Kluwer Arbitration Blog

Oil & Gas: Is Italy Doing It Wrong All Over Again?

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The Italian Republic – for better or for worse – is cracking down on hydrocarbon explorations and extractions. Kicking off with the regulatory changes recently brought about by the Italian Government, this post gauges their possible consequences for the stakeholders by going through a pending arbitration which may be ripe enough to become a benchmark for future cases on the horizon. The post ends with a possible amicable solution, following the steps of a previous KAB contribution.

Regulatory changes

In February this year, the Italian Parliament converted the Decree-Law No. 135/2018 into Law by passing the Act No. 11/2019. Article 11-ter of this Act has massive implications for the upstream oil & gas industry in Italy. It suspends all the exploration permits, as well as any new application for production concession for a period of 18 months, which can be stretched up to 2 years. During this temporary ban on upstream activities, the Minister of Economic Development, together with the Minister of Environment, is supposed to enact a Decree containing a Plan (named "PiTESAI") to determine, once and for all, the suitable areas for sustainable hydrocarbon exploration and production activities by having special regard for the marine ecosystem, fishery stocks and the impact on the coastline.

As soon as the Plan is adopted, the exploration permits – which are not compatible with the Plan – will be revoked accordingly. Any production concession application, pending during the adoption of the Plan and concerning areas later declared incompatible with the Plan, will be rejected, unless those production concessions are awarded before the adoption of the Plan (which is a relatively unrealistic event, given the objectives that led the Government to adopt the Decree-Law No. 135/2018 in the first place). Whereas any application for time extension regarding ongoing production concessions, which will fall within the incompatible areas with the Plan, will be declined.

Further, Article 11-ter of the Law 11/2019 is going to increase the administrative fees on hydrocarbon activities by 25 times as of 1 June 2019, in the bid to set up a fund to edge against potential investment arbitrations. The government is, indeed, well aware of the concrete risk posed by foreign oil & gas investors' arbitral claims, because of the pending Rockhopper v. Italy case. Hence, any investors' claims for direct or consequential damages, which may originate from the implementation of the Plan, will be covered (at least in theory) by the companies whose hydrocarbon production is left unharmed by the Plan itself. The Government estimates that such a fund will amount approximately to 470 million euros. However, this sum is far from being satisfactory to make up for the *damnum emergens* and *lucrum cessans* caused by the Government, according to the potentially affected companies (concerning at least 73 exploration permits).

As a result, the entire upstream industry in Italy – including both the companies whose explorations or productions have been halted, and those whose operational costs will exponentially rise – is disgruntled with the present situation and on the warpath.

The (almost ready) precedent

The *Rockhopper v. Italy* arbitration[1)] was launched in 2017 and is now arriving at its finish line. On February 4, 2019, a hearing on jurisdiction, liability and *quantum* was held in Paris, bringing the case to its closure. Therefore, according to the ICSID Arbitration Rules 38 and 46, the tribunal will have to render the award within 120 days from the closing of the proceeding (i.e. presumably around May or June 2019, unless, of course, the tribunal will extend this period by 60 additional days.

Reportedly, Rockhopper claimed compensation of 275 million euros from Italy for having breached its obligations under the ECT. This case is particularly important for the future arbitrations the oil & gas companies are now threatening to commence against Italy, because it shares similar, if not identical features, with their current situation:

1. The introduction and **retroactive application of a Legislative Act** to the existing concessions, thereby exploration and possible production activities are paralyzed;
2. A **Plan**, that will most likely turn into a **ban**, imposing completely **different zoning regulations** (just like Article 2 of the Legislative Decree 128/2010 did) and which will end up forbidding hydrocarbon explorations and extractions in blocks previously destined for such purpose as well as imposing additional limitations or burdensome compliance mechanism;
3. Probable **retraction of promises** given by previous governments contravening specific representations and inconsistencies all along the administrative procedures;
4. A further **increase of the government's take** on hydrocarbons, just like it occurred by means of Law No.134/2012 which raised off-shore royalties by more than 40% to finance sea protection and operational safety;
5. Possible **failures to observe the time-frame** to conclude the administrative procedure for the issuance of the relevant Environmental Impact Assessment Decrees concerning the production concession applications pending during the adoption of the Plan.

These analogous facts laid the foundation for Rockhopper's claims of ECT-grounded legitimate expectation violations and may now constitute the pillars for the looming arbitrations mirroring Rockhopper's case and its recurring pattern.

Despite Italy's denunciation of the ECT in January 2015, which became effective one year afterwards, Article 47(3) ECT, the ECT sunset clause, will protect for 20 more years investments in the oil & gas sector made in Italy before January 2016. Should the sunset clause fall short to light up the expectations of some foreign investors, Italy is a Contracting Party to an array of BITs, all containing a FET clause safeguarding investors' legitimate expectations. Hence, awaiting the adoption of the new Plan, investors have the time to rearrange their investments through one of the many countries which Italy has a BIT with.

Risk analysis

Given this picture, it is worth running a risk analysis for both sides. From Italy's perspective, there is the tangible risk of facing not just one, but multiple arbitrations; the possible defeat in the ongoing *Rockhopper* case (even though, arguably, the risk of being ordered to pay the 275 million euros is remote, as that sum could be reduced substantially); and the ensuing risk of setting an unfavorable precedent to be relied upon by the next belligerent oil & gas company.

From the disgruntled oil & gas companies' standpoint, there is the risk of losing time and money pending their arbitrations (which can go on from three to five years); the risk of having the tribunal drastically reducing the compensation they aspire to get; the risk of Italy non complying with the pecuniary obligations set in the award, thus causing further delays; and the ensuing risk of being compelled to choose between trying to enforce the award or selling it for less than what it was originally worth.

Circumventing double-sided risks: an amicable solution

In slightly different cases, where there happen to be a long-standing dispute among the different parties of a public-private joint venture for the exploitation of natural resources, the full course of an arbitral process may prolong, if not intensify, the conflict itself without making anyone happy. In these instances, if the State party's responsibility can be promptly ascertained, but its financial liability is below what the claimants are demanding, arbitrators have often come up with sensible solutions. A customary proposal by tribunals, for example, envisages the purchase by the State-party of the private parties' interests in the joint venture at the price the investment was made, plus a 2% annual interest rate from the date each investment was made, plus the payment of a reasonable bonus reflecting the end of the private parties' opportunity to obtain future profits from the concession. Understandably, such an overall payment should be secured by way of a bank guarantee and could be spread over a short number of years to be affordable.

This approach could be easily transferable – with the appropriate adjustments – in a **consolidated mediation** to solve the looming arbitrations unfolding before us, whose real causes are rooted in many years of a somewhat confused energy policy incapable of a long-term predictability (which is something pivotal to a sector where billions of euros are poured in with the hope of recouping gradually those investments with a reasonable profit over a long time span).

As to a positive example of a desirable amicable settlement, in the mid-eighties, Norway was in the midst of having to face multiple claims by oil & gas companies enraged at the retroactive application of a royalty payment regulation to their licenses. Right after the first leading case (*Ekofisk Royalty Case*) was ruled in favor of the claimant by the Norwegian Supreme Court on 19 December 1985, the Norwegian Government entered into negotiations with the other oil & gas companies providing them with a serious offer, instead of fueling their anger. Those companies, which waited for the outcome of that case and settled their dispute out of court, cut even a better deal (meaning a 3% higher compensation, plus interest on the overdue repayments) compared to the company that first commenced the court proceeding (which, in our case, could be Rockhopper). Simultaneously, Norway came out of that heated energy-related quarrel appearing even more trustworthy and appealing towards foreign energy companies.

As also indicated in an earlier KAB contribution, consolidated mediations could be the answer to multiple ongoing or potential arbitrations revolving around the same fact pattern, especially when a decision on a similar matter has already emerged and declared the victorious side by making following predictable awards. Eventually, both sides will avoid unnecessary risks, benefit more favorable terms and gain international credibility.

References

?1 See also the forward-looking Master Thesis from 2015 of Danilo Di Bella.

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