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Enforcing *Pacta Sunt Servanda*? Conoco-Phillips and Exxon-Mobil Versus the Bolivarian Republic of Venezuela

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ABSTRACT

In 2007, the government of Venezuela decided to re-structure certain oil projects, known as Associations, so as to bring them in line with the 2001 Hydrocarbons Law. In response, ExxonMobil and ConocoPhillips decided to exit Venezuela. Supposedly motivated by a commitment to uphold the principle of sanctity of contract, the companies subsequently initiated a series of arbitrations involving some of the largest claims ever put before international tribunals. However, the bargains that the companies insist they are defending are not reflected in the agreements that they had actually signed. Thus, these arbitrations amount to an attempt on the part of these companies to use international arbitral tribunals to re-draft on their behalf the contracts they had negotiated, so as to secure a windfall (which they had never bargained for) upon their exit from Venezuela.

'But Socrates,' said Hippias, 'how can anyone take laws seriously or believe in them, when often the same people who established them repeal and change them?'

(Xenophon, *Memorabilia*, 4.4.14.I-4)

Die Lüge wird zur Weltordnung gemacht (The world-order is based upon a lie).

Franz Kafka, *Vor dem Gesetz*

During the mid-1990s, Venezuela's national oil company, Petróleos de Venezuela S.A. ('PDVSA'), implemented a policy predicated on mobilizing the capital, technology and managerial capabilities of international oil companies in order to maximize the production of crude oil in Venezuela. This policy, known as *Apertura Petrolera* ("Oil Opening") did indeed translate into significant production gains [with oil production going from 2.6 million barrels per day (MMBD) in 1993 to 3.5 MMBD by 1998], incremental flows that played a decisive role in the oil market collapse of 1998 (which saw the price of oil plumbing its lowest levels, in real terms, since the end of the Second World War).

The standard-bearers of the *Apertura* were four large projects dedicated to the production, transportation and upgrading (i.e. partial refining) of extra-heavy crude oils (viscous crudes denser than water, with high sulphur and metals content), and to the marketing of the resulting upgraded (i.e. synthetic) crude oils. These projects were undertaken pursuant to Association Agreements (AAs) between foreign oil companies and PDVSA. Today, three of them (Petrozuata, Hamaca and Cerro Negro) are at the heart of arbitration proceedings which ConocoPhillips (COP) and ExxonMobil (XOM) mounted against the Republic of Venezuela in late 2007, before the International Centre for the Settlement of Investment Disputes (ICSID).[1] These arbitrations feature some of the largest claims ever to have been brought against a state by international investors (the approximate value of the COP claim, for example, is US$ 30.3 billion).[2]

This article seeks to provide a critical perspective on these arbitrations, by focusing on the wider economic context of the disputes and the strategic litigation choices made by major corporate claimants in investor-state arbitration processes. Such factors tend to figure peripherally in the analysis of specific disputes, since arbitrations are refractory to outside scrutiny, and detailed information (other than that which can be gleaned from arbitral decisions) is hard to come by. However, informational constraints are less pervasive in the case of the Venezuelan oil arbitrations, for which a wealth of documentary material exists: official Venezuelan publications derived from the statutory procedures for Congressional approval of the AAs, documents associated with the court proceedings to obtain attachments of PDVSA funds, partial decisions on jurisdictional matters in both ICSID cases, the award in an International Chamber of Commerce (ICC) case involving claims similar to those brought before ICSID, offering memoranda for bonds to finance the upgrading projects and, last but not least, diplomatic cables from personnel at the US embassies in Venezuela and elsewhere, placed in the public domain by *Wikileaks*.[3]

1 Petrozuata: AA signed in 1995 (50.1% COP; total COP investment: MMUS$ 1250); Hamaca (Ameriven): AA signed in 1997 (39.9% COP; total COP investment: 1600 MMUS$); Cerro Negro: AA signed in 1997 (41 2/3 per cent XOM; total XOM investment: 667 MMUS$). In addition, the claims cover two smaller exploration and production projects: Corocoro (signed in 1995; 32.5% COP share; COP outlays: 230 MMUS$ and no production at the time of nationalization) and La Ceiba (signed in 1996; 50% XOM share; XOM outlays: 180 MMUS$ and no development undertaken at the time of nationalization).

2 *ConocoPhillips Petrozuata B.V., ConocoPhillips Hamaca B.V. and ConocoPhillips Gulf of Paria B.V. v Bolivarian Republic of Venezuela, ICSID Case No ARB/07/30. Decision on Jurisdiction and Merits Dated September3, 2013* (hereafter '*COP ICSID*'): ¶ 214.

3 Some of the documents in the public domain cited in this article (like, for example, the Congressional Authorizations to the AAs, or the AAs themselves) exist only in hard copy form in archives in Venezuela. Electronically scanned copies can be obtained from the author by request.

The article starts by examining the legal background and market context of the projects at issue in these arbitrations. It explains that the legal framework of the projects (which represented a total departure from traditional principles of Venezuelan oil governance) was conceived with a very specific market environment in mind, one which was swept away by unexpected oil price rises. The article recounts a series of fiscal and legal reforms that the Venezuelan government adopted over the 2004–7 timeframe, and which culminated in the re-structuring of the AAs, to bring them in line with the legal requirements generally applicable to oil activities in Venezuela.

COP and XOM rejected the reform terms proposed by the government and embarked on legal proceedings raising claims of breach of a bilateral investment treaty (BIT) against Venezuela. The article suggests that the companies chose to go down this particular legal route because they saw it as affording them the opportunity to avoid going into the specifics of the deals they had actually signed when entering Venezuela. There exists a generalized erroneous belief that the investor-state disputes at issue in these arbitrations are *contractual* in character, a belief attributable to numerous misleading statements to that effect put on the public domain by the claimants (like the following declaration by XOM CEO Rex Tillerson: '[o]ur situation in Venezuela is a pure and simple contract. The contract was disregarded').[4] In fact, the quid of these companies' cases before ICSID is that the arbitration tribunals should disregard the most important among these 'pure and simple' terms in the companies' contracts with PDVSA. The article shows that all AAs were authorized subject to the express and essential condition that the State was to reserve all of its sovereign powers. Precisely because of this, COP and XOM obtained protection against adverse governmental measures through specific compensation mechanisms which made PDVSA answerable for the economic effects of such measures, but also capped PDVSA's potential liabilities, and provided that foreign investors would be deemed not to have suffered any adverse economic consequences from governmental measures when the price of crude oil exceeded a certain threshold level. The article concludes by pointing out that the bargains that COP and XOM insist they are defending are nowhere to be found within the agreements that they actually signed and that, therefore, the ICSID arbitrations by these companies amount to an attempt to use international arbitral tribunals to re-draft provisions which they themselves had negotiated, so as to secure a windfall for which they never bargained. Finally, the article offers some reflections on the wider implications of these enormous cases for the international dispute resolution structures centred on ICSID and BITs.

1. LEGAL BACKGROUND

The AAs owed their existence to a *régime d'exception* set out in the 1975 Oil Nationalization Law, which stated that, 'for reasons of national convenience', the Venezuelan state was to reserve all hydrocarbons-related activities for itself. However, Article 5 of this Law also defined two forms under which, after its promulgation, private capital might still be allowed to participate in the reserved hydrocarbons activities: (i) simple service contracts not affecting 'the essence of the reserved activities' and (ii) association agreements, permitted only 'in special cases and if convenient for the public

4 Steve Coll, *Private Empire. ExxonMobil and American Power* (Allen Lane 2012) 426.

interest', subject to congressional approval, and valid only if a State company had a participation in such associations that guaranteed their control by the State.[5]

The strict reservation of hydrocarbons activities to the State never commanded the support of PDVSA's top management, most of whom had spent the early (and often the greater) part of their careers working for foreign oil concessionaires. As Frank Alcock (first corporate vice-president, 1990–94, and vice-president of Mobil de Venezuela in 1974) made clear, the intellectual origins of the *Apertura* could be traced all the way back to 'the relationships with the [foreign] oil companies after nationalisation... There always existed [within PDVSA] a group who thought that the [oil] industry could be opened up more'.[6]

The views of this group regarding the desirability of foreign involvement in petroleum activities could generate no traction within a Venezuelan governmental apparatus flush with cash from the two oil price shocks of 1973–4 and 1979–81. However, Venezuelan government spheres grew less refractory towards foreign investment in the oil sector in the wake of the economic development failures of successive presidential administrations, and also to oil prices remaining relatively depressed after the1986 price collapse (spot North Sea Brent crude oil, for instance, averaged 18.27 dollars per barrel ('US$/B') for the period going from 1987 to 1995, the year when the first upgrading AA was signed). Furthermore, in 1993, the stable two-party political system that had prevailed in Venezuela since 1959 imploded (an event marked by the judicial impeachment of the serving president on trumped up charges of corruption), giving PDVSA a free hand to take charge of the definition and structuring of the oil agenda of the country.[7] With this, the company put the return of foreign investment to the Venezuelan oil sector at the top of the list of policy priorities, and pushed and cajoled the Venezuelan executive and legislature into accepting that, given the downbeat price environment and the lifting of restrictions on the participation of foreign capital in the petroleum sector of the former Soviet Union, costly and complex projects such as the upgrading AAs would not be sufficiently attractive for private international investors unless they were granted fiscal conditions that were unprecedentedly generous in a Venezuelan context (i.e. negligible or no royalties, no special petroleum taxes).

PDVSA's advocacy on fiscal issues bore fruit in the form of a lengthy royalty holiday and preferential income tax treatment for the AA upgrading projects. The former provided that the royalty obligations of the upgrading projects would be assessed at a reduced rate of 1% (as opposed to the prevailing statutory rate of 16 2/3 per cent) from the moment that each upgrading plant started commercial operations, and until such time as the cumulative gross income of an individual project had exceeded its total investment by a factor of three (but in no event for a period longer than 9 years), whereupon the usual statutory royalty rate—whatever it might be at the time—was to apply once again.[8] In addition, provisions were enacted to allow the

5 'Law that Reserves to the State the Industry and Trade of Hydrocarbons', *Official Gazette*, No 1.769 (Extraordinary), published 29 August 1975; Arts 1 and 5.

6 Interview in José Enrique Arrioja, *Clientes negros. Petróleos de Venezuela bajo la generación Shell* (Los Libros de El Nacional 1998) 157.

7 Bernard Mommer, *The New Governance of Venezuelan Oil* (Oxford Institute for Energy Studies 1998).

8 In 1998–9, PDVSA was in the process of implementing an initiative to lower the statutory royalty rate to a maximum of 5%.

participants in all AAs (including PDVSA) to pay income tax under the ordinary Venezuelan corporate regime, rather than the special regime applicable to petroleum activities.[9] It is worth mentioning that the economic viability of the projects was in no way dependent on the existence of these tax breaks, as proven by the fact that the royalty reduction for the AAs only materialized in May 1998, a considerable time after PDVSA and its foreign partners in the Petrozuata and Cerro Negro projects had decided to go ahead with them and, indeed, had finalized the financing of both projects through the issuance of bonds in international capital markets.[10]

The legal foundation for the royalty holiday was the 1943 Hydrocarbons Law, which gave the Venezuelan executive the faculty not only to reduce royalty rates to prolong the exploitation of fields nearing the end of their lives but also to reinstate the statutory royalty rate when, at its sole discretion, the reasons that had justified a royalty reduction being granted in the first place were no longer operative.[11] Crucially, the Venezuelan government never gave any undertaking that it would not reverse the preferential royalty treatment.[12] Likewise, as is generally the case elsewhere, the Venezuelan Income Tax has been subject to unilateral amendment by the legislature from time to time, without prior notice. And, again, the placement of the AAs in the non-oil section of the Income Tax Law was not accompanied by any assurance that the projects would remain there indefinitely. Both COP and XOM alleged that they had received such undertakings but were unable to produce any documentary evidence in support. Thus, the COP ICSID tribunal stated that the claimant had not 'demonstrated on the basis of the evidence … that the Respondent gave undertakings … in respect of the tax and related measures which were breached by the changes made to those measures and by the taking of the Claimants' assets', and that COP had effectively conceded that point by framing its argument 'by reference to legitimate or reasonable expectations, with at best passing and unsupported references to "commitments" '.[13] The XOM ICC tribunal, for its part, concluded as follows: '[t]here is no real dispute that the AA is governed by Venezuelan law and that there is no stabilisation or freezing clause that would purport to freeze Venezuelan law as it existed in 1997.'[14]

9 'Law of Partial Reform of the Income Tax Law', *Official Gazette* No 4.300 (Extraordinary), published 13 August 1991. The income tax rate for oil activities was 67.7% until 2000, and 50% thereafter. The income tax rate for non-oil activities was 30% until 1992 and 34% thereafter.

10 *Royalty Agreement of the Strategic Associations of the Orinoco Oil Belt between the Ministry of Energy and Mines and Petróleos de Venezuela, S.A.*, dated 29 May 1998. The upgrading projects adhered to the royalty agreement in November 1998, by which time the financing for Petrozuata and Cerro Negro had been finalized.

11 1943 Hydrocarbons Law, *Official Gazette*, No 31, published 13 March 1943, Art 41(3).

12 The Petrozuata Bond Offering Circular duly noted that, while it was true that '[i]n 1994, the Minister of Energy and Mines agreed in principle in a letter to reduce the royalty rate … to 1% for approximately nine years … [t]he Ministry could unilaterally modify (increase or decrease) the royalty at any time' (*Petrozuata Finance Inc, Confidential Offering Circular, Petrolera Zuata, Petrozuata C.A., dated 17 June 1997* (hereafter '*Petrozuata Offering Memorandum*'): 29).

13 *COP ICSID*: ¶350.

14 *ICC Case No 15415/JRF: Mobil Cerro Negro Ltd v Petróleos de Venezuela S.A. and PDVSA Cerro Negro S.A.; Final Award Dated 23 December 2011 (hereafter 'XOM ICC')*: ¶309.

2. THE MARKET CONTEXT

The AAs were prime examples of the sort of contract that was meant to become *de rigueur* in a market environment which would supposedly be characterized by resource abundance, untrammeled output and a fiscal race to the bottom among natural resource owners, as in a scenario imagined by Michael Klein of Royal Dutch/Shell:

> [w]ith declining real oil prices the fight over upstream rents continues to intensify. Many oil-exporting countries are crucially dependent on oil revenues…As population grows and the price of oil declines, producer countries open up all parts of the oil and gas business for foreign investors. They revise tax regimes to attract investors. In particular, countries with marginal fields abolish royalties…[B]y 2040…tax systems for upstream operations converge to regular corporate tax regimes as upstream rents diminish.[15]

Ironically, just as these lines were being published in 1999 (and as the first two upgrading projects were gearing towards production), the oil price was already on the rebound from its catastrophic 1998 cycle lows, and finding itself vertiginously propelled upwards by a feeble supply response in the face of runaway demand (emanating primarily from China), along a trajectory that would culminate in historical price highs in 2008. This price behaviour did indeed lead to a wholesale revision of tax regimes all over the globe, albeit in the exact opposite direction to the one foreseen by Klein. This process got underway in earnest in 2003, with the renegotiation and partial nationalization of the Dansk Undergrunds Consortium (DUC) oil and gas concession in Denmark (an unheralded yet momentous event). And where the Danes led, many other jurisdictions were eventually to follow in subsequent years (as the oil price spike became ever more pronounced), chief among them Venezuela.

The rising price of oil made it possible for foreign participants in the AAs to achieve robust returns on their investments even without preferential fiscal treatment. However, despite the buoyant price environment, the Venezuelan government saw fiscal receipts shrinking rather than growing, with the nadir coming in 2002 (a year when petroleum production activities in Venezuela yielded no income tax receipts at all, even though the price of oil was virtually double what it had been in 1998). Come 2004, international oil price levels were more or less double those of 1998, yet the upgrading projects were generating the lowest fiscal takes (both in relative and in absolute terms) ever recorded in the near centenarian history of Venezuelan petroleum.[16]

Given the change in market circumstances, in October 2004, the Venezuelan executive exercised the discretionary faculty under the 1943 Hydrocarbons Law to reinstate the 16 2/3 per cent statutory royalty rate for the AAs. However, as oil prices

15 Michael Klein, 'Energy Taxation in the 21st Century' (1999) Oxford Energy Forum 134.

16 Cerro Negro upstream gross income for the first three quarters of 2004 (ie before the reinstatement of the 16 2/3 per cent royalty) came to 24.80 US$/B of extra-heavy crude oil. Royalty payments were 0.25 US$/B and no income tax was paid at all. Such a level of fiscal income is comparable (at suitably deflated prices) with the one generated exactly 80 years before in the General Asphalt concession, which produced the country's first oil for export: gross income in 1924 (at 2004 prices) was US$/B 11.32, and fiscal income came to 0.35 US$/B per barrel (3.1% of gross income).

continued rising, the Venezuelan government (in common with many other governments around the world) realized that further measures would be necessary to limit the windfall profits accruing to oil companies. Thus, in June 2005, it was announced that the Income Tax Law would be amended to subject the upgrading projects to the 50% income tax rate generally applicable to companies in the hydrocarbons sector. These amendments only crystallized in August 2006, thereby bringing into effect a uniform income tax regime for all companies producing oil in Venezuela. Shortly before that, in May 2006, Venezuela had also introduced a uniform 33 1/3 per cent extraction (severance) tax creditable against royalties, and assessed on the gross value of liquid hydrocarbons extracted. However, even after these two measures, enacted in a year when the international price of crude oil averaged over 65 US$/B for the first time ever, the profitability of the AAs continued to exceed handsomely the estimates that COP and XOM had presented to buyers of the bonds used to finance the upgrading projects (hardly surprising, given the price scenarios underlying such estimates).[17]

The magnitude of the windfall profits being generated as the oil price continued to climb eventually led the Venezuelan government down the same path that the Danish government had blazed at an incipient stage of the oil price spike. Thus, on 26 February 2007, Decree-Law 5.200 was promulgated, requiring that the AAs be restructured to bring them in line with the legal requirements and fiscal conditions set out in the 2001 Organic Law of Hydrocarbons. In this way, the AAs—in which PDVSA affiliates had not been permitted by contract to hold majority stakes—would be transformed into mixed companies with a 60% PDVSA shareholding.[18] To effect this transformation from the association to the mixed company form—'migration', in official Venezuelan parlance—foreign participants in the AAs would have to reduce their equity in the projects by *selling* to a PDVSA affiliate enough shares to take the latter's shareholding over the requisite 60% mark.

The objective of these share purchases was for the government to capture another portion of the oil price windfall by means of the dividends to be declared by the projects, thereby making it unnecessary to alter tax and royalty rates further, in a manner that could lead to distortions in corporate investment.[19] Since the migration targeted windfall gains, investors would continue realizing attractive returns on their capital going forward, notwithstanding their reduced equity in the projects, as a high Chevron official explained to the US ambassador to Venezuela: 'Chevron's margin

17 The Petrozuata project was predicated on a long-term (nominal) price for West Texas Intermediate crude of 18 dollars US$/B (*Petrozuata Offering Memorandum*: C-26) and a breakeven heavy crude oil price (real) of only 8.63 US$/B (Benjamin C Esty, 'Petrozuata: A Case Study on the Effective Use of Project Finance' (fall 1999) 12(3) Journal of Applied Corporate Finance 37). In the case of Cerro Negro, the base case cash flow forecast assumed that the nominal price of the upgraded crude from the project would increase 'from US$10.76 in 2001 to US$15.97 in 2017' (*Cerro Negro Finance Ltd, Bond Offering Memorandum, dated June 11, 1998* (hereafter '*Cerro Negro Offering Memorandum*'): C-40). By 2007, Cerro Negro upgraded crude was fetching an average of 53.04 US$/B in the market.

18 'Decree with Rank, Effect and Force of Law on the Migration to Mixed Companies of the Association Agreements of the Orinoco Oil Belt, as well as the Exploration at Risk and Profit Sharing Agreements', *Official Gazette*, No 38.632, published 26 February 2007.

19 It is a well attested fact that very high marginal rates of income tax, for example, promote wasteful 'gold plating', as most of the cost of unnecessary expenditure is shifted unto the fisc.

per barrel in Venezuela before the recent changes in fiscal policies and equity structures was US$ 24. Even after the changes, Chevron's margin was still US$ 13 per barrel, over twice the margin of its operations in Argentina… [T]he high margins in Venezuela stem from the fact that it is not necessary to explore for crude in the Faja [i.e. the Orinoco Oil Belt].'[20]

To ensure the continuity of operations in the run-up to the deadline set out in Decree-Law 5.200 and thereafter, provisions were made whereby the PDVSA affiliates involved in the projects would take over the activities and assets of any company that did not reach basic agreement regarding the migration of its interests. In the event, these provisions had to be invoked when COP and XOM declined to participate in the migration (these companies would have had to reduce their shareholdings in Petrozuata and Hamaca, on the one hand, and Cerro Negro, on the other, to the tune of 10.1 and 11.1 percentage points, and 13 percentage points, respectively). Thus, on the 27th of June 2007, all COP and XOM assets dedicated to oil exploration and production in Venezuela had to be duly taken over by PDVSA. At that point, the companies and the government had been engaged for some time in discussions regarding compensation, but there was still an unbridgeable gulf between the views of the parties as to the value of the assets. Therefore, upon nationalization, no compensation from the government was immediately forthcoming. Thus, it was no surprise when, shortly thereafter, both companies initiated ICSID proceedings against Venezuela.

3. THE LEGAL RESPONSE OF THE COMPANIES

At first glance, COP and XOM would appear to have gone down very different paths in the pursuit of their legal claims against Venezuela. Even after COP filed for ICSID arbitration in December 2007, this company continued to discuss a negotiated settlement with Venezuela, involving the transfer of all or a part of PDVSA's shareholding interests in a number of US refineries as compensation. Negotiations (and ancillary due diligence activities) about the potential asset swap actually went on until September 2008, and only broke down irretrievably on the eve of the first meeting of the ICSID tribunal that was to hear the case.[21]

XOM, in contrast to COP, stayed true to its reputation 'as a company willing to fight instead of settle', and embarked upon a strategy aimed at bludgeoning the Venezuelan parties into acceptance of its terms.[22] After making it clear in mid-June 2007 that it would not migrate its interests, XOM proceeded to table a 'take-it-or-leave-it [compensation] demand for US$5 billion'.[23] XOM then filed a request for ICSID arbitration in October 2007, but the company agreed to continue cooperating with PDVSA on re-purchasing all outstanding Cerro Negro bonds in order to free funds belonging to both companies which were resting in accounts controlled by the Security Trustee of the bonds.[24] Unbeknownst to the Venezuelan parties, however,

20 Cable 07CARACAS1977, 9 October 2007, 'Ambassador Meets with Chevron': ¶10.

21 Cable 08CARACAS1246, 5 September 2008, 'Venezuela: ConocoPhillips Negotiations Stall': ¶1.

22 The phrase comes from the company's official historians: Joseph A Pratt and William E Hale, *Exxon. Transforming Energy, 1973-2005* (University of Texas at Austin 2013) 76.

23 *XOM ICC*: ¶3.

24 Coll (n 4) 429–34.

XOM was preparing to file a contractual claim against PDVSA before the ICC, as such a claim offered XOM the means 'to obtain a worldwide freezing order and attachments not available in the context of the ICSID proceeding' (because such actions are not allowed under the ICSID Convention).[25] XOM revealed its hand once PDVSA had funded the bond re-purchase in whole, and XOM had duly received its share of the funds. As the transaction closed (28 December 2007), PDVSA discovered that XOM had served an *ex parte* levy upon the former's share of the monies, 'despite the express representation made by the [XOM] parties in the Termination Agreement that no order existed which would prevent the consummation of the transactions'.[26] Shortly thereafter (24 January 2008), XOM moved to obtain a US$ 12 billion worldwide freezing order on PDVSA assets from the High Court in London, ostensibly in support of the ICC arbitration, again on an *ex-parte* basis.[27] The High Court rejected the submissions that XOM made in support of the action in their entirety but there can be little doubt that, had this legal manoeuvre succeeded, the financing of PDVSA's everyday operations under the freezing order would have become impossibly difficult.

For all their differences at a strategic litigation level, the COP and XOM cases are fundamentally similar in terms of the legal and jurisdictional basis of the various claims advanced therein, the sort of allegations raised by the claims, the magnitude of the relief requested and, crucially, their studious avoidance of certain key provisions contained in the AAs themselves. In a nutshell, the general thrust of the COP and XOM cases against Venezuela was that, in changing the fiscal conditions for the AAs, and then re-structuring them along the lines laid out in Decree Law 5.200, the Venezuelan government had ridden roughshod over the companies' vested rights, treating contractual undertakings 'as the proverbial "scrap of paper" that they can disregard at their convenience ... breaking all the commitments ... made to induce ... investment'.[28] The following sections will analyse whether these claims are borne out by the available evidence.

4. RELATIONSHIP BETWEEN QUANTUM OF CLAIMS AND UNLAWFULNESS OF MEASURES

At first glance, a layperson might be puzzled as to how the succession of fiscal and regulatory measures that the Venezuelan government took can be characterized as unlawful, given not only that the levying of taxes and the nationalization of private property are quintessential expressions of the sovereign power of any state, but also that both COP and XOM steadfastly maintain that 'the ICSID dispute is not over

25 Later on, XOM would also seek to use the ICC proceedings 'to build an argument ... supporting a future seizure of the 50% interest of a PDVSA subsidiary in the Chalmette refinery in Louisiana' (*XOM ICC*: ¶787).

26 A misrepresentation difficult to square with the principle of *pacta sunt servanda*. *Mobil Cerro Negro, Ltd v PDVSA Cerro Negro SA (Case 1:07-cv-11590-DAB), United States District Court for the Southern District of New York*, 'Memorandum of Law of Defendant PDVSA Cerro Negro S.A. in Opposition to Motions to Confirm December 27, 2007 Order of Attachment and January 8, 2008 Order of Supplementary Attachment': 16–17.

27 *Mobil Cerro Negro Ltd v Petróleos de Venezuela SA* [2008] EWHC 532 (Comm).

28 *XOM ICC*: ¶¶5, 18.

Venezuela's right to expropriate' (a right which they insist they are not challenging).[29] To make proper sense of the COP and XOM characterization of the Venezuelan government measures, it is necessary is to understand what happened to the world petroleum market after these companies decided to leave Venezuela in June 2007.

At that point in time, the monthly average spot price for Brent crude was 71.05 US$/B, and long-term forecasts saw this historically high price level increasing steadily, albeit modestly, in real terms. By July 2008, though, the monthly average price for Brent had rocketed to 132.72 US$/B, and the price forecasts for oil 20 years out had shifted upwards accordingly. Thanks to the timing of their Venezuelan exit, then, COP and XOM missed out entirely on the windfall that accompanied these record prices. Even more gallingly, any payment that they received in compensation from the Venezuelan government would not factor in either the price spike or the dramatically higher post-2008 oil price forecasts. This is because customary international law says that the quantum of compensation for a nationalized interest has to be determined on the basis of the market value of the asset on the eve of the nationalization measure (with income streams for the more distant future calculated on the basis of price forecasts current at the time).[30] This rule, however, has one crucial proviso: the nationalization measure has to be lawful.

The rule for unlawful nationalizations, as set out in the seminal *Case Concerning the Factory at Chorzów*, is very different.[31] In the latter circumstances, the owners of the nationalized property are entitled to receive not only compensation, but *reparations*, in the form of the full restitution of their property (or its value at the time of taking) plus damages for any increase of the value of the property between the date of the nationalization and the date when a judicial authority handed down a decision categorizing it as unlawful.[32]

International arbitration, with the *Chorzów Factory* rule as a backdrop, was a course of action with an enticing risk/reward balance for companies in the business position of COP and XOM. Regarding the latter company, for example, its official historians make it clear that, by the time of 'its highly publicised confrontation with [Venezuelan President Hugo] Chávez…the company had grown skeptical about the long-term prospects for all the projects in Venezuela in light of the increasingly hostile political environment and the volatility of oil and gas prices'.[33] There is no shortage of indicia that COP had grown similarly disenchanted with the set-up in Venezuela.[34] Both companies, therefore, had written off Venezuela, politically as well

29 Statement by XOM spokesperson quoted by Mark Curriden, 'Exxon Mobil's Dispute with Venezuela Has Global Implications' (2011) 97 ABA Journal 16.

30 As the Iran–US Claims Tribunal observed, 'the determination of the fair market value of any asset…requires a determination of the price estimates for sales of the future production that a reasonable buyer would use in deciding upon the price it would be willing to pay to acquire the asset. Moreover, any such analysis must also involve an evaluation of the effect on the price of any other risks likely to be perceived by a reasonable buyer at the date in question […]' (*Phillips Petroleum v Iran, 21 Iran-U.S.C.T.R. 79*: ¶111).

31 Permanent Court of International Justice, File E. c. Docket XI, Judgment No 8 (26 July 1927), Twelfth (Ordinary) Session, *Case Concerning the Factory at Chorzów (Claim for Indemnity)*: 47.

32 See *Phillips Petroleum v Iran, 21 Iran-U.S.C.T.R. 79*: ¶110.

33 Pratt and Hale (n 22) 333.

34 When the US Ambassador asked the COP chief negotiator about the possibility of the company reaching an agreement with the government and returning to Venezuela, the latter 'confirmed…that CP knew it

as on their balance sheets, and had little interest in reaching a long-term *modus vivendi* with the Venezuelan government. Thus, advancing enormous claims in international arbitration proceedings offered these companies the prospect of obtaining extraordinary monetary returns from their nationalized assets (returns that could eclipse those being realized by the many international companies that chose to stay in the country), at a cost representing a minute fraction of the potential rewards. Specifically, if an international arbitration tribunal could be somehow persuaded that the nationalization of the COP and XOM interests—as well the antecedent fiscal measures of the Venezuelan government—had been unlawful, then the quantum of the compensation these companies stood to receive would be determined on the actual date when a tribunal reached that conclusion (and the calculations would not only disregard the fiscal regime applicable at the time of nationalization and thereafter, but would also take into account the extremely high realized prices registered after 2007, as well as very bullish future price scenarios). On top of this, since parties affected by an unlawful nationalization are supposed to be placed in the position they would have enjoyed all along but for the intromission of the measure, both COP and XOM could try to claim additional compensation against potential income tax obligations that an arbitral award might attract in some other jurisdiction (i.e. tax gross-ups).

This business rationale behind the claims of the companies was made very clear to the US ambassador to Venezuela in meeting with COP's chief negotiator, where the latter explained that the company had 'two basic claims: a claim for compensation for its expropriated assets and a claim based on the progressive expropriation of the underlying assets ... the claim based on the progressive expropriation of the assets ... was on top of the fair market value of the assets'.[35] The COP officer went on to explain that, 'given the recent increase in oil prices, the fair market value of the [expropriated] assets ha[d] increased' and that, '[COP] also plan[ned] on increasing the settlement number for the second claim due to recent increases in oil prices'.[36]

In a nutshell, the fundamental reason that COP and XOM had to characterize the nationalization of their Venezuelan projects and preceding fiscal measures as unlawful was, quite simply, that it would otherwise have been impossible as a matter of arithmetic for these companies to come up valuations of US$ 12+ billion or US$ 30 billion for these interests (because, to reiterate, had they accepted that the measures had been lawful and that the dispute concerned solely the quantum of compensation, the valuation of their interests would have had to use the crude oil price forecasts available in July 2007 and the fiscal regime in place at the time Venezuela announced the migration initiative). Hence, the COP and XOM claims are best understood as logical chains that start with a conclusion (the quantum of compensation), from which the legal premises necessary to support such a conclusion (notably the requirement for unlawfulness) have been derived through a process of backward

would be welcomed back if they were willing to accept the ... [government's] terms and conditions because CP had proven itself as a good operator with which to partner', but also added: 'it won't happen' (Cable 08CARACAS1100, 7 August 2008, 'Update on ConocoPhillips Negotiations': ¶5).

35 Cable 08CARACAS487, 4 April 2008, 'ConocoPhillips Briefs Ambassador on Compensation': ¶¶14–15.

36 ibid: ¶¶4–5.

reasoning; rather than as a series of premises leading to a juridical conclusion (i.e. the alleged unlawfulness of the measures).

Quite apart from the above, claiming immense sums before ICSID held the added attraction that the arbitrations could be expected to have a considerable demonstration effect on other countries. These judicial proceedings, after all, unambiguously conveyed a message that governments needed to think carefully before doing anything that the likes of COP and XOM might take exception to, whether or not it affected genuine vested rights. The interest that companies with the global reach of COP and XOM had and have in spreading such a message can be readily discerned in the following exchange between the US ambassador to Kazakhstan and an XOM representative, at a time of particularly fraught negotiations involving the restructuring of the Kashagan Production Sharing Agreement (PSA): 'ExxonMobil Kazakhstan's Government Relations and Public Affairs Director ... told the Ambassador on January 11 [2008] that ExxonMobil will not change its position. ExxonMobil is a world-wide operation ... and cannot afford to create a precedent in Kazakhstan that will affect it elsewhere.'[37]

5. INVESTMENT LAW CLAIMS

The charge of unlawfulness, then, is integral to the COP and XOM claims, but bringing such a charge before an international tribunal (let alone making it stick) was not an exercise devoid of complications. First, the Republic of Venezuela was not a party to the AAs between PDVSA and its foreign partners, nor did it ever subscribe a specific investment contract between itself, as a host state, and the companies concerned, as investors.[38] Thus, no action could lie against the Republic on grounds of breach of contract. Secondly, all the measures referred to in the claims were carried out pursuant to laws of public policy, in an orderly, non-discriminatory and non-confiscatory manner, for a public purpose. They therefore bore the hallmarks of being *prima facie* lawful exercises of a state's sovereign powers. Indeed, it is difficult to appreciate in what fundamental way the Venezuelan government's reinstatement of the statutory royalty rate for the upgrading projects in October 2004 differs from, say, the British government's increasing the Supplementary Charge rate applicable to upstream petroleum income from 20% to 30% in 2011. Likewise, is it not the case that the enactment of the Venezuelan extraction tax in response to high oil prices, or the partial re-nationalization of the projects pursuant to the migration initiative, are quite similar to, say, the windfall tax on privatized utilities that the UK government levied in 1997, or the 2001 re-nationalization of Railtrack, respectively?[39]

'Not so', is the answer that the COP and XOM claims would give to these questions. Irrespective of what the position of Venezuelan government might be under its domestic law, the argument runs, the measures at issue in the arbitrations, in contrast

37 Cable 08ASTANA56, 11 January 2008, 'High-level Kashagan Talks Scheduled in Astana for January 13': ¶5.

38 Around 20% of the ICSID caseload is due to specific investment contracts between investors and host-states (*The ICSID Caseload—Statistics* (Issue 2012–2): 10).

39 Lucy Chennels, 'The Windfall Tax' (1997) 18(3) Fiscal Studies 279–91; Phillip Bagwell, 'The Sad State of British Railways: The Rise and Fall of Railtrack, 1992-2002' (2004) 25(2) The Journal of Transport History 111–24.

to the British tax and nationalization measures referred to above, were taken in clear contravention of international obligations that the Republic of Venezuela had assumed towards all foreign investors as a class, in general, and towards investors from a specific jurisdiction, in particular. Such obligations (which put the COP and XOM claims within the jurisdictional purview of ICSID), were embodied in two different legal instruments: Venezuela's Investment Law, promulgated in 1999, and the Netherlands-Venezuela Bilateral Investment Treaty (N-V BIT), ratified in 1993.[40] The COP and XOM cases before ICSID were therefore hybrids, in the sense that the alleged basis of jurisdiction for some of the claims advanced in them was a domestic investment law, while for others it was a treaty. What both types of claim had in common, though, was that they were distinctly problematic from a jurisdictional point of view.

As far as the domestic law claims were concerned, both COP and XOM argued that 'in adopting the 1999 Investment Law [Venezuela had] consented in advance to ICSID arbitration for all disputes covered by the ICSID Convention'.[41] Although the companies said that all of the Venezuelan measures at issue contravened the Investment Law, the main purpose of their Article 22 claims was to provide a jurisdictional umbrella for tax gross-ups put forward by US-based parent entities that could not otherwise raise treaty-based claims (on account of a US-Venezuela BIT having never been ratified). Both tribunals found unpersuasive the companies' jurisdictional arguments in support of claims brought under Article 22, on the grounds that 'if it had been the intention of Venezuela to give its advance consent to ICSID arbitration in general, it would have been easy for the drafters of Article 22 to express that intention clearly by using... well known formulas'.[42]

The fact that the COP and XOM Article 22 jurisdictional arguments could have come within striking distance of carrying the day is remarkable, in a worrisome way. After all, these claims amounted to billions of dollars, and yet their lack of substance was such that they would not have withstood a modicum of scrutiny in a court of law in the United States, the home country of COP and XOM (and key backer and promoter of ICSID). That much is made clear by the following appraisal, coming from well-informed officers in the US State Department:

> the international law firm Freshfields Bruckhaus Deringer [ICSID counsel for COP]... speculated... that this law may give rights to... pursue ICSID arbitration, even in the absence of a BIT with the BRV ['Bolivarian Republic of Venezuela']. (Comment: While this is an attractive legal argument... this claim is highly speculative and creative. Our reading of the Investment Promotion

40 'Decree with Rank and Force of Law on the Promotion and Protection of Investments (Decree No. 356)', *Official Gazette No 5.390 (Extraordinary)*, published 22 October 1999, and *Agreement on Encouragement and Reciprocal Protection of Investments (with Protocol), Venezuela-Netherlands, 22 October 1991, entered into force 1 November 1993, 1788 U.N.T.S. 45 (2000)*, respectively.

41 *Mobil Corporation, Venezuela Holdings, B.V., Mobil Cerro Negro Holding, Ltd, Mobil Venezolana de Petróleos Holdings, Inc, Mobil Cerro Negro, Ltd, and Mobil Venezolana de Petróleos, Inc v Bolivarian Republic of Venezuela, ICSID Case No ARB/07/27, Decision on Jurisdiction Dated 10 June 2010* (hereafter *'XOM ICSID'*): ¶¶140 and 139.

42 ibid.

Law is that investors only have rights to ICSID arbitration if they can qualify under a BIT).[43]

It is hard to imagine a more dismissive take on the legal theories underlying the Article 22 claims than the 'Comment' above. Quite apart from that, the actions that both companies took in belatedly restructuring their Venezuelan interests into a treaty jurisdiction (see below) belied their own argument that this article constituted an open-ended and unequivocal consent to ICSID jurisdiction. Had COP and XOM genuinely held this to be true, they would not have believed it necessary to seek the protection of the N-V BIT, as it is an elementary precept of international law that once consent to arbitration has been given, it cannot be unilaterally withdrawn.

6. WHY BREACH OF TREATY AND NOT OF CONTRACT?

Just like the Article 22 claims, the treaty claims that COP and XOM raised against Venezuela were seriously deficient from a jurisdictional point of view. In the event, these shortcomings proved not to be fatal, but only thanks to the willingness of the two tribunals concerned to overlook them, not least because they involved issues of procedure rather than lexicon (whereas in the case of the Article 22 claims, establishing ICSID jurisdiction required that a formulation of unequivocal consent to arbitration be conjured from a badly drafted statute originating in a country with a long-standing hostility to international arbitration). Even so, the acceptance of jurisdiction for these treaty claims required the departure by the tribunals involved from a clearly beaten track in international investment arbitration; namely, that 'to change the structure of a company complaining of measures adopted by a state for the sole purpose of acquiring an ICSID claim that did not exist before such change cannot give birth to a protected investment'.[44]

The jurisdictional deficiencies of the COP and XOM treaty claims stem from an undisputed fact which, as the reader will have occasion to judge, ought to be of decisive importance in these arbitrations; namely; that both COP and XOM were non-treaty investors when they went into the projects, and only sought to acquire treaty protection much later, by restructuring thereto unprotected investments into a treaty jurisdiction. In the case of COP, for instance, the insertion of Dutch entities in the corporate chains of ownership happened during July–August 2005 (for Petrozuata and Corocoro) and late September 2006 (for Hamaca) and, as COP officers made it clear to US embassy personnel, the company only 'incorporated its subsidiaries…as Dutch companies in order to take advantage of the Dutch [BIT]…to preserve their arbitration rights'.[45] As for XOM, the insertion of Dutch entities in the Cerro Negro and La Ceiba corporate chains took place in February and November 2006, respectively, by which time XOM had already notified the Venezuelan government that it was looking at a claims tab of US$ 2 billion and counting.[46]

43 Cable 07CARACAS217, 1 February 2007, 'International Arbitration vs the BRV': ¶10.

44 *Phoenix Action Ltd v Czech Republic, ICSID Case No ARB/06/5, Award dated 15 April 2009*: ¶ 92.

45 *COP ICSID*: ¶276. Cable 07CARACAS218, 1 February 2007, 'ConocoPhillips meets with Energy Viceminister': ¶6.

46 *XOM ICSID*: ¶¶186-87. Cable 06CARACAS3131, 17 October 2006, 'MEP Presents Terms for Strategic Association': ¶7.

According to Venezuela, these dates of incorporation demonstrated that the various Dutch entities had been 'created in anticipation of litigation ... for the sole purpose of gaining access to ICSID jurisdiction ... [an] abuse of the corporate form and blatant treaty-shopping [that] should not be condoned'.[47] The Venezuelan position was, therefore, that the claimants had no standing as Dutch investors to bring a case before ICSID, and that COP and XOM should therefore seek redress before Venezuelan courts.

Although the COP and XOM tribunals ultimately did not take Venezuela's jurisdictional objections on board, they agreed with the substantial points underlying these objections, in terms of the timing and rationale of the restructurings. The COP tribunal, for instance, stated that 'the only business purpose of the restructuring, as acknowledged by the Claimants' principal witness on this matter, was to be able to have access to ICSID proceedings'.[48] The XOM tribunal, for its part, concluded that 'the main if not the sole purpose of the restructuring was to protect Mobil investments from adverse Venezuelan measures in getting access to ICSID arbitration through the Dutch-Venezuela BIT'.[49] In the light of previous arbitral decisions like *Phoenix v Czech Republic*, such conclusions could have proved devastating for the claimants' cases, but both tribunals finessed the thorny issue of the 'abusive manipulation of the system of international investment protection under the ICSID Convention and the BITs' by taking the position that a restructuring carried out on the eve of suit could nevertheless qualify as '"legitimate corporate planning" as contended by the Claimants or[, alternatively,] an "abuse of right" as submitted by the Respondents. It depends upon the circumstances in which it happened'.[50] And, as the COP and XOM tribunals saw matters, the crucial circumstance surrounding these restructurings was that both companies had dedicated considerable sums to the upkeep of their extant projects.[51] In the words of the COP tribunal, this 'continued substantial involvement in the development and operation of the projects ... [was] evidence telling strongly against any finding of treaty abuse'.[52] The XOM tribunal, for its part, likewise took the line that XOM's maintenance expenditures in the Cerro Negro project amounted to 'new and important investments ... [being] projected and made', which meant that XOM was entitled to enjoy all the rights that any *bona fide* Dutch investor would have had.[53]

The conclusions of both tribunals on matters of treaty jurisdiction were generous towards the claimants (after all, if maintenance investment ruled out treaty abuse, then the only circumstance in which the latter could have been found would have involved the unlikely scenario of the claimants carrying out their respective restructurings, and then allowing the projects to fall to bits through disrepair). But the fact that these two giant companies could have been so uncharacteristically remiss about arranging treaty protection for their investments was, nevertheless, a major constraint

47 ibid: ¶27.
48 *COP ICSID*: ¶279.
49 *XOM ICSID*: ¶190.
50 ibid: ¶191.
51 And in the case of Corocoro, the furtherance of a project under commercial development.
52 *COP ICSID*: ¶280.
53 *XOM ICSID*: ¶32.

in terms of just how far either tribunal could go in order to accommodate the companies' claims. In particular, both tribunals reasoned that such rights as the companies were entitled to enjoy *qua* Dutch investors could only have existed once the Dutch entities had come into the picture. Such a conclusion essentially excluded the fiscal measures leading to the nationalization of the projects from the jurisdiction of the tribunals and, in effect, trimmed the arbitrations into what public opinion and the media had always thought (mistakenly) they were about: the lawfulness of the nationalization of the COP and XOM Venezuelan assets, and the amount of compensation due.[54] In other words, the proceedings boiled down to a judicial review of the behaviour of the Venezuelan government in the design and implementation of the migration policy and the ensuing negotiations, in the light of a central provision of the N-V BIT, Article 6, which reads thus:

> Neither Contracting Party shall take any measures to expropriate or nationalise investments of nationals of the other Contracting Party or take measures having an effect equivalent to nationalisation or expropriation with regard to such investments, unless … the measures are taken in the public interest and under due process of law … are not discriminatory or contrary to any undertaking which the Contracting Party taking such measures may have given … [and] are taken against just compensation. Such compensation shall represent the market value of the investments affected immediately before the measures were taken or the impending measures became public knowledge, whichever is the earlier … paid and made transferable, without undue delay, to the country designated by the claimants concerned … in any freely convertible currency accepted by the claimants.

We shall now turn to consider whether, or in what way, the nationalization of the Venezuelan assets of COP and XOM could have contravened the dispositions of the N-V BIT cited above, focusing in particular on the issue of compensation due. However, the discussion that follows has as its backdrop an anomaly that every reader should keep in mind; namely, that while both COP and XOM are by all accounts highly experienced and sophisticated international investors, not known for ever letting any obvious loose ends untied, they nevertheless displayed remarkable negligence in terms of structuring their Venezuelan investments so as to protect them through a treaty. Could the explanation for this anomaly be, perhaps, that neither COP nor XOM was especially bothered about structuring through a BIT jurisdiction because both companies had actually secured a different sort of protection mechanism, which they felt was more effective and predictable, as well as quicker and less cumbersome, than ICSID arbitration?

7. ISSUES OF COMPENSATION AND VALUATION

It is an undisputed fact that, before COP and XOM filed for ICSID arbitration, neither company had received any payment in consideration for the loss of their

54 In the COP ICSID case, exclusion of the fiscal measures came about through a finding that they were covered by carve-out provisions in Art 4 of the N-V BIT.

Venezuelan interests. Because of this, public opinion at large has tended to accept that—to paraphrase the principal memorial which XOM submitted to the ICC tribunal—the 'use [of] euphemisms – such as "migration to a mixed enterprise" or … [a] supposed refusal "to confor[m] … activities to the existing regulatory framework" … cannot conceal … that the [Venezuelan] Government seized … [COP and XOM's] entire interest in the joint venture[s] without paying compensation'.[55] However, as a matter of customary international law, this proposition has had a much easier ride than it deserves because, as Reinisch explains, 'the mere fact that compensation has not yet been paid does not render an expropriation illegal', especially if a state has shown a demonstrable willingness to engage in good faith negotiations to reach an agreement with the affected parties.[56] It is not difficult to understand why states should be under no obligation to come to an agreement with parties affected by a nationalization measure regarding the quantum of compensation owed to the latter, much less by a given deadline (before a filing for arbitration is made, say). Such an obligation would constitute a powerful lever whereby private parties could blackmail states into acquiescing to their proposed settlement terms, no matter how exorbitant. Furthermore, the *Chorzów Factory* decision itself indicates that the reparations standard of compensation does not apply where a nationalization would be *prima facie* lawful but for the non-payment of compensation.

Neither COP nor XOM deny participating in numerous discussions on compensation with the Venezuelan government, but they insist that Venezuela never made a settlement offer compliant with the N-V BIT. In public, both companies have consistently maintained that Venezuela only ever offered them book value for their expropriated assets.[57] There is, however, plenty of evidence available in the public record which belies the companies' statements to this effect and, just as importantly, casts doubt on their own assessments regarding the supposed 'market value' of their assets.

Turning to the first point, when Walker J. dismissed XOM's petition to the High Court in London to maintain the worldwide freeze on PDVSA's assets, he questioned whether the nationalization of the company's assets could 'properly be described as a case involving a lack of compensation'.[58] In this regard, Walker J. observed that the denunciation of the *Apertura* policy by the Venezuelan government had 'not prevented the negotiation of mutually acceptable arrangements with the vast majority of foreign oil interests', and which were not concluded on the basis of the book value of the assets involved.[59]

55 *XOM ICC*: ¶4.

56 August Reinisch, 'Legality of Expropriations' in August Reinisch (ed), *Standards of Investment Protection 171* (OUP 2008) 198–99. It is even possible to point to cases where expropriation measures have been held to be lawful although no offer to compensate the affected parties was made, let alone any indemnification paid: 'The Government of the State of Kuwait v. The American Independent Oil Company (Aminoil), Final Award dated March 24, 1982' (1982) 21 International Legal Materials 976; 'Libyan American Oil Company (LIAMCO) v. The Government of the Libyan Arab Republic, Award dated April 12, 1977' (1981) 20 International Legal Materials 1.

57 Cable 07CARACAS504, 8 March 2007, 'ExxonMobil: Out by July 1': ¶3.

58 [2008] EWHC 532 (Comm): ¶137.

59 ibid: 55.

The largest such arrangement involved Statoil and Total reducing their respective stakes in the Sincor upgrading project (by 16.77 percentage points and 5.323 percentage points, respectively), in order to accommodate an increased shareholding for a PDVSA affiliate. A confidential cable from the US embassy in Caracas recounting a meeting held on 12 September 2007 'to discuss the terms of the Sincor migration to a PDVSA-controlled joint venture' reveals that the president of Statoil Venezuela 'would not state the amount of the compensation... [but] implied that it was well above book value, which was PDVSA's opening offer'.[60] Indeed, the Statoil officer 'stated [that] Statoil would have refused to migrate its interest if it had only received book value'. Separately, when the 'Chevron Latin America president... met with the Ambassador on June 28 [2007]', he was at pains to point out that 'Chevron [had] received "fantastic" terms for the migration of the Hamaca strategic association to a PDVSA-controlled joint venture... [and] added [that] Chevron just kept what it had and "could have had more"'.[61] Last but not least, in yet another conversation with the US ambassador, the COP officer in charge of negotiations with Venezuela made it clear that 'the BRV ha[d] accepted... fair market value... [and] moved away from using book value as the standard for compensation and... agreed on a fair market methodology with discount rates for computing the compensation for the expropriated assets'. The COP officer also pointed out that COP had 'proposed a settlement number and the BRV appear[ed] to be open to it'.[62] Settlement never did happen, not because Venezuela insisted on counter-offering book value but, rather, because in 2008 the value gap widened on account of COP's belief that, 'given the recent increase in oil prices, the fair market value of the assets ha[d] increased'.[63]

Regarding the issue of the credibility of the COP and XOM damages claims, it is worth recalling that the compensation paid to the Sincor partners came to US$ 1.1 billion, and that the Sincor upgrader was considerably larger than any of the Petrozuata, Hamaca or Cerro Negro upgraders.[64] Besides this, however, there is no shortage of evidence to the effect that the COP and XOM figures are exaggerated, with perhaps none more damning than the scattergun manner in which XOM approached valuation in the various *fora* where its claims relating to the Cerro Negro project have been heard. In the High Court in London, XOM initially presented a damages figure of US$ 12 billion, the result of valuing project cash flows for 27.5 years and then simply adding them up, without discounting the sum to present value terms (in other words, XOM relied upon a discount rate of zero).[65] In the subsequent ICC case, XOM retreated from this position, but the company still valued

60 Cable 07CARACAS1822, 14 September 2007, 'Statoil: a Good Deal': ¶2.

61 Cable 07CARACAS1314, 2 July 2007, 'Chevron, Exxon, And CNPC Comment On Recent Events': ¶¶2, 4.

62 Cable 08CARACAS487, 4 April 2008, 'ConocoPhillips Briefs Ambassador on Compensation': ¶5.

63 ibid: ¶4.

64 The production capacity of the Petrozuata and Cerro Negro projects was approximately 100 thousand barrels per day ('MBD') of upgraded crude, while that of Hamaca was 150 MBD. The production capacity of the Sincor upgrader was 180 MBD.

65 Ostensibly because the AA formulae made no provision for discounting. *In the High Court of Justice, Queen's Bench Division, Commercial Court Claim No 2008 Folio 61, between Mobil Cerro Negro, Ltd (Claimant) and Petróleos de Venezuela S.A. (Defendant)*, 'First Affidavit of Hobert E. Plunkett, dated January 21, 2008': ¶¶7–18.

its interest with a discount rate of 3.37% (this was less than a US Treasury bond at the time, so XOM was asserting, in effect, that the indemnity cash flows from PDVSA had the same risk profile as a US Treasury bond). Furthermore, as PDVSA highlighted in its submissions to the ICC tribunal,

> it was not clear what amount Claimants expected Respondents to pay, whether it was the US$12 billion calculated by Mr. Plunkett [the XOM officer who had submitted an affidavit to the High Court], the US $10 billion set forth in the Summary of Claimant's Position in the Terms of Reference [of the ICC case], the US$7.6 billion originally calculated by one of the Claimant's external experts, the US$6.45 to US$6.85 billion now claimed or the US$5 billion that Claimant requested without explanation or discussion in the summer of 2007 for all of its interests in Venezuela.[66]

As things turned out, the ICC tribunal concluded that '[t]he "risk free" rate proposed by the Claimant [was] not acceptable', and selected a rate of 18% which 'appropriately reflect[ed] the risks related to the indemnity cash flow analysis in the…case [of Mobil Cerro Negro]'.[67] On the basis of this rate, the XOM ICC tribunal handed down an award of 908 MMUS$.

The XOM ICC award was in line with PDVSA's assertion that 'the full value of [XOM's] entire interest in the [Cerro Negro] Project…was less than US$1 billion' (i.e. a fraction of XOM's non-negotiable settlement figure of US$ 5 billion, itself less than half of the initial damages claims put before the ICC).[68] Turning to the COP case, the ICSID decision on jurisdiction reveals that, early on during the negotiations, Venezuela offered this company US$ 2.3 billion for its share in the Petrozuata and Hamaca upgraders, but COP was only willing to settle for US$ 6.5 billion (and the 2008 price spike would inflate the company's pretensions even further).[69]

Despite the substantial gaps dividing the parties on the issue of market value, it has always been Venezuela's position that 'settlement…would have been reached quite easily had [the companies] not insisted on receiving exorbitant compensation'.[70] At first glance, this might appear far-fetched but, as it happens, settlement would have been straightforward had either of these companies shown any regard for the terms of the contracts whose inviolability they say they are trying to uphold.

In the following section, it will be shown that, just as one would have expected, the COP and XOM officers who negotiated the AA contracts with PDVSA were indeed very diligent in trying to secure strong protection against adverse governmental action for their companies' respective investments. But the protection they eventually obtained did not come in the form of promises of stability from the Venezuelan government against unexpected and unwelcome legislative changes, especially with regards to taxation. Instead, at a point in time when there were no Dutch companies in

66 *XOM ICC*: ¶3(6).

67 ibid: ¶777.

68 *XOM ICC*: ¶3.

69 Curtis, Mallet-Prevost, Colt & Mosle llp, *Letter to Tribunal Regarding Decision on Jurisdiction and Merits*: ¶8 <http://italaw.com/sites/default/files/case-documents/italaw1583.pdf> accessed 9 May 2014.

70 *XOM ICC*: ¶8.

the picture (although the N-V BIT existed) and the Venezuelan Investment Law had not even been enacted, the COP and XOM officials obtained investment safeguards *from PDVSA* in the form of a mechanism whereby the companies would be compensated *by PDVSA* for governmental actions (*including nationalization*) which adversely affected the economics of the upgrading projects, *but only up to a defined limit*. And it is the existence of these safeguards—which, during the 1990s, were clearly seen by both COP and XOM as a superior and more robust alternative to ICSID treaty arbitration—which explains not only why it was that the companies decided to go ahead with very large capital-intensive projects in Venezuela without taking the seemingly elementary precaution of structuring their investments through a friendly BIT jurisdiction, but also why they only 'became Dutch' post-haste, on the eve of their exit from Venezuela (and a full 13 years after the N-V BIT was signed). These safeguards, in other words, are the proverbial elephant in the room of the COP and XOM ICSID cases against Venezuela. Thus, in order to make legal (and political) sense of these cases, it is necessary to understand not only the nature and rationale of the protection mechanisms that COP and XOM managed to negotiate for their Venezuelan investments, but also the reticence on the part of these companies to discuss these mechanisms in any meaningful way, in the context of the measures taken by the Venezuelan government over the 2004–7 timeframe.

8. AN INCONVENIENT TRUTH: CONTRACTUAL LIMITATIONS TO COMPENSATION

The central tenet behind Article 5 of the 1975 Oil Nationalization Law was that the exceptions contemplated to the blanket reservation of hydrocarbons sector to the State should be insulated 'with great legal security and extreme control'. That is why it was established that 'these association agreements [would] therefore require for their validity the approval of the [Congressional] Chambers in joint session, within the conditions that they set forth, once the National Executive [had] sufficiently informed them [that is, the joint Chambers of Congress] of all matters related to the relevant negotiation'.[71] These requirements (and associated conditions) were not mere formalities, but essential features of a law of public policy which, in turn, was the *sole source* of all rights that shareholders in the COP and XOM association projects in Venezuela might have had.

The basic terms and conditions in the key documents governing the upgrading projects—namely, the individual Congressional authorizations and the AAs themselves—were patterned after those in a number of reports which the Bi-Cameral Congressional Commission had prepared and submitted to the consideration of Congress (relying on information provided by the Venezuelan executive) on the pertinent circumstances for each proposed project. The reason behind the close adherence to the precedents set out in such reports, in terms both of contents and language, was explained, for example, in the *Congressional Authorization of the Petrozuata Association Agreement*: '[t]his authorisation will have to be used within the

71 'Exposición de Motivos, Ley Orgánica que Reserva al Estado la Industria y el Comercio de los Hidrocarburos', in *Nacionalización del petróleo en Venezuela, tesis y documentos fundamentales* (Catalá Centauro Editores 1975) 92–93.

legal framework of the 'conditions' expressly enumerated in said [Bi-Cameral Commission] Report, as they completely guarantee the strict fulfillment of the conditions of legality, legitimacy, opportunity and convenience expressed in the sole clause of Article 5 [of the Oil Nationalisation Law].'[72]

Among the many 'expressly enumerated' conditions in the Bi-Cameral Commission Reports was one which stipulated that the AAs were to include provisions whereby, in the event of the Venezuelan government taking actions which adversely affected the economics of the projects, the PDVSA affiliates participating in the projects would compensate their foreign partners. This was expressed in the following terms in the Twentieth Condition of the Cerro Negro Congressional Authorization:

> The Association Agreement shall include provisions allowing the renegotiation of the Agreement as necessary to compensate any Party other than LAGOVEN [the PDVSA affiliate which initially participated in this project], on equitable terms, for adverse and significant economic consequences arising from the adoption of decisions made by governmental authorities, or changes in legislation, that cause a discriminatory treatment of THE ASSOCIATION, any entity or THE PARTIES in their capacity as participants in THE ASSOCIATION.[73]

Crucially, the compensation for which PDVSA affiliates were to be held liable would not be open-ended and unlimited. Instead, the foreign parties would be deemed not to have suffered *any* economic damage from a discriminatory measure when the price of crude oil in the international market exceeded a certain threshold:

> However, it shall not be considered that a Party has suffered an adverse and significant economic consequence as a result of any of said decisions or changes in legislation, at any time when the Party is receiving income from THE ASSOCIATION equal to a price of crude oil above a maximum price that shall be specified in the Association Agreement.[74]

This price, in turn, was defined as follows in the offering prospectus for the bonds used to finance the Cerro Negro project:

> 'Material Adverse Impact' will be deemed to have occurred when Mobil Sub's Net Cash Flow in any fiscal year is decreased by more than an aggregate of 5% as compared to what Mobil Sub's Net Cash Flow would have been absent the

72 'Congressional Authorisation of the Petrozuata Association Agreement' (hereafter '*Petrozuata Congressional Authorisation*'), *Official Gazette No 35.293*, published 9 September 1993, Preamble. The term used in the original Spanish passage is 'taxativamente', which denotes conditions that are rigorous, strict and limiting.

73 'Congressional Authorisation of the Framework of Conditions for the Cerro Negro Association Agreement' (hereafter '*Cerro Negro Congressional Authorisation*'), *Official Gazette No 36.224*, published 10 June 1997, Eighteenth Condition.

74 ibid.

> Discriminatory Action(s); provided that after the first period of six consecutive months during which the average price of Brent crude oil (Free on Board [FOB] North Sea) is in excess of US$27 per barrel (in 1996 dollars) (the 'Threshold Price'), Lagoven Sub will not be required to compensate Mobil Sub for any Discriminatory Action(s) with respect to any day on which the price of Brent crude oil (FOB North Sea) is in excess of the Threshold Price....[75]

As to how exactly this Threshold Price was to be applied, the best explanation of the mechanism is to be found in Section 15.2(a) of the AA:

> Limitation on Lagoven CN's Obligation...[A]fter the first period of six (6) consecutive months during which the Price of Brent Crude Oil is in excess of the Threshold Price, Lagoven CN will not be required to compensate any Foreign Party for Discriminatory Measures with respect to any Fiscal Year in which the average Price of Brent Crude Oil is in excess of the Threshold Price, and such Foreign Party receives a Net Cash Flow, after taking into account the effect of the Discriminatory Measure, commensurate with a reference price for the Production produced by the Parties that bears at least a reasonable relationship, adjusted for quality and transportation differences, to the Threshold Cash Flow for such Fiscal Year.

In other words, 'once the price of Brent crude oil had exceeded this Threshold Price for six consecutive months, no compensation would be payable by Lagoven for any subsequent fiscal year in which the price of Brent crude oil (expressed in 1996 dollars) averaged more than 27 US$/B'. Thus, subsequent to the original triggering event, the foreign parties to the AA would not be able to seek redress from Lagoven for *any* excess cash flows resulting from high oil prices that the government might appropriate, *even if* said appropriation involved actions that actually qualified as 'Discriminatory Measures' under the AAs. Prominent among such measures was 'the expropriation or seizure of assets of the Project or of a Foreign Party's interests in the Project'.[76]

There were some differences among the compensation provisions in the various AAs at issue in the ICSID arbitrations, but the overall concept was very similar, including the notion of limitation of liability in high price scenarios. In the case of Petrozuata, compensation due was to be calculated (and limited)

> by reference to an average price of Brent Crude Oil deflated annually to 1994 in the world market. If such price of Brent Crude Oil is less than $18 per barrel, then compensation is at 100% of damages. If such price of Brent Crude Oil is more than $25 per barrel, then compensation is at 0% of damages. If such price of Brent Crude Oil is between $18 and $25 per barrel, the percentage of damages to be compensated shall be determined according to a specified formula. If damages exceed $75 million in any year, the amount compensated will

75 *Cerro Negro Offering Memorandum*: 33–42.

76 *Cerro Negro Association Agreement*, Clause I, Definition of 'Discriminatory Measure'.

> be at the greater of 25% of the actual economic damage and the amount resulting from the Brent Crude Oil calculation. All dollar amounts are adjusted for inflation.[77]

In the case of Hamaca, the foreign parties would be owed no compensation as long as they received a net cash flow in excess of a Threshold Cash Flow calculated at a Brent crude oil price of 27 US$/B in 1996 dollars, regardless of any adverse governmental measure (discriminatory or otherwise).[78]

The idea behind the compensation mechanisms at the core of all the extra-heavy crude oil upgrading projects was that the government would be deterred from changing the fiscal conditions by the knowledge that any attempt on its part to do so would cost the Venezuelan state oil company and its affiliates dearly. This intent is obvious in clause 15.1(c) of the Cerro Negro AA, for example:

> [i]n the event that a Discriminatory Measure for which Lagoven CN is paying compensation to a Foreign Party, or in response to which the Agreement has been modified, is reversed or ceases to be in effect, the obligation of Lagoven CN to pay compensation, or the modification made to the Agreement, shall cease to be in effect to the same extent; provided that the Foreign Party has been compensated for the damages previously suffered as a result of such Discriminatory Measure.[79]

However, so long as oil prices remained above certain levels, in a sustained fashion, the parties to the AAs were content not to have this Damoclean sword hanging over the head of the Venezuelan government.

In a research paper written in 1999, Bernard Mommer (who would later go on to be Venezuela's vice-minister of Hydrocarbons between 2005 and 2008) accounted for this apparent magnanimity by pointing out that the conditions that would have allowed 'the government…[to] impose some additional tax on the Association, collecting a part of that excess [profit] without [triggering] a payment of compensation by Lagoven' had only ever been satisfied in their entirety 'once during the 140-year history of oil, between 1980 and 1984, due to the Iranian revolution and the subsequent war with Iraq'.[80] Mommer considered that such freedom of action as these provisions supposedly afforded the government was illusory, given the unlikelihood that oil would ever exceed the Threshold Price for the requisite period of time. And it is precisely this which, in turn, explains why XOM and COP declined to structure their investments in Venezuela through The Netherlands. Simply put, the protection afforded by this compensation mechanism—administered by their solvent partner PDVSA (which also provided a parent guarantee for its operating affiliates) and underpinned by ICC arbitration—was seen by the companies as a far superior

77 *Petrozuata Offering Memorandum*: 72.
78 *Hamaca Association Agreement*, s 14.2.
79 *Cerro Negro Association Agreement*, clause 15.1 (c).
80 Bernard Mommer, 'Venezuela, política y petróleos' (1999) 16(42) Cuadernos del CENDES ¶4.3.5.

alternative to ICSID treaty arbitration (its main advantages being ease of calculation, enforcement and collection, and what looked like a very advantageous price threshold).

With the benefit of hindsight, it is obvious that both COP and XOM (and pretty much everybody else) turned out to be wrong about the future behaviour of the oil market in the medium and long term. But that does not mean that the contractual conditions which these companies bargained for and obtained—including the formulae for compensation on account of adverse governmental action—can or should be jettisoned without further ado. On the contrary, these formulae should carry great weight in terms of determining what was the fair market value of the Petrozuata, Hamaca and Cerro Negro upgrading projects on the eve of their nationalization, in line with the well-settled proposition that any restrictions or limitations on a contractual or property right must be taken into consideration when calculating the value of such right.[81] After all, no diligent prospective buyer would have failed to take these formulae into consideration when calculating a purchase price for the COP and XOM interests in 2007 and, in post-2000 market circumstances, any hypothetical buyer would have conferred a much lower value to a project with an income cap of 27 US$/B, adjusted by inflation, than to one without.

But why was it that the AAs needed to incorporate these compensation mechanisms in the first place? The answer can be found in some of the other essential conditions that the Venezuelan Congress stipulated for each one of the association projects, and which undermine the COP and XOM contentions (here expressed in a paraphrase of the XOM Chairman of the board) that these companies' legal disputes with Venezuela stem from 'the country's failure to abide by its terms and obligations…This is an issue about contract sanctity that provides the basis for all parties to know their rights and responsibilities'.[82]

Consider, for example, the Sixteenth Condition of the Petrozuata Congressional Authorization:

> The Association Agreement shall include provisions that allow Maraven to compensate the other parties, under equitable terms, for the significant and adverse economic consequences directly derived from the adoption of decisions by the national, state or municipal administrative authorities, or from changes in legislation that, due to their content and purpose, cause an unfair discriminatory treatment to the Company or to such other parties, always in their capacity as such and as parties to the Association Agreement, all without diminishing in any way the sovereign power to legislate, inherent in the very existence of the national, state and municipal legislative powers.

Further, the Eighteenth Condition made it clear that the 'Association Agreement to be executed, the commercial company to be created and the activities of a diverse

81 '[I]t is important to bear in mind…the terms upon which that interest was held…[as the contractual term] had an effect on the value of the asset in the Claimants' hands' *Waguih Elie Georg Siag and Clorinda Vecchi v Egypt, ICSID Case No ARB/05/15, Award dated 1 June 2009*: ¶¶577–78.

82 'Exxon: Venezuela Row about Government Honoring Contract' (*TDM News Digest*, 21 February 2008).

nature that will derive from such acts' would, in no case, 'in and of themselves give rise to liability on the part of the Republic of Venezuela, which could only arise in the event that such liability were to be assumed through a valid express legal act of its authorities'.[83]

In the case of the Hamaca project, the Nineteenth Condition of its corresponding Congressional Authorization stated, along similar lines, that '[t]he Association Agreement, the creation and operation of the Entities and other activities **shall not impose any obligation on the Republic of Venezuela nor shall they restrict its exercise of sovereign powers**'.[84] The Twenty-first Condition in the authorization complemented this by providing that, while foreign participants in the Hamaca Project would be entitled to receive compensation from a PDVSA affiliate—subject to the conditions and limitations established in the AA—in the event of certain specified changes in Venezuelan law or governmental actions, '[i]n no case will it be understood that the application of these mechanisms limits, affects or restricts in any way the power of governmental organs to adopt measures pursuant to the Constitution and applicable Laws'.[85] The content of the Eighteenth Condition of the Cerro Negro Congressional Authorization is, again, very similar: '[t]he Association Agreement, and all activities and operations conducted under it, **shall not impose any obligation on the Republic of Venezuela nor shall they restrict its sovereign powers, the exercise of which shall not give rise to any claim,** regardless of the nature or characteristics of the claim'.[86]

In sum, the documentary record reveals that all upgrading projects were authorized by the Venezuelan Congress subject to the express and essential condition that the State was to reserve all of its sovereign powers, including the power to enact and change laws and taxes and the power to nationalize in the public interest. And it was precisely *because* of the existence of this broad reservation of sovereign rights, and for the benefit of foreign investors like COP and XOM, that the compensation provisions were included in the AAs. Bearing that in mind, does it not look as if these same investors are resorting to international arbitration against the Venezuelan state in order not only to impugn the right of the Venezuelan government to take a succession of lawful measures targeting windfall profits but also to sidestep the compensation provisions in the AAs, all the while invoking the mantra of *pacta sunt servanda*?

It is worthwhile to let statements by representatives of the claimants themselves provide the reader with the answer to this question. Consider a cable from the petroleum attaché in the US embassy in Caracas reporting that he had been told by an 'ExxonMobil executive ... on May 17 [2006] that his firm did not believe it had a legal basis for opposing the tax increases' resulting from 'amendments to the Organic Hydrocarbons Law (OHL) that raise[d] income taxes on the strategic associations

83 *Petrozuata Congressional Authorisation*, Sixteenth and Eighteenth Conditions.

84 'Congressional Authorization of the Framework of Conditions for the Hamaca Association Agreement' (hereafter '*Hamaca Congressional Authorisation*'), *Official Gazette* No 36.209, published 20 May 1997, Twenty-First Condition, Nineteenth Condition; emphasis added.

85 *Hamaca Congressional Authorisation*: Twenty-first Condition.

86 *Cerro Negro Congressional Authorisation*, Eighteenth Condition; emphasis added.

from 34 to 50 percent and introduced a 33.3 percent extraction tax'.[87] In connection with this statement (which belies the submissions that XOM made regarding these measures in the ICSID arbitration), it is related elsewhere in the cable that the insuperable obstacle faced by any company spoiling for a legal fight lay in that

> each of the strategic association agreements has some form of indemnity clause that protects them from tax increases. Under the clauses, PDVSA will indemnify the partners if there is an increase in taxes. However, in order to receive payment, a certain level of economic damage must occur. In order to determine the level of damage, the indemnity clauses contain formulas that, unfortunately, assume low oil prices. Due to current high oil prices, it is highly unlikely that the increases will create significant enough damage under the formulas to reach the threshold whereby PDVSA has to pay the partners.[88]

Indeed, the unlikelihood that the actions of the Venezuelan government would transgress the boundaries of contractual provisions drawn up by the companies themselves, due to these price assumptions, had already proved a source of frustration for them before the migration initiative. For example, as early as January 2005, XOM was informing the US embassy 'that the company ha[d] decided to move ahead with some legal action in response to the unilateral GOV decision to increase the royalty payments levied on the extra heavy oil projects'.[89] In the event, this litigation over the royalty reinstatement did not materialize, in all probability out of an appreciation that the contents of the AA would have doomed such an enterprise to failure. Incidentally, in reporting the May 2006 conversation to his superiors in Washington DC, the US Ambassador to Venezuela concluded as follows: 'it appears that the six international oil companies (IOCs) that are partners in the strategic associations have very little in the way of legal remedies to combat the tax increases.'[90] Thus, even the US government was very much aware of the significance and operation of the compensation formulas in the AAs.

As to the way in which these companies saw in the raising of alleged breaches of treaty a means of avoiding the unpalatable outcomes of contractual mechanisms of their own devising, this comes across in a passage from a cable reporting a post-nationalization meeting held at US embassy premises in Caracas during September 2008. On that occasion, a COP officer highlighted to US diplomatic personnel that 'the original contracts for the Petrozuata and Hamaca Strategic Associations included clauses stipulating that, if the fiscal terms of the contracts were changed by the BRV, PDVSA would cover the losses of the investor up to a certain point. The maximum oil price named in the clause is much lower than current world oil prices which would be cited by ConocoPhillips in its claim to the ICSID panel' (in other words, the prices which would underlie the quantum section of its ICSID claim). However, the COP officer relayed that the company had received legal advice to the effect that

87 Cable 06CARACAS1445, 19 May 2006, 'Temperature Rises for Strategic Associations': ¶¶5, 3.

88 ibid: ¶5.

89 Cable 05CARACAS163, 19 January 2005, 'ExxonMobil Ready To Take On The Gov Over Royalty Issue': ¶¶2, 6.

90 Cable 06CARACAS1445, 19 May 2006, 'Temperature Rises for Strategic Associations': ¶1.

this was unlikely to cause problems for its suit because the company had 'filed its claims against the Government of Venezuela and not PDVSA'.[91] In other words, as far as COP was concerned, the fact that it was raising claims against Venezuela founded on alleged breaches of treaty by the latter, as opposed to claims founded on breaches of contract by PDVSA, meant that the actual contents of its AAs could be disregarded for the purposes of the dispute.

As can be appreciated, the *pacta* that COP and XOM claim to be defending are, in reality, the contracts that they have come to wish they had negotiated and signed, and which they now hope ICSID tribunals will write for them. Put bluntly, these ICSID arbitrations constitute an attempt on the part of these companies to exact a windfall as a way of cashing out from a country whose politics they had come to dislike for a variety of reasons, through the expedient of enlisting arbitrators to re-draft terms and conditions that might have looked exceptionally favourable initially, but which were left looking considerably less rich by an unforeseen development: 'the oil price spike that began in 2002 and that, though with some intermittence, continues.'[92] The governing documents of the AAs defined a certain space for profits, beyond which these documents made it crystal clear that the Venezuelan government could appropriate all economic benefits. With the benefit of hindsight, the companies want to avail themselves of ICSID to deny the right of the Venezuelan state to collect these windfall profits, by presenting the nationalization of their holdings as an outright confiscation, an act of high-handed governmental abuse violative of international law. Such an interpretation passes over the fact that the Venezuelan government neither intended nor wished to take over all of the COP and XOM interests in the country, and that this outcome was the consequence of the companies' refusal to reduce their equity participation in the projects in the context of the migration initiative. Thus, the companies' intransigence left the Venezuelan government facing a much higher compensation bill than would otherwise have been the case, which renders all the more objectionable their position that the limitations formulae should be set aside for the purposes of calculating compensation.[93] But then again, as the president of ExxonMobil de Venezuela put it to a US Senator when the latter visited Venezuela in 2005, 'ExxonMobil perhaps had a 'different perspective' on contract sanctity than other companies'.[94] Quite so, and it is a perspective that COP, for one, shares. But the really explosive, multi-billion dollar question is whether their self-serving perspective is one that the ICSID set-up is prepared and, indeed, can afford, to accommodate.

91 Cable 08CARACAS1246, 5 September 2008, 'Venezuela: ConocoPhillips Negotiations Stall': ¶3.

92 *Burlington Resources Inc v Republic of Ecuador, ICSID Case No ARB/08/5. Decision on Liability Dated 14 December 2012* (hereafter '*Burlington*'): ¶6.

93 As Marboe observes, 'many investment projects are based on or connected to a contract with the respondent State, a Statal entity, or a State-owned enterprise. The provisions of this contract naturally have a decisive impact on the value of the investment. This means that, for valuation purposes, the contractual provisions must be applied, even if the breach of the contract itself lies outside the jurisdiction of the tribunal' (Irmgard Marboe, *Calculation of Compensation and Damages in International Investment* (OUP 2009) 178–79.).

94 Cable 05CARACAS1029, 11 April 2005, 'Senator Coleman Meets with Energy Companies in Venezuela': ¶11.

9. '*TEDIOUS ARGUMENTS OF INSIDIOUS INTENT LEADING TO AN OVERWHELMING QUESTION*'?

Sigmund Freud once wrote, referring to the process of psychoanalysis, that if any particular subject is not allowed to be discussed freely in an analysis, sooner or later the entire analysis will be about that particular subject. Freud's insight is particularly apposite for the ICSID arbitrations at hand. For all of the claimants' systematic avoidance of the subject of compensation limitation in their pleadings and submissions, the endgame of both cases has inevitably come down to this: what are the respective tribunals going to do about these formulae?

The divergent corporate litigation strategies of the claimants meant that the COP and XOM tribunals encountered this question under different guises. In the XOM case, the core issue of the formulae was threshed out from the enveloping legal chaff by the ICC claim for breach of contract which, as already mentioned, XOM brought against PDVSA in early 2008 (and which concluded in December 2011). The XOM ICC claim (largely duplicative of the ICSID claim against the Republic) alleged breach of the covenant (guaranteed by PDVSA) whereby PDVSA-CN had undertaken to provide an indemnity to Mobil Cerro Negro in the event of certain adverse governmental measures (under the limitation of liability clauses that are supposedly irrelevant in the ICSID claims).[95] The ICC tribunal found that, while there had been no breach of contract on the part of PDVSA, some of the governmental acts at issue in the arbitration—specifically, the nationalization itself and the change in income tax rate—were indeed compensable events (i.e. 'Discriminatory Measures' under the AA definition) for which PDVSA was liable under the indemnity provisions of the AAs.

As mentioned before, the ICC tribunal awarded XOM a total of 907.58 MMUS$, applying the agreed contractual formulae on limits to compensation. XOM has sought to portray this award as representing 'recovery on a limited, contractual liability of PDVSA that was provided for in the Cerro Negro project agreement', a determination with no bearing on the 'larger' proceeding before ICSID.[96] However, XOM's interpretation of the outcome of the ICC arbitration is at odds with other key provisions in the Cerro Negro AA. According to XOM, 'the ICSID arbitration fulfills [*sic.*] Article 15.1(a) AA which requires the Claimant to pursue legal actions to mitigate damages suffered as a result of a Discriminatory Measure'.[97] But that same article also requires that XOM credit any and all net proceeds from any award obtained pursuant to such legal actions against damages payable calculated under the Cerro Negro compensation formulae or, in the event of such damages having already been paid, to reimburse such proceeds in full to PDVSA Cerro Negro (successor to Lagoven's interest in the project).[98]

95 'The Discriminatory Measures at issue in this ICC arbitration are among those at issue in the ICSID proceeding' (*XOM ICC*: ¶209).

96 'Exxon Mobil files another complaint against Pdvsa' *El Universal* (Caracas, 3 January 2012).

97 The article in question states that '[t]o the extent any legal remedy is available to reverse or obtain relief from such Discriminatory Measure, the Foreign Party shall commence and pursue legal actions to mitigate any damages suffered as a result of the Discriminatory Measure' (*Cerro Negro Association Agreement*, Art 15.1(a)).

98 'Any net proceeds received by the Foreign Party as a result of the pursuit of the aforesaid legal actions (after deduction of the legal costs incurred by the Foreign Party in connection therewith) shall be (i) applied against any amount ultimately determined to be owed by Lagoven pursuant to this Article or (ii) reimbursed to Lagoven if Lagoven previously has made payments to the Foreign Party with respect to the Discriminatory Measure in question' (ibid).

Bearing this is mind, plus the fact that the 2007 nationalization of XOM's interest in Cerro Negro was adjudicated as constituting a Discriminatory Measure, and that the 'Damages payable' for this measure have been not only calculated in accordance with the compensation formulae but also liquidated in full, the question arises whether, as a matter of contractual construction, the decision of the XOM ICC tribunal has effectively rendered XOM's ICSID claims moot (insofar as they relate to the Cerro Negro project).[99]

In the COP ICSID case, the dubious legal merits of the breach of treaty claims, on the one hand, and the ever-present compensation formulae, on the other, gave rise to a *Zugzwang* which the majority of the tribunal hearing that case tried to break in a manner that has taken the international dispute resolution system into uncharted, and very turbulent, waters. In a nutshell, having stated at the outset that its decision on jurisdiction would not look into 'the relevance, if any, of the compensation formulas included in the Petrozuata and Hamaca Association Agreements to the determination of the quantum of compensation payable in this case', the tribunal accepted that the governmental measures at issue in the arbitration had not been unlawfully taken.[100] Without more, such a conclusion would have been dispositive not only of the valuation date, but also of most of the assumptions under which such a valuation would have had to be carried out (i.e. cash flows to be calculated with price projections current at date of nationalization, with the fiscal regime generally applicable at that point). Assuming the use of a reasonable discount rate (one in line with that used in the XOM ICC case, say), such a valuation exercise would have resulted in a figure very close to the one resulting from applying the compensation limitation formulae (a figure which would come to a very small percentage of the amount claimed by COP).[101] However, this was not to be because two of the arbitrators reached the conclusion that Venezuela had 'breached its obligation to negotiate in good faith for compensation for its taking of the ConocoPhillips assets in the three projects on the basis of market value', which in turn meant that '[t]he date of valuation of the ConocoPhillips assets [would be] the date of the Award'.[102] Moving this date would enable the inclusion of post-2007 oil prices and price projections for the purposes of valuation which, in turn, would inflate the potential compensation payable to COP by many hundreds of millions, if not billions, of dollars.

To say these conclusions came out of the blue is an understatement, not least given that 'the Republic's good faith in negotiations was never even contested by Claimants' and the acceptance by the tribunal of 'how rarely courts and tribunals have held that a good faith or other related standard is breached... [because] [t]he

99 The ICC award has no effect on the ICSID claims deriving from the nationalization of the La Ceiba project.

100 *COP ICSID*: ¶¶344–60.

101 The XOM ICC tribunal made it clear that, had it been tasked with quantifying cash flows not subject to a protection mechanism, the discount rate would have had to be higher: '[t]he Tribunal considers that there is a difference between valuing future cash flows under an indemnity formula and valuing the potential cash flows from a project. There is a valid distinction between the two exercises, not the least of which being that there may be fewer risks to indemnity cash flows than to Project cash flows' (*XOM ICC*: ¶777).

102 *COP ICSID*: ¶404.

standard is a high one'.[103] *Ditto* that the logic underlying these conclusions was puzzling, on a number of grounds. For starters, the finding that the sole basis for unlawfulness was the lack of compensation was inconsistent with the majority's apparent acknowledgement that the *Chorzów Factory* standard of compensation does not apply where a measure would have been lawful but for the payment of compensation (so if *Chorzów Factory* were indeed applicable, the valuation date would have to be the date of the nationalization).[104] It is also difficult to fathom how, without coming to a view about the relevance of the compensation formulas to the issue of fair market value, the majority could hold that Venezuela's settlement offers indicated bad faith on its part (especially since the compensation offer that the claimants recognized had been made to them early in the negotiation process actually exceeded the amount reflected in claimants' own documents as the value of the nationalized interests only a short time before nationalization).[105] Likewise, the dearth of subsequent settlement offers that the majority adduced to ground its finding of bad faith was a reflection of the existence of a confidentiality agreement which Venezuela declined to breach by bringing up discussions covered by such agreement.[106] The notion that the failure to breach confidentiality is to be taken as proof of bad faith—or that the absence of evidence under such circumstances can be turned into a presumption or inference of bad faith—is perplexing, all the more so in the context of a case supposedly revolving around the principle of *pacta sunt servanda*.

Having handed down this decision, the majority then refused to entertain a request from Venezuela for a reconsideration hearing, meant primarily to address manifest errors in the factual premises underlying the purported finding of bad faith. The majority's refusal elicited a coruscating dissent from the arbitrator in the minority, exceptional for the forthrightness of the language with which it explained that the decision on jurisdiction was fatally compromised by 'an error relating to the temporal ambit of the Confidentiality Agreement, from which it drew far reaching conclusions, through speculative *ex hypothesi* reasoning and extrapolation'.[107] The dissenting arbitrator was particularly struck by how the diplomatic cables released into the public domain subsequent to the hearing held in May 2010 fit together in a narrative that 'radically confutes the one reconstructed by the Majority, relying almost exclusively on the assertions of the Claimants throughout their pleadings that the Respondent did not budge from its initial offer'.[108] In his view, this documentary evidence (whose 'veracity was not contested by the Claimants, only its relevance and admissibility') indicated that, 'if there was bad faith, it is not attributable to the Respondent, but to the Claimants who misled the Majority by their misrepresentations, in full awareness of their falsity'.[109] In the light of this dissenting opinion, it is not surprising that

103 *COP ICSID*: ¶275.

104 ibid: ¶¶340–43.

105 *Letter to Tribunal Regarding Decision on Jurisdiction…* : ¶11.

106 COP officers repeatedly breached the agreement to keep the US Embassy in Caracas abreast about the progress of negotiations.

107 *ConocoPhillips et al v Venezuela, ICSID Case No ARB/07/30. Decision on Respondent's Request for Reconsideration. Dissenting Opinion of Georges Abi-Saab*: ¶63.

108 ibid: ¶64.

109 ibid: ¶65.

Venezuela took the unusual step of filing a proposal for the disqualification of the arbitrators in the majority, which ICSID then rejected. As of the time of writing, the case has moved into the quantum phase.

Considerations of space preclude any extended critique of the factually-surprising position taken by the majority of the COP ICSID tribunal in relation to Venezuela's settlement offers, as compared to its rather more benevolent view of COP's approach to both negotiation and litigation. In any event, this is still a developing story, and it would be ill-advised to engage in speculation regarding its possible *dénouement*. What is more important is to highlight that the roundabout attempt on the part of COP and XOM to enlist international arbitrators as drafters-in-hindsight has plunged the whole international dispute resolution system into disarray, so much so that it does not seem exaggerated to suggest that the overwhelming question to which the giant arbitrations against Venezuela ultimately lead is: whither ICSID? Or could it even be: wither ICSID?

10. THE WIDER POLITICAL MEANING OF THE VENEZUELAN OIL ARBITRATIONS

The COP and XOM arbitrations are Venezuelan manifestations of a trend in international investment disputes which has seen the rise of the so-called mega-cases; that is, disputes where the amounts at stake run into the billions (even tens of billions) of dollars. Petroleum lies at the heart of many of these mega-cases, with the disputes underlying them arising 'in the wake of the oil price spike that began in 2002 and…with some intermittence, continues to this date', the bone of contention invariably being 'how the economic benefits of this oil price spike must be distributed'.[110]

In their submissions and pleadings to arbitral tribunals, oil companies have spiritedly asserted that these benefits must be distributed in strict accordance with the provisions of the contracts pursuant to which they undertook the exploitation of hydrocarbon resources of countries whose governments, they lament, are only too ready to renege on their bargains. However, as this article has shown, such accusations are best taken *cum grano salis*, given the way in which oil companies go about construing their agreements with governments. Nevertheless, the media, governmental actors and general public in developed countries have tended to accept uncritically that the ultimate objective behind these mega-cases has been the defence of the fundamental principle of sanctity of contract against the cupidity of unscrupulous governments.

In no small part, this is a reflection of the manner in which the business relationships between petroleum producing countries, on the one hand, and oil companies, on the other hand, are invariably portrayed, with the former being cast in the passive role of mere *capital importers* (rather than as owners and stewards of very valuable, non-renewable and depleting natural resources). This allows the attribute of scarcity to be conferred solely to the capital and expertise that the oil companies bring to the table, which in turn makes it possible for government fiscal take to be conceptualized as 'the "price" that investors are willing to pay for exclusive access to concession or contract areas for petroleum exploration, development and production', with this 'price', in turn, supposedly being 'determined by the market forces through…the

110 *Burlington*: ¶6.

supply of concession and contract areas by governments, and the demand for concession and contract areas by [international oil companies]'.[111] In this way, policy levers which are meant to be expressions of sovereignty (particularly those of a fiscal nature) are thereby metamorphosed into the constituent elements of purported bargains struck with the sole aim of inducing spoilt-for-choice investors to part with their capital and expertise. Thus, any *ex-post* alteration to this so-called 'price', resulting from these levers being moved by governmental actions, can consequently be characterized not as an exercise of a state's police powers, but as a breach of contract and/or an expropriation.[112] What is more, as the COP and XOM cases against Venezuela highlight, even fiscal measures targeting windfall profits are branded as expropriatory, despite the fact that, by definition, such profits would (and could) not have been in anybody's contemplation at the time an investment was made (which is why, as Sornarajah admonishes, '[t]he taxing of windfall profits (i.e. **profits which arise without any act on the part of the investor**) cannot amount to a taking. Thus, taxation of the oil industry for windfall profits due to price hikes cannot amount to a taking').[113] Incidentally, it is also worth noting that the immutability of these purported bargains is meant to apply only to governments, because private investors reserve the right to mobilize arrays of legal and accounting advisors to exploit any and all loopholes and angles in the pursuit of the 'maximisation of shareholder value', even if this means whittling down to almost nothing the actual fiscal 'price' that a state ends up receiving from the exploitation of its natural resources (as, indeed, happened in Venezuela).[114]

With such a meta-narrative serving as the backdrop for investment disputes (and given that the explicit *raison d'être* of the international dispute resolution system, after all, is *investment* protection), it is easy to see why, behind the closed doors of arbitration tribunals, investors will readily argue that any regulatory or tax measure taken by a state that may affect their bottom lines should be a source of liability. Thus, despite universal agreement among legal authorities in the sense that (to cite the words of the *Total v Argentina* arbitration tribunal) 'signatories of BITs do not thereby relinquish their regulatory powers nor limit their prerogative to amend legislation in order to adapt it to change, new emerging needs and requests of their people in the normal exercise of their prerogatives and duties', the plasticity and malleability of certain international investment law concepts, notably the fair and equitable treatment (FET) standard, have provided companies with an incentive to

111 Pedro van Meurs, *Maximizing the Value of Government Revenues from Upstream Petroleum Arrangements under High Oil Prices. A Discussion Document* (van Meurs Corporation 2008) 4.

112 This position is articulated at its most extreme in William Hogan, Federico Sturznegger and Laurence Tai, 'Contracts and Investments in Natural Resources' (in *The Natural Resources Trap. Private Investment without Public Commitment* (William Hogan and Federico Sturznegger eds, MIT Press 2010) 7), where even changes to the general rate of UK Corporation Tax are branded as partial expropriations.

113 Muthucumaraswamy Sornarajah, *The International Law on Foreign Investment* (CUP 2010) 405; emphasis added.

114 In contrast, the standard interpretation of the behaviour of corporations is that they 'do not typically renege on fiscal agreements', but only because reneging is defined as 'choosing to retain all revenues in a given period without paying taxes', while engaging in aggressive tax optimization does not qualify (Johannes Stroebel and Arthur van Benthem, 'Resource Extraction Contracts under Threat of Expropriation: Theory and Evidence' (2013) 95(5) Review of Economics and Statistics 1623.

adopt maximally intransigent negotiation and litigation strategies.[115] In a number of high profile cases (*Metalclad, CMS, Sempra, Enron*), arbitration tribunals have rewarded such conduct by providing significant compensation 'for failure to accord fair and equitable treatment even where ... no expropriation or discrimination of a foreign investor's investment has occurred'.[116] Such awards, in turn, have translated into a 'growing dissatisfaction of states with the international arbitral process [, which] looms as a major problem in investor/state relations and requires a critical assessment of the future of international arbitration as a means of settling investment disputes'.[117] The petroleum mega-cases have made an already fraught situation worse, partly on account of the sums of money at stake but also because some of these cases have resulted in decisions so adventurous and imbalanced as to make it impossible for (at least some) respondent states not to question the wisdom of their ongoing engagement in the whole international arbitration setup. Foremost among these contentious decisions are the majority decision on jurisdiction in *ConocoPhillips v Venezuela* and the majority decision on liability in *Occidental v Ecuador*.

The salient points of the former decision have already been touched upon, in particular the manner in which a finding of bad faith was conjured out of the ether so as to justify moving the valuation date (thereby inflating compensation). The legal duty to negotiate in good faith also featured prominently in the *Occidental* case, which arose from the termination by the Ecuadorean government of an oil exploration and production contract between itself and oil company Occidental, after the latter transferred an economic interest in the contract to a third party in a manner that was alleged to violate both the terms of the contract and Ecuadorean law. The decision to terminate was taken after discussions between the parties had failed to resolve the *impasse*, whereupon Occidental filed a request for arbitration, albeit without waiting for the period of time specified in the Ecuador-USA BIT. The tribunal did not consider that this procedural matter made the claim jurisdictionally deficient, on the grounds that the investor did not need to exhaust the 6-month applicable waiting period given its strongly held belief that any further negotiation on its part would have been pointless. The decision clearly implied that a similar conviction about the futility of negotiations would not have provided the Ecuadorean government with a valid excuse to break off discussions, though.[118]

This asymmetrical construction of the legal duty to negotiate in good faith was then taken to an altogether different plane in the subsequent decision on liability. The tribunal determined (unanimously) that Occidental's farm out agreement had

115 *Total S.A. v The Argentine Republic, ICSID Case No ARB/04/01. Decision on Liability Dated 27 December 2010*: ¶309(b).

116 Roman Picherack, 'The Expanding Scope of the Fair and Equitable Treatment Standard: Have Recent Tribunals Gone Too Far?' (2008) 9(4) The Journal of World Investment and Trade 255. The cases are: *Metalclad Corporation v The United Mexican States, ICSID Case No ARB(AF)/97/1; CMS Gas Transmission Company v The Republic of Argentina, ICSID Case No ARB/01/8; Sempra Energy International v The Argentine Republic, ICSID Case No ARB/02/16; Enron Corporation and Ponderosa Assets, L.P. v Argentine Republic, ICSID Case No ARB/01/3.*

117 George Kahale, III, 'A Problem in Investor/State Arbitration'(2009) 6(1) Transnational Dispute Management 1.

118 *Occidental Petroleum Corporation and Occidental Exploration and Production Company v The Republic of Ecuador, ICSID Case No ARB/06/11. Decision on Jurisdiction Dated 9 September 2008*: ¶¶93–94.

indeed breached the terms of the contract (and contravened municipal law in the bargain), but the arbitrators in the majority reasoned that this breach, 'while imprudent and ill advised, did not amount to bad faith', since Occidental executives had acted as 'business people, seasoned oilmen, for whom legal niceties were not as important as the business realities of the deal'.[119] The majority went on to hold that, in standing on its rights to terminate the Occidental contract on account of a breach that clearly went to its very root, the government of Ecuador had actually acted disproportionately and, hence, had violated the US-Ecuador BIT. Thus, the majority reached a conclusion that not only set aside the legal requirements established under the governing law of the agreement (subordinating such requirements to the 'business realities of the deal') but also seemed to stand on its head a cardinal principle of contract law of most jurisdictions (the standard of strict liability for breach, even in situations where the contract breaker has done their best, and not acted in bad faith). Thus, having prevailed in the key underlying legal issue to the dispute, Ecuador nevertheless found itself hit with the largest compensation award ever handed down in the history of ICSID (thereby confirming the fears of many state actors that the international dispute resolution structures might be so biased that governments cannot even afford to win investment disputes, let alone lose them).

The dismay with which many states have greeted decisions such as these has been aggravated by the fact that investors have resorted to arbitration proceedings in order to strip certain states of sovereign prerogatives—like the faculty to levy taxes on windfall profits associated with the exploitation of natural resources—which the governments of the countries of origin of these same investors (in other words, the counterparties in the BITs providing the jurisdictional basis to investor claims) have jealously guarded and never ceased exercising at their discretion. This has highlighted that the only thing that was ever meant to be bilateral about BITs is their name, because the *ethos* of the whole investor-state international dispute resolution system that these treaties underpin was to constrain the freedom of governmental action, but only in certain places. Thus, the proliferation of BITs seems to have given rise to a situation where the essential identifying trait of sovereignty—to be the highest unit of decision and action in a given territory, not subject to the will of any superior instance—continues to hold, and be true, for a small number of governments, but not for most others.

Consider the following announcement put out by the holder of an important concession which was the subject of a 'migration' initiative remarkably similar, both in conception and execution, to Venezuela's:

> [The Concessionaire] has reached an agreement with the…Government. The agreement **changes and increases taxation of income** under the…concession until its expiry in 2012 [and] the Government will receive a **20% share of the profit** [profit sharing was zero up until this point]. Simultaneously, the concession is extended to 2042 with the…Government joining [the consortium exploiting the concession] with an **ownership share of 20%** as of 2012 **without payment**.

119 *Occidental Petroleum v Ecuador, ICSID Case No ARB/06/11. Award Dated 5 October 2012*: ¶348.

> [The Concessionaire] has found it unreasonable to negotiate the existing agreement **under pressure of new legislation**, but found it prudent to accept a complete solution which should ensure a continued economically and for the society proper development of the oil and gas fields in question, also after 2012.[120]

These measures, which increased government take on the gross income generated by the concession from 41% (for the 2000–3 period) to 66% (for the 2004–11 period), were adopted less than 7 months after the legislature had asked the executive for a report 'outlining the possibilities of… ensuring that the State gains a larger share of the values in connection with the present and future exploitation of the oil and gas resources'.[121]

This chain of events could be interpreted as an illustration of the 'demonstration effect' that the fiscal measures implemented in Venezuela over the 2004–8 timeframe have had around the world. As a matter of fact, though, the restructuring of this particular concession was undertaken when the oil price spike was in its infancy (2003), way before the possibility of reinstating the statutory royalty rate for the Venezuelan upgrading projects was even contemplated. Furthermore, it was carried out by a Liberal-Conservative coalition government of a country not usually included among the standard-bearers of radicalism. The concession in question was the aforementioned one held by DUC, granted originally on 8 July 1962 to A.P. Møller–Mærsk A/S for the exploration and production of hydrocarbons throughout the whole of the landmass and territorial waters of Denmark.

The 'migration' of the DUC concession did not lead to any litigation. Thus, it is instructive to contrast this outcome with the legal storm that erupted upon the enactment, in August 2006, of the Algerian windfall profits tax (the *Taxe sur les profits exceptionnels* or TPE). Thanks to the existence of an Algeria-Denmark BIT, and the arbitration clause in their PSA with Sonatrach (the Algerian national oil company), Mærsk and its partner Anadarko were able to bring simultaneous multi-billion dollar ICSID and ICC claims against Algeria and Sonatrach, respectively (in a two-pronged litigation strategy redolent of that pursued by XOM against Venezuela and PDVSA), rather than in Algerian courts. This judicial assault was successful in forcing Algeria to settle with these companies on their terms even though the economic effects of the migration of the DUC concession, on the one hand, and the TPE, on the other, were not dissimilar.[122] This resemblance between the Danish and Algerian measures extends to the political plane, making it difficult to appreciate how the former could be an undisputed and legitimate exercise of a state's sovereign police powers, while

120 Mærsk Oil, *Oil Activities in the North Sea - Taxation and Concession*; press release dated 30 September 2003; emphasis added <http://www.maerskoil.com/media/newsroom/pages/oilactivitiesinthenorth-sea-taxationandconcession.aspx> accessed 9 May 2014.

121 Minister for Economic and Business Affairs, Denmark, *Report to the Danish Parliament on the North Sea October 2003*: 2. Preben Joker Thorsen, 'Denmark: Changes in Tax Regime. Danish Underground Consortium (DUC). The North Sea Agreement 2003', presentation delivered at *23rd International Tax Conference*, 31 October–1 November 2012 Oslo, Norway.

122 Although the burden of TPE was somewhat heavier, a logical result given the much higher productivity of Algerian oil and gas fields.

the latter allegedly amounted to an internationally unlawful act. This reflection leads to an unavoidable question: had Sonatrach been a party to the DUC concession, would it have had grounds to take the Danish government to arbitration under this very same BIT? The answer would appear to be yes. However, the Danish signatories of this BIT never lost sleep over such an eventuality, because they expected that all the investment flows protected by the treaty would be going in one direction, and one direction only (quite apart from the fact that no Danish state entity could have lawfully signed a PSA purporting to give guarantees against sovereign measures that might be taken by its government).

Consider also the aforementioned increase in Supplementary Charge rate applicable to upstream petroleum income which the British government introduced in 2011 (and which left oil companies active in the UK North Sea—including, again, Mærsk Oil—reaching for the smelling salts, not least because they lacked any legal recourse whatsoever against the measure).[123] The rationale behind this measure was eloquently articulated by the Chancellor of the Exchequer, George Osborne:

> I think it is perfectly legitimate for us to look at the price of oil at the moment…to say that the industry is making profits which they were not forecasting to make…[so] it is perfectly reasonable to look to the oil and gas industry for additional taxation…Given the high price of oil…it is still very profitable to invest and exploit these resources. The profits on a barrel of oil are going to be higher in the next five years than they were in the last five years…The companies were making £12.02 profit on a barrel of oil for the last five years. They are forecast to make £12.31 on the next five years on that barrel of oil, with the new tax. At the moment they are making £13.28…So their profits are going up even with the additional tax.

As a summing up of the economic factors which impelled the Venezuelan government (*qua* natural resource owner) to implement its policy of migration, the Chancellor's comment can hardly be bettered. Furthermore, the Chancellor also neatly disposed of the notion that sovereigns are supposed to ascertain what parties to be affected by tax measures might think about these, lest governmental action on the fiscal front be branded as arbitrary: 'I don't think it is possible to actively consult a business sector on a tax rise…I think that would have been very, very difficult to undertake and the previous Government…also took a similar view and didn't consult on its very similar increase in the supplementary charge.…[A]nd I thought it was a reasonable thing to ask of the oil companies, given the very high price of oil'.[124] Chancellor Osborne's sentiments in this regard were, again, very similar in their

123 The tone of their complaints and representations comes across well in the written evidence compiled in connection with hearings held by the House of Commons Scottish Affairs Committee (*Effects of Tax Increases on the Oil Industry. First Report of Session 2007–08 Report, Together with Formal Minutes, Oral and Written Evidence, HC 35, Incorporating HC 1326-i to iii, Session 2005–06*). See in particular 'Letter to the Chairman from Mærsk Oil North Sea UK Limited', in ibid: EV42.

124 *Transcript, The Rt Hon George Osborne MP, Chancellor of the Exchequer, United Kingdom, before the Parliamentary Treasury Committee (Oral Evidence taken before the Treasury Committee on Tuesday 29 March 2011 Examination of Witnesses, questions 417–529).*

overall thrust to those which late President Hugo Chávez voiced on the matter, with the crucial difference that the former kept inflammatory rhetorical flourishes to a minimum.

As regards the current state of the world petroleum industry and oil market, the main consequence of a two-decade-long spell of BIT-underpinned petroleum governance seems to be a worldwide dearth of investment opportunities involving anything other than difficult prospects (relative to likely future requirements), which manifests itself most tellingly by way of very high oil prices: 2011 was the first year in history when the international price of crude averaged over 100 US$/B, 2012 was the second, and 2013 the third. To an extent, this is a consequence of the fact that many countries have had to focus their attention and resources on restructuring and renegotiation of agreements (and their unavoidable handmaiden, litigation), which in turn has led to a reduction in the number of projects 'in the pipeline' in such countries, and has even shut some oil companies out from some highly prospective areas. There are many other places (say, Nigeria) where no such restructuring has occurred (or is even likely to occur), and yet investment flows there have also suffered, because of the calamitous economic and political sequels derived from the wholesale relaxation of fiscal terms in situations where, as Silvan Robinson put it so well, the overhead costs of the oil industry include 'the cost of running the whole country'.[125]

A key reason why, in recent times, the price of oil has not been even higher is the unfolding oil and gas shale revolution in North America, which has radically transformed both the US natural gas market (which has swung from a situation of impending shortage to one of surplus), and the US petroleum market (where flows of imported crude oil have shrunk markedly). The variable lifting costs of these non-conventional hydrocarbons makes their output contingent on persistently high oil price levels.[126] Such conditions will, of necessity, continue generating large rents in prolific conventional hydrocarbons provinces with low to moderate production costs. And for all the talk from petroleum company executives about an endless succession of attractive investment prospects (mainly non-conventional ones, of late), the denial of the sovereign right of resource owners to collect such rents (whether through arbitration or other means) will make it more rather than less difficult for oil and gas output to keep pace with rising worldwide demand, in a way that maintains prices within reasonable bounds. The ultimate reason why any such attempt is doomed to fail was pithily and unanswerably expressed by, of all people, Chancellor George Osborne himself (when justifying before Parliament the increase on direct levies on oil and gas companies in Great Britain in 2011): 'It is worth bearing in mind that this oil and gas is not theirs. It is ours, as a nation.'[127]

125 Silvan Robinson, 'Real Cost Base of Oil Isn't What You Think' *Petroleum Intelligence Weekly* (3 April 1989) 6.

126 The surge of non-conventional shale gas production has had a pronounced depressing effect on natural gas prices (and drilling) in the United States, but costly shale gas production operations have been largely kept afloat by revenues from the production of natural gas liquids, whose price follows that of oil.

127 *Transcript, The Rt Hon George Osborne MP*… .