Perenco v Ecuador: An Example of a “Lengthy, Complex, Multi-faceted, Hard Fought and Very Expensive” Investment Arbitration?

Kluwer Arbitration Blog
November 14, 2019

Daniela Páez-Salgado (Assistant Editor for South and Central America) (Herbert Smith Freehills) and Natalia Zuleta (Herbert Smith Freehills)

Please refer to this post as: Daniela Páez-Salgado (Assistant Editor for South and Central America) and Natalia Zuleta, ‘Perenco v Ecuador: An Example of a “Lengthy, Complex, Multi-faceted, Hard Fought and Very Expensive” Investment Arbitration?’, Kluwer Arbitration Blog, November 14 2019, http://arbitrationblog.kluwerarbitration.com/2019/11/14/perenco-v-ecuador-an-example-of-a-lengthy-complex-multi-faceted-hard-fought-and-very-expensive-investment-arbitration/

After 11 years and more than US$ 89 million in costs,[fn]Perenco claimed US$ 57,923,322 in legal costs and other expenses, while Ecuador claimed US$ 31,620,369.27 for legal costs and other expenses and an additional US$ 49,629.76 for Petroecuador’s legal costs (a total of US$ 31,701,618.76).[/fn] an international tribunal rendered a final decision awarding damages in the *Perenco v. Ecuador* saga. We discuss below the background of the case, the main decisions rendered throughout the proceedings, with a special focus on the latest award on damages rendered in favor of Perenco and Ecuador.

Background

On April 30, 2008, Perenco Ecuador Limited ("Perenco") brought a claim before the International Centre for Settlement of Investment Disputes ("ICSID") against Ecuador under the France-Ecuador BIT (the "BIT") and two Participation Contracts (which provided for ICSID arbitration) for the exploration and exploitation of hydrocarbons in two blocks of the Amazon region concluded between Perenco and Petroecuador, Ecuador's national oil company. Although Perenco acted as the operator of the two blocks, the entity that entered into the Participation Contracts was actually a consortium comprised by Burlington Resources Oriente Limited ("Burlington") and Perenco.

In 1993, Ecuador passed Law 44, recognizing "Participation Contracts" as the preferred contractual model for the exploration and exploitation of hydrocarbons. Under these production sharing contracts, the ownership of the hydrocarbons remained with the state, and the contractor received a fair share of the oil produced under a formula: as production increased in volume, or quality, the contractor's participation percentage decreased. Shortly after Perenco acquired its interests in Blocks 7 and 21, international oil prices began to rise dramatically. As a result, in 2006, the Ecuadorian Congress passed "Law 42", a law which amended the Hydrocarbons Law, granting the Government participation over 50% of the extraordinary income from the surge in oil prices. Ecuador then issued Decree 662 in 2007, which increased the windfall profit tax rate to 99%.

Perenco made payments pursuant to the new law from July 2006 through April 2008. In parallel, Perenco had been negotiating with Petroecuador (since January 2008) an agreement to transition to a new contractual model. However, on April 2008, President Correa announced that all existing production-sharing agreements were to be terminated within the year and new contracts would be implemented.

Hence, Perenco filed its Request for Arbitration with ICSID on April 30, 2008 and proposed to Ecuador the possibility of transferring the payments related to Law 42 to an escrow account, pending the resolution of the dispute. Ecuador did not accept such proposal. Despite Ecuador's refusal, Perenco began to deposit the Law 42 amounts into an off-shore escrow account. As a result, the Government began local proceedings to collect the sums allegedly owed by Perenco, and its production and shipments were seized. Finally, in 2010, Petroecuador terminated one of the contracts (Block 21) under the legal figure of *Caducidad*, under which the Ecuadorian Ministry of Energy and Non-renewable Natural Resources has the legal power to terminate a Participation Contract concluded between a private

party and Petroecuador.

Perenco's Claims with the ICSID Tribunal

Perenco claimed that Ecuador breached the fair and equitable treatment standard ("FET") under the BIT and that it had unlawfully expropriated its investment. Pursuant to Rule 40 of the ICSID Arbitration Rules, Ecuador brought counterclaims for environmental and infrastructure damages arising out of the operations in the oil blocks under the Participation Contracts, and not the BIT.

Burlington (one of the members of the consortium) also brought an independent investment arbitration claim against Ecuador under the US-Ecuador BIT for violation of FET and expropriation of its investment. In both the *Burlington* and the *Perenco* arbitrations, Ecuador brought counterclaims for environmental damages. The *Burlington* arbitration was resolved on February 7, 2017. The Tribunal found that Ecuador was liable for US$379.8 million on the grounds of expropriation and ruled that Ecuador was correct to expect that Burlington would remediate the blocks to natural background values and ordered US$ 39.2 million in compensation to Ecuador. This award caused a potential situation of double recovery for Ecuador, who was still seeking compensation for environmental damage from Perenco at the time of that award.

Decision on Jurisdiction and Merits

In 2011, the Tribunal upheld jurisdiction over Perenco's contract claims, but deferred its decision on jurisdiction over the treaty claims to the merits phase. One of the main issues over the treaty claims was Perenco's standing based on its nationality (Perenco is a Bahamian company indirectly owned by a French citizen who died intestate and therefore, by his beneficiaries). Finally, in its Decision on Remaining Issues of Jurisdiction and on Liability of September 12, 2014, the Tribunal concluded that it had jurisdiction over the treaty claims.

In that same decision, the Tribunal found that Ecuador (i) had breached both Participation Contracts, (ii) acted in violation of FET, and (ii) that Ecuador's decision to terminate the contract by declaring *Caducidad* amounted to an expropriation.

The FET violation was based on the issuance of Decree 662 in 2007, whereby the state would receive 99% of windfall profits, converting the Participation Contracts into *de facto* service contracts, leaving Perenco unprotected against lower oil prices. The Tribunal found that the measures implemented through Law 42 or Decree 662 did not rose to expropriation.

As the *Burlington* Tribunal, the Tribunal also found that Perenco was liable to Ecuador for environmental damage. In this regard, in a subsequent decision issued in 2015 (the Interim Decision on Ecuador's Environmental Counterclaim), the Tribunal held that under the Participation Contracts, Perenco was obliged to comply with Ecuadorian law, which included the constitutional regime of strict-liability for environmental harm. Therefore, because Perenco's activities amounted to a violation of Ecuador's environmental laws, the Tribunal held that Perenco was liable for those damages, which would be awarded by the Tribunal in the corresponding phase.

Decision on Damages

Once the Tribunal rendered a decision on liability and held a hearing on quantum, it rendered a final award on September 27, 2019. This award addressed the damages claimed by both parties; specifically, US$ 1.5 billion for the principal claim, and US$ 2.5 billion for the counterclaim. In the end, the Tribunal awarded Perenco US$ 449 million as compensation for Ecuador's violation of the Participations Contracts and the BIT, and awarded Ecuador US$ 54 million for its environmental counterclaim.

Application of a "Layering Approach" to Determine the Valuation Date

The Tribunal faced a challenge on the determination of the valuation date for the damages to be awarded to Perenco, given that Ecuador's two breaches took place nearly three years apart (Decree 662 in 2007; and *Caducidad* in 2010). Perenco alleged that because both breaches were inter-related, a single valuation date (the date *Caducidad* was declared) should be considered (¶72). On its side, Ecuador proposed a "layering approach" whereby the losses caused were to be assessed at the date of the breach that caused them. Under this methodology, two calculations

ought to be made: (i) lost profits caused by Decree 662 since its issuance up to the declaration of *Caducidad*; and (ii) value of the blocks on the date of expropriation at July 2010 (¶73).

The Tribunal agreed with Ecuador's approach. Under this more orthodox approach and pursuant to the Draft Articles on Responsibility of States for Internationally Wrongful Acts, the claimant has the burden of proving the damages proximately caused by each breach at the time of its occurrence. In this case, the Tribunal found that Perenco did not prove that the breaches resulting from the issuance of Decree 662 of 2007 and of the declaration of *Caducidad* were inter-related. For the Tribunal, the expropriation was not an expected consequence of the issuance of Decree 662 (¶111). Therefore, because the breaches caused by Decree 662 (violation of FET) and the declaration of *Caducidad* (expropriation) were separated by a period of time of over two years, they could not be lumped together as one date to calculate the damages (¶77).

Finally, because the Tribunal was concerned with the degree of randomness associated with employing the date of the award as the valuation date (as a single event can have dramatic effects in the valuation given the volatility of the oil market), it chose to calculate Perenco's loss of rights according to the prevailing market conditions and industry expectations at the time when the state declared *Caducidad* (¶116).

The Appointment of an Independent Expert and Apportionment of Liability to Perenco

To award the damages for the environmental counterclaim, the Tribunal appointed an independent expert given that there were certain issues of fact extremely difficult for it to make proper determinations based on the expert evidence presented by the parties (¶424). The independent expert's role was to "supplement the work performed by the Parties' experts" to establish a more reliable technical platform to support the Tribunal's decision (¶519).

Tribunal-appointed experts are not a novelty in international arbitration.[fn]Hodgson and Stewart, "Experts in Investment State Arbitration", Journal of International Dispute Settlement, 9, 453-463 (2018).[/fn] The rules of important arbitral institutions (*e.g.*, Article 29 of the UNCITRAL Arbitration Rules,

Rule 34(a) of the ICSID Arbitration Rules), as well as the IBA Rules on the Taking of Evidence provide for this alternative and have guidelines for tribunal-appointed experts (*see*, Article 6). However, it has not been very common for investor-state tribunals to appoint independent experts. In fact, tribunal-appointed damages experts were engaged in only eight publicly available cases since 2005 where damages were awarded.[fn]Choudhury, Nathan, "Tribunal –appointed damages experts: Procedural improvements can serve as a better alternative in arbitration", Thompson Reuters, p. 3-4 (2018).[/fn] In all of these cases, the tribunal expert appointment was made in addition to the party expert appointments.[fn]Ibid.[/fn]

In the case at hand, and from the procedural standpoint, the Tribunal allowed the Parties to submit two rounds of written submissions, make oral submissions and pose questions to the independent expert at a hearing. In addition, a witness conferencing session took place at the hearing, where the independent expert was paired with each party's expert and counsel was permitted to put questions to the two experts (¶¶627-630).

The independent expert was instructed to estimate the cost of remediating the "total measured contamination" in Blocks 7 and 21, so that the Tribunal could then decide how much of such contamination was Perenco's responsibility (¶750). For this last exercise the Tribunal had to consider two temporal issues that affected causation: (i) contamination caused by operators which operated the blocks prior to Perenco; (ii) contamination caused by Petroecuador after *Caducidad,* when it took over the operation of the blocks. The independent expert concluded that the full remediation costs amounted to US$ 160 million. The Tribunal then found that the total amount of damages attributable to Perenco was of US$ 93 million based on the expert evidence.

Implications of the Burlington Decision on Counterclaims

The *Burlington* Tribunal's Decision on Counterclaims (awarding US$ 39 million to Ecuador), left it to the *Perenco* Tribunal to deal with any issues of double recovery by Ecuador given that the *Perenco* Tribunal would have to decide on Ecuador's counterclaim after its decision. In March 2017, the Parties were invited to comment on the *Burlington* Tribunal's decision. Perenco alleged that Ecuador had already been compensated for any damages related to the counterclaims and it should not

be ordered to pay any damages; or that at least, the amount paid by Burlington to Ecuador should be set off from any remediation costs the Tribunal awards to Ecuador (¶894). Ecuador did not dispute that there was substantial overlap between the contamination estimated by the independent expert and the *Burlington* Tribunal given that the former had identified larger areas and additional volumes of soil contamination, additional mud pits and additional sites with groundwater contamination (¶891). Therefore, Ecuador proposed a framework based on a site-by-site comparison of areas, depths, volumes and costs between both cases.

The Tribunal rejected both Parties' approaches, and admitted that it "thought long and hard about how to protect against double recovery", and decided to treat the US$ 39 million as a down payment towards the total amount of damages payable by Perenco. Perenco was then ordered to pay US$ 54 million to Ecuador (¶¶896-899).

Conclusion

Despite the formal conclusion of the arbitral proceedings, the end of this dispute is yet to come. Perenco filed a petition in the U.S. District Court for the District of Columbia on October 1, 2019 to confirm the award, while ICSID registered the application for annulment on October 4, 2019 and granted the customary stay of enforcement of the award.

Overall, and apart from the Tribunal's own characterization of a "lengthy, complex, multi-faceted, hard fought and very expensive" proceeding (¶967), seems that this case also endorses 'Tribunals' activism' given that the Tribunal: issued provisional measures ordering a sovereign state to refrain from pursuing local judicial actions against the claimant; appointed an independent expert to assess the value of a state's counterclaim; and carefully considered the monetary award in another case to avoid double recovery concerns.