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Editor's Note:

ITN has obtained a copy of the hitherto unpublished arbitral award rendered on July 14th by an international arbitration tribunal in a dispute between the US-based water services company Azurix Corp. and Argentina.

A copy of the award has been posted on-line in the ITN documents centre so that interested readers can obtain a copy.

(See: <http://www.iisd.org/investment/itn/documents.asp>)

Articles 1 and 2 below discuss some of the award's key findings.

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Arbitration Watch:

1. Azurix wins claim against Argentina, recoups only part of sunk costs,
By Luke Eric Peterson

The US-based water services firm Azurix has won a \$165 Million (US) award against the Argentine Republic for breach of Argentina's obligations under the US-Argentina bilateral investment treaty (BIT). Azurix had sought some \$600 Million in compensation, for losses related to an ill-fated water and sewage concession in the Argentine Province of Buenos Aires.

In 1999, Azurix paid \$438 Million (US) in an auction for the exclusive right to run the concession for a 30 year period.

Virtually from the take-over of the concession by Azurix's local subsidiary Azurix Buenos Aires (ABA) in July of 1999, the US firm complained that the Argentine Province was letting political calculations interfere with the tariffs to be charged to water customers.

Controversy erupted in April of 2000 when an algae outbreak led provincial health authorities to warn customers that they should boil their tap water. Azurix alleged that provincial authorities bore responsibility for failing to complete work on equipment and systems which would be critical to algae removal. The company further accused the government of inciting public panic and encouraging consumers to refuse to pay their water bills following the incident.

Ultimately, the tribunal presiding over the BIT dispute held that the province had shown "a total disregard for their own contribution to the algae crisis and a readiness to blame the Concessionaire for situations that were caused by years of disinvestment and to use the incident politically" The tribunal added that the provincial authorities bore a responsibility to protect the public health, but in this instance they had "contributed to the crisis rather than assisted (sic) in solving it."

The ICSID tribunal reviewed a multitude of allegations by Azurix, and in a number of instances sided with the company in finding that the province was responsible for various failings – some of which were deemed to be mere contractual non-performance, while others verged into sovereign acts of a political nature which might trigger liability under the US-Argentina treaty.

In some crucial respects, however, the tribunal rejected claims put forward by Azurix. Most notable was the company's assertion that the amount bid for the concession (the so-called canon payment of \$438 Million) was to be taken into account for purposes of periodic tariff increases across the life of the concession.

Argentina responded that the investor was guilty of opportunistic behaviour – bidding an exaggerated price for the concession and hoping to recoup that investment through the mere renegotiation of tariffs. Argentina argued that such tactics would remove all element of risk from the investment.

After reviewing the underlying documents and agreements, the tribunal ruled that the so-called canon payment could not be considered as if it were to be recoverable through periodic tariff increases. Rather, it fell to the investor to make the appropriate calculation as to the earnings stream which could be generated by the concession, and to bid for that concession accordingly.

This finding would prove to be of significance when the tribunal turned to quantify the compensation owed to Azurix, after finding Argentina in breach of its treaty obligations.

According to the award, the tribunal held Argentina liable for not providing “fair and equitable treatment” and “full protection and security” to the investment as required under the US-Argentina treaty. Furthermore, the tribunal held Argentina liable for subjecting Azurix to “arbitrary measures” contrary to the BIT.

However, the tribunal held that Argentina had not breached the expropriation provisions of the BIT, nor Article II(7) of the treaty which requires that each party make public all laws, regulations, administrative practices and procedures, and adjudicatory decisions that pertain to or affect investments.” Finally, the tribunal rejected a claim that Argentina had breached a provision of the treaty which dictates that “Each party shall observe any obligation it may have entered into with regard to investments.”

Fuller discussion of some of the key legal findings can be found in the subsequent story in this newsletter.

The tribunal which arbitrated over the ICSID claim consisted of Mr. Andres Rigo Sureda, Mr. Marc Lalonde, and Mr. Daniel Martins. Mr. Lalonde, a former Canadian politician, was a member of a separate high-profile ICSID tribunal, which in 2005 held Argentina liable for breach of its treaty obligations owed to the US-based CMS Gas Transmission Company in relation to a claim arising out of Argentina’s financial crisis. That award is currently being challenged by Argentina, following an annulment application filed with the Washington-based ICSID.

Mr. Lalonde is a popular party-appointed arbitrator in a number of other ICSID cases, including two further cases against Argentina, and one each against the Democratic Republic of Congo, Lithuania, and Kazakhstan.

While Mr. Martins is not currently involved as arbitrator in other pending ICSID claims, Mr. Rigo is President of the tribunal in an ICSID arbitration between Siemens A.G. and the Argentine Republic. The Siemens case is one of numerous disputes arising out of the Argentine financial crisis, and an award is expected in that case imminently.

2. Analysis: tribunal finds several treaty breaches in Argentine treatment of water firm,
By Luke Eric Peterson

While there can be no definitive figures on the prevalence of investment treaty-based arbitrations, a minimum of ten such arbitrations are known to have arisen in relation to disputed water privatizations in the developing world.. The July 14th award in the case of *Azurix v. Argentina* marks the first time that a tribunal has passed judgment on the merits of any of these water services claims.

In contrast with a number of the disputes currently pending against Argentina, the *Azurix* dispute largely pre-dated the financial crisis which beset Argentina. As such, the basis of the dispute was rooted not in a series of emergency measures taken by Argentina, but rather a host of measures and actions taken by provincial water regulators in the province of Buenos Aires.

Having found that Argentine authorities were guilty of various failings with respect to their compliance with their obligations to *Azurix Buenos Aires*, the ICSID arbitral tribunal was tasked with determining to what extent the Argentine Republic was liable for breach of its international investment protection treaty commitments.

The claimant alleged that Argentina committed multiple breaches of the US-Argentine treaty, including that the investor had been subjected to expropriation without compensation and that they were denied fair and equitable treatment and full protection and security.

In considering *Azurix*'s expropriation claim, the tribunal was called on to decide to what extent the "purpose" underlying government measures was relevant to a determination as to whether such measures constituted expropriation under the US-Argentina treaty.

Azurix had argued for an approach which focused solely upon the effect, or degree of impact, suffered by the investor, whereas Argentina had insisted that the intentions of the state – for e.g. whether measures were taken in pursuit of important public interests - were critical to drawing the line between so-called "legitimate regulation and confiscatory regulation".

The presiding tribunal acknowledged that tribunals in other investment disputes have adopted divergent approaches to this question, and it ultimately concluded that "the issue is not so much whether the measure concerned is legitimate and serves a public purpose, but whether it is a measure that, being legitimate and serving a public purpose, should give rise to a compensation claim."

In particular, the tribunal expressed support for the approach adopted by an earlier ICSID tribunal in the case of *Tecmed v. Mexico*, where the presiding tribunal had borrowed a proportionality analysis from the jurisprudence of the European Court of Human Rights. On such an approach, a tribunal should assess the legitimacy of the aim being pursued, the degree of impact upon the foreign investor, and whether the means chosen were proportionate to the aim being pursued. Moreover, foreigners – as non-nationals not participant in domestic political processes – might be entitled to bear less of a burden than nationals of the host state when it came to the impact of government measures.

Having articulated this approach, the tribunal in the Azurix arbitration, would go on to find that the US water-services company had not suffered an expropriation of its contractual rights. Ultimately, the tribunal was not convinced that the degree of impact suffered by the claimant rose to the level where there was an expropriation:

“Azurix did not lose the attributes of ownership, at all times continued to control ABA and its ownership of 90% of the shares was unaffected. No doubt the management of ABA was affected by the Province’s actions, but not sufficiently for the Tribunal to find that Azurix’s investment was expropriated.”

Having found that the impact of the provincial actions did not rise to the level where they amounted to an expropriation, the tribunal gave no indication as to how it might have assessed the intentions underlying the impugned government actions.

The tribunal was convinced, however, that Argentina had denied the claimants “fair and equitable treatment” as required under the treaty.

The tribunal offered its view of past cases which had interpreted the meaning of this legal obligation, and ultimately sided with the majority of previous tribunals who have held that explicit “bad faith” or “malicious intention” need not be demonstrated in order to hold that states have treated foreign investors “unfairly” or “inequitably”.

Furthermore, the tribunal reasoned that what constituted “unfair” and “inequitable” treatment should be determined in light of the legitimate expectations which the investor had when making its investment.

Turning to evaluate Argentina’s liability in this light, the tribunal identified various instances where authorities acted unreasonably, engaged in political meddling or politicized discussions related to the tariff regime, thus leading to breach of the “fair and equitable treatment” obligation owed to Azurix.

The tribunal also entertained an argument by the claimants that they had suffered breaches of Article II (2) (c) of the treaty, which the claimants had construed as a so-called umbrella clause (i.e. a provision capable of transforming basic contractual breaches into breaches of international law).

However, the tribunal dispensed with this argument in summary fashion. The tribunal noted that the contracts invoked by Azurix were not entered into by the parties to the treaty arbitration - namely Azurix Corp and the Argentine Republic - but rather were between Azurix subsidiaries and the Province of Buenos Aires. Accordingly, the tribunal reasoned:

“While Azurix may submit a claim under the BIT for breaches by Argentina, there is no undertaking to be honored by Argentina to Azurix other than the obligations under the BIT. Even if for argument’s sake, it would be possible under Article II(2)(c) to hold

Argentina responsible for the alleged breaches of the Concession Agreement by the Province, it was ABA and not Azurix which was party to this agreement.”

On another of Azurix’s treaty claims, the tribunal did find that Argentina was liable for having subjected the US firm to “arbitrary measures” - defined, by the tribunal, as willful disregard for the law. The tribunal cited a number of actions of the Buenos Aires authorities which were deemed arbitrary:

“The Tribunal finds that the actions of the provincial authorities calling for non-payment of bills even before regulatory authority had made a decision, threatening the members of ORAB (the Argentine water regulator) because it had allowed ABA to resume billing ... (and) restraining ABA from collecting payment from its customers for services rendered before March 15, 2002 ... are arbitrary actions without base on the Law or the Concession Agreement and impaired the operation of Azurix’s investment.”

Finally, in a significant ruling, the tribunal held that the earlier-noted breaches of the “fair and equitable treatment” standard, also served to violate the obligation to provide “full protection and security”. The tribunal acknowledged that some recent US investment agreements have expressly limited the latter concept to the baseline level of physical police protection required under customary international law. However, the tribunal was of the view that the concept as written into the 1991 US-Argentina BIT could be construed as having not merely a physical protective component, but also a further requirement that host governments ensure the “stability afforded by a secure investment environment”.

In terms of compensation claimed, Azurix had sought \$449 Million (US) which reflected its estimate of the costs for acquiring the concession, the bulk of which went to the so-called Canon payment. Azurix also requested \$102.4 Million for its additional capital investments, \$15 Million for consequential costs including corporate and legal costs, and approximately \$120 Million in outstanding accounts receivables allegedly owed by former customers of Azurix Buenos Aires.

The tribunal determined that Azurix was entitled to “fair market value” compensation for the breaches of the BIT, to be calculated as the date (March 15, 2002) upon which the tribunal held the concession to have been formally terminated.

However, the tribunal rebuked Azurix for the amount it had laid out to obtain the Buenos Aires concession:

“First of all, in the Tribunal’s view, no well-informed investor, in March 2002, would have paid for the Concession the price (and more particularly, the Canon) paid by Azurix in mid-1999, irrespective of the actions taken by the Province and of the economic situation at that time.”

The tribunal also reverted to its earlier finding that the whopping \$438 Million Canon payment could not be considered as part of the recoverable asset base when it came to

setting periodic tariff adjustments. In the Tribunal's estimation, Azurix had wildly overbid for the concession, and the Tribunal was left to determine "what an independent and well-informed third party would be willing to pay for the Concession in March of 2002, in a context where the Province would have honored its obligations."

Ultimately, the Tribunal was of the view that "no more than a fraction of the Canon could realistically have been recuperated under the existing Concession Agreement." Accordingly, the Tribunal fixed the value of the Canon at \$60 Million (US).

Added to this was compensation in the amount of 105 Million (US) which reflected the Tribunal's accounting of Azurix's additional capital investments in the concession.

As for the accounts receivable, the Tribunal ruled that this amount was owed to Azurix Buenos Aires, and not the Azurix parent corporation.

Azurix had claimed a further \$7.9 Million (US) for legal work related to the arbitration proceeding, however the Tribunal bade each party to cover its own legal costs, while ordering Argentina to bear the costs of the arbitral proceeding (including arbitrator's fees and ICSID fees)

Finally, the tribunal absolved Azurix of any liability with respect to the non-execution of the investment plan which was to have been implemented during the first five years of the concession, and which contemplated several hundred million dollars in new investments.

At press time there was no word from Argentina as to whether it planned to pay the award or seek to annul it through application to the Washington-based ICSID.

The Azurix ruling marks the second such award to be rendered in favor of a foreign investor against Argentina in as many years. Previously, Argentine authorities have been robust in their criticism of the bevy of investment treaty lawsuits mounted in the aftermath of that country's financial crisis. Officials have insisted that they would challenge any awards rendered against Argentina, and have questioned the very legitimacy of the ICSID process to resolve such disputes.

It remains less clear if the Argentine government will adopt an equally hard-line posture in relation to a dispute which was not forged in the fire of that financial crisis.

3. British mining company serves notice of arbitration on Kyrgyzstan as dispute heats up, By Damon Vis-Dunbar

A high-profile row between a British gold mining company and the Kyrgyz Republic is now headed to formal arbitration.

As ITN reported in March, Oxus Gold plc has been enmeshed in a dispute with Kyrgyzstan since the government revoked its operating license in 2004, claiming that the UK company had repeatedly missed deadlines.

Oxus entered into a joint venture agreement with the state-owned Kyrgyzaltyn mining company in 1998, with Oxus holding a majority stake. The company claims it has poured some \$50 Million US into the Jerooy project, and stands ready to resume its activities in the country immediately. A source familiar with the Kyrgyz Government's position indicated that the Government vigorously contests the scale of Oxus's alleged investment and insists that the company lost any right to its license because it failed to live up to previous agreements.

Attempts to reach a negotiated settlement to the dispute have thus far been unsuccessful. Oxus had offered to enter into a 50-50 partnership with Kyrgyzaltyn, cutting the 67 per cent stake it held under the previous agreement, but the government rejected that offer.

A local source familiar with Kyrgyzstan's handling of foreign investment disputes had earlier told ITN that the operating license in question could not simply be reinstated; rather, under Kyrgyz law, it must go to tender. The Kyrgyzstan Prime Minister, Felix Kulov, has offered to reimburse the company for its expenses, following an internal audit.

However, three events in recent weeks mark a dramatic escalation in the dispute. First, Oxus announced that it was initiating arbitration proceedings for breach of the UK-Kyrgyzstan bilateral investment treaty. Then, Oxus' chief advisor in Kyrgyzstan, Sean Daly, was shot and wounded in Bishkek. Finally, a rival investor announced that it had been awarded the operating license that had been denied to Oxus.

Oxus has been quick to draw a link between these events.

"We are not entirely surprised by this latest announcement from Jerooy Altyn, claiming to have been awarded the license for the Jerooy gold deposit, following so closely on the attempted assassination of Oxus's representative in Bishkek," said a statement by Bill Trew, Chief Executive of Oxus.

Jerooy Altyn, the company that has been awarded the operating license, is a joint partnership between Global Gold GmbH, an Austrian-based private equity vehicle, and the state-owned Kyrgyzaltyn.

British Prime Minister, Tony Blair, waded into the dispute earlier this year, sending a letter to the Kyrgyz President warning that the government's actions posed "a real danger of damage to the Kyrgyzstan's reputation in the international markets."

Oxus's CEO has asked that the Tony Blair once again intervene, according to the Sunday Telegraph newspaper. "Tony Blair should write to the president of Kyrgyzstan again and ask him for an explanation," Trew told the newspaper.

Last Friday Oxus said it had informed the Kyrgyz government of its choice of arbitrator, Judge Charles N. Brower, but had yet to receive a response.

Judge Brower serves as arbitrator in a number of treaty-based investment arbitrations including six cases which are currently pending before the International Centre for Settlement of Investment Disputes (ICSID) and at least one UNCITRAL claim that was lodged against Argentina by the Canadian-based Bank of Nova Scotia.

Sources:

“UK gold mining company moves towards arbitration in dispute with Kyrgyzstan”, By Damon Vis-Dunbar and Luke Eric Peterson, Investment Treaty News, March 14, 2006

“Oxus asks PM to take action on Kyrgyzstan”, By Edward Simpkins, the Sunday Telegraph, July 23, 2006

“Oxus says Kyrgyz government awards disputed Jerooy mine license to another company”, AFX UK Focus, July 21, 2006

“Oxus offers Kyrgyz government new terms in gold mine row”, Reuters News, May 29, 2006

4. Chevron warns Ecuador on BIT claim as contract and environmental disputes persist, By Damon Vis-Dunbar

The American oil company Chevron has threatened to launch a claim against Ecuador for breach of the US-Ecuador bilateral investment treaty (BIT), in what could add a new arbitration case to an already lengthy list of legal disputes between these two parties.

A statement by the company in May said it had informed Ecuador that it is considering arbitration in response to a long-standing contractual dispute, thus setting in motion a six-month mandatory period of consultation before such proceedings could be initiated.

If Chevron follows through with its warning, the litigation would come on top existing cases filed in Ecuadorian courts against the government, as well as suits filed against Chevron by Ecuadorian citizens.

All of these disputes are rooted in Texaco’s investment in Ecuador during the 1970’s and 80’s, when its subsidiary, Texpet, operated oil fields as a minority partner of the state-owned oil company, Petroecuador. Texaco, which merged with Chevron in 2001, eventually sold its interest to Petroecuador in 1990, ending the partnership.

However, since its departure a series of lawsuits have been filed by residents of the Amazon rainforest alleging environmental damage. Meanwhile Chevron has responded with its own claims against Petroecuador related to various alleged contractual breaches.

Chevron's most recent warning that it may pursue arbitration for breach of the US-Ecuador BIT relates to a contractual dispute with Petroecuador. Under their agreement, Petroecuador was allowed to sell oil in Ecuador at below market prices, but Chevron alleges that some of that oil was resold on international markets. Chevron claims that it lost some \$750 Million US – a figure that Ecuador has challenged.

Seven unresolved claims have been filed in Ecuadorian courts, according to Chevron. "We have been patient and shown a great deal of forbearance with the government of Ecuador, but justice delayed is justice denied," reads a company statement.

A lawyer working for Ecuador acknowledged that a number of cases on this matter had been pending in Ecuadorian courts since the early nineties. However, this person said that a claim under the bilateral investment treaty would carry little weight, as the contractual dispute predates the BIT, which was signed in 1993.

Meanwhile, inhabitants of the Amazon rainforest continue to pursue Chevron in Ecuadorian courts, some 13 years after the first class action lawsuits were filed, seeking damages for environmental harm to the Amazon basin that Chevron allegedly left in its wake.

Three highly publicized lawsuits were originally launched by Ecuadorian and Peruvian citizens against Chevron in 1993 in US courts; however, Chevron successfully challenged those claims on the grounds that the cases should be heard in Ecuador, not the US.

A US judge argued that there was a strong public interest factor in not resolving these cases in New York, citing "the unfairness of imposing jury duty on a community with no relation to the litigation; the interest of having localized controversies decided home; and avoiding difficult problems in conflict and the application of foreign law."

Proceedings were taken up in Ecuador in 2003 on behalf of some 30 000 residents of the rainforest, and remain ongoing as the courts currently conduct a lengthy environmental inspection. A lawyer for Ecuador said that damages have been estimated at over a billion dollars US, since the plaintiffs are asking that Chevron undertake a major cleanup on the impacted region.

Amazon Watch, a non-governmental organization that has maintained a vigorous campaign against Chevron, puts the figure at \$6 Billion US, claiming the company dumped 18 billion tons of "toxic-waste" into a previously pristine area of the Amazon the size of Rhode Island. A wave of cancers, birth defects and miscarriages has flowed from Chevron's operations in the Amazon, says Amazon Watch.

When Texaco operated in Ecuador, it used a controversial method by which a mixture of water and oil were brought to the surface; the oil was separated from the water, and that water left to run-off into rivers and streams.

It is this cost-saving method that Amazon Watch and others have blamed for the alleged environmental damage. But Chevron defends the method, stating that it is still widely used: “In California, one of the most environmentally sensitive states in the U.S., local farmers use produced water from nearby oil fields to irrigate their crops,” says Chevron.

On yet another legal front, Chevron is trying to launch arbitration proceedings under American Arbitration Association (AAA) rules, in a bid to protect itself from damages that may arise out of the Ecuadorian class action suits.

Chevron claims that under the original 1965 joint operating agreement, signed with the company Gulf, it is not liable for claims made by third parties arising out of its role as operator of the Ecuadorian oil fields. That agreement also stipulates that disagreements should be settled through commercial arbitration under AAA rules.

So far Ecuador has blocked the arbitration proceedings by appealing to a New York state court. Ecuador points to the fact that the original operating agreement was made with Gulf, not Petroecuador, said a lawyer for Ecuador. While Petroecuador later took over from Gulf as the majority partner in the joint operation, it did not inherit the Texaco-Gulf joint operating agreement, said this lawyer.

Chevron challenges this position, arguing in a statement that “when Petroecuador assumed a 25-percent interest in the consortium in 1974, and subsequently assumed all of the Gulf Oil’s remaining interest in 1976 ... it assumed all of the rights and obligations of the JOA, even though it was not an original party to the agreement.”

Sources:

ITN interviews

“Chevron threatens arbitration against Ecuador”, Reuters News, May 25, 2006

Chevron website on the Ecuadorian dispute: <http://www.texaco.com/sitelets/ecuador/en/>

Amazon Watch website: <http://www.amazonwatch.org/>

5. Mexico prevails in NAFTA Chapter 11 arbitration over financial services, By Luke Eric Peterson

The Mexican Government has announced that it prevailed in a NAFTA Chapter 11 arbitration brought by a US-based financial services company, Fireman’s Fund Insurance Company.

According to a statement issued by the Mexican Government, an ICSID arbitral tribunal rejected the claim brought by a US-based subsidiary of the German insurance firm

Allianz A.G., which had sought damages arising out of its losses during the Mexican financial crisis of the mid-1990s.

In a 2003 ruling on jurisdiction in the case, an ICSID tribunal had ruled that foreign investors in the financial services sector are limited in their ability to mount investor-state arbitrations against NAFTA member-states under Chapter 11 of the NAFTA. In particular, claims that Fireman's Fund had suffered breach of the NAFTA standards for National Treatment and so-called Minimum Standards of Treatment were rejected on jurisdictional grounds.

Only Fireman Fund's expropriation claim could be examined on its merits by the tribunal, and in an award issued this month, the Mexican Government says that the presiding tribunal rejected those expropriation arguments on their merits.

The award has yet to be published, as the parties are currently discussing the redaction of sensitive financial information from the text of the award.

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