

# The Energy Charter Treaty: Dispute Resolution Mechanisms – and the Yukos Case

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An article called "Investors to seek legal redress over Yukos woes" in the *Financial Times* (November the 4<sup>th</sup>) gave rise to a wave of publications in the Russian and foreign media at the end of the 2004, retelling the same piece of 'news' that the shareholders had filed a complaint against the Russian administration under the terms of the Energy Charter Treaty (the ECT; accompanying comments differed depending on experience, professional competence or imagination of journalist involved). The only source mentioned in all publications was Mr Tim Osborn (the managing director of Menatep, the principal owner of Yukos, holding 60% of its shares). The following publications (cf e.g. *Kommersant-daily* of 6 December 2004) mentioned with reference to him that the case would be filed (probably with the International arbitration court in Stockholm) in the next three months. Usually the comments also mentioned that Russia has been applying the ECT provisionally, which at the least raises questions in relation to the applicability of dispute resolution mechanisms under the Treaty.

In early February, 2005 the new wave of 'news' on Yukos claim against Russian Federation on the basis of the ECT has appeared. This time the 'news' indicated that the claim would be handled through the arbitration rules of the UNCITRAL and in accordance with Article 26 of the Treaty.

The natural question is: what are the dispute resolution mechanisms of the Treaty, areas and cases of their application? We asked Dr. Konoplyanik, Deputy Secretary General of the Energy Charter Secretariat to answer this question. His article<sup>1</sup> follows.

**For information:** The ECT membership comprises 51 Eurasian states (including all EU countries, Russia and all CIS states) plus the European Communities as a "collective" member of the ECT. Seventeen states and 10 international organizations are observer parties to the Energy Charter process. The Treaty was signed in December, 1994 and came into force in April, 1998, i.e. today it is an integral part of international law, binding upon the Parties that have ratified it. The Treaty seeks to establish "uniform rules of the game" within the territories of its Signatories which have ratified it. Its scope includes the energy sector: from exploration and production of primary energy resources to end uses of energy. It covers investment, trade, energy transit and energy efficiency including related environmental aspects and sets forth the "minimum standard" for investment and trade protection and promotion within states at different levels of economic development and varying energy market development stages. The ECT and its instruments embrace not only the whole technological chain but also the entire investment cycle in the energy sectors of its constituent states, promote lower political risks and lower cost of capital for business activities in all phases of such cycles and seek to form a single energy space within Eurasia.

The ECT<sup>2</sup> contains a fully-fledged system of international dispute resolution. These provisions were developed in such an elaborate way because at the time when the Treaty was negotiated (early 90s) some Contracting Parties (CPs) – in particular countries in transition – did not yet have a sufficiently developed domestic juridical system. There was – and still is – concern about the neutrality, professional competence and efficiency of domestic courts in these countries, and the respect of the rule of law in business and social life.

By providing an alternative means of dispute resolution before international tribunals, the ECT contributes to increasing confidence of investors, their countries of origin and host countries to the level of legal protection of international investments and trade. Thus the ECT ensures reduction of risks and increase of investment and trade flows between its members. This is of particular relevance in the energy sector, since – due to the fact that capital intensity of investment projects in the energy sector is higher as compared to that of manufacturing industry, services and other sectors of economy, especially investment projects in upstream activities and infrastructure (transportation and distribution network) which in most cases can only be achieved by consortia of major companies –

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<sup>1</sup> The following publications were used for the preparation of this article: 'The Energy Charter Treaty. An East – West Gateway for Investment and Trade' (Editor of the English edition – T.Waelde, and Editor of the Russian edition – A.Konoplyanik), Moscow, Mezhdunarodnye otnosheniya, 2002, and 'The Energy Charter Treaty. A Reader's Guide'. – The Energy Charter Secretariat, Brussels, 2002.

<sup>2</sup> The ECT and related documents are available on the Energy Charter Secretariat's web-site [www.encharter.org](http://www.encharter.org).

disputes related to energy projects and companies may often be very complex and involve huge amounts of money.

The ECT includes several international dispute resolution mechanisms, each of them being designed to address a particular subject matter of the Treaty (Figure 1). The two basic forms of binding dispute settlement are the following:

! State-to-State arbitration for basically all disputes arising under the ECT (Article 27), except competition (Article 6 (7)) and environment (Article 19 (2));

! Investor-to-State arbitration for investment disputes (Article 26).

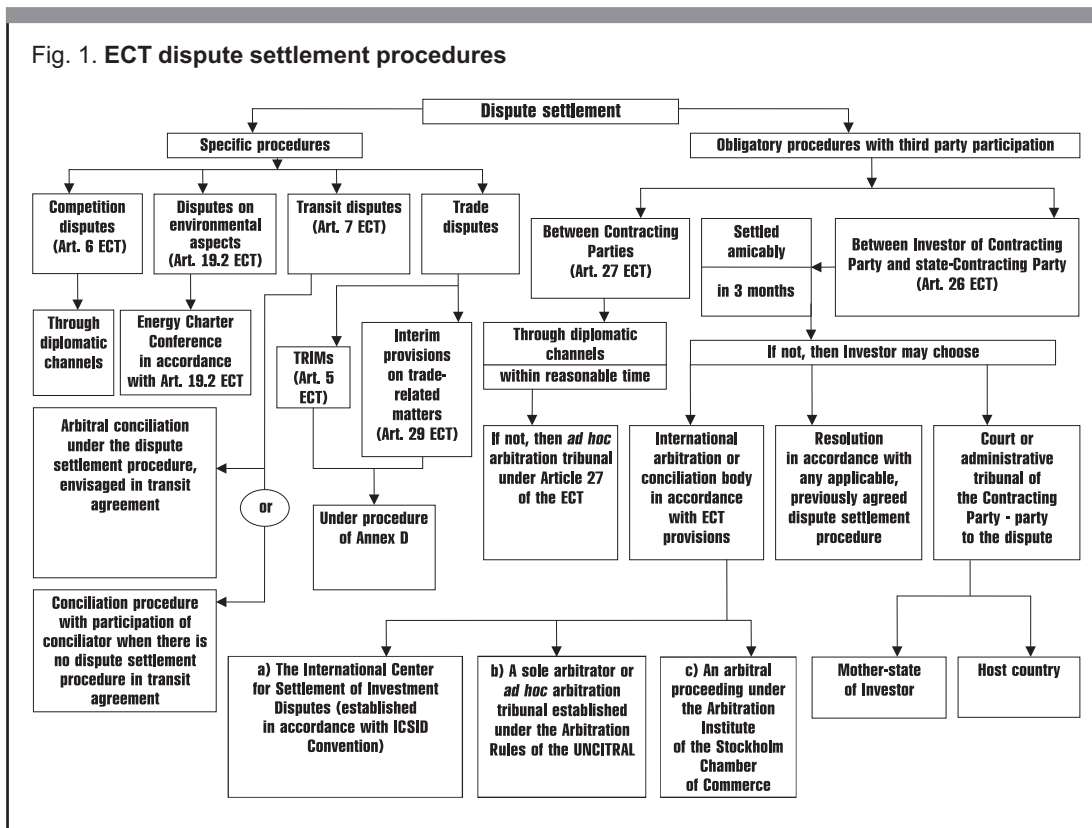
Special provisions have been developed for the resolution of inter-state disputes in the area of trade (Article 29, Annex D) and transit (Article 7). They derogate from the otherwise applicable general provisions on state-to-state dispute settlement. As far as competition (Article 6) and environment (Article 19) are concerned, the ECT does not establish binding arbitration procedures, but provides for “softer” and less formal dispute resolution mechanisms.

ECT negotiators did not want to “re-invent the wheel”. Therefore, as far as trade and invest-

ment disputes are concerned, the ECT provisions are based on the model of the WTO arbitration rules (for trade) and bilateral investment treaties (for investment). By contrast, the ECT dispute resolution rules concerning transit, competition and environment are new features, giving the Treaty a pioneer role in these areas.

In each case, the objective of international dispute settlement is not to favour foreign investors but to ensure an independent and neutral judicial forum. Overall, the ECT offers a dispute settlement system that is unique in the international arena both for the broad scope of covered issues (investment, trade, transit, competition and environmental protection – see Figure 1) and the number of countries having subscribed to it. This is where the special strength and the resulting legal attraction of the ECT is – today it has no alternative as to the comprehensive coverage of dispute resolution procedures both CP-to-CP and especially investor-to-CP.

The comprehensive system of ECT dispute resolution provisions defines their dual role: that of an efficient instrument for both resolution of disputes which have appeared as well as the prevention of disputes keeping CPs from violating the ECT provisions. That is why the small number of disputes under the ECT which have been resolved out of courts or in the courts (see Table 1) can not be used to mea-



**Table 1. Investor-to-State disputes under the ECT Article 26 known to the Energy Charter Secretariat (as of December 2004)**

Parties to the Dispute:		Date when the case was filed	Arbitration chosen by the investor	Status
Investor from a CP to the ECT	CP to the ECT			
AES Summit Generation Ltd (Investor from a European country)	Hungary	2001 (April)	ICSID	Originally the case was filed with ICSID, but in December 2001 it was solved out of court
Nykomb Synergetics Technology Holding (a Swedish Investor)	Latvia	2001	The Arbitration Institute of the Stockholm Chamber of Commerce	Decision in favour of the Investor was declared on 16.12.2003
A British investor	Kyrgyzstan	2003	The Arbitration Institute of the Stockholm Chamber of Commerce	The case filed with the arbitration institute
Plama Consortium Ltd (a Cypriote investor)	Bulgaria	2003	ICSID	The case filed with the arbitration institute
Alstom Power Italia SpA, Alstom SpA (Italian investors)	Mongolia	2004	ICSID	The case registered with the arbitration institute

sure the efficiency of the ECT dispute resolution system itself, since it is difficult to estimate the number of potential disputes which have been prevented due to the fact that the CPs were well aware of dispute resolution instruments available under the ECT and corresponding legal consequences in case of violation the ECT provisions. It should also be understood that the history of potential use of the ECT dispute resolution mechanism only starts from 16 April 1998 – the day when the ECT came into force and became an integral part of the international law.

## Investment Disputes

Articles 26 and 27 of the Treaty cover investments disputes. Article 26 deals with disputes between an investor and a host country and Article 27 covers disputes between States.

### 1. Investor-to-State disputes

Based on the model of bilateral investment treaties (BIT), Article 26 grants foreign investors the right to sue the host country in case of “an alleged breach of an obligation of the host State under Part III of the Treaty”, i.e. the provisions relating to investment promotion and protection. It is considered that the ECT, while basing itself on the BIT model, overcomes the differences in legal wording of the BITs, since, according to such a competent organization as the UNCTAD, “...given the sheer number of BITs, the formulations of individual provisions remain varied, with differences in the language of the BITs signed some decades ago and those signed more recently”.<sup>3</sup> Moreover, ECT goes further and provides better investment protection than BITs<sup>4</sup> (this point of view is shared by another competent organization such as the IEA, which stated that “the scope of energy investment and expropriation provisions of the Treaty is reported at times

to be broader than those agreed in BIT's. Therefore the Treaty provides better investment protection for investors than bilateral arrangements do”<sup>5</sup>).

To date, the Secretariat is aware of five complaints lodged under ECT Article 26, i.e. those filed by ECT member state investors against other ECT member states in which such investors made their investments: one dispute (vs. Hungary) has been settled out of court; one dispute (vs. Latvia) has been resolved by an arbitration award,<sup>6</sup> and three others (vs. Kyrgyzstan, Bulgaria and Mongolia) are in various stages of resolution (table 1).

The fact that all these cases emerged recently (in 2001-2004) shows that investors become more and more aware of both ECT and its dispute settlement mechanism for Investor-to-host State disputes. It looks that the information (even not yet confirmed) on filing one more case – by Yukos shareholders against Russia – reflects this trend and the growing trust in the objective nature of dispute resolution mechanisms under the ECT.

According to Article 26(1), disputes shall be settled, if possible, amicably. Both sides have a period of three months for consultations.

If consultations/negotiations fail, the foreign investor has three options where to submit the dispute for resolution (Article 26 (2)):

! To the domestic courts or administrative tribunals of the host state to the dispute;

<sup>3</sup> UNCTAD World Investment Report 2003. – UNCTAD/WIR/2003. – United Nations, New York and Geneva, 2003, p.89.

<sup>4</sup> Cf. Konoplyanik A. ‘Energy Charter Treaty may hold fair solution for creating the national oil company’. – ‘Oil & Capital: Russia & CIS Energy Magazine’, 1999, 1 5, p.14-17.

<sup>5</sup> IEA response to the Questionnaire for the Review to be conducted under Article 34(7) of the Energy Charter Treaty. – www.encharter.org, Message 543/04 Annex II (“Annex II to the draft report on the Review of the Energy Charter process, July 8, 2004”), section “Dispute Settlement”.

<sup>6</sup> For more details see ‘Investor wins first award under the Energy Charter Treaty’ – ‘Herbert Smith. International Law Briefing’. October 2004 (available at the Secretariat's website www.encharter.org with the kind permission of ‘Herbert Smith’).

! To any applicable, previously agreed dispute settlement procedure, e.g. an arrangement under BITs;

! To international arbitration.

If foreign investors choose to submit a dispute to international arbitration, they have the choice between basically three alternative arbitration procedures (Article 26 (4)):

! The International Centre for the Settlement of Investment Disputes, established by the ICSID Convention.<sup>7</sup> This option is available if both the home state of the investor and the host state are parties to the ICSID Convention;

! A sole arbitrator or an ad hoc arbitration tribunal established under the UNCITRAL Arbitration Rules,<sup>8</sup> or

! The Arbitration Institute of the Stockholm Chamber of Commerce.

There exist detailed procedural rules for all these arbitration proceedings, including the establishment of tribunals, selection of arbitrators, hearings and costs.

According to Article 26 (3)(a), each CP gives its unconditional consent to the submission of a dispute to international arbitration. However, there exist two exceptions to this rule:

! Article 26 (3)(b) permits CPs listed in Annex ID<sup>9</sup> to decline giving their unconditional consent to the submission of a dispute to international arbitration where the investor has previously submitted the dispute to another dispute resolution forum.

! Article 26 (3)(c) provides that CPs listed in Annex IA<sup>10</sup> do not give their unconditional consent to international arbitration in respect of disputes of alleged breaches of the obligation in the last sentence of Article 10(1)

(‘Each Contracting Party shall observe any obligations it has entered into with an Investor or an Investment of an Investor of any other Contracting Party’). The latter provision concerns the observance of obligations under an individual investment contract between a CP and an investor or investment of any other CP.

Regardless of which of the three above-mentioned basic options for international arbitration is chosen, the dispute shall be decided in accordance with the provisions of the Treaty and the rules and principles of international law (Article 26 (6)). The award is binding and final and may include interest (Article 26 (8)).

Pursuant to Article 26 (5)(b), an investor-state arbitration shall, at the request of any party to the dispute, be held in a state that is a party to the New York Convention.<sup>11</sup> This Convention requires state parties to recognise and enforce within their courts arbitral awards rendered in foreign states. Many of the parties to the New York Convention have declared that they will enforce an arbitral award only if it is rendered in a state that is also a party to the Convention. Thus, this provision permits the investor to ensure that such states are obliged to enforce the award.

It should be noted that the ICSID Convention already requires that its parties recognise and enforce ICSID arbitral awards. Therefore, if this option is chosen, the ICSID awards will generally be enforceable in a large number of states even if the New York Convention is, for some reason, inapplicable.

## 2. State-to-State disputes

In addition to investor-state dispute settlement, Article 27 of the ECT provides for inter-state arbitration. Once again, this reflects the practice of BITs.

In comparison with investor-to-state disputes under Article 26, the scope of inter-state disputes is wide. It is, in principle, not limited to investment disputes but applies to the application and interpretation of the Treaty as a whole – with very limited exceptions. However, for various kinds of inter-state dispute resolution (e.g. trade disputes), the ECT contains specific rules that derogate from the general provision of Article 27 (see below).

Unlike the investor-to-state disputes, the parties to state-to-state disputes, after exhausting attempts to settle them amicably, do not have a variety of alternative means. According to Article 27 (2), disputes have to be submitted to an ad hoc tribunal, subject to certain exceptions. For such disputes, the UNCITRAL rules shall apply, unless there is an agreement to the contrary between the CPs.

Pursuant to Articles 27 (2), and 28, international arbitration is not available in the following cases:

! Application or interpretation of competition and environmental issues (Articles 6 and 19);

<sup>7</sup> Convention on the Settlement of Investment Disputes between States and Nationals of other States opened for signature at Washington, D.C., 18 March 1965.

<sup>8</sup> UN Commission on International Trade Law.

<sup>9</sup> 24 CPs are listed in Annex ID: Australia, Azerbaijan, Bulgaria, Croatia, Cyprus, the Czech Republic, European Communities, Finland, Greece, Hungary, Ireland, Italy, Japan, Kazakhstan, Norway, Poland, Portugal, Romania, the Russian Federation, Slovenia, Spain, Sweden, and also Canada and United States who have not signed the ECT.

<sup>10</sup> 4 states are listed in Annex IA: Australia, Canada (hasn't signed the ECT), Hungary, Norway.

<sup>11</sup> United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards, done at New York, 10 June 1958.



- ! Observance of obligations under an individual investment contract against states listed in Annex IA;
- ! Application or interpretation of trade-related matters (Article 29) or trade-related investment matters (Article 5) unless both parties to the dispute agree otherwise.

The tribunal shall decide the dispute in accordance with the Treaty and applicable rules and principles of international law. The arbitral award shall be final and binding. Unless the parties to the dispute agree otherwise, the tribunal shall sit in The Hague, and use the premises and facilities of the Permanent Court of Arbitration.

The Secretariat is only aware of one dispute between the CPs under Article 27. Parties to the dispute resolved it by diplomatic channels (under Article 27(1)).

## Trade Disputes

In respect of trade-related disputes, Article 29 (7) of the Treaty provides for a dispute resolution mechanism (Annex D) that is based on the GATT/WTO panel model. It applies only in cases where at least one of the disputing parties is not a member of the WTO. The ECT fulfils a unique role in this respect, because it makes a GATT/WTO-like dispute settlement system available although not all parties to the dispute are GATT/WTO members. It makes it possible for a country non-member to the WTO to use the dispute resolution mechanisms, similar in substance to those of WTO, which undoubtedly should be a factor facilitating the accession of this country to WTO.

Disputes of an intra-GATT/WTO nature are to be resolved in the appropriate WTO fora. This approach avoids a possible parallelism of dispute settlement procedures concerning the same dispute ("forum shopping").

As a general rule, dispute settlement under Article 29 (7) is a substitute for state-to-state arbitration under Article 27 and investor-to-state arbitration under Article 26. Nevertheless, according to Article 28 CPs have the right to submit a trade-related dispute (including a dispute on trade-related investment measures (TRIMs)) to arbitration under Article 27, provided that they both agree. Article 29 does likewise not exclude that foreign investors bring actions relating to TRIMs under Article 26 (see Articles 5 and 10(11)). The different dispute resolution mechanisms reflect different in-

ternational approaches to the adjudication of disputes on investment and trade.

The ECT trade dispute resolution mechanism is lighter, less detailed and simpler than that developed in the WTO. Accepting the trade regime of the Treaty may therefore be an important interim step for non-WTO-ECT members towards membership in the WTO.

It is important to recall that the Treaty is not a "WTO mirror" and that it does not apply to all trade disputes. In particular, it does not apply to any dispute that arises under an agreement as described in Article XXIV of the GATT (relating to free trade area or customs union) or under an agreement among States that were constituent parts of the former Soviet Union (Article 29 (2b)).

## Transit Disputes

An effective mechanism for the resolution of transit disputes is particularly important, given the growing economic significance of energy transit related to the growth of economically justified distances for energy transportation (result of scientific and technological progress) as well as the number of state borders crossed.

Article 7 (7) gives CPs the possibility to invoke a conciliation mechanism concerning transit disputes. As compared to "normal" dispute settlement procedures under Article 27, conciliation might have the advantage of being faster and less formal which is especially important for securing uninterrupted transit.

A CP being party to the dispute may notify the dispute to the Secretary-General of the Secretariat who shall consult with the interested parties and appoint a conciliator within 30 days. If the conciliator fails to secure an agreement within ninety days, he/she (it) shall recommend a resolution or a procedure to achieve such resolution, and shall decide the interim tariffs and other terms and conditions to be observed until the dispute is resolved. Paragraph (7)(d) provides that the CPs "undertake to observe and ensure that the entities under their control or jurisdiction observe" any interim decision of the conciliator for twelve months, unless the dispute is resolved earlier. The conciliation procedures may only be invoked after exhaustion of all other dispute resolution remedies previously agreed upon between the CPs or entities concerned.

The concept of a conciliator<sup>12</sup> was introduced in order to ensure that when a transit dispute arises, in the case of an absence of relevant clauses in the contracts, the flow of transit goods is not interrupted during the dispute resolution period. Parties the most interested to have such a procedure in place were the exporting FSU countries, i.e. Russia in the first place. The scope of application for the procedure involving a conciliator is only the relations outside contracts which are concluded or in force. In case of contractual relations between the parties the dispute resolution procedure being used is the one envisaged by the contract, even if it requires interrupting transit supply for the period of dispute resolution. And only in case when there is no dispute resolution procedure in the contract, the mechanism involving a conciliator is used (Figure 2). It sharply narrows down the scope of application for a dispute resolution procedure involving a conciliator, since in the last ten years the consequences of the USSR breakdown in the contractual area have been practically overcome and those had actually been the reason for the elaboration of this approach for the transit disputes resolution.

Article 7(6) provides that the transit state shall not, in the event of a dispute over “any matter arising

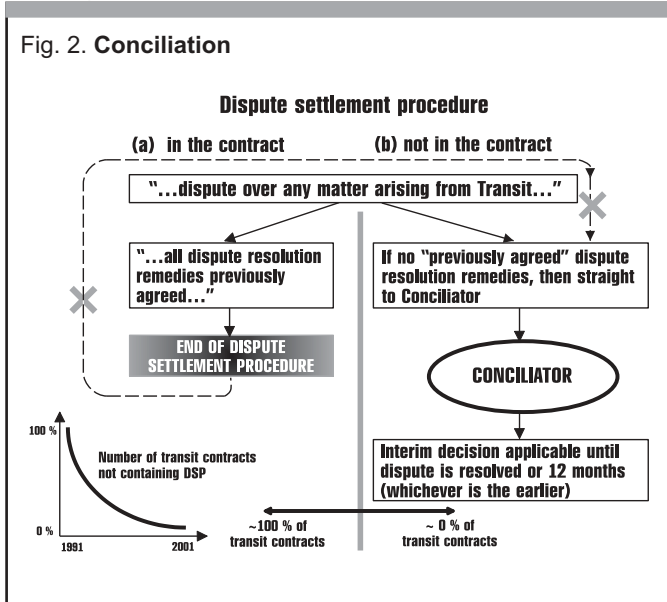
from that transit”, interrupt or reduce, or permit or require any entity to interrupt or reduce, the existing flow of energy materials and products prior to the conclusion of the conciliation mechanism set out in paragraph (7). There are only two exceptions to this prohibition: where this is specifically permitted in the original contract or agreement or allowed by the conciliator appointed to seek to resolve the dispute.

The Charter Conference has established *ad hoc* Rules concerning the conduct of conciliation and the compensation of the conciliator. Those rules envisage that the conciliation procedure does not possess an appealing character towards the dispute settlement provisions specified in the contract. That means that the conciliation procedure is not applicable if the transit dispute has already been solved with the help of finite and obligatory dispute settlement mechanisms such as court or arbitration. The IEA has commented that “the transit conciliation procedure is unique and many of the complexities have been clarified”.<sup>13</sup>

### Competition Disputes

Article 6 (5) deals with the settlement of competition disputes. One important example concerns disputes concerning state subsidies for energy companies. Article 6 (5) reflects the fact that the ECT does not establish a common competition regime between CPs. Rather, the ECT confirms the applicability of their domestic competition rules. Consequently, Article 6 (5) establishes “only” a mutual information and consultation mechanism in respect of the interpretation and application of national competition laws. Such an approach is based on the objective pattern according to which the level of competition in this or that country cannot be higher than the level of development of corresponding technical and economic infrastructure, which establish prerequisites to provide adequate levels of competition (i.e., it is not possible to provide freedom of choice within producers and consumers of energy with an insufficient state of development – size and diversity – of pipeline and electricity grids).

If a CP considers that any specified anti-competitive conduct carried out in the territory of another CP is adversely affecting an important interest concerning the alleviation of market distortions and barriers to competition, it may notify the other CP and request that the latter’s competition authorities initiate appropriate enforcement action. The notified CP, or, as the case may be, its competition authorities may consult with



<sup>12</sup> Prerequisites for the introducing a conciliation procedure for transit disputes are described in e.g. Konoplyanik A. ‘The ECT Transit Protocol: Russia’s concerns and possible ways to address them’ (in Russian) – “Nef’ i gaz i pravo”, 2002, No 5 (47), pp. 49-62

<sup>13</sup> IEA response to the Questionnaire for the Review to be conducted under Article 34(7) of the Energy Charter Treaty. – www.encharter.org, Message 543/04 Annex II (“Annex II” to the draft report on the Review of the Energy Charter process, July 8, 2004”), section “Dispute Settlement”.

the competition authorities of the notifying CP and shall accord full consideration to the request of the latter in deciding whether or not to initiate enforcement action with respect to the alleged anti-competitive conduct. The notified CP shall inform the notifying CP of the decision. In addition, CPs have the possibility to resolve the dispute through diplomatic channels. Pursuant to Article 6 (7), no other means of dispute settlement are permitted.

## Environmental Disputes

Article 19 contains various obligations of CPs with regard to the protection of the environment. According to Article 19 (2), the Energy Charter Conference shall, at the request of one or more CPs, review disputes concerning the application or interpretation of these obligations, aiming at a solution. The Energy Charter Conference therefore acts as a consultative body that may make recommendations to the parties in dispute on how to settle the case. However, this possibility only exists if arrangements for the consideration of such disputes are not available in other appropriate international fora.

## About Yukos case

Unable to comment on the very filing of the complaint (whether it has actually taken place, of which the Secretariat is unaware either formally or informally), I would like to draw the readers' attention to the following significant detail: each of the five countries, against which legal action was taken (see Table 1), had both signed and ratified the ECT – unlike Russia who has not yet ratified the Treaty (despite the erroneous statement to that effect in the *Financial Times* and in a number

of later publications).<sup>14</sup> The RF Government submitted the ECT for ratification back in 1996 but the Russian lawmakers have not yet passed an affirmative resolution.<sup>15</sup>

As one of the five countries which have not yet ratified the ECT, Russia (together with Belarus) is applying it on a provisional basis, in accordance with the 1969 Vienna Convention on the Law of Treaties, Part II, and the June 15, 1995 Federal Law on International Treaties of the Russian Federation, Section II, i.e. "to the extent such provisional application is not inconsistent with its constitution, laws or regulations" (ECT, Article 45).

The form and limits of legal consequences relating to provisional ECT application by a country have not yet been studied deep enough in international law. The analysis of provisional application (until entry into force) of international treaties by the Russian Federation carried out by the Russian MFA shows that in each case a careful background study is necessary in relation to the legal framework of provisional application of a treaty.

In the case discussed in the *Financial Times*, this means primarily a careful review of whether or not the said complaint (whose content or the very fact of filing are not known to us) falls under the legal framework of provisional application of the Energy Charter Treaty by the Russian Federation. □

<sup>14</sup> Including *inter alia* the interview with a prominent Western legal expert – see: "Emmanuel Gaillard, Menatep counsel – The Energy Charter will protect Group Menatep". – Interview to Interfax, February 20, 2005.

<sup>15</sup> On the ECT Ratification by Russia see e.g. Konoplyanik A. 'ECT Ratification by Russia: Debunking Misguided Opponents' Honest-to-Goodness Misapprehensions a Priority' – Chapter 22 in the Russian edition of 'The Energy Charter Treaty. An East – West Gateway for Investment and Trade' (Editor of the English edition – T.Waelde, and Editor of the Russian edition A.Konoplyanik), Moscow, Mezhdunarodnye otnosheniya, 2002; Konoplyanik A. 'There is only one way to the ECT Ratification. To find an agreement one needs to understand the arguments of the opponent' (in Russian) – "Nef' i kapital", 2001, No 3, pp. 8-10.