2 at 677

investment in Ecuador, due to lack of protection in tax laws, only to go back and encourage the United States Government to retaliate against the Ecuador for non-compliance issues speaks very badly of the United States government[61]. It could be argued that United States has prioritized the securing of oil contracts abroad to secure its own reserve. It is undoubtedly the United States government job to protect investment of foreign companies abroad[62], hence the signing of the Bilateral Investment Treaties across the world[63]; however, there should be a limit in the way a country proceeds in protecting the interests of its nationals abroad. In this case it could be seen as a measure to condition the benefits of a trade agreement, that has a little or nothing to do with this dispute, to the setback of application of existing laws in a determined country.

[61] See Ghaemmaghami, supranote 1 at 396-397
[62] See Id. at 400
[63] Foreign Trade Information System available at http://www.sice.oas.org/bitse.asp