Will the Energy Charter Treaty help international energy investors?

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The Energy Charter Treaty promised to provide an open and non-discriminatory regime for international energy investments in the transition economies of Central and Eastern Europe and the Commonwealth of Independent States. To date, the results have been mixed. The access provisions for the making of investments require considerable strengthening and will be the subject of supplementary treaties, currently under negotiation. In contrast, the provisions for the treatment and protection of investments are more robust, though tempered by the Transition Arrangements. The immediate and direct impact of the Energy Charter Treaty is likely to be modest. Still, the Treaty stands as a model of the evolution of national legal regimes, and the process of negotiation has provided a valuable learning experience for all sides. The real challenge will be encountered in the current negotiations of the Supplementary Treaty, as both "western" and "eastern" parties grapple with the full implications of the investment provisions.

Introduction

The Energy Charter Treaty is the most ambitious attempt to date to set up an international regime for both investment and trade. Aside from the North American Free Trade Agreement, it is the first major multilateral treaty that imposes obligations on governments concerning the protection and treat-

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ment of foreign direct investment (FDI), and these obligations are enforceable by private companies.

In some respects, the scope of the Treaty might be considered to be rather narrow: it covers investment and trade in the energy industry only, and just 49 countries plus the European Union have signed. However, the size of the relevant energy resources, the quantity of investment required to exploit them together with the demand for energy to ensure that the Treaty is of great potential importance in both financial and strategic terms.

The Energy Charter Treaty had a relatively brief incubation period for such a complex document. The initial proposal, in June 1990, led to the signing of the European Energy Charter in December 1991. Within three years, in December 1994, the Energy Charter Treaty was ready for signature. The treaty document, as it stands, should be considered as ''work in progress'' (Bamberger, 1996a), for supplementary treaties that should strengthen some of its ''soft law'' components, especially those relating to investment access, are still under negotiation.

Already there is a sizeable literature analysing the legal and political implications of the Treaty in some detail (see, for example, Waelde, 1996). Building on these previous accounts, a synthesis of the key investment issues of relevance to negotiators of other treaties of this kind, as well as to executives of transnational corporations (TNCs) in the energy industry, is presented here. The main value of the Treaty to TNCs is that it should lower the political risk relating to undertaking and managing investments in energy in the signatory States. Accordingly, the effectiveness of the investment provisions of the Treaty should be measured by the extent to which that goal is achieved.

The aim of this article is to evaluate the effectiveness of the Energy Charter Treaty from the point of view of a foreign energy investor. Issues such as security of energy supply for Western Europe (Papaioannou, 1996) are not addressed here. To assess the practical value of the Treaty for foreign investors, the following questions need to be answered:

- Are the provisions of the Treaty clearly expressed?
- Are the provisions contained in the Treaty sufficient for foreign investors?

- Are the provisions likely to be accepted and implemented (not just signed up for) by the present and future governments of the signatory States?
- Are the standards set by the provisions attainable in the signatory States?

To address these issues, the analysis of the key investment provisions of the Treaty is organized around five questions:

- What types of companies and activities are covered by the Treaty?
- To what extent does the Treaty create a non-discriminatory regime for FDI in energy?
- Does the Treaty improve the level of treatment and protection of FDI in energy?
- In what other ways does the Treaty help foreign investors?
- What is the likely impact of the Treaty on the pattern of FDI in energy?

Before embarking on answering these questions, it is worthwhile to review briefly the historical context of the Treaty in order to understand how it fits in with the evolving nature of international investment law.

The historical context

The Energy Charter Treaty did not come out of the blue. It is both rooted in history and is a product of its time. Precedents exist for most of its component parts. Yet, its final composition reflects the different interests of foreign investors and host countries: the desire of the foreign investors to seek protection for their investments and the desire of the host countries to retain control over their domestic economic policy.

Fluctuations in the balance of power between foreign investors and host countries are reflected in a long line of investment treaties, codes and national legislation (Muchlinski, 1996). The ascendancy of the protectionist camp after the First World War ensured that little progress was made to conclude multilateral treaties on the protection of foreign investment for more than forty years. It was not until the 1960s that a significant number of investment-protection treaties began to be signed, against a background of rising protectionism. The origins of the Energy Charter Treaty can be traced

to some of these agreements. The ICSID Convention of 1966 provided the framework for the arbitration provisions of the Energy Charter Treaty. At the same time, European countries had started to draw up a number of bilateral investment treaties (BITs) with host countries. The strength of these treaties was embedded in post-investment protection rather than in pre-investment access. The later BITs negotiated by the United States went much further by invoking the three key concepts of "national treatment", "most-favoured-nation" (MFN) and "fair and equitable treatment" (Shihata, 1995; Salacuse, 1996). These three strands form an essential part of the Energy Charter Treaty but, as is demonstrated later, have not been adopted as rigorously as investors might have wished.

The past twenty years have seen a number of attempts to draft multilateral guidelines and treaties for the treatment of FDI. Guidelines, such as those drawn up by OECD in 1976 and the World Bank in 1992, have the advantage of being relatively clear and brief, but they are not binding under international law. The Energy Charter Treaty was not the first enforceable multilateral agreement to address the admission and protection of FDI. And the 1990s have seen significant progress on this front with the North American Free Trade Agreement and the evolving Lomé IV Convention (Parra, 1995).

The immediate antecedent for the Energy Charter Treaty is the European Energy Charter of 1991. This originated as a purely European initiative to gain access to the energy resources of the former Soviet Union. The Charter (as opposed to the Treaty itself) was a non-binding agreement negotiated over a period of just five months. At the heart of the Charter lay the principles of security of energy supply for Western Europe and access to the hydrocarbon resources of the former Soviet Union for western companies. The signatories included most States in Western, Central and Eastern Europe and the Commonwealth of Independent States, as well as the European Union itself, Japan, Canada and the United States. The European provenance is reinforced by the resemblance that parts of the Energy Charter Treaty bear to the provisions of certain European Community directives, both draft and enacted.[1]

[1] A series of directives under article 52 of the Treaty of European Union imposes the non-discriminatory movement of capital, goods, services and people; the Hydrocarbons Licensing Directive, the Transit Directives for both gas and electricity and the draft Common Rules for gas and electricity are also relevant examples.

More recently, a large number of host countries have adapted their domestic legislation to encourage FDI, or at least reduce impediments to these investments. Seen in this light, the Energy Charter Treaty, in its present form, does not represent a leap forward. In many respects it is a logical progression from, and a synthesis of, previous attempts to create a legal order for international investment. Two notable deviations from the historical trend are the rather weak provisions for the admission of investment and the robust nature of some of the arbitration clauses.

Purpose and scope of the Treaty

The purpose of the Treaty is defined briefly in article 2 as being "to promote long-term cooperation in the energy field . . . in accordance with the objectives and principles of the Charter". Thus, it is necessary to examine first the European Energy Charter in order to appreciate the objectives of the Treaty with greater clarity. The central themes of the Charter would appear to be the security of energy supply, access to energy resources, energy efficiency and a liberalized international market for energy. Despite reference to the problems of reconstruction in Central and Eastern Europe, the purpose of the Charter was clearly to facilitate the access of companies to the energy markets and resources of that region and thus to enhance the security of energy supply in Western Europe. The scope of the Treaty is as broad as its purpose, but some care has been taken to define the range of activities, forms of investment and nature of investors that are to be covered by the Treaty.

Economic activity

The first step for a TNC is to determine which, if any, of its activities fall within the defined scope of the Treaty. Energy is a wide field, and many industrial TNCs are involved in one way or another in the use of energy. The Treaty goes to some length to constrain the scope of the term "energy investment". More specifically, an investment must be related to economic activity in the energy sector (art. 1 (5)). Energy research, for example, is excluded. Economic activity in the energy sector has two strands of definition: materials and products on the one hand and the nature of the activity on the other.

- The applicable energy materials and products are listed in annex EM of the Treaty. The list is extensive: nuclear materials, electrical power, petroleum, oil and gas, coal, lignite, peat coke and coal gas are all included. Exclusions are listed in annex NI. Fuel wood, charcoal and products from high temperature coal tar are excluded. To all intents and purposes, most forms of commercial energy are covered by the Treaty.

- Likewise, the nature of economic activity associated with energy materials and products is wide. It covers upstream as well as downstream activities, including transport and transmission. Specifically excluded are marine transport and the distribution of heat to multiple premises.

  Despite the care that has been taken to define energy materials and subsectors, ambiguity exists as to which specific activities are covered by the Treaty. For example, the refining of crude oil plainly falls under the terms of the Treaty. But it is not obvious whether investments in associated petrochemical plants are also covered. In practice, it is expected that the Treaty would be interpreted to cover activities carried out by companies whose core business or projects are related to energy.

Form of investment

An investment is defined as any ''kind of asset, owned or controlled directly by an investor'' in the energy sector (art. 1 (6)). These include property, companies, shares, claims to money or performance, financial returns and licences or permits.

Timing is an important aspect of the definition. The Treaty covers existing investments (made before the Treaty came into force), as well as later investments (art. 1 (6)). Except for the six signatories who chose to opt out of the provisional application (annex PA), the effective date of the Treaty is 17 December 1994. However, the Treaty cannot be invoked to apply to ongoing investment disputes over matters which arose before the effective date.

Two issues of potential concern to foreign investors in the Commonwealth of Independent States are the legal validity of investment and precontractual agreements. A valid investment agreement must be endorsed by a competent authority acting under the applicable law. In certain transition

economies, both the competent authority and the applicable law may either be defined poorly or be in a state of flux. Article 20 of the Treaty demands that laws and regulations covered by the Treaty be published and be made available to foreign investors. These should define the competent authorities and the regulatory procedures for acquiring investment rights. Therefore any contractual right which is issued by some other authority, or is in breach of the defined procedures, would not be deemed an ''investment'' under the terms of the Treaty .

Pre-contractual ''agreements'' are a common feature of negotiations in the Commonwealth of Independent States. These may take the form of ''Heads of Agreement'', ''Letters of Intent'', ''Protocols'' or ''Study Agreements''. According to article 1 (6) (f), such agreements should be classified as investments provided they embody legally valid rights granted by a competent authority and provided the agreement has some financial value to the investor.

Nature of the investor

The 50 Treaty signatories to date (mid-1996) include most OECD members, the Commonwealth of Independent States, Central and Eastern European countries, Japan and the European Union. The most notable exception is the United States. Neither the major oil exporting nations of the Middle East, nor the booming economies of South and South-East Asia are signatories to the Treaty.

The Treaty defines an investor as being either a natural person having nationality or residence in a contracting State, or a company that is incorporated in a contracting State (art. 1 (7)). Investors from a third State must satisfy these conditions fully. In other words, they must have substantial business activity in the contracting State, defined to include both equity and substantial influence.[2] For example, a United States affiliate incorporated in a European-Union member State cannot benefit from the Treaty unless that affiliate is both carrying out substantial business in that member State and controls directly the investment project in question. An investment by Esso (United Kingdom) in the Russian Federation would qualify, but a United States-managed project assigned to Esso (United Kingdom) would not (Waelde, 1995).

[2] Understanding IV (3), with respect to article 1 (6).

One issue that is not directly addressed by the Treaty is whether member States' shareholders in a company registered in a non-member country can rely on the Treaty for investments in other countries that are signatories to the Treaty. Clarification is necessary in the light of cases such as the Barcelona Traction case (Brownlie, 1990, p. 487).

Transition arrangements

The virtual impossibility of the transition economies being able to adhere to the terms of the Treaty in their entirety is acknowledged in part VI of that Treaty. Part VI presents a number of transition provisions (Konoplyanik, 1996). Annex T lists the 24 States that have claimed the right to these transitional arrangements; in effect, every signatory in Central and Eastern Europe and the Commonwealth of Independent States. Each country has chosen certain provisions from which it claims temporary exemption, and has identified measures that are required before full compliance is possible. The provisions covering anti-competitive behaviour and transparency are the most commonly invoked under the transition arrangements.

Of relevance to investment are the provisions of article 32 which allow for countries to "temporarily suspend full compliance" with one or more articles in a given list. Included are provisions for the treatment of investments (art. 10 (7)), the transfer of funds (art. 14 (1) (*d*)) and transparency (art. 20 (3)). From the point of view of the investor, the most disheartening aspect of these transitional arrangements is that they can be invoked until the year 2001.

The investment regime

The pre-investment provisions of the Energy Charter Treaty are of great importance to potential investors and have proved to be the most contentious. On the one hand, western energy companies to date have had little opportunity to invest in Central and Eastern Europe, and want "fair" access to investment opportunities. On the other hand, Central and Eastern European countries have little experience in dealing with western investors and wish to protect both the interests of their own companies and their right to control economic policy (Konoplyanik, 1996). That tension is particularly apparent in the phrasing of two articles of the Treaty: those parts of arti-

cle 10 covering investment protection, and article 18 that addresses sovereignty. It is also relevant for two other important articles concerning transparency (art. 20) and dispute resolution (art. 27).

Non-discrimination

The treatment of potential investors is addressed principally in article 10. This is reinforced by the reference in article 18 (4) to allocating rights for exploiting energy resources in a non-discriminatory manner. More specifically, the initial intention, at least of the western participants, was to provide for potential investors to be accorded national or MFN treatment at the access stage, whichever was the most favourable. Had this been achieved, the relevant phrases of the Treaty might have resembled those in the North American Free Trade Agreement.[3] This was not to be. The misgivings of the Central and Eastern European countries, and of the Russian Federation in particular (Konoplyanik, 1996), concerning their ability or willingness to be so open resulted in commitments that are carefully hedged by phrases such as "encourage", "endeavour" and "undertake to facilitate" (Shihata, 1995; Muchlinski, 1996). Indeed, the failure to establish a meaningful position is acknowledged by a provision to negotiate a supplementary treaty that will oblige the parties to provide national and MFN treatment (art. 10 (4)). That treaty is to be concluded by 1 January 1998. In the meantime, contracting parties are allowed to make a voluntary commitment to accord such treatment to potential investors (art. 10 (6) (*b*)), but to date none have done so (Seck, 1996).

Irrespective of these deficiencies, the concept of "national treatment" is likely to prove difficult to apply in the context of the Energy Charter Treaty. National treatment does not require that foreign investors be treated in an identical manner to domestic companies. Struggling industries, disadvantaged sectors of society and national security all offer grounds for providing favourable treatment to a host country's own firms (art. 24). During the next few years, the Russian Federation and the Commonwealth of Independent States are unlikely to be short of candidates to claim favourable treatment.

Even when such cases do not fall under the definitions provided by article 24, there exist industries in the Commonwealth of Independent States

[3] See chapter 11 of the North American Free Trade Agreement.

that may require some protection for a period longer than that defined by the Transition Arrangements. In international law, "national treatment" does not forbid differentiation between foreign and national investors based on legitimate policy objectives (Brownlie, 1990). Defining which policy objectives are legitimate, however, may not be straightforward. A further difficulty relates to whether violations of the principle of "national treatment" should be evaluated by making reference to the prevailing laws and regulations or to actual behaviour.

The foregoing discussion presupposes that national treatment is indeed desirable for foreign companies contemplating investment. This may not be the case. The legacy of communist rule has left heavy restrictions on the activities of domestic companies. Foreign investors may well prefer to receive MFN rather than national treatment in some cases (Waelde, 1995). The safety net of "standards required by international law" applies only to the post-investment stage (art. 10 (1)).

Transparency

Any company evaluating an investment opportunity must have access to the relevant laws and regulations. Without this information, the company can neither evaluate the commercial feasibility of a potential investment, nor can it determine how to secure an investment agreement. This is nowhere more important than in the transition economies, in which laws and regulations are not only in a state of flux, but also tend to be shrouded in secrecy. The importance of this is acknowledged by references to "transparency" in at least three articles of the Energy Charter Treaty: article 10 (1), article 18 (4) and article 20. Furthermore, article 20 provides that "laws, regulations, judicial decisions and administrative rulings . . . and agreements in force between Contracting Parties . . . shall" be published and accessible through a nominated point of enquiry.

These provisions to create transparency could contribute significantly to the development of a fair and equitable regime for undertaking FDI. What is not addressed is the issue of clarity or, rather, of conflict between laws and regulations. The immature and rapidly evolving nature of natural resources and energy laws in some countries has resulted in an assemblage of laws and regulations that are inconsistent, or downright contradictory (Konoplyanik, 1996). In such cases, transparency alone may be of little help. Such internal contradictions are rooted in divisions in the political and

bureaucratic structures of the country concerned, and little can be done by outsiders to resolve such problems. Individual investors themselves have to ensure that their agreements and contracts are supported by all relevant parties (Doeh, 1994).

A further weakness lies in the presence of article 20 (3), which concerns designated enquiry points, in the exemptions listed in the Transitional Arrangements (art. 32 (1)). A number of countries, including the Russian Federation, have claimed temporary suspension of the need to comply with that clause. The continued lack of designated enquiry points in these countries can only enhance the sense of bewilderment felt by potential foreign investors. This unsatisfactory situation is exacerbated by the weak provisions for arbitration covering the article on transparency (see below for further discussion).

Sovereignty

The sovereignty of the State over its energy resources is acknowledged in article 18. This is, in effect, the expression of "permanent sovereignty over natural resources", as championed by developing countries during the past few decades (Paasivirta, 1996). This declaration is supported by provisions that the Energy Charter Treaty shall not affect property ownership of natural resources (art. 18 (2)), and that the State can decide how and where its energy resources are exploited and under what terms (art. 18 (3)). These "nationalistic" phrases are tempered by the requirement that the sovereign rights are "exercised according to international law" (art. 18 (1)), and that article 18 (2) should not be "construed to allow the circumvention of the application of the other provisions of the Treaty" (Declaration V). Further, the parties are urged by article 18 (4) to make their energy resources available for exploitation.

Dispute resolution

The effectiveness of the regime for making investments is dependent on the mechanism for dispute resolution, as well as the wording of the relevant articles themselves. In this respect, the provisions for treatment, transparency and sovereignty are weakened by the nature of the available means for resolving disputes. More specifically, article 26 allows for disputes between an investor and a host government over matters covered in part III of the Treaty (which includes article 10, but excludes articles 18 and 20) to

be taken to arbitration. This mechanism is only available for investments already in place. Those provisions in article 10 relating to pre-investment treatment and the full contents of articles 18 and 20 concerning sovereignty and transparency are covered by the weaker dispute mechanism described by article 27 (Waelde, 1997, forthcoming).

Article 27 provides the general dispute settlement procedure for any matters arising under the terms of the Treaty. The critical difference between it and article 26 is that article 27 only provides for disputes between contracting parties, that is, States and not investors. First steps shall involve diplomatic channels. Only after a "reasonable period of time" may the dispute be taken for arbitration to an ad hoc tribunal working under UNCITRAL rules.

From the point of view of the individual investor, the settlement procedure provided by article 27 is not satisfactory. Few projects are sufficiently large to attract the interest of a TNC's home-country government (Seck, 1996). Only if a country is systematically discriminated against is its government likely to embark on the dispute settlement process with any degree of commitment (Paulsson, 1996). The Supplementary Treaty will define, hopefully, more rigorous standards for non-discrimination in the pre-investment regime and these will need to be supported by an arbitration mechanism that is stronger than that provided by article 27.

This fundamental weakness of the pre-investment regime highlights the importance of determining when that regime ends and the post-investment regime begins. It might be argued that an investment is only "made" when a productive operation has been established. However, the broad definition of the term "investment" in article 1 (6) provides that any right to undertake economic activity in the energy sector may be considered an investment (Waelde, 1995). In the case of the petroleum-extraction industry, the time of investment is considered to be the award of the exploration licence, not the production licence.

A non-discriminatory regime for FDI?

From the arguments presented above it is apparent that the Energy Charter Treaty, as it stands, has failed to provide binding provisions for the non-discriminatory treatment of potential foreign investors. National enterprises are still strongly favoured. This was probably unavoidable given, on

the one hand, the present political and economic state of most of the transition economies (Konoplyanik, 1996) and, on the other hand, the political pressures to produce a document that would be signed by most parties on schedule. Despite this ‘‘failure’’, the contracting parties have made two commitments: to ‘‘endeavour’’ to provide fair and non-discriminatory treatment to TNCs making investments, and to negotiate a supplementary treaty intended to include binding provisions. These negotiations will provide the ‘‘acid test’’ of whether or not the parties understand and accept the implications of the intended regime for undertaking investments.

The treatment and protection of investment

When evaluating an investment opportunity, foreign investors require assurances that they will be subject to fair and non-discriminatory treatment during the duration of their investments, and that these investments will be protected adequately against any form of expropriation.

The provisions of the Energy Charter Treaty that deal with the treatment and protection of actual (as opposed to potential) investments have real substance and, in certain respects, mark a significant advance from most existing treaties or codes. This is in stark contrast to the pre-investment regime outlined above that leaves much to be desired by the foreign investor.

The treatment of investments is covered by article 10, as is the undertaking of investments. The other key articles are article 12 on compensation for loss, article 13 on expropriation and article 26 on arbitration. The latter gives individual investors the right to take disputes with host governments to international arbitration. The combination of these provisions should provide investors with a higher degree of security than would be achieved under most other international regimes. This section illustrates just how favourable and asymmetric these provisions are, and highlights a small number of ambiguities or weakness.

The treatment of investments

Article 10 (1) obliges contracting parties to provide investments with ‘‘fair and equitable treatment’’, ‘‘most constant protection and security’’,

and treatment no "less favourable than that required by international law". An alleged violation of any of these host-country obligations provides grounds for the foreign investor to invoke international arbitration under article 26.

The last sentence of article 10 (1) binds the contracting parties to honour all obligations agreed with an investor from another contracting State. This phrasing goes some way beyond the texts of most BITs. It might be interpreted to cover obligations entered into by State enterprises as well. Articles 22 and 23 define a government's obligation to ensure that State enterprises, institutions vested with State powers and privileged private enterprises observe the provisions of the Treaty. Thus, in principle, a company can take a government to arbitration for a breach of obligation by a subnational body or State company. It is unlikely that all, or any, of the signatory States intended that article 10 (1) be interpreted in this way. In practice, this clause is aimed solely at investment agreements issued by empowered agencies that are legally valid under national law. The presence of this provision would appear as a counterbalance to the contents of article 18 on sovereignty over energy resources.

The standards of national and MFN treatment for investments are imposed by article 10 (7). (Problems associated with the interpretation and application of national treatment have already been outlined above in the section on undertaking FDI.) The MFN provision also requires some clarification. It is not clear whether it refers to individual investment agreements. May one company use another company's bargaining achievement to demand more favourable conditions and treatment in its own present or future contracts? It is to be hoped that the MFN provision does not interfere with negotiations between governments and individual companies. Rather, this provision should be taken to mean that the general standards of treatment must not be discriminatory with respect to the different nationalities of foreign investors.

Article 10 (7) occurs in the list of provisions that may be temporarily suspended under the Transitional Arrangements (art. 32 (1)). To date, only Bulgaria has suspended compliance with this article (annex T) but, as with all articles falling under the Transitional Arrangements, any member State may ask the Charter Conference for a temporary suspension.

Expropriation and compensation for losses

Articles 12 and 13 together cover a wide range of methods by which investors can lose their investments, and in most cases the Hull formula of prompt, adequate and effective compensation is invoked. Losses other than legal expropriation are addressed by article 12. Action by government forces or authorities that results in the destruction or the requisitioning of even part of an investment necessitates restitution or compensation according to the Hull formula (art. 12 (2)). In contrast, if the loss is caused by non-governmental agents as a result of any form of civil disorder no compensation is guaranteed. Article 12 (1) only obliges the host country to be non-discriminatory in its awards of compensation in such cases.

The coverage of expropriation in article 13 is as thorough as could be desired. Nationalization, expropriation and measures having equivalent effects are forbidden, except when such expropriation is in the public interest, non-discriminatory, according to the law and accompanied by compensation according to the Hull formula (Norton, 1996). The compensation required should equal the fair market value of the investment at the time of the expropriation, should be paid in a freely convertible currency and should include any interest resulting from delays in payment. Further, these provisions cover cases where a foreign investor holds shares in a locally incorporated enterprise (art. 13 (2)).

Together these provisions appear to form a formidable deterrent to expropriation and provide for compensation that should be acceptable to most foreign investors. Particularly notable are the explicit references to creeping expropriation and the rejection of book value as a basis for compensation. The issue of taxation as a form of expropriation is addressed further in article 21 (5). This article opens with the statement that "Except as otherwise provided in this Article, nothing in this Treaty shall create rights or impose obligations with respect to the Taxation measures of the Contracting Parties" (art. 21 (1)). It goes on to provide for non-discriminatory taxation in the fields of transit and the treatment of investments (art. 21 (2), (3)). Explicit reference to taxation constituting either expropriation or discriminatory expropriation is made in article 21 (5). This outlines procedures to be followed by investors or contracting parties seeking to resolve such a form of expropriation.

Despite the pains that have been taken to produce a robust treatment of the issue of compensation for expropriation, a number of ambiguities

remain. The most pernicious relates to the valuation of an investment. Whilst the willingness of transitional economies to agree to the inclusion of the Hull formula is certainly an achievement, some arbitral awards have tended to provide for "fair" or "appropriate" compensation, rather than "full" compensation (Sornarajah, 1996). The Energy Charter Treaty would seem to be attempting to reverse the trend towards "liberal" interpretations of required compensation by restating the Hull formula. However, it remains to be seen how it will be interpreted by tribunals set up under the Treaty regime.

In addition to this judicial nuance, real difficulty exists in determining the "fair market value" of an asset in a country in which markets are embryonic (Norton, 1996; Waelde, 1997). The use of discounted cash flow or net present value methodologies is not recommended explicitly. Nowhere is this problem more intractable than when the investment is "intangible", for example, in the case of an exploration licence covering unexplored territory. The future cash flow from an underexplored tract cannot be estimated meaningfully (Sornarajah, 1996). The problem of valuing intangible assets is a general one, and not specific to transition economies. However, poorly developed infrastructure and markets exacerbate the situation. For example, though crude oil has an international market value, if the exploration tract is remote and a new political or administrative regime suddenly makes the construction of a pipeline unlikely, the tract essentially has no value. And natural gas production may rely, at least in part, on domestic markets that are unpredictable with respect to both size and price.

Finally, a foreign investor should be absolutely clear that the Energy Charter Treaty does not prohibit nationalization in the public interest, provided that compensation is paid. This is reinforced by the declaration of sovereign rights contained in article 18. The fear exists that the strength of the latter article may provide grounds for host countries to renege on their Treaty obligations (Norton, 1996).

Arbitration of investment disputes

The procedure for settling disputes between an investor and a contracting party, as prescribed by article 26, is arguably the most radical component of the Energy Charter Treaty. It marks a significant advance in the field of international arbitral law, most particularly in the range of options granted to foreign investors (Paulsson, 1996). This arbitration procedure

covers disputes relating to actual investments and involving alleged breaches of obligations covered by Part III of the Treaty. These obligations are those of the host country only, and not of the foreign investor. Further, they relate principally to the protection and treatment of investments, compensation and expropriation. Matters relating to competition, transit and the environment are not subject to this procedure.

Only three months are allowed for the amicable resolution of a dispute—an unusually short time (Seck, 1996). After that period, the investor alone can choose to submit the dispute to a national tribunal, to invoke the settlement procedure previously agreed with the host country, or to seek international arbitration according to the procedures laid down by article 26 (4) of the Treaty. These include ICSID, an ad hoc tribunal using UNCITRAL rules, or the Stockholm Chamber of Commerce, all of which should apply the rules and principles of international law (art. 26 (6)). Any award shall be "final and binding" (art. 26 (8)).

The most notable aspect of these provisions is the asymmetry of treatment between the foreign investor and the host country. This dispute-settlement procedure refers to failures to honour obligations on the part of the host country only. Further, the foreign investor can choose the particular dispute mechanism to be followed, and the agreement of the host country is not required. Should foreign investors have failed in their obligations, the host country must rely either on national law, or on the terms of the investment agreement to achieve a settlement. The main justification for this asymmetry must be that such arbitration provisions provide the individual investors with protection they could not easily have achieved by negotiation. In principle, the combination of article 26 and article 10 (1), with the provision that contracting parties must honour all obligations entered into with foreign investors, means that investment agreements need not even contain dispute-resolution clauses.

Article 26 (2) allows, but does not oblige, the foreign investor to choose to submit the dispute for resolution under a previously agreed mechanism. The foreign investor is offered the alternatives of the courts and tribunals of the host country, or international arbitration. Thus, the foreign investor may ignore the dispute-resolution clauses contained in the investment agreement. This would seem to be a new departure in international investment law, for even the ICSID Convention requires a specific arbitration agreement between the foreign investor and the host State. Again, the use of ICSID is permitted under the terms of the Treaty (art. 26 (4) (*a*)), but

is not obligatory. In practice, the foreign investor is likely to continue to negotiate specific dispute-settlement procedures, at least until the arbitration mechanisms defined by the Energy Charter Treaty are tried and tested.

Contracting parties are legally bound to accept these arbitration procedures. Once the Treaty is effective, the only other option is to withdraw from the Treaty completely under the very restrictive conditions of article 47, under which investment obligations remain in effect for twenty years. Two opt-out mechanisms have been provided. Annex ID lists the countries that have not agreed unconditionally that disputes can be submitted to international arbitration, under the procedures defined in article 26 (3-8), if they have already been submitted to either a national tribunal or they have gone through the agreed settlement procedures. This list contains some 23 countries, nearly half of the 49 signatories. Four countries have chosen to exclude the last sentence of article 10 (1) from the scope of the arbitration procedures defined by both article 26 and article 27. In these cases, disputes arising from the failure of the host country to honour its contractual obligations should be settled by the agreed procedure, or be submitted to national courts, unless the host country agrees otherwise.

The principal weakness of the settlement procedures adopted by the Energy Charter Treaty relates to the unpredictability of the arbitral tribunals. By definition, the political sympathies and relevant expertise of the tribunals are highly variable. No opportunity exists for the steady accumulation of experience as would be the case if a permanent court had been established under the Treaty. The decision not to create such a permanent institution may have been driven by a concern that such a court could become too powerful, a law unto itself, as some regard the European Court of Justice (Waelde, 1997, forthcoming).

Improved treatment and protection for foreign investors?

The contents of the Energy Charter Treaty show that great progress has been made in drawing up robust provisions for post-investment regimes. In part, this success reflects the reality that few substantial foreign energy investments have been made to date in the transition economies. Key achievements include: national and MFN treatment, a wide-ranging definition of expropriation, the inclusion of the Hull formula on compensation and

the arbitration procedures. Thus, it may be argued that the Energy Charter Treaty provides a mechanism for improving the level of treatment and protection for investments; that is to say, it contributes to lowering the political risk for foreign investors. Against this lies the fact that only a few large energy investments have been made to date. Until the pre-investment regime is strengthened at national and Treaty levels, the post-investment regime has little meaning for most foreign investors.

Other provisions relevant to FDI in energy

Nearly every article of the Energy Charter Treaty contains provisions that have some relevance to FDI in energy in the contracting States (see, for example, Waelde, 1995; Brazell, 1995; Bamberger, 1996b). Below, three issues of great interest to managers of TNCs are examined briefly: trade, transit and the transfer of funds and key personnel.

Trade

Host governments can obstruct FDI through legislation or regulations directed at trade. The Energy Charter Treaty has adopted directly the Trade-Related Investment Measures (TRIMs) provisions of GATT by prohibiting requirements concerning local product content, trade balancing or foreign exchange balancing and domestic sales (art. 5). However, such measures may be applied "as a condition of eligibility for export promotion, foreign aid, government procurement or preferential tariff or quota programmes" (art. 5 (3)).

Whilst clearly an essential part of the Treaty, the TRIMs provisions, as they stand, are neither comprehensive nor robust. No mention is made of a number of TRIMs commonly applied in the energy industry, such as requirements to use local services, or to grant local equity, as well as requirements for technology transfer, or product export (Footer, 1996). A further caveat concerns the nature of TRIMs as defined by article 5. These measures are normally assumed to be in the form of national legislation and regulations. Thus, any freely negotiated contract that contains trade-related requirements would not normally be expected to lie in the scope of the TRIMs provisions of GATT, or the Energy Charter Treaty.

Transit

The ability to transport energy materials or products is crucial to almost any form of energy investment. This is especially relevant for the Commonwealth of Independent States, in which transit laws are either non-existent or not well developed, and many potential transit routes cross hostile terrains.

Article 7 provides that contracting parties should "take measures to facilitate" energy transit according to the "principle of freedom of transit" and in a non-discriminatory manner. Any dispute should be resolved either by an agreed mechanism, or by reference to the Secretary-General of the Treaty Conference who will appoint a conciliator. In the meantime, the supply of the energy materials or products must not be interrupted, and the conciliator has the power to decide and impose interim tariffs or conditions. In the case that conciliation is unsuccessful, the dispute can be taken to arbitration under article 27. In this respect, it is important to note that the foreign investor has no right to seek either conciliation or arbitration. The dispute must be pursued by the home country of the foreign investor.

Despite the welcome given to the transit provisions by practitioners in the petroleum industry (Jenkins, 1996; Suleimenov and Holland, 1996), it may be argued that article 7, by itself, cannot resolve the politically rooted disputes relating to the export of petroleum from Central Asia. The most formidable example is the need to find an export route from Azerbaijan to the west or south. Possible routes cross: Chechnya, Armenia, Georgia or the Islamic Republic of Iran. The construction and effective operation of pipelines will require significant improvement in the level of civil order in some of these territories, as well as multilateral agreements negotiated separately and signed by all parties along the route of each pipeline (Carver, 1995).

Key personnel

A foreign investor must retain some power to appoint staff in order to ensure that an investment is managed effectively. Article 11 allows the investor to appoint key personnel regardless of nationality, provided they have the necessary permits. The host country is obliged to examine in good faith their applications for entry according to the prevailing laws and regulations. The term "key personnel" is much wider than the often used term "senior management" and permits the investor to bring in technical and commercial

expertise that may not be available in the host country (Brazell, 1995). The strength of this article is reinforced by the fact that it is also subject to the dispute-settlement procedures of article 26, which allows the foreign investor to pursue a dispute.

These provisions should protect expatriate staff from expulsion for the duration of their work permit, provided that they are adhering to the activity described in the work permit. The weakness of this article lies in the dependence of the "hard law" provision, namely, that companies be able to choose whom they employ, on the "soft law" obligation of the host countries to "examine in good faith" requests for entry permits. Article 11 may be found to provide little help when entry permits need to be renewed for specific individuals in order to ensure continuity. The foreign investor may be best advised to enter a separate agreement on this point. In principle, article 11 prevents the local authorities from interfering with a foreign investor's choice of locally-hired staff members, but in practice the investor would be well advised to pay heed to local sensitivities.

Transfer of funds

However successful an investment, at the end of the day it all comes to naught if funds cannot be repatriated. Article 14 imposes formidable obligations on the host country in this respect. The foreign investor should be allowed to export the initial capital, returns, payments, proceeds of sale or liquidation and awards from dispute settlements. Further, such transfers should take place without delay in a freely convertible currency and at defined exchange rates. The length of the list of applicable sources of funds and the demand for prompt payment exceed the requirements of most BITs and multilateral conventions (Brazell, 1995; Waelde, 1995). Surprisingly, no provision exists for the payment of interest if the transfer is delayed, except in the case of arbitral awards. The main exception is that members of the Commonwealth of Independent States are permitted to reach separate agreements among themselves that would allow transfers to be made in the currency of one of the two parties (art. 14 (5)).

The legal effects of the Energy Charter Treaty

A detailed legalistic discussion of all the legal nuances of the Energy Charter Treaty with respect to its likely effectiveness is not provided here. It

is, however, worth identifying potential limitations to the implementation of what was intended to be a formidable document.

The question as to the binding nature of the provisions of the Treaty has a number of facets. First, whilst those provisions prefaced by "shall" clearly fall into the category of "hard law", it is debatable to what extent the provisions prefaced by "endeavour" and "undertake to facilitate" represent binding "soft law", or are merely exhortatory. The most satisfactory interpretation is that the Treaty does impose an obligation to make best efforts, and that the failure of a country to make these efforts places it in breach of its Treaty obligations.

The second aspect concerning the binding nature of the Treaty is its relationship to national law. The Energy Charter Treaty was clearly drawn up as a model for individual States to copy when designing their national laws (Muchlinski, 1996). Indeed, specific articles of the Treaty oblige the contracting parties to set up legal instruments and mechanisms to achieve the purposes of the Treaty (Loibl, 1996). The question still remains as to whether or not the Treaty has a direct effect on national courts without a specific act of incorporation. The answer to this depends on the constitution of individual States (Brazell, 1996; Muchlinski, 1996).

A final consideration concerns the unpredictable and fluid nature of international law. One of the central themes of the Energy Charter Treaty is its repeated insistence that the principles of international law be applied. The aim of this is to remove any "undesirable" behaviour from the context of national law and place it firmly in the international arena. This has clear advantages if national law is either hostile or inadequate. However, international law is not always reliable. A number of issues of international law can be seen to pose a threat to the implementation of this Treaty (Sornarajah, 1996). Either the perception that the Energy Charter Treaty is "unequal", or the declared principle of sovereignty over energy resources might be invoked to justify a breach of the provisions of the Treaty. Further, the political instability in parts of the Commonwealth of Independent States raises the spectre of major upheavals in government. A change of government in itself should not release a State from its Treaty obligations (Brazell, 1996); but, in practice, radically different administrations are unlikely to accord international investment treaties much respect (Sornarajah, 1996). In the not impossible event that a new State is created by secession, it may not consider itself to be bound by the Treaty (Sornarajah, 1996; Brazell, 1996).

Conclusions

What is the likely impact of the Treaty on energy investors?

The decision to make an investment in the field of energy is usually made after balancing the expected financial rewards with the attendant perceived geological, commercial and political risks (Seck, 1996). From the foreign investor's perspective, the value of the Energy Charter Treaty lies in its ability to ameliorate the level of political risk in the transition economies of Central and Eastern Europe. By definition, such a treaty neither addresses issues of commercial risk, nor can it eliminate political risk altogether, however tight its phrasing. In this respect, the direct impact of the Treaty as it stands on the pattern of FDI must be small.

The provisions for free access for undertaking FDI in energy are decidedly weak. But this is a result of political realities. Had stronger wording been achieved, it would probably have been unenforceable. Indeed, one strong feature of the investment provisions of the Treaty is that they are, by and large, consistent with existing practice and with other treaties and codes.

An attempt to reduce political risk for FDI must also address the post-investment regime. It is here that the Energy Charter Treaty has achieved robust and enforceable rules and procedures which represent an advance on even the most advanced BITs. These provisions should reduce political risk for companies whose home countries lack the political clout to negotiate such agreements individually.

Referring to the four criteria listed in the introduction for evaluating the practical value of the Energy Charter Treaty for foreign investors, the following conclusions can be drawn:

- The provisions of the Treaty are not all expressed unambiguously.
- The provisions, as they stand, are not sufficient; much remains to be achieved in the negotiations for a Supplementary Treaty.
- The balance of political power is shifting constantly in certain Central and Eastern European States. As a result, the governments in power today may well not accept the commitments of those in power at the time of signing.

- It is evident that some countries, due to formidable institutional and internal weaknesses, are not in a position to implement the investment provisions of the Treaty, even when taking into account the Transition Arrangements.

For these reasons, the direct and immediate impact of the Treaty on energy FDI is likely to be modest. This is reinforced by the absence from the list of signatories of the home country of the world's largest foreign investors in the energy field, the United States. By not signing, the United States has clearly protected itself from excessive inward FDI from signatory States. It would also appear to be betting that the Treaty does not become effective to an extent that United States companies become excluded from investment opportunities in the emerging economies. The international dimension of the Treaty is also limited by the absence of oil producers from the Middle East and rapidly growing economies in East Asia, all of which are starting to contribute to FDI in energy in a significant way.

The indirect impact of the Energy Charter Treaty promises to be of greater long-term significance than the Treaty's direct impact in terms of the reduction of political risk. The four-year dialogue that resulted in the current Treaty allowed considerable mutual understanding by both sides. Officials from the transition economies had the opportunity to learn about international investment law much more rapidly than would have been the case otherwise (Konoplyanik, 1996; Suleimenov and Holland, 1996). At the same time, OECD members were given the opportunity to appreciate the concerns of the transition economies. This dialogue is expected to continue and can only be of benefit to the investment process.

A tangible result of this learning process could be an increasing number of countries adopting investment laws and regulations that are broadly consistent with the principles laid down in the Treaty. In this respect, foreign investors in the energy business should welcome the Energy Charter Treaty and support the continued dialogue. In the meantime, a good measure of the intentions of the contracting parties will be the speed and nature of progress to conclude a Supplementary Treaty.

Wider implications for investors

Despite the intention of the Treaty to focus on "west-to-east" investment, the indiscriminate phrasing of the Treaty provisions has meant that

they are equally applicable to both "west-to-west" and "east-to-west" investment, as well as to "east-to-east" investment. As western countries begin to realize the full implications of these provisions, especially those for undertaking FDI, they may become as recalcitrant as the negotiators from the transition economies.

"West-to-west" investment is most relevant to the members of the European Union, given that the United States did not sign the Treaty. In this respect, the energy investment provisions of the Treaty are, in places, ahead of the enacted legislation of the European Union, though following the same lines as several planned directives. From that point of view, the Treaty can be seen as an active element of the European Union's energy policy (Schroth, 1996)—probably an unintended outcome.

Progress towards the European Internal Market for Energy has been slow, despite the unambiguous wording of the treaty of European Union (Klom, 1996). Though the oil market is essentially international and the distortions in the coal market are disappearing rapidly, the electricity and gas markets are still protected heavily. Agreement has recently been reached on Common Rules for Electricity, though in a highly compromised form. Further work is needed on Common Rules for Gas.

The Energy Charter Treaty is quite explicit about the need for an open market for all energy investments, including the transport of energy products. This should provide a much needed incentive for European Union governments to bring the Internal Market for Energy to fruition, or else risk that member States or their enterprises use the sanctions of the Energy Charter Treaty to prise open the market. In that respect, the Treaty poses a threat to certain vested interests in the European Union. More fundamentally, under the Energy Charter Treaty regime, certain Central and Eastern European countries are taking great strides forward in liberalizing their energy markets. The European Union is in danger of being left behind (Vaes, 1996).

The possibility of sizeable "east-to-west" investment is encouraged implicitly by the Treaty. Though such reciprocity may be welcomed by some companies (Jenkins, 1996), it is clearly an unintended side-effect of the structure and phrasing of the Treaty. When large energy companies of the Commonwealth of Independent States, especially those in the Russian Federation, begin to accumulate sizeable quantities of foreign currency, they will pose a significant commercial threat to companies in other contracting States. The wide definition of economic activity in the field of energy means

that these companies can claim national and MFN treatment should they wish to invest in existing or new projects and companies in Western Europe, ranging from pipelines and gas fields to exploration and energy-related services. This situation may have implications for the security of energy supplies that were not entirely foreseen by Western Europe. For example, Gazprom, the giant Russian gas company, is becoming a major player in Western Europe's gas industry in both transportation and sales, and is moving into power stations, crude-oil pipelines and even the upstream petroleum industry.

The implications of the Treaty for "east-to-east" investment have been welcomed in some quarters as making "a valuable contribution to the emergence of a new economic union" of States comprising the former Soviet Union (Konoplyanik, 1996). Having recently become independent, the desire for closer economic ties with the Russian Federation may not be uniform across these States. Of concern to foreign investors is the fact that the Russian companies will have a distinct advantage over the western newcomers. The business language is Russian, the bureaucrats are either Russian or Russian-trained, and the systems, though evolving, are of Russian design. Behind all this lies considerable political clout. Partnership with Russian companies in third-party States in the east may prove to be desirable—or even necessary for western companies.

The challenge ahead

Negotiating the Supplementary Treaty on the making of investments may take more time than planned originally. Both changing domestic politics in the transition economies and the gradual realization by all parties of the full implications of the Treaty may lead to foot-dragging or hedging on both sides. The challenge facing the Energy Charter Treaty secretariat and the negotiating teams is, therefore, to produce a regime that satisfies the reasonable requirements of investors and, at the same time, is acceptable to, and can be implemented in, the host States.

The current unsatisfactory situation is rooted partly in the political determination of the European Union and certain eastern States to complete a deal, any deal, on schedule (Dore, 1996). The impact of this undue haste may be seen in the slow progress in achieving ratifications to the Treaty, the absence of the United States from the signatories and the lack of interest shown by the energy industry. Even in 1993, the Treaty looked dangerously

ahead of its time. As reformers lose ground in certain transition economies, the Treaty runs the risk of becoming irrelevant. Great efforts are needed from all sides if the Energy Charter Treaty regime is to meet a fraction of the worthwhile ambitions of its creators. ■

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