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In the Arbitration under Art. 26 Energy Charter Treaty (ECT), Nykomb v. The Republic of Latvia - Legal Opinion by T.W. Wälde

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Legal Opinion

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In the Arbitration under Art. 26 Energy Charter Treaty (ECT)

Nykomb
Claimant / Investor

And

The Republic of Latvia
Respondent

June 2003

Table of Contents

I. The Object of This Opinion

1. I have written this opinion on the basis of my expertise relating to investment arbitration and EU and international energy law and policy, with a special focus on the Energy Charter Treaty. The opinion also reflects my 25-plus-years of practitioner experience in negotiating energy investment in transition and developing countries, in settling disputes, investigating factual background and context - the "real-life" of the international energy business. I can elaborate on this in the oral examination. It naturally informs my understanding of the factual situation to which the Energy Charter Treaty rules are to be applied.

2. I have served as the principal UN Adviser on natural resources, energy and investment law ("Interregional Adviser") from 1980 to 1990 dealing primarily with investment in the energy/resources sector. I have been serving since 1991 as Professor of International Economic, Natural Resources and Energy Law at the Centre for Energy, Petroleum and Mineral Law and Policy at the University of Dundee (CEPMLP/Dundee), the largest and leading graduate institution in this field worldwide (and as its Director from 1990 to 2001). I was awarded in a EU wide competition in 1995 the EU Jean-Monnet Chair for EU Economic & Energy Law. I have specialised in mediating, settling and advising on negotiations and disputes between energy investors and governments since 1976, both as a practitioner, academic, arbitrator, mediator and expert counsel. Currently, I serve as expert counsel and principal adviser of a government in a dispute with an international energy company. I have just completed a major project as the "Sole Mediator" in charge of a complex mediation achieving the restructuring of a series of long-term power purchase, electricity trading and related commercial and corporate agreements between a EU very large electricity company and a very large state electricity and transmission company in a major East European country. I also serve as arbitrator in a NAFTA Chapter XI dispute – a Canadian company against the government of Mexico.

   I have special expertise on the Energy Charter Treaty having followed its negotiation and implementation with numerous publications – among them the currently authoritative "Energy Charter Treaty" (Kluwer 1996), but also as chief adviser on several EU projects throughout Eastern Europe and Central Asia, as expert on this and another ECT-related legal procedure, and as adviser to several companies, governments and international organisations (among them the EU Commission, OPEC, APEC, the IEA, the World Bank and the UN). I also sit as arbitrator in one on-going NAFTA dispute and am the sole mediator in another, East European-located, energy investment dispute between a major company and a host government. I am a graduate (Referendar; Dr. iur.) of the University of Frankfurt and of Harvard Law School (LL.M.'73). I am a fully qualified lawyer under German law and have practiced in the – distant - past in Frankfurt as "Rechtsanwalt"[1] before taking on the role in the end as the principal UN Interregional Adviser on Energy/Investment Law and Policy.

3. My opinion in the present case focuses what I believe the legally correct interpretation and application of the Energy Charter Treaty – in the light of relevant arbitral jurisprudence and authoritative writing – to the facts of the case as I understand them to be. My opinion assumes the facts in evidence which I consider to have been presented by both claimant and respondent and not materially contested. It focuses on the legal analysis, but not on specific and perhaps relevant and controversial facts (e.g. specific contractual undertakings). The legal opinion does not assert itself any new facts, but relies on the facts presented in the statements by the two parties. Naturally, I look at these facts in light not only of the legal rules to be applied, but also in light of my 25+ years of experience of energy investment in difficult countries, in particularly in Eastern Europe and the former USSR.

   The purpose of these comments is to identify, highlight and develop the key legal questions of the Nykomb ./. Latvia arbitration relating to the Energy Charter Treaty, in particular how the facts so far identified and discussed in the Statement of Claim, the Statement of Defence, the Claimant's Reply to the Statement of Defence, Claimant's Brief I and the Respondent's Rejoinder give rise to a valid claim of Nykomb under the Energy Charter Treaty (in short: ECT).

4. The method I have applied consists of:

   a. A reasonably thorough review of the Statement of Claim, the Statement of Defense, the Claimant's Reply to the Statement of Defense, Claimant's Brief I and the Respondent's Rejoinder, with particular attention to the facts as they are presented by both sides and as they are not contested. Where facts have been contested and relevant to the legal issues raised, my legal opinion assumes that the facts alleged by the Claimant are correct;

   b. A review of the legal arguments in the five statements by claimant and respondent. Where legal theories have been raised in the various statements, I have tried to deal with them. This has required sometimes a closer examination of the facts combined with a legal theory, but I have tried to keep out of an assessment of the facts, in particular contested ones.

   c. A review of the language of the ECT, of relevant and by analogy comparable other legal instruments (bilateral and other multilateral investment treaties, in particular NAFTA Chapter XI;

[1] *A biographical note is attached to the legal opinion.*

of the relevant model language in the GATT); a review in particular of the salient decisions and significant views of authoritative international arbitral tribunals deciding on matters of investment protection, with a special, but not exclusive focus, on the more recent decisions in NAFTA Chapter XI and BIT cases (which I believe to be of the most relevant persuasive – but not legally binding – authority); a review of selected, relevant and authoritative writings as relevant.

d. Some – though cursory and due to lack of materials fragmentary – examination of relevant materials on the negotiating history of the ECT and discussions with some chief negotiators.

e. Application of what I consider standard methods of interpretation of modern international investment treaties in light of modern and evolving customary international law, state practice and good-governance standards as contained in the authoritative sources of international investment law (treaties, awards, state practice, authoritative writings).

5. I do not claim familiarity with the factual details of the specific case. I have, however, a reasonable degree of familiarity with investment conditions throughout the world and in particular in transition countries and in the energy industry gained in over 25 years of professional experience in the energy field in these countries. These stem from the fact that I acted as project director and chief adviser on a EU Phare project assessing compliance with the Energy Charter Treaty in all EU accession countries (including Latvia) in 1999/2000, several similar earlier advisory projects for governments, companies and international organisations in Eastern Europe and my academic, advisory, consultancy team management and dispute settlement work (including arbitration, as expert counsel, and in particular large-scale, complex mediation relating to an electricity project in a country similar to Latvia) on energy investments, policy and law reform in East European and transition countries. I have therefore collected and reviewed publicly available information on energy laws and policies in Latvia and on co-generation incentives and policies in the EU and the candidate countries. I have carried out a survey of information available on co-generation in the EU and in accession countries, the energy institutional, commercial and regulatory situation in Latvia and in particular Latvenergo, mainly through consultation of reliable and publicly available sources on the internet, including consultations with experts, in particular information on reports by the EU Commission, the US Department of Energy, a European co-generation working group, EURELECTRIC (the association of European electricity companies), Transparency International (the leading international anti-bribery association) and the European Bank for Reconstruction and Development.

6. A list of my publications is attached to this opinion. Most of them are related to advisory projects I have carried out.

7. I acknowledge my independent duty to assist the Tribunal in its determination of these matters. I undertake to attend any oral hearing in these proceedings unless otherwise ordered by the Tribunal. I understand that my duty to the Tribunal overrides any obligations to Nykomb or its counsel as the persons that engaged me to draft this opinion. To the best of my knowledge, the opinions and conclusions contained herein are correct and represent my objective assessment of the implications of the Energy Charter Treaty to the facts on which I have based the opinion.

II. Factual & Legal Context: Co-generation, Energy investment, production and imports in Latvia; role of Latvenergo (or "LE") and Nykomb; political context; energy law context

8. Latvia is a country that is still in transition from a state-owned and controlled energy industry towards liberalised markets as prescribed under the "Europe Agreement" and the accession agreement with the EU. In the early 1990s, there was in Latvia – as in most other East European countries bordering Russia – considerable concern over energy dependence on Russia. The Latvian energy and electricity systems are – dating from the time of the Soviet Union – integrated with the Russian and former Soviet system. Latvia, without its own meaningful sources of energy, is dependent on Russian and Lithuanian (marginally also Estonian) energy and electricity imports. Russian intervention in favour of Russian minorities in Latvia led to a strong concern in Latvia about Russia using the cut-off of energy. This concern was exacerbated by the fact that a considerable part of Latvia's energy import comes from the nuclear power plant "Ignalina" in Lithuania which dates from Soviet times, has a questionable safety record and is under constant pressure from the EU to close down. All these factors led to a – reasonable and justified – concern over energy import dependency and consequently to the call, and then formulation, of government policies to encourage domestic production of electricity.

9. In addition, obligations under the "Europe Agreement" with the EU (which regulates the pre-accession obligations to gradually adopt the EU "acquis")[2] and pressures from the EU led to a new and increasing emphasis on energy efficiency, environmental efficiency in energy production and a gradual adoption of the EU standards, rules and policies with respect to pollution in power combustion plants and

[2] *From Art. 81 of the Latvia-EU Europe Agreement: are highlighted as obligations to cooperate: "promotion of energy saving and energy efficiency,*
- environmental impact of energy production and consumption"; from Art. 83: "efficient, sustainable and clean energy production" and as instrument of cooperation the "approximation of laws (Community standards; from Art. 74: "Cooperation shall aim at maintaining and, if necessary, improving a legal framework and a favourable climate for private investment and its protection, both domestic and foreign, which is essential to economic and industrial reconstruction and development in Latvia. The cooperation shall also aim to encourage and promote foreign investment and privatization in Latvia. The particular aims of cooperation shall be: - for Latvia to establish a legal framework which favours and protects investment".

climate-change-related CO_2 emissions from power production. Latvia also signed not only the European Energy Charter, the Energy Charter Treaty, but also the Energy Charter Protocol on Energy Efficiency and related Environmental Aspects.[3] This Protocol obliges Latvia, inter alia, to:

a. *"support and promote ..**cogeneration**" (Art. 8, 2, h,*
b. *be " guided by the principle of "transparency of legal and regulatory frameworks" (Art. 3, 2, f)*
c. *and the appreciation of the "vital role of the private sector including small and medium -sized enterprises in promoting and implementing energy efficiency measures and intent on ensuring a favourable institutional framework for economically viable investment in energy efficiency" (Point 5 of Preamble).*

With growing proximity to the EU and then accession being planned and prepared, it was natural for Latvia to design policies that would meet EU climate change controls on CO_2 emissions by modern, energy-efficient methods of producing electric power such as co-generation. Co-generation would also help to meet the now approaching EU limits and standards for power plants and the EU's policies promoting energy efficiency. The Energy Charter Treaty – in particular Art. 19 (2,d)[4] – and the ECT Energy Efficiency Protocol reflect these energy policy priorities of the newly independent Latvia.

10. Co-generation is a technologically advanced, but as of now well established, method of achieving higher energy efficiency, i.e. of using less energy resource input for a given electricity output. It thereby involves less environmental problems (e.g. it involves a lesser CO_2 output per kilowatt produced). It is one of the energy efficiency methods envisaged in both Art. 19 of the ECT and is mentioned specifically in the ECT Energy Efficiency Protocol signed and ratified by Latvia. EURELECTRIC, the European organisation of electricity industry, has (12 May 2003, in a statement to the European Parliament) said on co -generation:

a. "*It is clear that CHP installations can make a significant contribution both to saving primary energy and to reducing environmental emissions*".
b. The Community Guidelines on State aid and Environmental Protection: (at No 31) state: '*Investments in the combined production of electric power and heat may also qualify under these guidelines if it can be shown that the measures beneficial in terms of the protection of the environment because the conversion efficiency is particularly high, because the measures will allow energy consumption to be*

[3] *Ratified on 5.9. 1999, signed by Latvia on 17 December 1994*
[4] *I.e. the obligation to "have particular regard to improving energy efficiency, ... to promoting the use of cleaner fules and to employ technologies and technological means that reduce pollution".*

reduced or because the production process will be less damaging to the environment. In this connection, the Commission will take into particular consideration the type of primary energy used in the production process. It should also be borne in mind that <u>increased energy use from combined production of heat and power is a Community priority for the environment</u>. Such investment may, therefore, be given aid at the basic rate of 40 % of eligible cost."

11. New co-generation investment – as most or all of environment-friendly energy production – can as yet not economically stand on its own feet. It competes in most or all countries with electricity production from plants which are depreciated. It competes also with power production using carbonaceous fuel where the external environmental effects are not as yet "internalised" into the cost structure by environmental charges. The same applies to competition with nuclear power where safety and de-commissioning costs are not as yet part of the cost structure. This competitive handicap of co-generation is particularly acute in the former Soviet Union. There are virtually no depreciation or other financial/capital costs added to power production. Electricity prices are for a number of reasons kept at a level below international market prices, substantially below true cost and massively below the cost involved in replacing old, environmentally heavily noxious production units. Power produced from nuclear plants is sold at extremely low prices as these plants as a rule carry no financial and depreciation cost, but also is very unsafe and production includes no element for upgrading, safety and decommissioning cost. Electricity exports out of Russia are sold at "dumping prices", often because for those who control Russian power production and exports there is an added incentive of personal interest to sell into countries such as Latvia. It has been widely reported that a part of the purchase price of such "dumped" Russian electricity is probably paid into the private offshore accounts of those who in one way or other control such transactions[5]. One of these arrangements became public in Latvia and caused a public scandal.

12. As a result of these economic forces, co-generation investment can only be undertaken if publicly supported. Such support can take the form of a public subsidy to the investment, of mandatory purchase by power distribution companies at a higher tariff than is charged on "normal" power fed into the public distribution system or other forms of support of an equivalent financial value to compensate for the "handicap" of new co-generation vis-à-vis established, depreciated, not fully cost reflective and often "dumped" environmentally "dirty" energy. The Latvian government could have chosen an investment support scheme, but since it did not have the funds, it rather chose the option of the "double tariff". This effectively meant that Latvenergo, not the government, not the government's treasury, had

[5] *I have heard at a lecture on Latvian energy policy in Riga that there was reports or even evidence that commissions are paid to probably privately held offshore accounts in Guernsey or Jersey (ECT seminar, Riga, 1999, notes)*

to bear the financial burden. As Latvenergo in principle should have been able to incorporate the "double-tariff" costs in its "regulatory rate base" on which electricity tariffs to consumers are based, the implication of the double-tariff mechanism was to make the Latvian consumers pay – not unreasonably – for the added cost of more environmental-friendly and domestically produced, i.e. more secure, electricity.

13. A recent Eurelectric Report[6] indicates that the "main method for supporting CHP, used in the majority of cases, is linked to the production (mostly to electricity production): dispatch priority and/or fixed price or a <u>price premium on produced kWhs</u>. The support schemes typically target operations under 50 MW/h capacity – such as the Windau plant. The <u>price premium</u> – comparable to the Latvian double tariff - is (in addition to investment support and tax incentives) the most frequent promotional instrument. For example:

> ***Denmark***
> *Price premium per kWh, depending on type and fuel. Dispatch priority for selected small CHP plants.*
> ***France*** *Fixed price for quality CHP*
> ***Germany***
> *Price premium per kWh for quality CHP-E, depending on age, type and size, focused on existing and modernised CHPplants*
> ***Netherlands*** *Exemption from energy tax for quality CHP Price premium per kWh for quality CHP; exemption from energy tax for heat Low tax scheme*
> ***Hungary*** *Dispatch priority; fixed and favourable long-term tariff; Mandatory purchasing by distributor*
> ***Spain*** *Dispatch priority for quality CHP; price premium per kWh*
> ***Sweden*** *Investment support of max 25% of the investment cost for biomass-fired CHP plants Price premium per kWh for plants < 1.5 MW*
> ***UK*** *Enhanced Capital Allowance Exemption from Climate Change Levy for quality CHP. Tax breaks*
> ***Finland:*** *Tax benefits for both input fuels and co-generated electricity*
> ***Poland:*** *Mandatory purchasing of co-generated electricity at a favourable price/tariff*

This – only rudimentary – survey indicates that the use of the "double-tariff" is nothing exceptional, or abusive, but aligned with standard EU practice to encourage co-generation – an obligation that Latvia has assumed through the several EU and energy treaties it acceded in the 1990s.

14. The energy policy issues and the need for governmental financial support for modern co-generation – the type that is according to the uncontested Statement of Claim deployed by the Claimant – are best

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[6] *EURELECTRIC is the European Energy Industry Association; European Combined Heat & Power: A Technical Analysis of Possible Definition of the Concept of "Quality CHP"; June 2002; Ref: 2002-112-0004*

and in the most authoritative way stated by the EU institutions in the official introduction to the proposed EU directive of the European Parliament and of the Council on the promotion of cogeneration[7]:

- *"Cogeneration is a highly efficient technique to provide electricity and heat for the European energy market. Promotion of cogeneration is a part of the strategy for efficient use of energy and supplementary to the strategy of increased use of renewables." (p. 2)*

- *In the Commission's cogeneration strategy from 1997, an overall indicative Community target of doubling the share of electricity production from cogeneration in total EU electricity production from 9% in 1994 to 18% by 2010 was set.*

- *In order to create a level playing field, regulatory certainty and in some cases financial support are vital for cogeneration. This applies to the current transitional phase of the liberalisation process, where the internal energy market is not fully completed and where internalisation of external costs is not reflected in energy prices. (page 2)*

- *Renewables and cogeneration are in some areas faced with similar problems such as for example lack of internalisation of external costs, the need to provide regulatory certainty concerning grid issues and administrative procedures. (p.4)*

- *If the price on the Nordic power market from May 2000 of 15 EUR/MWh is applied none of the cogeneration plants analysed would be feasible on purely economic criteria (p. 9)*

- *direct support for production of cogenerated electricity should be concentrated to electricity produced ... in installations with a capacity below an indicative threshold value of 50 MW (p. 10*

- *While the justification for financial support of cogeneration will disapear as the external costs are fully internalised in the market, support for cogeneration will in many cases be justifiable in the short to medium term. In order to reflect this aspect public support schemes should include the phase-out principle (p. 15)*

- *For Candidate countries (p. 22): "At the same time, district heating is sometimes faced with competition from other energy sources. Community action to promote cogeneration could therefore provide a stable and supportive framework for cogeneration and district heating in this region*."

15. The problem faced by the government of Latvia in its legitimate pursuit of the objective to promote domestic, modern and energy-

[7] *EU Commission, Brussels 22.7. 2002, COM (2002) 415 final*

efficient and environment-friendly co-generation was normal for most and probably all countries in a similar situation in transition countries: It had the right objectives, was prompted to pursue them by legal obligations already incumbent on it (Art. 19 ECT; ECT Energy Efficiency Protocol) and the Europe-Agreement-based obligation to adopt the EU "acquis"[8] (i.e. existing and evolving EU energy and environmental legislation with respect to climate change, control of CO2 emissions and promotion of energy efficient methods such as co-generation), but it did not find the financial resources to pay for it in the perhaps easiest way, i.e. a front-end, 40% investment grant as is explicitly envisaged in the EU Guidelines on state aids to environment-friendly energy investment. So it chose the most natural alternative, i.e. of giving responsibility to Latvenergo for implementing the incentive system for new co-generation and delegating the support obligation to Latvenergo.

16. Latvenergo, however, was not a willing or properly incentivated tool for such government policy. Its management was rather interested in pursuing very favourable purchases of "dumped" power from Russia and other ex-USSR states – even if this involved sometimes questionable deals with questionable commissions paid into offshore accounts. Latvenergo considered it politically difficult to raise the general tariffs to electricity consumers to pay for the "double tariff" it had been – against resistance – compelled to contract with the new co-generators. It saw no benefit for the company and its management in faithfully implementing the government pro-co-generation policy for new decentralised co-generation capacity, but only financial and political cost. This situation is not limited to Latvia: It has occurred in recent times in a number of similar cases where government promoted investment in new modern and efficient power capacity, but was unwilling to bear the political burden associated with the necessary higher tariffs to pay for them[9].

17. Latvenergo has had for several years the choice of importing very cheap – "dirty" – electricity from Russia and Lithuania. Because electricity demand collapsed when the USSR disappeared, there has been a surplus of generating capacity in the region. It is therefore significantly cheaper to purchase fuel at power stations in Russia

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[8] Signed in June 1995, effective February 1998, Latvia's request for EU accession is of October 1995. Under the Agreements, the partner countries also commit themselves to approximating their legislation to that of the European Union, particularly in the areas relevant to the internal market. This includes applying legislation favouring competition and applying state-aid rulings, which are compatible with comparable legislation in the EU. Legislation will also have to be introduced which provides similar levels of protection to intellectual, industrial and commercial property.

[9] I have discussed this in a lead study for a World Bank conference on regulatory risk for infrastructure/utility investment, published in J World Trade, 34 JWT 1-61 (2000); on the arbitrations following a similar disregard for contractual commitments undertaken in the context of power investment promotion: M. Kantor, International project finance and arbitration with public sector entities, 24 Fordham Intl LJ (2001) 1122; reprinted at www.gasandoil.com/ogel (issue 2) together with a debate on arbitration/disputes for breaches of such PPA agreements.

than to purchase power from new investments in Latvia. The annual reports and other official statements from Latvenergo suggest that management thinks that power which costs more than 4 E cents per kw/h is an expensive luxury that the average customer cannot afford. The fact that privatization – which is in the logic of EU accession – has been resisted in Latvia suggests that there may also be an alliance between Latvenergo management and unions and nationalists opposed to foreign investment. The tension between the official pursuit by government of the various energy efficiency and investment promotion policies explicit in EU accession and the more nationalist, protectionist, but also financial objectives of Latvenergo profiting from dumping of "dirty" electricity from Russia and Lithuania probably explain the convoluted dispute here at issue. It is by no means atypical. A similar dispute has arisen in Poland with respect to electricity imports based on long-term fixed-price terms from Sweden and in numerous countries in Asia and Latin America (Indonesia, India, Pakistan, Thailand, Argentina) where consumers, used to subsidized tariffs, could not be motivated to pay the tariffs necessary to repay the formerly encouraged foreign electricity investors.

18. Latvenergo was supposedly to be regulated by an independent regulatory office. However, there has been dissatisfaction with the operations of the regulatory agency. Also, reportedly and according to EU Commission assessments done with respect to the accession of Latvia to the EU (and the need to comply with the electricity directive of 1996 requiring a truly independent regulator), the previous (up to 2001) operating regulator was not considered properly independent, but too much dependent and intertwined personally and politically with Latvenergo. It is only since 2002, that a new effort was made to set up a truly independent regulatory agency[10].

According to all information, Latvenergo is:

- In 100% state ownership[11]
- Obligated by law to buy co-gen electricity
- The nation-wide exclusive electricity transmission and distribution, but also import/export monopoly

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[10] *Quoting from a country report on Latvia: "Up to July 2001, several institutions regulated public utilities in Latvia. The Energy Regulation Council – an institution under the supervision of the Ministry of Economy – was responsible for the regulation of the energy sector. The practical experience showed that the regulation was rather inefficient due to the fragmented institutions and limited resources available. Moreover, such regulation system did not ensure an independent decision making process. European Union reports on Latvia regularly emphasized the need to strengthen the regulatory process. To change the situation and improve the regulatory system, an institutional reform was implemented, changing the public utilities regulatory model. After four years of a legislative process, new public utilities regulatory institutions – Public Utilities Commission (PUC) and municipal Regulators - started their operations in July 2001, taking over the responsibilities from the Energy Regulation Council."*

[11] *In August 2000, the Latvian parliament reversed the planned privatization of Latvenergo, by amending the Latvian energy law to prevent it.*

- Under regulation by the state energy regulatory agency (now the Latvian Public Service Regulatory Commission)
- Subject to a controlling influence on decision-making, apart from day-to-day administration, by the parliament and by the main political parties[12]
- Under the direct political and ownership influence by the Ministry of Economy (which holds 100% of the shares)
- Its charter requires approval by the Cabinet/Council of Ministers[13]
- Constantly subject to politicised pressure by union workers who are opposed to privatization and keen to maintain the current employment numbers
- Entrusted with a strategic public service for the state[14]
- Its property is considered by the Energy law of strategic importance for the state and can not be divided or transferred to third parties; there is a legal prohibition on privatization of Latvenergo
- Latvenergo exercises extensive governmental and regulatory functions as it is empowered to terminate the operation of any company which has violated applicable rules on energy equipment, energy safety, electric and heat energy use[15]
- Latvenergo also exercises participation rights in energy policy formation in Latvia, inter alia as part of the Energy Consumers Committee formed by the Latvian Council of Ministers
- Latvenergo fulfills public and administrative functions relating to planning law under several regulations.
- While in theory the energy regulatory agency is expected to set tariffs, these tariffs have so far not been changed, i.e. are de facto dependent on determination by Latvenergo.

As a result of these influences and its institutional set up, Latvenergo is a governmental entity charged with implementing government energy policies (including international commitments of the government in the field of energy). There has been considerable amount of restructuring of Latvenergo over the past. Most notable is a Cabinet of Minister's Decision in February 2003 which confirms the primarily governmental nature of Latvenergo, its lack of independence vis-à-vis the government and that it has independence only in management terms and with respect to separate book-keeping[16]. It seems also uncontested that the government (through its PUC unit) is "responsible for setting heat and electricity tariffs for cogeneration power plants"[17]. Latvenergo is therefore neither a private company, nor a company operating under commercial criteria

[12] *I understand that memers of the Latvenergo supervisory board are to a significant extent representatives of the leading political parties.*
[13] *Cabinet order No. 402 of August 9, 2000*
[14] *Energy Law, Art. 20, as amended on August 3, 2000*
[15] *These regulatory functions are extensive and includes administrative warnings and the issuing of administrative orders to other companies*
[16] *News in the newsletter of the East European energy regulators, at: www.erranet.org/news/spring2003.htm consulted on 29/05/2003.*
[17] *ERRANET newsletter: same as above*

(i.e. negotiating freely its procurement and sales contracts), nor in a commercial context (i.e. a competitive, post-privatisation functioning energy market) nor does it have any substantial measure of strategic independence, apart from mere management powers over day-to-day matters and accounting that is kept separate from consolidated government accounting. The implication of this factual background to Latvenergo is that it must be seen as an instrumentality, organ or "emanation" of the state.

19. Latvia is as a transition economy in the middle of a transition between its former Soviet culture and a market economy. It ranks high the Transparency International corruption perception[18] - the highest of the EU candidate countries. Similarly, the EBRD ranking for quality of legal and institutional governance places Latvia at the bottom of the candidate countries. These – naturally not perfect, but only available reliable ranking systems – indicate that there is a high political and regulatory risk for a foreign investor, that it would not be sensible for a foreign investor to rely on the Latvian legal system and that the Energy Charter Treaty's investment protection is particularly relevant for foreign investors, more than in other East European EU candidate countries with a substantially better ranking. The Energy Charter Treaty was not made to protect foreign investment in countries with a high degree of quality of governance and rule of law, but for countries in transition with a low quality of governance.

20. There has been considerable (in my mind usually not substantiated) opposition by environmentalists groups against international investment arbitration, the argument being that property protection wins out over legitimate domestic environmental regulation. The current case is the only one I am familiar with which is the opposite: It is a foreign investor who, having developed an environment-friendly and energy-efficient power project, alleges improper infringement of its contract and property rights, largely because its investment can not compete on a level playing field with dumping of "dirty" electricity imports. It is therefore not only an investment protection issue , but a case of an environment-friendly foreign investor opposed to a state enterprise preferring to import cheap "dirty" electricity. Confounding all NGO critics of investment arbitration, this is a case where the issue is protection of environmental investment against unfair competition from "dirty" energy.

21. It seems also not contested that Latvenergo has an absolutely dominant, in effect monopoly (or technically more correct "monopsonist") position in the energy industry in Latvia, in particular towards independent power producers and co-generators. There seems to be no practical way for co-generators to sell their product except by selling to Latvenergo. The conduct expected of a publicly-

[18] *The country ranked 57 out of 84 countries in the Transparency International Corruption perception index. www.transparency.org/cpi/2000/cpi2000.html*

owned monopolist in the most strategic sector of the economy is naturally very different from private (or state-owned) companies operating in a competitive market. The issue of "commercial" versus "governmental" nature of a transaction plays an important role in this case – as in all cases where the issue is of public authorities or state-owned enterprises involved in contract disputes. I have in an earlier publication[19] argued that disputes relating to purely commercial contract matters might possibly not be covered by the Treaty; the example then formulated (and taken up frequently in writings by other legal authors and indeed resurfacing in the "Statement of Defense" is of the "sale of heating oil to a French village". I will examine this issue in more detail below, but one should emphasise that the uncontested position of Latvenergo as the monopolist in the most strategic energy sector, together with its character as a state enterprise, controlled by and tightly intertwined with the governmental, parliamentary and political process will be a significant factor in determining if the incriminated conduct – the refusal to honour the double tariff agreement – should be characterised as either commercial or rather governmental . It is often recognized that the duty under the ECT to provide "national or MFN treatment", i.e. not to discriminate, is comparable to the duties incumbent on dominant enterprises not to abuse their position, e.g. by refusals to deal, by discrimination between various dependent suppliers or purchasers under Art. 82 (ex-86) of the EC Treaty or the obligations of members states not to allow public enterprises entrusted with a public service function to disregard the competition law rules against, inter alia, the abuse of a dominant position (Art. 86 ex-90 EC Treaty). The occupation of a dominant position and in particular a monopoly in a strategic sector is the reason for placing special duties against abuse of such a position – both under relevant competition law (itself compared in the Statement of Defense with the Art. 10/22 duties under the ECT) and under the investment disciplines of the ECT. A breach of contract or discrimination would be seen under competition law (Art. 82, ex-86 of the EC Treaty or Art. 1 of the US Sherman Act) as an abuse of a dominant position if the willingness of the dominant enterprise to consider a breach of contract is related to its confidence in its superior or even overwhelming position of economic and political power.

22. On the opposite side, Nykomb is, without dispute (if one abstracts of allegations of financial weakness, especially as compared to Latvenergo) an established specialized small or middle-sized power engineering company with a specialty in co-generation and other environment-friendly energy technology. Such companies are as a rule not interested to become long-term investors, but rather prefer to sell technology, equipment and services. Occasionally, as is the case here, such engineering companies are pushed into the role of an investor, in particular if there is no domestic company with enough creditworthiness, capital and proven management track record to

[19] *International Investment under the 1994 Energy Charter Treaty, in: 29 JWT 5-72 (1995)*

enable a project that is bankable to bank lenders. From the uncontested facts it appears that the double-tariff agreement was obtained by a Latvian businessman (Sprinovskis) similar to several other comparable co-generation power sales agreements. The agreement was seen by most official authorities outside Latvenergo – which, however, signed it – as guaranteeing a double tariff for an initial, investment-recovery phase of eight years. This is consistent with the recommendations of the EU Commission in the draft co-generation directive. Government authorities – from the level of Prime minister downwards – and Latvian civil courts assumed formally and informally that a valid double-tariff agreement existed.

The financial models relied on by Vereinsbank, the lender, showed that the normal tariff would make the project not viable. Even an annual escalation of 8% would generate just enough to repay the loan, but not provide the normal industry return in high-risk countries such as Latvia. Given the high political and regulatory risk of Latvia – reflected in the low ranking of the EBRD legal reform survey, World Bank and corruption surveys by Transparency International, I suggest that a reasonable rate of return on investment should be at the order of about 25%. A comparison of the now partly publicly available financial calculations of the abrogated Indonesian power purchase agreements (PPAs) is likely to indicate such a return (or even higher) as appropriate. The fact that there was and is no other foreign investor in power generation in Latvia but Nykomb suggests that even the double tariff was, under Latvian circumstances, not a sufficient incentive to encourage private foreign investment in co-generation, i.e. something that Latvia committed itself under Art. 19 ECT, the Energy Efficiency Protocol and the 1995 "Europe Agreement" to do. Nykomb seems essentially to have slipped into the investment due to its commercial interest to apply and sell its technology and services and the insistence of Vereinsbank to have Nykomb act as the 51 %, and later also 100%, owner and operator of the co-generation plant.

23. The way Nykomb's role was arranged is fairly typical of modern investment arrangements for "IPPs" ("independent power producers"). Usually, there is a project company carrying out construction and operation owned by the foreign investor. Project finance is arranged through a lender, with the loans serviced by way of a priority right over available cash flow (e.g. tariff income). Security for the cash flow is provided mainly by a "take-or-pay contract" with a fixed or fairly fixed sales tariff for a period of time that is sufficient to repay interest and capital[20]. Modern investments in the power sector are as a rule carried out with an inextricable link to a long-term, fixed-price sales commitment, usually to a public utility – otherwise the investment would not be bankable.

[20] *M. Kantor, International Project Finance and Arbitration with public sector entities24 Fordham ILJ 1122 (2001*

24. The political context is according to what seems uncontested and is available from public sources roughly the following. There was an official pursuit of the co -generation promotion through double-tariffs at the governmental level and initially in parliament, but also, and in particularly later, nationalist opposition – combined with Latvenergo's pursuit of cheaper imports of "dirty" electricity. Both forces together probably prevailed over the Latvenergo's honouring of its contractual commitment to Nykomb.

This nationalist position is in most relevant countries with this type of "IPP disputes" – including in Latvia – as follows:

1) We the people of Latvia are the owners of our national power system and we must isolate it from the rest of the world, as much as possible, so that:
2) We will keep the profits from our power system in Latvian companies and under Latvian control. We will not allow foreigners to own the hydroelectric or other facilities and thereby earn profits that are taken out of the country.
3) We will prevent European or foreign electric companies from raising electricity prices to Latvian consumers. We will not privatize generating stations because that would only result in higher prices, which would pay for well-paid bankers, lawyers, business executives who produce nothing for the country because they are neither engineers nor factory workers. We will not allow rich capitalists from Germany or Sweden to raise prices to the Latvian population.
4) We will not allow the power system to be exposed to national security risks - for example, dependence on imports of Russian electricity, followed by blackmail and threats from Russia.

25. Nykomb got therefore caught in the tension between the national government – emphasising at a time domestic and environment-friendly generation encouraged through the DT, and Latvenergo, which seems to have grudgingly accepted at first the double-tariff (under the then prevailing laws), but which later freed itself from such constraints, mobilised its political supporters, managed to get the government to undo its former preferences for national and foreign investors and then tried to reject earlier contractual commitments – unsuccessfully with Gulbene and Liepajas Siltums (presumably both because the courts unanimously found the pertinent agreement did stipulate a double tariff and because Gulbene and Liepajas Siltums were domestic, i.e. politically much less vulnerable than Windau-Nykomb, now a foreign investor. The structure of this dispute is therefore quite typical of many cases of investment in power in transition or developing countries: A government, spurred on by national security and economic liberalisation models, encourages foreign investors. The national company – always in the continuing tradition of the socialist state agency and with a very strong nationalistic (and informally often a rent-seeking) motivation – is at first compelled to accept such policy, but then re-asserts itself and then rejects earlier commitments it did

not like in the first place and, with politics more favourable, feels capable of then rejecting explicitly. Bashing of foreign investors is in tune with nationalistic and xenophobic sentiment and is then easily combined with proper economic reasons (buying rather cheap energy abroad than expensive energy provided at full cost by foreign investors).

26. I assume for the purpose of my legal opinion and assessment of the ECT for the current case the following specific facts – it is not always clear to me if they are contested or not:

- That Windau, later owned by Nykomb, had an agreement with Latvenergo according to which it was entitled to sell its power production for eight (8) years at a tariff that was (with some adjustments) the double of the "normal" average tariff and that Latvian courts had considered that a similar, though legally weaker commitment (embodied not in a contract but a "letter of intent") by Gulbene, a Latvian-owned company, was in fact a "double tariff" 8-years power purchase agreement;
- That both Gulbene and Liepajas Siltums are paid the double tariff for roughly comparable co-generation plant production;
- That the "interim agreement" providing for 0.75 of the normal tariff was a provisional agreement to allow power flows from the Windau plant to start without affecting Nykomb's claims under the ECT;
- That the payment of a 0.75 of normal tariff makes the investment highly unprofitable for Nykomb, diminishes substantially its prospects for recovery of its original investment and achievement of a "reasonable rate of return";
- That Latvenergo is a state-owned company, emerging out of the former Soviet-style ministry (ministries) for energy/power, that it is controlled by the government or at least in mainly political ways, that it is subject to governmental price regulation and closely involved itself with price regulation, that it fulfils a strategic public service as the Latvian energy monopoly and has seen itself, and has been seen by the government and the political process as an instrument of governmental authority and responsibility for the key energy sector.
- That Nykomb took over from Windau and made its investment after the Energy Charter Treaty was applicable to Latvia, based on both provisional (Art. 45, 1) and ultimately full and effective application.

III. The Energy Charter Treaty – Interpretation and Relevant Precedents

27. The Nykomb/Latvia dispute raises a number of questions of interpretation of the ECT, in particular:

- The definition of covered "investment"

- The concept of "observance of obligations entered into with .. an investment of an investor" – in particular what kind of obligations are covered and which are not covered;

- The meaning of "national treatment" (i.e. non-discrimination) in Art. 10 (1) and Art. 10 (3) and the implication of "most-favoured nation treatment";
- The meaning of the principle of "fair and equitable treatment" and the prohibition on "unreasonable impairment" of management, maintenance, use, enjoyment or disposal (Art. 10 (10);
- The meaning of the prohibition of "measures having effect equivalent to nationalisation" without compensation in Art. 10 (1);
- The question of the proper scope of direct "state responsibility", in particular if this encompasses non-observance of obligations of the type at issue here (by the state and/or Latvenergo (LE) with respect to the double tariff and the legal significance of Art. 22 (1, 2 and 3);
- The question of the computation of damages and the entitlement of damages as between foreign investor and domestic subsidiary;
- The issue raised in the Statement of Defense if prior knowledge, or need to know, of the controversial nature of the promotional double-tariff, has any effect on the investor's claim.

28. How are these key concepts which are crucial for the determination of the dispute at stake here to be interpreted? The challenge of interpretation exists with all treaties, but it is arguably particularly acute with the Energy Charter Treaty. The reason is that the ECT, while relying on and incorporating a large amount of relevant language from other treaties, notably Chapter XI (investment) of the North-American Free Trade Agreement (NAFTA) and in particular the contemporary model US bilateral investment treaty), is frequent ambiguous, inconsistent and not drafted with maximum clarity and intelligibility in mind. One needs to bear in mind that the ECT was negotiated in considerable haste (1992-1994) following the formal proclamation and signature of the (legally non-binding) "European Energy Charter" of 1991.[21] The Chairman of the conference was worried that too much delay would undermine the momentum underlying the treaty. The controversial issues were therefore separated from the accepted formulations. The accepted formulations entered into the 1994 ECT, while the not yet solved issues were to be negotiated in a supplementary treaty (which has not been completed as of 2003). This haste – to ensure the Treaty was signed and not condemned to fail like the parallel negotiations for the "Multilateral Agreement on Investment" (terminated, without

[21] *Full text of all primary documents as annex in: T. Waelde (Ed.), The Energy Charter Treaty, Kluwer 1996. The negotiation history is discussed by Dore, Bamberger and others in contributions to this book.*

success, in 1998) means that the treaty's language is frequently not clear, not fully thought through and not fully consistent.

29. It is also necessary not to forget the authoritative, though not legally binding international instrument to precede the 1994 "Energy Charter Treaty" was the 1991 "European Energy Charter", a non-binding, but formal declaration of the participating governments[22]. Preamble paragraph No. 3 of the ECT – "*desiring to place the commitments contained in that Charter on a secure and binding international basis*" – makes the 1991 European Energy Charter into one of the authoritative instruments (Art. 31, 2, b of the Vienna Convention) for identifying properly the relevant "context" and "objects" of the Treaty.

30. The first line of interpretation guidelines is to be found in the Vienna Convention on Treaties:

> " in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose" (Art. 31 (1)[23].

The treaty therefore emphasises first the ordinary meaning before context, object and purpose are taken into account. The history of the treaty negotiations and circumstances at the conclusion – "travaux preparatoires" – are only of secondary and supplemental significance if normal interpretation leaves the "meaning ambiguous or obscure or leads to a result which is manifestly absurd or

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[22] *Published at p. 603 of T. Waelde (Ed), The Energy Charter Treaty*

[23] *Art. 31 (2): The context for the purposes of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes:*

(a) any agreement relating to the treaty which was made between all the parties in connection with the conclusion of the treaty" (this presumably refers to the "Understandings" and "Decisions" attached to the "Final Act"

b) any instrument which was made by one or more parties in connection with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty.

3. There shall be taken into account, together with the context:

a) any subsequent agreement between the parties regarding the interpretation of the tratey or the application of its provisions;

b) any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation;

c) any relevant rules of international law applicable in the relations between the parties (This presumably refers here to customary rules of international law – as indicated in accepted state and jurisprudential practice and authoritative interpretation (E.g. standard practice in modern investment treaties (of which there are over 2000 bilateral ones plus several – mainly NAFTA and the ECT – multilateral ones). – See Art. 38 of the Statute of the International Court of Justice which mentions as applicable international law:

- *international conventions*
- *international custom, as evidence of a general prctice accepted as law;*
- *the general principles of law recognised by civilised nations*
- *.. judicial decisions and the teachings of the most highly qualified publicists of the various nations, as subsidiary means for the determination of the rules of law*

unreasonable"[24]. There are no official or inofficial "travaux preparatoires". To the extent records of some meetings are available (as they are to a very limited extent to me), they are of very modest benefit because treaty negotiators often have not thought through, explicitly discussed, recognised or settled particular issues which come up in real-life application[25]. For the dispute at stake this means that the first recourse is a "good-faith" reading of the "ordinary meaning" – i.e. of concepts such as "obligations entered into", "fair and equitable", "unreasonable impairment", "national treatment", most-favoured nation treatment and "measures having having effect equivalent to nationalisation".

31. When the "ordinary meaning" is not clear, resort is therefore necessary to secondary interpretative methods, notably an examiniation of the context and purpose of the treaty. The overall background of the Treaty was the effort to help the transition economies of Eastern Europe to attract investment, mainly by helping to install a rule of law, safeguarding of property, respect for contracts and liberalisation of investment conditions in the model of Western market economies.[26] It is necessary – guided by the authoritative reference in Art. 31 (2) of the Vienna Convention on Treaties to the central role of the "preamble" in properly and formally identifying the "objects" of the treaty - to highlight the formulation of the relevant objects and purposes of the Treaty for interpretive reasons in the "Preamble", namely:

- " to place the commitments contained in the Charter (i.e. the 1991 European Energy Charter) on a secure and binding international basis",
- "liberalise investment and trade in energy",
- "attach utmost importance to the effective implementation of full national treatment and most favoured nation treatment",
- "having regard to competition rules concerning ... abuse of dominant position".

32. The Preamble of the Treaty refers to the 1991 "European Energy Charter" (EECH). Since the Treaty is to effectively implement the 1991 EECH (see above), it is also significant to recall for the concept of "context" and "purpose" of the ECT the relevant objectives and principles of the 1991 EECH, which are:

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[24] *Art. 32 of Vienna Convention: "Recourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, in order to confirm the meaning resulting from the application of Art. 31 , or to determine the meaning when the interprtation according to Art. 31: a) leaves the meaning ambiguous or obscure; or b) leads to a result which is manifestly absurd or unreasonable.*

[25] *I have discussed such manifestly contradictory statements (in the same session, by the same EU representative) in my article: Investment Arbitration under the Energy Charter Treaty, in: 12 Arbitration International 429 (1996)*

[26] *See Introduction by Ruud Lubbers, then Dutch Prime Minister and initiator of the ECT negotiations, in: Waelde, 1996. Lubbers highlights the "transformation to market economy", the "growing concern for the environment" and the recognition of the central role of "national treatment" as key objectives underlying the treaty.*

- *"to create a climate favourable to the operation of enterprise and to the flow of investments" (Title I);*
  "recognising the <u>role of entrepreneurs</u>, operating within a transparent and equitable legal framework" (preamble);
- *"<u>efficient energy systems</u> in the production …of energy and for the protection of the environment" (Preamble);*
- *"creating mechanisms and conditions for using energy as economically and efficiently as possible" (title II, 3);*
- *"promotion and <u>protection of investments</u>" (title II, No. 4, including the reference to "ensure* ***<u>a high level of legal security</u>****" and to a "stable, transparent legal framework for foreign investments, in conformity with the relevant international laws and rules on investment..";*
- *"creation of framework conditions for* ***<u>profitable investments in energy efficiency projects</u>****" (Title II, 7).*

The 1991 European Energy Charter is therefore an instrument made and accepted by the ECT parties "in connection with the conclusion of the treaty" and "accepted .. as an instrument related to the treaty" (Art. 31, 1 (a) and (b) of the Vienna Convention). This means that it is an instrument of high authority for interpretation – somewhat below the preamble, but definitively ranking in weight and relevance considerably above the "supplementary means of interpretation" (Art. 32) such as the "travaux preparatoires". The fact that it was completed earlier is of no significance for its authoritative function to guide interpretation since the ECT is explicitly based on the EECH, the EECH is referred to as the set of guiding principles meant to be legally implemented by the ECT in the ECT preamble and the EECH is the first step in a (not yet completed) sequence of the creation of the Energy Charter process.

33. The objectives of the ECT relevant for interpretation can also be inferred from the "Energy Charter Protocol on Energy Efficiency and Related Environmental Aspects" (annexed to the ECT and forming part of the ECT). It emphasises the need for :

- *"appreciating the vital role of the <u>private sector including small and medium -sized industries in promoting and implementing energy efficiency measures</u> and intent on ensuring a favourable institutional framework for economically viable investment in energy efficiency" (preamble EECH '91 No. para 7);*
- *"transparency of legal and regulatory framework" (Art. 3 (1)-f;*
- *"recognising the vital role of the private sector" (Art. 3, 6);*
- *"support and* ***<u>promotion of cogeneration</u>*** *and of measures to increase the efficiency of district heat production (Art. 8, I);*
- *The Annex to the Energy Efficiency Protocol takes up again the emphasis on "improving energy efficiency in power generation and transmission: (by) –* ***cogeneration****;*
- *ensuring that adequate institutional and legal infrastructure exist" (Art. 8, j).*

34. The implication of these quite explicitly and specifically identified objectives is that the overriding purpose of the Treaty is the encouragement of private investment by stable, equitable, transparent conditions at a "**high level" of protection**. Energy efficiency and environment-friendly types of energy investment – with an explicit and repeated reference to "co -generation" is at the core of the Treaty's policy to encourage and protect foreign investment. The tools – the "investment disciplines" in part III of the Treaty – have to be seen as instruments to implement the overall emphasis on promotion of private investments – with a special highlighting of "co-generation" (Art. 8 (1) of Energy Efficiency Protocol annexed to the ECT).

35. The implication of these authoritative sources for identifying the ECT's "context, object and purposes" is that the Treaty emphasises a "high" (i.e. not as other BITs a "normal") level of protection of foreign investors, encourages specifically "co-generation", highlights the importance of "liberalisation", i.e. movement away from socialist command-control energy economy and monopolies with a new emphasis on property, contract and competition and highlights all features of a market economy in energy which are the opposite of socialist energy industry – that is respect for property rather than pervasive state control, separation of private ownership and entrepreneurship from politicised comingling of state, politics and energy industry, fair and transparent treatment of foreign investor – rather than exposing them to the volatilities and vagaries of intricate and not easily intelligible political manoeuvering. The ECT is trying to help transition economies to move from socialist energy industry – with its practices of disrespect of ownership, contract, investment and lack of clarity on the rules – to a modern market economy system where the opposite prevails. It recognises that the difficulty of transition economies is precisely the survival of earlier, socialist and command-control nationalist and xenophobic tendencies and that the best remedy is a system of investment protection which is transparent and enforceable before a non-national arbitration forum. The Treaty's language has therefore to be seen before the background and overall objectives and context – liberalisation and modernisation of still state-dominated energy industries, and the objects and purposes – to provide in a legally binding form with maximum effectiveness a high degree of investment security in environment-friendly co -generation.

36. From this detailed identification of relevant objectives of the Treaty identified in a formal, explicit and legally relevant form (i.e. not super-imposed by the interpreter's personal subjective views and preferences) it seems clear that the broad thrust of the ECT is intended to offer extensive, rather than restrictive, protection to foreign energy investors and their investments. It also suggests that a higher degree of protection is envisaged for such energy investment which meet the additional preferences in the Treaty for co -generation and environment-friendly and energy-efficient investment projects and that nothing in the purpose, context,

background of the Treaty calls for a restrictive approach to the interpretation of its terms. The theme of encouraging private investment in environment-friendly projects (mentioning specifically co-generation) is pervasive in the Treaty, the 1991 European Energy charter and the Energy Efficiency Protocol. The "Foreword" written by the ECT's "father", Dutch ex-Prime Minister Ruud Lubbers, emphasises again how important the link of investment-energy-environment was in the minds of the political sponsors and technical drafters of the Treaty[27].

37. There are other authoritative precedents which are relevant for the construction of the ECT's provisions. The ECT was not a stand-alone investment treaty coming from nowhere, but rather the logical continuation of treaty-based investment protection in the over 2000 bilateral investment treaties (BITs) (several of them, notably 1995 with the US, concluded by Latvia) and in particular the 1992 North-American Free Trade Agreement's Chapter XI (investment protection). Most of the language of the ECT's part III and IV is borrowed often literally from the modern generation of US Bilateral investment treaties (e.g. US-Latvia 1995) and Chapter XI of the NAFTA. Some language and precedent – notably concerning "national treatment" (non-discrimination) has been heavily influenced, often in fact literally borrowed, from the GATT (in particular Art III and XVII).

International arbitration tribunals are not bound by a formal rule binding them to the jurisprudence by other arbitral tribunal ("stare decisis"). However, modern practice consists of a growing line of investment arbitral jurisprudence, mainly under the ICSID Convention and dealing with BITs (for a list: www.worldbank.org/icsid) and under the NAFTA Chapter XI (www.naftaclaims.org). While there is no comprehensive consistency, most or all arbitral tribunals now study very carefully other recent awards; they are often quoted, discussed extensively and relied upon. It seems that a modern investment arbitration tribunal now as a rule wishes to place itself within the emerging line of authoritative precedents emerging from both ICSID jurisprudence based on BITs and NAFTA tribunal jurisprudence based on Chapter XI of the NAFTA. This lex mercatoria, or increasingly compatible and reciprocally related arbitral jurisprudence seems, as the argument of counsel and the reasoning by the tribunals indicates, to be taken very seriously by most internationally active arbitrators. Many of the issues relevant in the Nykomb/Latvia case have been raised in comparable ICSID or NAFTA cases. Some have even led to the authoritative ICSID procedure of annulment of an arbitral award – e.g. the annulment of the direction of one ICSID tribunal to the investor to seek recourse from domestic courts.[28] The extensive discussion in those cases is

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[27] Ruud Lubbers, Foreword, in: T. Waelde (Ed) Energy Charter Treaty, op. cit. supra, 1996

[28] Soc Lyonnaise des Eaux/Aguas del Aconquija, www.worldbank.org/icsid, forthcoming in International Legal Materials 2003. The tribunal held, contrary to the relevant US-Argentina BIT, that the investor should seek justice first from a domestic court. The award was annulled for misunderstanding the right of investors under modern BITs to avoid local

therefore seen to produce authoritative awards which, if not a legally binding precedent in a formal sense, are now widely seen to constitute a high level of persuasive authority and increasingly accepted “international arbitral jurisprudence”. While each case, situation and treaty is different, most of the cases apply identical or highly similar and comparable principles.

38. The main cases[29] relevant for the Nykomb – Latvia dispute are:

- Myers v. Canada: discrimination, protectionist intent; damages suffered by the wholly-owned domestic subsidiary are considered as damages to the foreign parent;
- Pope-Talbot: fair and equitable standard; discrimination;
- Metalclad: fair and equitable by multiple breaches of transparency standard; expropriation by “regulatory taking”;
- Methanex (not yet finalised): discrimination with protectionist intent against foreigners in competitive relationship; US responsibility for subnational authority (state of California);
- Azinian: exclusion of wholly commercial disputes without regulatory or governmental dimension from investment arbitration in a situation where the government entity had no exclusive rights, power or monopoly and the breach was exclusively commercial, without any element of at least partial reliance on governmental powers;
- LANCO and Lyonnaise des Eaux v. Argentina (annulment award): No need to exhaust domestic remedies; straight recourse to Treaty-based arbitration possible;
- Feldman Karpa v. Mexico: 615 (2002) AT P. 625: "The tribunal may not deal with acts or omissions that occurred before (the date NAFTA become effective)". "However, this also means if there has been a permanent course of action by .. (government) which started (before effectiveness) and went on after that date, and which, therefore, became "breaches of NAFTA Ch XI.. the post (effectiveness date).. part of ..government's alleged activity is subject to the tribunal's. What this means is that if a "bad" behaviour is continued during the time after the Treaty became effective, the Treaty - and the tribunal's jurisdiction - is applicable; Feldman Karpa v. Mexico is also an authority for the application of the discrimination test, mainly by shifting the burden or proof on the government if a distinct treatment of like situations between foreign and domestic investor/competitor has been established.
- Maffezini v. Argentina Jurisdiction award: First application of MFN principle in investment treaties; determines that not only substantive benefits, but also procedural benefits (here; arbitration rights) and be conferred by way of operation of the MFN clause; confirms that state-owned companies can be

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courts (“exhaustion of local remedies”) and go straight to the Treaty-based arbitration procedure.

[29] *The NAFTA cases are available from www.naftaclaims.org; several ICSID cases are available from www.worldbank.org/icsid ; the Indonesian cases are on file with the author and have been summarised in Mealy’s International Arbitration Reports.*

considered under functional and structural tests as emanations of the state even if organised in private law form

- There are also two recent awards (Himpurna; Karaha Bodas) dealing with breach of long-term power-purchase agreements by Indonesian state companies and calculation of damages. The key feature here is that the investor was awarded both the expenses for the investment plus future profits from the PPA discounted to net present value;
- ME Cement v. Egypt, an ICSID/BIT case: indirect expropriation of a license granted by making it economically unviable to produce under the license;
- CME v Czech (2003, including May 2003 confirmation by Svea Court of Appeal): breach of "fair and equitable" and discrimination standard by autonomous public entity interfering in contractual relations between foreign investor and domestic partner and favouring in this dispute the domestic partner – with a total award of over 350 M US$ (which were paid by the Czech government);
- Mondev v. US (NAFTA), modernised and evolving concept of "fair and equitable treatment"; reference to fundamental rules of international law preventing the abrogation of contract by state authority without compensation.
- Salini Costruttori v Morocco,[30]: construction agreement falling under both the – wide – terms of the Italy-Morocco BIT and the – narrower – terms of Art. 25 ICSID; also the most recent authority on the direct responsibility of the state for a state-owned public services company even if set up in a private law corporate form. Functional and structural test: State-ownership and control sets up presumption of state-organ role; function of providing public services serves to attribute conduct to state.

39. There is another line of jurisprudence with interpretative significance for the Nykomb/Latvia dispute based on WTO panel and Appeals Body decisions. WTO disputes are different from ECT and BIT/NAFTA disputes as in WTO disputes there are only state parties and no entitlements to complain are bestowed on private investors. But WTO cases have in a most authoritative fashion interpreted the "national treatment" (non-discrimination) principle. The Asbestos case [31] is the most recent and most authoritative case. It develops "discrimination" as in a two-step procedure: In a first stage, the "likeness" of two products is determined; in a second stage, a prima facie determination of distinct treatment is made. The party accused of discrimination has then the burden of proof to show that it had no legitimate reason for distinct treatment and that the distinction is not merely based on the quality of the allegedly discriminated company as "foreign". The Asbestos case as other earlier WTO cases on national treatment also are relevant for the question if a "protectionist and discriminatory intent" is required and needs to be

[30] *ICSID Case Arb. 00/4 Decision on Jurisdiction of July 23, 2001, reprinted in 129 Journal de Droit International (Clunet) 196 (2002, electronically on file with the author*
[31] *EC - Asbestos, WT/DS135/AB/% of 5 April 2001;*

proven. The WTO cases indicate the position that such an intent is not necessary – though when present it helps to identify discrimination. It is rather the "design, architecture and the revealing structure of a measure" which is thoroughly analysed in order to identify protectionist discrimination"[32] or:

> *"The subjective intentions inhabiting the minds of individual legislators or regulators do not bear upon the inquiry if only because they are not accessible to treaty interpreters. It does not follow, however, that the statutory purposes or objectives – that is, the purpose or objectives of a member's legislature and government as a whole – to the extent that they are given objective expression.. are not pertinent"*[33].

40. The protectionist – that is discriminatory - intent is therefore inferred from objective elements:

> *.. is not an issue of intent. It is not necessary for a panel to sort through the many reasons legislators and regulators often have for what they do and weigh the relative significance of those reasons to establish legislative or regulatory intent. If the measure is applied to imported or domestic products so as to afford protection, then it does not matter that there may not have been any desire to engage in protectionism in the minds of the legislator or the regulators who imposed the measure. It is irrelevant that protectionism was not an intended objective if the particular tax measure in question is nevertheless .. applied to imported or domestic products so as to afford protection.. This is an issue of how the measure in question is applied. .. We believe that an examination in any case of whether dissimilar taxation has been applied so as to afford protection requires a comprehensive and objective analysis of the structure and application of the measure in question on domestic as compared to imported products. We believe it is possible to examine objectively the underlying criteria used in particular tax measure, its structure and its overall application to ascertain whether it is applied in a way that affords protection to domestic products".*[34]

41. A similar approach would and has been used by the European Court of Justice to identify a discriminatory purpose of governmental measures. It is rather the effect than a particular individual intention which determines the finding of discrimination[35]. While WTO cases deal with trade – not investment – and ECJ cases mainly with freedom of movement (which is mainly an issue of investment access), their by now very extensive and authoritative jurisprudence

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[32] *WTO Japan- Alcoholic Beverages at 119, 120 WT/DS8, 10, 11/AB/R adopted 1 November 1996*

[33] *WTO Chile – Alcoholic Beverages Case, 12 January 2000 WTDS 87, 110,AB/R*

[34] *WTO, Japan – alcoholic beverages, supra*

[35] *see the discussion of national treatment/ discrimination infra.*

on discrimination can not be ignored when issues of discrimination are raised under investment treaties. It is now recognised that trade and investment law have a tendency to converge, with similar principles, and often language, borrowed by investment treaty drafters from trade treaties. The ECT was influenced very much by the just preceding negotiation of the WTO agreements from 1990-1992 which overlapped with the beginning of the ECT negotiation. Indeed, many negotiators were involved in the formulation of both treaties. The WTO Appeals Body is at present the most authoritative, and in terms of number of cases and depth of scrutiny, the most influential international economic judicial body[36].

42. Finally, the Energy Charter Treaty needs to be interpreted in accordance with and in reliance on generally accepted rules and principles of international law. This rule of interpretation is based both on the Treaty itself – Art. 26 (6):

> *"A tribunal established under paragraph (4) shall decide the issues in dispute in accordance with this Treaty and applicable rules and principles of international law".*

And Art. 31 (3)(c) of the Vienna Convention on Treaties – which is recognised to be an expression of generally recognised principles of international law formulates the principle for interpretation:

> *"There shall be taken into account, together with the context, any relevant rules of international law applicable in the relations between the parties"*

This leads to the more specific guideline in Art. 38 of the Statute of the International Court of Justice which highlights:

- "treaties"
- "customary international law" (including "state practice"),
- "general principles of law recognised by civilised nations"
- "judicial teachings"
- "teachings of the most highly qualified publicists".

While this is directly applicable to the ICJ, it is also generally considered to be the universally accepted definition of international law principles applicable and authoritative as well for international arbitral tribunals.

43. While there is a well-known tension between international-law arbitrators – who have little problem in applying and identifying relevant international law principles – and commercial arbitrators –

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[36] This discussion relies on a Legal Opinion, submitted in the on-going Methanex v. US NAFTA arbitral proceeding, by Prof CD Ehlermann, the former Director General of the EU Commission's Legal Services and thereafter the Chairman of the WTO Appeals Body, see also: Ehlermann, Six Years on the Bench of the "World Trade Court"Some Personal Experiences as Member of the Appellate Body of the World Trade Organization, Journal of World Trade, 2002, vol. 36, no. 4, pp. 605-639. On file with the author.

who have a tendency to consider international law too general and controversial, it is suggested that as of 2003, international law principles and rules are sufficiently specific to be practically applicable. The over 2000 bilateral treaties (plus the at least equivalent number of treaty relations implicit in multilateral treaties)[37] do indicate an emerging and already existing consensus on most of the basic rules of investment protection. This consensus forming customary law is supplemented by the increasing number of modern investment awards. While such awards were rare after WW II, they have very rapidly increased over the last 15 years. Most of them are by now publicly available. Without excessive attention to the last-ranked source – writings of eminent "publicists", it is now possible to identify relevant rules of international law mainly out of modern treaty/ state practice and pertinent arbitral awards. Arguably, state practice, an important source of customary international law, can also be identified in particular in the relevant EU-wide rules on energy regulation, in particular the electricity directive of 1996, the implementing and directive-compatible energy reform legislation in all EU and all "candidate" countries (including Latvia) and the now authoritative guidelines by the "Florence process", i.e. the forum of EU electricity regulators set up and operating in association with the staff of the European Commission[38].

44. The relevance of principles and rules of international law – as they specifically apply to foreign investment – is much greater than even the treaty language (Art. 26 (6)) suggests. Most if not all of the Treaty's relevant articles are not revolutionary or even novel, but formulate in contemporary language principles of traditional public international law on state responsibility with respect to the protection of property of aliens. Such traditional international law was challenged in the 1960-1970s under the heading of the "New International Economic Order", principally by developing and then Communist countries. But it has re-emerged, in a modern shape and integrating modern standards of good-governance (such as in particular a much greater emphasis on environmental/ sustainable development issues, but also on ensuring treaty coverage also reaches subnational authorities and state enterprises), in the post-1990s treaty generation best embodied in Chapter XI of the NAFTA, the Energy Charter Treaty and the modern model bilateral investment treaty as pioneered in particular by the US and the UK. Much of the more classic discussion of protection of aliens' property – post WW I and post WW II, but also in the US-Iran claims tribunal cases – is therefore relevant today as the Energy Charter Treaty in effect "codifies" such classic notions of the protection of aliens' property reflecting an open and liberal approach to international investment and trade. The one difference between the ECT and

[37] *Without deeper mathematics, I consider the ECT to be the equivalent of about 2000 bilateral investment protection treaties, taking into account that we have now over 50 countries in investment protection relations among each other.*
[38] *The reports, recommendations and guidelines of the "Florence" EU electricity regulators process are available from the website of the EU Commission's DG TREN at: http://europa.eu.int/comm/energy_transport/en/envir_integr_en.html*

similar modern investment treaties and classical principles of protecting aliens' property is that the Treaty has codified such principles, in contemporary legal terminology and in view of contemporary challenges (e.g. the significance of state enterprises), but always with the tendency to formulate issues which were ambiguous or controversial in traditional international law with a view to select the solution which is most advantageous to foreign investors. Only such an approach would do justice to the overarching aim of encouraging foreign investment by extensive protection of investor's proprietary rights. Traditional international law can therefore be used for interpreting treaty provisions, but rather to give specific shape and to expand than to restrict investor protection.

IV. The Main Issues for Nykomb's Claim against Latvia

45. The main claims or causes of action by Nykomb against the Republic of Latvia are based on the specifically enumerated disciplines in the ECT, namely:

- Non-observance of contractual commitment (Art. 10, 1)
- Breach of non-discrimination duty (Art. 10, 1 and 3)
- Breach of fair and equitable treatment (Art. 10, 1)
- Breach of prohibition against unreasonable and discriminatory impairment (Art. 10, 1)
- Expropriation of contractual rights by continued non-compliance (Art. 13)

They require that the "eligibility" criteria of the Treaty – "investment" in particular – are met.

46. I will deal with these issues by focusing on the contested questions of interpretation of the relevant treaty provisions and their application to the specific facts of this case. Additional pertinent issues to be dealt with are:

- The responsibility of the Latvian State for actions/ omissions of its government and of its state enterprise Latvenergo. The issue will be dealt once with respect to the "sanctity of contract" breach issue(see below), but is equally applicable to the other alleged breaches by conduct of Latvenergo.
- Is there direct access to Treaty-arbitration even if a recourse to domestic courts appears feasible?
- Does the fact that the double tariff was implicated in domestic dispute, and that Nykomb knew this or should have known this, have any impact on the legitimacy of its claim?
- Can Nykomb claim payment of the contractual rights viz. compensation for the damage suffered by Windau?

47. Before undertaking a more detailed examination of these issues, it is useful to recall current and widespread arbitral practice in dealing

with these questions. The question of “sanctity of contract” or breach/ revocation of contracts with foreign companies by the state has been the subject of arbitral jurisprudence throughout the last century, even before the “sanctity of contract” clause entered into modern BIT practice. Contract breaches are dealt with under the “sanctity of contract” clause where this clause is available, otherwise on more general grounds such as “expropriation” (of contractual proprietary rights) or discrimination. “Fair and equitable treatment” and its affiliated formulations (“no unreasonable impairment..”) have been “dormant” throughout most of the relevant history, but have suddenly been revived by arbitral tribunals, under the NAFTA and BITs since the 1990s, because they provide a flexible instrument to assess governmental conduct relying on modern and evolving concepts of good-governance. Arbitral tribunals have perhaps used this standard most frequently in recent years. Discrimination (“national treatment”) has again been largely dormant in the past, but has recently been revived vigorously as arbitral tribunals (and counsel) have discovered that behind many actions affecting foreign investors is some action of protectionist privilege in favour of domestic competitors capturing the political process. “Expropriation” – and mostly now in the form of “regulatory taking” under the heading of “action with an effect equivalent to (tantamount to) expropriation” has been used in post WW II in particular the Czech, then Communist, government’s action against foreign companies where the de-facto taking was camouflaged by “velvet” forms respecting legal niceties[39] and avoiding outright and formal expropriation and again in the US-Iran Claims tribunal cases[40]. In recent cases, “regulatory taking” is regularly pleaded, but apart from the recent Metalclad v. Mexico case, arbitral tribunals have as a rule preferred to decide cases rather on the “fair and equitable treatment” and the “non-discrimination” standards, arguably for reasons of judicial economy. Another reason has probably been the intention to avoid the perhaps politically more sensitive qualification of an exorbitant governmental measure short of a formal taking as “expropriation”. Though all modern treaties now explicitly recognise that a “taking” can occur without formal expropriation when the investor is rather “squeezed” out gradually by regulatory pressure rather than if its investment is properly and formally “taken” away.

48. Is Nykomb a “treaty investor” and has it made an “investment” under the terms of the Treaty?

It is not clear to me from the Statement of Defense if the respondent is challenging the status of Nykomb’s investment in the Windau-operated co-generation plant at Bauska as “investment” by an “investor” under the Treaty. But the repeated references that this is primarily or exclusively a “commercial dispute” could be seen as

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[39] *Seidl-Hohenveldern, I.; Internationales Konfiskations-undEnteignungsrecht (Tubingen, 1952).*
[40] *The best survey here is C. Brower & J. Brueschke, The Iran-United States Claims Tribunal (Martinus Nijhoff, The Hague, 1998),*

questioning the qualification of the double-tariff contract as "investment".

49. The concept of protected "investment" has undergone in recent decades considerable change. While classic international law protected all property rights of aliens, investment treaties in the 1960s to about 1980 focused only on "foreign direct investment" understood as a lasting, commercial, revenue-generating operation. Often, this notion of "investment" was further qualified by references to approval procedures in national law and further limitations contained in national law. But this limited notion of "investment" mainly as "foreign direct investment under the IMF definition" has been superseded in most recent investment treaties, multilateral (NAFTA) and bilateral, but in particular by the Energy Charter Treaty by a much more extensive concept which in my view reverts to the original, classic notion of "proprietary rights" of aliens. The proper approach is therefore not to look at now obsolete definitions in other, particularly older legal instruments, but focus as per the guidance of the Vienna Convention on Treaties on the text (mainly Art. 1 (6)) of the Energy Charter Treaty. While there are many definitions around – mainly "foreign direct investment" as a more lasting commitment of capital with management and control to generate revenues or "portfolio investment" as a purely financial commitment without necessarily any control or equity components, the proper source for defining the eligibility criteria of "investment" and "investor" is the Energy Charter Treaty itself. Nykomb – as a company set up in Sweden – is a Treaty "investor" under Art. 1 (7((a)(ii) – a "company .. organised in accordance with the law applicable in that Contracting Party", i.e. Sweden.

50. But Windau and its contract with Latvenergo needs also to be an "investment". Art. 1 (6) defines as "investment" for Treaty purposes:

> "every kind of asset, owned or controlled directly or indirectly by an investor".
>
> "Asset" is an item of property or a proprietary right of some financial value. The ownership of Windau, itself owning its energy production facilities and the contract with Latvenergo, itself a proprietary right of some financial value, is undoubtedly "assets". They are controlled directly by the investor. There is accordingly no doubt that Nykomb owns an "investment" in Latvia, the more so as the definition is intentionally very extensive – "every kind of" asset.

This result is confirmed by the sub-categories in Art. 1 (6), namely:

- "tangible and intangible property" – Windau, itself owned by Nykomb, owns both tangible and intangible (i.e. the contract) property rights
- "company" or "shares" in a company: Nykomb's ownership of the shares of Windau

- "other debt of a company" – the contract against Latvenergo is a "debt" owned by Windau, itself owned b y Nykomb
- "claims to money and claims to performance pursuant to contract having an economic value and associated with an investment": the contractual rights of Windau against Latvenergo are "claims to contractual performance", they are "associated with an investment", i.e. the assets held by Nykomb and Windau.
- "returns": the contractual payments due by Latvenergo to Windau are "returns" on the investment made by Nykomb
- "any right conferred by law or contract or by virtue of any licences and permits granted pursuant to law to undertake any economic activity in the energy sector": Windau was granted a license to produce energy through its co -generation plant.

Both under the general "catch -all" provision of Art. 1 (6) and the subcategories Art. 1 (6) (a, b, c, e, f) Nykomb's activity in Latvia qualifies therefore as "investment" in this sense required by the Treaty. Such an "investment" has to be " any investment associated with an economic activity in the energy sector" (Art. 1 (6, last sentence). Art. 1 (5) again confirms that "production" and "sale" of "energy materials" means an "economic activity in the energy sector". Annex EM confirms at para 27.16 that "electrical energy" is covered by the term "energy materials" and Annex NI (non-applicable energy materials and products for definition of economic activity in the energy sector in accordance with Art. 1 (5) does not exclude electricity. There is no doubt that Windau's co -generation activity constitutes the very core of economic activity in the energy sector[41].

51. Further explanation or argument is not necessary in view of the clear and very detailed formulation of the "ordinary meaning" of the Treaty. Since, however, the term investment is often still understood not in the sense of "proprietary assets" as in the ECT and modern investment treaties, but in the older sense of "foreign direct investment" , it is perhaps useful to appreciate that with such a broad and expansive notion of "investment" modern investment treaties have in fact re-stated the classical notions that a state is obligated not to affect any proprietary rights – including contracts – of aliens. It is by way of such extensive protection that the objective of the treaty to promote "direct investment" – i.e. attracting foreign companies to a more lasting commitment in the country – is best

[41] *Art. 1 (6) could be seen to use a circular way of defining "investment", i.e. "investment" being an "investment" "associated with an economic activity". The way to read this correctly is to understand that Art. 1 (6) (a -f) defines what an "investment" is – in line with modern treaties as virtually any proprietary right ("asset") and to understand the last sentence in Art. 1 (6) as adding the qualification that the investment (as defined above) has to fulfil two additional conditions: First, it must be "associated with an economic activity" (i.e. rather than in the field of politics) and, second, that the economic activity must take place in the "energy sector" – since this is the overall distinction between the sectoral "Energy" Charter Treaty and general "investment treaties".*

fulfilled. A recent UN report[42] re-states and explains this general modern trend towards an – again – asset-focused rather than long-term commitment-based understanding of the term of protected "investment":

> *"Instruments mainly directed at the protection of FDI usually define investment in a broad and comprehensive manner. They cover not only the capital (or the resources) that have crossed borders with a view to the acquisition of control over an enterprise, but also most other kinds of assets of the enterprise or of the investor - property and property rights of various kinds; non-equity investment, including several types of loans and portfolio transactions; and other contractual rights, sometimes including rights created by administrative action of a host State (licences, permits, etc.)." (p. 56).*

> *"Protection-oriented instruments ... seek to safeguard the interests of the investors (or, in broader context, to promote FDI by safeguarding the investors' interests). For the purposes of protection, investment is understood as something that is already there (or that will be there, by the time protection becomes necessary). The older terminology, which referred to "acquired rights" or to "foreign property" (see, for example the 1967 OECD draft Convention on the Protection of Foreign Property), makes the context clear, as does the more recent usage of "assets" as the key term. From such a perspective, the exact character of the particular assets is not by itself important, since protection (mainly against extraordinary Government action damaging to them) is to be extended to them after their acquisition by the investor, when they already form part of the investor` s patrimony. Definitions tend therefore to be broad, in order to cover as many as possible of the investor's assets." (p. 57).*

The Paper concludes this part of its discussion by noting that the two types of definition are not inconsistent, but simply serve different purposes. It goes on to note that:

> *"Recent practice in regional and multilateral agreements that are intended both to liberalize investment regulation and to protect investments appears to favour broader definitions - witness the definitions found in NAFTA, the MERCOSUR Protocols, the Energy Charter Treaty and especially the draft MAI." (p. 57*).

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[42] *UNCTAD, Trends in International Investment Agreements: An Overview, 1999 ; this discussion uses elements from a legal opinion submitted by a distinguished international lawyer in another confidential context.*

52. One of the earliest multilateral texts– the 1967 OECD Draft Convention on the Protection of Foreign Property[43] (ILM, vol. 7(1968), p. 118) adopted a very broad definition. Article 1 provides for protection for foreign "property", and para 2(a) of the Commentary to that Article states that: "In international law the rules contained in the Convention . . . apply to property in the widest sense of the term which includes, but is not limited to, investments". The term "property" is defined in Article 9(c) of the Draft Convention as meaning: "all property, rights and interests, whether held directly or indirectly, including the interest which a member of a company is deemed to have in the property of the company…". Para 3(a) of the Commentary on this Article states that: "The definition of [property], which is in conformity with international judicial practice, shows that it is meant to be used in its widest sense which includes, but is not limited to, investments".

53. This concern with all aspects of foreign-owned property built upon and reflected then current attitudes to the diplomatic protection of aliens and their property, rather than any particular concern with economically related foreign property - economically-related property was treated as part of the broader category of property in general. Later the need to protect specifically economically-related foreign property became a major concern of States, leading to the conclusion of treaties dealing specifically with "investments" rather than with the broader concept of "property". This called, accordingly, for suitable definitions of the kinds of "investments" to be covered in such investment protection treaties, both multilateral and bilateral. One such multilateral treaty was the North American Free Trade Agreement ("NAFTA"), concluded in 1992[44]. It is comprehensive in its application to economic assets and interests. The draft Multilateral Agreement on Investment ("MAI") was prepared within the OECD in the 1990s, and had reached an advanced stage when negotiations petered out in 1998. By then the Negotiating Text included a broad asset-based definition of "Investment" - "Every kind of asset owned or controlled, directly or indirectly, by an investor, including (i) …, (ii)…, etc. - (viii) . . ." (the full text taken from Böhmer, German YBIL, vol. 41 (1996), pp. 277-278) and available from www.oecd.org

Similarly, Article 1 of Protocol No. 1 to the European Convention on Human Rights gives protection to everyone's "possessions". In enquiring into the possibility of this provision being used to protect FDI, Ruffert (German YBIL, vol. 43 (2000), pp. 116, 122.123) has summarised the position thus (footnotes omitted):

> *"The Court has always attributed a broad meaning to these terms [i.e. "Possessions/Property", "Biens", "Eigentum"] containing in substance the right of property. The guarantee of property, whether movable or immovable, is not confined to tangible property in a private law sense, but includes all*

[43] *ILM, vol. 7(1968), p. 118*
[44] *ILM, vol. XXXII (1993), pp. 289, 605 at pp. 647-8)*

vested rights bearing any economic value whatsoever... The reason given by the Court for adopting such a broad concept has been the very breadth afforded the definition of 'property' itself in general Public International Law. The concept was developed in the sphere of the treatment of aliens.... The Convention adopts its notion of property from general Public International Law. Thus it covers what have commonly been held to be property rights.... The Court does not exclude any recognized vested right from the guarantee which would consequently be of great efficiency to the investor if applied to FDI...."

The recent Salini v. Morocco case[45] confirms this interpretation. It is based on a formulation in the Italy-Morocco BIT which is similar to Art. 1 (6) ECT with its reference to "rights to any contractual performance having economic value" and "any economic right conferred by law or contract". The tribunal had no difficulty of finding that the subcontract for the provision of construction services constituted an "investment" both under the wide concept of the Italy-Morocco BIT and under the – as some suggest – possibly more narrow concept of investment under Art. 25 of the ICSID Convention.[46] But even then, as the Salini tribunal stated, no ICSID award ever dismissed claims based on the absence of an "investment". The Nykomb v. Latvia award would have constituted an "investment" even under the – as some argue - more limitative understanding of "investment" under Art. 25 ICSID Convention; it in fact exceeds by far the requirements for the Salini v Morocco project (2-5 years duration; some involvement in financing; contribution of know how and technology) and some assumption of risk for the entrepreneur.

54. To conclude: The text of the Treaty – as the text of most or all comparable contemporary investment treaties (US, UK and other BITs; draft Multilateral Agreement on Investment; European Convention of Human Rights; Art. 1, Additional Protocol; Chapter XI of the NAFTA) – applies intentionally and explicitly a very extensive concept of investment, with investment not being understood as in the much narrower economic and statistical term "foreign direct investment", but rather as a modern re-statement of the classical notion of "proprietary rights"[47]. A commercial character of the

[45] *Reference supra – ICSID decision of 2001*

[46] *The ICSID convention is not applicable in the Nykomb – Latvia case. Art. 25 of the ICSID Convention refers to investment, but refrained from defining it. It was considered at the time – 1966 – that this concept then was more likely to similar to the IMF definition requiring a more lasting commitment of capital and control, but the absence of a definition makes even the ICSID term of investment amenable to the evolution of the concept in modern treaties.*

[47] *This is also the conclusion of Pasivirta, ECT and Investment Contracts, in T. Waelde, The ECT, 1996, 356, 357 – "contractual rights" as "property rights" with protection of*

transaction as such does not detract from the qualification as "investment" by an investor under Art. 1 of the Treaty. Even if the older and more limitative concept of "foreign direct investment" were to applied – something which the Treaty specifically rejects – Nykomb activity would still be qualified as "foreign direct investment" – a lasting commitment of capital, ownership and management to set up a project meant to generate recurrent revenues.

55. Non-Observance of Contractual Commitment (Art. 10 (1, last sentence)[48]

Given the centrality of the "double tariff agreement" Windau/Latvenergo and its alleged breach, it makes most sense to start examining first the application of the "sanctity of contract" clause in Art. 10 (1, last sentence):

> *"Each Contracting Party shall observe any obligations it has entered into with an investor (i.e. Nykomb) or an "investment of an investor" (which means according to Art. 1 (6) Windau) of any other Contracting Party".*

56. Applying the "ordinary meaning" interpretation (which is the absolutely first-ranked one, see above), the only serious questions seems to be if "it" means also Latvenergo, as an instrumentality of the Republic. If this question can be answered positively, then there seems to be no doubt that on "ordinary meaning" interpretation the respondent is responsible for any breach of an agreement concluded. To sum up: The state is according to the ordinary meaning of Art. 10 (1) responsible for the contracts it has entered to. It cannot revoke or breach them without engaging its international law responsibility under the Treaty.

57. It is useful to recall the status of traditional international law on breach of government contract with aliens. The formulations in Art. 10 (1) are based on, and possibly further develop these traditional principles. Sir Gerald Fitzmaurice, then the UK's leading international lawyer commented in 1961 on the earlier Ambatielos case:

> *"a state is only directly responsible, on the international plane, for acts involving breaches of contract where the breach is not a simple breach .. but involves an obviously arbitrary or tortuous element" and with respect to the earlier Norwegian loans case : "Lauterpacht would have considered that a failure by a government to honour a gold clause in a contract with a foreigner involved a sufficiently tortuous*

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contracts essentially covering the future stream of income from the operation of the contract ("reliance interest").

[48] *Sometimes this clause – found not only in the ECT, but in most modern BITs, is also called the "sanctity of contract" clause.*

element to bring the case within the above mentioned principle".[49]

The – authoritative – resolution of the UN General Assembly 1803 (XVII) provides that:

"Foreign investment agreements freely entered into by .. sovereign states shall be observed in good faith"

and the equally authoritative Restatement of the Foreign Relations Law of the US Section 712 (1986) provides:

"A state is responsible under international law for injury resulting from : 2) a repudiation or breach by the state of a contract with a national of another state where the repudiation or breach is discriminatory or motivated by other non-commercial considerations and compensatory damages are not paid".

The Commentary suggests that the contract has to be breached for governmental rather than commercial reasons, but not if it is based on a bona fide dispute about the obligation or if the non-performance is motivated by commercial considerations <u>and</u> the state is prepared to pay damages.

58. Stephen Schwebel, the former President of the International Court of Justice (and arbitrator in the CME-Czech R Stockholm case) on whose analysis I here rely concludes that:

" the breach of such a contract by a state in <u>ordinary</u> commercial intercourse is not, in the predominant view, a violation of international law, but the use of sovereignty authority of a state, contrary to the expectations of the parties, to abrogate or violate a contract with an alien is a violation in international law."[50]

In support of his position he also refers to the 1923 Shufeldt case where the arbitrator held that property rights were created by contract and expropriated by non-commercial use of sovereign authority, including US Iran claims tribunal cases (SECDO/NIOC). Schwebel distinguishes between purely commercial reasons and the implication of "governmental" reasons to determine when a breach of contract of an alien with government is a case of expropriation. The state has to "employ its legislative, administrative or executive authority as only a state can employ governmental authority to undo the fundamental expectations on the basis of which the parties characteristically contract" (at p. 413).

[49] *Gerald Fitzmaurice, Hersch Lauterpacht, XXXVII BYBKIL 1961, 64-65*
[50] *S. Schwebel, The Breach by a State of a contract, in Giuffre, Festschrift Ago, 1987, 409 et seq.*

59. The question then arises – and possibly relevant for the case at issue – if Art. 10 (1, last sentence) ECT (and the similar language in all recent US and other countries' BITs) merely affirms this traditional distinction between "purely" commercial contract disputes[51] or if the omission of an explicit reference to "commercial-only disputes" and the requirement of "governmental nature" of contract breaches e contrario means that the ECT has again, as in many other situations, taken an expansive approach in formulating otherwise traditional international law principles. The "ordinary meaning" interpretation suggests that the ECT has chosen not to affirm the "commercial-nature" exception, but rather imposed liability on governments even for contract breaches for commercial reasons – which actually would conform to the above-cited "Commentary" to the US Restatement where a commercial-only breach of contract requires compensation. Reading the "commercial exception" into Art. 10 (1) would require overriding the "ordinary meaning" with a pro-state, contra-investor approach that could only be justified if the result would be "manifestly absurd or unreasonable" (Art. 32, Vienna Convention). It seems very doubtful if the "ordinary meaning" solution – obliging the state to pay at least compensation for a "normal" breach of contract - is "manifestly absurd or unreasonable". While one could argue that commercial courts should normally deal with such matters, the underlying philosophy of the ECT is that in a dispute between the state and a foreign investor domestic courts are part of the state and that the Treaty therefore provides the only impartial dispute settlement forum available. My suggestion is not to take a position in this difference between the "ordinary meaning" of a modern, pro-investment treaty and traditional international law preceding the treaty, but rather to reconcile both positions by seeking a solution where a modern interpretation of the requirement of "governmental" dimension of the breach allows to bypass a clear-cut decision for or against the interpretative dispute. It is with this criterion in mind that I propose to examine the specific facts of the Windau-Latvenergo situation in light of the "sanctity of contract" clause of Art. 10 (1). If the Tribunal would consider the dispute at issue not as "purely commercial", but also coloured by governmental policy and authority, then the question of the ultimate scope of Art. 10 (1, last sentence) could be left open.

60. It seems accepted (and not seriously contested in the "Statement of Defense") that Latvenergo has breached the March 1997 agreement to pay for 8 years the double tariff. The power purchase agreement was not something that was freely negotiated between willing buyer and seller, but rather the opposite: Windau had no other choice but to sell to Latvenergo, the electricity monopsonist in Latvia. There was no privatised and competitive electricity market in Latvia. There was no room for the normal commercial "haggling" about price and conditions that takes place between participants in functioning energy markets. Latvenergo was compelled by the government's

[51] A position I have argued, without the benefit of deeper analysis, in my article in Journal of World Trade, 1995, supra – and on which the Statement of Defense seems to rely.

policy to encourage co-generation (itself a reflection of the international treaty commitments of Latvia (Art. 19 ECT; 1995 Europe Agreement; Energy Efficiency Protocol following on the 1991 European Energy Charter) to take the co-generated electricity (even if it had much cheaper "dirty" electricity available from Russia and the Ignalina nuclear plant in Lithuania and even if the import of such cheaper electricity was much more preferred by Latvenergo's financial controllers, but also through the manifold, personally profitable linkages between ex-Soviet power industry executives. The mandatory power purchase from environment-friendly co-generation plants was policy implementation by Latvenergo as the instrument of government energy policy and supply responsibility. Latvenergo undoubtedly would not have wanted to buy electricity at a higher price than it paid for cheap imports of "dirty electricity" if it could have made up its mind in a purely commercial setting.

61. Nor was the double-tariff something that both parties negotiated "at arms' length". If it had been a normal commercial setting, Latvenergo would not have wanted to purchase the electricity and certainly not at a higher price than it paid both to its established domestic generators and to usually even cheaper foreign suppliers. But Latvenergo was not acting as a commercially oriented company in a commercial, competitive and open energy market, but as – albeit always probably reluctant – tool of government policy. The purchase agreement refers with respect to the purchase tariff payable by Latvenergo to the 1995 Entrepreneurial Law. While the form of contract is used, the purpose, context and the crucial content of the contract does not reflect commercial purposes and free play of forces, but rather reflects overall Latvian government energy policy at the time. The substance, the underlying reasons, the purpose and the content of the agreement can therefore not be qualified as "fully" or even "mainly" commercial, but as predominantly, if not exclusively "governmental". It should be qualified as an "investment agreement" in the classical sense whereby the state and the investor agree on key terms which are essential for the investor to make its investment and where the state uses the foreign investor's technical, financial and managerial capabilities to pursue its public policies. In this case, the non-commercial and governmental character seems to be confirmed by three key indicators:

- "Ratione materiae": The fact that the purpose of the agreement was to develop co-generation as a non-commercial, but environment-friendly way of producing energy in accordance with the newly assumed government obligations under several international treaties;
- "Ratione personae": The fact that the contract was concluded by Latvenergo, a state-owned company, fulfilling an essential and strategic public service in Latvia, fully owned, tightly regulated and with an intertwining of links with government, parliament, regulatory agency and the political process in Latvia acting in a sphere where its character as monopoly and sole possible purchaser was at issue;

- "Ratione naturae": The fact that both the purchase obligation rested on Latvenergo's position as the state-owned monopoly utility implying a mandatory purchase obligation and that the price was not negotiated, but set by law.

62. The fact that the contract was not a normal commercial contract (the "Statement of Defense" describes the breach of contract as an ...*everyday commercial risk*" and "*commercially justifiable standpoint*" (4.1.4.13), but an "investment agreement" in the sense of traditional "state contracts" is further confirmed by the economic background: Investors were only interested in building co-generation plants if the "double tariff" was guaranteed. As the survey of co-generation support in Europe (above) indicates, co-generation cannot stand on its own, in particular in a country like Latvia where there is direct import competition with cheap "dirty" electricity. This applied to Windau as to the other co-generators (Liepajas Siltums; Gulbene). This fact was recognised in the applicable Entrepreneurial Law and its relevant articles (Exhibits C 9 and 16), with additional protection for foreign investors against subsequent change in the Foreign Investment Law. The reference to regulatory change (Clause VI) meant marginal changes in the standard tariff to be "doubled" for payment were allowed to change the base, before doubling, but not the principle that the co-generators should be paid the double of the normal tariff. Force majeure (Clause V) was relevant to impossibility of LE to take the produced electricity, but not to the double tariff: Inability to pay or unwillingness to pay cannot be justified by force majeure. The Karaha Bodas arbitral tribunal deciding on a long-term PPA obligation made impossible by presidential decree decided, in a similar way, that the force majeure principle cannot be invoked to justify breach of a PPA.[52]

63. That this understanding– the only economically sensible understanding – of the double tariff contract promise was shared by everybody can be inferred from the several statements by the Prime Minister (Exhibit C 44), the Council of Ministers and internal government communications – everybody assumed a double tariff was legally validly agreed. In the parallel case of Gulbene, LE contested before the Latvian courts the validity of a double-tariff clause in a legally weaker situation[53]. Nevertheless, the district court in Riga, the appeals court and the Latvian Supreme Court without dissent and doubts held that a double tariff was validly agreed for 8 years, because the "letter of intent" referred to the then effective Entrepreneurial Law with its determination of a double tariff for 8 years for co-generator plants. LE itself recognised the weakness of its legal position by withdrawing, subsequent to the Gulbene decisions, its attempt to use the Latvian judiciary to invalidate the double-tariff guarantee in its contract with Windau.

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[52] *Mealy's International Arbitration reports; on file with author and counsel*

[53]*Gulbene had a "letter of intent", but not an instrument entitled "contract". The Latvian courts decisions in the "Gulbene case" reinforce the impression that even in Latvia the double-tariff was not seen as a commercial-contractual matter, but as a matter of payment determined by law, with the contract merely used to regulate formal and technical details.*

64. The question therefore is if the contract – or better the overall relationship – between, on one hand, Windau/Nykomb, and, on the other Latvenergo/Government falls under the Art. 10 (1, last sentence) concept of "*any obligation entered into*". A strict application based on the "ordinary meaning" would have no problem whatsoever to subsume the contract with its double-tariff provision by reference to the Entrepreneurial Law as an "obligation entered into". If the more restrictive theory, based on pre-Treaty traditional international law were used, its "commercial nature" test would have to be applied. The "Statement of Defense" relies here on the example of a "French village buying heating oil from a Japanese seller" – an example I have formulated in an article in 1995[54] - to illustrate when a contract with a state instrumentality is "commercial" rather than "governmental". But this example also helps to distinguish the Windau-Latvenergo contract. In the Windau-Latvenergo contract, context, purpose, nature and tariff reference were all "governmental". The contract was a mandatory implementation of official government policy to comply with its international treaty commitment, made with an investor (in the conventional meaning of "foreign direct investor") by a public entity with a country-wide strategic role and mission. A French village, however, buying heating oil is neither a monopsonist (heating oil sellers can sell to many other prospective purchasers); there is a liberalised and competitive market. The prices will be freely negotiated depending on demand and supply. The supplier of heating oil to the French village is not implementing, by long-term commitment of capital, technology and management, any French overall energy policy. Apart from public procurement law aiming to obtain a competitive price under transparent conditions, there is no regulation involved and the price is not set up at an above-market level to encourage a particularly environment-friendly and energy-efficient energy production. The French-village example, aptly used in the Statement of Defense, is therefore very different. It is an everyday commercial transaction with no particular governmental character and colour apart from the fact that the village is a subnational authority. The Windau/Nykomb case, on the other hand, appears in my view to qualify as an eminently "governmental" relationship, with the instrument of contract law merely used to translate government policy into technical and detailed form.

65. The recent Azinian v. Mexico case (chaired by distinguished arbitrator Jan Paulsson)[55] may be of further assistance in clarifying when a contractual relationship is rather commercial or rather governmental. The award suggests that NAFTA Chapter XI does not protect purely commercial contract disputes where no governmental or regulatory authority is involved or denial of justice exists. One needs to bear in mind, however, that the NAFTA does not include a "sanctity of contract" provision such as Art. 10 (1, last sentence) ECT. The

[54] *Journal of World Trade, 1995*
[55] *www.naftaclaims.com*

Azinian case had therefore to be decided rather on grounds of “fair and equitable treatment” and expropriation. But the Azinian case is very different from the Windau-Latvenergo situation – and much more similar to the “French village buying heating oil” scenario evoked by the Statement of Defense. In essence, Azinian involved a contract to supply services for a municipal waste disposal dump by a US company with no established business record. The contract was terminated by the Mexican municipality because the US contractor was unable to supply the services promised, consisted largely of bankrupts, had no capital, could not perform and obtained the contract th rough deception. Mexican courts agreed with this termination because of non-compliance. The arbitral tribunal found no fault with the Mexican court decisions. It could not identify either unfair treatment of the foreign contractor nor expropriation. As there was no valid contract, the expropriation clause of NAFTA protecting valid contracts against governmental abrogation could not be invoked. The Azinian case had no element of a public, country -wide energy monopoly mandated to purchase energy-efficient energy at a price mandated by law in pursuit of national energy policies and international treaty commitments. The only governmental element present was that the contract was signed with a public entity. The complaint in Azinian was not over non-payment of a legislatively mandated higher-than-normal co-generation tariff, but simply over termination of contract for non-performance. The Azinian case in fact therefore helps to distinguish between purely commercial and mainly governmental contracts, but also between purely contractual reasons for termination (in Azinian: evidence of non-performance) and governmental reasons (in Windau-Nykomb: Change of public tariff regulation and unwillingness of Latvenergo to stick to the earlier, legislatively imposed tariff).

66. There has also been an argument that Art. 10 (1, last sentence) covers only “investment agreements” in the sense of the contracts between governments and foreign (direct) investors concluded in the past in mainly African and some Asian countries[56]. These agreements were usually used for defining a number of state-issued guarantees and incentives and details of, often, natural resources and energy exploration and development. Again, such a restrictive view is not contained in the text. One can argue that if the drafters of this clause had wanted to narrow down “obligations the state entered into” to the more narrow term of traditional government-foreign direct investor state agreements, they would, could and should have said so. Furthermore, to read a not existing limitation of Art. 10 (1, last sentence) to traditional African “state contracts” would change the

[56] Sometimes called “convention d’etablissement” or “state contract” or “economic development agreements”, F. A. Mann, State contrac ts and State responsibility, 54 AJIL 572 (1960). For a reference to this view: Passivirta, Energy Charter Treaty and Investment Contracts, in: T. Waelde, The Energy Charter Treaty, 1996l, p. 356 -360. Paasivirtta, however, identifies the fact that an investor (i.e. long-term investor) “relies” on the contract to make the investment as the distinguishing feature of “investment Agreements”. It should be noted that Dr Paasivirta was the first Legal Adviser of the Energy Charter Conference Secretariat.

geographical, political and legal setting of the ECT fundamental: The Treaty was not meant to apply in the special situation of mainly African developing countries, but to the core countries of Western and Eastern Europe. These countries are not developing countries, have never viewed themselves as developing countries and a possibly obsolete model of "concession" or "state contracts" much discussed in the 1950s-1980s can not have been in the mind of the Treaty drafters when developing an obligation for mainly East and West European countries (plus then US, Canada, Japan and Australia). The idea has always been (note the reference, supra, to a "high" quality of investment protection) that the ECT members, foremost the EU accession (now "candidate") countries such as Latvia, should be obliged to strive for a much higher standard of governance and investment protection than, say, underdeveloped countries in Africa. Otherwise, the explicit parallel relationship between EU and ECT accession would make no sense.

One needs also to bear in mind that the modern electricity investment approach – as it has developed over the last 15 years following opening-up of hitherto fully closed electricity markets[57] has as a rule not consisted of a typical traditional "state contract", but rather of a license (to produce electricity) for an "IPP" ("independent power producer") linked to the essential long-term "PPA" ("power purchase agreement"), usually at a fixed-price sufficient to recover the plant investment, meet return requirements and repay debt, with the – usually – still state-owned power transmission and distribution monopoly. This is exactly what happened between Windau and Latvenergo – though on a lesser level of legal sophistication than in the much larger IPP projects in Asia and Latin America. To sum up: It is not compatible with the "ordinary meaning", "object and context" of Art. 10 (1, last sentence) to read into this "sanctity of contract" provision a limitation to traditional, now rarely used "state contracts" ("investment concession contracts", "economic development agreements") as used in the past, but rarely any longer, in mainly African underdeveloped countries. On the other hand, the legal package (electricity production license plus long-term PPA) constitutes the modern form of an electricity investment contract-plus-license package. If one would read Art. 10 (1) in a limitative sense, the arrangement present here would be covered. In fact it is most likely that this type of arrangement was the one the drafters had in mind, or would have had in mind had they contemplated the regulatory risk of electricity investment[58] in a transition economy with a low governance and rule of law ranking such as Latvia. If one defines an "investment agreement" as a contract, or contractual package/arrangement on which an investor relies, with a "justifiable expectation" in order to make on the basis of such contract a long-

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[57] *M. Kantor, 2001, supra*

[58] *This is explained in my study for the World Bank, published as: International Treaties and Regulatory Risk in Infrastructure Investment, 34 JWT 1-61 (2000); also: www.worldbank.org/riskconference and: Theodore Moran, Political and regulatory risk in infrastructure, Report for World Bank Infrastructure investment risk conference, Rome 1999;*

term investment[59] confiding in the willingness and ability of the government to stick to the contract, then the license-cum-PPA arrangement made here between Windau and Latvenergo is an "investment agreement", and arguably at the very core of what the "sanctity of contract" clause was intended to protect. Art. 2 of the Energy Charter Treaty with its emphasis on "long-term cooperation in the energy field" tends to reinforce the view, that the more long-term an investment, the more there is justification to protect the contracts at the base of such long-term investment as strictly as possible. Windau/Nykomb's investment in the co-generation plant is a long-term investment. This is also reflected in the 8-years duration of the "double-tariff agreement" – as made mandatory by the 1995 Entrepreneurial law, but also reflecting the financial requirements of debt amortisation and investment recovery and at that time standard Latvenergo practice (as practised also with the Gulbene and Liepajas Siltums co-generation arrangements).

67. Such investment promotion operated by the combination of Art. 10 (1, last sentence – sanctity of contract) ECT in combination with the double tariff contract Windau-Latvenergo is further enhanced by the Investment Law's guarantee that rights once granted would be respected and not taken away.

> *"In the event that future laws of the Republic of Latvia worsen the investment conditions, a foreign investment shall be subject to the laws which were in effect <u>on the date the investment was made".</u>*(Art. 8 (4) of 1991 Latvian Foreign Investment Law.

68. With the protection of Art. 10 (1, last sentence) covering the double-tariff contract Windau/Latvenergo against non-compliance by the state and a deterioration of the investment conditions specified in the contract (payment of the 0.75 rather than the double tariff), no further protection is necessary. But Art. 8 (4) of the Latvian Foreign Investment Law re-affirms and reinforces this protection. It adds to the legitimate expectations of the foreign investor created by the double-tariff agreement. Art. 8 (4) of the Foreign Investment Law is usually characterised as a "stabilisation clause". One can view this Art. 8 (4) – the stabilisation clause – as a reinforcement of the contractual promise in the double tariff contract, or as a separate offer by the Latvian state not to let the legal investment conditions during the making of the contract deteriorate. In this case, Art. 8 (4) would create a second agreement between the foreign investor and the Latvian state which is super-imposed on the original double-tariff contract with Latvenergo. It is by now accepted in arbitral jurisprudence that a state can bind itself by a stabilisation promise made not only specifically in a written contract, but also by a promise made in legislation and then accepted and acted upon by the

[59] *So Paasivirta, op. cit. supra, p. 363, 364*

investor making its investment in confidence on the added stability promised in the law. This is confirmed in the lead “Pyramids” case[60]

69. Latvenergo was in this situation the government’s instrument to use double-tariff promises to encourage private, including foreign, investments. The take-or-pay power purchase agreement (PPA) is the standard instrument in international practice to make a foreign investment economically viable. Without such take-or-pay, fixed-tariff PPAs no private and foreign investor will obtain financing in high-risk situations where one government monopoly dominates the whole sector – in particular if much cheaper energy can be imported from abroad. In a free and competitive energy market, LE would have been restructured and privatised and the government would have had to either subsidise the co-generation projects directly or impose, by regulation, the obligation on existing power suppliers to purchase a certain amount at a specified price from private co-generators. As the Latvian market was and remains state-controlled and not competitive and liberalised, the only available and most frequently used method to encourage co-generation, in particular in the light of “energy dumping” from abroad, is to compel the state enterprise to engage into a fixed-tariff, long-term PPA. The contract between Windau and LE is therefore in substance an investment agreement. It regulates, together with the license, the essential authorisation for investment and provides the essential condition – the fixed-price long-term PPA. It is therefore not comparable with the purchase of heating oil by a French village which the “Statement of Defense” uses as the example of a commercial contract that would not be covered by Art. 10 (1). The “French village” analogy of a commercial contract might be workable if:

- Windau would sell energy to a private company or even a state-owned company in a competitive and fully liberalised market;
- There were no issues of governmental determination of prices, of use of special public pricing rules to encourage investment in environmental-friendly co-generation at stake;
- Latvenergo was not the comprehensive, state-owned, controlled and instrumentalised entity with monopoly purchasing and selling power, but one of many actors in a competitive and open market;
- The government had not been involved in its legislative (double-tariff Entrepreneurial law), regulatory (the various regulations on price), policy-setting (policy to encourage co-generation) and policy implementation roles (as indicated by the records of various decisions by the Prime Minister or Council of Ministers on the double tariff issue). It is hard to envisage the French president conducting meetings with investors and the French cabinet of ministers to discuss contractual problems of “supplying heating oil to a French village”. The governmental

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[60] *Southern Pacific Properties v. Arab Republic of Egypt, Decision on Jurisdiction: 16 YBCom.Arb. 16 , 32(1991) (government’s offer of arbitration agreement was contained in legislation and then accepted by investor by making the investment.*

character of state actions is therefore also indicated by the involvement of a state's most senior government officers[61].

70. The contract – and it needs to be seen together with the relevant laws making specific promises to foreign investors (double tariff; no subsequent regulatory change), the license and the various promises made in meetings (e.g. with Prime Minister, Exhibit C 35 in November 1999) – is therefore far from being a "normal commercial contract", but rather a hybrid element where legislative, regulatory, policy, governmental, licensing, contractual matters are combined, with the use of the contractual instrument constituting an expression of government policy and law, but also a specific instrument to facilitate the financing and investment process. It is therefore rather the equivalent of the traditional form of "state contracts", though in the more modern form now used frequently to encourage energy investment by long-term, fixed-price PPAs with government involvement or guarantee. In no way did Art. 10 (1) ECT envisage, for the East European transition countries, something similar to the investment agreements or "conventions d'etablissement" which were concluded in the past by mainly Francophone African countries for oil, gas, mining and timber exploitation. The ECT did not want to protect only a specific form of agreement, but agreements which in substance and purpose were concluded "under the colour of governmental authority" to promote investment. The reference to the obligation of Latvia, as signatory to both the ECH of 1991 and the 1994 ECT to promote private investment in a transparent way and a high level of protection in co-generation (supra) only reinforces the view of the Windau-Latvenergo contract as not a merely commercial contract, but a contract to encourage environment-friendly energy investment in an otherwise commercially not viable form. It is this form of contract – easily entered into, leading the investor to investment of risk capital and thus being exposed to political and regulatory risk – which Art. 10 (1) ECT had in mind. Such contracts have everywhere in developing and transition countries come under attack as private investors have tried to obtain – promised – tariffs at a level suitable for recovery of investment and return and then confronted political, often xenophobically motivated, domestic opposition[62]. The purpose of the ECT – promotion of investment at a high level of protection in areas such as– specifically named – co-generation – is best served by not allowing all-powerful, monopolistic state companies, closely intertwined formally and informally with the political, regulatory and governmental process – to escape lightly from their obligations.

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[61] This is also the view of the International Law Commission where the Commentary (To Art. 5, infra quoted in full) makes reference to the way government functions are seen in the historical, political and cultural context of a country. The double-tariff agreement with Windau-Nykomb was seen in Latvia as a matter for the highest level of government – but supplying heating oil to villages in Provence would not be seen as a matter even for quite low levels of departemental officials.

[62] As occurred with PPAs and similar utility concessions in Argentina, India, Pakistan, Indonesia and Thailand: M. Kantor, 2001, supra.

71. Another solution would also do injustice to standard interpretation rules: Art. 10 (1) does not exclude "commercial" contracts from Treaty protection. It includes according to its "ordinary meaning" all "obligations entered into with an investment of an investor". Any interpretation which limits the explicitly very wide literal scope of this particularly significant discipline needs to be particularly strongly justified. There is no substantiated justification to exclude investment-related, legislation-based energy efficiency incentive contracts with the all powerful government-owned and tightly controlled energy monopoly. The case referred to of the "French village buying heating oil" may be a case that should not be covered by the treaty – but it is not comparable to the Windau-LE cogeneration investment agreement. The "Statement of Defense" (4.1.4.10) therefore possibly correctly suggests that "governmental" as compared to "mere commercial" breaches are covered by Art. 10 (1). It suggests also possibly correctly (4.1.4.11) that "*investment agreements of a certain magnitude*" – as contrasted with "purely commercial contracts" fall under Art. 10 (1). It is therefore up to the tribunal to determine if the Windau/Nykomb double-tariff agreement with Latvenergo – concluded in pursuit of governmental international treaty commitments and national energy policies, against the commercial judgement and self-interest of Latvenergo, regulated by law and with the crucial price clause regulated by the 1995 Entrepreneurial Law and "stabilised" by Art. 8 (4) of the 1991 Latvian Foreign Investment law - can qualify as "purely" commercial and the breach as a "mere" commercial breach without any governmental implications.

72. Attribution of Latvenergo conduct in breach of part III ECT obligations to the Republic of Latvia: Is the Government of Latvia Directly Responsible for Actions of Latvenergo?

The respondent can be responsible directly for conduct by the government, but also by attribution, under international law and/or specific ECT rules, for the conduct of the state enterprise Latvenergo. The following parts of the opinion examine the issue of attribution of Latvenergo conduct to the Republic. This analysis is applicable to all of the alleged breaches of part III ECT where the conduct of Latvenergo constitutes the basis for the alleged breach. The first key issue was if the breach of the double tariff contract is a breach of "obligation" covered by Art. 10 (1, last sentence) or if this was in the words of the "Statement of Defense" only an "everyday commercial risk" excluded from the scope of Art. 10 (1, last sentence). The second key issue is if the conduct of Latvenergo can be attributed to the government. Under general international law, the government is strictly liable for the conduct of all state organs and instrumentalities, while it has only a "due diligence" obligation for the conduct of private actors not attributed to the state. The question is if the conduct of a state enterprise such as Latvenergo can in the circumstances of this case be attributed to the state. My opinion will now examine this second issue.

73. The question can be discussed at any length and detail, in volving both the role of state enterprises in engaging state responsibility under general international law and the specific implications of Art. 22 (1, 3 and 4) of the ECT. Without wishing to bypass at least a summary of such an examination, I suggest that ultimately the response depends on the qualification of the relevant conduct and of Latvenergo as <u>"merely" commercial</u> or as "at least to a significant extent motivated and coloured by the purposes, policies, context and nature of governmental action. As we shall see, both general international law, relevant BIT practice and Art. 22 (1) will attribute state enterprise conduct under at least to some extent the "flag" of government to the state, while possibly avoiding such attribution if the state enterprises acts in form, character, purpose and influence exclusively as a private commercial player, acting exclusively for commercial reasons in an exclusively commercial context of at-arm's-length business transactions. This view seems to be also shared by the Respondent (4.1.4.11 to 4.1.4.13), to quote:

> *"the nature of the breach committed by the state enterprise must not only be tied to misconduct of a commercial nature, but must also contain <u>elements of abuse of the special position as a state enterprise, be it market power, a monopoly position or special rights.</u> This interpretation is consistent with the Draft Articles (sc. Of the International Law Commission on State Responsibility) which require the exercise of governmental power to attach state responsibility."*

The Statement of Defense suggests as well that the Respondent should be not responsible for the actions of Latvenergo "merely" because the latter is a state enterprise.

74. I suggest that the Tribunal should employ the test if Latvenergo was "merely", i.e. exclusively acting as a private commercial operator in a competitive market, or if there were at least some relevant elements of governmental policy, of abuse of its special position, monopoly position or special rights (4.1.4.11 of Statement of Defense). Latvenergo's position is not only a de-facto monopoly, but a monopoly for energy transmission and distribution conferred and affirmed by law, regulated by governmental regulatory agencies, supervised by the Ministry of Economy and the Parliament, in a field that in Latvia has always been regarded as a state prerogative.

75. The Commentary to Art. 5 of the International Law Commission's Draft on State Responsibility suggests as conceptual framework for conducting that examination:

> *"If it is to be regarded as an act of the State for purposes of international responsibility, the conduct of an entity must accordingly concern governmental activity and not other*

private or commercial activity in which the entity may engage.

And:

what is regarded as governmental, <u>depends on the particular society, its history and traditions</u>. Of particular importance will be not just the content of the powers, but the way they are conferred on an entity, <u>the purposes</u> for which they are to be exercised and the extent to which the entity is <u>accountable to government</u> for their exercise. These are essentially questions of the application of a general standard to varied circumstances."

76. As is uncontested, Latvenergo is a state-owned and controlled entity that exercised an effective and legally confirmed monopoly in the Latvian energy industry. Latvenergo does not operate freely in a de-regulated, liberalised and competitive market on purely commercial considerations. It is heavily regulated, though it is recognised that the energy regulatory agency operating before 2002 was not truly independent, but much influenced by both Latvenergo and the government apparatus. Latvenergo was never autonomous in the sense of a company that was operating freely in a competitive market, with state ownership being merely incidental and of no relevant influence on the nature and effect of its actions. It is uncontested that it has a countrywide monopoly, but also a monopoly of buying and selling electricity abroad. The role of Latvenergo not as a commercial company operating at arm's length from the government, but as a governmental entity closely integrated into the governmental system has been recognised by the Decision of the Council of Ministers in 2003 which formalised the role of Latvenergo as an organ of the government, excepting only autonomy for day-to-day management and separate book-keeping[63]. No supplier of energy can do business if LE is not willing to purchase – and this is why LE is by the past and current energy law obligated to purchase, i.e. not exercise its purely commercial judgements, but act under regulated powers. The application of the Art. 10 (1 last sentence) principle of "sanctity of contract" to state entities running the strategic sector of the economy is, as the Statement of Defense correctly observes, closely related to public rules to check the abuse of monopoly power under, for example, Art. 82 (ex-Art.86 of the EU Treaty[64]. There is no need for regulatory control of commercially

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[63] Reported in the official newsletter of the East European energy regulators: <u>www.erratnet.org'news/spring2003.htm</u> consulted on 29/5/03

[64] A state-owned entity can not be absolved from breaches of competition law – abuse of dominant position in the market – under Art. 86 (ex-90). To the contrary, such state-owned companies have been seen by the European Court of Justice to operate under rigorous rules of competition law from which they can only be exempted in narrowly interpreted cases when an "essential public service" requires necessarily, and within the boundaries of proportionality and least-restrictiveness, such an exemption to ensure the essential public service can be provided, ECJ Decision of 23. 10. 1997 (EC v France et.al.,

acting companies acting within a liberalised and competitive market. But the energy market in Latvia is neither commercial, nor liberalised nor competitive. A dominant enterprise abuses its monopoly if it without good reasons refuses to buy from buyers which are dependent on it and if it out of a position of dominance refuses to honour contracts it was earlier compelled to conclude for public policy reasons.

77. These criteria correctly highlighted in the Statement of Defense help to identify Latvenergo's conduct not as "normal commercial conduct" – i.e. for reasons of commercial convenience not to honour agreements made earlier - but as an act motivated by political, governmental and/or regulatory reasons (the growing resentment in Latvia and specially in Latvenergo against more expensive payment for environment-friendly co-generation, in particularly if no domestic powerbrokers are involved any longer) and by abuse of absolutely dominant political and market power. The uncontested facts of the "interim agreement" help to distinguish between commercial convenience and the exercise of dominant, state-controlled power: If Latvenergo had been acting in a purely commercial sense in a commercial electricity market, its refusal to respect the double-tariff contract would have been of relatively minor significance. Windau/Nykomb could have then sought a different customer, sold at market prices and try to obtain the co-generation incentive by litigation. But the fact that Windau was compelled to accept in the interim even a 0.75 tariff reflects the fact that there was and still is no commercial electricity market in Latvia and Windau had at least for interim purposes and to enable production to start accept what Latvenergo offered.

78. Latvenergo's conduct is not that of a private company in an open, commercially motivated market, but that of a quasi-socialist bureaucratic empire, closely intertwined with domestic politics and deeply suspicious against foreign investors. The fact that it has no autonomy is also confirmed by the February 2003 Cabinet of Ministers' decisions which confirm the position of Latvenergo as a closely integrated organ of the state and instrument of its energy policies. Latvenergo uses its leverage against much smaller foreign entrepreneurs perhaps naïve enough to have trusted in its earlier contract, government and legislative assurance and the environmental and energy benefits of its investment – as compared to benefiting from imported energy dumped onto the Latvian markets by environmentally unsafe nuclear companies in Russia and Lithuania. The non-compliance of the contract by Latvenergo does not only have some "elements of abuse" as required in the Statement of Defense for the applicability of Art. 10 (1), but seems wholly motivated by an abuse of its dominant, state-supported market power in a non-competitive energy market in Latvia. The "Statement of Defense" (4.1.4.13) suggests that Art. 10 (1) does not

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Lecheler/Gundel, Die Rolle von Art. 90 II and II EGV in einem liberalisierten Energiemarkt, EugH Entscheidung v 23.10.97 92, Recht der Energie, 1998, p. 92 cover the "everyday commercial risk", while it concedes that it does cover the "<u>special risk when dealing with state enterprises</u>". Observing the tension between the state and LE when the double tariff was introduced and grudgingly included in the – several – LE co-generation support agreements and the later move of both LE and after a while also the government in the contrary direction – of rather buying cheap dumped energy from abroad than continuing to support environment-friendly co-generation in Latvia, it appears obvious that this is not an "everyday commercial risk", but a "special risk of dealing with state enterprises". An "everyday commercial risk" assumes that Windau as co-generator had a choice to sell to other companies and that co-generation would not be in need for a special subsidy in view of the by now enthusiastically embraced energy dumping from Russia. The special risk of dealing with state enterprises emphasised in the "Statement of Defense" is best illustrated in this case where a co-generation investor was induced by public policy, by concertation and in consultation with the highest levels of government, by legislative promises and implementing contracts, to invest and then sees his investment undermined by a shift in public policy preferences.

79. The "Statement of Defense" places its emphasis not on the breach of the agreement – which seems hardest to deny, but rather on an attempt to qualify the contract and its breach as "commercial" and thereby insulate the government of Latvia for such conduct by its energy enterprise. It attempts to use the alleged "commercial nature" both to exclude it from the scope of Art. 10 (1) and, simultaneously, argue against responsibility of Latvia for actions by Latvenergo. The issue can be looked at from the angle of customary international law relating to state enterprises and Art. 22 of the Treaty.

80. The arrangement between the government and Windau, by the governmental energy production license, by law (Entrepreneurial Law) and by contract with LE, was meant to promote and enable an investment for co-generation that would have been not viable on purely commercial terms – there was no way to compete with cheap nuclear energy dumped by Russian importers in collaboration, allegedly at times collusion, with Latvenergo. The agreement with the dominant state-owned, state-controlled and state-intertwined energy monopoly inherited and continuing attitudes of the Socialist economy was primarily a governmental investment arrangement. The lack of exclusive commerciality therefore prevents an insulation of the government from actions of Latvenergo.

81. This result is confirmed by a reasoning based on the authoritative draft articles 4, 5, 8 and 11 by the International Law Commission (Exhibit 39) on state responsibility. The criteria referred to – an "organ includes any person or entity which has that status in accordance with internal law of the state" (Art. 4 (2) – allows attribution of conduct of LE directly to the state. LE is an organ of the state; its status as energy monopoly and comprehensive energy

entity responsible for the public service of energy supply, under the public control by special regulatory authorities, in state ownership and in an organisational system where state control dominates indicates its role as organ of the state. Even if it were not a formal "organ" of the state, Art. 5 would attribute co nduct to the state as LE is by its law and organisational set-up empowered with the public service function, but not as one company among many other energy suppliers in a competitive and liberalised energy industry as now prevailing throughout Europe, but as the one and only state-licensed, regulated, -owned and –controlled monopoly. It is not the form – e.g. incorporated company – chosen, but the function and reality of the organisation and conduct of Latvenergo which determines if it should be seen as an "organ" of the state or as a "normal commercial" company operating exclusively under commercial perspectives, but which happens to be owned by the state. This is confirmed by unanimous recent arbitral practice[65].

82. Art. 8 of the ILC draft confirms this. Ins tructions, control or direction of or by the state are here additional criteria for attributing conduct to the state. The view that state enterprises should be seen as organs of the state if acting beyond a purely commercial function and not as "normal" private companies has been accepted by most authoritative writers[66]. The distinction between "iure imperii" (i.e. attribution to the state) and purely "iure gestionis" (i.e. purely commercial nature not attributable to the state) has been used to similar e ffect in cases of granting sovereign immunity (for acts iure imperii). The attribution of state enterprise conduct to the state has been particularly frequent in situations of the former socialist economies where largely a unity of command, control and interest between the state as such and its state enterprises, even if engaged in commercial conduct abroad, was assumed. The unity between the state and its enterprises has also been recognised in several cases where enterprises claimed – without success – force majeure because of a state-issued regulation or the state, or the state enterprise, claimed immunity for debt of the respective other.[67] These criteria are explicitly recognised in the "Statement of Defense" (Art. 4.1.4.6 and 4.1.4.8).

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[65] *Maffezini on jurisdiction; Tradex Hellas v. Albania (jurisdictional award) and Salini v Morocco (final award), www.worldbank.org/icsid*

[66] *FK.H. Boeckstiegel, Der Staat als Vertragspartner auslaendischer Privatunternehmen, Athenaeum, 1971 p. 58 to 75. ; an English updated version has been published in 1984. authorities cited in Waelde/Wouters, State responsibility in a liberalised world economy: state, privileged and subnational authorities under the 1994 Energy Charter Treaty, in: Neth.Yearbook of International Law Vol 27, 1996, at p. 143, 154-156.*

[67] *See survey by Mann, Further Studies in International Law, 1990, 199-216; ; B. Smith, State Reseponsibility and the Marine Environment 1988; Boeckstiegel, 50-75 referring to two relevant cases: The Anglo-Iranian Oil company case of 1952 where the fact that the company assumed a strategic role in domestic energy supply was enough to attribute its conduct to the state (and provide it with sovereign immunity) and the Caboletn v. NIOC case, (cited t p. 67) where "control" by the state, "parliamentary control" and the "promotion of the primordial economic and social interests of the state of Iran in the oil industry" were criteria to attribute the NIOC conduct to the state.*

83. The perhaps still most detailed examination of these issues is Prof Boeckstiegel's work of 1971[68]. The author has since become one of the leading international arbitrators, in particular in investment matters[69]. He identifies several criteria which, each, lead to attribution of state enterprise conduct to the state:

- If the agreement with the state enterprise creates a legitimate expectation with the foreign contractor that the state is involved: The numerous interventions and assurances by the Latvian state at the highest level (Prime Minister, Cabinet of Ministers), but also the double-tariff foundation in the "Entrepreneurial Law" suggest that Windau/Nykomb had a legitimate impression and expectation that the double-tariff promise was not only a matter for Latvenergo, but for the Latvian state.
- If the conduct at issue – the double-tariff power purchase agreement – reflected not a commercial interest of the state company, but rather the pursuit and compliance with international treaty obligations of the state as such. This was certainly the case as the Latvian state sought with its double-tariff policy to comply with its obligations under Art. 19 ECT, the Energy Efficiency Protocol and the Europe Agreement.
- If the conduct at issue reflected rather "governmental conduct" than mere commercial considerations. The double-tariff PPA had no underlying commercial reason, but exclusively a governmental policy as foundation. Even the breach reflected that the government had effectively given up – due to lack of political strength – the promotion of co-generation and domestic security of supply and had, with Latvenergo, changed towards the much cheaper and institutionally and often personally more profitable policy of importing cheap "dirty" nuclear and other power from in particular Russia.
- If the state enterprise at issue represents not an autonomous commercial operator, but rather fulfils essential public functions. Latvenergo as public energy monopoly continued the functions of the former Soviet-times and Soviet-style electricity ministry rather than a private commercial company.

The result – attribution of Latvenergo conduct to the government as a state organ acting not "merely" under commercial colour, but rather with a governmental character, can also be achieved by a proper determination of the rules on burden of proof. In the past, the issue of a state enterprise being either a purely commercial company, with government ownership being only incidental, or rather an organ of the state, acting integrated into the state machinery of the state, has been mainly discussed in the context of claims for sovereign immunity and of disregard for excuses based on

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[68] *Boeckstiegel, Der Staats als Vertragspartner auslaendischer Unternehmen, 1971, here pp. 58-75.*
[69] *Most prominently, as President of the London Court of International Arbitration and the US-Iran Claims Tribunal.*

"force majeure" based on government regulation claimed by a state company[70]. If a state enterprise was seen to be "exterior" to the state, than force majeure claims might have been validated and sovereign immunity claims disallowed. But it seems from all pertinent cases, that the starting point for tribunals was to assume "interiority", i.e. integration into the state machinery due to the ownership by the state. Ownership itself suggests a prima facie proof of control, of lack of sufficient autonomy and of action rather under governmental colour than under purely commercial colour. It is then up to the state enterprise – here the state – to provide the counter-proof that the enterprise at stake (i.e. Latvenergo) is "exterior" to the government and other state organs[71]. The fact that Latvenergo is an exclusive domestic and energy import-export monopoly, tightly regulated, confirmed as having no serious decision-making powers apart from day-to-day management and separate book-keeping by the February 2003 Decision of the Cabinet of Ministers, that it was used in the past for implementing government policy (e.g. the double-tariff incentive to encourage co-generation investment – among many other policies) all suggest that the government will have a very difficult burden, if not an impossible burden, to prove that Latvenergo is in reality like a private company, operating under primarily commercial conditions in a primarily commercial market, with state ownership being merely an insignificant incidental attribute of a company that otherwise is, is seen and acts like a "normal" private company. Several cases– in the context of attributing liability for state enterprise debt to the state or state debt to the state enterprises – have thus considered that complete ownership, control and supervision required a "piercing of the corporate veil". [72] To quote F.A. Mann, one of the most prominent authorities in the field:

> *"We should not pretend that a state corporation whether we call it an "emanation" or an "instrumentality" or an "alter ego" has any degree of independence, except, possibly, in matters of mere routine or that the state has no other function or influence than as a majority shareholder".*[73]

And Jan Paulsson, in a review of Prof Boeckstiegel's "Arbitration and State Enterprises (1984):

> *"This legal separation is not absolutely immune and that the corporate veil may be lifted if functional considerations make*

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[70] See: Boeckstiegel, 1973, 50-68; F.A. Mann, Further Studies in International Law, Clarendon Press, Oxvford 1990,

[71] F.A. Mann, 1990, supra, speaks here of a "rebuttable presumption" in favour of identifying the state enterprise with the state, with reference to Boeckstiegel, 1973, 55-75.;

[72] F.A. Mann, 1990, 204 – Algerian state bank; 209 – Cuban state bank, 215 – Cuban sugar selling company, and 211 – identification of a state entity incorporated under private law, but in effect subordinated to the Spanish Ministry of Agriculture as "organs" of the state.

[73] F.A. Mann, 1990, 216 with reference to command-control economies such as Socialist states.

that necessary to avoid discrimination, manipulation or privileges in international trade".[74]

These results are confirmed by a comparison with the most relevant recent arbitral awards: In the jurisdiction decision in Maffezini v. Spain [75], the tribunal affirmed that a majority state-owned company was for purposes of attribution to the state an organ of the state. It relied on a "structural" test – mainly majority (not 100% as in Latvenergo) ownership and government control, combined with a "functional test " – mainly the primacy of a public service function. It developed the rule that ownership by the state, directly or indirectly, gives rise "to a rebuttable presumption that it is a state entity" (para 77). The functional test would distinguish between activities that were "essentially commercial rather than governmental in nature"[76] while indications for the execution of governmental functions will indicate attributability to the state (para 85)[77].

In the recent Salini v. Morocco case[78], the tribunal applied the same structural and functional tests as the Maffezini tribunal. It considered that private-law incorporation of the state public service company ADM did not prevent attribution. It relied here on, first, the public ownership and control, and , second, on the nature of the activities of ADM (public transport) and the non-commercial nature of the market ("la nature administrative du marche", para 34) to attribute ADM conduct to the state. Based on an examination of all circumstances, it concluded that ADM was an organ of the state. The commentary to the decision[79] notes the significance of the award in recognizing that governmental measures engage state responsibility, provided the governmental measure have a discriminatory character, make contract execution more onerous or are equivalent to expropriation.

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[74] *In: Arbitration International, Vol. 1 (1985)*

[75] *Decision on Jurisdiction, 25 January 2000, www.worldbank.org/icsid; at paras. 71-89*

[76] *With reference here to CO Banka v Slovak Republic, ICSID Case Arb. 97/4, Decision on Objections to Jurisdiction of May 24, 1999; ICSID Review 14, 1999 at p. 250*

[77] *In the subsequent decision on the merits the tribunal considered "SODIGA", a majority state-owned, but private-law incorporated, company an organ of the state, though involved at the time in transition from a governmental to a commercial company:*

> *"Financial companies such as SODIGA could not at the period relevant to the present to be held to fall "entirely" outside the overall scheme of public administration."*
> *And*
> *"The structural test, however, is but one element to be taken into account. Other elements to which international law looks are, in particular, the control of the company by the State or State entities and the objectives and functions for which the company was created".*

The tribunal in the end decided against state liability, but only because it did not view the provision of information by SODIGA as an essentially governmental function and because the damages suffered by Maffezini were essentially commercial misjudgement on his behalf which had nothing to do with the involvement of the state economic development agency.

[78] *supra, at paras 32-35*

[79] *Clunet/ Journal du Droit International, 2002, p. 214*

84. All tests to distinguish the non-attributable private, commercial conduct of an autonomous, business-like but accidentally state-owned company from the politically controlled, public service delivering and public-policy implementing attributable conduct point under the uncontested facts of the case towards attribution.

85. Once "mere" commerciality is denied, and the arrangement between Windau with the government of Latvia (including the contract with LE) are viewed as a promotional agreement to encourage and facilitate investment in the otherwise commercially unviable environment-friendly cogeneration, everything falls into place: The government seeks to comply with its international obligations (Art. 19 ECT; Energy Efficiency Protocol; Europe Agreement) to promote co-generation through the use of Latvenergo as the most convenient instrument; the alternative of providing direct co-generation investment support is not yet practical in Latvia as this form is characteristic for a competitive and liberalised market with privatised energy distribution and transmission companies (and Latvia does not have such funds available). To ensure Latvenergo must pay the double tariff it enacts the double-tariff promise in the "Entrepreneurial Law". LE executes government policy, on the general and specific instruction of the government; it exercises governmental authority and acts essentially as a (though internally unwilling) tool of official government policy. That it is owned, controlled, regulated and tightly intertwined with the political process and government is just an additional reinforcing factor. It is hard to envisage a situation in a post-socialist transition economy with continuing existence of a comprehensive, all-pervasive, not yet privatised energy monopoly inherited from socialism operating in not competitive markets where a state enterprise acts for purely commercial reasons – as the "Statement of Defense" requires in order to reject state responsibility. One can theoretically envisage cases in market economies where enterprises "happen to be owned by the state", but operate free from political, governmental and regulatory intervention and direction in a fully competitive energy market and with the state purely exercising the very limited role of a owner-shareholder watching over the economic return from its portfolio investment. This is indeed the model of the 1996 EU Electricity Directive and the context and purpose of Art. 86 (2) of the EU treaty. But LE is surely not a case of such purely commercial, autonomously operating company free from any special responsiveness to government and politics. It is precisely the type of entity the ECT needs to discipline in order to pursue its objectives – market economy, liberalisation and – as the Statement of Defense puts it so aptly, absence of "abuse of special position as state enterprise, be it market power, a monopoly position or special rights.

86. In conclusion, LE is part of the state; by concluding an agreement linked (as "Statement of Defense" highlights it correctly) to both an individual license and the general co-generation promoting Entrepreneurial Law of 1995, Windau concluded a contract of a highly governmental nature and implications with the state of Latvia.

Similarly, the breach of this commitment had nothing to do with "normal" commercial reasons, but with the change of energy policy – from domestic co-generation support to import of cheap "dirty" energy – and the political reluctance of the government to hold Latvenergo to its earlier commitments. There would be no further need to look in the ECT for additional reasons for attributing LE conduct to the republic. But Art 22 (1) ECT provides a further reinforcing clarification, in line with the tendency of modern BITs to deal with the issue of "out-contracted" government power to semi-autonomous state entities. I will examine Art. 22 (1) and its attribution of state enterprise conduct to the state in the following.

87. "Additional" or "Special" Attribution of Latvenergo conduct to the State under Art. 22 (1) ECT ?

> *"Each Contracting party shall ensure that any state enterprise which it maintains or establishes shall conduct its activities in relation to the sale or provision of goods and services in its area in a manner consistent with the Contracting Party's obligations under part III of this Treaty."*

As in many if not most articles of the Treaty, this clause has to be seen before traditional international law which the Treaty throughout seeks to confirm where advantageous for the investor, clarify where the drafters saw ambiguities in traditional international law and sometimes, cautiously, to develop further where such a development was considered to give greater effectiveness to investor protection. But in all cases, the Treaty sought to rather improve and expand than to restrict traditional international law principles in terms of investor protection.

There are two significant features[80] arising out of the "ordinary language" of this clause:

First, "shall ensure" denotes "strict liability", not just "due diligence". It means, in dictionary terms "guarantee"[81]. It means the state is fully liable, without excuse as if the conduct were directly its own. This can be inferred from the normal meaning of the words used ("shall" means in treaty language a hard-law obligation as contrasted to the "soft-law" term "Should"; "ensure" means to guarantee a certain conduct, not just to make "best efforts" to obtain a certain action or result). The strict liability meaning emerges also out of the distinction between the justiciable part III obligations – where "ensure", i.e. strict liability, is used, and the obligations under other parts of the article, where the words "shall (not) encourage or require" are used (Art. 22 (2). Art. 22 therefore distinguishes very

[80] The clause, as the qualification "in relation to sale or provision of goods and services in its area" are very similar on Art. XVII GATT. The qualification means that the state enterprise must take the role of either a seller or a purchaser of goods and services", i.e. participate in markets.
[81] See Rodale, Synonym Finder, also "secure, attain, lock in, bring about, , assure, dismiss all doubts, warrant, underwrite".

clearly and explicitly between the "hard" obligations (in part III) and other obligations (outside part III of the Treaty) where the obligation is of a lower intensity and rather a "soft-law" obligation. This distinctive use of "hard law " ("shall ensure") and soft-law ("shall not encourage") terminology corresponds precisely with the justiciability of obligations under Art. 26 (investment arbitration). What is justiciable under part III is characterised by "hard-law" language, what is not is characterised by "soft-law" language. The distinction makes clear sense and the difference is manifestly intentional and carefully chosen.

Secondly, obligations that are primarily based on the "investment disciplines" in part III are justiciable by Art. 26 arbitration, obligations that are primarily based on articles outside part III (e.g. Art. 7, transit; Art. 6, Art. 5, competition; Art. 5, Trade-related investment measures; Art 8, transfer of technology; Art. 9, access to capital) are not justiciable under Art. 26. Sometimes they can be arbitrated under Art. 27 (inter-state arbitration) or they are not enforceable at all by arbitration, but merely by consultation, discussion or other low-level, soft-law dispute measures provided in the specific articles (e.g. interim tariff fixing under Art. 7 (7) [82].

88. The text's reference to "strict liability" (by use of the words "shall ensure") and to the – under Art. 26 justiciable – obligations under part III of the Treaty – suggests that Art. 22 (1) does not set up a new, primary obligation of the state relating to conduct by its state enterprises, but is an attribution rule. It intends to "clarify" and "confirm" what is already implicit in general principles of state responsibility: That if the state is responsible for conduct of its state enterprises and other autonomous and subnational enterprises and if the disciplines, as enumerated in part III of the Treaty, are justiciable under Art. 26, then it flows naturally from this premise that the state has "strict liability" (and not as with respect to entities which do not form part of the state only a "due diligence" obligation). To "ensure" or "guarantee" means that there is a primary obligation for which the state is responsible through the attribution rule of Art. 22 (1).

89. The parallel reference to "part III" in Art. 22 (1) and Art. 26 (1) makes clear that the obligations referred to in Art. 22 (1) are the same obligations as referred to in Art. 26 (1). It also makes clear that Art. 22 (1) does not set up a new, primary, obligation, but merely clarifies and confirms the attribution of responsibility of the state for conduct breaching part III obligations by all of its organs, entities and enterprises. If it were otherwise, the careful distinctions ("Shall not encourage or require" in Art. 22 (2) for all "non-part III"

[82] *They are sometimes justiciable under Art. 27 – inter-state arbitration, sometimes there is a specific dispute settlement method, usually of much "softer character" (e.g. Art. 7) and sometimes they are specifically excluded from formal dispute procedures. For the overall context: T. Waelde, Investment Arbitration under the ECT, Arbitration International, 1996*

obligations versus the "part III" obligations in Art. 22 (1) would make no sense.

90. Does this interpretative conclusion have to change because Art. 23 (2) refers to the applicability of "dispute settlement provisions in parts II, IV and V of this treaty" in "respect of measures affecting the observance of the treaty.. which have been taken by regional or local governments or authorities within the area of a Contracting Party"? Does this mean the Treaty drafters wanted only to attribute "regional and local government conduct" to the state, but not state-enterprise (Art. 22 (1)) and not "governmental authority" (Art. 22 (3))? - If this were the purpose of Art. 23 (2), the drafters could, and should have included a clause which stated clearly that Art. 26 does not cover conduct by state companies (and governmental authorities under Art. 23 (3), but only of regional and local governments under Art. 23. This was done, for example, in Art. 6 (7) (competition law), Art 7 (7) (special transit dispute procedure), Art. 1 (5,b) (special tax disputes procedure), Art. 26 (3, b) and Art. 26 (3c) (limitation of Art. 26 arbitration for Annex ID and IA countries). But the drafters have not included an explicit and clear exclusion of Art. 26 arbitration for conduct of state enterprises, to the contrary, they have carefully aligned the reference to part III obligations in Art. 22 (1) and Art. 26 (1).

91. The reference in Art. 23 (2) can be explained differently. First, it does not relate only to investment arbitration in part V of the treaty (which covers both Art. 26 investor-state and Art. 27 state-state arbitration), but all specialised dispute provisions, including those which were carved out of Art. 26. Second, it is clearly linked to Art. 26 (8) which provides that in the case of conduct by subnational governments the state may choose to pay monetary compensation rather than restitution. Behind these complicated mechanisms – subjection of subnational government conduct to investment arbitration, but with a monetary compensation option only, lies a compromise for a difficult problem for the US and even more so Canada[83]. Both countries are federal countries. They have had throughout great difficulties to get political and legal acceptance for applying international economic treaties to their federal states and provinces. Considerable problems arose in the context of GATT/WTO ratification, but also of NAFTA ratification[84]. The compromise reached here was to clarify (what has been heavily disputed inside both countries) that the ECT duties are applicable to subnational government conduct (achieved by Art. 23 (2), but to let the governments keep the options of rather paying cash than having to

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[83] *The US and Canada, one should bear in mind, participated in the negotiations, the US as the probably most influential participant. The investment regime of the ECT is largely a copy of the modern US BIT (e.g. 1995 Latvia-US BIT).*

[84] *Ernst-Ulrich Petersmann, The GATT/WTO Dispute Settlement System, International Law, International Organisations and Dispute Settlement, Kluwer Law International, London 1997; Kenneth J. Cooper, "To Compel or Encourage: Seeking Compliance with International Trade Agreements at the State Level 2 Minn.J.Global Trade 143 (1993 .*

compel its states and provinces to conform to an arbitral ruling (achieved by Art. 26 (8). This special accommodation of US/Canadian problems with respect to dispute settlement for conduct of subnational governments is further illustrated by "Annex P" – special subnational dispute procedure of the Treaty. Art. 23 (2) therefore tries to settle a specific US/Canadian problem, but cannot be used as "special law" to draw conclusions on the attribution of state-owned and controlled enterprise conduct to the state. With Art. 23 (2) and Art. 26 (8), the negotiators sought to formulate a general solution for federal states and provinces which was legally and politically feasible, they had, though, no desire to create an arbitration exception for state enterprises as compared to subnational governments. It is also likely that the formulation in Art. 23 (2) was prompted by the additional intention to ensure that disputes about the trade rules of the ECT – located in part VI of the ECT (and intentionally excluded from Art. 23 (2) – would be exclusively under the Treaty's dispute provisions for trade rules and not be subject to Art. 23 or Art. 26 and 27.

92. One needs to bear in mind that the ECT has been negotiated and finalised in haste (supra). It is often difficult to find a clear answer from very detailed and complex language. The history of the treaty is largely not available. I have tried to examine the background of Art. 22 in consultation with treaty negotiators. The – limited - result is that a main negotiator – with weak recollection - thought that it was natural that conduct of state enterprises was covered by investment arbitration. There was a debate about providing an arbitration right of investors directly against state enterprises (which would have made practical sense[85]), but this (US-proposed) idea, opposed by Hungary, was in the end not accepted. Delegates – if they thought at all about the issue – seem to have been satisfied with the solution of arbitrable state responsibility for state enterprise conduct – rather than a directly effective obligation of state enterprises, made justiciable via Art. 26. The US-proposed solution appeared too radical. There was also a concern to ensure that the investment arbitration provision of Art. 26 in connection with Art. 22 (1) would not be relied upon to use investment arbitration for trade dispute (for which the ECT provides a distinct solution). This, possibly, explains why both Art. 22 (1) and Art. 26 (1) contain the identical reference to part III (the investment disciplines). If this consideration about the drafting history is correct, it would reinforce the view that for the Treaty drafters it was evident that – for part III disciplines - Art. 22 (1), Art. 22 (3) and (4) entities – were covered by investment arbitration as normal "emanations" of the state.

93. The conclusion is therefore that the Treaty does not materially modify established principles of state responsibility for state enterprises, but merely clarifies and confirms that a state can not escape from liability if it delegates the problematic conduct to a

[85] *I have advocated de lege ferenda such a solution, Netherlands YbkIntl Law 1996, but it can not be read into the ECT as it stands.*

semi-autonomous entity it controls and owns. The Treaty's solution supports a more extensive view of state responsibility for state enterprises rather than a more restrictive view – as is consistent with the overall approach of the Treaty. The principal obligation is contained in part III. Art. 22 (1) makes explicit reference to this– limitative – list of disciplines. Art. 22 is merely a clarificatory attribution provision.

94. Does this result change because Art. 26 (1) provides for investor-state arbitration only for disputes:

> *"which concern an alleged breach of an obligation of the former under part III"?*

The Respondent argues that the reference in Art. 26 (1) only to "obligations ..under part III" would exclude state responsibility for state enterprises under Art. 22 (1); this clause is located in part IV, not V of the treaty. But if one understands Art. 22 (1) not as a "primary obligation", but only as a secondary, derivative "attribution norm", its location in part IV of the treaty is of no importance for Art. 26 investor-state arbitration. The obligation here at issue is not in Art. 22 (1), but in Art. 10 (1, last sentence), i.e. in part III. The text in its "ordinary meaning" already suggests that Art. 22 (1) is not a primary obligation, but rather a secondary rule for attributing state responsibility: "Ensure" meaning "guarantee" pre-supposes the existence of the primary obligation – it is another, primary obligation the fulfilment of which is guaranteed. Art. 22 (1) also refers back to the "obligations under part III" of the Treaty. Given the not fully settled status of the international law on state responsibility for state-enterprises (with commercial action possibly excluded, but action of more governmental nature included), Art. 22 (1) follows, as the Treaty does throughout, the method of re-formulating traditional and general international law, but often clarifying ambiguous issues in favour of the investor. All arguments therefore advocate a view of Art. 22 (1) as an attribution norm. The primary obligation – e.g. Art. 10 (1, last sentence), but also all other relevant investment disciplines – is located in part III. Art. 22 in part IV merely provides clarificatory and interpretative help.

95. This role and function can also be inferred from the context and architecture of the Treaty and in particular part IV of the Treaty. If, as the respondent alleges, anything in part IV were excluded from consideration in investment arbitration, then several key and strategic explicit policy intentions of the drafters of the Treaty would not work. Art. 18 – in part IV – is recognised to be a key device of the Treaty for limiting some of the investment disciplines in part III by highlighting sovereignty. The same function is fulfilled by Art. 19 emphasising the relevance of environmental obligations. Art. 21 – Taxation – contains a most elaborate and complex system by partly excluding and partly limiting both in substance and procedure the application of Art. 26 investment arbitration for tax disputes; it clearly restricts the scope for several part III investment disciplines

(in particular expropriation and national treatment). If placement in part IV would make a rule inapplicable for investment arbitration, Art. 21 would lose its explicit purpose. Similarly, Art. 24 contains many limitations on the application of part III investment disciplines[86]. These articles are meant to be read together with the investment disciplines of part III: they interpret, confirm, clarify, modify and restrict both scope and content and procedures of arbitral enforcement. The only sensible interpretation which provides internal consistency of Treaty interpretation and proper effect to the provisions in part IV is to see part IV as a collection of "miscellaneous" provisions (in earlier drafts this part had the title: "Context") which do not set new, primary and original obligations up on its own, but which help to interpret, limit or expand the meaning and scope of the "primary" obligations included in part III[87]. The Statement of Defense's argument would mean that provisions in the Treaty outside part III could not be taken into account in Art. 26 investment arbitration. Not only would this make most of the clarifications and modifications in part IV meaningless (and they are clearly meant to in particular limit or clarify primary obligations), but also the definitional section such as in part I. Art. 24 (2)(b) refers back to part III and establishes the function of Art. 24 (in part IV, as Art. 22) to limit and condition the part III investment disciplines. It thereby confirms the close connection between the primary obligations in part III and the limitative or clarificatory conditions in part IV. Any other interpretation would render the part IV provisions meaningless. This would defeat the principle of treaty interpretation that treaty provisions should be given a meaningful "effet utile".

96. This interpretive result is also confirmed by an analysis of the overall purposes of the Treaty and its – interpretation-guiding – predecessor European Energy Charter. The Treaty's investment disciplines are designed for legally binding effect at a "high level" of investment protection. In case of doubt and ambiguity, these purposes mandate the selection of the interpretative solution which is most suitable to give maximum effect to these objectives (Art. 31 (1) of the Vienna Convention). If governments, in particular in transition countries (the main scenario the ECT has in mind) let their still very much socialist state enterprises and similar entities carry out the "dirty business" of discrimination, breach of commitments and undermining of proprietary rights to accommodate political pressure for patronage, xenophobia and protectionism, then the treaty's objectives of introducing market economy principles of good governance would not be respected. The ECT negotiators were very much aware of the dominant role played by some all-powerful state enterprises in the energy sector, with a dominant position over pipelines, transmission grids and other essential facilities. This awareness explains that Art.

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[86] *Art. 24 – exceptions – contains a long list of exceptions to the part III investment disciplines concerning energy security, human, animal or plant life or health, public order etc.*

[87] *I have reached the same result in an article written in 1995 – with less in-depth analysis and without the challenge of a particular case: Waelde/Wouters, Netherlands Ybk Intl Law 1996.*

22 was negotiated explicitly, rather than leaving the matter to traditional principles of attribution of state responsibility. There was no support for a position that countries should be able to delegate "dirty business" to such state enterprises without having to answer for their behaviour via Art. 26 investment arbitration.

97. The more we still have features of the old command-control socialist economy surviving, the more it is important under the Treaty to catch misconduct where it occurs, and not only at the "clean-hands" level of central government only. A comparison with the rules of the NAFTA investment chapter – which is the basis for much of ECT language and concepts – confirms this reading. Art. 1503 with Art. 1116 allows arbitration over breaches of the investment duties by state enterprises. This is as in the ECT a logical consequence of the concept of state responsibility that it required an explicit exemption for Mexican state enterprises (Annex 1120.1)[88] A comparison of the (not arbitrable) NAFTA Art. 1502 and Art. 22 (1) with its direct reference to part III obligations suggests the ECT drafters were creating a broader scope of coverage than the NAFTA. This is consistent with the general aim of the ECT to provide not a "normal" level, but a "high" level of investment protection for the mainly East European transition economies.

98. <u>Attribution of Latvenergo Conduct to the State by way of Art. 22 (3)?</u>

> "*Each Contracting Party shall ensure that if it establishes or maintains an entity and entrusts the entity with regulatory, administrative or other governmental authority, such entity shall exercise that authority in a manner consistent with the Contracting Party's obligations under the Treaty".*

Art. 22 (3) should be seen as the parallel obligation to Art. 22 (1). If Art. 22 (1) covers state enterprises engaged in buying and selling, Art. 22 (3) covers such entities which exercise elements of governmental authority. The legal implication of Art. 22 (3) is strict liability (e.g. full attribution) of such conduct to the state. Art. 22 (3) does not only mention the key investment disciplines of part III, but refers to all "obligations under the Treaty". It is hard to make sense out of this distinction, except that the arbitrable disciplines of part III may have been more prominently in the mind of the Treaty drafters for state enterprises than for the other "governmental entities". As the state is already under international law responsible for the entities named in Art. 22 (3), it should perhaps be seen as nothing

[88] But the wording of the exemption confirms that the NAFTA treaty parties, as the ECT parties, assumed automatically that a state is responsible for conduct by its enterprises as the Annex says: "an investor of another party may not allege that Mexico has breached an obligation under (i) section A or Article 1503 (2) – state enterprises. Mexico is here clearly seen as one statal unity comprising as well its state enterprises. A similar precedent effect can be developed out of the comparable interpretation of Argentine bilateral investment treaties – e. g. in the LANCO case – where the Argentine state was held responsible, without the same clear rule as in Art. 22 (1) ECT, for conduct by its state port company, at: 42 International Legal Materials 1135-1163 (2002)

more than an affirmation of traditional principles of state responsibility, clarified for less initiated users of the ECT: That the state is responsible not only for the central government, but also for autonomous energy regulatory agencies (as are now almost universally present in Europe's energy markets). But the attribution rule is the same as in Art. 22 (1): The state is fully and strictly responsible, and if an autonomous regulatory agency breaches a part III obligation, the investor can arbitrate such a breach under Art. 26.

Does, however, Art. 22 (3) cover Latvenergo? There have been energy regulatory agencies for Latvia, in charge mainly for setting tariffs to final consumers, in existence since the mid- or late 1990s. All one needs to find, however, is that Latvenergo exercises – and in particular in the relation to Windau-Nykomb – some element of "governmental" authority. Art. 22 (3) would then be an attribution rule that can operate separately and additionally to the attribution rule in Art. 22 (1). Considering the uncontested fact that Latvenergo was the instrument of government – rather than acting out of its own commercial interest and strategy – in encouraging co-generation through the double-tariff arrangement and that the ups and downs of the double tariff reflected government policy rather than commercial judgement, then its action vis-à-vis Windau-Nykomb must be seen as characterised rather by "governmental" than "commercial" nature and function. Art. 22 (3) would therefore operate as an additional attribution rule. The result – that attribution can be inferred both from Art. 22 (1) and Art. 22 (3) is not surprising. Both, in my view, formulate the ECT's understanding of applicable international rules on attribution of semi-autonomous state entity conduct to the state. A state-controlled entity which acts with some governmental authority and purpose is therefore likely to be caught by the same rules, irrespective if formulated rather with a state-owned company or a state-controlled semi-autonomous "entity" in mind.

99. <u>Attribution of Latvenergo Conduct to the State by way of Art. 23 (4)?</u>

> "*No contracting party shall encourage or require any entity to which it grants exclusive or special privileges to conduct its activities in its area in a manner inconsistent with the Contracting Party's obligations under this Treaty".*

Art. 23 (4) sets up state responsibility – with a prohibition to "encourage or require" – for enterprises which may be private, but have been granted "exclusive or special privileges". This term has been used in the GATT, but in particular in the EU Electricity Directive and jurisprudence with respect to Art. 86 (ex-90) EU Treaty. Latvenergo has been granted the exclusive privilege of being the only supplier of electricity in Latvia. It is companies with such a government-granted exclusive position that Art. 23 (4) targets. If the government provides such exclusive privileges, it shall at least not facilitate discriminatory and other conduct contravening the part III obligations. It is a factual assessment if Latvia at least "encouraged" Latvenergo to breach the double-tariff agreement, discriminate against Windau as compared to Gulbene and others and breached the “fair and equitable” treatment obligations. Since the Republic owns and controls Latvenergo, it is possible to infer from Latvenergo’s conduct that the state, as its owner and controlling influence, at least “encouraged” such behaviour incompatible with the part III obligations. The proper approach is to read Art. 23 (4) as setting up a rebuttable presumption that the owner and controlling influence over an entity with “special and exclusive privileges” at least “encourages” – if not “requires” – the entity in question towards the questionable conduct at issue. The Republic would have to prove conclusively that it was not involved, directly or indirectly, in Latvenergo’s conduct towards Windau-Nykomb. In view of the publicised, politicised and well known problem between Windau-Nykomb and Latvenergo about the double tariff, the frequent intervention of the Prime Minister and the Cabinet of Ministers, such a proof of complete ignorance and abstention on the side of the Republic is very difficult to demonstrate.

As a result, it would be possible as well to obtain the attribution of Latvenergo conduct to the Republic under Art. 23 (4). Since Latvenergo, however, is more than an entity with “special and exclusive privileges”, but an entity that is for structural and functional reasons in its conduct towards Windau-Nykomb an instrumentality of the state, the stricter attributio n rule of Art. 23 (1) may be easier to work with than the somewhat less strict (“not encourage” rather than “shall ensure) attribution rule of Art. 23 (4). Art. 23 (4), though, does not include the reference of Art. 23 (1) to “sale or provision of goods and services”.

100. Attribution of Latvenergo Conduct to the State by way of Most-Favoured Clause

Finally, there is another method by which Nykomb can claim state responsibility of Latvia for the conduct of Latvenergo. Under Art. 10 (3) and (7) of the ECT, Nykomb is entitled to most-favoured treatment, i.e.:

> *(3):”treatment means treatment accorded by a contracting party which is no less favourable than that which it accords to .. investors of any other contracting party or any third state whichever is the most favourable”*
> *and*
>
> *(7)Each contracting party shall accord to investments … treatment no less favourable than that which it accords to .. the investors of any other contracting party or any third state .. whichever is the most favourable”.*

By way of Art. 2 (2,b) of the 1995 Latvia-US bilateral investment treaty (BIT), Latvia has agreed that :

> *"Each party shall ensure that any state enterprise that it maintains.. acts in a manner that is not inconsistent with the party's obligations under this treaty wherever such enterprise exercises any regulatory, administrative or other governmental authority that the party has delegated to it".*

This means that if this clause is seen as better to ECT investors than the treatment in the ECT, ECT investors can invoke the clarified specific state responsibility under the US -Latvia BIT, in particular since this BIT is almost identical to the ECT's investment regime. There is no doubt that the Art. 2 (2,b) US-Latvia BIT obligation is fully justiciable under this Treaty's investment arbitration provision equivalent to Art. 26 ECT. In the recent Maffezini-case [89], an ICSID tribunal relying on the US -Spain BIT applied, by operation of the most-favoured nation clause, more favourable arbitration procedures and rules, than were contained in the US -Spain BIT. The MFN clause in the ECT applies to the US -Latvia BIT as it is an "eiusdem generis" (same type) treaty comparable to the ECT. I therefore consider that there is no reason why in this case the tribunal cannot also rely on the US-Latvia BIT and apply it in the context of an ECT arbitration if this BIT provides in any distinct issue a better treatment. From the uncontested facts available, it appears that Latvenergo has not acted in exclusively commercial capacity ("iuris gestionis"), but largely or overwhelmingly as an instrumentality of government implementing government regulation and policies and international treaty commitments ("iure imperii"). The conditions for unconditional and under the arbitration method justiciable state liability for the conduct of its state enterprise under the US -Latvia BIT exist. In consequence, if they are seen to offer the investor a better treatment than the one in the ECT (which in my understanding they don't), Nykomb can as well rely on the inclusion of state enterprise in state responsibility via the US-Latvia BIT imported by Art. 10 (3) and (7) most-favoured nation clause.

101. <u>Is Latvia directly Responsible for "Obligations entered into" by the government itself?</u>

Latvia's responsibility under the Treaty can not only be engaged by the conduct of subsidiary state organs (such as Latvenergo), but also of the government itself. Art. 10 (1) does not require a formal "contract", but refers only to "obligations entered into". This formulation, based on the recent US BIT model agreement (also in the US-Latvia BIT of 1995) suggests that any agreement – i.e. a meeting of the minds with the sense of creating legal obligations relating to an investment – suffices. In the Pyramids-case[90] an ICSID tribunal found an agreement in official declarations by the government (contained in investment legislation, but also investment brochures and related instruments) provided the investor relied

[89] *www.worldbank.org/icsid; Maffezini v. Kingdom of Spain (Case ARB/97/7*

[90] *Pyramids Case, Decision (in excerpts) published in 16 YBCom.Arb. 16 , 32(1991)*

upon and accepted by the investor in making its investment. This is also the doctrinal understanding of investor-state arbitration under Art. 26 ECT (and similar BITs) – that the government makes an offer in the treaty; with the investor's acceptance (which can be implicit), an arbitral agreement ensues.

The government of Latvia has made public is willingness to encourage investment in co-generation and pay for 8 years the double tariff in the 1995 Entrepreneurial Law. Nykomb-Windau relied on it in making its plant investment. Furthermore, Nykomb received in several cases assurances from the highest level of government (including in the meeting with the then Prime Minister, Exhibit C 35) that it would be granted the double-tariff. The double tariff was always seen in the intensive debate about it in Latvia not as a commercial matter, but as a matter of national energy security, energy-efficiency and environment-friendly energy policy. The close intertwining of both Latvenergo actions and government actions therefore suggests that not only was there a formal contract Windau-Latvenergo incorporating the double-tariff in implementation of government policy, but also that the government of Latvia as such was part of the arrangement. The meeting of the Cabinet of Ministers (Exhibit C 35) indicates that the prevailing view was that there was a policy-based arrangement between, on one hand, the government and Latvenergo and, on the other, Windau-Nykomb, for using the double tariff to encourage an otherwise not commercially viable environment- and energy-security-wise, investment for public policy purposes. The government position was informed by the fact that promotion of co-generation was a sensible energy-efficiency policy, furthermore it was obliged under its relevant international obligations (ECT; Energy Efficiency Protocol; Europe Agreement) to promote co-generation, and preferably through private investment. If it then dealt sometimes through Latvenergo, and sometimes directly with the investor, then one can infer from such conduct that there was a uniform action by the various organs of the state involved in setting and implementing energy policy to make private investors such as Windau-Nykomb invest. An agreement does therefore not only exist strictly on the level Windau-Latvenergo, but also of Windau-Nykomb with the Republic directly. If the arrangement had been exclusively and purely an occasional sales contract – such as the "heating oil supply to a French village" as developed in the Statement of Defence – then there would not have been a reason for the highest level of government to be involved in arranging and supporting the double-tariff investment incentive.

To conclude:

Based on the available and uncontested facts, it appears that there was an "investment agreement" between, on one hand, Windau/Nykomb, and, on the other hand, both Latvenergo and the government itself, to encourage Windau/Nykomb to invest in an energy-efficient co-generation plant. This arrangement was reinforced by the energy production license, by the "double tariff for

8 years" tariff clause incorporating or referring to the "Entrepreneurial Law" and by repeated assurances by the highest level of government, including the Prime Minister after a Cabinet of Ministers view, that this agreement was valid and would be honoured. The breach of the investment agreement – both by Latvenergo and directly by the government – constitutes a breach of Art 10 (1, last sentence) of the ECT. As to Latvenergo's conduct, it is directly attributable to the government in particular as Latvenergo did not contract with Windau/Nykomb in form and substance in an exclusively commercial light, character and context, but rather in implementation of formal government policy.

102. Is there a case of Discrimination against Nykomb as a Foreign Investor?

Art. 10 (3) and (7) – plus the obligation to avoid "unreasonable or discriminatory measures" impairing the management and enjoyment of investments in Art. 10 (1) – prohibit discrimination between foreign and domestic investors. The prohibition on discrimination is used in Art. 10 (1):

> *"no contracting party shall in any way impair by unreasonable or discriminatory measures their management, maintenance, use, enjoyment or disposal".*
>
> *In Art. 10 (3):*
>
> *"For the purposes of this Article, "Treatment" means treatment by a contracting party which is no less favourable than which it accords to its own investors.."*
>
> *and in Art. 10 (7):*
>
> *"Each contracting party shall accord to investments in its area of investors of other contracting parties, and their related activities including management, maintenance, use, enjoyment or disposal, treatment no less favourable than that which it accords to investments of its own investors..".*

While it is not clear why this – single – standard (also called "national treatment") is repeated three times in Art. 10, it is probably the most sensible approach to consider Art. 10 to include, even if repeated in a more expansive and emphatic form, one single standard of non-discrimination of national treatment. The standard is probably borrowed from both WTO law (Art. III) where it applies to discrimination between imported products, but also from several OECD instruments on "national treatment". It is considered the cornerstone of modern international abd EU economic law. The political sponsors of the Treaty[91] saw this as the key principle – as it is seen for the overall architecture of international economic law: GATT, NAFTA and bilateral investment treaties. The Energy Charter Treaty – as Art. 1102 of the NAFTA – apply this standard to investments rather than only trade. It has become for arbitral tribunals dealing with NAFTA Chapter XI disputes the perhaps most significant standard as it appears easier to prove and adjudicate, also with judicious management of the burden of proof, than some of the other more complex standards. The non-discrimination standard aims to create a "level playing field" between foreign and national companies, an essential pre-condition of a liberalised market economy. It also aims at compensating for the natural favour of government for its domestic constituencies, including national competitors of foreign investors and the equally natural tendency in most or all countries to consider the foreign investor with a negative eye, exploit disputes with foreign investors politically and apply protectionist policies, often against official statements on investment promotion.

103. The national treatment/ non-discrimination test has been developed in recent arbitral cases under the NAFTA where it is now considered the touchstone of NAFTA arbitration[92]. The most relevant recent arbitral cases are Myers v. Canada; also Pope-Talbot v. Canada; and most recently in Feldman v. Mexico), as well as in several recent WTO cases (notably the Asbestos decision by the WTO Appellate Body)[93] and similar cases of the European Court of Justice [94].

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[91] Foreword of the ECT father, Ruud Lubbers, in: T. Waelde, The Energy Charter Treaty, 1996, op. cit. supra

[92] Todd Weiler, paper on file with author, 2003: 2002 In Review: From Expropriation to Non-Discrimination: "This approach has been so universally adopted because it provides a familiar touchstone for Tribunal members and counsel, who can have recourse to a wealth of applicable WTO jurisprudence on non-discrimination, as compared to the relative dearth of modern (and relevant) jurisprudence available for the interpretation of Articles 1105 and 1110".

[93] 1. Canada - Administration of the Foreign Investment Review Act (L/5504, 7 Feb. 1984)
2. EEC - Measures on Animal Feed Proteins, adopted on 14 March 1978, BISD 25S/49 (also interpreted Art. III:43. Canada - Import, Distribution and Sale of Certain Alcoholic Drinks by Provincial Marketing Agencies (DS/R, 18 Feb 1992)
4. Italian Discrimination against Imported Agricultural Machinery, report of the panel (L/833 BISD 7S/60) adopted on 23 October 1958 (also interpreted Art. III:4, but again likeness was not a problem.)
5. United States - Measures affecting Alcoholic and Malt Beverages, adopted on 19 June 1992, BISD 39S/206-299,
6. US - Section 337 of the Tariff Act of 1930, adopted on 7 November 1989, BISD 36S/345-402 (a ruling has been made on the basis of Art. III:4, but apparently no problem regarding likeness).
7. Canada - Certain Measures concerning Periodicals, Report of the Appellate Body, WT/DS31/AB/R, 30 June 1997
8. Canada - Certain Measures Affecting the Automotive Industry, (WT/DS139) adopted 19 June 2000
9. European Communities - Measures Affecting Asbestos and Asbestos-Containing Products, Report of the Appellate Body, WT/DS135/AB/R, 12 March 2001
10. Korea - Measures Affecting Imports of Fresh, Chilled and Frozen Beef, Report of the Appellate Body, WT/DS161/AB/R, WT7DS169/AB/R, 11 December 2000 (also Art. III:4)
11. United States - Standards for Reformulated and Conventional Gasoline, Appellate Body

104. The standard approach to identify discrimination is to follow the following procedure:

1. Identification of relevant subjects for comparison: To determine whether the investment of the investor in the foreign territory is in "like circumstances" or "like situations" with the domestic investment that is allegedly receiving the more favourable treatment.[95] The question is if the two activities – one owned

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Report and Panel Report, adopted on 20 May 1996, WT/DS2/9

GATT and WTO Cases where Article III has been discussed, but largely limited to the tax context of paragraph 2

12. Chile - Taxes on Alcoholic Beverages, Report of the Appellate Body, WT/DS87/AB/R, WT/DS110/AB/R
13. Japan - Taxes on Alcoholic Beverages, Report of the Appellate Body, adopted on 1 November 1996, WT/DS8/AB/R, WT/DS10/AB/R, WT/DS11/AB/R
14. Korea - Taxes on Alcoholic Beverages, Panel Report, WT/DS75/R, WT/DS84/R, 17 September 1998; Report of the Appellate Body, WT/DS75/AB/R, WT/DS84/AB/R, 18 January 1999
15. US - Taxes on Automobiles, Panel Report of 11 October 1994, DS31/R, (unadopted)
16. US - Taxes on Petroleum and Certain Imported Substances, BISD 34S/136, 154, 1987

[94] *Case 8/74 Procureur du Roi v. Dassonville [1974] ECR 837*
Case 120/78 Rewe Zentrale AG v. Bundesmonopolverwaltung fuer Branntwein (Cassis de Dijon) [1979] ECR 649
Case C-267,268/91 Criminal proceedings agains Keck and Mithouard [1993] ECR I-6097
Case C-237/94 O'Flynn v. Adjudication Officer [1996] ECR I-2617
Case C-415/93 Union Royale Belge des Societes de Football Association ASBL v. Jean Mark Bosman [1995] ECRI-4921 (services)
C-470/93 Verein gegen Unwesen im Handel und Gewerbe v. Mars [1995] ECR I-1923
Case C-368/95 Vereinigte Familiapress v. Heinrich Bauer Verlag [1997] ECR I-3689
Case C 412/93 Societe d'Importation Edouard Leclerc-Siplec v. TFI Publicite SA and M6 Publicite [1995]ECR I-179
Case C-405/98 Konsumentombudsmannen v Gourment International Products AB (GIP) [2001]ECR I-1795
Case C-384/93 Alpine INvestments v. Minister van Financien [1995] ECR I-1141 (services)
Case C-189/95 Criminal Proceedings against FRanzen [1997] ECR I 5909
Case C-254/98 Schutzverband gegen unlauteren Wettbewerb v. Tk Heimdienst Sass GmbH [2000] ECR I-151
Case C-39/90 Denkaviut Futtermittel v. Land Baden Wuertemberg [1991] ECR I-3069
Case C-67/97 Criminal Proceedings against Bluhme (Danish beekeeping case) [1998] ECR I-8033
C-184/96 Commission v. France (Foie Gras)[1998] ECR I-6197
Case C-67/97 Criminal Proceedings against Bluhme (Danish beekeeping case) [1998] ECR I-8033
Case C-9/99 Echirolles Distribution SA v. Association du Dauphine and others [2000] ECR I 8207
Case C-379/98 PreussenElektra v. Schleswag AG [2001] ECR I 2099

[95] *NAFTA Article 1102 uses "like circumstances", while virtually all BITs use "like situations". All NAFTA Investor-State Tribunal awards interpreting the meaning of "like circumstances" have agreed that in determining "likeness" of investments, there is a two step test. First, are the two investments operating in the same "business or economic sector"? (S.D. Myers and Canada, NAFTA/UNCITRAL Arbitration, Partial Award, November 13, 2000 at para. 250; Pope & Talbot and Canada, NAFTA/UNCITRAL Arbitration, Award on the Merits Phase 2, at para. 78; Marvin Feldman and Mexico, ICSID/NAFTA Arbitration, at para.172). If so, then the second step is to inquire whether there any reasonable public*

by a foreign investor, the other one by a domestic commercial operator, are sufficiently “like”. Physical characteristics, their role in the market place, mutual substitutability and the perceptions of the consumer are the main categories to define “likeness”. While the “likeness” has led to intensive controversy and debate in many WTO and NAFTA cases (e.g. Methanex v. US), this problem does not arise in the Nykomb-Latvenergo situation. Windau, Gulbene and Liepajas Siltums produce with electricity a product that is not only “like”, but identical. Even if environmental factors of production are taken into account, the products are “like”, if not identical.

2. Consideration of the relative treatment received by each compared activity: If the two investments are found to be “like” then the question becomes whether or not the impugned treatment being complained of is either *de jure* or *de facto* “less favourable”. This means that the domestic operator must be treated distinctly, and more favourably than the foreign investor. There may be minor distinctions on which so far no information has been made available by the Respondent. But it is manifest that the payment – a 0.75 tariff paid to the foreign investor Windau-Nykomb compared to the 2x (double) tariff paid to the at least two domestic investors – is fundamentally different. Such fundamental difference relates to most significant aspect of the investment, the sales tariff. The distinction heavily favours the Latvian competitors/compared operators to the detriment of Windau/Nykomb. The initial comparison is made between the claimant, and/or its investment, and any domestic investors/investments operating in the same business or economic sector. A government cannot find an excuse by pointing to some domestic investors which are discriminated against, while other domestic investors are favoured. It is the best level of treatment made available to ***any*** other domestic investor/investment operating in like circumstances which is employed for the comparison[96]. In the Feldman v. Mexico case, it was not necessary for him to prove that he was receiving less favorable treatment ***because*** he was a foreigner; only that he was a foreigner receiving worse treatment than a comparable investor/investment.

3. Consideration of whether any factors exist which could justify any difference in treatment so found: The last question to be posed is if there are sufficiently strong legitimate reasons to justify such difference. If there is different treatment of “like” activities, then the burden of proof is on the respondent to show

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policy reasons for permitting the respondent government to undertake the impugned discrimination and therefore not be in violation of the national treatment obligation. (S.D. Myers and Canada, Partial Award, November 13, 2000 at para. 250; Pope & Talbot and Canada, NAFTA/UNCITRAL Arbitration, Award on the Merits Phase 2, at para. 78 ;Marvin Feldman and Mexico, ICSID/NAFTA Arbitration at para. 170)

[96] *For a detailed analysis: Feldman v. Mexico; Todd Weiler, 2003, op. cit. supra*

that such legitimate reasons exist.[97] Such legitimate reasons can not be that the distinctly treated investor is foreign; to the contrary, if it is the foreign investor which is treated substantially worse than the domestic investor, then the presumption is that there are no legitimate reasons and that the foreign investor is treated worse for the usual reasons – lack of political leverage, resentment of foreign investors, economic nationalism and protectionism, patronage and other more problematic case of close intertwining of national businesses with domestic politics, administration and government.

105. This methodology for identifying discrimination was also proposed in a not-opposed "Declaration" by the US and Canada included in the Final Act of the Energy Charter Conference[98]. This "Declaration" by Canada and the US, though not opposed and not a necessarily binding interpretation, emphasises that circumstances must be examined on a case-by-case basis and that only cases in "similar circumstances" can be considered.[99] It further postulates that "legitimate policy objectives" may justify differential treatment to "reflect a dissimilarity of relevant circumstances". The Declaration continues:

> *"A measure aimed specifically at investors because they are foreign, without sufficient countervailing policy reasons consistent with the preceding paragraph, would be contrary to the principles of Art. 10".*

The US/Canada Declaration – which can be said to have a certain, but not a binding authority with respect to interpretation – does not require "likeness", presumably a tighter standard of comparison, but merely "similarity", i.e. a more extensive standard of comparison. Both the relevant case law – NAFTA arbitrations, ECJ and WTO jurisprudence – suggest that the comparison can not be too formal; that "disguising" a discrimination under a generally accepted principle (e.g. environmental protection) does not help to avoid the qualification of discrimination and that treaties, courts and arbitral tribunal view with great suspicion – and a corresponding much more intensive burden of proof on the respondent government – when the quality of

[97] In the Feldman v. Mexico arbitration, the Tribunal placed the onus on Mexico to disprove the prima facie allegation of discrimination raised by the claimant. The Tribunal found that Mexico was not forthcoming in producing evidence that could only be in the hands of the respondent's tax authorities and therefore the lack of production of such evidence was justification for the Tribunal to make an adverse inference against Mexico to find a breach of its national treatment obligation under NAFTA Article 1102 on a de facto basis. See Marvin Feldman v. Mexico, ICSID/NAFTA Arbitration, Award at paras. 176 & 177.The same methodology is applied by the WTO Appellate Body (see the Legal Opinion of Prof C D Ehlermann, 2002, provided in the Methanex case, on file with the author.

[98] This declaration, as the other Understandings and Declarations and Decisions is published in: T. Waelde (ed), 1996, p. 617, 618

[99] This formulation paraphrases the reference to "like situations" in Art. II of the Argentina/US BIT, op.cit. 129

"foreign" seems to be one or the main criterion for the differentiation.[100]

106. From the information available, many if not most independent power producers in Latvia receive a higher than the standard tariff. This is not disputed by the respondent. It has already been recognised by the respondent (4.5.6 and 4.5.7) that in several cases the payment is higher than the normal tariff. In the case of Gulbene and Liepajas Siltums, the Republic concedes that they both are paid, for 8 years, the double tariff. The Liepajas Siltums agreement was signed in 1995, the Gulbene about the same time as the Windau agreement, i.e. in May 1997. (Exhibit R 4 and R 6). Gulbene and Liepajas Siltums are the most comparable situations as both deal with environment-friendly co -generation, have been designed, negotiated, contracted and started to deliver in – roughly – the same period of Windau. These – Latvian-owned – companies compete with Windau-Nykomb in terms of supplying electricity to Latvenergo, though in the very regulated and state-controlled context of the as yet un-privatised, un-deregulated and un-liberalised energy market in Latvia. The Gulbene case is particularly instructive as all Latvian courts – from the lowest to the highest level – have accepted a much weaker "letter of intent" combined with a reference to the 1995 Entrepreneurial Law as evidence of a legally valid "double tariff for eight years" contract.

107. According to established jurisprudence, it is now up to the Respondent to prove that the different and more favourable treatment to Gulbene and Liepajas Siltums – as well as the many other forms of higher than standard tariff payments to independent power producers – are justified.[101] The burden is very high as prima facie Windau-Nykomb seems to have been singled out because it is foreign-owned. This singling-out of Windau-Nykomb is the more problematic as the differentiated and worsening treatment started after Windau was sold by a local businessman to a Swedish energy engineering company. General references (4.5.7) are made in the Statement of Defense to "business history, bargaining powers, technical data, financial position, location and "all other factors that

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[100] *See S.D. Myers v. Canada, NAFTA/UNICITRAL Arbitration, Partial Award, November 13, 2000 at paras. 162 and 255. The Tribunal commented at para. 255 in this respect as follows:*

> *para 255. "CANADA was concerned to ensure the economic strength of the Canadian industry, in part, because it wanted to maintain the ability to process PCBs within Canada in the future. This was a legitimate goal, consistent with the policy objectives of the Base1 Convention. There were a number of legitimate ways by which CANADA could have achieved it, but preventing SDMI from exporting PCBs for processing in the USA by the use of the Interim Order and the Final Order was not one of them. The indirect motive was understandable, but the method contravened CANADA's international commitments under the NAFTA. CANADA's right to source all government requirements and to grant subsidies to the Canadian industry are but two examples of legitimate alternative measures. The fact that the matter was addressed subsequently and the border re-opened also shows that CANADA was not constrained in its ability to deal effectively with the situation."£*

[101] *See Marvin Feldman v. Mexico, ICSID/NAFTA Arbitration, paras. 176 & 177.*

would typically lead to a differentiation in treatment". "Obviously, a comparison of such facts may reveal that there are legitimate reasons for applying different tariffs".

108. Such general statements are not enough to counter the prima facie evidence of discrimination against Windau-Nykomb as a foreign company and because it is a foreign company. The Respondent would under now standard principles and practices of WTO and NAFTA arbitral jurisprudence on "national treatment" have to prove specifically and with substantiated detail and documentation that there are reasons for the distinct, unfavourable treatment. Such reasons would have to be considered by the Tribunal as "legitimate". Simply being a foreign investor cannot by itself constitute such a legitimate reason justifying less favourable treatment. Any evidence of being treated in a less favourable way because of foreign ownership creates an almost unsurmountable burden of proof, as there will be very few, if any, legitimate reasons to treat a foreign investor worse than domestic investors.

109. On this the Feldman Karpa v. Mexico tribunal[102]:

> "*On the question of burden of proof, the majority finds the following statement of the international law standard helpful, as stated by the Appellate Body of the WTO:*
>
> > *... various international tribunals, including the International Court of Justice, have generally and consistently accepted and applied the rule that the party who asserts a fact, whether the claimant or respondent, is responsible for providing proof thereof. Also, it is a generally accepted canon of evidence in civil law, common law and, in fact, most jurisdictions, that the burden of proof rests upon the party, whether complaining or defending, who asserts the affirmative of a claim or defence. If that party adduces evidence sufficient to raise a presumption that what is claimed is true, the burden then shifts to the other party, who will fail unless it adduces sufficient evidence to rebut the presumption.* (Emphasis supplied.)
>
> *Here, the Claimant in our view has established a presumption and a prima facie case that the Claimant has been treated in a different and less favorable manner than several Mexican owned cigarette resellers, and the Respondent has failed to introduce any credible evidence into the record to rebut that presumption*."

110. From the uncontested facts and the general reply in the Statement of Defense it appears, that there are no legitimate, justifying concrete

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[102] *At para. 177*

and specific reasons for the singling-out of the only foreign-owned co-generator. The Statement of Defense suggests that there "may" be justifying reasons. This is as good as conceding there are no justifying reasons that can be presented and substantiated in the required detail. In NAFTA and WTO arbitral practice, the tribunals have taken such unwillingness or inability to specify and substantiate justifying reasons as a reason to infer that there was discrimination, both in fact and in intent. All evidence tends to suggest that Windau-Nykomb is negatively singled-out, indeed penalised for either being foreign-owned and perhaps for not playing according to unspoken rules of the game in Latvia. All indications are that there is a valid case of discrimination, that the Respondent has been unable to provide a sufficient specific and individualised legitimate reason and that the Claimant has been singled out because it is foreign-owned and after it was acquired by a Swedish company.

111. Does the Respondent have direct responsibility for the discrimination against Windau/Nykomb with respect to the double-tariff payments?

Should it be established that there is discrimination under Art. 10 (1, 3 and 7), then Latvia has to be responsible. The same arguments apply as before for attributing Latvenergo conduct to Latvia.

As in the examination of the earlier cause of action concerning the "sanctity of contract" clause, Latvia is also likely to incur responsibility not just for attribution of Latvenergo conduct, but for its own conduct. The non-payment of the double tariff is not only due to Latvenergo refusal, but also to the failure of the government to ensure that the double tariff was paid. The government had built up through the Entrepreneurial Law of 1995 a legitimate expectation with Windau/Nykomb that following investment it would be paid the double tariff for 8 years. That expectation was confirmed in the several meetings, in particular the Prime Minister. The ensuing non-payment therefore constitutes in my view very likely also discrimination directly by the government. By allowing Gulbene and other Latvian companies who had invested in co-generation facilities of roughly the type of Windau-Nykomb and about the same time to receive the double tariff – due under any established European practice for this sort of environment-friendly and energy-efficient project, but not to Windau-Nykomb, the government itself has not "accorded .. treatment no less favourable" to Nykomb than which "it accords to investment of its own investors" (Art. 10 (7). The government cannot hide behind Latvenergo and use Latvenergo to escape from its international treaty obligation – evidence of such escape-seeking is itself an internationally recognised reason to attribute direct responsibility to the state.[103]

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[103] *Boeckstiegel, 1973, pp. 68-70*

112. Is there a Case of Breach of the "Fair and Equitable Treatment Standard" and/or "Unreasonable Impairment of the Management and Enjoyment of the Investment?

Art. 10 (1) contains a number of standards which are not easily disentangled. I shall start first with the overarching theme:

> *"Each Contracting Party shall.. encourage and create stable, equitable, favourable and transparent conditions for investors of other .. Parties".*

It follows by specifying the "treatment obligations": "such conditions shall include a commitment to accord at all times to investments of investors of other contracting parties":

- "fair and equitable treatment"
- "Such investments shall also enjoy the most constant protection and security"
- and "no contracting party shall in any way impair by unreasonable or discriminatory measures the management, maintenance, use, enjoyment or disposal" (of the investments)

113. Some introductory remarks on the structure of these good-governance obligations in Art. 10 (1) are necessary. First, the overarching theme helps to specify the relatively open-ended obligations – and more than in many other investment treaties. Stability, favourable conditions and transparency are here highlighted as significant principles for the interpretation of the following standards. The obligation to "encourage and create" such conditions can not be read to in fact reduce the legal effect of the following standards – as it would be if the "encourage and create" obligation would be seen as qualifying the following three standards as a kind of "soft-law" "best-efforts" undertaking only. It is clear from the following language – "*shall include a commitment to accord*" – that the ECT as all other BITs and traditional international law imposes here a hard-law, fully legally binding obligation to comply with these standards. That becomes also clear when taking into account the third sentence in Art. 10 (10) – "such investments shall also enjoy the most constant protection and security" and "no contracting party shall in any way impair by unreasonable .. measures..". If the Energy Charter treaty wanted to use soft-law obligations, it uses language such as (Art. 10 (2): "Shall endeavour to accord" (i.e. shall "try") or, in Art. 18 (4): "undertake to facilitate" (again a shall "try") soft-law obligation. The state has no excuse to say: "I am encouraging and creating favourable conditions, but I have, unfortunately, not yet succeeded. So let us wait with the application of the treatment obligations until I have managed to create the conditions".

Art. 10 (1) is the core of the Treaty's hard-law investment treatment obligations; they are "hard-law" because the investor has made its investment and is now exposed to political and regulatory risk. In contrast, in Art. 10 (2), the obligation on states related to the "making" of investment (access) is soft-law; the reason is that here the investor is considering investment, but has not yet made it and is not yet exposed to the political risk. Sentence 2 in Art. 10 (1) contains an accumulation of emphatic references to "hard-law": "Shall" – "commitment" – "at all times" – "accord fair and equitable treatment". Any other reading of Art. 10 (1) would go counter the explicit purposes to provide legally binding commitments for treatment of investments made and to be at least as good, if not better ("high level of investment protection") than all other comparable bi- and multilateral investment treaties.

114. The three standards in Art. 10 (1) express a common theme. This common theme is that the state is under an obligation to provide a "high" [104] level of investment protection, which standards such as "fair", "equitable", "constant protection" and "reasonableness" being used. The "high" standard of protection suggests that the one difference of the ECT to many BITs is that it is in the main not focused on underdeveloped countries and their much greater difficulty to adopt good-governance conduct, but rather at transition economies in Eastern Europe preparing for accession to the EU from which a higher than normal governance standard can be expected. The dominant objective of the Treaty is to encourage foreign investment in energy and environment-friendly projects in Eastern Europe.[105] This is considered to be best achieved by a rigorous obligation to protect foreign property and contract rights, based on the theory (and empirical evidence) that countries which protect property rights will attract most investment and economic development. These high standards are therefore intended to countervail the remaining and inherent tendencies in post-socialist countries to protect domestically powerful persons and deal foreign investors operating in the same business a weak card. The most recent and perhaps most pertinent application of the "fair and equitable" standard has been in the CME v Czech case, confirmed in 2003 by the Svea Court of Appeals [106]. They are meant to externally promote and stabilise economic reform by providing a discipline against inherent nationalist, protectionist and surviving socialist tendencies to disregard contract and property rights.

115. The proper meaning of in particular the "fair and equitable standard" is much discussed and currently controversial, in particular in the

[104] See supra for reference to the "high" level of investment protection mandated by the European Energy Charter and translated, explicitly – see preamble – by the ECT into legally binding commitments.
[105] Supra; part II and Foreword Ruud Lubbers – the "father" of the Treaty – in Waelde, Ed. 1996.
[106] See here the CME v. Czech Republic Case, decision on the merits of 2001, available at: http://www.cetv-net.com/ and confirmed by the Svea Court of Appeals on May 15, 2003 (decision on file with the author)

context of the NAFTA investment arbitrations. The NAFTA governments have claimed (and issued an "interpretative decision")[107] that "fair and equitable" meant no more than the traditional "minimum standard" in international law. According to Canada this meant the standard , as defined in the 1920s, in the Neer case related to the Mexican civil-war and post-civil-war situation, as "egregious and outrageous" behavior[108]. All arbitral tribunals, however, have developed the concept of "fair and equitable" as, at least, a contemporary version of the minimum standard.[109] The current understanding is that "fair and equitable" is an "evolving standard", reflective of contemporary notions of fairness, in particularly as indicted by modern treaty practice and not "frozen in time" in the aftermath of the Mexican revolution's unrest in 1926.

The Mondev tribunal therefore held:

> *"Conduct which may not have violated international law in the 1920s might very well be seen to offend internationally accepted principles today". (at para 108). Agreeing with Pope-Talbot it continued:*
>
> *"Art. 1105 (i.e. fair and equitable) incorporated an evolutionary standard which allowed subsequent practice, including treaty practice, to be taken into account" (para 105).*

The main controversy has been over the question (now decided, but only for NAFTA) if the "fair and equitable" standard was nothing but the traditional international minimum standard (itself, naturally, evolving) or if it existed "in addition" to this international minimum standard. It is, though, not clear to me if this makes any difference. Since both standards are of an "evolutionary nature" and are open-ended, and presumably a possible "international minimum standard" includes "fair and equitable treatment" anyway, the question of "additionality" seems not relevant. What is relevant is how "fair and equitable" is interpreted and applied. In the case of the ECT, with a different formulation here than in Art. 1105 of the NAFTA, the

[107]NAFTA Interpretative Decision, 31 July 2001 – available from www.naftaclaims.com This decision may be binding on NAFTA arbitral tribunals since 2001, but certainly has no relevance on ECT interpretation.

[108] AmJ Intl Law, 1927, 555: "an outrage, bad faith, wilful neglect of duty or insufficiency of government action so far short of international standards that every reasonable and impartial person would recognize its insufficiency". In the ELSI v. Italy case "wilful disregard of due process of law, an act which shocks, or at least surprises, a sense of judicial propriety" was referred to. In another case, of 1927, Judge Nielsen suggested a "pronounced degree of improper government action" – quoted in the P. Dumberry, The quest to define fair and equitable treatment for investors under international law, 3 J World Investment (2002) 657, 685.

[109] Investor-State Tribunals in Pope & Talbot and Mondev have concluded that the minimum standard of treatment has evolved in the contemporary context. See Pope & Talbot and Canada, Award in Respect of Damages, May 31, 2002 at para. 65; Mondev International Ltd. and USA, NAFTA/ICSID Arbitration, Award, at paras. 114-116; also ADF v. Canada

arguments for “fair and equitable” being different from “treatment under international law” are compelling. The reason is that sentence 2 in Art. 10 (1) ECT deals with “fair and equitable” plus the other, reinforcing duties, while “international law, including treaty obligations” follows as a separate and independent obligation in sentence 3.

116. The controversies about “fair and equitable” and “unreasonable impairment” being part or not of an international minimum standard can possibly be resolved by a closer look at the language of the Treaty which, according to Art. 31 of the Vienna Convention, is in most cases the ultimate arbiter of the legal meaning. Art. 10 (1) does not mention an international minimum standard at all. It mentions in sentence 4 (more on this below) “international law, including treaty obligations”. It may therefore be the best approach to simply start with the ordinary meaning of the words. “Fair and equitable” is almost everywhere seen as one single concept. I suggest, though, that it refers to two distinct meanings well established in international and comparative law:

- **“Fair**” refers to – always contemporary – standards of justice and good-governance, but not as they are derived from individual subjective values, but from the most pertinent and authoritative legal instruments and similar authoritative instruments reflecting contemporary (and always evolving) standards of justice. In the context of Europe – which is the relevant legal space for this situation in view of the ECT focus and Latvia’s impending EU accession – this are the relevant treaty rules (European Energy Charter, Energy Charter Treaty, Efficiency Protocol, Europe Agreement) but also the accepted jurisprudence (“Acquis”) of the European Court of Justice, the common principles of European constitutional and administrative law, in particular on “legitimate expectations”, “legal certainty” and protection of property rights developed by the European Court of Justice and the jurisprudence of the European Court of Human Rights to Art.1, Additional Protocol of the European Convention on Human Rights.. Authoritative guidelines – such as the EU Florence Electricity regulators forum recommendations – can be relied upon as subsidiary, but industry-specific indicators for the relevant standard of justice
- **“Equitable**” suggests to a comparative lawyer something slightly distinct from “fairness”. It suggests that a formal legal rule – e.g. the “corporate veil” created by a separate legal personality for a state enterprise – can be disregarded by the operation of countervailing principles of material justice. There are numerous principles in common and civil law which are associated with the term “equity” – like “venire contra factum proprium”, estoppel, abuse of law, or protection of confidence established (“Vertrauensschutz”, “droit acquis”).

117. It is therefore in my view necessary to compare both established and in particular modern arbitral jurisprudence with concepts of “fairness

and equity" applied in comparable circumstances in particular in Europe.

118. The Metalclad v. Mexico tribunal[110] considered that this standard required governments in essence to act in the following way:

> *"to act in a transparent manner, to provide investors with a fair hearing, not to make decisions on the basis of irrelevant factors and not to frustrate the legitimate expectations of investors (when they are raised as a result of government conduct"*[111]

It looked at the "totality" of circumstances and found a breach of the "fair and equitable standard" in a situation where the higher level of government permitted an environmental investment and encouraged the claimant to carry out that investment, thus creating the legitimate expectation that it would be able to operate it, while a lower level of government undermined the permitting and encouragement in a number of ways[112], thus making the executed investment economically unfeasible. The Tribunal said in particular:

> *"Once the authorities of the central government.. become aware of any scope for misunderstanding or confusion in this connection, it is their duty to ensure that the correct position is promptly determined and clearly stated so that investors can proceed with all appropriate expedition in the confident belief that they are acting in accordance with all relevant laws" (para 76)*

For the Metalclad tribunal, the fact that Metalclad "was led to believe and did believe" in the relevant government commitments (para 85), that it did investment under the eyes of government which realised they had made the investor trust in their commitments (87-90) was an essential element in finding a breach of the "fair and equitable" principles. It was the building of a an expectation – and a legitimate one – with the investor and its confidence in the validity of such governmental commitment – clearly visible to the authorities – which made the unexpected undermining of governmental authorisations by the lower authorities and then its toleration by the higher authorities a breach of the "fair and equitable" discipline. These standards appear to apply in a way that is comparable in all essential aspects with the Windau-Nykomb – Latvenergo/Latvia relationship. Here, the government made the investor invest in – quite legitimate – confidence in the promises contained in the Entrepreneurial Law, governmental assurances (including at one time the Prime Minister)

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[110] www.naftaclaims.com *paras. 74 –110*

[111] *This – correct - summary is by Prof T. Weiler, A First Look at the interim awards in S Myers v. Canada, 2001 (on file with author), 24 Hastings International & Comparative Law Review, 2001. It summarises the Metalclad tribunal's reasoning, in particular at paras.85, 87, 89 and 90.*

[112] *There is a possibility that Metalclad was punished by subordinate authorities for not providing the required sweeteners and personal incentives expected.*

and the contract with Latvenergo. All involved authorities could see that Windau-Nykomb was investing because of such – legitimate – expectations. The turnaround of Latvenergo reversing its earlier commitment without, in the end, effective overriding by the higher and supervisory levels of government was equivalent to the central Mexican governments ultimate toleration of the lower authorities undermining of the Metalclad investment.

119. In the Pope-Talbot v. Canada case[113], the tribunal rejected the 1926 Neer-case threshold of "egregious and outrageous" conduct and applied a "higher standard of treatment" than in the 1926 case. It also relied on recent treaty practice to give more substance to the standard. The tribunal found a breach of the "fair and equitable standard" in the conduct of a government regulatory entity which seemed to penalise the claimant because it was foreign and protested against restrictive regulation meted out.

120. In the Mondev v. US case[114], the tribunal rejected the claim because the incriminated conduct had existed before the NAFTA took effect and because it did not see "tortuous interference with contracts" and limited immunity from suit of government agencies as a breach of the fair and equitable standard. But it did suggest the standard should be seen as evolutionary and reflecting modern expectations of good government conduct. It suggested that concordant provisions in the hundreds (now thousands) of bilateral investment treaties concluded formed the content of contemporary international law and quoted in support a US statement that "sovereignty may not be a ground for revocation or amendment of a party's obligations to investors (especially contracts). The Mondev award also held:

> *"A governmental prerogative to violate investment contracts would appear to be inconsistent with the principles embodied in Art. 1105 (i.e. fair and equitable treatment) and with contemporary standards of national and international law..". (para 134)*

and it quoted with approval the transmittal statement by the US government to US Congress on the US–Albania BIT of 1995 on the fair and equitable standard:

> *"The general reference to international law also implicitly incorporates other fundamental rules of international law: for example that sovereignty may not be grounds for unilateral revocation or amendment of a party's obligations to investors and investments (especially contracts)" (at para 112)*

121. In the Myers v. Canada case[115], the tribunal decided the case on discrimination. But it also suggested that intentional discrimination

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[113] *www.naftaclaims.com, para. 59 et seq; award of 31 May 2002;*
[114] *www.naftaclaims.com*
[115] *www.naftaclaims.com, paras. 266-68*

on the basis of nationality by a consistent series of actions by the Canadian Minister of Environment constituted a breach of the "fair and equitable" standard under international law.

122. In the ADF v US case[116] the tribunal suggested:

> "*We understand the Mondev Tribunal to be saying – and we would respectfully agree with it – that any general requirement to accord "fair and equitable treatment" and "full protection and security" must be based upon State practice and judicial or arbitral case law or other sources of customary or general international law.*[117]

123. The "fair and equitable standard" has also been relied upon by several other tribunals awarding compensation to investors[118]. The most recent case is the much discussed CME v. Czech Republic. Here, a foreign investor carried out a significant investment in television operations in the Czech Republic. But, as the tribunal found, he was in the end squeezed out by camouflaged collusion between the Czech government entity in charge of television industry and a powerful Czech media investor. In effect, the Czech government entity changed the conditions and agreements with respect to the TV license in such a way that in the end only the Czech investor, and not the US investor, could survive economically. To quote the tribunal:

- "*The Media Council breaches its obligation of fair and equitable treatment by evisceration of the arrangements in reliance on upon with (probably: "which") the foreign investor was induced to invest.*[119]
- *These "actions were unreasonable as the clear intention of the 1996 actions was to deprive the foreign investor of the exclusive use of the License under the MoA and the clear intention of the 1999 actions and inactions was (sc. "to") collude with the foreign investor's Czech business partner to deprive the foreign investor of its investment. The behaviour .. also smacks of discrimination against the foreign investor".*

124. Damages awarded (in 2003) and affirmed by the Svea Court of Appeals were 350 M $ plus cost[120]. The case has considerable

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[116] *at paragraph 184; ADF v. Canada, www.naftalaw.com*
[117] *ADF Award, at para. 184.*
[118] *AAPL v. Republic of Sri Lanka, 30 ILM 577 (1991);. International Centre for Settlement of Investment Disputes (ICSID): Wena Hotels Ltd. v. Arab Republic of Egypt (Decision on Jurisdiction), Case No. ARB/98/4 (June 29, 1999); it is being considered in several ongoing nafta cases: Waste management v. Mexico; Methanex v. US; UPS v. Canada; Adams v. Mexico; Crompton v. Canada; Kenex v US; Calmark v. Mexico; Fireman's Fund v. Mexico*
[119] *CME v. Czech R, op. cit supra, at para 611, 612*
[120] *An earlier arbitration by Mr Lauder under the US-Czech BIT ("London arbitration") failed to produce a damages award in 2001.The tribunal found discriminatory treatment, but did not find a proximate enough cause between the discriminatory conduct and the damages claimed.*

implication for the Nykomb-Latvia procedure. First, it is comparable in so far as the rules (BIT – ECT) are close to identical. Second, the overall situation is that of a foreign investor induced to invest under the impression of government promises creating a legitimate expectation in an East European transition country, and then being manipulated out of its acquired rights by a protectionist exercise of delegated governmental powers in favour of a powerful local man and to the detriment of the investor. In the Nykomb-Latvia situation, several similar key elements are present: The favouring of national investors with the double-tariff, the rapid withdrawal and continuous administrative, judicial, regulatory and political difficulties then created for the foreign investor – but not the domestic investor. The economic logic of the Windau-Nykomb situation is that the project in the end is no longer viable for Nykomb, with the result that a domestic investor would be the only logical purchaser at a distress price.

125. These arbitral awards suggest that there are several ways to give concrete and specific shape to the "fair and equitable", "constant protection" and "no unreasonable impairment" standards of Art. 10 (1):

- A procedural standard requiring due process, proper hearing, transparency
- A material standard of "fairness and equity" which needs to be specified not out of the subjective preferences of the arbitrators, but out of contemporary notions and practices of good governance – the question is: How do reasonably well governed governments in Europe behave in this type of situation?
- A reference as much as possible to current sources of international law, that is mainly arbitral awards, treaty practice (which would be both investment, trade, energy, but also environmental and human rights treaties and other authoritative instruments, such as guidelines and codes of conduct. What is not appropriate is to "fill" the "fair and equitable standard" with subjective values of the interpreters [121].
- The reference to such other established legal standards as "disappointment of legitimate expectations, induced by government, upon which the investor acted ("investment-backed legitimate expectations" counterbalanced by reasonable actions for public policy and public interest. The standard of protecting "investment-backed legitimate expectations" is universal in comparative constitutional law of developed countries, in the general of EU law developed by the European Court of Justice and the European Court of Human Rights and international arbitral jurisprudence
- The establishment of a minimum threshold below which minor infractions of government do not count

[121] *Mondev. V. US, paras. 119, 120.*

- The idea that it is by a cumulation of in itself often only minor acts of governmental misconduct up to the required minimum threshold that a breach of the two standards can be established.

126. If one applies these standards to the conduct of Latvenergo in combination with other Latvian government institutions (regulatory authorities, cabinet of Ministers, Parliament, courts, Prime Min ister), then it appears that:

- Windau -Nykomb were induced by the formal energy-efficiency policy and the double-tariff promise contained in the entrepreneurial law, followed-up by the double-tariff agreement referring to the Entrepreneurial law, the fact that other investors in a comparable situation were paid the double tariff to invest. This legitimate expectation in the double-tariff was after Nykomb's take-over affirmed by the Cabinet of Ministers, the Prime minister and other official actions.
- Whatever the "real" background and intentions of the key players, it must appear to Nykomb that the double-tariff was suddenly disappearing once Nykomb took over, and the cooperation between powerful Latvian businessmen and the government and Latvenergo did no longer exist. Much as in the CME case, Nykomb was made to be concerned that a "squeeze-out", by financially drying out the company, has been under way to penalise Nykomb for having replaced a domestic, politically influential, investor.
- In the CME v Czech case, the tribunal dismissed as justification that other investors were treated in a similar shabby manner (para. 611). In the Nykomb – Latvia case, other investors were not treated badly at all – provided they were Latvian-owned.
- Current international law (including the commitments by the Latvian government under Art. 19 ECT, the Energy Efficiency Protocol, the Europe Agreement with the EU) and the 1996 Electricity Directive (applicable as an obligation to adopt now, and fully applicable upon accession) oblige Latvia to promote co-generation; a tariff premium (in lieu of investment support) is one of the major, acceptable and in practice most frequent ways to promote co-generation.
- The compulsion on Nykomb to accept the "interim" agreement with its 0.75 tariff – exploiting the fact that Nykomb had invested, the plant was ready, but no other purchaser than Latvenergo could possibly exist – has an element of compulsion and unconscionable pressure similar to the administrative harassment in the Pope-Talbot case, the unexpected undermining of the valid federal permits by provincial and local authorities in the Metalclad case, the constant political and regulatory harassment of Myers by the Environment Minister in the Myers-Canada case or the "velvet" squeeze-out by the Media Council of foreign investor CME in the CME v. Czech case.
- The forward-backward on the double tariff in government, the machinations in Parliament (where Latvenergo has its own

backers) appear comparable to the Metalclad problems with contradictory permitting and un-permitting in various levels of government. As in Metalclad, one cannot exclude (but never prove) that Windau-Nykomb is penalised for not conforming with informal rules of the game in Latvian politics.

127. To sum up: Based on the overall intention and arbitral and treaty-based precedents for giving a modern meaning to "fair and equitable" and "no unreasonable impairment", there are strong, and possibly overwhelming arguments for considering the combined conduct by Latvenergo, the government and other Latvian public authorities towards Windau-Nykomb as breaching these two crucial investment protection standards. Different from the NAFTA awards rendered against Mexico, a developing country with notorious governance problems, the ECT standard should be seen not as a low-quality minimum standard, but actually as a very high standard to which the ECT countries, after their experience with Socialism and with the intention to rapidly achieve standards of governance of market economy, have subscribed. As the ECT, different from NAFTA, adds also the criteria of "stable", "transparent", "favourable" and "most constant .. security" as well as a reference to the "enjoyment" of the investment, its overall good-governance standard (which is in my view the common theme of Art. 10 (1)) appears much higher than the minimum standard, even in contemporary interpretation, to be applied to underdeveloped countries. It should be developed out of contemporary, mainly European notions (given the context of the Treaty) of civilised, high-quality governance as evidenced by the rule of law, transparency, stability and best regulatory practice. These rules are not subjective or discretionary, but they are codified in the most relevant European legal instruments: The ECT, The Energy Efficiency Protocol, the Europe Agreement, The EU Treaty, the ECHR, the 1996 electricity directive and the authoritative recommendations by the Florence European Regulatory Forum.

128. If one applies the "<u>unreasonable impairment</u>" standard on its own (but under the guidance of Art. 10 (1, first sentence – stable – equitable – favourable and transparent investment conditions)[122], then a breach emerges as well from such a separate examination. The state electricity monopoly in combination with government induced the company to invest in a market characterised by energy dumping from abroad. All new investment required (cross-) subsidisation by higher-than-import-market-based energy prices. If the state energy monopoly in combination with the government, the only possible buyer, once the investment is carried out and the investor has "taken the plunge", drops such promised and legitimately expected protection, it fails "<u>legitimate, investment-</u>

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[122] *This standard is rarely dealt with separately, usually it is subsumed together with the "fair and equitable" standard, e.g. in the CME-Czech R award. Presumably it is meant to cover conduct which, while substantially affecting foreign investment, falls short of the higher threshold of government action tantamount in effect to expropration.*

backed expectations", the key concept generally used. If then the investment is no longer to earn enough to repay debt, investment and earn a minimum rate of return commensurate with the original risk taken, it is "impaired" in the sense of a government action with a very serious impact on the asset value, but possibly not yet enough to give rise to "expropriation".

129. But the "impairment" must also be "unreasonable". Unreasonable again bears no relation with personal subjective values of the tribunal, but it refers to common standards of good governance. Is it reasonable to shift the risk of investing in power supply in a country which after a policy shift lets itself be swamped by dumped cheap – mostly nuclear - energy, but is keen to develop greater energy self-reliance, from the government to a foreign private investor (while still protecting its domestic investors)? It is not: The principle is that he who has an interest in a particular situation should also carry the cost and risk for creating such situation. This principle is not subjectively derived from individual values, but from the most authoritative legal instruments in the field of energy law and extensive state practice in Europe – the region which counts here for a definition of "reasonableness". EU practice, as I have examined repeatedly, is to promote co-generation. Adding a "tariff premium" is one of the most acceptable and frequent practices. The "unwritten" quasi-constitutional principles which the European Court of Justice has read into the EU treaty provide for protection of investment-backed legitimate expectations[123]. A EU government cannot grant an incentive, encourage an investor to carry out such investment in the interests of EU energy and environmental policy objectives of the highest order, and then withdraw it without incurring judicial sanction.

130. All indications therefore point towards "unreasonable impairment". The attribution to the government follows the principles discussed above, though in the cases of the three Art. 10 (1) standards of good-governance the government itself is as much responsible as it is by attribution of Latvenergo conduct.

131. Is there a breach of the obligation under Art. 10 (1, 4th sentence) to accord "treatment at least as favourable as that required under international law, including treaty obligations"?

Different from at least the NAFTA where the relationship between "international law", minimum standard and "fair and equitable" is controversial and now probably settled by the NAFTA governments interpretative decision, under the ECT Art. 10 (1), 4th sentence is clear that a breach of the ECT arbitrable under Art. 26 can occur when "international law, including treaty obligations" are breached. Since international law and treaty obligations is a wide field, there is

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[123] J. Usher, General Principles of EC Law, London 1998, 54-65 – with an extensive analysis of the relevant ECJ decisions, in particular: 1973, ECR 723 at p.; 729-730 ; Austria v. Council, 1997, ECR II-39

arguably an argument not to make any international customary or treaty law arbitrable, but to require some reasonably close connection between the respective international law or treaty obligation and the interests, legal rights and damages suffered by the investor. The Myers v. Canada tribunal – in the NAFTA situation where the separate role of international law is much more limited – considered:

- *"that the fact that a host party has breached a rule of international law that is specifically designed to protect investors will tend heavily in favour of finding a breach of Art. 1105".*[124]

132. Other authors have sought to interpret this statement in the sense that obligations from international economic treaties (such as the WTO or others) could be "actionable" if such rules have at least as a significant side-effect and subsidiary intention the protection of private commercial operators.

133. Using this standard, one will examine first customary international law to see if a relevant duty can be identified. But as most or all of relevant international law protecting aliens' property is codified in the ECT, it not easy to identify a rule that would provide more benefit than the ECT– or bilateral treaties imported via the MFN-clause (Art. 10 (3) and (7). It is rather necessary to examine specif ic treaty obligations. The most relevant treaties are the often cited Energy Efficiency Protocol – a fully fledged international treaty which Latvia has ratified on 5 January 1999. This treaty combines duties of promoting co -generation with those of encouraging private entrepreneurship and investment. The grant of a double tariff to encourage co-generation, only to withdraw it once the investment is carried out, constitutes a breach of this obligation. Such breach becomes actionable directly by the investor under Art. 10 (1, 4th sentence). Similar duties to promote energy-efficient energy production, to promote and protect investment and to keep monopolies from abusing their dominant position are found in the Latvian "Europe Agreement"[125] and by reference in the Europe Agreement the competition law of the EU, in particular 82 (ex-86) which prohibits the abuse of a dominant position (as Latvenergo exercises without dispute) towards utterly dependent suppliers. Other relevant obligations in treaties including Art. 1 of the Additional First Protocol of the European Convention on Human rights protecting proprietary rights against un-compensated taking (ratified

[124] *para 264*

[125] *Art. 72, 82, 83 – promotion of environment -friendly energy and energy efficiency; Art 74: "The particular aims of cooperation shall be: - for Latvia to establish a legal framework which favours and protects investment; Art. 64: "The following are incompatible with the proper functioning of this Agreement, in so far as they may affect trade between the Community and Latvia:(ii) abuse by one or more undertakings of a dominant position the territories of the Community or of Latvia ; 2. Any practices co ntrary to this Article shall be assessed on the basis of criteria arising from the application of the rules of Articles 85, 86 and 92 of the Treaty establishing the European Community*

by Latvia on 27.06.1997. [126] Art. 1 has been interpreted by the European Court of Human Rights to include a far-reaching protection against state-originated abrogation of individual proprietary rights, including contracts.[127] All these "treaty-based" obligations have either as primary objective (Art. 1, Additional Protocol of the ECHR) or as at least secondary objective (the investment-promotion obligations of the Europe Agreement or Art. 82 (ex-86) of the EU Treaty the protection of individual interests. The conduct of the respondent – Latvenergo in combination with the government – indicates a disregard of prior contracts, the abuse of dominant power by pressuring the claimant into an exploitative "interim" agreement and a disregard of the obligations assumed to promote and protect investment in energy-efficient co-generation. The Art. 10 (1, 4th sentence) obligation to respect the – restrictively interpreted – relevant international treaties appears therefore also to be breached.

134. <u>Was the contractual right of Windau-Nykomb subject to a "measure having effect equivalent to .. expropriation" under Art. 13 (1) ECT?</u>

The non-payment of the guaranteed double-tariff has, so far, not led to a formal transfer of Windau's property to the government, Latvenergo or a third party. It is possible that this is likely to occur if the economics remain at the current depressed level (with 0.75 of the normal tariff) paid, in particular if Windau gets squeezed between the substandard tariff payment on one side and a high energy input (natural gas) price on the other. The question here examined is if the current action/inaction by the combination of Latvenergo and other government bodies falls under the prohibition of not compensated "measure having effect equivalent to expropriation" under Art. 13 (1). The ECT employs, like most modern investment treaties, a much more expansive notion of expropriation. No longer do they only cover formal expropriation, with the transfer of assets of title and assets to the government, but also action which has a comparable economic effect. This is sometimes called "regulatory taking" – if it is effected by governmental regulation or similar administrative action or "creeping" expropriation ("indirect", "constructive" expropriation, action "tantamount to expropriation") if the expropriation goal is achieved not in one visible formal step, but rather by a series of escalating pressures on the economic viability of the asset until the investor has either given up or has lost control over most of the economic functions (value, saleability; operational control")[128].

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[126] *Art. 1: " Every natural or legal person is entitled to the peaceful enjoyment of his possessions. No one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by the general principles of international law."*

[127] *For an overview of jurisprudence: Luigi Condorelli, Premier Protocole Additionel in: Pettiti, La Convention Europeene des Droits de l'Homme, Economica Paris 1995; Waelde/Kolo, ICQL 2001 supra; ECHR Greek Refineries Stran case (9 December 1994) retrievable at: http://hudoc.echr.coe.int/hudoc/ViewRoot.asp?Item=0&Action=Html&X=526204736&Notice=1&Noticemode=2&RelatedMode=0*

[128] *T Waelde/A. Kolo, Environmental Regulation, Investment Protection and*

135. There is considerable judicial and arbitral precedence: In the US-Claims tribunal jurisprudence, in several cases expropriation was found, even if no formal transfer of the title to the investment to the government had taken place. It was the impossibility or impracticability to exercis e the normal functions of ownership due to governmental interference or omission of required protection that was considered to be equivalent to expropriation[129]. In several recent NAFTA cases[130] the issue of regulatory taking was raised under the NAFTA protect ion against measures "tantamount to expropriation" (Art. 1110). The tribunal as a rule did not reject such plea, but relied rather on the "fair and equitable" and the "national treatment" standard.

136. However, in the Metalclad v. Mexico case, the tribunal agreed that the imposition of a subsequent regulation which made the continuation of the operations of the investment economically no longer viable constituted a "regulatory taking" in the sense of Art. 1110[131]. An "ecological" decree which was imposed by the governor after the investment had been set up, with the purpose to make effective operation of the facility impossible, was considered a "regulatory expropriation" – together with the totality of government actions depriving the investor of the essence of its investment[132]:

> "*Thus, expropriation under the NAFTA includes not only open, deliberate, and acknowledged takings of property, such as outright seizure and or formal or obligatory transfer of title in favour of the host State, but also covert or incidental interference with the use of property which has the effect of depriving the owner, in whole or significant part, of the use or reasonably-to-be-effected economic benefit of property even if not necessarily to the obvious benefit of the host State".*

137. The Feldman Karpa /Mexico tribunal decided rather on discrimination, but considered that a regulatory taking were possible.

The Tribunal also passed comment on the wider issue of expropriation and government regulation, stating (at para 110):

> *"No one can seriously question that in some circumstances government regulatory activity can be a violation of Article*

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regulatory taking in international Law 50 ICLQ 811 -848 (2001)

[129] Sedco v. Iran, 15 Iran-US claims tribunal reports at 31; Petrolane, 27 Iran -US cl Trib Rept. 64; Eastman Kodak, 17 Iran -US Cl Trib Rep. 153 – unlawful interference with ownership to give rise to claim for unlawful interference; Amoco Intl Finance, 16 US Iran Cl. Trib Rep 189

[130] Ethyl; Methanex; Myers; Pope -Talbot; Metalclad, www.naftaclaims.com

[131] Metalclad Corp. v. United Mexican States, (August 30, 2000) 40 ILM 36 (2001) at para. 111, at para. 109, 103

[132] Tthe Vancouver court that set aside a part of this tribunal's judgement upheld its judgement and reasoning with respect to the regulatory taking, for a comment: T. Weiler, Metalclad v. Mexico, 2002, paper on file with the author

1110. For example, in Pope & Talbot, Canada argued that "mere interference is not expropriation; rather, a significant degree of deprivation of fundamental rights of ownership is required." That tribunal rejected this approach:
Regulations can indeed be characterized in a way that would constitute creeping expropriation... Indeed, much creeping expropriation could be conducted by regulation, and a blanket exception for regulatory measures would create a gaping loophole in international protection against expropriation. (Id., para. 99.)"

138. The challenge is to distinguish between legitimate regulation and related government action circumscribing property – as happens under the "police power" of government all the time, and when the intervention into property rights "goes too far"[133]. In the Metalclad v. Mexico case (paras 102-112) it was both the combination of federal government authorisation, consequent reliance by the investor by investing, and then undermining of the earlier federal government authorisation by the local and regional governments which led the tribunal to find a case of "indirect expropriation".[134] In the Feldman case, expropriation was in the end denied as the investor did not own a clear right that was taken.

139. The concept of regulatory taking has been extensively developed in US Constitutional law on "takings". There is considerable authority that a regulation that undermines the economic use of property and destroys "investment-backed" expectations is unlawful[135]. This applies also to government measures which breach, by use of "sovereign power" (i.e. regulation) agreements made by the government[136]. In the more recent authoritative case[137], the US Supreme Court employs these tests for determining a regulatory taking:

- *that the regulation and comparable government action denies all economically beneficial or productive use of the property*
- *where a regulation falls short of eliminating all economically beneficial use, a taking nonetheless may have occurred*

[133] The "going too far" is the traditional criterium in US (14th amendment) constitutional law for defining a regulatory taking, see the cases below and Waelde/Kolo 2001 op. cit. supra The authority is Pennsylvania Coal v. Mahon, 260 US 393 (1922)
[134] It relied here on an earlier case, Biloune v. Ghana Investment Centre, 95 ILR 183, 207 (1993) where the investor, "basing itself on the representation of a government affiliated entity, began construction and then was issued with a stop work order after a substantial amount of work had been completed.
[135] Dolan v. City of Tigard ("One of the principal purposes of the Takings clause is 'to bar government from forcing some people alone to bear public burdens which, in all fairness and justice, should be borne by the public as a whole"); referring to Armstrong v. US, 364 US 40 at 49; Nollan v. California Coastal Commission, 483 US 825 at 835 n. 4 (1987); Eastern Enterprises v. EPEL, et al, (1998), supra at p. 7 of 19; Pumpelly v. Green Bay Co., 80 U.S. (13 Wall) 166 (187) at 177-78; ; Lucas v. South Carolina Coastal Commission, supra, Stevens v. City of Cannon Beach, 114 S.Ct. 1332 (1994); Ehrlich v. City of Culver, 12 Cal. 4th 854 (1996).
[136] US v. Winstar, 116 SCt 2432 (1996)
[137] Palazzalo v Rhode Island, 533 US 606 (2001)

depending on balancing several factors including the regulation's effect, the extent to which the regulation and comparable government action interfere with reasonable investment-backed expectation and the character of the government action.

140. In a subsequent case, the importance of the public interest involved and the reasons for imposing the temporary restriction were balanced against the investment-backed expectations.[138] Similar criteria have been developed by the European Court of Human Rights under Art. 1 of the Additional Protocol (supra), the European Court of Justice and most European constitutional courts.

141. The key for assessing the Latvian government actions (including Latvenergo) is the balancing of, on one hand, the creation of "investment-backed expectations" (which has occurred) with, on the other hand, possible public interest justifications (which do not seem to exist) and the required "intensity" of the damage inflicted on the investor. It is at this stage that I can, on the basis of the information available, not make a definitive judgement. If the facility is now largely worthless and could only be sold at a distress price to a Latvian investor, then a regulatory taking has occurred. This point may have been reached now, or it may be reached at some point in the future if Nykomb is squeezed hard enough between the 0.75 tariff now paid and its costs so that it is compelled to liquidate the investment.

142. Reviewing the factual background: The State electricity company, in combination with the communicative acts by other governmental organs (the 1995 Entrepreneurial Law, , the Council/Regulator later confirmed by the Prime Minister and the Cabinet of Ministers) promised to pay double tariff. This was a pre-requisite for the investment, i.e. created a "investment-backed expectation". The State electricity company, on its own or due to regulatory or other pressure by the central government, then refused to pay this contractual tariff without further valid and not contrived excuses based in contract law (such as, as in the Azinian v. Mexico case, non-performance). If such measures completely undermined and destroyed the economic value of the investment, then a case of "regulatory taking", i.e. action equivalent to expropriation, has taken place. This is even if the formal title to the investment rests with the investor and if the investor continues to run the operation and receives a fee (which presumably covers only or in the main the operating expenses). The original investment (with its expectation of a reasonable rate of return) has effectively been destroyed. In the Nykomb/Latvia case, the financial analysis made (Exhibit C 23) suggests that a 0.75 tariff at most covers operating cost and possibly a part of the debt service, but it does not allow the investor to recover its investment and a reasonable rate of return – which should be around 20-25%, perhaps even higher.

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[138] *Tahoe Sierra Pres Council V. Tahoe RPA 535 US 302 (2002)*

Finally, it is generally recognised as uncontroversial that expropriation occurs when a government, by action under the "colour and flag" of government – rather than by dispute based on merely commercial contract issues – functionally and in effect negates a valid contract. This is the established principle under internatonal law[139]; it probably explains why the ECT (as other modern in particular US and UK BITs) has "codified" this principle in the "sanctity of contract" clause of Art. 10 (1, last sentence). But there is no reason not to consider government action with an impact equivalent to a negation of a governmental contract also and in addition as expropriation under Art. 13 ECT.

143. Can Nykomb also rely on other bilateral investment treaties concluded by Latvia to the extent these provide a better treatment?

Under the MFN-clause of Art. 10 (discussed above in connection with the attribution and reference to the Maffezini v. Spain case), Nykomb can rely on any treatment provided in other Latvian BITs which is better than the treatment available under the ECT.

Latvia has concluded such BITs with the Czech Republic, Israel, Canada, US, Sweden, Germany, Finland, Norway, Switzerland and other countries[140]. These relate to the same field ("eiusdem generis") as the ECT. Any better solution can be "imported" into the treatment disciplines, or the arbitration procedure of the ECT.

My own survey indicates that these BITs do not contribute in a legally significant way to the treatment available in a way that is better than that provided in the ECT. But I must make here a proviso: ECT rules are often more difficult to interpret than BIT rules. If there is an ambiguity where the tribunal would not want to follow the interpretation I suggest, it would make sense to use the relevant BIT language if it is clearer. These BITs can be used in two ways: First, by interpreting ECT language in conformity with the BIT if the BIT language would provide a clearer and more favourable meaning and, second, by importing the BIT provision if the BIT provides a clearly superior solution for the investor. The most pertinent BIT is the US-Latvia BIT of 1995. Its most relevant provisions are:

- Art. 1 – definitions: Investment is as in the ECT defined as "a claim to money or a claim to performance having economic value and associated with an investment". What this does is in the main confirm the "extensive" concept of investment to qualify Windau-Nykomb's co-generation facility and related contractual arrangement as a protected investment.

[139] Stephen Schwebel (former President of the ICJ), 1987, op. cit. supra

[140] *List available from www.worldbank.org/icsid; text from the Oceana/ICSID publication series (loose-leaf) on Investment Treaties.*

- Art. II (2a): Confirms that state enterprises with "regulatory, administrative or other governmental authority" must comply with the investment disciplines; this is arbitrable (under Art. VI (c) of the BIT. This BIT rule suggests that the interpretation being given to Art. 22 (1, 3, 4) should not be less favourable to the investor than this BIT rule.
- Art. II (3) contain in essence the same rules as part III of the ECT. It confirms the "observation of obligations" – sanctity of contract – rule of Art. 10 (1, last sentence) ECT, the prohibition on arbitrary or discriminatory measures against the investor (Art. II (3, b), fair and equitable treatment, treatment no worse than required by international law and protection against "indirect expropriation through measures tantamount to expropriation" (Art. III (1). These investment disciplines mainly confirm the interpretation of the Energy Charter Treaty's part III obligation in this legal opinion; they possibly strengthen the view that a "regulatory taking" depriving the investor of the economic value of its investment requires compensation under Art. 13 ECT.
- Art VI (arbitration) does not include any exclusion of an investment discipline or attribution rule and therefore suggests that the ECT should be interpreted in the same way.

The Canada-Latvia BIT is similar, but has a number of limitations which make it in most aspects less favourable than the ECG. It does though (Art. VIII) confirm the recognition of the "regulatory taking" concept ("measures having an effect equivalent to .. expropriation"). Its exclusion of subsidies granted by state enterprises (Art. VI (2) is not contained in the ECT – with the argument then arising that the absence of such exclusion confirms that the ECT's investment disciplines (in particular non-discrimination) is applicable to investment subsidies by state enterprises.

The Latvia-Finnish BIT confirms the wide concept of "investment" (i.e. "every kind of asset connected with economic activities" (Art. 1). The France-Latvia BIT covers (in the formal exchange of cover letters) that impediments to the sale of energy is covered by the investment disciplines (Art. 1) of the Treaty. This provision could argue for the Latvenergo's refusal to apply agreed contract terms to the sale of electricity by Windau to Latvenergo to be covered by the ECT's investment disciplines[141].

The Swedish-Latvia BIT (Art. 2 (2) highlights that fair and equitable treatment is to be applied to the sale of the production by investors – presumably ensuring that the sales obstruction by Latvenergo against Windau's electricity production is covered.

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[141] " son considerees comme des entraves de droit ou de fait au traitement juste et equitable toute restriction a l'achat et au transport de matieres premieres et de matieres auxiliaries, d'energie... , toute entrave a la vente et au transport des produits a l'interieur du pays et a l'etranger, ainsi que toutes autres measures ayant un effet analogue".

The Swiss-Latvia BIT (Art. 11) emphasises ("shall constantly guarantee the observance of the commitments it has entered into with respect to the investments of investors..") the government obligation to keep the commitments of the state (and its instrumentalities).

These bilateral investment treaties can be examined in more detail. I view them as reinforcing and confirming the interpretation I have developed for a number of sometimes hard to understand ECT obligations – e.g. the fact that discrimination by the state enterprise with respect to the purchase of electricity by Windau is covered and that arbitration includes acts contrary to part III obligations by state-owned enterprises acting not exclusively with a commercial character.

144. Does it make any difference if Nykomb knew, or should have known, that there was an intense political debate about the double tariff?

The Respondent has developed the theory that Nykomb knew, or should have known, of the controversies with respect to the double tariff. It suggests that it purchased Windau with the intention to use the ECT (not available to the earlier, Latvian, owner) to extract the "double-tariff" payment in addition to cheap acquisition of the assets. I will not examine the consistency of this narrative with the facts of the case, but I will look here at the question what the implication of this theory could be for Nykomb's claim. Would it make a difference if Nykomb knew, or should have known, that Windau's double tariff contract with LE was politically controversial.

145. Knowledge that a particular government policy is debated does not detract from the validity of a legal title properly acquired. Otherwise, it would be difficult to acquire any valid legal title and contract from any government. Nor the ECT nor any other investment treaty provides for an excuse of contractual or treaty performance in case of domestic controversies about specific policies. Law emphasises the compliance with proper procedures and the reliance on legally effective rules to establish the validity of a title – there are enough cases of governments being elected on very narrow grounds, of legislation passed by tiny majorities without that the validity of title derived from such legislation is ever questioned. To add the requirement of "political consensus" to the effectiveness of legislation or rights derived from legislation and contracts would add an insupportable element of uncertainty to any transactions. Politics in post-socialist countries is particularly volatile. There are inherited elements of command-control socialism, political networks connected to business, use of legislature, courts, the government and the press for purposes and interests which are difficult for an insider to understand properly, and even more difficult for an outsider.

146. Investment treaties such as the ECT have not been designed for the situation of absence of political risk, but rather for situations and countries in transition where political risk is highest. The ultimate aim

of the ECT is to compensate for the high political risk in East European post-Socialist countries by providing a Treaty-based external discipline enforceable by international arbitration. This is why investment treaties exist – they protect valid legal rights which are undermined by the vagaries and volatilities in post-socialist transition economies. This point has been made most recently by the CME v. Czech Republic tribunal in the award recognised in May 2003 by the Svea Court of Appeals. Investment treaties are meant to help to steer such countries into a better established system of rule of law, rather than constantly changing politics. If prior knowledge or need of knowledge of political controversy would defeat a treaty's investment protection, there would be no case where a treaty could be applied except in the rare and rather illusionary situation of an uncontroversial investment – but then the Treaty would not be necessary. Prior knowledge or political debates such as the double tariff can therefore not be a defense for the respondent for any of the part III ECT disciplines.

147. Foreign investors in transition countries take a considerable risk as is known to everybody. The fact that they take such risks is not a legitimate reason to deny them the Treaty's protection. To the contrary, the Treaty's emphasis on entrepreneurial development, investment by small and middle-sized companies, on transparency and investment protection, means that the Treaty has to focus on making such very large risks taken more manageable for investors. An insistence that a risk-taking investor deserves no protection misunderstands the nature of always risky investment (in particular in transition countries) and the objective of the treaty to encourage investors to take such risks by providing some protection. As any investment arbitration demonstrates, even the Treaty's theoretically far-reaching protection is difficult, risky and very costly to obtain in practical life. The fact that there is only one foreign investor in co-generation, in spite of what was meant to be an attractive investment incentive, indicates that the risks were in fact much higher than Nykomb reckoned. The double-tariff, provided by law but in a low-quality investment climate[142], was actually not enough to compensate the very high political and regulatory risk.

148. Would prior knowledge or need to know about the contested nature of the "double-tariff" defeat other treaty-based claims of Nykomb, i.e. discrimination, the Art. 10 (1) composite standard of high-levels of good-governance (above) or "measure equivalent to expropriation"? The treaty – different perhaps from an "international minimum standard" more suitable to underdeveloped countries – places a duty to provide a high-level of protection on Latvia. It is consistent with the ECT's primarily European target area and its function to prepare East European countries for accession to the EU. Again, knowledge by an investor that Latvia may not be up to speed in its compliance with the ECT and the EU accession does not free

[142] *See supra for the bottom ranking of Latvia in the relevant EBRD legal quality and the Transparency International bribery survey as compared to all other candidate countries.*

the Republic from its obligation to provide a high-quality investment regime. One of the objectives of the ECT was to help the post-socialist countries to attain higher levels of investment protection than they would attain without the treaty. It would be counter-productive if they could use the fact of their under-achievement of Treaty and EU standards in actual practice as an escape from the Treaty's specific investment disciplines. Misconduct is not more tolerable because the relevant actor engages frequently and visibly in such misconduct.

149. The same question can be raised with respect to the "regulatory taking" claim under Art. 14. Here, the issue of "legitimate, investment-backed expectations" is a key part of the regulatory taking analysis. It is not contested that Nykomb has made considerable investment in expectation of the effectiveness of the double-tariff commitment by the government and LE. Was this a "legitimate" expectation if Nykomb knew, or should have known, that there was political controversy? I suggest that an expectation is legitimate if it is based on a reasonable interpretation of applicable and relevant law. As the three-level judicial pronouncement in favour of the double-tariff contract in the case of Gulbene's "letter of intent" illustrates, Nykomb's trust in its double-tariff right was confirmed by the unanimous, three-level judicial determination. It is suggested that an expectation is only then illegitimate if it is accompanied by breach of law or egregious rules of morality ("contra bonos mores"), such as collusion, bypassing of mandatory procedural rules or corruption. Nykomb warrants to me that is has not paid any bribes or similar payments to Latvian officials and has no knowledge of such payments carried out by others, nor does it have any knowledge of any payments or similar sweeteners paid by Latvian businessmen in this case related to situations before it took over the investment. It has no factual knowledge if bribery, collusion or other problematic practices have been associated with the double-tariff payment in the other, Latvian-controlled cases. The concept that prior knowledge, need to know and conscious taking of political, commercial and regulatory risk by Nykomb should lead to a denial of Treaty protection is therefore untenable.

<u>V. Should Nykomb have sought recourse from domestic courts first?</u>

150. The Respondent raises the exception to the claim that Nykomb should have had recourse (either first or exclusively) from domestic courts. I am advised that this was in fact an option considered by Nykomb, in particularly after being sued by Latvenergo for cancellation of its double-tariff contract. After the withdrawal of this litigation by Latvenergo, Nykomb could itself have sued LE for the double tariff on the precedent of the Gulbene court decisions (Exhibit C 41-42). The reason that Nykomb did not take this– possible and available – course of action is that it was advised to trust rather the ECT's system of independent arbitration under Art. 26 than Latvian

courts. The EBRD legal quality survey and the Transparency corruption survey place Latvia at the bottom of the candidate countries. No competent counsel could have failed to advise Nykomb of the risk of taking its case to a domestic court. Before Latvian courts it would have been a foreigner, in a climate of strong resentment of foreign investors, seeking a payment from Latvia's largest state enterprise. The very reason for Art. 26 is that the Treaty drafters recognised – like virtually all negotiators of modern bilateral and multilateral investment treaties – that investors can be legitimately concerned about an independent and impartial judgement if they seek justice before a state's judicial system against the very state itself. The arbitration facility provided by Art. 26 is provided exactly for the type of concern Nykomb had.

151. The text of Art. 26 is very clear that "exhaustion of domestic remedies", a traditional 19th century principle, is no longer required in the ECT, like in all other modern investment treaties:

> *"The investor party to the dispute may choose to submit it (i.e. the dispute) for resolution to:*
>
> *i. the courts or administrative tribunals*
>
> *ii. in accordance with applicable, previously agreed dispute settlement procedure, <u>or</u>*
>
> iii. *in accordance with the following paragraph (which provides in Art. 26 (3,a) "unconditional consent to the submission to international arbitration.."*

152. This language is as clear as it is possible. The investor has the right to submit its dispute to the Art. 26 arbitration procedure, even if it agreed on another dispute settlement procedure (26,2,b) or if domestic courts are competent to hear the dispute (26, 2, a). Several ICSID arbitral tribunals have recently had opportunity to deal with the assertion by respondent governments that an "exhaustion of domestic remedies" was required or that a concession contract included an exclusive jurisdiction of domestic administrative courts[143]. The ICSID tribunal in the Aconquija-case had remanded the administrative/concession contract questions to the administrative courts of the Argentine province of Tucuman. This decision was annulled by the ICSID Annullment Committee as a case of serious and material misunderstanding and incorrect application of the ICSID convention. Investors under this convention have the right to go directly to an ICSID arbitration procedure, thereby bypassing available domestic court jurisdiction.[144] There is accordingly no doubt, neither in the clear wording of Art. 26 ECT nor in established authoritative international arbitration practice at the highest level possible that modern investment treaties such as the ECT do not

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[143] *The LANCO and the Lyonnaise des Eaux/Aconquija v. Argentina cases, www.worldbank.org/icsid. Lanco v Argentina, icsid Case ARb 97/6 40 ILM 457(2001); Aguas del Aconquija/Cie generale des eaux, v. Argentina, 40 iLM 426 (2001)*

[144] *42 International Legal Materials 1135-1163 (2002)*

require affected investors to first exhaust local remedies and have recourse to local courts, even if those have jurisdiction, but that the Treaties entitle them to seize directly the international, treaty-based arbitral tribunal set up in the Treaty[145].

VI. Does Nykomb own the claim?

153. Respondent asserts that the claim for compensation is not owned by Nykomb, but Windau, its Latvian, now 100% owned subsidiary. It alleges that therefore there cannot be a direct claim by Nykomb against the Republic. But this position misunderstands the essence of modern investment law according to which the foreign investor is entitled to bring claims for actions which impair the Treaty-based rights of its domestic subsidiary. This is explicitly recognised in Art. 1 (6) of the ECT where the investment is defined as:

> *"every kind of asset, owned or controlled directly or indirectly by an investor and includes.. (c) claims to money and claims to performance pursuant to contract having an economic value an associated with an investment".*

154. Since Windau is the "investment" (Art. 1, 6,a – a Latvian company owned and controlled by Nykomb – the investor (Art. 1,7,a, ii) – and the claims to monetary payments/ claims to performance are "associated" with Windau (the investment), the claims for double-tariff payments are an "investment" of the foreign investor, Nykomb. As such, it forms part of the dispute relating to an "investment" (Art. 26, 1) between the investor, Nykomb, and Latvia, the Contracting Party.

155. This is not just the rule of the ECT, but standard modern investment law. Ever since the International Court of Justice (ICJ) issued its criticized Barcelona Traction decision in the early 1970's, it has been widely accepted that if the relevant investment treaty contemplates a claim being brought by a shareholder in an investment enterprise, such an investor would be permitted to recover losses for its proportionate share of the damages owing to the investment enterprise for the treaty breach in question[146]. The recent Mondev

[145] This has been confirmed also in the Tradex Hellas v. Albania case, jurisdictional award, 24 December 1996 (available at www.worldbank.org/icsid), chairman Boeckstiegel and the Salini v. Morocco case, cited supra (JDI/Clunet 2001).

[146] This has been the case under the NAFTA and most BITs; Sornarajah and Dolzer & Stevens confirm this state of affairs, Sornarajah, The International Law on Foreign Investment Cambridge 1994; Rudolf Dolzer/Margrete Stevens, Bilateral Investment Treaties, Kluwer/ Nijhoff,Dordrecht 1995; Wayne Mapp, -United States Claims Tribunal: The First Ten Years, 1981-1991: An Assessment of the Tribunal's Jurisprudence and Its Contribution to Intemational Law, - Manchester Univ Pr; (August 1993) Brower/Brueschke, US Iran Claims Tribunal; Schreuer, ICSID Commentary, on Art. 25.

NAFTA award (at paras 79-86) discusses this in detail.[147] The NAFTA award in Pope-Talbot[148] concerning damages makes the point that an investor who wholly owns and controls an investment enterprise will be entitled to claim 100% of the losses experienced by that investment enterprise[149].

> *"The foreign investor can bring an action in its own name for the benefit of a local enterprise which it owns and controls" (Mondev v US, para. 80)"*

156. Since Nykomb owns 100% of Windau, it can bring the whole of Windau's double-tariff claim on its own behalf and implicitly thereby also on behalf of Windau (to avoid double-counting).[150] There is also authoritative precedent according to which the controlling investor (even if it owns less than 100%) can claim the whole of the damages suffered by the subsidiary (e.g. in the Pope-Talbot damag es award), but that is not at issue here.

VII. Compensation and Damages

157. The ECT provides considerable leeway to the arbitral tribunal to decide on compensation. Art. 26 (6) refers to the treaty and applicable rules and principles of international law for deciding the dispute. Art. 13 (1, d) refers, for expropriatory action (or its equivalent) to "prompt, adequate and effective compensation" to amount to the "fair market value of the investment". The arbitral tribunal accordingly has the power to order restitution, i.e. place Nykomb in the situation as if the incriminated breach of the Treaty's obligation had not occurred, or order monetary compensation. Rules and principles of international law, in particular as applied by pertinent ICSID and NAFTA tribunals, provide both for compensation and for damages.[151] Restitution would mean an award ordering the government to pay the not-yet-paid double-tariff for electricity already delivered (i.e. the difference between what was paid and what should have been paid. According to Art. 26 (8) such an award may also include interest and should include it here as Nykomb was denied the use of promptly paid monies.

158. As to future payments, the award could include an order to provide restitution, i.e. to pay the full double-tariff and, failing such payment, damages, i.e. the aggregate sum of future payments due under the double-tariff principle, discounted by a reasonable discount rate to

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[147] *Mondev International Ltd. v. USA, NAFTA/ICSID Arbitration, Award, at paras. 79-86.*

[148] *www.naftaclaims.org, at paras. 70-80*

[149] *Pope & Talbot and Canada, NAFTA/UNICTRAL Arbitration, Award in Respect of Damages, May 31, 2002 at para. 80.*

[150] *This result can also be inferred from Art. 26 (7) ECT.*

[151] *S.D. Myers and Canada, NAFTA/UNCITRAL Arbitration, Second Partial Award, October 22, 2002 at para. 100. The Tribunal concluded in this arbitration that awarding loss of future profits was appropriate in the circumstances.*

the present. One should bear in mind that in the Karaha Bodas award of 2002, against the government of Indonesia, for non-fulfillment of a take-or-pay power-purchase obligation, the arbitral tribunal awarded both the already incurred expenses for an investment (105 M US $) plus the discounted net present value of the payments due for committed, but refused, capacity throughout the term of the PPA (over 150 M USD $).

Signed in the original:

____
Professor Thomas Wälde

Place and date:

Annex 1: List of – select and relevant – Publications

Books (Authored/Edited)
International Oil&Gas Policies: Moving Eastwards (Ed, with G.Ndi), Graham & Trotman, 1994
European Community Energy Law: Selected Topics (Ed, with D.McDougall), London, Graham & Trotman, 1994
Legal Implications of the European Energy Charter/Charter Treaty, CPMLP Dundee, January 1995 (Editor with K. Christie)
The 1994 Energy Charter Treaty : A Gateway for East-West Investment & Trade (Editor/Contributor), Kluwer International/Nijhoff, July 1996
Making Development Work: legislative Reform for Institutional Transformation and Good Governance (with R. and A. Seidman Eds), Kluwer 1999
Energie-Investitionen in der ex-UDSSR, Schriftenreihe des Europa-instituts Saarbruecken, 1997 :Internationale Investitionen im Energiesektor der frueheren Sowjetunion: Zwischen wirtschaftspolitischem und rechtlichem Anspruch und der chaotischen Wirklichkeit jenseits des Kommunismus,
Energy Charter Treaty (edited, with A. Konoplyanik), Moscow, 2002 M. O. Publishers, ISBN 5 – 7133-1139-2

Articles:

Developing a Framework for Russian Oil&Gas Legislation: Will a Russian Model Emerge? in: Butterworths Central & East European Business Law Bulletin, Vol.3,No.2, March 1993, 19-24
Legislative Reform in Transition Economies (with J. Gunderson), in: Int'l&Comp.L.Q. Vol.43,April 1994, pp.347-379
The Russian Oil&Gas Industry and Foreign Investment, Opec-Bulletin, 25 (July 1994) 16-21
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The Energy Charter Treaty: Introductory Note, in: 35 Int'l Legal Materials 509 (April 1995); translated into Russian, Report to Russian Ministry of Energy & Fuel
International Investment under the 1994 Energy Charter Treaty, 29 J. World Trade Law5-73 (1995)
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With Martin Friedrich, Introductory Note, Russian Federal Law on Production-sharing Agreements, 35 ILM 1251 (1996)

Will the Energy Charter Treaty help international energy investors, in: 5 Transnational Corporations 31-60 (1996) - with Philip Andrews-Speed

T. Waelde /G. Ndi, Stabilising international investment commitments, in: 31 Texas Int'lLJ 215-268 (1996)

International Investment under the 1994 Energy Charter Treaty, in: 29 JWT 5-72, (1995)

Thomas Waelde, Renegotiating previous governments' privatization deals: the 1997 UK windfall tax on utilities and international law, 19 Northwestern J Int'l Law & Business, 405-424 (1999) (with Abba Kolo)

International Treaties and Regulatory Risk in Infrastructure Investment, 34 JWT 1-61 (2000)

Renegotiation and Contract Adaptation in International Investment Projects, in: 1 J. World Investment 5-58 (2000) (with A. Kolo)

Multilateral Investment Agreements in the Year 2000, in: Souverainete etatique et marches internationaux, Melanges en l'honneur de Philippe Kahn (C. Leben, E. Loquin, M. Salem), Dijon 2000 (revised version of: International law of foreign investment: towards regulation by multilateral treaties, in Business Law International, 1 Business Law International 50-80 (1999)

Energy Charter Treaty in 2000: in a new Phase, 18 JENRL 331-352 (2000) (with C. Bamberger and J. Linehan)

The end of Transition: An institutional interpretation of Energy Sector Reform in Eastern Europe and the CIS, MOST 11, 91-108 (2001) (with Christian von Hirschhausen)

T Waelde/A. Kolo, Environmental Regulation, Investment Protection and regulatory taking in international Law 50 ICLQ 811-848 (2001)

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International Energy Trade and Access to Energy Networks (with A. Gunst) , 36 J World Trade 191-218 (2002)

Contributions to Books and Professional Journals

La privatisation des Entreprises Nationales dans le Secteur Energetique, pp. 163-171, in: A. Lapointe/ G. Zaccour, Ajustements structurels et gestion du Secteur Energetique en Afrique (Colloque Douala Mai 1992), Editions Technip, Paris 1993

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International Dimension of EU Energy Law and Polich, in: Malgosia Fitzmaurice, Natural Resources in the 21 Century, Kluwer 2003 (forthcoming)
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International Energy Law: The Key Players, in: A. Bradbrook, IUCN book on International Energy, 2003/2004 (forthcoming)

Annex II: Biograpical Information

Law Degree (Frankfurt), LL.M. (Harvard), Dr. iur. (Frankfurt, s.c.l.) has spent the last 30 years on international economic law, in particular natural resources and energy industries, international investment, negotiation, renegotiation and dispute settlement, legislative reform, financing and tax. After law practice and a research fellowship with the Institute for International Economic Law in Frankfurt, he worked for various UN agencies (Centre on Transnational Corporations, UNIDO, Natural Resources and Energy Division), until 1990 as the UN Interregional Adviser on International Investment Policy and Petroleum/Mineral Legislation. In this time, he designed, set-up, arranged funding and managed advisory teams, in virtually all developing countries on behalf of the World Bank, the UN and the EC dealing with legislative reform and large-scale natural resources/energy & infrastructure project negotiations. Throughout the 1980s, he was responsible for the completion of major natural resources investment contracts, in particular in Africa (Mali, Angola, Mozambique, Ethiopia, Burkina Faso, Guinea, Liberia), Asia, Latin America and Eastern Europe. Advisory services included negotiation, renegotiation and conciliation/ dispute settlement in natural resources and energy projects amounting to several billion US$.

Since 1991, he is the Professor of International Economic, Natural Resources and Energy Law and was (until 2001) the Executive Director of the Centre for Energy, Petroleum and Mineral Law & Policy at the University of Dundee. The Centre has had a period of spectacular growth and is now the major international institution in its field for graduate studies (with over 200 graduate students, of which over 30 PhDs), professional training and research. It had a growth (in terms of budget and other performance figures) from 30 K in 1991 to over 2 Million £ in 2000. It runs numerous international conferences, and executive training seminars and offers an interdisciplinary programme on natural resources, energy and environmental law, investment & finance, EC integration, international business and financial transactions providing full- and part-time degree-oriented training for graduate students and professionals (Diploma; LL.M.; MSc; MBA and PhD). It is completely self-funded. It has obtained the highest rating in Scotland for its quality of research and graduate teaching.

He advises many of the leading international energy and mining companies, governments, international organisations and national technical assistance agencies, now in particular in the CIS (including Russia, Ukraine, Kazakhstan, Uzbekis tan, Georgia, Kyrgysztan, Azerbaijan and Eastern Europe), Latin America (in particular Venezuela, Brazil), Middle East, Africa (in particular Nigeria) and Asia on investment & energy legislation and negotiations, tendering, renegotiation and dispute manag ement. He has acted as the chief adviser on several EU Synergy, Phare and TACIS projects on oil&gas, energy, mineral and transit law and large-scale contract/project negotiations (Russia, 1995 in a Pan -European Consortium; Ukraine, 1995/96; Uzbekistan, 1998; all East European countries, 1999/2000), a mineral law reform project (1998, Nigeria), an Asian Development Bank project on petroleum policy in Vietnam (1997), Ukraine (oil&gas law, 1998), Colombia (1999); EC Phare (review of energy law/regulatory systems in all East European countries (1998/99), mineral law (Iran); production-sharing contracts (Ukraine); oil&gas law (Nigeria 2000); conciliation in investment disputes (oil&gas); transit & pipelines/ Caspian & Baltics, 1999); APEC (2001, electricity interconnectors); OPEC (2002 – international treaties); Serbia (2002 concession/ infrastructure law and contracting); South Africa (mineral tax reform). He speaks at about 15 academic, professional and industry conferences per year throughout the world. He was asked by the World Bank to act as principal consultant on a study of political/legal/contractual and regulatory risk in large infrastructure projects in developing countries. He was invited to give a keynote presentation at the annual International Law Lecture Series at the Permanent Court of Arbitration, Peace Palace. He serves as a member of the CEPS think-tank on Caucasus Security, as Associate Fellow of CEPS (Brussels), acted as key speaker in the Venice NATO conference on the Caspian and heads a CEPMLP task force on oil&gas and governance issues in the Caspian (with Terry Adams).

He is Chief Editor of the series "International Natural Resources & Energy Law and Policy (Kluwer), the Corresponding Editor responsible for natural resources/energy and international investment of International Legal Materials, the main international law research/documentation journal, Managing Editor of the Journal for Energy & Natural Resources Law, the principal journal in its field, Joint Director of the Journal for Mineral Business, Policy & Environment. He set up, and acts as Chief Editor, of the CEPMLP Internet Journal on natural resources, energy and international business transactions, the first internet-based journal in its field (with over 300 000 visits per year) and the CEPMLP Yearbook on Natural Resources, Energy and International Business Transactions, the Dundee graduate students law review, as Associate Editor of the Journal of World Trade and the Journal of World Investment. He is also the director of ENATRES, the only global, internet-based discussion forum on energy/natural resources law and policy and on the Editorial Board of Business Law International (Published by the International Bar Association). He has recently created a new internet forum on oil, gas, energy, mining, investment and infrastructure dispute management (OGEMID) and the new "OGEL" intelligence newsletter, i.e. an internet-based journal, newsletter, I-forum and knowledge bank intelligence service on oil, gas and energy law. He published, in 1996, the authoritative book on the "Energy Charter Treaty" and several articles on international arbitration, investment and legislative reform; an updated version of the book appeared in 2002 in Russian, jointly edited with Andrei Konoplyanik. His latest book (with A. & R. Seidman) is on Good Governance and Legislative Reform (Kluwer 1999). Currently, he works on a series of (partly already published) articles on new challenges for international investment law (regulatory taking in international law; international investment arbitration and amicus brief, confiscatory taxation; renegotiation), an article on access regimes for cross-border energy trade, a book on EU Energy Law and another one on International Energy Law.

In 1995, he was awarded by the European Commission the prestigious first "Jean-Monnet Chair on European Economic and Energy Law" in a Europe-wide competition. He has served, in 1998, as Visiting Professor (premiere classe) at the Institute of Advanced International Studies (IHEI), Faculte de Droit, Universite de Paris II (Pantheon-Assas), at American University, Washington DC and lectures frequently at several US universities (U of Texas; SMU in Dallas; Catholic U in Washington DC) and (repeatedly) the Royal Institute of International Affairs, London. He is a frequent assessor for professorial appointments in the UK and around the world and PhD examiner in the UK (LSE), France (Paris II) and elsewhere; Thomas Waelde also serves as Chair of the Board of Trustees of the Natural Resources/Energy Law Trust.

Thomas Waelde has spent 25 years in advising on negotiations/ renegotiations and disputes in the natural resources, energy and infrastructure industries. As the principal UN adviser on energy/resources law, he advised, helped to renegotiate and mediate – successfully - major investment disputes in the Dominican republic (500 Million US$), Mali (100 M $) and other countries. He has been nominated by several oil companies to dispute settlement and ADR-projects (Bangla Desh; Algeria) and runs a mediation practice focusing on international natural resources, energy and infrastructure industries; his mediation experience has been recognised by his clients– including the leading international energy companies (both oil& gas and electricity) - to have saved 80% of likely litigation cost and settled disputes to both parties' satisfaction in 20% of the time required for arbitration. Mediation experience covers both company-company and company-state disputes. His latest mediation covers a complex, cross-border energy investment dispute, with two key actors, several additional actors, all under the shadow of three complex, discoordinated and constantly moving regulatory regimes.

He is a specialist on international investment arbitration, with several articles (Arbitration International 1996; J of World Trade, 2000) on investment arbitration and infrastructure/regulatory risk resolution. He teaches investment arbitration at CEPMLP/Dundee (and acts as external examiner for Lord Dervaird's (Prof Iain Murray) international commercial arbitration course at the University of Edinburgh). Recently, he has advised OPEC (on investment arbitration in international treaties), APEC (on dispute settlement methods for interconnector-infrastructure investment), the government of Serbia (on concession law reform, tender guidelines including investment arbitration). At present, he serves as expert counsel, strategic adviser, mediator and arbitrator in a total of six on-going NAFTA, ECT and contract-based arbitrations on both investor and government side. He is a member of the panel (energy – natural resources/environment) of international arbitrators appointed by the Secretary General of the Permanent Court of International Arbitration.

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