EXPERT VIEW: ENERGY CHARTER TREATY (II)

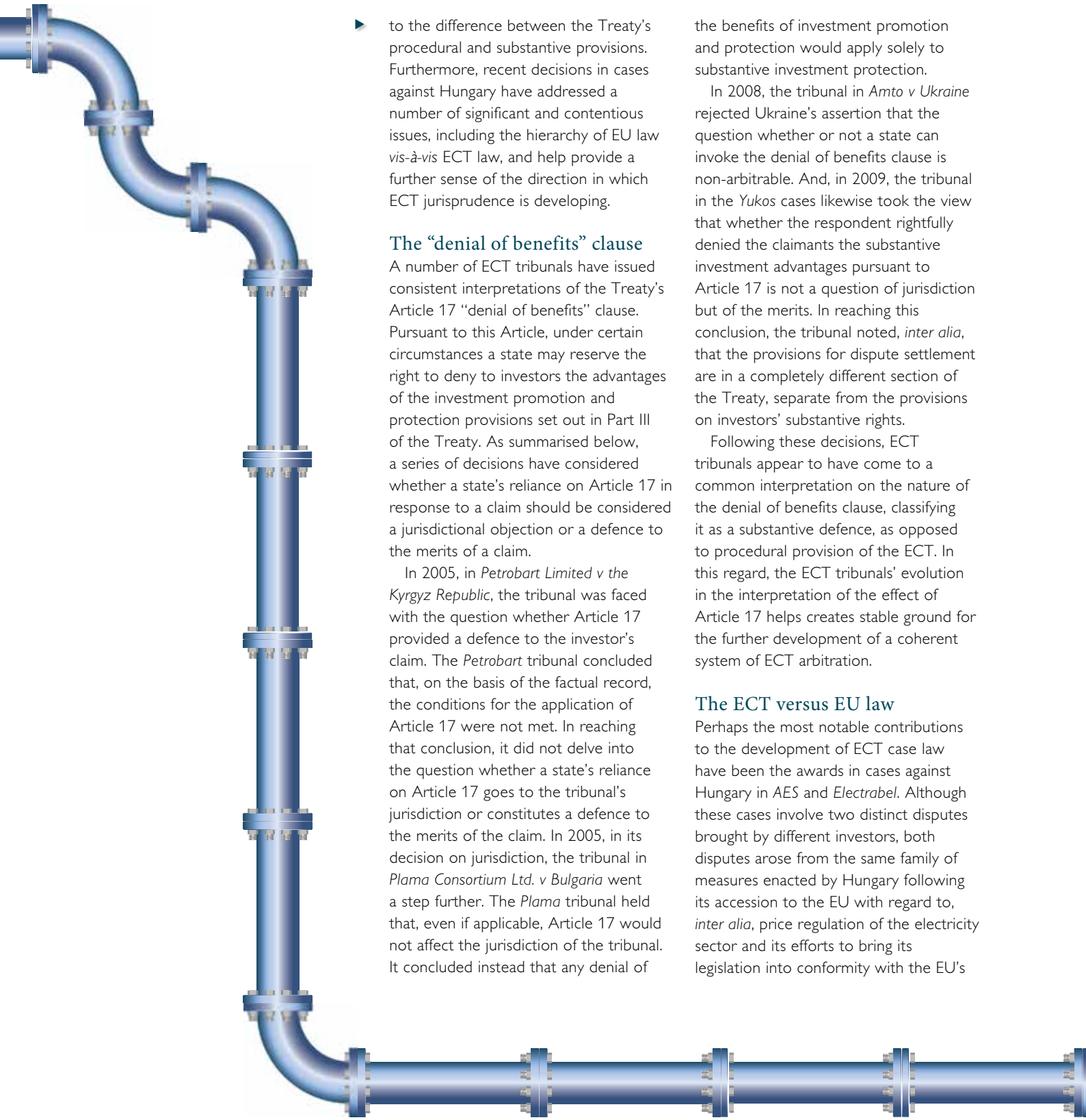
Steven Finizio and **Sonja Sreckovic** of **WilmerHale** continue our focus on the Energy Charter Treaty, which while still in its infancy in terms of case numbers, is now starting to deliver decisions that are of interest to the wider investment arbitration community

TURNING ON THE GAS

The Energy Charter Treaty (ECT) was born out of the European Community's initiative to develop energy cooperation between Eastern and Western Europe. As of today, it has 53 signatories. The cornerstone of the ECT is the promotion and protection of energy investments and investment dispute resolution. The ECT differs from many other investment treaties in its potentially global, rather than regional, reach. It also differs in regulating a specific field of investment: it is the only binding multilateral instrument dealing with intergovernmental collaboration in the energy sector.

Because it is a fairly novel undertaking, it is taking time for a substantial body of ECT case law to develop. While the ECT was signed in late 1994, it did not come into force until April 1998. Since then, the ECT Secretariat has registered 33 cases, 13 of which are pending. In this regard, the ECT is a ship that turns slowly: it is hard to draw general conclusions as to the treaty's procedural and substantive standards.

Nonetheless, recent decisions by arbitral tribunals provide some sense of the ongoing development of ECT case law, particularly with regard



to the difference between the Treaty's procedural and substantive provisions. Furthermore, recent decisions in cases against Hungary have addressed a number of significant and contentious issues, including the hierarchy of EU law *vis-à-vis* ECT law, and help provide a further sense of the direction in which ECT jurisprudence is developing.

The "denial of benefits" clause

A number of ECT tribunals have issued consistent interpretations of the Treaty's Article 17 "denial of benefits" clause. Pursuant to this Article, under certain circumstances a state may reserve the right to deny to investors the advantages of the investment promotion and protection provisions set out in Part III of the Treaty. As summarised below, a series of decisions have considered whether a state's reliance on Article 17 in response to a claim should be considered a jurisdictional objection or a defence to the merits of a claim.

In 2005, in *Petrobart Limited v the Kyrgyz Republic*, the tribunal was faced with the question whether Article 17 provided a defence to the investor's claim. The *Petrobart* tribunal concluded that, on the basis of the factual record, the conditions for the application of Article 17 were not met. In reaching that conclusion, it did not delve into the question whether a state's reliance on Article 17 goes to the tribunal's jurisdiction or constitutes a defence to the merits of the claim. In 2005, in its decision on jurisdiction, the tribunal in *Plama Consortium Ltd. v Bulgaria* went a step further. The *Plama* tribunal held that, even if applicable, Article 17 would not affect the jurisdiction of the tribunal. It concluded instead that any denial of the benefits of investment promotion and protection would apply solely to substantive investment protection.

In 2008, the tribunal in *Amto v Ukraine* rejected Ukraine's assertion that the question whether or not a state can invoke the denial of benefits clause is non-arbitrable. And, in 2009, the tribunal in the *Yukos* cases likewise took the view that whether the respondent rightfully denied the claimants the substantive investment advantages pursuant to Article 17 is not a question of jurisdiction but of the merits. In reaching this conclusion, the tribunal noted, *inter alia*, that the provisions for dispute settlement are in a completely different section of the Treaty, separate from the provisions on investors' substantive rights.

Following these decisions, ECT tribunals appear to have come to a common interpretation on the nature of the denial of benefits clause, classifying it as a substantive defence, as opposed to procedural provision of the ECT. In this regard, the ECT tribunals' evolution in the interpretation of the effect of Article 17 helps creates stable ground for the further development of a coherent system of ECT arbitration.

The ECT versus EU law

Perhaps the most notable contributions to the development of ECT case law have been the awards in cases against Hungary in *AES* and *Electrabel*. Although these cases involve two distinct disputes brought by different investors, both disputes arose from the same family of measures enacted by Hungary following its accession to the EU with regard to, *inter alia*, price regulation of the electricity sector and its efforts to bring its legislation into conformity with the EU's

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legislation. Both cases (albeit in varying degree) shed light on the contentious issue concerning the hierarchy between EU and ECT law.

Following the privatisation of the Hungarian energy sector in 1995, foreign investors entered the Hungarian electricity market and invested substantial funds into the power generation sector. However, following its accession to the EU, Hungary altered the regime for calculating prices paid to electricity generators (this was the issue raised in *AES* and *Electrabel*) and terminated its power purchase agreements (this was the issue raised in *Electrabel*).

In response to these measures, **AES** and **Electrabel** commenced ICSID arbitration proceedings, alleging that these changes negatively impacted their investments in Hungary and breached the ECT. Both cases involved a number of claims, and various procedural issues and questions of applicable law were entertained. As summarised below, the tribunals' decisions in those cases on the issue of the applicable law are of particular interest, given their potential significance to the standard of treatment afforded to investors under the ECT.

At the outset, both tribunals, looked to the text of ECT Article 26(6) and concluded that the applicable law was the ECT along with the applicable rules and principles of international law. Also, both the *AES* and *Electrabel* tribunals had to determine what role, if any, EU competition law played in view of the applicable law.

The *AES* tribunal held that EU law should be considered when assessing "whether Hungary was, may have been, or may have felt obliged under EC law to act as it did", but that this "is only an element to be considered…when determining the rationality,' 'reasonableness,' 'arbitrariness' and 'transparency' of [Hungary's actions]." In reaching this conclusion, it reasoned that EU law had a dual nature. On the one hand, it is an international law regime. On the other hand, once introduced in the national legal orders of EU member states, it forms part of these legal orders. Consequently, as part of national legal orders, EU law was a fact to be considered in this analysis.

This is where the *AES* and *Electrabel* tribunals' reasoning part ways. The *Electrabel* tribunal declined to classify EU law merely as a fact, but took the view that EU law should be regarded primarily as international law. In doing so, the tribunal referred to the practical consequences should a ruling under the ECT require a member state to deviate from mandatory EU law.

In its award, the *Electrabel* tribunal discussed a scenario in which the ECT and EU law could not be interpreted harmoniously, i.e. where a "material inconsistency" existed in the interplay of their respective provisions. Reasoning that "it is equally important for the Tribunal ascertain the effect of EU law... [and bearing] in mind the very real practical consequences of any ruling under the Energy Charter Treaty that requires Hungary to act inconsistently with EC mandatory law," the *Electrabel* tribunal concluded that "EU law has to be classified first as international law." The *Electrabel* tribunal therefore departed from the *AES* tribunal's reasoning that EU law should solely be considered as a fact in considering the host state's actions under the ECT.

The *Electrabel* tribunal then considered the effect of successive treaties dealing with the same subject matter, and the hierarchy of EU and ECT law in such circumstances. The tribunal concluded that, pursuant to Article 307 EC, EU member states are precluded from using ▶

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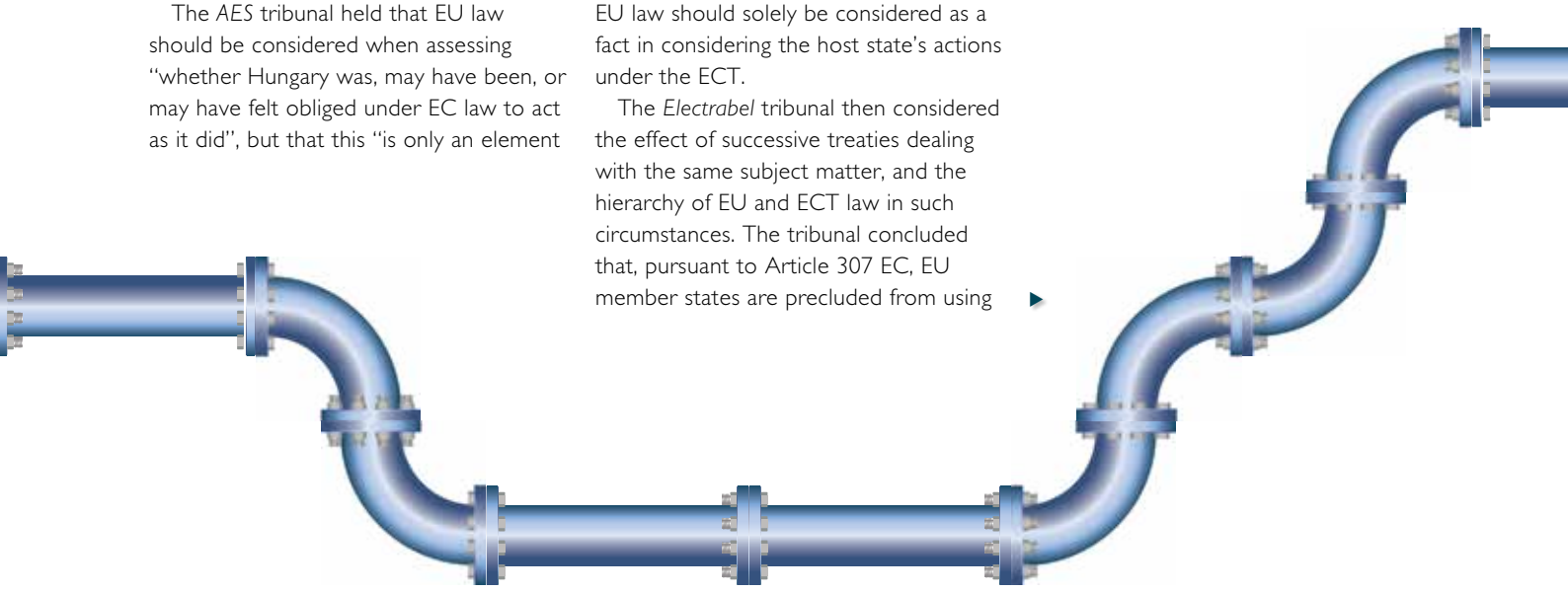

pre-existing treaty rights against other EU member states. The tribunal therefore stated, in this hypothetical circumstance, where "the ECT and EU law remained incompatible notwithstanding all efforts at harmonisation," that "the ECT could not apply inconsistently with EU law to such a national's claim against an EU Member State" and that "EU law would prevail over the ECT's substantive protections."

The *Electrabel* tribunal's reasoning – and the predominant position it gives EU law – has potentially significant ramifications. Even though the *Electrabel* tribunal treated this as a hypothetical scenario, the tribunal's reasoning is clear and may give investors a degree of discomfort.

While the *Electrabel* tribunal noted that the ECT and EU law have similar objectives, it effectively held that an investor cannot have a legitimate expectation that the ECT would protect its investment from the effects of EU law. Under the reasoning of the *Electrabel* tribunal, an EU investor may not be able to use the substantive rights accorded to it by the ECT as protection against an action by an EU member state, when that state can show that its actions comply with its obligations under EU law. For this reason, the *Electrabel* case represents a milestone in the development of case law concerning the relationship between EU law and intra-EU investment treaty arbitration.

While there have only been a small number of ECT decisions since 2001, there is every reason to expect an increasing number of ECT claims. It is therefore noteworthy that ECT tribunals are providing some consistency in interpreting important procedural questions, and providing some predictability about important aspects of the Treaty's mechanisms. More importantly, the *AES* and *Electrabel* decisions reflect a willingness by ECT tribunals to tackle controversial topics that should be of more general interest. In this regard, the *Electrabel* case is not only a contribution to the body of ECT case law, but also a contribution to investment law more generally. ■

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